INTERNAL REVENUE BULLETIN

Bulletin No. 2019–05
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

NOTICE 2019–11, page 430.
This notice provides a waiver of additions to tax for underpayment of estimated income tax for individuals. This waiver is limited to individuals whose total withholding and estimated tax payments made on or before January 15, 2019, equal or exceed eighty-five percent of the tax shown on the return for the 2018 taxable year.

REG–106089–18, page 431.
Section 163(j) imposes a limitation on the deduction for business interest expense. These proposed regulations replace previously issued proposed regulations, and provide guidance on calculating the limitation, certain exceptions to the limitation, and the applicability of the limitation in consolidated group, partnership, and international contexts.

Finding Lists begin on page ii.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

Part III. Administrative, Procedural, and Miscellaneous

Notice 2019–11

Relief from Addition to Tax for Underpayment of Estimated Income Tax by an Individual

SECTION 1. PURPOSE

This notice provides a waiver of the addition to tax under section 6654 of the Internal Revenue Code (Code) for the underpayment of estimated income tax for certain individuals who would otherwise be required to make tax year 2018 estimated income tax payments on or before January 15, 2019. This waiver is limited to individuals whose total withholding and estimated tax payments equal or exceed eighty-five percent of the tax shown on the return for the 2018 taxable year.

SECTION 2. BACKGROUND

Generally, the Code requires taxpayers to pay federal income taxes as they earn income. To the extent these taxes are not withheld, a taxpayer must pay estimated income tax on a quarterly basis.

Section 6654 provides that, in the case of an individual, estimated income tax is required to be paid in four installments and the amount of any required installment is 25 percent of the required annual payment. Generally, under section 6654(d)(1)(B), the required annual payment is the lesser of (i) 90 percent of the tax shown on the return for the taxable year or (ii) 100 percent of the tax shown on the taxpayer's return for the preceding taxable year (110 percent if the individual's adjusted gross income on the previous year's return exceeded $150,000), so long as the preceding taxable year was a full twelve months long. However, an individual may not use the tax for the preceding taxable year to calculate the required estimated tax payments if that taxable year was not 12 months long, or the individual did not file a return for that preceding taxable year. Under section 6654(d)(2), the amount of the required installment is the annualized income installment for those taxpayers who establish that such amount is lower than 25 percent of the required annual payment determined under section 6654(d)(1). Pursuant to section 6654(g), income taxes withheld from wages are deemed to be paid evenly throughout the tax year, unless the taxpayer establishes the dates on which the amounts were actually withheld. Section 6654(a) imposes an addition to tax for failure to make a sufficient and timely payment of estimated income tax.

An individual taxpayer will not be subject to the addition to tax if an exception or waiver provision applies. Under section 6654(e)(1), an addition to tax will not be imposed on an individual taxpayer if the taxpayer owes less than $1,000 in tax, after subtracting tax withheld on wages. Under section 6654(e)(2), an individual will not be subject to an addition to tax if the individual did not have any tax liability for the previous year, the preceding taxable year was 12 months, and the individual was a citizen or resident of the United States throughout the preceding tax year. In addition, the Secretary is authorized by section 6654(e)(3)(A) to waive the addition to tax if he "determines that by reason of casualty, disaster, or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience."

The December 22, 2017, enactment of Public Law 115–97, commonly referred to as the "Tax Cuts and Jobs Act" or "TCJA," included a broad array of changes to the Code affecting millions of individual taxpayers. On February 28, 2018, the Internal Revenue Service (IRS) released an updated Withholding Calculator on IRS.gov and a new version of Form W–4 to help individual taxpayers determine their appropriate amount of 2018 tax withholding. Despite the release of the updated Withholding Calculator and new Form W–4, some individual taxpayers may have been unable to accurately calculate the amount of their required estimated income tax payments for the 2018 tax year. Accordingly, the IRS is providing additional relief to individual taxpayers by waiving certain penalties if the requirements set forth in section 3 of this notice are satisfied.

SECTION 3. WAIVER FOR UNDERPAYMENT OF ESTIMATED INCOME TAX

Pursuant to the authority in section 6654(e)(3)(A), the addition to tax under section 6654 for failure to make estimated income tax payments for the 2018 taxable year otherwise required to be made on or before January 15, 2019, is waived for any individual whose total withholding and estimated tax payments made on or before January 15, 2019, equal or exceed eighty-five percent of the tax shown on that individual's return for the 2018 taxable year.

To request this waiver, an individual must file Form 2210, *Underpayment of Estimated Tax by Individuals, Estates, and Trusts*, with his or her 2018 income tax return. The form can be filed with a return filed electronically or on paper. Taxpayers should complete Part I of Form 2210 and the worksheet included in the form instructions to determine if the waiver in this notice applies. If the waiver applies, check the waiver box (Part II, Box A) and include the statement "85% Waiver" with the return. Forms, instructions, and other tax assistance are available on IRS.gov. The IRS toll-free number for general tax questions is 1-800-829-1040. This waiver is in addition to any other exception that section 6654 provides to the underpayment of estimated income tax.

SECTION 4. IF WAIVER DOES NOT APPLY

If neither the waiver provided by this notice nor any other exception applies to an individual taxpayer, the amount of the addition to tax is determined by applying the underpayment interest rate established under section 6621 of the Code to each required installment of estimated tax that was underpaid for the period that the installment is underpaid. The period of the underpayment runs from the due date for the installment to the earlier of April 15, 2019, or the date on which the underpayment is paid. This notice has no effect on determining the amount of each required installment for an individual whose total withholding and estimated tax payments do not equal or exceed eighty-five percent of the tax shown on that individual's return for the 2018 taxable year.

SECTION 5. CONTACT INFORMATION

The principal author of this notice is Michael A. Franklin of the Office of the Associate Chief Counsel (Procedure and Administration). For further information, please contact Mr. Franklin at (202) 317-6844 (not a toll-free number).

Part IV. Items of General Interest

Limitation on Deduction for Business Interest Expense

REG–106089–18

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notification of public hearing; and withdrawal of notice of proposed rulemaking.

SUMMARY: This notice of proposed rulemaking provides rules regarding the limitation on the deduction for business interest expense after the enactment of recent tax legislation. Specifically, these regulations provide general rules and definitions. The regulations also provide rules for calculating the limitation in consolidated group, partnership, and international contexts. The regulations affect taxpayers that have deductible business interest expense, other than certain small businesses, electing real property trades or businesses, electing farming businesses, and certain utility businesses. This document also withdraws a notice of proposed rulemaking relating to the disallowance of a deduction for certain interest paid or accrued by a corporation. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments must be received by February 26, 2019. Outlines of topics to be discussed at the public hearing scheduled for February 27, 2019, at 10 a.m. must be received by February 26, 2019. If there is not sufficient time to discuss all of the topics on February 27, 2019, the hearing will continue the following day at 10 a.m. in the same location.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–106089–18), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–106089–18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, 20224, or sent electronically, via the Federal Rulemaking Portal at http://www.regulations.gov (indicate IRS and REG–106089–18). The public hearing will be held in the Main IRS Auditorium beginning at 10 a.m. in the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning § 1.163(j)–1, § 1.163(j)–2, § 1.163(j)–3, § 1.163(j)–9, or § 1.263A–9, Zachary King, (202) 317-4875, Charles Gorham, (202) 317-5091, Susie Bird, (202) 317-4860, Jaime Park, (202) 317-4877, or Sophia Wang, (202) 317-4890; concerning § 1.163(j)–4, § 1.163(j)–5, § 1.163(j)–10, § 1.163(j)–11, § 1.381(c)(20)–1, § 1.382–1, § 1.382–2, § 1.382–5, § 1.382–6, § 1.383–0, § 1.383–1, § 1.1502–13, § 1.1502–21, § 1.1502–36, § 1.1502–79, § 1.1502–91, § 1.1502–95, § 1.1502–98, § 1.1502–99, or § 1.1504–4, Kevin M. Jacobs, (202) 317-5332, Russell Jones, (202) 317-5357, or John Lovelace, (202) 317-5363; concerning § 1.163(j)–6 or § 1.469–9(b)(2), Meghan Howard, (202) 317-5055, William Kostak, (202) 317-6852, Anthony McQuillen, (202) 317-5027, Adrienne Mikolashek, (202) 317-5050, or James Quinn (202) 317-5054; concerning § 1.163(j)–7, § 1.163(j)–8, or § 1.882–5, Angela Holland, (202) 317-5474, Steve Jensen, (202) 317-6938, or Charles Rioux, (202) 317-6842; concerning § 1.446–3, RICs, REITs, REMICs, and the definition of the term "interest", Michael Chin, (202) 317-5846; concerning submissions of comments and outlines of topics for the public hearing, Regina Johnson (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 163(j) of the Internal Revenue Code (Code). Section 163(j) was amended as part of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115–97 (2017) (TCJA). Section 13301(a) of the TCJA amended section 163(j) by removing prior section 163(j)(1) through (9) and adding section 163(j)(1) through (10). The provisions of section 163(j) as amended by section 13301 of the TCJA are effective for tax years beginning after December 31, 2017. Unless otherwise indicated, all references to section 163(j) in this document are references to section 163(j) as amended by the TCJA.

Section 163(j), prior to the amendment by the TCJA (old section 163(j)), disallowed a deduction for "disqualified interest" paid or accrued by a corporation in a taxable year if two threshold tests were satisfied. The first threshold test under old section 163(j) was satisfied if the payor's debt-to-equity ratio exceeded 1.5 to 1.0 (safe harbor ratio). The second threshold test under old section 163(j) was satisfied if 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 for purposes of old section 163(j) included interest paid or accrued to (1) related parties when no Federal income tax was imposed with respect to such interest; (2) unrelated parties in certain instances in which a related party guaranteed the debt; or (3) a real estate investment trust (REIT) by a taxable REIT subsidiary of that REIT. Interest amounts disallowed for any taxable year under old section 163(j) were treated as interest paid or accrued in the succeeding taxable year and could be carried forward indefinitely. In addition, any excess limitation, namely, the excess of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense, could be carried forward three years under old section 163(j)(2)(B). On June 18, 1991, the Department of the Treasury (Treasury Department) and the IRS published in the **Federal Register** (56 FR 27907) a notice of proposed rulemaking (1991–2 C.B. 1040) (Prior Proposed Regulations) to implement the rules under old section 163(j).

In contrast to old section 163(j), for tax years beginning after December 31, 2017, section 163(j) generally limits the amount of business interest expense that can be deducted in the current taxable year (also referred to in this Explanation of Provisions as the current year). Under section 163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of (1) the taxpayer's business interest income for the taxable year; (2) 30 percent of the taxpayer's adjusted taxable income (ATI) for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year. The limitation under section 163(j)(1) applies to all taxpayers, except for certain small businesses that meet the gross receipts test in section 448(c) and certain trades or businesses listed in section 163(j)(7).

Section 163(j)(2) provides that the amount of any business interest not allowed as a deduction for any taxable year as a result of the limitation under section 163(j)(1) is carried forward and treated as business interest paid or accrued in the next taxable year. In contrast to old section 163(j), section 163(j) does not provide for the carryforward of any excess limitation.

Section 163(j)(3) provides that the limitation under section 163(j)(1) does not apply to a taxpayer, other than a tax shelter as defined in section 448(a)(3), with average annual gross receipts of $25 million or less, determined under section 448(c) (including any adjustment for inflation under section 448(c)(4)). For taxpayers other than corporations or partnerships, section 163(j)(3) provides that the gross receipts test is determined for purposes of section 163(j) as if the taxpayer were a corporation or partnership.

Section 163(j)(4) provides special rules for applying section 163(j) in the case of partnerships and S corporations. Section 163(j)(4)(A) requires that the limitation on the deduction for business interest expense be applied at the partnership level, and that a partner's ATI be increased by the partner's share of excess taxable income, as defined in section 163(j)(4)(C), but not by the partner's distributive share of income, gain, deduction, or loss. Section 163(j)(4)(B) provides that the amount of partnership business interest expense limited by section 163(j)(1) is carried forward at the partner-level. Section 163(j)(4)(B)(ii) provides that excess business interest expense allocated to a partner and carried forward is available to be deducted in a subsequent year only if the partnership allocates excess taxable income to the partner. Section 163(j)(4)(B)(iii) provides rules for the adjusted basis in a partnership of a partner that is allocated excess business interest expense. Section 163(j)(4)(D) provides that rules similar to the rules of section 163(j)(4)(A) and (C) apply to S corporations and S corporation shareholders.

Section 163(j)(5) and (6) defines "business interest" and "business interest income," respectively, for purposes of section 163(j). Generally, these terms include interest expense and interest includible in gross income that is properly allocable to a trade or business (as defined in section 163(j)(7)). The legislative history states that "a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision." H. Rept. 115–466, at 386, fn. 688 (2017).

Under section 163(j)(7), the limitation on the deduction for business interest expense in section 163(j)(1) does not apply to certain trades or businesses. The excepted trades or businesses are the trade or business of providing services as an employee, electing real property businesses, electing farming businesses, and certain regulated utility businesses.

Section 163(j)(8) defines ATI as the taxable income of the taxpayer without regard to the following: items not properly allocable to a trade or business; business interest and business interest income; net operating loss deductions; and deductions for qualified business income under section 199A. ATI also generally excludes deductions for depreciation, amortization, and depletion with respect to taxable years beginning before January 1, 2022 and includes other adjustments provided by the Secretary of the Treasury.

Section 163(j)(9) defines "floor plan financing interest" 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 section 163(j)(1).

Section 163(j)(10) provides cross references to provisions requiring that electing farming businesses and electing real property businesses excepted from the limitation under section 163(j)(1) use the alternative depreciation system (ADS), rather than the general depreciation system for certain types of property. The required use of ADS results in the inability of these electing trades or businesses to use the additional first-year depreciation deduction under section 168(k) for those types of property.

The Conference Report states that "[i]n the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level." H. Rept. 115–466, at 386 (2017). Old section 163(j) treated an affiliated group as one taxpayer, and authorized super-affiliation rules for treating certain other groups as one taxpayer. Both of these provisions were removed by the TCJA, and no equivalent provisions are included in section 163(j).

On April 16, 2018, the Treasury Department and the IRS published Notice 2018–28 (2018–16 I.R.B. 492) to announce an intent to issue proposed regulations that will provide guidance to assist taxpayers in complying with section 163(j). Notice 2018–28 further describes certain rules that those proposed regulations will include to provide taxpayers with interim guidance as more comprehensive guidance is developed. In addition, Notice 2018–28 requested comments from taxpayers about the application of section 163(j). Where relevant to the provisions of these proposed regulations, comments are addressed in the Explanation of Provisions section.

Notice 2018–28 also stated the intent of the Treasury Department and the IRS to withdraw the Prior Proposed Regulations issued under old section 163(j).

Explanation of Provisions

These proposed regulations would withdraw the Prior Proposed Regulations and provide guidance regarding the new limitation on the deduction for business interest expense under section 163(j). These proposed regulations also would add or amend regulations under certain other provisions of the Code where necessary to provide conformity across the Income Tax Regulations. A significant number of the terms used throughout these proposed regulations are defined in proposed § 1.163(j)–1. Some of these terms are discussed in this Explanation of Provisions section as they relate to specific provisions of these proposed regulations.

Consistent with section 163(j)(1), these proposed regulations would limit a taxpayer's deduction for business interest expense to the sum of the taxpayer's current-year business interest income, 30 percent of the taxpayer's ATI, and certain floor plan financing interest expense. These proposed regulations would provide that any amount of business interest expense that cannot be deducted because of the limitation under section 163(j)(1) (section 163(j) limitation) can be carried forward and treated as business interest expense in future years. These proposed regulations also would provide special rules related to the business interest expense carried forward ("disallowed business interest expense carryforwards") by passthrough entities, C corporations, and consolidated groups. Amounts carried forward under old section 163(j) as disallowed disqualified interest are included as disallowed business interest expense carryforwards of a taxpayer to the extent that the amounts otherwise qualify as business interest expense of the taxpayer under these proposed regulations.

These proposed regulations are organized into eleven sections, proposed §§ 1.163(j)–1 through 1.163(j)–11. Proposed § 1.163(j)–1 would provide common definitions used throughout the proposed regulations. Proposed § 1.163(j)–2 would provide general rules relating to the computation of a taxpayer's section 163(j) limitation and proposed § 1.163(j)–3 would provide ordering and other rules regarding the relationship of the section 163(j) limitation and other provisions of the Code affecting interest. Proposed § 1.163(j)–4 would provide rules applicable to C corporations (including REITs, RICs, and consolidated group members) and tax-exempt corporations, whereas proposed § 1.163(j)–5 would provide rules governing the disallowed business interest expense carryforwards of C corporations. Proposed § 1.163(j)–6 would provide special rules for applying the section 163(j) limitation to partnerships and S corporations. Proposed § 1.163(j)–7 would provide rules regarding the application of section 163(j) to foreign corporations and their shareholders, whereas proposed § 1.163(j)–8 would provide rules regarding the application of section 163(j) to foreign persons with effectively connected income. Proposed § 1.163(j)–9 would provide rules regarding elections for excepted trades or businesses as well as a safe harbor for certain REITs. Proposed § 1.163(j)–10 would provide rules to allocate expense and income between non-excepted and excepted trades or businesses. Finally, proposed § 1.163(j)–11 would provide certain transition rules relating to the application of the section 163(j) limitation. The remainder of this Explanation of Provisions section discusses these eleven sections, as well as related conforming and coordinating provisions set forth in these proposed regulations.

1. *Proposed § 1.163(j)–1: Definitions*

Proposed § 1.163(j)–1 would provide definitions of terms used in these proposed regulations. This part 1 of the Explanation of Provisions section briefly discusses the most significant definitions contained in proposed § 1.163(j)–1.

A. Adjusted Taxable Income

i. Background

The Prior Proposed Regulations under old section 163(j) defined adjusted taxable income to include a number of adjustments in addition to those set forth in the statutory text of old section 163(j). Some of the additional adjustments resulted in an adjusted taxable income value that approximated cash flow. Two commenters to Notice 2018–28 asked if ATI for purposes of section 163(j) would also attempt to approximate cash flow. Comments on the Prior Proposed Regulations raised a number of administrative concerns with the additions and subtractions to ATI that approximated cash flow in those proposed regulations. The Prior Proposed Regulations were not finalized and therefore did not incorporate the suggestions of these comments to abandon this approach. In addition, because the Prior Proposed Regulations were never finalized, the approach of the Prior Proposed Regulations was never formally required or adopted. Finally, nothing in the Conference Report or the text of section 163(j) requires or suggests that adjustments should be made to ATI in order to approximate cash flow. Such a requirement could have been written into the statutory language or the discussion of section 163(j) contained in the Conference Report if Congress intended ATI to be adjusted in such a manner.

As a result, these proposed regulations would not adopt a cash flow approach to ATI. Instead, proposed § 1.163(j)–1(b)(1) would follow the statutory framework of section 163(j)(8) and define ATI to include the adjustments specified in section 163(j)(8)(A), as well as additional adjustments under the authority granted in section 163(j)(8)(B) to prevent double counting and other distortions of items such as floor plan financing interest expense and certain deductions for depreciation, amortization, or depletion upon the sale or disposition of property.

ii. General Application of the Definition of ATI

To compute ATI, taxpayers would first compute taxable income, as defined in proposed § 1.163(j)–1(b)(37), in accordance with section 63. In computing taxable income for this purpose, taxpayers would treat all business interest expense as deductible without regard to the section 163(j) limitation. Second, taxpayers would add or subtract, as appropriate, the items specified in these proposed regulations as adjustments to taxable income.

iii. Adjustments to ATI Specifically Referenced in Section 163(j)(8)(A)

Proposed § 1.163(j)–1(b)(1) includes as adjustments to taxable income items specifically referenced in section 163(j)(8)(A): any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; business interest and business interest income; net operating loss deductions under section 172; deductions for qualified business income under section 199A; and, deductions for depreciation, amortization, and depletion, but only with respect to taxable years beginning before January 1,

2022. Net operating losses under section 172 are added to taxable income in determining ATI, including net operating losses arising in taxable years prior to the effective date of these proposed regulations and carried forward. For purposes of computing ATI, it is intended that deductions for depreciation include special allowances under section 168(k). Additionally, to clarify an issue raised by a commenter in response to Notice 2018–28, the Treasury Department and the IRS note that an amount incurred as depreciation, amortization, or depletion, but capitalized to inventory under section 263A and included in cost of goods sold, is not a deduction for depreciation, amortization, or depletion for purposes of section 163(j).

iv. Other Adjustments to ATI Under Section 163(j)(8)(B)

These proposed regulations would include a number of adjustments under the authority granted in section 163(j)(8)(B). For example, these proposed regulations would include special rules that apply in defining the taxable income of: a regulated investment company (RIC) or REIT in proposed § 1.163(j)–4(b)(4)(ii); a consolidated group in proposed § 1.163(j)–4(d)(2)(iv); a partnership in proposed § 1.163(j)–6(d)(1); an S corporation in proposed § 1.163(j)–6(l)(3); and certain controlled foreign corporations in proposed § 1.163(j)–7(c)(1).

Under the authority granted in section 163(j)(8)(B), proposed § 1.163(j)–1(b)(1) also includes additional adjustments to prevent double counting. Thus, in addition to a subtraction for any floor plan financing interest expense, these proposed regulations include adjustments for sales or dispositions of certain property for taxable years beginning before January 1, 2022. Proposed § 1.163(j)–1(b)(1)(i)(D), (E), and (F) would provide that in determining the amount of a taxpayer's ATI for a taxable year, deductions for depreciation under section 167 or 168, the amortization of intangibles and other amortized expenditures, and depletion under section 611 are added back to a taxpayer's taxable income. As a result, the taxpayer would have increased their taxable income by these amounts for section 163(j) purposes. However, the Treasury Department and the IRS note that a taxpayer could receive a double benefit associated with the depreciation, amortization, and depletion, for ATI calculation purposes if the taxpayer's ATI is increased in respect of a deduction associated with depreciation, amortization, or depletion and then the taxpayer sells or otherwise disposes of the property that was depreciated, amortized, or depleted. This double benefit would result because the amount of the gain that would otherwise be reflected in the 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. Additionally, similar concerns are present if the property was held by either a partnership or a member of a consolidated group and the partnership interest or the stock of the member is sold or otherwise disposed of, because the adjusted basis in the partnership interest or member stock would have been reduced to reflect the depreciation, amortization, or depletion. As a result, these proposed regulations would eliminate the double benefit associated with these sales or other dispositions of property. See proposed § 1.163(j)–1(b)(1)(ii)(C), (D), and (E).

v. Other Rules for Adjusting ATI

Taxpayers can take each adjustment into account only once for purposes of computing ATI; for instance, a deduction for the depreciation of nonbusiness property under section 167 cannot be taken into account as an adjustment to taxable income as both a deduction for depreciation and an item of deduction that is not properly allocable to a trade or business. For purposes of computing ATI, only the adjustments to taxable income that are specified in these proposed regulations may be made. For instance, a deduction under section 243 for dividends received by a C corporation that is neither a RIC nor a REIT reduces the taxable income of the C corporation, and the C corporation cannot add back the amount of such deduction in computing ATI. Proposed § 1.163(j)–4(c)(2) would provide special rules that affect deductions under section 243 for RICs and REITs.

If for a taxable year a taxpayer is allowed a deduction under section 250(a)(1), the taxpayer should take into account the deduction when computing taxable income that is used to calculate ATI, but these proposed regulations would provide that the taxable income limitation in section 250(a)(2) does not apply for this purpose. Taxpayers, however, may be required to make adjustments adding back the section 250(a)(1) deduction to the extent that some or all of the deduction is attributable to an inclusion under section 951A. See proposed § 1.163(j)–7(d).

A separate set of proposed regulations under development will provide general guidance regarding section 250, including the computation of the section 250 deduction and the application of the taxable income limitation in section 250(a)(2).

vi. Comment Request Related to Ordering of Code Provisions

The Treasury Department and the IRS are also aware that various Code provisions in addition to sections 163(j) and 250 (for example, see section 246(b)), affect the amount of taxable income of a taxpayer and are based on, or are limited in some fashion based upon, the taxable income of the taxpayer. As a result, ordering rules are necessary to coordinate application of all of these provisions of the Code with one another. The Treasury Department and the IRS request comments on this matter, which presents broader issues than the ordering of these provisions relative to the application of section 163(j) and may therefore be addressed in guidance unrelated to these proposed regulations.

vii. Comment Request Related to the Computation of ATI

The Treasury Department and the IRS request comments regarding the methodology for computing ATI for purposes of these proposed section 163(j) regulations, including any items that should be included as additional adjustments to taxable income.

B. Interest

There are no generally applicable regulations or statutory provisions addressing when financial instruments are treated as debt for Federal income tax purposes or when a payment is interest. As a result, the proposed regulations draw upon past guidance and case law that address the meaning of interest in the context of Federal tax law. As a general matter, the factors that distinguish debt from equity are described in Notice 94–47, 1994–1 C.B. 357, and interest is defined as compensation for the use or forbearance of money. *Deputy v. Dupont*, 308 U.S. 488 (1940). Using these well-established principles regarding the meaning of interest, these proposed regulations would define interest to include any amount paid or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of section 1275(a) and § 1.1275–1(d) (similar to the definition of interest described in *Deputy v. Dupont*). Thus, these proposed regulations would apply to interest associated with conventional debt instruments, as well as transactions that are indebtedness in substance although not in form. See *Schering-Plough Corp. v. U.S.*, 651 F.Supp. 2d 219 (N.J. Dist. Ct. 2009), aff'd sub nom. *Merck & Co., Inc. v. U.S.*, 652 F.3d 475 (3d Cir. 2011); *Mapco Inc. v. U.S.*, 556 F.2d 1107 (Ct. Cl. 1977). The interest definition in these proposed regulations also would include any amount treated as interest under other provisions of the Code or the regulations thereunder, such as original issue discount, accrued market discount, and amounts with respect to an integrated transaction under § 1.1275–6.

For purposes of section 163(j), these proposed regulations also would treat as interest certain amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis. Income, deduction, gain, or loss from a transaction used to hedge an interest bearing asset or liability, a substitute interest payment made on a debt instrument under the terms of a securities lending or a sale-repurchase transaction, certain commitment fees, and certain debt issuance costs are examples of amounts that would be treated as interest under these proposed regulations. In addition, in order to prevent transactions that are essentially financing transactions from avoiding the application of section 163(j), these proposed regulations contain an anti-avoidance rule that treats as interest expense for purposes of section 163(j) 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.

Treating amounts that are closely related to interest as interest income or expense when appropriate to achieve a statutory purpose is not new; most of the rules treating such payments as interest in these proposed regulations were developed in §§ 1.861–9T and 1.954–2. As a consequence of these rules, however, in some cases certain items could be tested under section 163(j) that are not treated as interest under other provisions that interpret the definition of interest more narrowly. Thus, for example, in certain cases, an amount that was previously deductible under section 162 without limitation could now be tested as business interest expense under section 163(j).

As previously noted, these proposed regulations address the treatment of a commitment fee paid in connection with a lending transaction. This treatment is based on a rule in § 1.954–2(h). The Treasury Department and the IRS request comments on whether other types of fees paid in connection with a lending transaction that are not otherwise treated as interest for Federal income tax purposes should be treated as interest for purposes of section 163(j). As also previously noted, these proposed regulations would treat as interest certain amounts that are closely related to interest and that affect the economic yield or cost of funds of transactions involving interest. The Treasury Department and the IRS request comments on whether additional guidance is needed regarding amounts that are covered or not covered by this rule, specific types of amounts that should or should not be covered, how such amounts are linked to related transactions involving interest, and how such amounts are treated for financial reporting or other nontax purposes. More generally, the Treasury Department and the IRS request comments on whether other types of income and expense should be treated as interest income or interest expense for purposes of section 163(j). For example, should income earned by a taxpayer in a transaction in which the taxpayer provides the use of funds be treated as interest income of the taxpayer if such income is earned predominantly in consideration of the time value of money?

Finally, these proposed regulations generally would treat a swap with significant nonperiodic payments as two separate transactions consisting of an on-market, level payment swap and a loan. The loan would be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan, determined in accordance with § 1.446–3(f)(2)(iii)(A), would be recognized as interest expense to the payor and interest income to the recipient. This provision in these proposed regulations would apply in the same manner as § 1.446–3(g)(4) before it was amended on May 8, 2015, by T.D. 9719 (80 FR 26437, as corrected by 80 FR 61308 (October 13, 2015)), except that this provision would not apply to a collateralized swap that is cleared by a derivatives clearing organization or by a clearing agency. The treatment of such collateralized cleared swaps is reserved, and these proposed regulations would not require testing the assets used for collateralization or condition the exception for collateralized cleared swaps on the extent of collateralization. The Treasury Department and the IRS request comments on the proper treatment of swaps that are cleared by a derivatives clearing organization or by a clearing agency, and any requirements with respect to collateralization that would be necessary or appropriate to identify swaps that could be used to effectively advance funds through the use of nonperiodic payments.

The Treasury Department and the IRS considered three options with respect to the definition of interest. The first option considered was to not provide a definition of interest, and thus rely on general tax principles and case law for purposes of defining interest for purposes of section 163(j). While adopting this option might reduce the compliance burden for some taxpayers, not providing an explicit definition of interest would create its own uncertainty as neither taxpayers nor the IRS might have a clear sense of what types of payments are treated as interest income and interest expense for purposes of section 163(j). Such uncertainty could increase burdens to the IRS and taxpayers including with respect to disputes and litigation about whether particular payments are interest for section 163(j) purposes. Importantly, this option could be distortive as it could result in inappropriate outcomes for taxpayers that earn income that is economically similar to interest income but that has not historically been so treated under general tax principles. For example, in the case of the acquisition of a customer receivable at a discount, existing income tax principles may treat the difference between the acquisition price and the amount ultimately paid on the receivable as ordinary income that is not interest income. In addition, such an approach to the definition of interest would incentivize taxpayers to engage in transactions that provide leverage while generating deductions economically similar to interest but make arguments that such deductions fail to be described by existing principles defining interest expense. If successful, such strategies may greatly limit the application of section 163(j), contrary to the Congressional intent of limiting the deductibility of interest of businesses with the greatest levels of leverage. See House Report, H.R. 115–409 at 248. In addition, such an approach may ignore the statutory language of section 163(j)(1) "[t]he amount allowed as a deduction *under this chapter* for any taxable year for business interest. . ." (emphasis added), which is, on its face, broader than merely deductions under section 163.

The second option considered would have been to adopt a definition of interest but limit the scope of the definition to cover only amounts associated with conventional debt instruments and amounts that are generally treated as interest under the Code or regulations for all purposes prior to the passage of the TCJA. For example, this is similar to the definition of interest proposed in § 1.163(j)–1(b)(20)(i). While this would bring clarity to many transactions regarding what would be deemed interest for the section 163(j) limitation, the Treasury Department and the IRS believe that this approach would potentially distort future financing transactions. Some taxpayers would choose to use financial instruments and transactions that provide a similar economic result to using a conventional debt instrument, but would avoid the label of interest expense under such a definition, potentially enabling these taxpayers to avoid the section 163(j) limitation without a substantive change in capital structure. As a result, the transactions discussed in the prior paragraph would continue to be possible and incentivized under this approach.

In addition, there are certain transactions where under a specific provision of the Code and regulations, amounts could be characterized as ordinary income when in substance the amounts are interest income. For example, in the case of the acquisition of a customer receivable at a discount, existing income tax principles may treat the difference between the acquisition price and the amount ultimately paid on the receivable as ordinary income that is not interest income; however, such income would count as interest income under economic principles. As another example, the receipt of substitute interest paid on a securities loan arrangement may, under existing income tax principles, also be treated as ordinary income rather than interest income despite the fact that such income would also be treated as interest income under economic principles. Prior to the enactment of the section 163(j) interest limitation in TCJA, whether such amounts were labeled as ordinary income or interest income was not often material to the overall tax liability of most taxpayers, but now this distinction may have a significant impact on a large number of taxpayers.

The final option considered and the one ultimately adopted in these proposed regulations is to provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that may otherwise have been entered into to avoid the application of section 163(j). This approach has the advantage of also providing rules that clearly treat amounts as interest in appropriate cases. Although a comprehensive definition of interest requires an unavoidable degree of detail, the benefits of a detailed definition should decidedly outweigh any complexity that results. The proposed regulations also reduce taxpayer burden by adopting definitions of interest that have already been developed and administered in §§ 1.861–9T and 1.954–2, and add several definitions of interest income that were suggested by commenters (such as the rules regarding amounts on contingent payment debt instruments in § 1.163(j)–1(b)(20)(iii)(B)).

The Treasury Department and the IRS invite comments on the definition of interest for purposes of section 163(j) contained in these proposed regulations, whether another definition of interest would be more appropriate in the context of section 163(j), and, generally, what definition of interest would be the most appropriate definition for purposes of section 163(j).

C. Trades or Businesses and Excepted Trades or Businesses

While section 163(j) and the legislative history to section 163(j) provide that certain activities are not treated as trades or businesses, neither section 163(j) nor its legislative history provide a definition of what activities generally constitute a trade or business. The most established and developed definition of trade or business is found under section 162(a), which permits a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. The rules under section 162 for determining the existence of a trade or business are well-established, and there is a large body of case law and administrative guidance interpreting the meaning in section 162 of a trade or business. Therefore, these proposed regulations would define a trade or business as a trade or business within the meaning of section 162, and such definition should aid taxpayers in the proper allocation of interest expense, interest income, and other tax items to a trade or business and an excepted trade or business.

These proposed regulations would also define excepted trades or businesses that are not subject to the limitation of interest expense deduction under section 163(j). These excepted trades or businesses are defined in 163(j)(7)(A), and include (1) the trade or business of providing services as an employee; (2) certain real property businesses that elect to be excepted; (3) certain farming businesses that elect to be excepted; and (4) certain regulated utility businesses. These proposed regulations would provide additional guidance with respect to regulated utility businesses and the allocation of interest expense to such businesses. See proposed §§ 1.163(j)–1(b)(13) and 1.163(j)–10. Proposed regulations under section 469 would provide additional detail with respect to the definition of a real property trade or business. See proposed § 1.469–9(b).

The Treasury Department and the IRS invite comments on whether another definition of trade or business would be preferable or appropriate in the context of section 163(j).

D. Electing Real Property Trade or Business

These proposed regulations would provide that taxpayers can make an election to treat certain trades or businesses as an excepted trade or business if it is a real property trade or business under section 469(c)(7)(C), or certain trades or businesses that are conducted by REITs. Definitions and special rules for REITs would be provided in proposed § 1.163(j)–9.

E. Electing Farming Business

These proposed regulations would provide that taxpayers can make an election to treat a trade or business that is a farming business as defined in section 263A(e)(4) or that is a farming business under § 1.263A–4(a)(4) for capitalization purposes as an excepted farming business for purposes of section 163(j). These proposed regulations would also provide that a trade or business that is a specified agricultural or horticultural cooperative under section 199A(g)(4) and regulations thereunder can elect to be an excepted farming business for purposes of section 163(j). The Treasury Department and the IRS note that section 163(j)(7)(B) cites section 199A(g)(2) for the definition of a specified agricultural or horticultural cooperative. However, after Public Law 115–141 amended section 199A, the correct citation is section 199A(g)(4). Additionally, the Treasury Department and the IRS are developing separate proposed regulations to provide additional guidance under section 199A(g).

F. Regulated Utility Trade or Business

Consistent with section 163(j)(7)(A)(iv), these proposed regulations would provide that an excepted trade or business includes a regulated utility trade or business that furnishes or sells certain regulated items to the extent the rates for such furnishing or sale have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative. Certain regulated items are electrical energy, water, or sewage disposal services; gas or steam through a local distribution system; or transportation of gas or steam by pipeline.

Section 163(j) does not define the term "electric cooperative" either directly or by reference to other provisions of the Code. The tax treatment of an electric cooperative is generally governed by section 501(c)(12) of the Code, sections 1381 through 1388 in subchapter T of chapter 1 of subtitle A of the Code (subchapter T), or the common law applicable to cooperatives prior to the enactment of subchapter T. For purposes of section 163(j), the tax treatment of an electric cooperative is not relevant because the statutory language of section 163(j)(7)(A) only requires that rates be set by the ratemaking body of an electric cooperative and does not impose a requirement that the electric cooperative have any particular tax treatment. Accordingly, for purposes of section 163(j), the term electric cooperative includes an electric cooperative that is exempt from income tax under section 501(c)(12), an electric cooperative that is taxable under subchapter T, and an electric cooperative furnishing electric energy to persons in rural areas that is taxable under pre-subchapter T law.

A commenter suggested that rules similar to those that have been used to define public utility property under section 168(i)(10) be used to determine the trade or business that qualifies as a regulated public utility and to distinguish between a regulated and a non-regulated trade or business. The statutory language of section 163(j)(7)(A)(iv) is very similar to that provided under section 168(i)(10) for the definition of a public utility property. Under section 168(i)(10), public utility property is defined as property that is predominately used in one of the enumerated trades or business, which includes the furnishing or sale of certain regulated items listed in section 163(j)(7)(A)(iv), and where the rates for such furnishing or sale are established or approved on a cost of service and rate of return basis.

The Treasury Department and the IRS are aware that such furnishing or sale of the regulated items may not have been established or approved on a cost of service and rate of return basis by a governing or ratemaking body. For example, a public utility may sell some of its electrical energy output at market rates. In this situation, the activity related to the sales at market rates would not be treated as activities related to an excepted regulated utility trade or business under these proposed regulations. Thus, these proposed regulations would provide that to the extent a taxpayer is engaged in both excepted and non-excepted regulated utility trades or businesses, the taxpayer must allocate tax items between the trades or businesses if less than 90 percent of the total output is sold on a cost of service and rate of return basis. Some regulated utility trades or businesses with de minimis market rate sales, rather than pursuant to a cost of service and rate of return basis, are treated as entirely excepted trades or businesses. See proposed § 1.163(j)–10(c)(3)(iii)(C)(*3*). Guidance related to the allocation methodology for regulated public utility trades or businesses is also provided in proposed § 1.163(j)–10(c)(3)(ii)(C).

G. Floor Plan Financing Interest Expense

These proposed regulations would provide that certain business interest expense paid or accrued on indebtedness used to acquire an inventory of motor vehicles is deductible without regard to the section 163(j) limitation. These proposed regulations would treat all floor plan financing interest expense as business interest expense for purposes of section 163(j), regardless of whether it would otherwise be considered properly allocable to a trade or business that is not excepted under section 163(j).

One commenter to Notice 2018–28 recommended a rule that debt incurred to purchase construction machinery or equipment for sale or lease to farmers should be considered floor plan financing indebtedness for purposes of section 163(j). While H.R. 1, 115th Cong. (as passed by the House of Representatives, November 16, 2017) included construction machinery and equipment in the definition of "motor vehicle" for purposes of floor plan financing indebtedness, the TCJA does not include such machinery and equipment in the statutory definition. The definition of "motor vehicle" for purposes of floor plan financing indebtedness is based on the equipment held for sale or lease, not on the kind of business that the purchaser or lessee is engaged in. Therefore, these proposed regulations do not include the rule suggested by the commenter and merely cross-reference the definition of "motor vehicle" as set forth in section 163(j)(9)(C).

2. *Proposed § 1.163(j)–2: Deduction for Business Interest Expense Limited*

A. General Rules

Consistent with section 163(j)(1), these proposed regulations would provide that the deduction for business interest expense for any taxpayer, other than businesses qualifying for the small business exemption, cannot exceed the sum of current-year business interest income, 30 percent of ATI, and current-year floor plan financing interest expense. See proposed § 1.163(j)–2(b).

To the extent that a taxpayer has business interest expense for the taxable year in excess of the section 163(j) limitation, these proposed regulations would allow the taxpayer a disallowed business interest expense carryforward to the next taxable year. See proposed § 1.163(j)–2(c). The limitation under section 163(j)(1) applies to the total amount of business interest expense of the taxpayer in a taxable year (including disallowed business interest expense carryforwards from prior taxable years) and does not directly trace to interest expense in respect of any particular debt obligation of the taxpayer. Similarly, the disallowed business interest expense carryforward allowed in a taxable year represents the total amount of disallowed business interest expense that is carried forward to the taxable year and does not directly trace to a particular debt obligation of a taxpayer.

B. Exemption for Certain Small Taxpayers; Aggregation; Inherently Personal Items

Consistent with section 163(j)(3), these proposed regulations would provide that taxpayers that meet the gross receipts test of section 448(c) are not subject to the section 163(j) limitation. Eligible taxpayers are those, other than tax shelters under section 448(a)(3), with average annual gross receipts of $25 million or less, tested for the three taxable years immediately preceding the current taxable year. Such a taxpayer is not permitted to make an election under either section 163(j)(7)(B) or (C) because the taxpayer is already not subject to the section 163(j) limitation.

The gross receipts test of section 448(c) is an annual determination based on the prior three taxable years. Thus, a taxpayer's status as an exempt small business under section 163(j) may change from year to year. Because the exemption applies to the taxpayer, any interest paid or accrued in the taxable year in which the taxpayer meets the gross receipts test under section 448(c) is not subject to the section 163(j) limitation. Accordingly, and consistent with section 163(j)(2), these proposed regulations would provide that if a taxpayer who is subject to the limitation under section 163(j)(1) carries disallowed business interest expense forward to a taxable year in which the taxpayer qualifies for the small business exemption, the amount of the carryforward is not subject to the section 163(j) limitation in that taxable year and would be deductible in that taxable year unless disallowed, deferred, or capitalized under another provision of the Code.

Consistent with the regulations under section 448(c), for organizations that are exempt from tax under section 501(a), these proposed regulations would provide that only gross receipts from the activities of such organization that constitute unrelated trades or businesses are taken into account in determining whether the gross receipts test is satisfied. The Treasury Department and the IRS request comments on whether additional guidance is needed in the case of any other exempt organizations with respect to the application of the gross receipts test for purposes of section 163(j).

These proposed regulations would also provide that each partner in a partnership includes a share of partnership gross receipts in proportion to such partner's distributive share of items of gross income that were taken into account by the partnership under section 703. With respect to shareholders in S corporations, these regulations would provide that such shareholders include a pro rata share of the S corporation's gross receipts. The Treasury Department and the IRS request comments on this approach, and also whether other approaches to determining the gross receipts of partners and S corporation shareholders for purposes of section 163(j) would more accurately measure the gross receipts of such partners and shareholders.

These proposed regulations would provide that a taxpayer who is not subject to section 448 is treated as though it were a partnership or corporation when applying the section 448(c) gross receipts test for purposes of the section 163(j) small business exemption. The aggregation rules of sections 52 and 414 would apply to determine whether entities should be aggregated for purposes of the gross receipts test. For an individual taxpayer, it is intended that gross receipts include all items that a business entity could receive, including, but not limited to, business receipts and investment receipts. The only items that an individual taxpayer may exclude from gross receipts for the purpose of the section 163(j) small business exemption are inherently personal items. Inherently personal items include Social Security benefits, personal injury awards and settlements, disability benefits, and wages received as an employee that are reported on Form W–2. Guaranteed payments are not generally equivalent to salaries and wages. See Rev. Rul. 69–187. The Treasury Department and the IRS request comments regarding the scope of inherently personal items.

3. *Proposed § 1.163(j)–3: Relationship of Business Interest Deduction Limitation to Other Provisions Affecting Interest*

These proposed regulations would provide ordering and operating rules to control the interaction of the section 163(j) limitation with other provisions of the Code. The legislative history to the TCJA shows an intent for section 163(j) to apply after other provisions that defer, capitalize, or disallow interest expense. See H. Rept. 115–466, at 387 (2017). Therefore, these proposed regulations generally would apply to interest expense that could be deducted without regard to the section 163(j) limitation; interest expense that has been disallowed, deferred, or capitalized in the current taxable year, or which has not yet been accrued, would not be taken into account for purposes of section 163(j). However, it is intended that, under these proposed regulations, section 163(j) would apply before the operation of the loss limitation rules in sections 465 and 469 and before the application of section 461(l), consistent with how taxpayers apply old section 163(j)(7). In addition, the Treasury Department and the IRS request comments regarding the interaction between section 163(j) and the rules addressing income from discharge of indebtedness under section 108.

The Treasury Department and the IRS have received comments on the interaction of sections 163(j) and 59A, relating to the tax on the base erosion minimum tax amount. These proposed regulations reserve on the interaction of these provisions. The comments previously received, as well as any additional comments received, will be further considered in conjunction with separate guidance under section 59A.

4. *Proposed § 1.163(j)–4: General Rules Applicable to C Corporations (including REITs, RICs, and Members of Consolidated Groups) and Tax-Exempt Corporations*

Proposed § 1.163(j)–4 would provide certain rules regarding the computation of items of income and expense under section 163(j) for taxpayers that are C corporations (including members of a consolidated group, REITs, and RICs) and tax-exempt corporations. Proposed § 1.163(j)–4(b) would provide rules regarding the characterization of items of income, gain, deduction, or loss. Proposed § 1.163(j)–4(c) would provide rules regarding adjustments to earnings and profits. Proposed § 1.163(j)–4(d) would provide special rules applicable to members of a consolidated group.

A. Proposed § 1.163(j)–4(b): Characterization of Items of Income, Gain, Deduction, or Loss

Like other taxpayers, corporations are subject to the limitations on the deductibility of business interest expense in section 163(j). However, unlike other taxpayers, corporations are not subject to the limitations on the deductibility of investment interest expense in section 163(d). In enacting section 163(j), which excludes from the definition of business interest in section 163(j)(5), investment interest within the meaning of section 163(d), and excludes from the definition of business interest income, investment income within the meaning of section 163(d), Congress commented on the interaction between section 163(d) and (j) and the implications thereof for the application of section 163(j) to corporations. More specifically, the legislative history states that–

> [s]ection 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.

H. Rept. 115–466, at 386, fn. 688 (2017).

Although the foregoing language could be read to apply to both C corporations and S corporations, it is clear that an S corporation can have investment income and investment expenses within the meaning of section 163(d). These items are separately stated on an S corporation's Schedule K–1, "Partner's Share of Income, Deductions, Credits, etc.," and they are passed through to an S corporation's shareholders. Thus, Congress appears to have made the foregoing statement with C corporations in mind.

Consistent with congressional intent, proposed § 1.163(j)–4(b) would provide that, solely for purposes of section 163(j), and except as otherwise provided in proposed § 1.163(j)–10 (concerning allocations between excepted and non-excepted trades or businesses), all interest paid or accrued by a taxpayer that is a C corporation is treated as business interest expense, and all interest received or accrued by a taxpayer that is a C corporation and that is includible in the taxpayer's gross income is treated as business interest income. Thus, all of a C corporation's interest expense would be subject to limitation under section 163(j), and all of a C corporation's interest income would increase the C corporation's section 163(j) limitation, except to the extent such interest expense or interest income is allocable to an excepted trade or business under proposed § 1.163(j)–10.

To reflect congressional intent, and to achieve consistency with the treatment of interest income and interest expense, proposed § 1.163(j)–4(b) would further provide that, solely for purposes of section 163(j), and except as otherwise provided in proposed § 1.163(j)–10, all other items of income, gain, deduction, or loss of a taxpayer that is a C corporation are properly allocable to a trade or business. As a result, such tax items would be factored into a C corporation's calculation of its ATI (except to the extent such items are allocable to an excepted trade or business).

Although a C corporation cannot have investment interest, investment expenses, or investment income, within the meaning of section 163(d), for purposes of section 163(j), a partnership in which a C corporation is a partner may have such tax items. The partnership will allocate such tax items to its partners, including its C corporation partners, as separately stated items. Thus, the question arises how to treat investment interest, investment expenses, and investment income that is allocated by a partnership to a C corporation partner.

To address this situation, proposed § 1.163(j)–4(b) would recharacterize investment interest expense that a partnership allocates to a C corporation partner as interest expense properly allocable to a trade or business of the C corporation. Similarly, proposed § 1.163(j)–4(b) would treat investment income and investment expenses that a partnership allocates to a C corporation partner as properly allocable to a trade or business of the C corporation. See the discussion in part 6(G) of this Explanation of Provisions section. However, this rule would not apply to the extent a C corporation partner is allocated a share of a domestic partnership's gross income inclusions under section 951(a) or 951A(a) that are treated as investment income at the partnership level. See § 1.163(j)–7(d)(1)(ii) and the discussion in part 7 of this Explanation of Provisions section.

The recharacterization of investment items at the C corporation partner level under proposed § 1.163(j)–4(b) would not affect the character of these items at the partnership level. It also would not affect the character of the investment interest, investment income, and investment expenses allocated to other (non-C corporation) partners.

Investment interest expense of a partnership that is treated as business interest expense by the C corporation partner would not be treated as excess business interest expense within the meaning of section 163(j)(4)(b)(i) and proposed § 1.163(j)–6. Similarly, investment interest income of a partnership that is treated as business interest income by the C corporation partner would not be treated as excess taxable income within the meaning of section 163(j)(4)(C) and proposed § 1.163(j)–6. This is the case because these items were not treated as business interest expense or factored into the ATI calculation, respectively, at the partnership level. For a discussion of the rules governing excess business interest expense and excess taxable income, see part 6 of this Explanation of Provisions section.

Except as otherwise provided in proposed § 1.163(j)–4(b)(4)(ii) and (iii), the foregoing rules would apply to RICs and REITs. The Treasury Department and the IRS request comments on whether additional special rules are needed for any other entities that are generally taxed as C corporations, including but not limited to cooperatives (as defined in section 1381(a)) and publicly traded partnerships (as defined in section 7704(b)).

These rules also would apply to a corporation that is subject to the unrelated business income tax under section 511, but only with respect to such corporation's items of income, gain, deduction, or loss that are taken into account in computing the corporation's unrelated business taxable income.

B. Proposed § 1.163(j)–4(c): Effect on Earnings and Profits

Distributions by a C corporation to its shareholders out of earnings and profits (E&P) are treated as dividends under section 316(a). Although the Code does not define the term "earnings and profits," the computation of E&P generally is based upon accounting concepts that take into account the economic realities of corporate transactions, in particular, their impact on the corporation's economic ability to pay dividends to its shareholders, and the applicable tax laws.

Proposed § 1.163(j)–4(c) generally would provide that the disallowance and carryforward of a deduction for a C corporation's business interest expense under proposed § 1.163(j)–2 will not affect whether or when such business interest expense reduces the taxpayer's E&P. In other words, C corporations generally should not wait to reduce their E&P for business interest expense until the taxable year in which a deduction for such expense is allowed under section 163(j). This approach, which is the same approach used in the Prior Proposed Regulations under old section 163(j) (see § 1.163(j)–1(e), 56 FR 27907 (June 18, 1991)), reflects the fact that the payment or accrual of business interest expense generally reduces the C corporation's dividend-paying capacity in the year the expense is paid or accrued, without regard to the application of section 163(j). Additionally, disallowed business interest expense carryforwards are somewhat analogous to net operating loss (NOL) carryovers, and taxpayers reduce their E&P in the year the losses that give rise to an NOL are incurred rather than in a subsequent year in which an NOL carryover is absorbed.

However, the section 163(j) regulations would contain several modifications to or clarifications of the general rule regarding E&P. First, if a taxpayer is a RIC or a REIT for the taxable year in which a deduction is disallowed under section 163(j), or in which the RIC or REIT is allocated excess business interest expense from a partnership under section 163(j)(4)(B)(i) and proposed § 1.163(j)–6, then the taxpayer's E&P would not be reduced in the year the expense is paid or accrued without regard to the application of section 163(j). Rather, the taxpayer's E&P would be reduced in the taxable year(s) in which the business interest expense is deductible or, if earlier, in the first taxable year for which the taxpayer no longer is a RIC or a REIT. See proposed § 1.163(j)–4(c)(2) and the discussion of RICs and REITs later in part 4(C) of this Explanation of Provisions section.

Second, a taxpayer would not reduce its E&P in a taxable year beginning after December 31, 2017, to reflect any carryforwards of disallowed disqualified interest (within the meaning of old section 163(j)) to the extent the taxpayer previously reduced its E&P to reflect those interest payments in a prior taxable year. See proposed § 1.163(j)–11(b).

Third, C corporations other than REITs and RICs would make special E&P adjustments with respect to excess business interest expense allocated from a partnership. In general, a C corporation partner must reduce its E&P to reflect expense allocations from the partnership, including allocations of excess business interest expense. However, with respect to excess business interest expense in particular, the C corporation partner also must increase its E&P upon the disposition of the partnership interest to reflect the amount of excess business interest expense that the partner did not take into account while it held the partnership interest.

C. RICs and REITs

RICs and REITs are C corporations and are generally subject to the rules that apply to other C corporations, unless a provision in subchapter M of chapter 1 of the Code makes the rules inapplicable. There are no rules in subchapter M or section 163(j) that make section 163(j) inapplicable to REITs or RICs. Therefore, under these proposed regulations, RICs and REITs would be subject to section 163(j). Some REITs may not have any business interest expense subject to limitation under section 163(j) because they have only electing real property trades or businesses described in section 163(j)(7)(B). Other REITs, however, will have trades or businesses for which the REIT cannot or will not make the election under section 163(j)(7)(B). For example, a mortgage REIT cannot make such an election because real property financing is not an activity described in section 469(c)(7)(C).

RICs and REITs often derive a significant amount (if not all) of their income from property held for investment. However, under these proposed regulations, RICs and REITs would apply the same rules as other C corporations in determining which items are properly allocable to a trade or business. Thus, solely for purposes of 163(j), all of the interest expense and interest income of a RIC or REIT would be treated as business interest expense and business interest income, and all other items of income, gain, deduction, or loss of a RIC or REIT would be treated as properly allocable to a trade or business under proposed § 1.163(j)–4(b), except as otherwise provided in proposed § 1.163(j)–10.

RICs and REITs differ from other taxpayers because the income tax liability of a RIC or REIT is not based directly on its taxable income. Instead, tax is imposed on a RIC's investment company taxable income (ICTI) and a REIT's real estate investment trust taxable income (REITTI), each of which is determined by making certain adjustments to taxable income. These adjustments include the allowance of the deduction for dividends paid and the disallowance of the special corporate deductions in part VIII of subchapter B of chapter 1 of the Code (sections 241 and following) except section 248. The special corporate deductions include the dividends received deduction and the deductions under section 250 in respect of foreign-derived intangible income and global intangible low-taxed income (GILTI).

Under section 163(j)(8), a taxpayer's ATI generally is based on its taxable income, and there is no statutory requirement under which the ATI of a RIC or REIT would be based on ICTI or REITTI. Therefore, unless regulations provide otherwise, the ATI of a RIC or REIT does not reflect the deduction for dividends paid. A RIC or REIT typically pays dividends sufficient to eliminate all or nearly all ICTI or REITTI. As a result, if the ATI of a RIC or REIT took into account the deduction for dividends paid, the ATI of the RIC or REIT typically would be zero, or close to zero. It would be distortive to treat the deduction for dividends paid as reducing ATI because this deduction is merely the mechanism by which RICs and REITs shift the tax liability associated with their income to their shareholders, as intended pursuant to subchapter M of the Code. Therefore, these proposed regulations would not provide a rule that would cause the ATI of a RIC or REIT to take into account the deduction for dividends paid. The deduction for dividends received and the other special corporate deductions previously mentioned, however, are deductions that should reduce the ATI only of taxpayers that benefit from the deductions in determining tax liability. To reduce ATI for such items for taxpayers that cannot in fact utilize these deductions would be distortive. Therefore, under these proposed regulations, the ATI of a RIC or REIT would be increased by the amounts of these special corporate deductions, which decreased the RIC's or REIT's taxable income, because the deductions do not reduce the tax liability of RICs and REITs (or the amounts that RICs or REITs must distribute to eliminate entity-level tax).

RICs and REITs must meet distribution requirements each year in order to be allowed the deduction for dividends paid. If interest expense paid or accrued by a RIC or REIT is disallowed or deferred under section 163(j), or if a RIC or REIT is allocated any excess business interest expense from a partnership, such expense will not reduce the entity's taxable income, the entity's ICTI or REITTI as the case may be, or the amount of dividends that the entity must pay from its earnings and profits. Therefore, the earnings and profits of the RIC or REIT also should not be reduced. Accordingly, these proposed regulations would contain a special rule for RICs and REITs under which their earnings and profits generally would not be reduced by a disallowed business interest expense deduction in the year it is disallowed, or by any excess business interest expense allocated from a partnership.

D. Proposed § 1.163(j)–4(d): Special Rules for Consolidated Groups

Section 1502 provides broad authority for the Secretary of the Treasury to prescribe such regulations as are necessary in order that the tax liability of any affiliated group of corporations filing a consolidated return may be returned, determined, computed, assessed, collected, and adjusted, in order to clearly reflect the income tax liability of the consolidated group and to prevent the avoidance of such tax liability. The legislative history of section 163(j) states that, "[i]n the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level." H. Rept. 115–466, at 386 (2017). Consistent with legislative intent, proposed § 1.163(j)–4(d) generally would provide that a consolidated group (as defined in § 1.1502–1(h)) has a single section 163(j) limitation. In contrast, members of an affiliated group that does not file a consolidated return would not be aggregated for purposes of applying the section 163(j) limitation. Additionally, partnerships that are wholly owned by members of a consolidated group would not be aggregated with the consolidated group for purposes of applying the section 163(j) limitation. The Treasury Department and the IRS have determined that non-consolidated entities should not be aggregated for purposes of applying the section 163(j) limitation because, whereas old section 163(j)(6)(C) expressly provided that "[a]ll members of the same affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer," section 163(j) no longer contains such language, and nothing in the legislative history of section 163(j) suggests that Congress intended non-consolidated entities to be treated as a single taxpayer for purposes of section 163(j).

Proposed § 1.163(j)–4(d) would provide specific rules regarding the calculation of the section 163(j) limitation for a consolidated group. In particular, proposed § 1.163(j)–4(d) would provide that the relevant taxable income in computing the group's ATI is the group's consolidated taxable income determined under § 1.1502–11 without regard to any carryforwards or disallowances under section 163(j). Additionally, if for a taxable year a member of a consolidated group is allowed a deduction under section 250(a)(1) that is properly allocable to a non-excepted trade or business, then, for purposes of calculating ATI, consolidated taxable income for the taxable year is determined as if the deduction were not subject to the limitation in section 250(a)(2) and the regulations thereunder. For this purpose, the amount of the deduction allowed under section 250(a)(1) is determined without regard to the application of section 163(j) and the section 163(j) regulations. Moreover, for purposes of calculating the group's section 163(j) limitation, the group's current-year business interest expense and business interest income, respectively, would be the sum of the current-year business interest expense and business interest income of all members of the group. For purposes of this Explanation of Provisions and the proposed section 163(j) regulations, the term "current-year business interest expense" means business interest expense that would be deductible in the current taxable year without regard to section 163(j) and that is not a disallowed business interest expense carryforward from a prior taxable year (see proposed § 1.163(j)–5(a)(2)(i)). Additionally, intercompany obligations (as defined in § 1.1502–13(g)(2)(ii)) would be disregarded for purposes of determining a member's current-year business interest expense and business interest income and for purposes of calculating the consolidated group's ATI, and intercompany items and corresponding items (within the meaning of § 1.1502–13(b)(2)(i) and (b)(3)(i), respectively) would be disregarded for purposes of calculating the group's ATI to the extent those items offset in amount.

Proposed § 1.163(j)–4(d) also cross-references the rules in § 1.1502–32(b), which govern investment adjustments within a consolidated group. Under those rules, if a member has current-year business interest expense for which a deduction is disallowed in the current taxable year under section 163(j), basis in the member's stock would be adjusted in a later taxable year when the expense is absorbed by the group.

Proposed § 1.163(j)–4(d) would further clarify that the transfer of a partnership interest in an intercompany transaction that does not result in the termination of the partnership is treated as a disposition for purposes of the basis adjustment rule in section 163(j)(4)(B)(iii)(II), regardless of whether the transfer is one in which gain or loss is recognized. Several examples would be added to § 1.1502–13(c)(7)(ii) to illustrate the application of these rules. The Treasury Department and the IRS have determined that intercompany transfers of partnership interests should be treated as dispositions for purposes of section 163(j)(4) because dispositions are broadly defined in section 163(j)(4)(B)(iii)(II), and because ignoring intercompany transfers of partnership interests for purposes of section 163(j)(4) would be inconsistent with the view that an entity whose owners are all members of the same consolidated group can be a partnership. In contrast, a change in status of a member, becoming or ceasing to be a member of a consolidated group, would not be treated as a disposition for these purposes.

The Treasury Department and the IRS request comments as to whether the intercompany transfer of a partnership interest in a nonrecognition transaction should constitute a disposition for purposes of section 163(j)(4)(B)(iii)(II) and, if so, how § 1.1502–13(c) should apply to such a transfer if there is excess taxable income in a succeeding taxable year. The Treasury Department and the IRS also request comments as to the treatment of the transfer of a partnership interest in an intercompany transaction that results in the termination of the partnership.

Additionally, proposed § 1.163(j)–4(d) would provide that a member's allocation of excess business interest expense from a partnership and the resulting decrease in basis in the partnership interest under section 163(j)(4)(B) is not a noncapital, nondeductible expense for purposes of § 1.1502–32(b)(3)(iii). Similarly, an increase in a member's basis in a partnership interest under section 163(j)(4)(B)(iii)(II) to reflect excess business interest expense not deducted by the consolidated group is not tax-exempt income for purposes of § 1.1502–32(b)(3)(ii). These special rules are intended to ensure that the allocations and basis adjustments under proposed § 1.163(j)–6 do not result in investment adjustments within the consolidated group. This result is appropriate because the application of the proposed § 1.163(j)–6 rules does not result in a net reduction in the tax attributes of the member partner; rather, there is an exchange of one type of attribute for another (excess business interest expense allocated from the partnership vs. basis in the partnership interest). The Treasury Department and the IRS request comments as to whether additional rules are needed to prevent loss duplication upon the disposition of stock of a member holding partnership interests.

5. *Proposed § 1.163(j)–5: General Rules Governing Disallowed Business Interest Expense Carryforwards for C Corporations*

Proposed § 1.163(j)–5 would provide certain rules regarding disallowed business interest expense carryforwards for taxpayers that are C corporations, including members of a consolidated group. Proposed § 1.163(j)–5(b) would provide rules regarding the treatment of disallowed business interest expense carryforwards. Proposed § 1.163(j)–5(c) would provide cross-references to rules regarding disallowed business interest expense carryforwards in transactions to which section 381(a) applies. Proposed § 1.163(j)–5(d) would provide rules regarding limitations on disallowed business interest expense carryforwards from separate return limitation years (SRLYs). Proposed § 1.163(j)–5(e) would provide cross-references to rules regarding the application of section 382. Proposed § 1.163(j)–5(f) would provide rules regarding the overlap of the SRLY limitation with section 382.

A. Proposed § 1.163(j)–5(b): Treatment of Disallowed Business Interest Expense Carryforwards

Proposed § 1.163(j)–2 limits the amount of business interest expense for which a deduction is allowed in the taxable year. Proposed § 1.163(j)–2 further provides that the amount of any business interest expense not allowed as a deduction for any taxable year as a result of the section 163(j) limitation is carried forward to the succeeding taxable year as a disallowed business interest expense carryforward.

Proposed § 1.163(j)–5(b)(2) generally would provide that, for a C corporation taxpayer that is not a member of a consolidated group, current-year business interest expense is deducted in the current taxable year before any disallowed business interest expense carryforwards from a prior taxable year are deducted in that year. Disallowed business interest expense carryforwards are then deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, subject to certain limitations (for example, the limitation under section 382). S corporations would be subject to similar rules (see proposed § 1.163(j)–6(l)(5)).

Proposed § 1.163(j)–5(b)(3) would provide similar rules applicable to consolidated groups. In addition, disallowed business interest expense carryforwards from prior separate limitation years (as defined in § 1.1502–1(e)) would be subject to the SRLY limitation. See the discussion of the SRLY rules in part 5(C) of this Explanation of Provisions section.

There are several reasons why the Treasury Department and the IRS have determined that current-year business interest expense and disallowed business interest expense carryforwards should be distinguished for taxpayers that are C corporations and S corporations, and why current-year business interest expense should be deducted before carryforwards from prior taxable years.

First, section 163(j) generally reflects an annual accounting approach. The section 163(j) limitation is calculated anew each year based on the taxpayer's taxable income for that year, and no excess limitation from prior taxable years carries forward to succeeding taxable years. By prioritizing the deduction of current-year business interest expense over disallowed business interest expense carryforwards from prior taxable years, this rule conforms to the annual accounting approach of section 163(j).

Second, if taxpayers were required to deduct disallowed business interest expense carryforwards before or simultaneously with current-year business interest expense, they could end up using some or all of their section 382 limitation on disallowed business interest expense carryforwards rather than on NOLs or other tax items subject to the section 382 limitation. For example, assume that X, a stand-alone C corporation, has $40x of disallowed business interest expense carryforwards and $30x of NOL carryovers from Year 1, both subject to a section 382 limitation of $35x. In Year 2, X has $50x of current-year business interest expense and a section 163(j) limitation of $45x. If X were required to use its disallowed business interest expense carryforwards before its current-year business interest expense, such carryforwards would absorb all of X's section 382 limitation for the current taxable year, and X would not be able to use any of its NOL carryovers. In contrast, under the rule in proposed § 1.163(j)–5(b), X would use $45x of its current-year business interest expense and none of its disallowed business interest expense carryforwards, thus freeing up its section 382 limitation for its NOL carryovers.

Third, taxpayers that file a consolidated return are required to track their losses by taxable year for purposes of applying the NOL carryover and carryback rules of § 1.1502–21(b) and the NOL SRLY limitation rules of § 1.1502–21(c). As noted in part 5(C) of this Explanation of Provisions section, similar SRLY rules would apply to disallowed business interest expense carryforwards. Thus, a non-consolidated corporation must track its disallowed business interest expenses by the year in which such expenses are paid or accrued without regard to section 163(j) so that such corporation can comply with the SRLY limitation rules in the event the corporation joins a consolidated group.

Finally, the Treasury Department and the IRS note that, under proposed § 1.163(j)–4(c), C corporations must track their disallowed business interest expense carryforwards by the year in which such items arose (and in which an E&P adjustment was made; see the discussion of proposed § 1.163(j)–4(c) in part 4 of this Explanation of Provisions section) to ensure that E&P is not further reduced in a subsequent year in which the carryforward is deducted. Thus, the Treasury Department and the IRS have determined that these proposed rules should not create an additional administrative burden for C corporations.

Proposed § 1.163(j)–5(b)(3) would further provide rules regarding which member's business interest expense would be deducted by the consolidated group in the current taxable year. If a group's section 163(j) limitation for the taxable year exceeds the aggregate amount of business interest expense, including disallowed business interest expense carryforwards, of all members, then each member's business interest expense, including carryforwards, would be fully deducted in that year, subject to other limitations, such as the section 382 limitation and the SRLY limitation. However, if the aggregate amount of business interest expense, including carryforwards, of all members exceeds the group's section 163(j) limitation for the year, then certain ordering rules would apply:

- □ *Step 1*: First, the consolidated group would determine whether its section 163(j) limitation for the current year equals or exceeds the members' aggregate current-year business interest expense. If so, then no amount of the consolidated group's current-year business interest expense would be subject to disallowance in the current year under section 163(j), and the consolidated group would skip Steps 2 and 3 of these ordering rules. If not, then the consolidated group must apply Step 2.
- □ *Step 2*: If the members' aggregate current-year business interest expense exceeds the group's section 163(j) limitation for the current year, each member with current-year business interest expense and either current-year business interest income or floor plan financing interest expense would deduct its current-year business interest expense up to the amount of its business interest income and floor plan financing interest expense for the year.
- □ *Step 3*: If the consolidated group has any section 163(j) limitation remaining after the application of Step 2 of these ordering rules, each member with remaining current-year business

interest expense would deduct its current-year business interest expense pro rata, based on the relative amounts of remaining current-year business interest expense of all members.

- *Step 4*: If the consolidated group has any section 163(j) limitation remaining after the application of Step 1 of these ordering rules, each member's disallowed business interest expense carryforwards from a prior taxable year would be deducted on a pro rata basis, beginning with the earliest year, subject to certain limitations such as the section 382 limitation and the SRLY limitation. For example, assume that P and S are the only members of a consolidated group with a section 163(j) limitation of $200x for the current year (Year 2). Further assume that the amount of current-year business interest expense deducted in Year 2 is $100x, and that P and S, respectively, have $140x and $60x of disallowed business interest expense carryforwards from Year 1 that are not otherwise subject to limitation (for example, under section 382). Under these facts, P would be allowed to deduct $70x of its carryforwards from Year 1 (($140x / ($60x + $140x)) x $100) in Year 2, and S would be allowed to deduct $30x of its carryforwards from Year 1 (($60x / ($60x + $140x)) x $100) in Year 2.
- *Step 5*: Any member with remaining business interest expense after applying Steps 1 through 4 of these ordering rules would carry such expense forward to the succeeding taxable year as a disallowed business interest expense carryforward.

If a corporation ceases to be a member during a consolidated return year, the amount of its business interest expense, including carryforwards from prior taxable years, that is neither deducted by the consolidated group in that year nor reduced under § 1.1502–36(d) would be carried forward to the corporation's first separate return year.

The foregoing rules are intended to roughly mirror the rules in § 1.1502–21 governing the absorption of a consolidated net operating loss (CNOL). However, the Treasury Department and the IRS considered various other approaches to allocating disallowed business interest expense carryforwards among members of a consolidated group. For example, one alternative approach under consideration was a regime whereby disallowed business interest expense carryforwards would be allocated based upon the actual use of externally borrowed funds by each member. Under such an approach, intercompany obligations would be taken into account in allocating disallowed business interest expense carryforwards.

The Treasury Department and the IRS do not propose to adopt such an approach, for several reasons. First, requiring taxpayers to trace externally borrowed funds to the member that ultimately uses such funds would create an administrative burden for taxpayers. Second, because money is fungible, a tracing regime would place undue importance on the location of intercompany obligations. Thus, this approach would permit significant manipulation through the creation of intercompany obligations for the purpose of shifting disallowed business interest expense carryforwards among members. Third, this approach could result in the non-economic allocation of disallowed business interest expense carryforwards to members with no business interest expense to creditors outside the consolidated group. This approach would result in value transfers among consolidated group members and require complex rules to account for those transfers. These proposed regulations implement the statute consistent with legislative intent while avoiding these complications.

The Treasury Department and the IRS request comments on the rules in proposed § 1.163(j)–5(b)(3), including comments on whether these rules should be revised to incorporate additional language or principles from the CNOL allocation rules in § 1.1502–21.

B. Proposed § 1.163(j)–5(c): Disallowed Business Interest Expense Carryforwards in Transactions to Which Section 381(a) Applies

In the case of certain asset acquisitions, section 381(a) generally requires the acquiring corporation to succeed to and take into account the tax items described in section 381(c) of the distributor or transferor corporation. In the TCJA, Congress added disallowed business interest expense carryforwards to the list of items to which the acquiring corporation succeeds in a transaction to which section 381(a) applies (see section 381(c)(20)).

Sections 1.381(c)(1)–1 and 1.381(c)(1)–2 provide rules that, in part, limit the acquiring corporation's ability to use NOL carryforwards in the acquiring corporation's first taxable year ending after the acquisition date. The Treasury Department and the IRS have determined that similar rules should apply to disallowed business interest expense carryforwards. See proposed §§ 1.163(j)–5(c) and 1.381(c)(20)–1.

The Treasury Department and the IRS request comments as to whether section 381(c)(20) and proposed §§ 1.163(j)–5(c) and 1.381(c)(20)–1 should apply to excess business interest expense allocated to a corporate partner.

C. Proposed § 1.163(j)–5(d): Limitations on Disallowed Business Interest Expense Carryforwards From Separate Return Limitation Years

In general, the taxable income of a consolidated group is determined by aggregating the income and losses of each member. Thus, a consolidated group may offset the income earned by profitable members against the losses incurred by other members. However, an exception to this general rule applies to losses incurred by a member in a taxable year in which the member did not join in filing a consolidated return with the current group. The SRLY limitation in § 1.1502–21(c) generally limits the amount of a member's losses arising in a SRLY that may be included in the consolidated group's CNOL to the amount of net income generated by that member. Similar rules in §§ 1.1502–15 and 1.1502–22(c) apply to built-in losses and net capital losses, respectively. Absent a SRLY limitation and other limitations, notably section 382, the consolidated group could reduce its consolidated taxable income simply by acquiring new members with built-in losses, NOLs, net capital losses, or disallowed business interest expense carryforwards.

The Treasury Department and the IRS have determined that rules similar to those in § 1.1502–21(c) should apply to disallowed business interest expense carryforwards. See proposed § 1.163(j)–5(d). However, the calculation of the SRLY limitation for disallowed business interest expense carryforwards would differ from the calculation of the SRLY limitation for NOL carryovers. The SRLY limitation for NOL carryovers is cumulative—in other words, it is based upon a member's aggregate contribution to consolidated taxable income, determined by reference to only the member's tax items, for all consolidated return years of the consolidated group in which the member was included in the group. As a result, a member may carry forward its unused SRLY limitation from one year to the next. In contrast, the SRLY limitation for disallowed business interest expense carryforwards would be calculated annually based upon a member's section 163(j) limitation, determined by reference to only the member's tax items, for any given taxable year. As a result, a member may not carry forward its unused section 163(j) SRLY limitation from one year to the next. The Treasury Department and the IRS have determined that this result is appropriate because Congress did not retain the excess limitation carryforward provisions from old section 163(j). Thus, allowing members to carry forward their unused section 163(j) SRLY limitation would be inconsistent with congressional intent.

Proposed § 1.163(j)–5(d) would provide several additional limitations on a member's ability to use its disallowed business interest expense carryforwards arising in a SRLY. First, such items only may be taken into account by the consolidated group in a taxable year to the extent the group has any remaining section 163(j) limitation for that year after applying the rules in proposed § 1.163(j)–5(b). Second, such items only may be taken into account to the extent the SRLY member's section 163(j) limitation for that year exceeds the amount of the member's business interest expense already taken into account by the group in that year under the rules in proposed § 1.163(j)–5(b). Third, SRLY-limited disallowed business interest expense carryforwards would be deducted on a pro rata basis with non-SRLY limited disallowed business interest expense carryforwards from taxable years ending on the same date.

The Treasury Department and the IRS request comments on the SRLY rules in proposed § 1.163(j)–5(d), including whether a member's SRLY-limited disallowed business interest expense carryforwards should cease to be subject to a SRLY limitation (to the extent of the member's stand-alone section 163(j) limitation) in taxable years in which the member's stand-alone section 163(j) limitation exceeds the consolidated group's section 163(j) limitation.

D. Proposed § 1.163(j)–5(e): Application of Section 382

Like the SRLY limitation, the section 382 limitation limits a taxpayer's ability to reduce its taxable income simply by acquiring a loss corporation. In general, if a loss corporation experiences an ownership change, section 382 limits the amount of the new loss corporation's taxable income that can be offset by pre-change losses to the product of the old loss corporation's value at the time of the ownership change times the long-term tax-exempt rate. For a discussion of the regulations under sections 163(j), 382, and 383 that govern the applicability of section 382 to business interest expense, see parts 11 and 14 through 16 of this Explanation of Provisions section.

E. Proposed § 1.163(j)–5(f): Overlap of SRLY Limitation with Section 382

As noted in parts 5(C) and 5(D) of this Explanation of Provisions section, both the SRLY limitation and the section 382 limitation are intended to prevent taxpayers from trafficking in loss corporations. Moreover, both of these limitations could apply to the same corporation as a result of the same transaction (for example, if a consolidated group acquires a loss corporation in a transaction that is an ownership change for purposes of section 382) or as a result of several transactions that occur within a short period of time.

Section 1.1502–21(g) provides an overlap rule to prevent both the section 382 limitation and the SRLY limitation from applying to NOL carryovers under certain circumstances. The Treasury Department and the IRS have determined that a similar overlap rule should apply with respect to disallowed business interest expense carryforwards. Thus, proposed § 1.163(j)–5(f) would apply the principles of § 1.1502–21(g) to disallowed business interest expense carryforwards when the application of the SRLY limitation would result in an overlap with the application of section 382.

6. *Proposed § 1.163(j)–6: Application of the Business Interest Expense Deduction Limitations to Partnerships and Subchapter S Corporations*

A. In General

Proposed § 1.163(j)–6 would provide guidance regarding partnership and S corporation deductions and carryforwards under section 163(j). To the extent a partnership is subject to the limitations imposed by section 163(j), the section 163(j) limitation shall be applied at the partnership level and any deduction for business interest expense not disallowed under section 163(j) is taken into account in determining the nonseparately stated taxable income or loss of the partnership. Similar rules shall apply to an S corporation. See part 6(H) of this Explanation of Provisions section for a discussion of rules specific to S corporations.

The phrase "nonseparately stated taxable income or loss of the partnership" has not previously been defined by statute. However, section 1366(a)(2) provides a definition of "nonseparately computed income or loss" as applied to S corporations. The legislative history of section 163(j) references "ordinary business income or loss" as reflected on Form 1065, "U.S. Return of Partnership Income," and the partner's distributive share as reflected in Box 1 of Schedule K–1. H. Rept. 115–466, at 387, fn. 690 (2017).

One commenter noted that, in general, an item of income or deduction that is included in nonseparately stated income of a partnership, as determined under section 702(a)(8), loses its tax character in the hands of the partner to whom the item is allocated. The Treasury Department and the IRS agree that for purposes of proposed § 1.163(j)–6(a), to the extent a partnership's business interest expense is less than or equal to the partnership's section 163(j) limitation, such business interest expense loses its character as business interest expense at the partner's level for purposes of the partner's section 163(j) calculation (that is, the business interest expense is not subject to further limitations under section 163(j)). See proposed § 1.163(j)–6(c).

For purposes of the Code other than section 163(j), proposed § 1.163(j)–6(c) would provide that business interest expense and, in the case of a partnership, excess business interest expense, retains its character as business interest expense at the partner and S corporation shareholder-level. For purposes of section 469, such interest retains its characterization as either passive or non-passive when allocated to the partner or shareholder. Additionally, for purposes of section 469, business interest expense from a partnership or S corporation and, in the case of a partnership, excess business interest expense, remains interest derived from a trade or business in the hands of a partner or shareholder, even if the partner or shareholder does not materially participate in the partnership or S corporation's trade or business activity. See proposed § 1.163(j)–3 for additional rules regarding the interaction among sections 461(l), 465, 469, and 163(j).

The Treasury Department and the IRS intend to adopt rules for the proper treatment of business interest income and business interest expense with respect to lending transactions between a passthrough entity and an owner of the entity (self-charged lending transactions). Although reserved in these proposed regulations, the Treasury Department and the IRS intend to adopt certain rules to re-characterize, for both the lender and the borrower, the business interest expense and corresponding business interest income arising from a self-charged lending transaction that may be allocable to the owner, to prevent such business interest income and expense from entering or affecting the section 163(j) limitation calculations for both the lender and the borrower in such situations. One possible approach is to adopt rules similar in scope as those contained in § 1.469–7, dealing with the treatment of self-charged lending transactions for purposes of section 469. The Treasury Department and the IRS request comments with respect to any potential rules that may be considered to achieve this result, as well as comments regarding the potential adverse effects that such rules may have with respect to other Code provisions, such as section 163(d), and any methods for mitigating or eliminating those effects.

Guidance on the treatment of excess business interest expense in tiered partnerships has been reserved in these proposed regulations. Section 163(j)(4) requires the section 163(j) limitation to be taken into account at the entity-level and for business interest expense carryforwards to be allocated to partners. The Treasury Department and the IRS request comments regarding whether, in a tiered partnership arrangement, carryforwards should be allocated through upper-tier partnerships. Additionally, comments are requested regarding how and when an upper-tier partner's basis should be adjusted when a lower-tier partnership is subject to a section 163(j) limitation.

Guidance regarding the application of section 163(j) to a partnership merger or division has been also reserved in these proposed regulations. The Treasury Department and the IRS request comments on the effect of partnership mergers and divisions on excess business interest expense, excess taxable income, and excepted trade or business elections in the context of section 163(j).

B. ATI of a Partnership

i. In General

Proposed § 1.163(j)–6(d) would provide guidance on the ATI of a partnership. Subject to the modifications set forth in proposed § 1.163(j)–6(d) and described in this part 6.B of this Explanation of Provisions section, the ATI of a partnership would be calculated in accordance with proposed § 1.163(j)–1(b)(1). The ATI of the partnership would include any items described in section 703(a)(1), including both separately and nonseparately stated items, to the extent such items are otherwise included under proposed § 1.163(j)–1(b)(1).

ii. Section 743(b), Section 704(c)(1)(C), and Remedial Allocations

The Treasury Department and the IRS considered multiple possible approaches to address the treatment of section 743(b) adjustments to the basis of partnership property upon the transfer of a partnership interest, built-in loss amounts with respect to partnership property under section 704(c)(1)(C), and remedial allocations of income, gain, loss or deduction to a partner pursuant to section 704(c) and § 1.704–3(d) (collectively, partner-level adjustments) under section 163(j). One approach would disregard partner-level adjustments when calculating both the partnership's and the partner's ATI for purposes of section 163(j). This approach is consistent with section 743(b) and the accompanying regulations, which mandate that section 743(b) adjustments are not to be taken into account when determining the partnership's income, gain, deduction, or loss under section 703, and that section 743(b) adjustments are not taken into account until after a partner's distributive share of a deduction is determined.

This approach could, however, lead to odd results. For example, if because of positive section 743(b) adjustments, no current partner includes gain in taxable income on the sale of the partnership property, but the partnership still receives the benefit of the taxable income in its ATI, the partners would be allowed to take a larger amount of business interest expense as a current-year deduction than if the partnership's ATI had included the section 743(b) adjustment. Additionally, when the transferor sells its partnership interest, it generally includes in taxable income the gain resulting from the sale and could possibly include the gain in its own ATI calculation for purposes of its own section 163(j) limitation calculation. This situation could result in the double counting of the income in ATI for section 163(j) purposes, first by the transferor partner on the sale of the partnership interest and again by the partnership on a sale of partnership property.

Under a second approach considered, the partnership would increase or decrease its ATI by the amount of the partner-level adjustments allocated to each partner. Essentially, the partnership would be required to aggregate all partner-level adjustments and take them into account at the partnership level for purposes of section 163(j). The Treasury Department and the IRS viewed taking partner-level adjustments into account at the partnership level as being contrary to the intent of section 743(b), section 704(c)(1)(C), and remedial allocations, and have therefore not adopted this approach.

Under a third approach, (i) partner-level adjustments are not taken into account when computing ATI for purposes of the partnership's section 163(j) limitation; and (ii) each partner's partner-level adjustments are taken into account as items derived directly by the partner in determining its own section 163(j) limitation. This approach takes partner-level adjustments into account at the partner, rather than partnership, level when determining the partner's ATI.

This third approach was recommended by a commenter with respect to section 743(b) adjustments. The commenter argued that if a rule was adopted requiring that a partner's section 743(b) adjustment be included in the computation of a partnership's ATI for purposes of applying section 163(j) at the partnership level, then a particular partner's section 743(b) adjustment could impact the deductibility of partnership interest by other partners, which would be inconsistent with the basic approach taken in the section 743(b) regulations. The Treasury Department and the IRS agree that this approach strikes the best balance between the entity-level calculation under section 163(j) and the aggregate nature of section 743(b) adjustments, as well as other partner-level adjustments. Accordingly, partner-level adjustments are not taken into account when the partnership determines its section 163(j) limitation under proposed § 1.163(j)–6(f). Instead, partner-level adjustments are taken into account by the partner in determining the partner's ATI pursuant to proposed § 1.163(j)–6(e). However, in keeping with the entity approach taken under section 163(j)(4), a partnership shall take adjustments made to the basis of its property pursuant to section 734(b) into account for purposes of calculating its ATI pursuant to proposed § 1.163(j)–6(d).

The commenter acknowledged that this approach would create disparities between the situation where a partnership purchases assets in which, until 2022, depreciation will enter into the partnership's ATI; and a transaction structured as a purchase of partnership interests, where depreciation generated by a section 743(b) basis adjustment or section 704(c) remedial allocation will not enter into a partnership's ATI. The Treasury Department and the IRS are aware of these concerns and request additional comments on the impact of partner-level adjustments on a partnership's ATI calculation under section 163(j), particularly as it relates to publicly traded partnerships.

C. ATI and Business Interest Income of Partners

i. In General

Proposed § 1.163(j)–6(e) would provide that the ATI of a partner shall generally be determined in accordance with proposed § 1.163(j)–1(b)(1) without regard to such partner's distributive share of any items of income, gain, deduction or loss of such partnership, and shall be increased by such partner's share of excess taxable income, as defined in proposed § 1.163(j)–1(b)(13) and determined pursuant to proposed § 1.163(j)–6(f). This provision prohibits the double counting of items in ATI by a partner in its own section 163(j) calculation when a partnership has already taken those items into account under section 163(j). To the extent a partnership has excess taxable income, a partner may include its share of the partnership's excess taxable income, as determined in proposed § 1.163(j)–6(f), in the partner's own ATI for purposes of determining the partner's section 163(j) limitation. For guidance regarding the partner's inclusion of partner-level adjustments, see proposed § 1.163(j)–6(e). For guidance regarding the recharacterization of a partnership's investment interest, investment income, and investment expenses at the C corporation partner-level, see proposed § 1.163(j)–4(b)(3).

ii. Sale of Partnership Interests

Proposed § 1.163(j)–6(e)(3) would provide guidance on the inclusion of the proceeds from the sale of a partnership interest in the selling partner's ATI. In the event a partner sells a partnership interest and the partnership in which the interest is being sold owns only non-excepted trade or business assets, as such term is defined in proposed § 1.163(j)–6(b)(6), the gain or loss on the sale of the partnership interest is included in the partner's ATI. If a partner sells a partnership interest and the partnership in which the interest is being sold owns both excepted assets, as such term is defined in proposed § 1.163(j)–6(b)(7), and non-excepted assets, the partner shall generally use the method set forth in proposed § 1.163(j)–10(c) in order to determine the amount properly allocable to a non-excepted trade or business, and therefore, properly includible in the partner's ATI. Proposed § 1.163(j)–6(e)(4) would also apply to tiered partnerships.

The Treasury Department and the IRS also considered adopting a reasonable method standard by which a partnership could determine the amount properly allocable to a non-excepted trade or business, and therefore, properly includible in the partner's ATI. Such provisions would have adopted tracing rules similar to those set forth in § 1.163–8T, as modified by Notice 88–20, 1988–9 I.R.B. 5 (Feb. 9, 1988), Notice 88–37, 1988–15 I.R.B. 8 (Mar. 16, 1988), and Notice 89–35, 1989–13 I.R.B. 4 (Mar. 9, 1989). The Treasury Department and the IRS request comments on what reasonable methods other than the method set forth in proposed § 1.163(j)–10(c), possibly including a tracing method similar to § 1.163–8T, would be appropriate in order to determine the amount properly allocable to a non-excepted trade or business and under what circumstances such methods would be appropriate.

iii. Double Counting of Business Interest Income Prohibited

Notice 2018–28 stated that for purposes of calculating a partner's annual deduction limitation under section 163(j) for business interest expense paid or accrued by the partner, the partner shall only include business interest income from a partnership in its section 163(j)(1)(A) amount to the extent that business interest income exceeds business interest expense determined at the partnership level under section 163(j). Additionally, a partner shall not include its share of the partnership's floor plan financing for purposes of determining the partner's annual deduction limitation for business interest expense under section 163(j)(1)(C). Proposed § 1.163(j)–6(e)(2) would incorporate these limitations into these proposed regulations.

D. Section 163(j) Partnership Calculation

i. Allocation of Deductible Business Interest Expense and Section 163(j) Excess Items – Made in the Same Manner as the Nonseparately Stated Taxable Income or Loss of the Partnership

Section 163(j)(4)(A)(ii)(II) states that a partner's excess taxable income is determined in the same manner as the nonseparately stated taxable income or loss of the partnership. Section 163(j)(4)(B)(i)(II) states that excess business interest expense is allocated to each partner in the same manner as the nonseparately stated taxable income or loss of the partnership. Similarly, excess business interest income is allocated to each partner in the same manner as the nonseparately stated taxable income or loss of the partnership. The phrase "nonseparately stated taxable income or loss of the partnership" is not defined in section 163(j), and as mentioned in part 6(A) of this Explanation of Provisions section, has not previously been defined by statute or regulations. The phrase "in the same manner as" is also undefined.

Under the proposed regulations, the manner for allocating excess taxable income, excess business interest income, and excess business interest expense (hereinafter "section 163(j) excess items") must be consistent with the Treasury Department and the IRS's resolution of the following three descriptive (1 through 3) and two normative (4 through 5) issues: (1) Section 163(j) is applied at the partnership level; (2) a partnership cannot have both excess taxable income (or excess business interest income) and excess business interest expense in the same taxable year; (3) parity must be preserved between a partnership's deductible business interest expense and section 163(j) excess items and the aggregate of each partner's share of deductible business interest expense and section 163(j) excess items from such partnership; (4) if in a given year a partnership has both deductible business interest expense and excess business interest expense, a partnership should not allocate excess business interest expense to a partner to the extent such partner was allocated the items comprising ATI (or business interest income) that supported the partnership's deductible business interest expense; and (5) if in a given year a partnership has excess taxable income (or excess business interest income), only partners allocated more items comprising ATI (or business interest income) than necessary to support their allocation of business interest expense should be allocated a share of excess taxable income (or excess business interest income).

One commenter proposed a manner for allocating section 163(j) excess items that would require a partnership to allocate each section 163(j) excess item (for example, excess business interest expense) in the same proportion as its underlying section 163(j) item (business interest expense). For example, if partnership AB had $30 of business interest income, which it allocated solely to A, and $40 of business interest expense, which it allocated $20 each to A and B, then A and B would each have $15 of deductible business interest expense and $5 of excess business interest expense. In situations where the partnership does not allocate all of its section 163(j) items pro rata, such as this example, this method could require a partnership to allocate its section 163(j) excess items in a manner inconsistent with the Treasury Department and the IRS's resolution of issues four and five. Because this approach could require a partnership to arguably allocate inappropriate amounts of section 163(j) excess items to its partners, it is not adopted in these proposed regulations.

The calculation adopted in proposed § 1.163(j)–6(f)(2) preserves the entity-level calculation requirement set forth in section 163(j)(4), while also preserving the economics of the partnership and respecting any special allocations made by the partnership in accordance with section 704 and the regulations thereunder. Applying the method in these proposed regulations to the previous example, A would have $20 of deductible business interest expense, and B would have $10 of deductible business interest expense and $10 of excess business interest expense. This result is consistent with the Treasury Department and the IRS's interpretation of section 163(j) as previously discussed.

ii. Allocation of Deductible Business Interest Expense and Section 163(j) Excess Items – General Calculation

Proposed § 1.163(j)–6(f)(2) provides that partnerships must allocate any section 163(j) excess items and any deductible business interest expense in the manner described in paragraphs (f)(2)(i) through (xi). In general, each paragraph (i) through (xi) is a step in a set of instructions that, when completed, provide the partnership with the proper allocation of each of its section 163(j) excess items to each of its partners. This resulting array of allocations is consistent with the Treasury Department and the IRS's resolution of the five key issues described in part 6(D)(i) of this Explanation of Provisions section. Stated otherwise, such prescribed allocations recognize the aggregate nature of partnerships under subchapter K of the Code to the greatest extent possible while remaining consistent with section 163(j) applying at the partnership level.

No rule set forth in proposed § 1.163(j)–6(f)(2) of this section prohibits a partnership from making an allocation to a partner of any section 163(j) item that is otherwise permitted under section 704 and the regulations thereunder. Accordingly, any calculations in proposed § 1.163(j)–6(f)(2)(i) through (xi) are solely for the purpose of determining each partner's deductible business interest expense and section 163(j) excess items, and do not otherwise affect any other provision under the Code, such as section 704(b). Proposed § 1.163(j)–6(f)(2) creates numerous defined terms. These defined terms are solely for the purpose of proposed § 1.163(j)–6(f)(2) and are meant to aid the partnership in its application of proposed § 1.163(j)–6(f)(2) by allowing the calculation to be broken into discrete steps.

Proposed § 1.163(j)–6(f)(2)(i) requires the partnership to calculate its section 163(j) deduction pursuant to proposed § 1.163(j)–2(b). This step is the entity-level calculation required by section 163(j)(4)(A), and it provides the partnership with its total amount of deductible business interest expense, excess business interest income, excess taxable income, and excess business interest expense under section 163(j) for a taxable year. The remaining steps in proposed § 1.163(j)–6(f)(2)(ii) through (xi) determine the allocations a partnership must make of its deductible business interest expense and each section 163(j) excess item to its partners. At the conclusion of the eleven steps set forth in proposed § 1.163(j)–6(f)(2), the total amount of deductible business interest expense and section 163(j) excess items allocated to each partner will equal the partnership's total amount of deductible business interest expense and section 163(j) excess items.

Proposed § 1.163(j)–6(f)(2)(ii) begins the partner-level calculations. It should be noted that the calculations under proposed § 1.163(j)–6(f)(2) do not determine a partner's allocation of business interest expense, business interest income or items comprising ATI, as these allocations are determined under section 704(b) and (c) and the regulations thereunder. Rather, the proposed § 1.163(j)–6(f)(2) partner-level calculations determine each partner's amount of deductible business interest expense and amount of any section 163(j) excess items. This determination provides the starting point for the remainder of the steps in proposed § 1.163(j)–6(f)(2). Only items that were taken into account in the partnership's section 163(j) calculation are taken into account for the proposed § 1.163(j)–6(f)(2) partner-level calculation. Section 743(b) adjustments, built-in loss amounts with respect to partnership property under section 704(c)(1)(C), section 704(c) remedial allocations, allocations of investment income and expense, and amounts determined for the partner under § 1.882–5 are therefore not taken into account for purposes of the proposed § 1.163(j)–6(f)(2) partner-level calculation. To clarify that only section 163(j) items of the partnership are relevant for the calculations under proposed § 1.163(j)–6(f)(2), paragraph (f)(2)(ii) defines "allocable ATI" as a partner's allocable share of the partnership's ATI, "allocable business interest income" as a partner's allocable share of the partnership's business interest income, and "allocable business interest expense" as a partner's allocable share of the partnership's business interest expense that is not floor plan financing interest expense.

As noted previously, the primary goal of proposed § 1.163(j)–6(f)(2) is to provide the partnership with an array of allocations that recognizes the aggregate nature of partnerships under subchapter K of the Code to the greatest extent possible while still remaining consistent with section 163(j) applying at the partnership level. Proposed § 1.163(j)–6(f)(2)(iii) through (v) contain the adjustment mechanism necessary to achieve this goal. Section 163(j) permits taxpayers with a sufficient amount of appropriate income (ATI and business interest income) to deduct their business interest expense. However, section 163(j) applies at the entity level with respect to partnerships under section 163(j)(4). Proposed § 1.163(j)–6(f)(2)(iii) recognizes this normative principle of the statute, and then proposed § 1.163(j)–6(f)(2)(iv) and (v) reconcile the proposed § 1.163(j)–6(f)(2)(iii) partner-level calculation with the proposed § 1.163(j)–6(f)(2)(i) partnership-level result.

To illustrate the mechanism at work in proposed § 1.163(j)–6(f)(2)(iii) through (v), consider the example used above. Partnership AB has $30 of business interest income, which it allocates solely to A, and $40 of business interest expense, which it allocates $20 each to A and B. Upon applying proposed § 1.163(j)–6(f)(2)(iii), AB determines that A has been allocated more allocable business interest income than necessary to deduct its allocable business interest expense ($10 of allocable business interest income excess), and B has not been allocated enough allocable business interest income to deduct its allocable business interest expense ($20 of allocable business interest income deficit). Because AB cannot have both excess business interest income and excess business interest expense in the same year, proposed § 1.163(j)–6(f)(2)(iv) and (v) reconcile the proposed § 1.163(j)–6(f)(2)(iii) partner-level calculation with the proposed § 1.163(j)–6(f)(2)(i) partnership-level result. This process of reallocating allocable business interest income excess to partners with allocable business interest income deficits is broken into two steps; proposed § 1.163(j)–6(f)(2)(iv) first proportionately reduces each partner's excess amount, and then proposed § 1.163(j)–6(f)(2)(v) proportionately reduces each partner's deficit amount to reflect the reallocation of the benefit of the excess amounts.

Proposed § 1.163(j)–6(f)(2)(vii), (ix), and (x) contain the same adjustment mechanism as proposed § 1.163(j)–6(f)(2)(iii) through (v), except for ATI instead of business interest income. To illustrate, if in the previous example AB had $100 of ATI which it allocated solely to A instead of $30 of business interest income, AB would perform the calculations in proposed § 1.163(j)–6(f)(2)(vii), (ix), and (x) – which parallel the calculations in proposed § 1.163(j)–6(f)(2)(iii) through (v) – and arrive at the same result. The partnership must make the adjustments regarding business interest income (proposed § 1.163(j)–6(f)(2)(iii) through (v)) before the adjustments regarding ATI (proposed § 1.163(j)–6(f)(2)(vii), (ix), and (x)) due to section 163(j)(4)(C), which requires partnerships to first fully offset business interest expense using business interest income before turning to ATI.

Finally, proposed § 1.163(j)–6(f)(2)(xi) allocates section 163(j) excess items and deductible business interest expense to the partners. Excess business interest income as determined in proposed § 1.163(j)–6(f)(2)(i) is allocated dollar for dollar to the partners with final allocable excess business interest income determined pursuant to proposed § 1.163(j)–6(f)(2)(iv). After grossing up each partner's final ATI capacity excess amount by ten-thirds (10/3) (the multiplicative inverse of the 30 percent ATI limitation), excess taxable income, as determined in proposed § 1.163(j)–6(f)(2)(i), is allocated dollar for dollar to partners with final ATI capacity excess amounts determined pursuant to proposed § 1.163(j)–6(f)(2)(ix). It is necessary to gross up the ATI capacity excess amount by ten thirds in order to account for the reduction to ATI capacity that occurred in proposed § 1.163(j)–6(f)(2)(vii). Excess business interest expense is allocated dollar for dollar to partners with final ATI capacity deficit amounts determined pursuant to proposed § 1.163(j)–6(f)(2)(x). A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense.

iii. Allocation of Deductible Business Interest Expense and Section 163(j) Excess Items – Steps 6 and 8

In a given year, if a partnership does not have any partners with a negative allocable ATI under proposed § 1.163(j)–6(f)(2)(vi) (that is, an allocable ATI under proposed § 1.163(j)–6(f)(2)(ii) that is comprised of more items of deduction and loss than income and gain), then the partnership would not have any adjustments under proposed § 1.163(j)–6(f)(2)(vi) and (viii). Thus, the only adjustments and reallocations the partnership would have to perform as part of its proposed § 1.163(j)–6(f)(2) calculation are described in part 6(D)(ii) of this Explanation of Provisions section. However, if a partnership does have a total negative allocable ATI that is greater than zero, then the partnership would have adjustments under proposed § 1.163(j)–6(f)(2)(vi), and may have adjustments under proposed § 1.163(j)–6(f)(2)(viii) as well. Proposed § 1.163(j)–6(f)(2)(vi) and (viii) are closely related. In general, proposed § 1.163(j)–6(f)(2)(viii) corrects distortions that would otherwise occur following certain proposed § 1.163(j)–6(f)(2)(vi) adjustments.

The purpose of proposed § 1.163(j)–6(f)(2)(vi) is to address the situation in which a partner's allocable ATI under proposed § 1.163(j)–6(f)(2)(ii) is comprised of more items of deduction and loss than income and gain – that is, negative allocable ATI. For purposes of the section 163(j) calculation, a partnership that has ATI of less than zero will not be able to deduct business interest expense with respect to ATI under section 163(j)(1). Accordingly, for purposes of the proposed § 1.163(j)–6(f)(2) calculation, the partnership must ensure that each partner has a "final allocable ATI" of at least zero before performing the ATI adjustment calculation described in proposed § 1.163(j)–6(f)(2)(vii), (ix), and (x). This is accomplished by proportionately reallocating positive allocable ATI from partners with positive allocable ATI to partners with negative allocable ATI in order to gross such partners up to zero. Upon completion of the calculation in proposed § 1.163(j)–6(f)(2)(vi), the aggregate of the partners' final allocable ATI amounts will equal the partnership's ATI amount used in calculating its section 163(j) limitation under proposed § 1.163(j)–6(f)(2)(i), and no partner will have a final allocable ATI amount less than zero.

A partnership must always apply proposed § 1.163(j)–6(f)(2)(vi), even if the partnership does not have any numerical adjustment resulting from it. For example, if a partnership has a total negative allocable ATI of $0 in proposed § 1.163(j)–6(f)(2)(vi), then even though the partnership will not reallocate any positive allocable ATI in proposed § 1.163(j)–6(f)(2)(vi), the partnership must still apply proposed § 1.163(j)–6(f)(2)(vi) to convert each partner's positive allocable ATI to final allocable ATI, which is used in subsequent paragraphs as the successor term of allocable ATI.

The purpose of proposed § 1.163(j)–6(f)(2)(viii) is to ensure that any adjustments the partnership was required to make under proposed § 1.163(j)–6(f)(2)(vi) do not result in proposed § 1.163(j)–6(f)(2) requiring the partnership to allocate deductible business interest expense and section 163(j) excess items in an inequitable manner. To illustrate, consider the following example. Partnership ABC has $100 of ATI, comprised of $200 of items of income and gain and $100 of deduction and loss, and $40 of business interest expense. ABC allocates the income and gain $100 each to A and C, and all $100 of the deduction and loss to B. ABC has $40 of business interest expense, which it allocates $20 each to A and B. Upon applying proposed § 1.163(j)–6(f)(2)(i), ABC has $30 of deductible business interest expense and $10 of excess business interest expense.

Given these facts and the Treasury Department and the IRS's interpretation of section 163(j), A is clearly entitled to treat all $20 of its allocable business interest expense as deductible business interest expense in the current year, and B should be allocated the $10 of excess business interest expense. However, in the absence of proposed § 1.163(j)–6(f)(2)(viii), proposed § 1.163(j)–6(f)(2) would require ABC to make different, less equitable, allocations. The issue stems from proposed § 1.163(j)–6(f)(2)(vi). Following the application of proposed § 1.163(j)–6(f)(2)(vi) and (vii), A has an ATI capacity deficit of $5, B has an ATI capacity deficit of $20, and C has an ATI capacity excess of $15. The calculations in proposed § 1.163(j)–6(f)(2)(ix) and (x) reallocate ATI capacity excess to partners with ATI capacity deficits solely based on each partners ATI capacity deficit relative to the total ATI capacity deficit. Because proposed § 1.163(j)–6(f)(2)(ix) and (x) only takes each partner's proportionate share of ATI capacity deficit into account when reallocating ATI capacity excess, proposed § 1.163(j)–6(f)(2)(ix) and (x) always treat all of partners as though they are on equal footing regardless of any adjustments that may have happened in proposed § 1.163(j)–6(f)(2)(vi). As a result, in the absence of proposed § 1.163(j)–6(f)(2)(viii), A would be allocated deductible business interest expense of only $18 (instead of $20), and B would be allocated excess business interest expense of only $8 (instead of $10).

The proposed § 1.163(j)–6(f)(2)(viii) adjustment begins by filtering out partnerships that do not need to make the adjustment using the criteria listed in proposed § 1.163(j)–6(f)(2)(viii)(A). This treatment is possible due to the predictability and limited universe of situations that require a proposed § 1.163(j)–6(f)(2)(viii) adjustment. Specifically, a proposed § 1.163(j)–6(f)(2)(viii) adjustment is always triggered when a positive allocable ATI partner that helped gross up a negative allocable ATI partner in proposed § 1.163(j)–6(f)(2)(vi) is subsequently forced to compete with such partner for a limited amount of ATI capacity excess.

Next, under proposed § 1.163(j)–6(f)(2)(viii)(B), a partnership must determine each partner's priority amount. This priority amount represents what a partner's ATI capacity would have been if such partner had not been required under proposed § 1.163(j)–6(f)(2)(vi) to offset another partner's negative allocable ATI. For purposes of determining whether to apply proposed § 1.163(j)–6(f)(2)(viii)(C) or (D) and performing the calculations under the applicable paragraph, each partner's usable priority amount must be determined. A partner's usable priority amount is the lesser of its priority amount and ATI capacity deficit.

A partnership must use the amounts it determined under proposed § 1.163(j)–6(f)(2)(viii)(B) to determine whether it must perform the calculations in proposed § 1.163(j)–6(f)(2)(viii)(C) or (D). If the total ATI capacity excess amount, as determined under proposed § 1.163(j)–6(f)(2)(vii), is greater than or equal to the total usable priority amount, then the adjustments in proposed § 1.163(j)–6(f)(2)(viii)(C) must occur. If the total usable priority amount is greater than the total ATI capacity excess amount, as determined under proposed § 1.163(j)–6(f)(2)(vii), then the adjustments in proposed § 1.163(j)–6(f)(2)(viii)(D) must occur. The application of proposed § 1.163(j)–6(f)(2)(viii)(C) or (D) may result in adjustments to the partner's ATI capacity excess (and deficit) amounts used in proposed § 1.163(j)–6(f)(2)(ix) and (x).

The purpose of these adjustments is to ensure that the partners who had a negative allocable ATI do not improperly benefit under proposed § 1.163(j)–6(f)(2)(ix) through (xi) to the detriment of the partners who had a positive allocable ATI. In general, proposed § 1.163(j)–6(f)(2)(viii)(C) and (D) correct any artificial distortion of the economics between the partners that may have occurred under proposed § 1.163(j)–6(f)(2)(vi) by modifying the outputs of proposed § 1.163(j)–6(f)(2)(vii) to restore the partners' true economic arrangement before such outputs are used in proposed § 1.163(j)–6(f)(2)(ix) and (x). Stated otherwise, proposed § 1.163(j)–6(f)(2)(viii)(C) and (D) compensate for the assumption made by proposed § 1.163(j)–6(f)(2)(ix) and (x) that all partners are always on equal footing by modifying the outputs of proposed § 1.163(j)–6(f)(2)(vii) to put all partners on equal footing before allowing such outputs to reach proposed § 1.163(j)–6(f)(2)(ix) and (x).

Turning back to the foregoing example, in accordance with proposed § 1.163(j)–6(f)(2)(viii), ABC would first determine whether it has all three attributes in proposed § 1.163(j)–6(f)(2)(viii)(A)(*1*) through (*3*). Because ABC (1) has excess business interest expense under proposed § 1.163(j)–6(f)(2)(i); (2) has total negative allocable ATI greater than $0 under proposed § 1.163(j)–6(f)(2)(vi); and (3) has a total ATI capacity excess amount greater than $0 under proposed § 1.163(j)–6(f)(2)(vii), ABC must perform the calculations and make the necessary adjustments described under proposed § 1.163(j)–6(f)(2)(viii)(B) and (C) or (D). Given ABC's facts, proposed § 1.163(j)–6(f)(2)(viii)(B) would require ABC to perform the calculations in proposed § 1.163(j)–6(f)(2)(viii)(C). As a result, A would be allocated deductible business interest expense of $20, and B would be allocated excess business interest expense of $10 and deductible business interest expense of $10. This result is consistent with the Treasury Department and the IRS's resolution of the five key issues described in part 6(D)(i) of this Explanation of Provisions section.

The Treasury Department and the IRS request comments on the approach described in this part 6(D). Specifically, comments are requested regarding other reasonable methods to allocate deductible business interest expense, excess taxable income, and excess business interest expense in a manner that permits partners that bear the taxable income supporting the deductible business interest expense to be allocated a disproportionate share of deductible business interest expense and excess taxable income. Finally, comments are requested regarding the fungibility of publicly traded partnership interests with respect to the foregoing approach.

E. Business Interest Expense Carryforwards

i. In General

Proposed § 1.163(j)–6(g) would provide that to the extent a partnership has business interest expense in excess of its section 163(j) limitation, such excess business interest expense shall not be carried forward by the partnership. Instead, such excess business interest expense would be allocated to the partners in accordance with proposed § 1.163(j)–6(f).

A commenter requested guidance regarding whether a partner will be permitted to use its share of the partnership's excess business interest income in the current taxable year to absorb the partner's excess business interest expense allocated from such partnership in prior years. The Treasury Department and the IRS believe that it is consistent with section 163(j) to allow excess business interest income allocated to a partner from a partnership to absorb the partner's excess business interest expenses allocated from that same partnership in an earlier taxable year to the extent of the excess business interest income allocated to the partner. This allowance places partners in a similar position to other taxpayers with carryforwards.

Regarding a partner's allocation of excess taxable income, the Treasury Department and the IRS considered three options when drafting guidance on the deductibility of a partner's excess business interest expense carryforward as it relates to a partner's share of excess taxable income. Section 163(j)(4)(B)(ii)(I) provides that the carryforward "shall be treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income." The first option would apply a plain reading of the statutory language to treat as paid or accrued by the partner the amount of excess business interest expense carryforward from the partnership equal to the excess taxable income the partner is allocated from the partnership, but it would limit the deductibility of the excess business interest expense by a partner to the partner's business interest income and 30 percent of the partner's ATI for the taxable year. Given this interpretation is the most consistent with the plain meaning of the statute, proposed § 1.163(j)–6(g) would provide that to the extent a partner receives an allocation of excess taxable income from a partnership in a taxable year, such partner's excess business interest expense is treated as paid or accrued in that year in an amount equal to the partner's share of the excess taxable income. To the extent the partner's excess business interest expense exceeds its share of the partnership's excess taxable income in a taxable year, it remains excess business interest expense and is carried over to the following taxable year. When the excess business interest expense is treated as paid or accrued, it becomes business interest paid or accrued by the partner and may be deducted by the partner, subject to any partner-level section 163(j) limitation and any other applicable limitations.

The second option considered would entitle a partner to deduct excess business interest expense only to the extent the partner can deduct that excess business interest expense against the excess taxable income received from the partnership (for example, 30 percent of excess taxable income which increases the partner's ATI under section 163(j)(4)(A)(ii)(II)), regardless of any ATI or business interest income that the partner has from sources other than the partnership. This option would produce the same result as if the partnership had paid or accrued all the relevant income and expense in a single year. The legislative history can be read to suggest this result: "The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward." H. Rept. 115–466, at 391 (2017). However, this interpretation does not appear to be consistent with the plain language of the statute, which states that excess business interest expense is treated as paid or accrued to the extent of the partner's excess taxable income.

The third option considered would entitle a partner to fully deduct excess business interest expense to the extent it receives an allocation of excess taxable income from the same partnership (for example, for every dollar of excess taxable income a partner is allocated, the partner is able to deduct one dollar of excess business interest expense). This interpretation would treat all excess business interest expense, to the extent of excess taxable income, as interest deductible under section 163(a). However, this interpretation ignores the possibility that the partner may be subject to its own section 163(j) limitation and ignores the 30 percent limitation on ATI that a partnership would be subject to had the business interest expense been paid or accrued in the current year. Accordingly, this option is not adopted in the proposed regulations.

ii. Ordering Rule

The ordering rule in proposed § 1.163(j)–6(f)(2)(iii) would clarify that to the extent a partner is allocated excess taxable income or excess business interest income from a partnership in the current taxable year and, in a prior year, that partner was allocated excess business interest expense from that same partnership that has not been previously treated as paid or accrued by the partner, the partner must treat that current-year excess taxable income and excess business interest income as causing the excess business interest expense carried forward from the partnership to be treated as paid or accrued in such year to the extent of the excess taxable income and excess business interest income. In the event a partner receives excess taxable income or excess business interest income from a partnership, it cannot choose to keep excess business interest expense as not paid or accrued in the current taxable year.

F. Basis Adjustments

i. Basis and Capital Account Adjustments for Excess Business Interest Expense Allocations

Generally, a partner's adjusted basis in its partnership interest shall be reduced by allocated items of partnership loss or deduction, but not below zero, pursuant to § 1.704–1(d)(2). Deductible business interest expense and excess business interest expense are subject to section 704(d). If a partner is subject to a limitation on loss under section 704(d) and a partner is allocated losses from a partnership in a taxable year, § 1.704–1(d)(2) requires that the limitation on losses under section 704(d) be apportioned amongst these losses based on the character of each loss (each grouping of losses based on character being a "section 704(d) loss class"). If there are multiple section 704(d) loss classes in a given year, § 1.704–1(d)(2) requires the partner to apportion the limitation on losses under section 704(d) to each section 704(d) loss class proportionately. For purposes of applying this proportionate rule, any deductible business interest expense (whether allocated to the partner in the current taxable year or suspended under section 704(d) in a prior taxable year), any excess business interest expense allocated to the partner in the current taxable year, and any excess business interest expense from a prior taxable year that was suspended under section 704(d) ("negative section 163(j) expense") shall comprise the same section 704(d) loss class. Once the partner determines the amount of limitation on losses apportioned to this section 704(d) loss class, any deductible business interest expense is taken into account before any excess business interest expense or negative section 163(j) expense.

The adjusted basis of a partner in a partnership interest is reduced, but not below zero, by the amount of excess business interest expense allocated to the partner pursuant to proposed § 1.163(j)–6(f)(2). Negative section 163(j) expense is not treated as excess business interest expense in any subsequent year until such negative section 163(j) expense is no longer suspended under section 704(d). Consequently, an allocation of excess taxable income or excess business interest income does not result in the negative section 163(j) expense being treated as business interest expense paid or accrued by the partner. Further, unlike excess business interest expense preventing a partner from including excess taxable income in its ATI as described in section 163(j)(4)(B)(ii) flush language, negative section 163(j) expense does not affect, and is not affected by, any allocation of excess taxable income to the partner. Accordingly, any excess taxable income allocated to a partner from a partnership while the partner still has a negative section 163(j) expense will be included in the partner's ATI. However, once the negative section 163(j) expense is no longer suspended under section 704(d), it becomes excess business interest expense, which is subject to the general rules in proposed § 1.163(j)–6(g). Section 163(j) has no effect on the maintenance of capital accounts (for example, a partner's capital account is reduced in the year such partner is allocated excess business interest expense). See § 1.704–1(b)(2)(iv)(*b*).

The guidance provided in proposed § 1.163(j)–6(h)(2) is intended to address situations in which a partner is subject to a limitation under section 704(d) and is also allocated excess taxable income. Pursuant to proposed § 1.163(j)–6(g), excess business interest expense would otherwise be treated as paid or accrued by the partner in an amount equal to the excess taxable income, but the partner's basis in the partnership does not increase in an amount equal to the allocated excess taxable income and, therefore, remains subject to the loss limitation in section 704(d). The approach taken in proposed

§ 1.163(j)–6(h)(2) attempts to reconcile the competing deduction limitations imposed by sections 704(d) and 163(j) along with section 163(j) treating excess business interest expense as paid or accrued by the partner when the partner is allocated excess taxable income. The Treasury Department and the IRS request comments on this issue.

ii. Basis Adjustments Upon Disposition of Partnership Interests Pursuant to Section 163(j)(4)(B)(iii)(II)

Proposed § 1.163(j)–6(h)(3) would provide that if a partner disposes of all or substantially all of its partnership interest, the adjusted basis of the partner in the partnership interest shall be increased immediately before the disposition by the amount of excess, if any, of the amount of the basis reduction under proposed § 1.163(j)–6(h)(1) over the portion of any excess business interest expense allocated to the partner under proposed § 1.163(j)–6(f)(2) which has not been previously treated under proposed § 1.163(j)–6(g) as business interest expense paid or accrued by the partner, regardless of whether the disposition was as a result of a taxable or non-taxable transaction. No deduction under section 163(j) shall be allowed to the transferor or transferee under chapter 1 of the Code for any excess business interest expense resulting in a basis increase under section 163(j) and these proposed regulations or for any negative section 163(j) expense.

In the event a partner disposes of less than substantially all of its interest in a partnership, proposed § 1.163(j)–6(h)(2) would provide that a partner shall not increase its basis in its partnership by the amount of any excess business interest expense that has not yet been treated as paid or accrued by the partner in accordance with proposed § 1.163(j)–6(g). Any such excess business interest expense would remain excess business interest expense in the hands of the transferor partner until such time as the transferor partner is allocated an appropriate amount of excess taxable income or excess business interest income from the partnership or added to the basis of its partnership interest when the partner fully disposes of the partnership interest. Additionally, any negative section 163(j) expense shall remain negative section 163(j) expense of the transferor partner until such negative section 163(j) expense is no longer suspended under section 704(d). These rules are similar to the rules found under section 469 and the regulations thereunder relating to suspended passive activity loss deductions.

The Treasury Department and the IRS considered alternate approaches when analyzing the effect of partial dispositions on a partner's basis. One alternate approach would add excess business interest expense to the partner's basis in the partnership interest to the extent the partner's capital account is reduced by the transfer or redemption. A second approach would increase the partner's remaining basis in the partnership interest by the amount of excess business interest expense that is proportionate to the amount of the partner's adjusted basis in the partnership interest that was transferred or redeemed. This method would require a partner to track its basis in the partnership interest in a manner similar to that set forth in Rev. Rul. 84–53, 1984–15 I.R.B. 17, 1984–1 C.B. 159 (Apr. 9, 1984). The Treasury Department and the IRS request comments on this issue.

G. Investment Items

Proposed § 1.163(j)–6(j) would provide guidance on the treatment of investment income and expense items under section 163(d) allocated by a partnership to its partners. Notice 2018–28 stated that the Treasury Department and the IRS intend to issue regulations clarifying that, solely for purposes of section 163(j), in the case of a taxpayer that is a C corporation, all interest paid or accrued by the C corporation on indebtedness of such C corporation will be business interest expense within the meaning of section 163(j)(5), and all interest on indebtedness held by the C corporation that is includible in gross income of such C corporation will be business interest income within the meaning of section 163(j)(6). Additionally, comments were received requesting guidance on the treatment of investment interest expense and investment interest income, as defined in section 163(d), allocated to a C corporation (corporate partner) by a partnership.

The Treasury Department and the IRS considered two approaches to address this issue. Under the first approach, the investment interest expense would be allocated directly from the partnership to the corporate partner without being subject to the section 163(j) limitations of the partnership. This option is most consistent with a plain reading of the statute. The definition of business interest expense under section 163(j)(5) specifically excludes investment interest. Section 163(j)(4) requires the business interest expense deduction to be calculated with respect to the partnership's specific items of income and expense, and the statute does not require any partner-specific considerations to be taken into account when performing the calculation at the partnership level.

The legislative history of section 163(j) indicates that a corporation can never have investment income and expenses, and instead, those items shall be treated as business interest income and expenses: "Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Therefore, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision." H. Rept. 115–466, at 386, fn. 688 (2017).

This language suggests a legislative intent to transform any interest that would otherwise be classified as investment interest in the hands of the corporate partner into business interest expense, thereby subjecting that interest to the corporate partner's limitations under section 163(j).

The second approach considered would require a partnership to perform a notional calculation under section 163(j) with respect to the investment interest that is allocated to its corporate partners. Based on the text and legislative history, this provision could arguably be interpreted to mean that investment interest expenses should be classified as business interest expenses at the time they are allocated to a corporate partner, and accordingly, the partnership should perform a section 163(j) calculation with respect to those items because section 163(j) requires a partnership to take the business interest expense deduction into account. Because this calculation would be done at the partnership level, any partnership with both corporate and non-corporate partners would need to make two section 163(j) calculations: one for any corporate partners and one for non-corporate partners.

Proposed § 1.163(j)–6(j) would adopt the first approach. Section 163(j)(4) does not require the partnership to look beyond its own tax attributes to that of its partners when making a determination as to whether a section 163(j) calculation is necessary. Accordingly, a plain reading of the statute does not support the partnership treating investment interest as business interest expense prior to allocating the interest to its partners. Instead, the statute appears to require the corporate partner to calculate its section 163(j) limitation while including this investment interest as it would with all other business and investment interest it receives from all sources.

It should be noted that, with respect to passthrough entities, including S corporations, engaged in trades or businesses that are not passive activities and with respect to which certain owners of the passthrough entities do not materially participate for purposes of section 469, as described in section 163(d)(5)(A)(ii) and as illustrated in Rev. Rul. 2008–12, the rules of section 163(j)(4) will apply to business interest expense allocable to such trades or businesses of those passthrough entities if those entities are otherwise subject to section 163(j). To the extent business interest expense of a passthrough entity is not limited under section 163(j), such business interest expense may still be limited by section 163(d) at the passthrough entity owner level in these situations. With respect to partnerships, to the extent that such business interest expense is limited under section 163(j)(4) and becomes a carryover item of partners who do not materially participate with respect to such trades or businesses, those items will be treated as items of investment interest expense in the hands of those owners for purposes of section 163(d) once those carryover items are treated as paid or accrued in a succeeding taxable year. The Treasury Department and the IRS have concluded that this is the result of the statutory rules contained in section 163(d)(4)(B) and (d)(5)(A)(ii) and, therefore, no additional rules are needed in regulations to reach this result.

H. S Corporations

i. In General

Section 163(j)(4)(D) provides that rules similar to those contained in section 163(j)(4)(A), relating to the entity-level treatment of the section 163(j) deduction, and section 163(j)(4)(C), relating to the definition of excess taxable income, apply to S corporations. Accordingly, proposed § 1.163(j)–6(l) would provide that, in the case of any S corporation, (i) the section 163(j) deduction limitation would be applied at the S corporation level, and (ii) any deduction for business interest expense would be taken into account in determining the nonseparately stated taxable income or loss of the S corporation.

An S corporation would determine its amount allowed as a deduction for business interest expense for the taxable year, that is, its section 163(j) deduction limitation, in the same manner as set forth in proposed § 1.163(j)–2(b). Due to the fact that S corporations generally are required to make pro rata distributions of income, allocations of excess taxable income and excess business interest income would be made in accordance with the shareholders' respective interests in the S corporation after the S corporation determines its section 163(j) deduction limitation pursuant to proposed § 1.163(j)–2(b), in accordance with section 1366(a)(1). See section 1361(b)(1)(D); § 1.1361–1(l) (non-pro rata distributions may create a second class of stock). Because partner-level adjustments are not applicable to S corporation shareholders, the ATI of an S corporation generally would be determined in accordance with proposed § 1.163(j)–1(b)(1) without additional modifications.

ii. Dispositions of S Corporation Stock

Proposed §§ 1.163(j)–6(l)(4)(ii) and 1.163(j)–10(b)(4)(ii) would provide guidance regarding the inclusion of the proceeds from the dispositions of S corporation stock in the selling shareholder's ATI. Specifically, proposed § 1.163(j)–6(l)(4)(ii) would provide that, in the event that a shareholder of an S corporation recognizes gain or loss upon the disposition of stock of the S corporation, and the corporation in which the stock is being disposed owns only non-excepted trade or business assets, the gain or loss on the disposition of the stock would be included in the shareholder's ATI. Under proposed § 1.163(j)–10(b)(4)(ii), if a shareholder recognizes gain or loss upon the disposition of stock in an S corporation that owns (1) non-excepted assets and excepted assets, (2) investment assets, or (3) both, the shareholder would determine the proportionate share of the amount properly allocable to a non-excepted trade or business, in accordance with the allocation rules set forth in proposed § 1.163(j)–10(c)(5)(ii)(B)(*3*), and would include such proportionate share of gain or loss in the shareholder's ATI. Proposed § 1.163(j)–10(b)(4)(ii) would also apply to tiered passthrough entities, as defined in proposed § 1.163(j)–7(f)(13), by looking through each passthrough entity tier (for example, an S corporation that is the partner of the highest-tier partnership would look through each lower-tier partnership), subject to proposed § 1.163(j)–10(c)(5)(ii)(D).

iii Double Counting of Business Interest Income Prohibited

Proposed § 1.163(j)–6(l)(4)(iii) would incorporate the limitations set forth in Notice 2018–28, which the Treasury Department and the IRS issued "to prevent the double counting of business interest income and floor plan financing interest expense for purposes of the deduction afforded by section 163(j)." Notice 2018–28, section 7. Consistent with the Notice's statement regarding the application of such limitations to S corporations and their shareholders, proposed § 1.163(j)–6(l)(4)(iii) would provide that, for purposes of calculating an S corporation shareholder's section 163(j) limitation, the shareholder would not include business interest income from an S corporation that is subject to section 163(j) except to the extent it is allocated excess business interest income from that S corporation pursuant to proposed § 1.163(j)–6(l)(1). In addition, proposed § 1.163(j)–6(l)(4)(iii) would provide that an S corporation shareholder could not include its share of the S corporation's floor plan financing interest expense for purposes of calculating a shareholder's section 163(j) limitation because such floor plan financing interest expense would have already have been taken into account by the S corporation in determining its nonseparately stated taxable income or loss for purposes of section 163(j).

iv. Business Interest Expense Carryforwards

Section 163(j)(4) does not indicate the manner by which disallowed business interest expense carryforwards should be treated by an S corporation and its shareholders. However, by virtue of the fact that section 163(j)(4)(D) references both sections 163(j)(4)(A) and (C), but not (B), an inference could be made that Congress intended that disallowed business interest expense carryforwards that arise from an S corporation should be treated differently than excess business interest expense incurred by a partnership. The legislative history appears to support such inference by indicating that the "special rule for carryforward of disallowed partnership interest" in section 163(j)(4)(B) "does not apply to S corporations and their shareholders." H. Rept. 115–466, at 391 (2017).

In light of the statutory language and the legislative history, proposed § 1.163(j)–6(l)(5) provides that the rules set forth in proposed § 1.163(j)–2(c) govern the treatment of S corporation business interest expense carryforwards. Consequently, if an S corporation has a disallowed business interest expense carryforward in the year the S corporation terminates, such item will be carried forward to the succeeding C corporation taxable year. The Treasury Department and the IRS request comments regarding the treatment of disallowed business interest expense carryforwards as an attribute of the S corporation, subject to section 382 limitations, as opposed to the shareholders, and the timing for any adjustments to shareholder basis and the S corporation's accumulated adjustment account. By deferring adjustments to shareholder basis and the S corporation's accumulated adjustments account until any carryforwards are deductible at the corporate level, these proposed regulations generally would match the economics of these adjustments to the shareholders holding stock at the time the S corporation's carryforwards would become deductible.

The Treasury Department and the IRS, however, have considered an alternative option to the rules set forth in proposed § 1.163(j)–6(l)(5). This alternative option would allocate carryforwards from an S corporation to its shareholders in a manner similar to proposed § 1.163(j)–6(g) for partnerships and their partners. This option would require shareholders to receive excess taxable income or excess business interest income from the S corporation in order to treat the disallowed business interest carryforwards as paid or accrued by the shareholder. The shareholder's basis and the S corporation's accumulated adjustment account would be reduced upon an allocation of excess business interest expense to the shareholders.

This alternative option would set forth a framework that would be consistent with the flow-through nature of S corporations. For example, S corporations, similar to partnerships, allocate items of deduction and expense in the year that they occur, even if such items might be suspended at the shareholder-level under section 1366(d). In addition, S corporation shareholders calculate their respective bases in a manner similar to partners, except that S corporation shareholders do not take into account entity-level debt. Thus, corporate attributes generally are suspended at the shareholder-level under the existing subchapter S framework. The Treasury Department and the IRS request comments on this alternative approach and the authoritative support for adopting it.

v. Applicability of Section 382 to S Corporations Regarding Disallowed Business Interest Expense Carryforwards

Although the Treasury Department and the IRS have determined that sections 381(c)(20) and 382(d)(3) and (k)(1) apply to S corporations with respect to disallowed business interest expense carryforwards, the Treasury Department and the IRS continue to consider the extent to which section 382 should apply to S corporations for purposes other than section 163(j). The application of section 382 to S corporations for purposes of section 163(j) should not be construed as creating any inference regarding the application of section 382 to S corporations for other purposes. The Treasury Department and the IRS seek comments regarding the proper integration of these two Code sections and subchapter S of the Code (for example, comments regarding the interaction between sections 382 and 1362(e)(6)(D)).

I. Partnership or S Corporation Not Subject to Section 163(j)

Proposed § 1.163(j)–6(m) would provide guidance regarding partnerships and S corporations not subject to section 163(j). If a partnership or S corporation is not subject to section 163(j) by reason of proposed § 1.163(j)–2(d) (exempt entity), the exempt entity would not be required to perform the business interest expense limitation calculations under proposed §§ 1.163(j)–2(b) and 1.163(j)–6. To the extent a partner or shareholder receives business interest expense from an exempt entity, however, that business interest expense will be subject to the partner or shareholder's own section 163(j) deduction. In the event a partner or shareholder is subject to section 163(j) and the S corporation or partnership is not, the partnership or S corporation shall provide the partner or shareholder with the information necessary to inform the partner or shareholder of the partner or shareholder's share of the partnership or S corporation's business interest expense, business interest income, and items of ATI.

To the extent a partnership or S corporation is not subject to section 163(j) by reason of proposed § 1.163(j)–1(b)(38)(ii) because it has an excepted trade or business (excepted entity), the excepted entity would not have to perform the business interest expense limitation calculations under proposed §§ 1.163(j)–2(b) and 1.163(j)–6 with respect to the business interest expense that is allocated to such electing trade or business. To the extent a partner or shareholder is allocated any section 163(j) item that is allocated to the partnership's excepted trade or business (excepted 163(j) items), such excepted 163(j) items would be excluded from the partner or shareholder's section 163(j) deduction calculation.

In the event a partnership allocates excess business interest expense to one or more of its partners, and in a later taxable year becomes exempt from the requirements of section 163(j)(4), proposed § 1.163(j)–6(l) would provide that the excess business interest expense from the prior taxable years is treated as paid or accrued by the partner in such later taxable year.

7. *Proposed § 1.163(j)–7: Application of Section 163(j) to Foreign Corporations and Their Shareholders*

A. Overview

The Treasury Department and the IRS received comments requesting clarification on whether section 163(j) applies to a controlled foreign corporation (as defined in section 957) (CFC) and, if so, the manner in which it applies.

These proposed regulations would provide the general rule that 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. See proposed § 1.163(j)–7(b)(2). Thus, a CFC with business interest expense would apply section 163(j) to determine the extent to which that expense is deductible for purposes of computing subpart F income as defined under section 952, tested income as defined under section 951A(c)(2)(A), and income which is effectively connected with the conduct of a U.S. trade or business (ECI), as applicable. Additional guidance for a CFC (and other foreign persons) with ECI is provided in proposed § 1.163(j)–8 and discussed in part 8 of this Explanation of Provisions section.

Notwithstanding the general applicability of section 163(j) to CFCs under these proposed regulations, the Treasury Department and the IRS have determined that it is appropriate in certain cases to modify its application. As discussed in part 7(B) and part 7(C) of this Explanation of Provisions section, these proposed regulations would, in certain cases, limit the amount of a CFC's business interest expense subject to the section 163(j) limitation and modify the computation of a CFC's ATI, respectively.

The Treasury Department and the IRS continue to study whether it would be appropriate to provide additional modifications to the application of section 163(j) to CFCs and whether there are particular circumstances in which it may be appropriate to exempt a CFC from the application of section 163(j). The Treasury Department and the IRS request comments on this matter.

B. Computation of Amount of Business Interest Expense Subject to Section 163(j)

The Treasury Department and the IRS are aware that if business interest expense is paid by one CFC to a related CFC, the application of section 163(j) could result in an inappropriate mismatch of a deduction and payee income item. Such mismatch could inappropriately impact the calculation of the tax liability of a United States shareholder, as defined in section 951(b), under section 951A or the GILTI provision. Consider an example where a United States person (USP) wholly owns two CFCs (CFC1 and CFC2), and CFC1 has made a loan to CFC2 with respect to which CFC1 annually accrues $100x of business interest income that is included in CFC1's tested income, and CFC2 pays or accrues $100x of business interest expense, which absent section 163(j), would be fully deductible in computing CFC2's tested income or tested loss, as applicable. Thus, the intercompany business interest income and business interest expense would fully offset one another for purposes of computing USP's inclusion under section 951A(a). To the extent section 163(j) were to disallow a deduction for business interest expense to CFC2 while the business interest income would be included in CFC1's tested income, the amounts would not fully offset, and USP's inclusion under section 951A(a) may be increased solely due to the use of intercompany debt between CFC1 and CFC2.

The Treasury Department and the IRS considered the possibility of completely disregarding all business interest income and business interest expense with respect to intercompany debt between related CFCs for purposes of computing the section 163(j) limitation of the lender CFC and borrower CFC (the disregard approach). However, the disregard approach was rejected because it could cause inappropriate results where, for example, one CFC (CFC finco) borrows from a third party and on-lends the debt proceeds to one or more other CFCs within a group (funded CFCs). Assume for purposes of simplicity that a CFC finco charges interest on loans to the funded CFCs at the same rate that it is charged by the third party. If intercompany business interest income received by CFC finco and business interest expense paid or accrued by the funded CFCs were disregarded in determining each CFC's section 163(j) limitation, then CFC finco would have no business interest income, and all of CFC finco's business interest expense paid to the third party would be subject to the section 163(j) limitation. Furthermore, all of the funded CFCs would have no business interest expense subject to the section 163(j) limitation. This would be the case, even though the funded CFCs have borrowed from CFC finco and have the use of the funds originally borrowed from the third party.

The Treasury Department and the IRS have determined that an approach that better reflects the reality of borrowings by related CFCs is one that takes into account the principle that money is fungible within a group of highly related CFCs (such a group, a "CFC group" and a CFC that is a member of the group, a "CFC group member"). Accordingly, these proposed regulations would provide for an election to apply an alternative method that would limit the amount of business interest expense of a CFC group member subject to the section 163(j) limitation to the amount of the CFC group member's allocable share of the CFC group's applicable net business interest expense. See proposed § 1.163(j)–7(b)(3). The applicable net business interest expense of a CFC group is the excess, if any, of the sum of the amounts of business interest expense of each CFC group member over the sum of the amounts of business interest income of each CFC group member. See proposed § 1.163(j)–7(f)(3). A CFC group member's allocable share is computed by multiplying the applicable net business interest expense of the CFC group by a fraction, the numerator of which is the CFC group member's net business interest expense (computed on a separate company basis), and the denominator of which is the sum of the amounts of the net business interest expense of each CFC group member with net business interest expense (computed on a separate company basis). See proposed § 1.163(j)–7(f)(1).

Thus, if an election is made to apply the alternative method and if a CFC group has only intercompany debt within the CFC group, then the amount of the CFC group's applicable net business interest expense is zero, and no business interest expense of any CFC group member would be subject to the section 163(j) limitation. As a result, for example, there would be no increase in an inclusion under section 951A(a) solely by reason of the use of intercompany debt within a CFC group. On the other hand, if a CFC group has applicable net business interest expense, then, consistent with the principle that money is fungible, each CFC group member that has net business interest expense, computed on a separate company basis, will determine its allocable share of the applicable net business interest expense, and such allocable share is the amount of business interest expense of the CFC group member that is subject to the section 163(j) limitation. Using its allocable share of the CFC group's applicable net business interest expense, a CFC group member computes its section 163(j) limitation on a separate company basis. However, as discussed in part 7(C) of this Explanation of Provisions section, under these proposed regulations, for purposes of computing a CFC's ATI, an upper-tier CFC group member takes into account a proportionate share of the "excess" ATI of a lower-tier CFC group member.

In general, for purposes of these proposed regulations, a CFC group means two or more CFCs, if at least 80 percent of the stock by value of each CFC is owned, within the meaning of section 958(a), by a single U.S. shareholder or, in aggregate, by related U.S. shareholders that own stock of each member in the same proportion. See proposed § 1.163(j)–7(f)(6). For purposes of identifying a CFC group, members of a consolidated group are treated as a single person, as are individuals filing a joint return, and stock owned by certain passthrough entities is treated as owned by the owners or beneficiaries of the passthrough entity. The Treasury Department and the IRS determined that the alternative method is appropriately limited to situations in which a payor CFC and payee CFC have substantially identical ownership by United States shareholders because the alternative is based on the principle that money is fungible. The alternative is based on the principle that money is fungible, but fungibility should only apply in cases of close relationship where borrowings essentially support the entire group. Furthermore, the mismatch of a deduction and a payee income item is most significant when the payee and payor CFC have substantially identical ownership by United States shareholders. These proposed regulations narrow the scope of foreign corporations that are CFCs for this purpose to those foreign corporations in which at a least one United States shareholder owns stock, within the meaning of section 958. These proposed regulations refer to such a CFC as an "applicable CFC." See proposed § 1.163(j)–7(f)(2).

If one or more CFC group members conduct a financial services business, the alternative method is applied by treating those entities as comprising a separate subgroup (such a subgroup, a "financial services subgroup" and such a member, a "financial services subgroup member"). For this purpose, an entity conducts a financial services business if it is an eligible controlled foreign corporation, as defined in section 954(h)(2)(A), is a qualified insurance company, as defined in section 953(e)(3), or is eligible for the dealer exception in computing foreign personal holding company income as described in section 954(c)(2)(C). The Treasury Department and the IRS determined that it is appropriate to apply the alternative method separately for entities that conduct financial services businesses, because those businesses are typically highly leveraged with significant amounts of business interest income and business interest expense and could reasonably be expected to cause distortion if included in the alternative method with other, non-financial services business CFC group members.

These proposed regulations generally treat a controlled partnership (in general, a partnership in which CFC group members own, in aggregate, at least 80 percent of the interests) as a CFC group member and the interest in the controlled partnership is treated as stock. Thus, for example, if a U.S. person wholly owns two applicable CFCs, which each own a 50-percent interest in a partnership, then, if an election is made to apply the alternative method, the partnership will also apply the alternative method. The Treasury Department and the IRS determined that it is appropriate to extend the relief to partnerships that are substantially owned by CFC group members because the principle that money is fungible is not limited to corporate entities. Furthermore, absent such a rule, a partnership could be used to inappropriately exclude an applicable CFC from the CFC group by having the partnership own the applicable CFC.

These proposed regulations exclude from the definition of a CFC group member an applicable CFC that has ECI. Thus, an applicable CFC with ECI may not compute its section 163(j) limitation under the alternative method, and furthermore, the CFC group, and any financial services subgroup, must exclude such CFC from all group-level computations (for example, in determining the amount of the CFC group's applicable net business interest expense). The Treasury Department and the IRS determined that it is appropriate to exclude an applicable CFC with ECI from application of the alternative method so that section 163(j) applies to a CFC with ECI in the same manner as it does to a domestic C corporation. However, although an applicable CFC with ECI cannot use the alternative method, an applicable CFC with ECI is treated as a CFC group member solely for purposes of determining a CFC group. Thus, for example, if an applicable CFC with ECI is wholly owned by an upper-tier CFC and the applicable CFC with ECI wholly owns a lower-tier CFC, the lower-tier CFC may still qualify as a CFC group member.

If not all CFC group members have the same taxable year, then, if the election is made, these proposed regulations require that all group-level computations be made with respect to a majority U.S. shareholder taxable year. See proposed § 1.163(j)–7(f)(11). Thus, if, for example, USP, a domestic corporation with a calendar taxable year, wholly owns two applicable CFCs, one with a calendar year and one with a November 30 fiscal year, then, with respect to USP's 2019 calendar year, the group-level computations must be determined using amounts for the taxable year ending November 30, 2019, for the one applicable CFC, and amounts for the taxable year ending December 31, 2019, for the other applicable CFC.

Finally, these proposed regulations provide rules concerning the election (referred to as a "CFC group election"), including the requirements for making the CFC group election, the manner for making the CFC group election, and the duration of the CFC group election. See proposed § 1.163(j)–7(b)(5). The Treasury Department and the IRS determined that the alternative method should be elective, rather than required, because for certain situations, the general application of section 163(j) may be preferable to taxpayers.

C. Rules for Computing the ATI of an Applicable CFC

Proposed § 1.163(j)–7(c) would provide rules for computing the ATI of an applicable CFC. The principles of § 1.952–2 for determining the CFC's income and deductions or, for CFCs with ECI, the rules of section 882, apply for purposes of computing the CFC's taxable income. See proposed § 1.163(j)–7(c)(1). The Treasury Department and the IRS request comments on the application of the rules under § 1.952–2 for purposes of determining a CFC's taxable income for purposes of section 163(j). In particular, comments are requested as to whether these rules should allow a CFC a deduction, or require a CFC to take into account income, that is expressly limited to domestic corporations under the Code. For example, questions have arisen as to whether a CFC should be allowed a dividends-received deduction under section 245A, even though section 245A by its terms applies only to dividends received by a domestic corporation.

To mitigate potential double-counting of income in ATI, any dividend received by an applicable CFC from a related person is subtracted from the distributee's taxable income for purposes of computing ATI as the dividend represents income that could be part of the distributing corporation's ATI. See proposed § 1.163(j)–7(c)(2).

If a CFC group election is in effect with respect to a CFC group, then an upper-tier CFC group member takes into account a proportionate share of the "excess" ATI (referred to in these proposed regulations as "CFC excess taxable income") of each lower-tier member in which it directly owns stock for purposes of computing the upper-tier member's ATI. See proposed § 1.163(j)–7(c)(3). The meaning of the term CFC excess taxable income is analogous to the meaning of the term "excess taxable income" in the context of a partnership and S corporation, and, in general, means the amount of a CFC group member's ATI in excess of the amount needed before there would be disallowed business interest expense. See proposed § 1.163(j)–7(f)(5). A CFC group member that is a partnership does not have CFC excess taxable income because under the statute and proposed § 1.163(j)–6, the partnership has excess taxable income and such excess taxable income is allocated to the partners of the partnership. For a discussion of the computation of a partnership's excess taxable income and the treatment of a partner's distributive share of any such excess taxable income, see the discussion in part 6 of this Explanation of Provisions section.

The process of computing and "rolling up" CFC excess taxable income among CFC group members for purposes of computing ATI of each of the CFC group members begins with a lowest-tier member and continues through the chain of ownership to a highest-tier member of the CFC group (referred to in these proposed regulations as a "specified highest-tier member"). Thus, a lowest-tier member computes its section 163(j) limitation, and if the lowest-tier member has CFC excess taxable income, the CFC excess taxable income is taken into account proportionately by one or more higher-tier members that directly own stock of the lower-tier member for purposes of computing ATI; and, if such a higher-tier member has CFC excess taxable income, such CFC excess taxable income is taken into account by a next higher-tier member, and so forth.

A higher-tier member that is a partnership may take into account a pro rata share of the CFC excess taxable income of a lower-tier member, other than a partnership, which does not have CFC excess taxable income, for purposes of computing the higher-tier member partnership's ATI and determining if the higher-tier member partnership has excess taxable income that may be allocated to CFC group members that are partners.

D. Rules for Computing ATI of a United States Shareholder

i. General Rules

In general, a United States shareholder that owns, within the meaning of section 958(a), stock of a CFC is required to include in its gross income each year its pro rata share of the CFC's subpart F income, and investments in U.S. property, as defined in section 956. In addition, a United States shareholder that owns stock of a CFC is required to include in its gross income for each year its GILTI. Thus, these income inclusions are included in the United States shareholder's taxable income, and absent an exercise of regulatory authority, would be included in ATI.

To avoid double counting of the taxable income of a CFC already taken into account to determine the CFC's section 163(j) limitation, proposed § 1.163(j)–7(d)(1)(i) would provide the general rule (the double counting rule) that the ATI of a United States shareholder is computed without regard to any amounts included in gross income under sections 78, 951(a), and 951A(a) that are properly allocable to a non-excepted trade or business of the United States shareholder (each amount, a "specified deemed inclusion" and such amounts, collectively "specified deemed inclusions") and any deduction allowable under section 250(a)(1)(B), without regard to the taxable income limitation in section 250(a)(2), by reason of a specified deemed inclusion (such a deduction, a "specified section 250 deduction").

To the extent a United States shareholder includes amounts in gross income under section 78, 951(a), or 951A(a) that are not properly allocable to a non-excepted trade or business, for example, because such amounts are treated as investment income, within the meaning of section 163(d), of the United States shareholder, then such amounts are not included in ATI (see proposed § 1.163(j)–1(b)(1)(ii)(F)). Thus, for example, if a United States shareholder that is a domestic partnership includes amounts in gross income under section 951(a) or 951A(a) that are treated as investment income with respect to the domestic partnership and therefore are not properly allocable to a trade or business, then such amounts are not included in the ATI of the domestic partnership. However, absent a special rule, to the extent such income inclusions are taken into account as a distributive share of a C corporation partner, the income inclusions would be included in the ATI of the C corporation partner (see proposed § 1.163(j)–4(b)(3)). This result would be contrary to the purpose of the double counting rule. Accordingly, to prevent income inclusions under sections 951(a) and 951A(a) that are treated as investment income with respect to a domestic partnership from being included in the ATI of a corporate partner, these proposed regulations provide that a C corporation partner may not treat such amounts as properly allocable to a trade or business of the C corporation partner. See proposed § 1.163(j)–7(d)(1)(ii).

ii. Rules for a United States Shareholder of a CFC group Member with a CFC Group Election in Effect

If a United States shareholder owns directly or indirectly through one or more foreign partnerships stock of a CFC group member that is a specified highest-tier member for which a CFC group election is in effect, and the specified highest-tier member has CFC excess taxable income that is treated as being attributable to taxable income of the CFC group that resulted in the United States shareholder having specified income inclusions, the United States shareholder may add to its taxable income an amount equal to its proportionate share of the "eligible" CFC excess taxable income of the specified highest-tier member and any other highest-tier members (the addback rule). See proposed § 1.163(j)–7(d)(2). However, the addition to taxable income under the addback rule is limited to the portion of the specified deemed inclusions, all of which are subtracted from taxable income of any United States shareholder under the double-counting rule, that is with respect to CFC group members, reduced by the portion of any specified section 250 deduction that is allowable by reason of such specified deemed inclusions. These proposed regulations refer to the portion described in the preceding sentence as "CFC group inclusions" (see proposed § 1.163(j)–7(d)(2)(iii)). Furthermore, the limitation is computed without regard to amounts included in gross income by reason of section 78 with respect to CFC group members. This result is appropriate because section 78 requires a deemed inclusion only in order to carry out the purposes of the foreign tax credit provisions.

To determine the amount of "eligible" CFC excess taxable income (ETI) of a specified highest-tier member (defined under proposed § 1.163(j)–7(d)(2)(ii) as "eligible CFC group ETI"), the CFC excess taxable income is multiplied by the specified ETI ratio. The specified ETI ratio is a fraction (expressed as a percentage) that compares the amounts of taxable income of each specified highest-tier member and each specified lower-tier member of the specified highest-tier member to the portions of such taxable income that gave rise to inclusions under section 951(a) or 951A(a). The specified ETI ratio includes in the numerator and the denominator of the fraction only taxable income amounts with respect to CFC group members that have CFC excess taxable income without regard to the "roll up" of CFC excess taxable income from a lower-tier member. See proposed § 1.163(j)–7(f)(14). The purpose of the specified ETI ratio is to address the fact that within the CFC group, income of a lower-tier member CFC that is neither subpart F income nor tested income to the extent of GILTI is included in CFC excess taxable income and may be used by an upper-tier CFC group member. It would be distortive for a United States shareholder to obtain an increase in ATI in respect of such income because this income is not taxed in the United States. The specified ETI ratio is intended to provide an estimate of the portion of CFC excess taxable income attributable to this income. The Treasury Department and the IRS determined that this formulaic approach is superior to a tracing approach, because a tracing approach would increase complexity and therefore also generally increase administrative and compliance burdens.

If a United States shareholder of a CFC group member with a CFC group election in effect is a domestic partnership (a U.S. shareholder partnership), the addback rule does not apply to determine the ATI of the U.S. shareholder partnership. See proposed § 1.163(j)–7(d)(3). This is because the Treasury Department and the IRS are of the view that if a U.S. shareholder partnership includes amounts in gross income under section 951(a) or 951A(a) with respect to stock of a CFC group member, then such amounts will, in virtually all fact patterns, be treated as investment income with respect to the partnership, and therefore interest expense of the partnership that is allocable to stock of a CFC group member will be treated as investment interest expense that is not subject to section 163(j) at the partnership-level. In this case, however, if a U.S. shareholder partnership has a domestic C corporation partner (a U.S. corporate partner), the addback rule is applied, with certain modifications, to the U.S. corporate partner for purposes of computing the U.S. corporate partner's ATI. In particular, for purposes of computing the amount of the addition to taxable income of the U.S. corporate partner allowed under the addback rule, the addback rule is modified to provide that the U.S. corporate partner takes into account not only its own specified deemed inclusions with respect to stock of a CFC group member, but for this purpose also its distributive share, if any, of amounts included in gross income under section 951(a) or 951A(a) of the U.S. shareholder partnership with respect to stock of a CFC group member. In addition, the addback rule is modified to provide that for purposes of determining a U.S. corporate partner's pro rata share of eligible CFC excess taxable income of a specified highest-tier member, the U.S. shareholder partnership is treated as if it were a foreign partnership.

E. Effect on Earnings and Profits

Under proposed § 1.163(j)–7(e), and consistent with the rules in proposed § 1.163(j)–4(c), the disallowance and carryforward of a deduction for a foreign corporation's business interest expense does not affect whether and when such business interest expense reduces the corporation's earnings and profits. For example, in the case of a passive foreign investment company (PFIC), the disallowance and carryforward of a deduction will not impact the amount of inclusions of earnings under section 1293 if the PFIC is treated as a qualified electing fund. Similarly, the disallowance and carryforward of a deduction for an applicable CFC's business interest expense will not affect the limitation of subpart F income to earnings and profits under section 952(c).

8. *Proposed § 1.163(j)–8: Application of Section 163(j) to Foreign Persons with Effectively Connected Income*

In general, unlike U.S. citizens or residents that are subject to U.S. tax on their worldwide income, a nonresident alien individual or foreign corporation is subject to net basis income taxation only with respect to its income that is or is treated as effectively connected with a trade or business (ECI) conducted in the United States as provided under section 872 or 882. Deductions are allowed only to the extent that they are connected with such income. In certain circumstances, the tax liability may be reduced or eliminated by the provisions of an income tax treaty entered into by the United States with a foreign country. While a nonresident alien individual or foreign corporation that is not an applicable CFC (hereafter a non-CFC FC) that has ECI is still subject to section 163(j) and the section 163(j) regulations, the rules need to be modified since these foreign persons are only taxed on their ECI. Accordingly, the definitions for ATI, business interest expense, business interest income, and floor plan financing interest expense in § 1.163(j)–1 are modified to limit such amounts to income which is effectively connected income and expenses properly allocable to effectively connected income. See proposed § 1.163(j)–8(b).

As discussed in part 6 of this Explanation of Provisions section, section 163(j)(4) provides that in the case of a partnership, section 163(j) is applied at the partnership level. The partner's ATI is increased by the partnership's excess taxable income, and the partnership's excess business interest expense is allocated to the partner as disallowed business interest expense carryforward that can be deducted when the partners are allocated excess taxable income from the partnership, but only to the extent of such excess. Pursuant to section 163(j)(8)(B), which permits adjustments to the computation of ATI, a nonresident alien individual or non-CFC FC that is a partner in a partnership that is engaged in a U.S. trade or business modifies the application of the general allocation rules in § 1.163(j)–6 with respect to excess taxable income, excess business interest expense, and excess business interest income of the partnership to take into account the limitation of such foreign person's liability for U.S. tax to its ECI. The excess amounts of the partnership, therefore, can be used by the nonresident alien individual or non-CFC FC only to the extent of the partnership's income that would be effectively connected income with respect to the foreign partner. The amount of excess taxable income and excess business interest expense that can be used by such partner is determined by multiplying the amount of the excess taxable income or the excess business interest allocated under § 1.163(j)–6 by a ratio equal to the ATI of the partnership, with the adjustments described previously to limit such amount to only effectively connected income or expense items, over the ATI of the partnership determined under § 1.163(j)–6(d). The amount of excess business interest income that can be used by such partner is limited to ECI business interest income over allocable ECI business interest expense. See proposed § 1.163(j)–8(c).

Proposed § 1.163(j)–8(e) would also include rules coordinating section 163(j) and § 1.882–5. Section 1.882–5 provides rules for determining the amount of a foreign corporation's interest expense that is allocable under section 882(c) to ECI. These proposed regulations require that a foreign corporation that has ECI must first determine its business interest expense allocable to ECI under § 1.882–5 before applying section 163(j). The foreign corporation then applies section 163(j) to its business interest expense to determine if any of that business interest expense is disallowed business interest expense. If the foreign corporation is also a partner in a partnership that has ECI, the foreign corporation must back out that portion of the business interest expense determined under § 1.882–5 which is deemed to have come from the partnership as such business interest expense has already been subject to section 163(j) at the partnership level and the foreign corporation is then left with only the non-partnership business interest expense. If the partnership also had disallowed business interest expense, a portion of the partnership-level interest expense that was backed out of the amount determined under § 1.882–5 will also be disallowed business interest expense. Disallowed business interest expense determined at either the partner-level or partnership level, as appropriate, will not be taken into account for the purpose of determining interest expense under § 1.882–5 in subsequent tax years, but rather will be subject to the limitations of section 163(j).

As provided in proposed § 1.163(j)–8(d), an applicable CFC (as defined in proposed § 1.163(j)–8(g)(1)) that has ECI must first apply the general rules of section 163(j) and the section 163(j) regulations, pursuant to § 1.163(j)–7(b)(2), to determine how section 163(j) applies to the applicable CFC. If, after applying section 163(j) and the section 163(j) regulations, the applicable CFC has disallowed business interest expense, the applicable CFC then must apportion a part of its disallowed business interest expense to interest expense allocable to effectively connected income as determined under § 1.882–5.

These proposed regulations also provide that disallowed business interest expense and disallowed business interest expense carryforwards will not affect the determination of effectively connected earnings and profits or U.S. net equity for purposes of the branch profits tax under section 884. These rules are consistent with the general principles of these proposed regulations with respect to earnings and profits. See proposed §§ 1.163(j)–4(c) and 1.163(j)–8(f).

9. *Proposed § 1.163(j)–9: Elections for Excepted Trades or Businesses; Safe Harbor for Certain REITs*

A. Election Procedure

Proposed § 1.163(j)–9 would provide guidance relating to the election to be treated as an excepted trade or business for real property or farming trades or businesses. These proposed regulations clarify that an election is made for a particular trade or business, not necessarily for a particular entity, and would apply for the taxable year that the election is made and all subsequent years.

Proposed § 1.163(j)–9 would provide the time and manner in which to make the election. Taxpayers making the election should attach an election statement to their timely filed original Federal income tax return, including extensions. The statement should include basic information of the taxpayer and the electing trade or business. Where a taxpayer has multiple trades or businesses that may be eligible for the election, an election must be made for each trade or business, and the election statement must specify or describe the different electing trades or businesses. The election statement is necessary in order for taxpayers and for the IRS to identify each electing trade or business. The Treasury Department and the IRS request comments on whether the information required to be included in the statement is sufficient, or whether additional information should be included to reduce any potential audit controversy.

Because the election applies to the particular trade or business, the election generally terminates automatically if the taxpayer ceases to exist, or ceases the operation of the electing trade or business. However, these proposed regulations would also provide that where a taxpayer transfers all of the assets of an electing trade or business to a related party, the election does not terminate for that trade or business, and transfers to the related party. The purpose of this rule is to disregard a transaction that purports to be a termination or cessation of a trade or business, but is merely a change in the form of conducting the trade or business where the taxpayer (through a related party) retains a relationship to such trade or business. For this purpose, a related party means any person who bears a relationship to the taxpayer which is described in section 267(b) or 707(b)(1). Additional guidance may be provided detailing transactions in which an election might terminate.

Additionally, these proposed regulations would contain an anti-abuse rule to prevent a situation where the taxpayer attempts to terminate the election through a transfer of the assets in the trade or business, but with the intent of resuming a trade or business of a similar nature. These proposed regulations would provide that if a taxpayer re-acquires substantially all of the assets used in the trade or business, or substantially similar assets, and resumes conducting such prior trade or business within 60 months of ceasing the trade or business, the election will be revived with the resumed trade or business.

The Treasury Department and the IRS request comments on the method by which certain taxpayers can make the election under section 163(j)(7)(B) or (C), and the types of transactions in which the election should terminate.

B. Safe Harbor for Certain REITs

Proposed § 1.163(j)–9(g) provides a special safe harbor for REITs. For REITs that take advantage of this safe harbor, the rules applicable to REITs are substantially similar to the general rules provided for other taxpayers. However, these proposed regulations provide certain modifications to take into account the existing rules governing REIT taxation.

If a REIT holds real property, interests in partnerships holding real property, or shares in other REITs holding real property, the safe harbor provides that the REIT is eligible to make an election to be an electing real property trade or business for all or part of its assets. For this purpose, the term "real property" is defined consistently with the definition of real property under section 856, rather than the more restrictive definition set forth under the proposed section 469 regulations.

The term "real property trade or business" in section 469(c)(7)(C) does not include real property financing and, for purposes of the section 163(j) regulations, any assets used in a real property financing trade or business are generally allocated to a non-excepted trade or business. Under proposed § 1.163(j)–9(g), REIT real property financing assets include mortgages, guaranteed mortgage pass-thru certificates, real estate mortgage investment conduit (REMIC) regular interests, and debt instruments issued by publicly offered REITs.

If a REIT makes an election to be an electing real property trade or business, and the value of the REIT's real property financing assets is 10 percent or less of the value of the REIT's total assets, then, under the safe harbor, all of the REIT's assets are treated as assets of an excepted trade or business. This determination is based on the same values used for the REIT asset test under section 856(c)(4) as of the close of the REIT's taxable year. If a REIT makes an election to be an electing real property trade or business, and the value of a REIT's real property financing assets is more than 10 percent of the value of the REIT's total assets, then, under the safe harbor, the REIT's business interest income, business interest expense, and other items of expense and gross income are allocated between excepted and non-excepted trades or businesses under the rules set forth in proposed § 1.163(j)–10, as modified by proposed § 1.163(j)–9(g)(4).

For purposes of valuing a REIT's assets, REIT real property financing assets also include partnership assets that a REIT is deemed to hold under § 1.856–3(g) and the portion of a REIT's interest in another REIT attributable to that other REIT's real property financing assets. The Treasury Department and the IRS request comments on whether the list of real property financing assets in these proposed regulations includes all direct and indirect investments that REITs make to finance real property.

Under the safe harbor, the definition of real property under § 1.856–10 applies to determine whether the assets of a REIT are properly allocable to an excepted trade or business. If a REIT holds an interest in a partnership, in applying the partnership look-through rule described in proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*), the REIT also applies this definition of real property to determine whether the partnership's assets are allocable to an excepted trade or business.

Under section 856(c)(5)(B), shares in other REITs qualify as real estate assets without regard to the portion of the REIT owned. Under the safe harbor, if a REIT (shareholder REIT) owns shares in another REIT and all of the other REIT's assets are treated as assets of an excepted trade or business, then all of shareholder REIT's adjusted basis in the shares of the other REIT is properly allocable to an excepted trade or business of shareholder REIT. If this is not the case, the safe harbor provides that shareholder REIT applies the partnership look-through rule described in proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*) (as if the other REIT were a partnership) in determining the extent to which shareholder REIT's adjusted basis in the shares of the other REIT is properly allocable to an excepted trade or business of shareholder REIT. If shareholder REIT does not receive the information from the other REIT that is necessary to apply the look-through rule, then shareholder REIT's shares of the other REIT are properly allocable to a non-excepted trade or business of shareholder REIT.

C. Anti-abuse Rule for Certain Real Property Trades or Businesses

The Treasury Department and the IRS have determined that it would be inappropriate to allow an election to be an excepted real property trade or business for a trade or business that leases substantially all of its real property to the owner of the real property trade or business, or to a related party of the owner. To permit such an election would encourage a taxpayer to enter into non-economic structures where the real estate components of non-real estate businesses are separated from the rest of such businesses in order to artificially reduce the application of section 163(j) by leasing the real property to the taxpayer or a related party of the taxpayer and electing for this "business" to be an excepted real property trade or business. As a result, these proposed regulations would also contain an anti-abuse rule. If at least 80 percent of the business's real property, determined by fair market value, is leased to a trade or business under common control with the real property trade or business, the trade or business will not be eligible for the election. Common control in this case means that 50 percent of the direct and indirect ownership interests in both businesses are held by related parties within the meaning of sections 267(b) and 707(b). REITs that lease qualified lodging facilities, as defined in section 856(d)(9)(D), and qualified healthcare properties, as defined in section 856(e)(6)(D), are generally permitted pursuant to section 856(d)(8)(B) to lease these properties to a taxable REIT subsidiary; thus, this anti-abuse rule does not apply to these types of REITs. The Treasury Department and the IRS request comments on whether other exceptions to the anti-abuse rule (such as, for example, an exception for certain fact patterns where real property that is leased from a related party is ultimately sub-leased to a third party) would be appropriate.

10. *Proposed § 1.163(j)–10: Allocation of Expense and Income to an Excepted Trade or Business*

As provided in section 163(j)(7) and proposed § 1.163(j)–2, certain trades or businesses are excepted from the application of section 163(j), including electing real property trades or businesses, electing farming businesses, regulated utility trades or businesses, and the trade or business of performing services as an employee. Section 1.163(j)–10 would provide rules for determining the amount of a taxpayer's interest expense, interest income, and other tax items that is properly allocable to excepted and non-excepted trades or businesses for purposes of section 163(j). It is not necessary for a taxpayer to undertake any allocations under proposed § 1.163(j)–10 if all of the taxpayer's items are properly allocable to non-excepted trades or businesses, or if all of the taxpayer's items are properly allocable to excepted trades or businesses.

Proposed § 1.163(j)–10(a) would provide an overview of the section and certain general rules, including rules regarding the application of the allocation rules to members of a consolidated group. Proposed § 1.163(j)–10(b) would provide rules regarding the allocation of tax items other than interest expense and interest income between excepted and non-excepted trades or businesses. Proposed § 1.163(j)–10(c) would provide the general method of allocating interest expense and interest income between excepted and non-excepted trades or businesses using asset basis, as well as various special rules that would apply under this general method. Proposed § 1.163(j)–10(d) would describe several limited situations in which tracing rather than asset-based allocation is required.

Organizations subject to tax under section 511 are required to compute their unrelated business taxable income separately with respect to each trade or business, resulting in a more granular allocation than is required for purposes of the section 163(j) regulations. Accordingly, proposed § 1.163(j)–10(a)(5) would provide that such organizations would apply the allocation rules under section 512 and the regulations thereunder in determining whether items of income or expense are allocable to an excepted trade or business. The Treasury Department and the IRS request comments as to whether additional guidance is needed regarding the allocation of income and expenses of an organization subject to tax under section 511 to an excepted trade or business for purposes of section 163(j).

A. Proposed § 1.163(j)–10(a): Overview

Before applying the allocation rules in proposed § 1.163(j)–10, a taxpayer first must determine whether any interest paid or accrued is properly allocable to a trade or business. If so, and if the taxpayer does not qualify for the small business exemption under section 163(j)(3) and proposed § 1.163(j)–2, the taxpayer must apply the allocation rules of proposed § 1.163(j)–10 if the taxpayer has tax items from both excepted and non-excepted trades or businesses. The taxpayer must do so in order to determine the amount of interest expense that is business interest expense subject to limitation under section 163(j) and to determine which items are included or excluded in computing its section 163(j) limitation.

For purposes of the allocation rules in proposed § 1.163(j)–10, a taxpayer's activities are not treated as a trade or business if those activities do not involve the provision of services or products to a person other than the taxpayer. For example, if a taxpayer engaged in a manufacturing trade or business has in-house legal personnel that provide legal services solely to the taxpayer, the taxpayer is not treated as also engaged in the trade or business of providing legal services.

Additionally, for purposes of the allocation rules in proposed § 1.163(j)–10, a consolidated group would be treated as a single corporation. Thus, stock of a member that is owned by another member of the same group would not be treated as an asset for purposes of proposed § 1.163(j)–10, and the transfer of member stock to a non-member would be treated by the group as the transfer of the member's assets. Additionally, the group, rather than a particular member, would be treated as engaged in excepted or non-excepted trades or businesses. Intercompany obligations issued by a member borrower would not be considered an asset of the creditor member for purposes of allocating asset basis between excepted and non-excepted trades or businesses. Moreover, intercompany transactions would be disregarded for purposes of proposed § 1.163(j)–10, along with the resulting offsetting items.

The Treasury Department and the IRS have determined that this approach to consolidated groups is necessary for purposes of proposed § 1.163(j)–10 because a particular trade or business may be conducted by multiple group members that also are engaged in other trades or businesses. Under these proposed regulations, the distinction between excepted and non-excepted trades or businesses applies at the level of the trade or business, not at the level of the group member; thus, the allocation rules in this section apply without regard to which member conducts a trade or business or possesses assets used in a trade or business.

The Treasury Department and the IRS considered an approach to the allocation rules in proposed § 1.163(j)–10 that would have taken into account intercompany transactions between consolidated group members engaged in excepted trades or businesses and members engaged in non-excepted trades or businesses. However, this approach would have resulted in different treatment for consolidated groups in which each member conducts a single trade or business and consolidated groups in which a single member engages in multiple trades or businesses. Moreover, if intercompany transactions were taken into account for purposes of proposed § 1.163(j)–10, then taxpayers potentially could increase the amount of interest allocable to an excepted trade or business or increase their section 163(j) limitation by engaging in intercompany transactions. Thus, the Treasury Department and the IRS have determined that intercompany transactions should be disregarded for purposes of proposed § 1.163(j)–10.

After a consolidated group has determined the percentage of the group's interest expense that is allocable to an excepted trade or business and thus is not subject to limitation under section 163(j), this exempt percentage would be applied proportionally to each member that has paid or accrued interest to a person other than a group member during the taxable year. Thus, in general, each member with interest paid or accrued to a lender that is not a group member will have the same percentage of interest allocable to excepted trades or businesses, regardless of whether any particular member actually engaged in an excepted trade or business. For rules regarding the deduction of interest expense paid or accrued by group members, see the discussion of proposed § 1.163(j)–5(b) in part 5 of this Explanation of Provisions section.

B. Proposed § 1.163(j)–10(b): Allocating Tax Items Other Than Interest Income and Interest Expense

In general, gross income other than dividends and interest income would be allocated to the trade or business that generated such gross income. The Treasury Department and the IRS request comments regarding this method of allocating items of income other than dividends and interest, including comments as to how this rule should be expanded or clarified.

With regard to dividend income, the Treasury Department and the IRS have determined that, if a taxpayer's ownership interest in a corporation equals or exceeds a certain threshold, the taxpayer generally should look through to the business activities of the corporation that paid the dividend. More specifically, if a taxpayer owns at least 80 percent of the stock of a domestic C corporation or a CFC (by vote and value; see section 1504(a)(2)) that is not eligible for the small business exemption under section 163(j)(3) and proposed § 1.163(j)–2(d)(1), then the taxpayer's dividend income would be treated as allocable to excepted or non-excepted trades or businesses based upon the relative amounts of the payor corporation's adjusted basis in the assets used in such trades or businesses. Additionally, if at least 90 percent of the payor corporation's adjusted basis in its assets is allocable to either excepted trades or businesses or non-excepted trades or businesses, then all of the taxpayer's dividend income from such corporation for the taxable year would be treated as allocable to either excepted or non-excepted trades or businesses, respectively.

If a shareholder in an S corporation looks through to the S corporation's basis in its assets for purposes of the basis allocation rules in proposed § 1.163(j)–10(c), the shareholder also would be required to look through to the S corporation's basis in its assets for purposes of characterizing any dividends received from the S corporation.

If a taxpayer receives a dividend that is not investment income, and if the dividend look-through rule is inapplicable to the taxpayer, then the taxpayer would treat the dividend income as allocable to a non-excepted trade or business. The Treasury Department and the IRS request comments on this proposed rule, including whether taxpayers that are C corporations or tax-exempt corporations should treat dividend income as allocable to a non-excepted trade or business if they fail to meet the minimum ownership threshold for dividends from domestic C corporations and CFCs.

With regard to dispositions of stock in a corporation or interests in a partnership, if a taxpayer recognizes gain or loss upon the disposition of stock in a non-consolidated C corporation that is not property held for investment, within the meaning of section 163(d)(5), and if the taxpayer looks through to the corporation's basis in its assets for purposes of the basis allocation rules in proposed § 1.163(j)–10(c), then the taxpayer would allocate the gain or loss to excepted or non-excepted trades or businesses based upon the relative amounts of the corporation's adjusted basis in the assets used in its trades or businesses, determined pursuant to proposed § 1.163(j)–10(c). If the taxpayer does not look through to the corporation's basis in its assets, the taxpayer would treat the gain or loss as allocable to a non-excepted trade or business. If a taxpayer recognizes gain or loss upon the disposition of interests in a partnership or stock in an S corporation that owns (1) non-excepted assets and excepted assets, (2) investment assets, or (3) both, the taxpayer would determine the proportionate share of the amount of basis properly allocable to a non-excepted trade or business in accordance with the allocation rules set forth in proposed § 1.163(j)–10(c)(5)(ii)(A) or proposed § 1.163(j)–10(c)(5)(ii)(B)(*3*), as appropriate, and include such proportionate amount of gain or loss in the taxpayer's ATI.

With regard to expenses, losses, and deductions other than interest, any such items that are definitely related to a trade or business, within the meaning of § 1.861–8(b), would be allocable to that trade or business. All other expenses would be ratably apportioned to gross income. The Treasury Department and the IRS request comments on this proposed method of allocating expenses other than interest expense, including whether this proposed rule should incorporate any of the special allocation rules in § 1.861–8(e).

C. Proposed § 1.163(j)–10(c): Allocating Interest Expense and Interest Income

Proposed § 1.163(j)–10(c) would set forth the general rule for allocating interest expense and interest income between excepted and non-excepted trades or businesses. Under this general rule, interest expense and interest income would be allocated between excepted and non-excepted trades or businesses based upon the relative amounts of the taxpayer's adjusted basis in the assets used in its excepted and non-excepted trades or businesses. This general method of allocation reflects the fact that money is fungible and the view that interest expense is attributable to all activities and property, regardless of any specific purpose for incurring an obligation on which interest is paid.

Under proposed § 1.163(j)–10(c), a taxpayer would determine the adjusted basis in its assets on a quarterly basis (each such quarterly period, a "determination period") and average those amounts to determine the relative amounts of asset basis for its excepted and non-excepted trades or businesses for a taxable year. The Treasury Department and the IRS request comments on the frequency of asset basis determinations required under proposed § 1.163(j)–10(c).

Proposed § 1.163(j)–10(c)(1) contains a general de minimis rule. Under this rule, if at least 90 percent of a taxpayer's basis in its assets for the taxable year is allocable to either excepted or non-excepted trades or businesses, determined under proposed § 1.163(j)–10(c), then all of the taxpayer's interest expense and interest income for that year that is properly allocable to a trade or business would be treated as allocable to excepted or non-excepted trades or businesses, respectively. The Treasury Department and the IRS request comments as to whether the application of this de minimis rule should be elective.

If an asset is used in more than one trade or business during a determination period, the taxpayer's basis in such asset would be allocated to each trade or business using the permissible methodology (see the following paragraph) that most reasonably reflects the use of the asset in each trade or business during the determination period. An allocation methodology most reasonably reflects the use of the asset in each trade or business if the methodology most properly reflects the proportionate benefit derived from the use of the asset in each trade or business.

Proposed § 1.163(j)–10(c) would provide several permissible methodologies for allocating basis in an asset used in more than one trade or business during a determination period, including the following: the relative amounts of gross income that an asset generates, has generated, or may reasonably be expected to generate with respect to the trades or businesses; the relative amounts of physical space used by each trade or business if the asset is land or an inherently permanent structure; and the relative amounts of output of each trade or business if each trade or business generates the same unit of output. The choice of method would be subject to de minimis exceptions, and taxpayers generally would not be permitted to vary their allocation methodology across determination periods within a taxable year or from one year to the next. Additionally, if none of the permissible methodologies reasonably reflects the use of an asset in each trade or business, the taxpayer's basis in the asset would not be taken into account for purposes of proposed § 1.163(j)–10(c). The Treasury Department and the IRS request comments on these proposed methods of allocating basis in an asset used in more than one trade or business.

Proposed § 1.163(j)–10(c)(3)(iii) would provide that for utility trades or businesses, the only permissible method for allocating asset basis between excepted and non-excepted utility activities is the relative amounts of output of the trades or businesses. For example, if an asset is used to furnish or sell electric energy, and a portion of the energy is sold to wholesale customers where rates are not set on a cost of service and rate of return basis while the remaining portion is sold at a rate established by a ratemaking body described in proposed § 1.163(j)–1(b)(13), the taxpayer must allocate the basis in the asset between the taxpayer's excepted and non-excepted trades or businesses. The Treasury Department and the IRS believe that other methods listed in proposed § 1.163(j)–10(c) that do not take into account the relative amounts of regulated and unregulated utility activities do not properly reflect the proportionate benefit derived from the use of the asset in each trade or business. The Treasury Department and the IRS request comments on this allocation methodology, including whether another methodology would more accurately reflect the extent to which a trade or business is an excepted utility business for this purpose.

These proposed regulations also would provide a de minimis rule for utility trades or businesses. Under the proposed de minimis rule, if more than 90 percent of the output of a trade or business is sold at rates described in the exception for regulated utility trades or businesses, the taxpayer would treat the entire trade or business as an excepted trade or business. The Treasury Department and the IRS request comments with respect to the de minimis rule for assets used in a utility trade or business, including whether another percentage threshold with respect to the de minimis rule would be more appropriate.

The allocation of asset basis between excepted and non-excepted trades or businesses under proposed § 1.163(j)–10(c) would be subject to numerous additional special rules. First, a taxpayer's adjusted basis in tangible depreciable property other than inherently permanent structures for which a deduction is allowable under section 167 would be determined using the alternative depreciation system under section 168(g). Additional first year depreciation, for example under section 168(k), would not be taken into account for purposes of the basis allocation rule in proposed § 1.163(j)–10(c) due to the distortive effects that such depreciation would have upon the relative adjusted basis of assets. Further, a taxpayer's adjusted basis in tangible depreciable property other than inherently permanent structures for which a deduction is allowable under section 168 of the 1954 Code (former section 168) would be determined using the taxpayer's method of computing depreciation for the property under former section 168. Additionally, a taxpayer's adjusted basis in any intangible asset with respect to which a deduction is allowable under section 167 or section 197 would be determined in accordance with section 167 or section 197, as applicable. Self-created intangibles would not be taken into account for purposes of the allocation rules in proposed § 1.163(j)–10(c). The Treasury Department and the IRS request comments on these proposed rules regarding asset basis in depreciable property, including whether taxpayers should be permitted to use other methods of depreciation, such as the general depreciation system under section 168(a), for purposes of proposed § 1.163(j)–10(c).

Second, the adjusted basis of any asset that is land, including nondepreciable improvements to land, or an inherently permanent structure used in a trade or business generally would be its unadjusted basis rather than its adjusted basis. This special rule, which would not apply to land or inherently permanent structures that fall within the special rule described in the following paragraph, is intended to provide taxpayers with a readily ascertainable figure that better reflects the relative underlying value of this limited class of assets—which, in some cases, are held for many years—than adjusted basis. The Treasury Department and the IRS request comments regarding this approach to allocating basis to land and inherently permanent structures, including whether this rule should be elective, and whether taxpayers should be able to use fair market value rather than acquisition basis for land or inherently permanent structures used in a trade or business.

Third, assets that have been acquired or that are under development but that are not yet used in a trade or business would not be taken into account for purposes of proposed § 1.163(j)–10(c). Such assets would include (but would not be limited to) construction works in progress, such as buildings, airplanes, or ships, prior to their completion, and land that was acquired by a taxpayer for construction of a building by the taxpayer to be used in a trade or business if the building is not yet placed in service. This rule would not apply to stock in a corporation or interests in a partnership. The Treasury Department and the IRS request comments on this special rule, including whether and to what extent exceptions are needed (for example, with respect to start-up businesses).

Fourth, trusts required by law to fund specific liabilities (for example, pension trusts and plant decommissioning trusts) would not be taken into account for purposes of proposed § 1.163(j)–10(c).

Fifth, taxpayers generally would be permitted to look through their interests in partnerships or S corporations, and taxpayers that satisfy a minimum ownership threshold in non-consolidated domestic C corporations and CFCs would be required to look through their interests in such corporations, in determining the extent to which their basis in a partnership interest or corporate stock is allocable to excepted or non-excepted trades or businesses. For domestic C corporations and CFCs, the minimum ownership threshold would be 80 percent by vote and value (see section 1504(a)(2)). Partners that own 80 percent or more of the capital or profits interests in a partnership, and shareholders that own 80 percent or more of S corporation stock by vote and value, generally would be required, rather than merely permitted, to look through their interests in the partnership or S corporation for this purpose.

These look-through rules would not apply to a taxpayer with an interest in a partnership or non-consolidated subsidiary that is eligible for the small business exemption under section 163(j)(3) and proposed § 1.163(j)–2(d)(1). The Treasury Department and the IRS have determined that the look-through rules should not be available in these cases because of the administrative burden that would be imposed on small businesses from collecting and providing information to their shareholders or partners regarding inside asset basis when those small businesses are themselves exempt from the application of section 163(j). The Treasury Department and the IRS also have determined that small businesses that are exempt under section 163(j)(3) and proposed § 1.163(j)–2(d)(1) may not make an election under proposed § 1.163(j)–9.

If a taxpayer does not look through a C corporation for purposes of the allocation rules in § 1.163(j)–10(c), and if the taxpayer is not a C corporation or tax-exempt corporation, the taxpayer generally would treat its basis in the stock as an asset held for investment; if the taxpayer is a C corporation or tax-exempt corporation, the taxpayer would treat its entire basis in the C corporation stock as allocable to a non-excepted trade or business. If a taxpayer does not look through a partnership or S corporation, and if the taxpayer is not a C corporation or tax-exempt corporation, the taxpayer would generally treat its basis in a partnership interest or S corporation stock as either an investment asset or a non-excepted trade or business asset. If the taxpayer does not look through a partnership or S corporation, and if the taxpayer is a C corporation or a tax-exempt corporation, the taxpayer would treat its entire basis in the partnership interest or S corporation stock as allocable to a non-excepted trade or business.

The Treasury Department and the IRS request comments on these proposed look-through rules, including whether any further adjustments should be made to the taxpayer's basis in its partnership interest or corporate stock (for example, under § 1.861–12(c)(2)) and whether the minimum ownership threshold for nonconsolidated domestic C corporations and CFCs should be modified.

Sixth, a taxpayer's basis in its customer receivables and cash and cash equivalents would be disregarded for purposes of proposed § 1.163(j)–10(c). This rule is intended to discourage taxpayers from moving cash to excepted trades or businesses to increase the amount of asset basis therein. For these purposes, the term "cash and cash equivalents" would include cash, foreign currency, commercial paper, interests in certain investment companies, government obligations, derivatives that are substantially secured by an obligation of a government, and similar assets. The Treasury Department and the IRS request comments on this special rule, including the list of assets to which it would apply, and whether any exceptions should apply, such as for working capital.

Seventh, solely for purposes of determining the amount of basis allocable to excepted and non-excepted trades or businesses under proposed § 1.163(j)–10(c), an election under section 336, 338, or 754, as applicable, would be deemed to have been made for any acquisition of corporate stock or partnership interests with respect to which the taxpayer demonstrates to the satisfaction of the Commissioner of the Internal Revenue Service (the Commissioner) that the taxpayer was eligible to make such an election but was actually or effectively precluded from doing so by a regulatory agency with respect to a regulated utility trade or business. The Treasury Department and the IRS have determined that such a rule is necessary to place taxpayers that are actually or effectively precluded from making an election under section 336, 338, or 754 on the same footing for purposes of the basis allocation rules in proposed § 1.163(j)–10(c) as taxpayers that are not subject to such limitations. The Treasury Department and the IRS request comments on this special rule.

Eighth, taxpayers would be required to comply with certain reporting requirements regarding their asset basis allocation under proposed § 1.163(j)–10(c). Additionally, taxpayers would be required to keep books of account and other records and data as necessary to substantiate the taxpayer's use of an asset in an excepted trade or business (see § 1.6001–1). If the taxpayer fails to provide the required information, proposed § 1.163(j)–10(c) would permit the Commissioner to treat all of the taxpayer's interest expense as properly allocable to a non-excepted trade or business, unless the taxpayer shows that there was reasonable cause for failing to comply with, and the taxpayer acted in good faith with respect to, these reporting requirements. The Treasury Department and the IRS request comments on these proposed reporting requirements and the consequences of failing to satisfy these requirements.

Finally, proposed § 1.163(j)–10(c) would provide that a taxpayer's adjusted basis in an asset will not be taken into account for purposes of this section if one of the principal purposes for the acquisition, disposition, or change in use of that asset is to increase artificially the amount of basis allocable to excepted or non-excepted trades or businesses.

The foregoing basis allocation rules would not apply to disallowed business interest expense carryforwards, with the exception of disallowed disqualified interest. Disallowed business interest expense carryforwards other than disallowed disqualified interest would have been allocated during the year in which they were first disallowed under section 163(j). On becoming carryforwards, these disallowed expenses would retain their allocation from prior taxable years and would not be reallocated in a subsequent taxable year. The Treasury Department and the IRS request comments as to how the allocation rules in proposed § 1.163(j)–10 should apply to disallowed disqualified interest.

These basis allocation rules also would not apply to floor plan financing interest expense. As provided in section 163(j)(1)(C) and proposed § 1.163(j)–2, taxpayers are entitled to deduct their business interest expense to the full extent of their floor plan financing interest expense.

The Treasury Department and the IRS considered various alternatives to asset basis in determining how interest expense should be allocated between excepted and non-excepted trades or businesses. One such alternative was a tracing regime whereby taxpayers would be required to trace disbursements of debt proceeds to specific expenditures. However, tracing would impose a significant administrative burden upon taxpayers. Further, it is not clear how taxpayers would retroactively apply a tracing regime to existing debt. In particular, because C corporations would have had no reason to trace the proceeds of any existing indebtedness, imposing a tracing regime on existing indebtedness would require corporations to reconstruct the use of funds within their treasury operations at the time such indebtedness was issued, even if the issuance occurred many years ago, and even if the funds were used for a myriad of purposes across a large number of entities. Such an approach would involve a great deal of administrative cost and may be impractical or even impossible for indebtedness issued years ago.

Moreover, because money is fungible, the Treasury Department and the IRS have determined that a tracing regime would be distortive and subject to manipulation, and thus would not be appropriate. Although taxpayers are impacted from both a commercial and tax perspective by the amount of capital raised through the issuance of equity and indebtedness, any trade or business conducted by a taxpayer is generally indifferent to the source of funds. As a result, if taxpayers were allowed to use a tracing regime to allocate indebtedness to excepted trades or businesses, there would be an incentive to treat excepted trades or businesses as funded largely from indebtedness, and to treat non-excepted trades or businesses as funded largely from other types of funding, such as equity funding, despite the fact that, as an economic matter, all of a taxpayer's trades or businesses are funded based on the taxpayer's overall capital structure.

The assumption that a trade or business is indifferent to its source of funds may not be appropriate in cases in which certain indebtedness is secured by the assets of the trade or business and cash flow from those assets is expected to support the payments required on the indebtedness. These proposed regulations would provide for a limited tracing rule in those cases. See the discussion of qualified non-recourse indebtedness in proposed § 1.163(j)–10(d) in part 10(D) of this Explanation of Provisions section.

The Treasury Department and the IRS also considered allocating interest expense based upon the relative fair market value of the assets used in excepted and non-excepted trades or businesses. However, determinations of fair market value frequently are burdensome for taxpayers, which may have numerous assets without a readily established market price, and for the IRS. For this reason, disputes between taxpayers and the IRS over the fair market value of an asset are a common and costly occurrence. In the TCJA, Congress repealed the use of fair market value in the apportionment of interest expense under section 864 of the Code (see section 14502(a) of the TCJA). Thus, the Treasury Department and the IRS have determined that allocating interest expense based upon the relative fair market value of assets is a less viable approach than a regime based upon relative amounts of asset basis.

The Treasury Department and the IRS also considered allocating interest expense to excepted and non-excepted trades or businesses based on the relative amounts of gross income generated by such trades or businesses. However, gross income is more variable and volatile than asset basis, in part because it is based on an annual measurement. Methods could be developed to look at multiple years of gross income through an averaging or other smoothing methodology, but any such approach would necessarily create a number of difficult technical questions because the income of different trades or businesses may be subject to differing business cycles and the timing of income items may be within taxpayers' control. In the TCJA, Congress also repealed the use of gross income in the apportionment of interest expense under section 864 of the Code (see section 14502(a) of the TCJA).

Thus, although allocating interest expense between excepted and non-excepted trades or businesses using asset basis is not without its shortcomings, the Treasury Department and the IRS have determined that this approach represents the most viable option. The Treasury Department and the IRS also note that various commenters recommended using this approach to allocate interest expense between excepted and non-excepted trades or businesses.

The Treasury Department and the IRS have determined that the same approach should be used to allocate interest income, for several reasons. Such an approach is simpler to administer than applying a separate regime to interest income. Additionally, using the same regime for both interest expense and interest income reduces the likelihood that the IRS or taxpayers will be whipsawed. Under this rule, the greater the amount of basis in assets used in excepted trades or businesses, the greater the amount of both interest expense that is not subject to the section 163(j) limitation and interest income that is not properly allocable to a trade or business and that, as a result, is not factored into the taxpayer's calculation of ATI, which reduces the amount of interest expense that may be deducted.

The Treasury Department and the IRS request comments on the use of asset basis to allocate interest expense and interest income between excepted and non-excepted trades or businesses, including whether other measures, such as gross income, should be used in addition to, or instead of, asset basis. The Treasury Department and the IRS also request comments on the special rules contained in proposed § 1.163(j)–10(c), including whether additional special rules are needed (for example, for financial instruments that are marked to market within the meaning of section 475, or additional rules contained in § 1.861–12T).

D. Proposed § 1.163(j)–10(d): Direct Allocations

The basis allocation rules in proposed § 1.163(j)–10(c) would not apply to interest expense and interest income in several circumstances. First, a taxpayer with qualified nonrecourse indebtedness would be required to directly allocate interest expense from such indebtedness to the taxpayer's assets, as provided in § 1.861–10T(b). Second, a taxpayer that is engaged in the trade or business of banking, insurance, financing, or a similar business would be required to directly allocate interest expense and interest income from such business to the taxpayer's assets used in that business. The special rule for cash and cash equivalents under proposed § 1.163(j)–10(c) would not apply to such taxpayers.

A taxpayer to which both proposed § 1.163(j)–10(c) and (d) apply would be required to reduce its asset basis for purposes of proposed § 1.163(j)–10(c) to reflect assets to which interest expense is directly allocated under proposed § 1.163(j)–10(d).

The Treasury Department and the IRS request comments as to whether direct allocation should be required in any other circumstances, including but not limited to circumstances in which a taxpayer with both excepted and non-excepted trades or businesses is subject to significant limitations on transferring borrowed funds outside the excepted trade or business. The Treasury Department and the IRS also request comments on whether a taxpayer should be permitted to elect to treat all of its interest expense and interest income as properly allocable to non-excepted trades or businesses for purposes of section 163(j), in lieu of applying the allocation rules in proposed § 1.163(j)–10(c) and (d).

11. *Proposed § 1.163(j)–11: Transition Rules*

Proposed § 1.163(j)–11 would provide certain transition rules. Proposed § 1.163(j)–11(a) would provide rules that apply if a corporation (S) that is subject to the section 163(j) limitation joins a consolidated group whose taxable year began before January 1, 2018, and thus is not currently subject to the section 163(j) limitation. For example, assume that S is a calendar-year, stand-alone C corporation, and that S is acquired by Acquiring Group (with a November 30 fiscal year) on May 31, 2018. Acquiring Group is not subject to the section 163(j) limitation during its taxable year beginning December 1, 2017, but S is subject to the section 163(j) limitation for its short taxable year beginning January 1, 2018. Is S subject to the section 163(j) limitation for the taxable period beginning June 1, 2018? What happens to any disallowed business interest expense carryforwards from S's short taxable year ending May 31, 2018?

Proposed § 1.163(j)–11(a) would provide that, in those situations to which proposed § 1.163(j)–11(a) applies, the status of the acquiring group will control the application of section 163(j) to a target during the period that the target is included in the group. Therefore, if S is subject to the section 163(j) limitation at the time of its acquisition by a consolidated group with a taxable year beginning before January 1, 2018, then S will not be subject to the section 163(j) limitation for the portion of the acquiring group's taxable year in which S is a member. Additionally, any disallowed business interest expense carryforwards from S's taxable year that ended on the date of S's change in status will be carried forward to the acquiring group's first taxable year beginning after December 31, 2017.

Proposed § 1.163(j)–11(b) of this section would provide special rules for taxpayers with carryforwards under old section 163(j). Old section 163(j)(1)(A) disallowed a deduction to a corporation for disqualified interest (within the meaning of old section 163(j)(3)) paid or accrued by the corporation during the taxable year if old section 163(j) applied to such year. Old section 163(j)(1)(B) provided that any amount disallowed under old section 163(j)(1)(A) for any taxable year would be treated as disqualified interest paid or accrued in the succeeding taxable year.

Proposed § 1.163(j)–11(b) would provide that a taxpayer's interest expense for which a deduction was disallowed under old section 163(j) is carried forward to the taxpayer's first taxable year beginning after December 31, 2017, and is subject to disallowance under section 163(j) and proposed § 1.163(j)–2, except to the extent such interest is allocable to an excepted trade or business under proposed § 1.163(j)–10.

As noted in part 4(D) of this Explanation of Provisions section, old section 163(j) treated all members of the same affiliated group as a single taxpayer regardless of whether such members filed a consolidated return, but the section 163(j) regulations would treat members of the same affiliated group as one taxpayer only if such members file a consolidated return. Proposed § 1.163(j)–11(b) would provide rules based upon the rules in § 1.163(j)–5(c)(2) of the Prior Proposed Regulations for allocating disallowed disqualified interest carryforwards among members of an affiliated group that was treated as a single taxpayer under old section 163(j).

Proposed § 1.163(j)–11(b) also would clarify the application of section 382 to disallowed disqualified interest carryforwards. For example, disallowed disqualified interest would not be treated as a pre-change loss subject to a section 382 limitation under section 382(d)(3) with regard to an ownership change on a change date occurring before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, unless the disallowed disqualified interest is carried forward under section 163(j)(2). But see section 382(h)(6)(B) regarding built-in deduction items.

Similarly, for purposes of section 382(k)(1), regarding determination of status as a loss corporation, disallowed disqualified interest would not be treated as a carryforward of disallowed interest described in section 381(c)(20) with regard to an ownership change on a change date occurring before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, unless the disallowed disqualified interest is carried forward under section 163(j)(2). But see section 382(h)(6) regarding built-in deductions. For a description of changes to regulations under section 382, see the discussion of proposed §§ 1.382–2 and 1.382–6 in parts 14 and 15 of this Explanation of Provisions section.

Finally, whereas old section 163(j)(2)(B)(ii) permitted taxpayers with excess limitation, within the meaning of old section 163(j)(2)(B)(iii), to carry such limitation forward, section 163(j) contains no such language. Thus, the Treasury Department and the IRS have determined that no amount of excess limitation under old section 163(j)(2)(B) may be carried forward to taxable years beginning after December 31, 2017.

12. *Proposed § 1.263A–9*

Because of the amendments to section 163(j), a conforming amendment to § 1.263A–9(g) is required. Proposed § 1.263A–9 would update references to section 163(j) to reflect current law.

13. *Proposed § 1.381(c)(20)–1*

As noted in part 5 of this Explanation of Provisions section, Congress added disallowed business interest expense carryforwards to the list of items to which the acquiring corporation succeeds in a transaction to which section 381(a) applies. See section 381(c)(20). Sections 1.381(c)(1)–1 and 1.381(c)(1)–2 provide rules that, in part, limit the acquiring corporation's ability to use NOL carryforwards in the acquiring corporation's first taxable year ending after the acquisition date. The Treasury Department and the IRS have determined that similar rules should apply to disallowed business interest expense carryforwards.

Proposed § 1.381(c)(20)–1 also would provide that, for purposes of section 381(c)(20), the term "carryover of disallowed business interest described in section 163(j)(2)" includes disallowed disqualified interest.

14. *Proposed § 1.382–2*

In the TCJA, Congress added section 382(d)(3) and a new sentence to section 382(k)(1) for taxable years beginning after December 31, 2017. Section 1.382–2 contains certain definitions for purposes of sections 382 and 383 and the regulations thereunder, including definitions of the terms "pre-change loss" and "loss corporation."

Section 382(d)(3) provides that, for purposes of section 382, the term "pre-change loss" includes carryovers of disallowed interest described in section 163(j)(2) "under rules similar to the rules" in section 382(d)(1). Section 163(j)(2) provides that interest expense paid or accrued in a taxable year that is not allowed as a deduction pursuant to section 163(j)(1) is carried forward to the succeeding taxable year. Section 382(d)(1) treats as a "pre-change loss" both (i) net operating loss carryforwards to the taxable year in which the change date occurs (change year), and (ii) the net operating loss carryforward for the change year, to the extent such loss is allocable to the pre-change period. Proposed § 1.382–2 would clarify the equivalent treatment of items under section 382(d)(1) and (3) by providing that a "pre-change loss" includes the portion of any disallowed business interest expense of the old loss corporation paid or accrued in the taxable year of the testing date that is attributable to the pre-change period.

For purposes of determining the portion of disallowed business interest expense that is attributable to the pre-change period, proposed § 1.382–2 would require that disallowed business interest expense be ratably allocated to each day in the year, regardless of whether the loss corporation makes a closing-of-the-books election under § 1.382–6(b)(2) with regard to allocating its other taxable items to the pre-change period and the post-change period within the change year. This ratable allocation of disallowed business interest expense is consistent with the allocation of the loss corporation's deduction for business interest expense in the taxable year of the ownership change (see proposed § 1.382–6). Ratable allocation also is consistent with the general application of the section 163(j) regulations, which apply without regard to any particular debt instrument or particular date of payment or accrual of interest. See the discussion in part 2(A) of this Explanation of Provisions section.

The TCJA also modified section 382(k)(1) to provide that the term "loss corporation" includes a corporation entitled to use a disallowed business interest expense carryforward. These proposed regulations would revise § 1.382–2 to reflect the changes to the definitions of the terms "pre-change loss" and "loss corporation." These provisions would be applicable with regard to ownership changes occurring on or after the date on which the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

15. *Proposed § 1.382–6*

When a loss corporation experiences an ownership change, § 1.382–6(a) provides that, in general, the loss corporation must allocate its NOL or taxable income and its net capital loss or modified capital gain net income for the change year between the pre-change period and the post-change period by ratably allocating an equal portion to each day in the year. However, instead of using ratable allocation, a loss corporation may elect to use the closing-of-the-books method in § 1.382–6(b). A closing-of-the-books election applies only for purposes of certain allocations, such as NOL or taxable income allocations, and does not terminate the loss corporation's taxable year as of the change date.

Proposed § 1.382–6 would clarify that, for purposes of section 163(j), a loss corporation's current-year business interest expense may not be allocated under the closing-of-the-books method. Thus, even if a taxpayer generally has a closing-of-the-books election in effect for the change year, the taxpayer would be required to ratably allocate its current-year business interest expense for which a deduction is allowable under section 163(j) in that year between the pre-change period and the post-change period. For example, if X, a calendar-year loss corporation, experiences an ownership change on May 26, 2019, and if X has $100x of current-year business interest expense for which a deduction is allowable under section 163(j) for that year, $40x of X's business interest expense deduction would be allocated to the pre-change period, and $60x of X's business interest expense deduction would be allocated to the post-change period, regardless of which of the two general allocation methods – ratable allocation or closing-of-the-books – X uses. Under this approach, taxpayers would not need to compute ATI separately for the pre-change and post-change periods.

The Treasury Department and the IRS are considering publishing a separate notice of proposed rulemaking to address, among other issues, the treatment of a corporate partner's excess business interest expense (including negative section 163(j) expense) under section 382.

16. *Proposed § 1.383–1*

Section 1.383–1(d) provides ordering rules for the utilization of pre-change losses and pre-change credits and for the absorption of the section 382 limitation and the section 383 credit limitation. Generally, pre-change capital losses are absorbed first for these purposes, followed by NOLs and recognized built-in losses, other pre-change losses and, finally, pre-change credits.

The Treasury Department and the IRS have determined that disallowed business interest expense carryforwards should be absorbed after pre-change capital losses and all recognized built-in losses, but before NOLs. Disallowed business interest expense carryforwards should be absorbed before NOLs because taxpayers must calculate their current-year income or loss in order to determine whether and to what extent they can use an NOL in that year, and deductions for business interest expense, including carryforwards from prior taxable years, factor into the calculation of current-year income or loss.

Proposed § 1.383–1 would reflect the addition of disallowed business interest expense to the ordering rules, would make conforming changes to other provisions, and would update other provisions to reflect additional changes effectuated by the TCJA. The ordering rules in proposed § 1.383–1 include alternative rules that reflect the fact that certain regulations pertaining to the interaction between sections 163(j) and 382 may not be applicable to all ownership changes.

17. *Proposed § 1.469–9(b)*

These proposed regulations would also propose amendments to § 1.469–9(b) to provide rules relating to the definition of real property trade or business under section 469(c)(7)(C). Specifically, these proposed regulations would provide guidance on the meaning of real property and on the types of trades or businesses that qualify as "real property trades or businesses" for purposes of section 469(c)(7).

Section 469(a) of the Code disallows passive activity losses or credits. In general, a passive activity loss is the excess of the aggregate losses over the aggregate income from all passive activities in a taxable year. A passive activity is defined as any trade or business activity in which the taxpayer does not materially participate, and any rental activity subject to the exception for rental real estate under section 469(c)(7). Generally, under section 469(c)(2), a rental activity is treated as a per se passive activity regardless of whether the taxpayer materially participates in the activity.

The Omnibus Budget Reconciliation Act of 1993, Public Law 103–66, sec. 13143(a), added section 469(c)(7) to the Code effective for tax years beginning after December 31, 1993. In doing so, Congress expressed the belief that applying the "per se" passive rule to all rental real estate activities disadvantaged taxpayers who were otherwise actively engaged in real estate businesses and who also owned rental real estate. According to H. Rept. 103–111, 103rd Cong., 1st sess. (May 25, 1993), "[t]he committee considers it unfair that a person who performs personal services in a real estate trade or business in which he materially participates may not offset losses from rental real estate activities against income from nonrental real estate activities or against other types of income such as portfolio investment income." Section 469(c)(7) was added to alleviate this unfair treatment.

Section 469(c)(7) provides that the rental real estate activities of qualifying taxpayers who are actively engaged in real property trades or businesses are not subject to the "per se" passive rule in section 469(c)(2). Instead, under section 469(c)(7), a rental real estate activity of a qualifying taxpayer will not be a passive activity if the taxpayer materially participates in the rental real estate activity.

In section 469(c)(7)(C), Congress defined "real property trade or business" as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." However, neither section 469 nor the legislative history defines any of the terms contained in section 469(c)(7)(C).

These proposed regulations would amend the regulations under section 469 to provide a definition of the term "real property" along with certain other terms contained in section 469(c)(7)(C). Consistent with ordinary usage, these proposed regulations would define "real property" to include land, buildings, and other inherently permanent structures that are permanently affixed to land, and exclude from the definition certain other items, such as machines and equipment that serve an active function, which may be permanently affixed to real property.

Given Congress's focus in enacting section 469(c)(7) to provide relief to entrepreneurs in real property trades or businesses with some nexus to or involvement with rental real estate, these proposed regulations would not include trades or businesses that generally do not play a significant or substantial role in the creation, acquisition, or management of rental real estate in the definition of real property trade or business under section 469(c)(7)(C). Therefore, taxpayers engaged in trades or businesses that are not directly or substantially involved in the creation, acquisition, or management of rental real estate, or that provide personal services which are merely ancillary to a real property trade or business, will generally not be treated as engaged in real property trades or businesses for this purpose. In addition, machinery, equipment, and other assets or items that are not generally viewed as items of real property until after their installation or permanent affixation to real property (for example, HVAC systems, elevators, escalators, solar panels, glass fixtures, doors, windows, tiling, etc.) will not be treated as real property for these purposes and, accordingly, taxpayers engaged in trades or businesses of manufacturing, installing, operating, maintaining, or repairing such items generally will not be treated as engaged in real property trades or businesses within the meaning of section 469(c)(7)(C).

As the Treasury Department and the IRS have previously recognized (see Notice of Proposed Rulemaking, "Definition of Real Estate Investment Trust Real Property," published in the **Federal Register** (79 FR 27508, 27510) on May 14, 2014), the term "real property" appears in numerous Code provisions, which could ordinarily imply that, absent specific statutory modifications, the term "real property" should have the same meaning throughout the Code. However, the context and legislative purpose underlying a specific Code provision may necessitate a broader or narrower definition of the term "real property" than may be applied for other Code provisions. These proposed regulations under section 469 provide a definition of real property that is, for example, narrower than the one provided in the REIT context. The definition provided in these proposed regulations would apply solely for purposes of section 469(c)(7), and these regulations should not be construed in any way as applying to, or changing, the definitions in other Code provisions.

These proposed regulations would also define "real property operation" to mean the work done on a day-to-day basis by a direct, or indirect, owner of the real property, in a trade or business relating to the maintenance and occupancy of the real property to make the property available to be used, or held out for use, by customers. Similarly, these proposed regulations would define "real property management" to mean work performed by third party managers on behalf of owners in a trade or business relating to the day-to-day maintenance and occupancy of the real property to make it available to be used, or held out for use, by customers. In both instances, the principal purpose of the trade or business must be the provision of the use of the real property (or physical space accorded by or within the real property) to one or more customers, and not the provision of other significant or extraordinary services to customers in conjunction with the customers' incidental use of the real property or physical space accorded by or within the real property.

These proposed regulations would reserve on the remaining terms in section 469(c)(7)(C). Comments are requested as to whether further definitions are needed.

18. *Proposed § 1.860C–2*

Because REMICs are not treated as carrying on a trade or business for purposes of section 162 and are not C corporations, the Treasury Department and the IRS have determined that section 163(j) should not apply to REMICs, and these proposed regulations would amend § 1.860C–2 to provide that a REMIC is allowed a deduction, determined without regard to section 163(j), for any interest expense accrued during the taxable year. Section 1.860C–2(b)(2)(ii) of these proposed regulations would apply for taxable years beginning after December 31, 2017. However, taxpayers may rely on proposed § 1.860C–2(b)(2)(ii) prior to the date final regulations are published in the **Federal Register**.

19. *Proposed § 1.1502–36*

Section 1.1502–36 contains the unified loss rule, which limits the ability of a consolidated group to recognize non-economic or duplicated losses on subsidiary stock. The rule applies when a consolidated group member transfers subsidiary (S) stock that has a loss. If § 1.1502–36(d) applies to the transfer of a loss share, the attributes of S and its lower-tier subsidiaries are reduced as needed to prevent the duplication of any loss recognized on the transferred stock. Such attributes include capital loss carryovers, NOL carryovers, deferred deductions, and basis of assets other than cash and general deposit accounts. See § 1.1502–36(d)(4).

The Treasury Department and the IRS have determined that, for purposes of § 1.1502–36(d), disallowed business interest expenses should be treated as deferred deductions. Section 1.1502–36 would be modified accordingly.

20. *Proposed §§ 1.1502–91 through 1.1502–99*

As discussed in parts 11 and 14 through 16 of this Explanation of Provisions section, the section 163(j) regulations and §§ 1.382–2, 1.382–6, and 1.383–1 of these proposed regulations would address the application of section 382 to business interest expense, including disallowed business interest expense carryforwards. Sections 1.1502–90 through 1.1502–99 contain rules applying section 382 to a consolidated group. These proposed regulations would add a new coordination rule in § 1.1502–98(b) pursuant to which the rules in §§ 1.1502–91 through 1.1502–96 would apply to business interest expense, including disallowed business interest expense carryforwards, of members of a consolidated group (or corporations that join or leave a consolidated group), with appropriate adjustments.

The Treasury Department and the IRS request comments on the new coordination rule in § 1.1502–98(b), including whether additional examples should be added to clarify the application of this rule.

21. *Areas Where the Proposed Regulations Have Reserved on Issues*

The proposed regulations reserve on a number of issues, either where the reserved issue is expected to be addressed in other guidance, where comments would be helpful in determining the best manner of addressing an issue, or where the Treasury Department and the IRS are unsure whether additional guidance would be helpful.

A. Reservations Made Because Other Guidance May Address the Reserved Issue

The proposed regulations reserve on the interaction of sections 163(j) and 59A because separate guidance under section 59A is expected to address these issues.

The proposed regulations under sections 382 and 383 also reserve on a number of paragraphs related to the treatment of a corporate partner's excess business interest expense (including negative section 163(j) expense) under section 382. The Treasury Department and the IRS are considering publishing a separate notice of proposed rulemaking to address these and other issues related to section 382.

B. Reservations Made Where Comments Would Be Helpful in Determining the Best Manner of Addressing an Issue

The proposed regulations reserve on the treatment of collateralized cleared swaps and the types of fees that should be treated as interest for purposes of the interest definition because comments would be helpful in determining the best manner of addressing these issues. The proposed regulations also reserve on the coordination with certain other statutory provisions based on or limited by the income of taxpayers because determining the best approach for ordering such provisions would benefit from comments.

For similar reasons, the proposed regulations also reserve on the proper treatment of business interest income and business interest expense with respect to lending transactions between a pass-through entity and an owner of the entity (self-charged lending transactions), the treatment of excess business interest expense in tiered partnerships has been reserved in these proposed regulations, and the application of section 163(j) to a partnership merger or division.

C. Reservations Made Where the Treasury Department and the IRS are Unsure Whether Additional Guidance Would Be Helpful

The proposed regulations reserve on nine of the eleven terms listed in section 469(c)(7)(C). Comments are requested as to whether further definitions are needed. However, in the absence of comments requesting additional guidance with respect to these terms, it is unclear whether such additional guidance would be helpful.

Finally, the proposed regulations also reserve on additional guidance in the case of certain exempt organizations with respect to the application of the gross receipts test for purposes of section 163(j) because in the absence of comments it is unclear whether any such rules are necessary.

Statement of Availability of IRS Documents

The IRS Notices and Revenue Procedures cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at http://www.irs.gov.

Proposed Applicability/Effective Dates

Except as otherwise provided in this section, the regulations are proposed to be effective for taxable years ending after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of these regulations to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of §§ 1.163(j)–1, 1.163(j)–2, 1.163(j)–3, 1.163(j)–4, 1.163(j)–5, 1.163(j)–6, 1.163(j)–7, 1.163(j)–8, 1.163(j)–9, 1.163(j)–10, and 1.163(j)–11, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

With respect to proposed §§ 1.382–2, 1.382–5, and 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2 and 1.382–5), if applicable, the regulations are proposed to be effective for ownership changes occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of §§ 1.382–2 and 1.382–5, and 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2 and 1.382–5), if applicable, to an ownership change that occurs in a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of §§ 1.163(j)–1, 1.163(j)–2, 1.163(j)–3, 1.163(j)–4, 1.163(j)–5, 1.163(j)–6, 1.163(j)–7, 1.163(j)–8, 1.163(j)–9, 1.163(j)–10, and 1.163(j)–11, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, and 1.1504–4 to taxable years beginning after Decembers 31, 2017.

Special Analyses

I. *Regulatory Planning and Review – Economic Analysis*

Executive Orders 13771, 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

These proposed regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as Economically Significant under section 1(c) of the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations and thereby subject to review under Executive Order 12866. Accordingly, these proposed regulations have been reviewed by OIRA. In addition, the Treasury Department and the IRS expect the proposed regulations, when final, to be an Executive Order 13771 regulatory action and request comment on this designation. For more detail on the economic analysis, please refer to the following analysis.

A. Background and Overview

The TCJA substantially modified the statutory rules of section 163(j) to limit the amount of net business interest expense that can be deducted in the current taxable year of any taxpayer with only limited exceptions. As previously described in this preamble, section 163(j) prior to TCJA generally applied to domestic corporations with interest paid or accrued to related persons that were not subject to Federal income tax. As described in the Explanation of Provisions section, the amount allowed under section 163(j)(1) as a deduction for business interest expense is limited to the sum of (1) the taxpayer's business interest income for the taxable year; (2) 30 percent of the taxpayer's ATI for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year. The section 163(j) limitation applies to all taxpayers, except for certain small businesses with average annual gross receipts of $25 million or less and certain trades or businesses. Any amount of business interest not allowed as a deduction for any taxable year as a result of the limitation under section 163(j)(1) is carried forward and treated as business interest paid or accrued in the next taxable year under section 163(j)(2).

Congress modified section 163(j) under TCJA, in part, out of concern that prior law treated debt-financed investment more favorably than equity-financed investment. This debt bias generally encouraged taxpayers to utilize more leverage than would occur in the absence of the Code. Limiting the deduction of business interest is meant to reduce the relative favorability of debt and hence encourage a more efficient capital structure for firms. Congress also believed it necessary to apply the limit broadly across different types of taxpayers so as not to distort the choice of entity (see H. Rept. 115–409, at 247 (2017)).

B. Need for the Proposed Regulations

Because the section 163(j) limitation has been substantially modified, a large number of the relevant terms and necessary calculations that taxpayers are currently required to apply under the statute can benefit from greater specificity. Among other benefits, the clarity provided by the proposed regulations generally helps ensure that all taxpayers calculate the business interest expense limitation in a similar manner.

For example, there is no universal definition for the term "interest" under the Code. In general, because section 163(j) applies to limit certain deductions for interest under chapter A of the Code, the proposed regulations' definition of the term "interest" is relatively broad to create a balanced application of section 163(j). This definition limits tax-avoidance incentives for taxpayers to, in form, label payments as something other than interest that, in substance, are economically interest. At the same time, this definition allows taxpayers to treat certain amounts of income as business interest income for purposes of calculating the section 163(j) limitation that they may be required to, for non-tax reasons, label as something other than interest, so that taxpayers with such income are not unduly impacted by the section 163(j) limitation.

Pursuant to section 163(j)(8)(B), the proposed regulations prescribe adjustments to the calculation of ATI to prevent double counting of deductions and to provide relief for particular types of taxpayers or taxpayers in particular circumstances to ensure that such taxpayers are treated similarly to other taxpayers when calculating ATI.

The statute applies broadly to different types of entities, including passthrough entities such as partnerships and S corporations. The statute specifies that the section 163(j) limitation applies at the entity level for a partnership but that items such as excess business interest expense and excess taxable income must be allocated to partners for a variety of reasons including to compute their own 163(j) limitation. The statute further specifies that the items should be allocated in the same manner as "nonseparately stated taxable income or loss of the partnership"; however, this concept has not previously been defined by statute or regulations. Without the specified method of allocating these excess items provided by the proposed regulations, partnerships would likely have both significant flexibility but also uncertainty in determining which partners receive excess items. This flexibility could potentially lead partnerships to specially allocate items of income or expense such that they are separately stated to change the partner's allocation of excess interest expense or excess taxable income.

There are a number of potential uncertainties in how taxpayers should apply the section 163(j) limitation to CFCs in a manner consistent with other provisions of the Code. For example, interest deductions of individual CFCs may be limited by section 163(j) but might not be if the interest deductions of CFCs were computed on a group basis. The proposed regulations provide an election for treating related CFCs similarly to a consolidated group for the purpose of calculating the amount of business interest expense for purposes of the section 163(j) limitation. This election also provides clarity that in performing a CFC group calculation, finance and non-finance businesses are largely treated as separate groups (because of the dual role of interest payments as a cost of goods or services sold as well as a payment for debt finance and because of possible distortions in the case of conglomerate companies with financial and non-financial businesses in their CFCs, due to financial businesses' outsize amounts of interest expense and income). The proposed regulations also provide clarity by permitting the bottom-up transfer within chains of CFCs of excess taxable income for electing groups of CFCs.

Other areas where clarity is provided under the proposed regulations for CFCs include adjustments for partnerships held by CFCs, the treatment of CFCs with effectively connected income (ECI), the treatment of intergroup dividends (to avoid double counting of ATI), the effect of deemed inclusions (from branch income, Subpart F income, and GILTI) (also to avoid double counting of ATI), and the effect foreign derived intangible income (FDII) on ATI.

For purposes of section 163(j), the statute states in section 163(j)(7) that the term "trade or business" does not include certain regulated utilities, or an electing real property trade or business or an electing farming business. While the statute does reference other places in the Code where a farming business and a real property trade or business are described or defined, regulations have not previously been issued under section 469(c)(7)(C), the rule that section 163(j) refers to in order to define a real property trade or business. The proposed regulations provide such a definition, which clarifies whether a trade or business could elect as a real property trade or business to be excepted from section 163(j). In addition, the proposed regulations describe procedures for allocating income and business interest income and expense between excepted and non-excepted trades or businesses of the taxpayer. The proposed regulations provide a uniform method for allocating income and business interest income and expense which should lower administrative and compliance costs relative to no guidance being provided.

C. Economic Analysis

1. Baseline

The analysis in this section compares the proposed regulations to a no-action baseline reflecting anticipated Federal income tax-related and other economic behavior in the absence of these proposed regulations.

2. Anticipated Benefits

a. In General

The Treasury Department and the IRS expect that the definitions and guidance provided in the proposed regulations will enhance U.S. economic performance relative to the baseline. An economically efficient tax system generally aims to treat income and expense derived from similar economic decisions similarly in order to reduce incentives to make choices based on tax rather than market incentives. In this context, an important benefit of this part of the proposed regulations is to reduce taxpayer uncertainty regarding the calculation of the section 163(j) limitation relative to an alternative scenario in which no such regulations were issued and thus to help ensure that all taxpayers interpret the statutory rules of section 163(j) in a similar manner, a tenet of economic efficiency.

b. Proposed §§ 1.163(j)–1 through 1.163(j)–5

The proposed regulations make several adjustments to the calculation of ATI. One of these adjustments prevents the double counting of depreciation deductions when a depreciable asset is sold (only relevant for taxable years beginning before January 1, 2022). Other adjustments apply to particular types of taxpayers, such as RICs, REITs, or consolidated groups. These adjustments ensure that the section 163(j) limitation is applied evenly across different types of taxpayers in a manner consistent with the Code. Without such adjustments, certain taxpayers may be disadvantaged relative to otherwise similar taxpayers. For example, if RICs and REITs included the dividends paid deduction when calculating ATI, then these taxpayers would almost always have ATI of zero or close to zero, which would limit the ability of such taxpayers to ever deduct business interest expense for Federal income tax purposes.

In addition, the proposed regulations define the term "interest." There are several places in the Code and regulations where interest expense or interest income is defined, such as in the regulations that allocate and apportion interest expense (§ 1.861–9T) and in the subpart F regulations (§ 1.954–2). However, these rules only apply to particular taxpayers in particular situations. As described in the Explanation of Provisions section, there are no generally applicable statutory provisions or regulations addressing when financial instruments are treated as debt for Federal income tax purposes or when a payment is interest. The approach taken to defining interest for the section 163(j) limitation in these proposed regulations is to (1) include amounts associated with conventional debt instruments and amounts already treated as interest for all purposes under existing statutory provisions or regulations; (2) add some additional amounts that are functionally similar to interest, such as the rules regarding amounts on contingent payment debt instruments in § 1.163(j)–1(b)(20)(iii)(B), which was drafted in response to comments, or amounts treated as interest for certain purposes, such as amounts described in §§ 1.861–9T and 1.954–2; and (3) provide an anti-avoidance rule based on the economic principle that any expense or loss predominantly incurred in consideration of the time value of money is treated as an interest expense for section 163(j). Thus, the proposed regulations would apply to interest associated with conventional debt instruments, as well as transactions that are indebtedness in substance even if not in form.

Other options for defining interest were considered by the Treasury Department and the IRS but were determined to be less beneficial and not chosen. The first option considered would be to not provide a definition of interest in the proposed regulations, and thus rely on general tax principles and case law for purposes of defining interest for purposes of section 163(j). While adopting this option might reduce the compliance burden for some taxpayers, not providing an explicit definition of interest would create its own uncertainty (as neither taxpayers nor the IRS might have a clear sense of what types of payments are treated as interest income and interest expense for purposes of section 163(j)). Such uncertainty could increase burdens to the IRS and taxpayers including with respect to disputes and litigation about whether particular payments are interest for section 163(j) purposes.

In addition, such an approach to the definition of interest could encourage taxpayers to engage in transactions that provide financing while generating deductions economically similar to interest but make arguments that such deductions fail to be described by existing principles defining interest expense. There are several reasons why curbing such taxpayer behavior would be beneficial. First, taxpayer use of such transactions is likely to be uneven and dependent in part on the subjective understanding of taxpayers regarding whether such transactions would be allowable under the statute. Second, the ability of taxpayers to engage in such transactions would likely be correlated with size of the trade or business, with large businesses more likely to benefit from such avoidance strategies than small businesses. Third, when the deciding factor for using such transactions is the tax benefit of avoiding a section 163(j) limitation, then such transactions would impose more cost or risk on the taxpayer than using a traditional debt instrument. Engaging in such transactions is an inefficient use of resources. Fourth, such avoidance strategies may also discourage taxpayers from shifting to a less leveraged capital structure, and thus would counteract the intention of the statute to reduce the prevalence of highly-leveraged firms and the probability of systemic financial distress. Fifth, greater use of financing outside of conventional debt instruments may make it more difficult for financial institutions to determine the overall level of leverage and credit risk of firms seeking financing, which may distort the allocation of capital across businesses away from firms and investments with less credit risk.

The second option considered would have been to adopt a definition of interest but limit it to amounts associated with conventional debt instruments and amounts that were already treated as interest under the Code or regulations for all purposes prior to the passage of the TCJA. For example, this is similar to the definition of interest proposed in § 1.163(j)–1(b)(20)(i). While this would bring clarity to many transactions regarding what would be deemed interest for the section 163(j) limitation, it would potentially distort future financing transactions. Some taxpayers would choose to use financial instruments and transactions that provide a similar economic result of using a conventional debt instrument, but would avoid the label of business interest expense, potentially enabling these taxpayers to avoid the section 163(j) limitation without a substantive change in capital structure. The arguments discussed above regarding the costs of this situation would continue to apply.

In addition, there are certain transactions where under a specific provision of the Code and regulations, amounts could be deemed ordinary income when in substance the amounts are interest income. For example, the receipt of substitute interest paid on a securities loan arrangement may, under existing income tax principles, be treated as ordinary income rather than interest income despite the fact that such income is economically equivalent to interest income. Prior to the enactment of the 163(j) interest limitation, whether the amount was labeled as ordinary income or interest was not material to the overall tax liability of the taxpayer, but now this distinction matters.

Because of the tax-motivated financing distortions that would arise from a less comprehensive definition of interest, the Treasury Department and the IRS consider the best approach to the definition of interest is to expand the definition beyond § 1.163(j)–1(b)(20)(i). Under § 1.163(j)–1(b)(20)(ii) and (iii), the Treasury Department and the IRS identified existing financial transactions that have the economic substance of debt and interest, but under the existing Code and regulations may have been deemed ordinary income or gain or may have been treated as interest for limited purposes, and clarifies that such amounts would be considered interest income or expense for the purpose of the new section 163(j) limitation.

In addition, it is difficult for the Treasury Department and the IRS to specifically identify every type of transaction already in practice or to anticipate future innovations in financial transactions, therefore, proposed § 1.163(j)–1(b)(20)(iv) provides an anti-avoidance rule that any expense or loss predominately incurred in consideration of the time value of money is treated as an interest expense for purposes of section 163(j). This should help limit the ability of taxpayers to structure transactions in such a way that would allow deductible expenses that are economically similar to interest and frustrate the application of the statute.

In summary, the definition of interest in these proposed regulations provides clarity to taxpayers and the IRS regarding which specific transactions and types of transactions generate interest subject to the section 163(j) limitation, which should lower compliance and administrative costs relative to providing no definition or a more limited definition of interest. Also, the proposed definition should encourage a more efficient allocation of capital and use of financing across taxpayers.

c. Proposed § 1.163(j)–6

The proposed regulations § 1.163(j)–6 provide guidance on how to allocate partnership excess business interest expense, excess business interest income, and excess taxable income to partners. The statute specifies that the limitation applies at the partnership level but that these items must be allocated to partners for their own 163(j) limitation and because carryforwards of these items occurs at the partner level. Without a specified method of allocating these excess items, partnerships would likely have significant freedom to determine which partners receive excess items. While the statute specifies that the items should be allocated in the same manner as "nonseparately stated taxable income or loss of the partnership", this concept has not previously been defined by statute or regulations. Partnerships have significant control over what items are separately and nonseparately stated for each partner and could potentially reclassify income to be separately stated to favorably change the partner's allocation of excess interest expense or excess taxable income.

The allocation method detailed in the proposed regulations follows a number of principles. First, it ensures that the sum of the excess items at the partner level is equal to the partnership level. Second, it ensures that the partnership does not allocate excess business interest expense to a partner that was allocated items comprising ATI and business interest income that supported the partnership's deductible business interest expense (unless the partner was allocated more interest expense than its share of deductible business interest expense). Finally, it ensures that the partnership allocates any excess taxable income or excess business interest income to partners that are allocated more items comprising ATI or business interest income than necessary to support their allocation of business interest expense. The proposed regulations provide a method to ensure that all partnerships allocate these items consistently and in a way that matches income and interest expense, thus promoting economically efficient investment decisions. Equivalently, they address tax motivated allocations of excess items to avoid the section 163(j) limitation.

The proposed regulations also ensure that, for owners of partnerships and S corporations, business interest income is used only once, at the entity level, in offsetting business interest expenses. This eliminates the incentive to create tiered partnerships purely to double-count interest income in order to avoid the Section 163(j) limitation. It also avoids exacerbating the incentive to seek out interest income relative to other forms of income in order to avoid the Section 163(j) limitation. By avoiding these incentives, the proposed regulations would reduce economically inefficient uses of resources.

d. Proposed §§ 1.163(j)–7 through 1.163(j)–8

The Treasury Department and the IRS expect that proposed §§ 1.163(j)–7 through 1.163(j)–8 will implement the section 163(j) limitation consistent with preserving the integrity of the international tax system reflected in the Code after TCJA. As described in the Explanation of Provisions section, business interest deductions of individual CFCs may be limited by section 163(j) even when, if calculated on a group basis, business interest deductions would not be limited. The application of section 163(j) to CFCs on an individual basis can result in inappropriate results in certain cases. In particular, to the extent section 163(j) were to disallow a deduction for business interest expense to a CFC that has borrowed from a related CFC, the interest paid to the lender CFC would be included in the income of the lender CFC, the amounts would not fully offset, and the United States shareholder's inclusion under subpart F and GILTI may be increased solely due to the use of intercompany debt between these CFCs. Taxpayers could restructure or "self-help" to reduce this problem, but that option involves economically wasteful restructuring costs to the taxpayer. Another option is to ignore within-group interest payments (the "disregard approach"), but that could lead to inappropriate results, for example, a CFC group member borrowing from a third party and using the loan proceeds to lend to related CFCs (borrowing CFCs) would not be able to have interest income from the loans to the borrowing CFCs offset the interest expense to the third party lender for purposes of the section 163(j) limitation while the borrowing CFCs would not have any interest expense subject to the section 163(j) limitation, even though they are benefiting from the capital provided by the third party loan. The Treasury Department and the IRS consider a preferable option within the authority of the Treasury Department and the IRS to be to allow an election to treat related CFCs and their U.S. shareholders as a group for purposes of calculating the amount of business interest expense subject to the section 163(j) limitation (the "alternative method").

e. Proposed §§ 1.163(j)–9 through 1.163(j)–11

Proposed § 1.163(j)–9 provides (1) guidance in applying the rules for farming and real property trade or business elections and (2) guidance in use of a safe harbor for REITs. For electing real property trade or business and electing farming business, the statue specifies that "any such election shall be made at such time and in such manner as the Secretary shall prescribe, and once made, shall be irrevocable." Therefore proposed § 1.163(j)–9 provides taxpayers with the time and manner for electing real property trades or businesses and electing farming businesses. In addition, proposed § 1.163(j)–9 defines the conditions under which an election terminates. Without these conditions specified, taxpayers may engage in behavior which counteracts the intention of the statute and would not otherwise be taken except to game the irrevocable nature of the election the statute specified. The conditions specified increase the likelihood that all similarly situated taxpayers interpret the 'irrevocable' designation similarly and will not engage in tax-motivated behavior to appear to cease operations in an effort to change an irrevocable designation.

Proposed § 1.163(j)–9(g) provides a safe harbor for certain REITs to elect to be electing real property trades or businesses. In addition, a special rule applies to REITs for which 10 percent or less of the value of the REIT's assets are real property financing assets. Under this rule, all of the assets of the REIT are treated as real property trade or business assets. The benefit of the safe harbor is to provide REITs the same tax treatment and apply the same general rules as apply to other taxpayers, an economically efficient approach. The special rule threshold of 10 percent for real property financing assets has the benefit of maintaining consistency with section 856(c)(4), which uses the same values for the REIT asset test at the close of the REIT's taxable year. Taxpayers will benefit in reduced time and cost applying new rules if they are familiar and consistent with other rules that they must comply with under the Code.

Proposed § 1.163(j)–9 provides a rule that stipulates that if at least 80 percent of a trade or business's real property (by fair market value) is leased to a trade or business under common control with the real property trade or business, the trade or business cannot make an election to be an electing real trade or business. In the absence of such a rule, taxpayers could restructure their business such that real estate components of non-real estate businesses are separated from the rest of their business to artificially reduce the application of section 163(j) by leasing the real property to the taxpayer and electing this "business" to be an excepted real property trade or business. Therefore, the prime benefit of this rule is to preserve the intent of the statute of allowing elections in the real property sector without incentivizing other sectors of the economy to restructure their business for the sole intent of avoiding the section 163(j) limitation. This guidance ensures that taxpayers face more uniform incentives when making economic decisions, a tenet of economic efficiency. Rules that maintain consistent structuring activity across taxpayers also increases IRS's ability to consistently enforce the tax rules, thus decreasing opportunities for tax evasion.

Proposed § 1.163(j)–10 provides rules for allocations of ATI and interest expense and interest income between excepted and non-excepted trades or businesses. The proposed regulations allocate interest expense and interest income between the related excepted and non-excepted trades or businesses based upon the relative amounts of the taxpayer's adjusted tax basis in the assets used in its excepted and non-excepted trades or businesses. As discussed in the Explanation of Provisions section, this general method of allocation reflects the fact that money is fungible and the view that interest expense is attributable to all activities and property, regardless of any specific purpose for incurring an obligation on which interest is paid. Since any allocation method will require an increase in compliance costs for taxpayers, an allocation is only required when the share of the asset tax basis in the excepted or non-excepted business exceeds 10 percent. Finally, this asset basis approach provides consistency with the regulations under section 861. By providing taxpayer guidance that is already familiar to them and consistent with other parts of the Code, taxpayers benefit in reduced time and cost spent learning and applying new rules.

The Treasury Department and the IRS considered several alternatives to this asset basis approach for allocating interest income and expense. First, a tracing approach was considered whereby taxpayers would be required to trace disbursements of debt proceeds to specific expenditures. However, tracing would impose a significant administrative burden upon taxpayers due to the complexity of matching interest income and expense among related companies. Further, it is not clear how taxpayers would retroactively apply a tracing regime to existing debt. In particular, because C corporations would have had no reason to trace the proceeds of any existing indebtedness, imposing a tracing regime on existing indebtedness would require corporations to reconstruct the use of funds within their treasury operations at the time such indebtedness was issued, even if the issuance occurred many years ago, and even if the funds were used for a myriad of purposes across a large number of entities. Such an approach would involve a great deal of administrative cost and may be impractical or even impossible for indebtedness issued years ago.

Moreover, because money is fungible, a tracing regime would be distortive and subject to manipulation. Although taxpayers are impacted from both a commercial and tax perspective by the amount of capital raised through the issuance of equity and indebtedness, any trade or business conducted by a taxpayer is generally indifferent to the source of funds. As a result, if taxpayers were allowed to use a tracing regime to allocate indebtedness to excepted trades or businesses, there would be an incentive to treat excepted trades or businesses as funded largely from indebtedness, and to treat non-excepted trades or businesses as funded largely from other types of funding, such as equity funding, despite the fact that, as an economic matter, all of a taxpayer's trades or businesses are funded based on the taxpayer's overall capital structure.

The Treasury Department and the IRS rejected a tracing approach because the complexity of such an approach could be more difficult for taxpayers and the IRS to administer and would create too great an incentive to structure financing with the sole purpose of avoiding the application of the statute. The assumption that a trade or business is indifferent to its source of funds may not be appropriate in cases in which certain indebtedness is secured by the assets of the trade or business and cash flow from those assets is expected to support the payments required on the indebtedness. These proposed regulations would provide for a limited tracing rule in those cases. See the discussion of qualified non-recourse indebtedness in proposed § 1.163(j)–10(d) in part 10(D) of the Explanation of Provisions section.

Second, the Treasury Department and the IRS also considered allocating interest expense based upon the relative fair market value of the assets used in excepted and non-excepted trades or businesses. However, determinations of fair market value frequently are burdensome for taxpayers, which may have numerous assets without a readily established market price, and for the IRS. For this reason, disputes between taxpayers and the IRS over the fair market value of an asset are a common and costly occurrence. In the TCJA, Congress repealed the use of fair market value in the apportionment of interest expense under section 864 of the Code (see section 14502(a) of the TCJA). Thus, the Treasury Department and the IRS have determined that allocating interest expense based upon the relative fair market value of assets is a less viable approach than a regime based upon relative amounts of asset basis.

Third, the Treasury Department and the IRS also considered allocating interest expense to excepted and non-excepted trades or businesses based on the relative amounts of gross income generated by such trades or businesses. However, gross income is more variable and volatile than asset basis, in part because it is based on an annual measurement. Methods could be developed to look at multiple years of gross income through an averaging or other smoothing methodology, but any such approach would necessarily create a number of difficult technical questions because the income of different trades or businesses may be subject to differing business cycles and the timing of income items may be within taxpayers' control. In the TCJA, Congress also repealed the use of gross income in the apportionment of interest expense under section 864 of the Code (see section 14502(a) of the TCJA). The Treasury Department and the IRS request comment on the approaches and decisions discussed in this section.

3. Anticipated Impacts on Administrative and Compliance Costs

The proposed regulations include requirements about how excess interest income, interest expense, and taxable income should be allocated to partners. This allocation method will require some partnerships to do a number of calculations to figure out the appropriate allocations.

The proposed regulations as applied to CFCs involve additional tax calculations, such as aggregating CFC income, separating finance from non-finance businesses, and eliminating intra-group dividends, but these calculations are relatively simple and involve data that are already collected. Hence, the increase in compliance costs should not be substantial. Furthermore, because the alternative method is elective, the associated compliance costs would be avoided if the election is not made.

As the compliance costs in both of these cases would be part of the cost of filing tax Form 8990, "Limitation on Business Interest Expense," the estimate of the cost of these calculations will be included as part of the overall reporting burden of Form 8990, as is further discussed in the next section.

D. Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

1. Collections of Information

The collection of information in these proposed regulations is in §§ 1.163(j)–9 and 1.163(j)–10. The collection of information in proposed § 1.163(j)–9 is required for taxpayers to make a one-time election to treat their real property or farming trade or business as an electing real property trade or business or an electing farming trade or business under section 163(j)(7)(B) and (C). The collection of information in proposed § 1.163(j)–10 is required for taxpayers to demonstrate how they allocated their interest expense, interest income, and other items of income and deduction between excepted and non-excepted trades or businesses. It is necessary to report this information to the IRS to ensure that taxpayers properly report the amount of interest that is potentially subject to the limitation.

The collection of information is necessary to ensure tax compliance but is not expected to be available as a finalized IRS form by the end of the calendar year. When available, draft revised versions of the affected IRS forms will be posted for comment at https://apps.irs.gov/app/picklist/list/draftTaxForms.html. All of the information collections mentioned in §§ 1.163(j)–9 and 1.163(j)–10 may eventually be reported on a form. The specific forms that are expected to change as a result of these proposed regulations are described in more detail in the next section.

2. Future Expected Modifications to Forms to Collect Information

In order to collect necessary information, we are modifying four forms (Forms 1120, 1120S, 1065, and 1120–REIT) and creating one new form (Form 8990). We are modifying Forms 1120, 1120S, 1065, and 1120–REIT to ask filers about the applicability of section 163(j) and the need to file the new Form 8990, as well as the related one-time election statement. When the changes to the IRS forms are finalized, every taxpayer who deducts business interest beginning in tax year 2018 generally will be required to file a new tax Form 8990, "Limitation on Business Interest Expense IRC 163(j)," except for taxpayers with average annual gross receipts of $25 million or less for the three prior tax years (as determined under section 448(c) principles, and as adjusted for inflation starting in 2019). For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)), the reporting burden of tax Form 8990 is associated with OMB control number 1545-0123. Tax Form 8990 is estimated to be required by fewer than 92,500 taxpayers in 2018.

The draft forms are available on the IRS website at:

Draft Form	IRS Website Link
Form 1120	https://www.irs.gov/pub/irs-dft/f1120–dft.pdf (Draft instructions: https://www.irs.gov/pub/irs-dft/i1120–dft.pdf)
Form 1120S	https://www.irs.gov/pub/irs-dft/f1120s–dft.pdf (Draft instructions: https://www.irs.gov/pub/irs-dft/i1120s–dft.pdf)
Form 1065	https://www.irs.gov/pub/irs-dft/f1065–dft.pdf (Draft instructions: https://www.irs.gov/pub/irs-dft/i1065–dft.pdf)
Form 1120-REIT	https://www.irs.gov/pub/irs-dft/f1120rei–dft.pdf (Draft instructions: https://www.irs.gov/pub/irs-dft/i1120rei–dft.pdf)
Form 8990	https://www.irs.gov/pub/irs-dft/f8990—dft.pdf

A draft of the Form 8990 instructions is not available at the time of the proposed rule-making. When available, a draft of the IRS Form 8990 instructions will be posted for comment at https://www.irs.gov/pub/irs-dft/f8990--dft.pdf.

3. Burden Estimates

The following estimates are based on the information that is available to the IRS. The most recently available 2015 Statistics of Income (SOI) tax data indicates that 80,702 firms would have contemplated a one-time election to opt out of the section 163(j) limitation as an electing real property trade or business or as an electing farming business were the statute then in effect. The Treasury Department and the IRS anticipate that these proposed regulations will apply to a similar proportion of taxpayers going forward. This estimate is based on a count of filers of Forms 1120, 1120S, 1065, and 1120–REIT in the real estate and farming industries that had over $25 million in gross receipts in taxable year 2015. Each of these forms for taxable years after 2017 will ask filers about the applicability of 163(j) and the need to file Form 8890 as well as the related one-time election. Similarly, using the 2015 SOI tax data, we estimate that 82,755 firms would have allocated interest income and expenses among multiple trades or businesses, some of which are excepted from the section 163(j) limitation and some that are not. This estimate is a count of all tax Forms 1120, 1120S, and 1065 in real estate, farming, and public utilities industries that had over $25 million in gross receipts. While the number of affected taxpayers will increase with growth in the economy, the Treasury Department and the IRS expect that the portion of affected taxpayers will remain approximately the same over the foreseeable future.

The time and dollar compliance burden are derived from the Business Taxpayers Burden model provided by the IRS's Office of Research, Applied Analytics, and Statistics (RAAS). This model relates the time and out-of-pocket costs of business tax preparation, derived from survey data, to assets and receipts of affected taxpayers along with other relevant variables. See Tax Compliance Burden (John Guyton et al, July 2018) at https://www.irs.gov/pub/irs-soi/d13315.pdf. A respondent may require more or less time than the estimated burden, depending on the circumstances.

The burden estimates listed in the below table attempt to capture only those discretionary changes made in these proposed regulations, and may not include burden estimates for forms associated with the statute. Changes made by the Act or through new information collections are captured separately in forthcoming published Supporting Statements for each of these forms and will be aggregated with the estimates provided below to summarize the total burden estimates for each information collection listed below. Those total burden estimates will be available for review and public comment at https://www.reginfo.gov/public/Forward?SearchTarget=PRA&textfield. The Treasury Department and the IRS request comment on these estimates.

	Likely Respondents	**Estimated number of respondents (2015 levels)**	**Estimated average annual burden hours per respondent**	**Estimated total annual reporting burden (hours) (2015 levels)**	**Estimated monetized burden @ $95/hour ($2017 millions)**	**Estimated frequency of responses**
§ 1.163(j)–9 (one-time election statement)	Individuals, corporations, and partnerships with real property or farming trades or businesses with gross receipts exceeding the statutory threshold of $25 million	80,702 business respondents (including Forms 1120, 1120–REIT, 1120–S, and 1065 filers)	0 to 30 minutes (estimated average: 15 minutes)	20,176	$1.9	One-time

	Likely Respondents	Estimated number of respondents (2015 levels)	Estimated average annual burden hours per respondent	Estimated total annual reporting burden (hours) (2015 levels)	Estimated monetized burden @ $95/hour ($2017 millions)	Estimated frequency of responses
§ 1.163(j)–10 (annual allocation statement)	Individuals, corporations, and partnerships (1) with more than one trade or business (at least one of which is a real property or farming trade or business), and (2) public utilities, with gross receipts exceeding the statutory threshold of $25 million	82,755 business respondents (including Forms 1120, 1120–S, and 1065 filers)	15 minutes to 2 hours (estimated average: 1 hour)	82,755	$7.9	Annually
§ 1.163(j)–10 (one-time start-up cost to develop procedures for filing an annual allocation statement)	Same as above	82,755	4 hours (start-up burden)	331,020	$31.4	One-time
Three year monetized burden estimate					$19.0	Three year annual average

The three-year annual average of the monetized burden for the information collection and resulting from discretionary requirements contained in this rulemaking is estimated to be 19.0 million ($2017) ([($1.9 million+ $31.4 million) + ($7.9 million x 3)]/3). To ensure more accuracy and consistency across its information collections, the IRS is currently in the process of revising the methodology it uses to estimate burden and costs. Once this methodology is complete, the IRS will provide this information to reflect a more precise estimate of burdens and costs.

The Treasury Department and the IRS request comment on the assumptions, methodology, and burden estimates related to this information collection. Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP: T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by February 26, 2019.

Comments are specifically requested concerning–

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

II. *Regulatory Flexibility Act*

It is hereby certified that these proposed regulations, if adopted as final, will not have a significant economic impact on a substantial number of small entities. Although the Treasury Department and the IRS believe that the proposed regulations may impact small entities, the number of small entities impacted is low.

Section 163(j) provides exceptions for which many small entities will qualify. First, under section 163(j)(3), the limitation does not apply to any taxpayer, other than a tax shelter under section 448(a)(3), which meets the gross receipts test under section 448(c) for any taxable year. A taxpayer meets the gross receipts test under section 448(c) if the taxpayer has average annual gross receipts for the 3-taxable year period ending with the taxable year that precedes the current taxable year that do not exceed $25,000,000. Second, section 163(j) provides that certain trades or businesses are not subject to the limitation, including the trade or business of performing services as an employee, electing real property trades or businesses, electing farming businesses, and certain utilities as defined in section 163(j)(7)(A)(iv). Lastly, certain REITs, as described in proposed § 1.163(j)–9(g), are eligible to make the election out of the limitation as real property trades or businesses.

Any economic impact on any small entities as a result of the requirements in this notice of proposed rulemaking are not expected to be significant. The small entities potentially subject to the provision in proposed § 1.163(j)–9 are individuals, corporations, including S corporations, and partnerships that (1) have average annual gross receipts for the 3-taxable year period ending with the taxable year that precedes the current taxable year exceeding $25,000,000, and (2) want to make the election out of the limitation as an electing real property trade or business under section 163(j)(7)(B) or electing farming business under section 163(j)(7)(C). Proposed § 1.163(j)–9 requires such taxpayers to attach a one-time statement to their return providing the taxpayer's name, address, social security number (SSN) or employer identification number (EIN), a description of the taxpayer's electing trade or business, including the principal business activity code, and a statement that the taxpayer is making an election under section 163(j)(7)(B) or (C), as applicable.

The small entities potentially subject to the requirements in proposed § 1.163(j)–10 are individuals, corporations (including S corporations), and partnerships that (1) have average annual gross receipts for the 3-taxable year period ending with the taxable year that precedes the current taxable year exceeding $25,000,000, and (2) have multiple trades or businesses, some of which are excepted from the limitation and some of which are not excepted from the limitation, for which the taxpayer must properly allocate business interest expense. Proposed § 1.163(j)–10 requires such taxpayers to attach an annual statement to their return demonstrating the following: (1) The taxpayer's adjusted basis in the aggregated assets used in its excepted and non-excepted businesses, (2) the determination dates on which asset basis was measured during the taxable year, (3) the names and TINs of all entities for which basis information is being provided, (4) asset basis information for corporations or partnerships if the taxpayer looks through to the corporation's or partnership's basis in the corporation's or partnership's assets under proposed § 1.163(j)–10(c)(5)(ii), and (5) a summary of the method or methods used to determine asset basis in property used in both excepted and non-excepted businesses.

As discussed elsewhere in this preamble, the reporting burden for the one-time election statement is estimated at 0 to 30 minutes, depending on individual circumstances, with an estimated average of 15 minutes for all affected entities, regardless of size. The reporting burden for the annual allocation statement is estimated at 15 minutes to 2 hours, depending on individual circumstances, with an estimated average of 1 hour. The estimated monetized burden for compliance is $95 per hour.

For these reasons, the Treasury Department and the IRS have determined that the collections of information in this notice of proposed rulemaking will not have a significant economic impact. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Notwithstanding this certification, the Treasury Department and the IRS invite comments from interested members of the public on both the number of entities affected and the economic impact on small entities.

It is hereby certified that proposed §§ 1.163(j)–4, 1.163(j)–5, and 1.163(j)–6 will not have a significant economic impact on a substantial number of small entities. Although the Treasury Department and the IRS believe that the proposed regulations may affect small entities, the economic impact on small entities as a result of the notice of proposed rulemaking is not expected to be significant. In particular, only firms with more than $25 million in gross receipts are required to file a tax Form 8990. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Notwithstanding this certification, the Treasury Department and the IRS invite comments from interested members of the public on both the number of entities affected and the economic impact on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS in the preamble under the **ADDRESSES** section. The Treasury Department and the IRS request comments on all aspects of the proposed rules.

All comments submitted will be made available at *http://www.regulations.gov* for public inspection and copying. A public hearing has been scheduled for February 27, 2019, beginning at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC 20224. If there is not sufficient time to discuss all of the topics on February 27, 2019, the hearing will continue the following day at 10 a.m. in the same location. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For more information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic by February 26, 2019. Submit a signed paper or electronic copy of the outline as prescribed in this preamble under the **ADDRESSES** heading. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Susie Bird, Charles Gorham, Zachary King, Jaime Park, Kathy Reed, and Sophia Wang, Office of the Associate Chief Counsel (Income Tax and Accounting); Kevin M. Jacobs, Russell Jones, and John Lovelace, Office of the Associate Chief Counsel (Corporate); Meghan Howard, William Kostak, Anthony McQuillen, Adrienne Mikolashek, and James Quinn, Office of the Associate Chief Counsel (Passthroughs and Special Industries); Angela Holland, Steve Jensen, and Charles Rioux, Office of the Associate Chief Counsel (International); William E. Blanchard, Michael Chin, Steven Harrison, Andrea Hoffenson, and Diana Imholtz, Office of the Associate Chief Counsel (Financial Institutions and Products). Other personnel from the Treasury Department and the IRS participated in their development.

* * * *

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Proposed Regulations

Under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking that was published in the **Federal Register** on Tuesday, June 18, 1991, (56 FR 27907, as corrected by 56 FR 40285 (August 14, 1991)) is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 – INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by:

1. Adding entries in numerical order for §§ 1.163(j)–1 through 1.163(j)–11;
2. Revising the entry for §§ 1.263A–8 through 1.263A–15;
3. Adding entries in numerical order for §§ 1.382–1 and 1.383–0;
4. Revising the entry for § 1.383–1; and
5. Adding entries in numerical order for §§ 1.860C–2 and 1.1502–90.

The additions and revisions read, in part, as follows:

Authority: 26 U.S.C. 7805***

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Section 1.163(j)–1 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–2 also issued under 26 U.S.C. 1502.

Section 1.163(j)–3 also issued under 26 U.S.C. 1502.

Section 1.163(j)–4 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–5 also issued under 26 U.S.C. 1502.

Section 1.163(j)–6 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–7 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–8 also issued under 26 U.S.C. 163(j)(8)(B).

Section 1.163(j)–9 also issued under 26 U.S.C. 163(j)(7)(B) and (C) and 26 U.S.C. 1502.

Section 1.163(j)–10 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–11 also issued under 26 U.S.C. 1502.

*****

Sections 1.263A–8 through 1.263A–15 also issued under 26 U.S.C. 263A(j).

*****

Section 1.382–1 also issued under 26 U.S.C. 382(m).

*****

Section 1.383–0 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 383.

Section 1.383–1 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 383.

*****

Section 1.860C–2 also issued under 26 U.S.C. 860C(b)(1).

*****

Section 1.1502–90 also issued under 26 U.S.C. 382(m) and 26 U.S.C. 1502.

*****

Par. 2. Section 1.163(j)–0 is added to read as follows:

§ 1.163(j)–0 Table of contents.

This section lists the table of contents for §§ 1.163(j)–1 through 1.163(j)–11.

§ 1.163(j)–1 Definitions.

(a) In general.
(b) Definitions.
(1) Adjusted taxable income.
(i) Additions.
(ii) Subtractions.
(iii) Depreciation, amortization, or depletion expenses capitalized to inventory under section 263A.
(iv) Other adjustments.
(v) Additional rules relating to adjusted taxable income in other sections.
(2) Business interest expense.
(i) In general.
(ii) Special rules.
(3) Business interest income.
(i) In general.
(ii) Special rules.
(4) C corporation.
(5) Cleared swap.
(6) Consolidated group.
(7) Consolidated return year.
(8) Disallowed business interest expense.
(9) Disallowed business interest expense carryforward.
(10) Disallowed disqualified interest.
(11) Electing farming business.
(12) Electing real property trade or business.
(13) Excepted regulated utility trade or business.
(i) In general.
(ii) Excepted and non-excepted utility trades or businesses.
(14) Excess business interest expense.
(15) Excess taxable income.
(16) Floor plan financing indebtedness.
(17) Floor plan financing interest expense.
(18) Group.
(19) Intercompany transaction.

(20) Interest.
(i) In general.
(ii) Swaps with significant nonperiodic payments.
(A) Non-cleared swaps.
(B) [Reserved]
(iii) Other amounts treated as interest.
(A) Treatment of premium.
(*1*) Issuer.
(*2*) Holder.
(B) Treatment of ordinary income or loss on certain debt instruments.
(C) Substitute interest payments.
(D) Section 1258 gain.
(E) Amounts affecting a taxpayer's effective cost of borrowing.
(F) Yield adjustments.
(G) Certain amounts labeled as fees.
(*1*) Commitment fees.
(*2*) [Reserved]
(H) Debt issuance costs.
(I) Guaranteed payments.
(J) Factoring income.
(iv) Anti-avoidance rule for amounts predominantly associated with the time value of money.
(v) Examples.
(21) Interest expense.
(22) Interest income.
(23) Inventory.
(24) Member.
(25) Motor vehicle.
(26) Old section 163(j).
(27) Real estate investment trust.
(28) Real property.
(29) Regulated investment company.
(30) S corporation.
(31) Section 163(j) limitation.
(32) Section 163(j) regulations.
(33) Separate return limitation year.
(34) Separate return year.
(35) Separate taxable income.
(36) Tax-exempt corporation.
(37) Taxable income.
(i) In general.
(ii) General rules to coordinate the application of sections 163(j) and 250.
(iii) [Reserved]
(iv) Special rules for defining taxable income.
(38) Trade or business.
(i) In general.
(ii) Excepted trade or business.
(iii) Non-excepted trade or business.
(39) Unadjusted basis.
(c) Applicability date.

§ 1.163(j)–2 Deduction for business interest expense limited.

(a) Overview.
(b) General rule.
(c) Disallowed business interest expense carryforward.
(1) In general.
(2) Coordination with small business exemption.
(3) Cross-references.
(d) Small business exemption.
(1) Exemption.
(2) Application of the gross receipts test.
(i) In general.
(ii) Gross receipts of individuals.
(iii) Partners and S corporation shareholders.
(iv) Tax-exempt organizations.
(e) REMICs.
(f) Calculation of ATI with respect to certain beneficiaries.
(g) Examples.
(h) Anti-avoidance rule.
(i) Applicability date.

§ 1.163(j)–3 Relationship of business interest deduction limitation to other provisions affecting interest.

(a) Overview.
(b) Coordination of section 163(j) with certain other provisions.
(1) In general.
(2) Disallowed interest provisions.
(3) Deferred interest provisions.
(4) At risk rules, passive activity loss provisions, and limitation on excess business losses of noncorporate taxpayers.
(5) Capitalized interest expenses under sections 263A and 263(g).
(6) Reductions under section 246A.
(7) Section 381.
(8) Section 382.
(9) Other types of interest provisions.
(10) [Reserved]
(c) Examples.
(d) Applicability date.

§ 1.163(j)–4 General rules applicable to C corporations (including REITs, RICs, and members of consolidated groups) and tax-exempt corporations.

(a) Scope.
(b) Characterization of items of income, gain, deduction, or loss.
(1) Interest expense and interest income.
(2) Adjusted taxable income.
(3) Investment interest, investment income, and investment expenses of a partnership with a C corporation partner.
(i) Characterization as expense or income properly allocable to a trade or business.
(ii) Impact of characterization on partnership.
(iii) Investment interest expense and investment interest income of a partnership not treated as excess business interest expense or excess taxable income of a C corporation partner.
(4) Application to RICs and REITs.
(i) In general.
(ii) Taxable income for purposes of calculating the adjusted taxable income of RICs and REITs.
(iii) Other adjustments to adjusted taxable income for RICs and REITs.
(5) Application to tax-exempt corporations.
(6) Examples.
(c) Effect on earnings and profits.
(1) In general.
(2) Special rule for RICs and REITs.
(3) Special rule for partners that are C corporations.
(4) Examples.
(d) Special rules for consolidated groups.
(1) Scope.
(2) Calculation of the section 163(j) limitation for members of a consolidated group.
(i) In general.
(ii) Interest.
(iii) Calculation of business interest expense and business interest income for a consolidated group.
(iv) Calculation of adjusted taxable income.
(v) Treatment of intercompany obligations.
(3) Investment adjustments.
(4) Ownership of partnership interests by members of a consolidated group.
(i) Dispositions of partnership interests.
(ii) Basis adjustments under § 1.1502–32.
(iii) [Reserved]
(5) Examples.
(e) Cross-references.

(f) Applicability date.

§ 1.163(j)–5 General rules governing disallowed business interest expense carryforwards for C corporations.

(a) Scope and definitions.
(1) Scope.
(2) Definitions.
(i) Current-year business interest expense.
(ii) Allocable share of the consolidated group's remaining section 163(j) limitation.
(iii) Consolidated group's remaining section 163(j) limitation.
(iv) Remaining current-year interest ratio.
(b) Treatment of disallowed business interest expense carryforwards.
(1) In general.
(2) Deduction of business interest expense.
(3) Consolidated groups.
(i) In general.
(ii) Deduction of business interest expense.
(A) General rule.
(B) Section 163(j) limitation is equal to or exceeds the current-year business interest expense and disallowed business interest expense carryforwards from prior taxable years.
(C) Current-year business interest expense and disallowed business interest expense carryforwards exceed section 163(j) limitation.
(iii) Departure from group.
(iv) Example.
(c) Disallowed business interest expense carryforwards in transactions to which section 381(a) applies.
(d) Limitations on disallowed business interest expense carryforwards from separate return limitation years.
(1) General rule.
(2) Deduction of disallowed business interest expense carryforwards arising in a SRLY.
(3) Examples.
(e) Application of section 382.
(1) Pre-change loss.
(2) Loss corporation.
(3) Ordering rules for utilization of pre-change losses and for absorption of the section 382 limitation.
(4) Disallowed business interest expense from the pre-change period in the year of a testing date.
(f) Overlap of SRLY limitation with section 382.
(g) Additional limitations.
(h) Applicability date.

§ 1.163(j)–6 Application of the business interest deduction limitation to partnerships and subchapter S corporations.

(a) Overview.
(b) Definitions.
(1) Section 163(j) items.
(2) Partner basis items.
(3) Remedial items.
(4) Excess business interest income.
(5) Deductible business interest expense.
(6) Section 163(j) excess items.
(7) Non-excepted assets.
(8) Excepted assets.
(c) Character of business interest expense.
(d) Adjusted taxable income of the partnership.
(1) Modification of adjusted taxable income for partnerships.
(2) Section 734(b), partner basis items, and remedial items.
(e) Adjusted taxable income and business interest income of partners.
(1) Modification of adjusted taxable income for partners.
(2) Partner basis items and remedial items.
(3) Disposition of partnership interests.
(4) Double counting of business interest income and floor plan financing interest expense prohibited.
(f) Allocation and determination of section 163(j) excess items made in the same manner as nonseparately stated taxable income or loss of the partnership.
(1) Overview.
(i) In general.
(ii) Relevance solely for purposes of section 163(j).
(2) Steps for allocating deductible business interest expense and section 163(j) excess items.
(i) Partnership-level calculation required by section 163(j)(4)(A).
(ii) Determination of each partner's relevant section 163(j) items.
(iii) Partner-level comparison of business interest income and business interest expense.
(iv) Matching partnership and aggregate partner excess business interest income.
(v) Remaining business interest expense determination.
(vi) Determination of final allocable ATI.
(A) Positive allocable ATI.
(B) Negative allocable ATI.
(C) Final allocable ATI.
(vii) Partner-level comparison of thirty percent of adjusted taxable income and remaining business interest expense.
(viii) Partner priority right to ATI capacity excess determination.
(ix) Matching partnership and aggregate partner excess taxable income.
(x) Matching partnership and aggregate partner excess business interest expense.
(xi) Final section 163(j) excess item and deductible business interest expense allocation.
(g) Carryforwards.
(1) In general.
(2) Treatment of excess of business interest expense allocated to partners.
(3) Excess taxable income and excess business interest income ordering rule.
(h) Basis adjustments.
(1) Section 704(d) ordering.
(2) Excess business interest expense basis adjustments.
(3) Basis adjustments upon disposition of partnership interest.
(i) Complete disposition of partnership interest.
(ii) Partial disposition of partnership interest.
(i) [Reserved]
(j) Investment items.
(k) [Reserved]
(l) S corporations.
(1) In general.
(2) Character of deductible business interest expense.
(3) Adjusted taxable income of an S corporation.
(4) Adjusted taxable income and business interest income of S corporation shareholders.
(i) Adjusted taxable income of S corporation shareholders.
(ii) Disposition of S corporation stock.

(iii) Double counting of business interest income and floor plan financing interest expense prohibited.
(5) Carryforwards.
(6) Basis adjustments and disallowed business interest expense carryforwards.
(7) Accumulated adjustment accounts.
(8) Termination of qualified subchapter S subsidiary election.
(9) Investment items.
(m) Partnerships and S corporations not subject to section 163(j).
(1) Partnerships and S corporations not subject to section 163(j) by reason of the small business exemption.
(2) Partnerships and S corporations not subject to section 163(j) by reason of an excepted trade or business.
(3) Partnerships that allocated excess business interest expense prior to becoming not subject to section 163(j).
(4) S corporations with disallowed business interest expense carryforwards prior to becoming not subject to section 163(j).
(n) [Reserved]
(o) Examples.
(p) Applicability date.

§ 1.163(j)–7 Application of the business interest deduction limitation to foreign corporations and United States shareholders.

(a) Overview.
(b) Application of section 163(j) to an applicable CFC and certain partnerships.
(1) Scope.
(2) General application of section 163(j) to an applicable CFC and a partnership with at least one partner that is an applicable CFC.
(3) Alternative approach for computing the deduction for business interest expense.
(4) Treatment of certain partnerships as a CFC group member.
(i) General rule.
(ii) Exception for certain partnerships engaged in a United States trade or business.
(5) CFC group election.
(i) Manner of making a CFC group election.
(ii) Consistency requirement.
(iii) Duration of a CFC group election.
(c) Rules concerning the computation of adjusted taxable income of an applicable CFC and certain CFC group members.
(1) Computation of taxable income.
(2) Treatment of certain dividends.
(3) Treatment of CFC excess taxable income.
(i) In general.
(ii) Ordering rules.
(d) Rules concerning the computation of adjusted taxable income of a United States shareholder.
(1) In general.
(i) Treatment of gross income inclusions that are properly allocable to a non-excepted trade or business.
(ii) Treatment of deemed inclusions of a domestic partnership that are not allocable to any trade or business.
(2) Additional rule after application of paragraph (d)(1) of this section for a United States shareholder of a CFC group member with a CFC group election in effect.
(i) In general.
(ii) Eligible CFC group ETI.
(iii) CFC group inclusions.
(3) Special rules if a domestic partnership is a United States shareholder of a CFC group member with a CFC group election in effect.
(4) Inclusions under section 951A(a).
(e) Effect on earnings and profits.
(f) Definitions.
(1) Allocable share.
(i) General rule.
(ii) Special rule if there is a financial services subgroup.
(2) Applicable CFC.
(3) Applicable net business interest expense.
(4) Applicable subgroup net business interest expense.
(5) CFC excess taxable income.
(i) In general.
(ii) CFC group member is a partnership.
(6) CFC group.
(i) In general.
(ii) Aggregation rules.
(7) CFC group election.
(8) CFC group member.
(9) Financial services subgroup.
(10) Financial services subgroup member.
(11) Majority U.S. shareholder taxable year.
(12) Net business interest expense.
(13) Passthrough entity.
(14) Specified ETI ratio.
(i) In general.
(ii) Includable CFC group members.
(iii) Numerator.
(iv) Denominator.
(15) Specified highest-tier member.
(16) Specified lower-tier member.
(17) Specified taxable year.
(18) United States shareholder.
(g) Examples.
(h) Applicability date.

§ 1.163(j)–8 Application of the business interest deduction limitation to foreign persons with effectively connected income.

(a) Overview.
(b) Application of section 163(j) and the section 163(j) regulations to specified foreign persons with effectively connected taxable income.
(1) In general.
(2) Modification of adjusted taxable income.
(3) Modification of business interest expense.
(i) General rule.
(ii) Exclusion of certain business interest expense of a specified foreign partner.
(4) Modification of business interest income.
(5) Modification of floor plan financing interest expense.
(6) Modification of allocation of interest expense and interest income that is properly allocable to trade or business.
(c) Partner-level modifications to § 1.163(j)–6 for partnerships engaged in a U.S. trade or business.
(1) Modification related to a partnership's excess taxable income.
(2) Modification related to a partnership's excess business interest expense.
(3) Modification related to a partnership's excess business interest income.
(d) An applicable CFC with effectively connected taxable income.
(e) Coordination of section 163(j) and § 1.882–5.
(1) General rules.
(i) Ordering rule.
(ii) Treatment of disallowed business interest expense carryforward.

(iii) Treatment of allocable excess business interest expense.

(iv) Scaling ratio.

(2) Amount of interest determined under § 1.882–5 that is disallowed business interest expense.

(i) Foreign corporation is not a specified foreign partner.

(ii) Foreign corporation is a specified foreign partner.

(f) Coordination with branch profits tax.

(1) Effect on effectively connected earnings and profits.

(2) Effect on U.S. net equity.

(g) Definitions.

(1) Applicable CFC.

(2) ECI excess business interest income.

(3) Effectively connected taxable income.

(4) Specified excess business interest expense.

(5) Specified excess taxable income.

(6) Specified foreign partner.

(7) Specified foreign person.

(8) Specified ratio.

(h) Examples.

(i) Applicability date.

§ 1.163(j)–9 Elections for excepted trades or businesses; safe harbor for certain REITs.

(a) Overview.

(b) Scope and effect of election.

(1) In general.

(2) Irrevocability.

(c) Time and manner of making election.

(1) In general.

(2) Election statement contents.

(3) Consolidated group's trade or business.

(4) Partnership's trade or business.

(d) Termination of election.

(1) In general.

(2) Taxable asset transfer defined.

(3) Related party defined.

(4) Anti-abuse rule.

(e) Additional guidance.

(f) Examples.

(g) Safe harbor for REITs.

(1) In general.

(2) REITs that do not significantly invest in real property financing assets.

(3) REITs that significantly invest in real property financing assets.

(4) REIT real property assets, interests in partnerships, and shares in other REITs.

(i) Real property assets.

(ii) Partnership interests.

(iii) Shares in other REITs.

(5) Value of shares in other REITs.

(6) Real property financing assets.

(h) Special anti-abuse rule for certain real property trades or businesses.

(1) In general.

(2) Exception for certain REITs.

(i) Applicability date.

§ 1.163(j)–10 Allocation of interest expense, interest income, and other items of expense and gross income to an excepted trade or business.

(a) Overview.

(1) In general.

(i) Purposes.

(ii) Application of section.

(2) Coordination with other rules.

(i) In general.

(ii) Treatment of investment interest, investment income, and investment expenses of a partnership with a C corporation or tax-exempt corporation as a partner.

(3) Application of allocation rules to foreign corporations and foreign partnerships.

(4) Application of allocation rules to members of a consolidated group.

(i) In general.

(ii) Application of excepted business percentage to members of a consolidated group.

(iii) Basis in assets transferred in an intercompany transaction.

(5) Tax-exempt organizations.

(6) [Reserved]

(7) Examples.

(b) Allocation of tax items other than interest expense and interest income.

(1) In general.

(2) Gross income other than dividends and interest income.

(3) Dividends.

(i) Look-through rule.

(ii) Inapplicability of the look-through rule.

(4) Gain or loss from the disposition of non-consolidated C corporation stock, partnership interests, or S corporation stock.

(i) Non-consolidated C corporations.

(ii) Partnerships and S corporations.

(5) Expenses, losses, and other deductions.

(i) Expenses, losses, and other deductions that are definitely related to a trade or business.

(ii) Other deductions.

(6) Treatment of certain investment items of a partnership with a C corporation partner.

(7) Example—Allocation of income and expense.

(c) Allocating interest expense and interest income that is properly allocable to a trade or business.

(1) General rule.

(i) In general.

(ii) De minimis exception.

(2) Example.

(3) Asset used in more than one trade or business.

(i) General rule.

(ii) Permissible methodologies for allocating asset basis between or among two or more trades or businesses.

(iii) Special rules.

(A) Consistent allocation methodologies.

(*1*) In general.

(*2*) Consent to change allocation methodology.

(B) De minimis exceptions.

(*1*) De minimis amount of gross income from trades or businesses.

(*2*) De minimis amount of asset basis allocable to a trade or business.

(C) Allocations of excepted regulated utility trades or businesses.

(*1*) In general.

(*2*) Permissible method for allocating asset basis for utility trades or businesses.

(*3*) De minimis rule for excepted utility trades or businesses.

(*4*) Example.

(4) Disallowed business interest expense carryforwards; floor plan financing interest expense.

(5) Additional rules relating to basis.

(i) Calculation of adjusted basis.

(A) Non-depreciable property other than land.

(B) Depreciable property other than inherently permanent structures.

(C) Special rule for land and inherently permanent structures.

(D) Depreciable or amortizable intangible property and depreciable income forecast method property.

(E) Assets not yet used in a trade or business.

(F) Trusts established to fund specific liabilities.

(G) Inherently permanent structure.

(ii) Partnership interests; stock in non-consolidated domestic corporations.

(A) Partnership interests.

(*1*) Calculation of asset basis.

(*2*) Allocation of asset basis.

(*i*) In general.

(*ii*) De minimis rule.

(*iii*) Partnership assets not properly allocable to a trade or business.

(*iv*) Inapplicability of partnership look-through rule.

(B) Stock in non-consolidated domestic corporations.

(*1*) In general.

(*2*) Domestic non-consolidated C corporations.

(*i*) Allocation of asset basis.

(*ii*) De minimis rule.

(*iii*) Inapplicability of corporate look-through rule.

(*3*) S corporations.

(*i*) Calculation of asset basis.

(*ii*) Allocation of asset basis.

(*iii*) De minimis rule.

(i*v*) Inapplicability of S corporation look-through rule.

(C) Stock in CFCs.

(D) Inapplicability of look-through rule to partnerships or non-consolidated corporations to which the small business exemption applies.

(E) Tiered entities.

(iii) Cash and cash equivalents and customer receivables.

(iv) Deemed asset sale.

(v) Other adjustments.

(6) Determination dates; determination periods; reporting requirements.

(i) Definitions.

(ii) Application of look-through rules.

(iii) Reporting requirements.

(A) Books and records.

(B) Information statement.

(iv) Failure to file statement.

(7) Ownership threshold for look-through rules.

(i) Corporations.

(A) Asset basis.

(B) Dividends.

(ii) Partnerships.

(iii) Inapplicability of look-through rule.

(8) Anti-abuse rule.

(d) Direct allocations.

(1) In general.

(2) Financial services entities.

(3) Assets used in more than one trade or business.

(4) Adjustments to basis of assets to account for direct allocations.

(5) Example.

(e) Examples.

(f) Applicability date.

§ 1.163(j)–11 Transition rules.

(a) Application of section 163(j) limitation if a corporation joins a consolidated group with a taxable year beginning before January 1, 2018.

(1) In general.

(2) Example.

(b) Treatment of disallowed disqualified interest.

(1) In general.

(2) Earnings and profits.

(3) Disallowed disqualified interest of members of an affiliated group.

(i) Scope.

(ii) Allocation of disallowed disqualified interest to members of the affiliated group.

(A) In general.

(B) Definitions.

(*1*) Allocable share of the affiliated group's disallowed disqualified interest.

(*2*) Disallowed disqualified interest ratio.

(*3*) Exempt related person interest expense.

(iii) Treatment of carryforwards.

(4) Application of section 382.

(i) Ownership change occurring before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

(A) Pre-change loss.

(B) Loss corporation.

(ii) Ownership change occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

(A) Pre-change loss.

(B) Loss corporation.

(iii) Definitions.

(5) [Reserved]

(6) Treatment of excess limitation from taxable years beginning before January 1, 2018.

(7) Example.

(c) Applicability date.

Par. 3. Sections 1.163(j)–1 through 1.163(j)–11 are added to read as follows:

Sec.

* * * * *

1.163(j)–1 Definitions.

1.163(j)–2 Deduction for business interest expense limited.

1.163(j)–3 Relationship of business interest deduction limitation to other provisions affecting interest.

1.163(j)–4 General rules applicable to C corporations (including REITs, RICs, and members of consolidated groups) and tax-exempt corporations.

1.163(j)–5 General rules governing disallowed business interest expense carryforwards for C corporations.

1.163(j)–6 Application of the business interest deduction limitation to partnerships and subchapter S corporations.

1.163(j)–7 Application of the business interest deduction limitation to foreign corporations and United States shareholders.

1.163(j)–8 Application of the business interest deduction limitation to foreign persons with effectively connected income.

1.163(j)–9 Elections for excepted trades or businesses; safe harbor for certain REITs.

1.163(j)–10 Allocation of interest expense, interest income, and other items of expense and gross income to an excepted trade or business.

1.163(j)–11 Transition rules.

* * * * *

§ 1.163(j)–1 Definitions.

(a) *In general*. This section defines terms used in the section 163(j) regulations. For purposes of the rules sets forth in §§ 1.163(j)–2 through 1.163(j)–11, additional definitions for certain terms are provided in those sections.

(b) *Definitions*–(1) *Adjusted taxable income*. The term *adjusted taxable income* (ATI) means the taxable income of the taxpayer for the taxable year, with the adjustments in this paragraph (b).

(i) *Additions*. The amounts of the following items (if any) are added to taxable income to determine ATI –

(A) Any business interest expense;

(B) Any net operating loss deduction under section 172;

(C) Any deduction under section 199A;

(D) For taxable years beginning before January 1, 2022, any deduction for depreciation under section 167, section 168, or section 168 of the Internal Revenue Code of 1954 (former section 168);

(E) For taxable years beginning before January 1, 2022, any deduction for the amortization of intangibles (for example, under section 167 or 197) and other amortized expenditures (for example, under section 195(b)(1)(B), 248, or 1245(a)(2)(C));

(F) For taxable years beginning before January 1, 2022, any deduction for depletion under section 611;

(G) Any deduction for a capital loss carryback or carryover; and

(H) Any deduction or loss that is not properly allocable to a non-excepted trade or business (for rules governing the allocation of items to an excepted trade or business, see §§ 1.163(j)–1(b)(38) and 1.163(j)–10).

(ii) *Subtractions*. The amounts of the following items (if any) are subtracted from taxable income to determine ATI–

(A) Any business interest income;

(B) Any floor plan financing interest expense for the taxable year;

(C) With respect to the sale or other disposition of property, the lesser of:

(*1*) Any gain recognized on the sale or other disposition of such property; and

(*2*) Any depreciation, amortization, or depletion deductions for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property;

(D) With respect to the sale or other disposition of stock of a member of a consolidated group that includes the selling member, the investment adjustments, as defined under § 1.1502–32, with respect to such stock that are attributable to deductions described in paragraph (b)(1)(ii)(C) of this section;

(E) With respect to the sale or other disposition of an interest in a partnership, the taxpayer's distributive share of deductions described in paragraph (b)(1)(ii)(C) of this section with respect to property held by the partnership at the time of such sale or other disposition to the extent such deductions were allowable under section 704(d); and

(F) Any income or gain that is not properly allocable to a non-excepted trade or business (for rules governing the allocation of items to an excepted trade or business, see §§ 1.163(j)–1(b)(38) and 1.163(j)–10)).

(iii) *Depreciation, amortization, or depletion expenses capitalized to inventory under section 263A*. Depreciation, amortization, or depletion expense that is capitalized to inventory under section 263A is not a depreciation, amortization, or depletion deduction for purposes of this paragraph (b)(1).

(iv) *Other adjustments*. ATI is computed with the other adjustments provided in §§ 1.163(j)–2 through 1.163(j)–11.

(v) *Additional rules relating to adjusted taxable income in other sections*. (A) For rules governing the ATI of C corporations, see §§ 1.163(j)–4(b)(2) and (3) and 1.163(j)–10(a)(2)(ii).

(B) For rules governing the ATI of RICs and REITs, see § 1.163(j)–4(b)(4).

(C) For rules governing the ATI of tax-exempt corporations, see § 1.163(j)–4(b)(5).

(D) For rules governing the ATI of consolidated groups, see § 1.163(j)–4(d)(2)(iv) and (v).

(E) For rules governing the ATI of partnerships, see § 1.163(j)–6(d).

(F) For rules governing the ATI of partners, see § 1.163(j)–6(e).

(G) For rules governing partnership basis adjustments impacting ATI, see § 1.163(j)–6(h)(2).

(H) For rules governing the ATI of S corporations, see § 1.163(j)–6(l)(3).

(I) For rules governing the ATI of S corporation shareholders, see § 1.163(j)–6(l)(4).

(J) For rules governing the ATI of applicable CFCs and certain CFC group members, as defined in § 1.163(j)–7(f), see § 1.163(j)–7(c).

(K) For rules governing the ATI of United States shareholders of applicable CFCs, including the treatment of inclusions under sections 78, 951(a), and 951A(a), see § 1.163(j)–7(d).

(L) For rules governing the ATI of specified foreign persons, as defined in § 1.163(j)–8(g)(7), with effectively connected income, see § 1.163(j)–8(b)(2).

(M) For rules governing the ATI of specified foreign partners, as defined in § 1.163(j)–8(g)(6), other than applicable CFCs, as defined in § 1.163(j)–8(g)(1), see § 1.163(j)–8(c)(1).

(N) For rules governing the ATI of certain beneficiaries of trusts and estates, see § 1.163(j)–2(f).

(2) *Business interest expense*–(i) *In general*. The term *business interest expense* means interest expense that is properly allocable to a non-excepted trade or business or that is floor plan financing interest expense. Business interest expense also includes disallowed business interest expense carryforwards (as defined in paragraph (b)(9) of this section). For the treatment of investment interest, see section 163(d); and for the treatment of personal interest, see section 163(h).

(ii) *Special rules*. For special rules for defining business interest expense in certain circumstances, see §§ 1.163(j)–3(b)(2) (regarding disallowed interest expense), 1.163(j)–4(b) (regarding C corporations) and (d)(2)(iii) (regarding consolidated groups), and 1.163(j)–8(b)(3) (regarding foreign persons engaged in a U.S. trade or business).

(3) *Business interest income*–(i) *In general*. The term *business interest income* means interest income which is properly allocable to a non-excepted trade or business. For the treatment of investment income, see section 163(d).

(ii) *Special rules*. For special rules defining business interest income in certain circumstances, see §§ 1.163(j)–4(b) (regarding C corporations) and (d)(2)(iii) (regarding consolidated groups) and 1.163(j)–8(b)(4) (regarding foreign persons engaged in a U.S. trade or business).

(4) *C corporation*. The term *C corporation* has the meaning provided in section 1361(a)(2).

(5) *Cleared swap*. The term *cleared swap* means a swap that is cleared by a derivatives clearing organization, as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a), or by a clearing agency, as such term is defined in section 3 of the Securities Exchange

Act of 1934 (15 U.S.C. 78c), that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively, if the derivatives clearing organization or clearing agency requires the parties to the swap to post and collect margin or collateral.

(6) *Consolidated group*. The term *consolidated group* has the meaning provided in § 1.1502–1(h).

(7) *Consolidated return year*. The term *consolidated return year* has the meaning provided in § 1.1502–1(d).

(8) *Disallowed business interest expense*. The term *disallowed business interest expense* means the amount of business interest expense for a taxable year in excess of the amount allowed as a deduction for the taxable year under section 163(j)(1) and § 1.163(j)–2(b).

(9) *Disallowed business interest expense carryforward*. The term *disallowed business interest expense carryforward* means any business interest expense described in § 1.163(j)–2(c).

(10) *Disallowed disqualified interest*. The term *disallowed disqualified interest* means interest expense, including carryforwards, for which a deduction was disallowed under old section 163(j) (as defined in paragraph (b)(26) of this section) in the taxpayer's last taxable year beginning before January 1, 2018, and that was carried forward pursuant to old section 163(j).

(11) *Electing farming business*. The term *electing farming business* means a trade or business that makes an election as provided in § 1.163(j)–9 or other published guidance and that is–

(i) A farming business, as defined in section 263A(e)(4) or § 1.263A–4(a)(4); or

(ii) Any trade or business of a specified agricultural or horticultural cooperative, as defined in section 199A(g)(4).

(12) *Electing real property trade or business*. The term *electing real property trade or business* means a trade or business that makes an election as provided in § 1.163(j)–9 or other published guidance and that is described in—

(i) Section 469(c)(7)(C) and § 1.469–9(b)(2); or

(ii) Section 1.163(j)–9(g).

(13) *Excepted regulated utility trade or business*–(i) *In general*. The term *excepted regulated utility trade or business* means a trade or business–

(A) That furnishes or sells:

(*1*) Electrical energy, water, or sewage disposal services;

(*2*) Gas or steam through a local distribution system; or

(*3*) Transportation of gas or steam by pipeline; and

(B) To the extent that the rates for the furnishing or sale of the items in paragraph (b)(13)(i)(A) of this section–

(*1*) Have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof and are determined on a cost of service and rate of return basis; or

(*2*) Have been established or approved by the governing or ratemaking body of an electric cooperative.

(ii) *Excepted and non-excepted utility trades or businesses*. If a taxpayer is engaged in both an excepted trade or business and a non-excepted trade or business described in this paragraph (b)(13), the taxpayer must allocate items between the trades or businesses. See §§ 1.163(j)–1(b)(38) and 1.163(j)–10(c)(3)(iii)(C). Some trades or businesses with de minimis furnishing or sales of items described in paragraph (b)(13)(i)(A) of this section that are not sold pursuant to rates determined on a cost of service and rate of return basis as required in paragraph (b)(13)(i)(B)(*1*) of this section, or by the governing or ratemaking body of an electric cooperative as required in paragraph (b)(13)(i)(B)(*2*) of this section are treated as excepted trades or businesses. See § 1.163(j)–10(c)(3)(iii)(C)(*3*).

(14) *Excess business interest expense*. The term *excess business interest expense* means, with respect to a partnership, the amount of disallowed business interest expense of the partnership for a taxable year under section § 1.163(j)–2(b), except as provided in § 1.163(j)–6(h)(2).

(15) *Excess taxable income*. With respect to any partnership or S corporation, the term *excess taxable income* means the amount which bears the same ratio to the partnership's ATI as–

(i) The excess (if any) of–

(A) The amount determined for the partnership or S corporation under section 163(j)(1)(B); over

(B) The amount (if any) by which the business interest expense of the partnership, reduced by the floor plan financing interest expense, exceeds the business interest income of the partnership or S corporation; bears to

(ii) The amount determined for the partnership or S corporation under section 163(j)(1)(B).

(16) *Floor plan financing indebtedness*. The term floor plan financing indebtedness means indebtedness–

(i) Used to finance the acquisition of motor vehicles held for sale or lease; and

(ii) Secured by the inventory so acquired.

(17) *Floor plan financing interest expense*. The term *floor plan financing interest expense* means interest paid or accrued on floor plan financing indebtedness. For purposes of the section 163(j) regulations, all floor plan financing interest expense is treated as business interest expense. See paragraph (b)(2) of this section.

(18) *Group*. The term *group* has the meaning provided in § 1.1502–1(a).

(19) *Intercompany transaction*. The term *intercompany transaction* has the meaning provided in § 1.1502–13(b)(1)(i).

(20) *Interest*. The term *interest* means any amount described in paragraph (b)(20)(i), (ii), (iii), or (iv) of this section.

(i) *In general*. Interest is an amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of section 1275(a) and § 1.1275–1(d), and not treated as stock under § 1.385–3, or an amount that is treated as interest under other provisions of the Internal Revenue Code (Code) or the regulations thereunder. Thus, for example, interest includes–

(A) Original issue discount (OID), as adjusted by the holder for any acquisition premium or amortizable bond premium;

(B) Qualified stated interest, as adjusted by the holder for any amortizable bond premium or by the issuer for any bond issuance premium;

(C) Acquisition discount;

(D) Amounts treated as taxable OID under section 1286 (relating to stripped bonds and stripped coupons);

(E) Accrued market discount on a market discount bond to the extent includible in income by the holder under either section 1276(a) or 1278(b);

(F) OID includible in income by a holder that has made an election under § 1.1272–3 to treat all interest on a debt instrument as OID;

(G) OID on a synthetic debt instrument arising from an integrated transaction under § 1.1275–6;

(H) Repurchase premium to the extent deductible by the issuer under § 1.163–7(c);

(I) Deferred payments treated as interest under section 483;

(J) Amounts treated as interest under a section 467 rental agreement;

(K) Amounts treated as interest under section 988;

(L) Forgone interest under section 7872;

(M) De minimis OID taken into account by the issuer;

(N) Amounts paid or received in connection with a sale-repurchase agreement treated as indebtedness under Federal tax principles; in the case of a sale-repurchase agreement relating to tax-exempt bonds, however, the amount is not tax-exempt interest;

(O) Redeemable ground rent treated as interest under section 163(c); and

(P) Amounts treated as interest under section 636.

(ii) *Swaps with significant nonperiodic payments*–(A) *Non-cleared swaps*. A swap other than a cleared swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan, determined in accordance with § 1.446–3(f)(2)(iii)(A), is recognized as interest expense to the payor and interest income to the recipient.

(B) [Reserved]

(iii) *Other amounts treated as interest*–(A) *Treatment of premium*–(*1*) *Issuer*. If a debt instrument is issued at a premium within the meaning of § 1.163–13, any ordinary income under § 1.163–13(d)(4) is treated as interest income of the issuer.

(*2*) *Holder*. If a taxable debt instrument is acquired at a premium within the meaning of § 1.171–1 and the holder elects to amortize the premium, any amount otherwise deductible under section 171(a)(1) as a bond premium deduction under § 1.171–2(a)(4)(i)(A) or (C) is treated as interest expense of the holder.

(B) *Treatment of ordinary income or loss on certain debt instruments*. If an issuer of a contingent payment debt instrument subject to § 1.1275–4(b), a nonfunctional currency contingent payment debt instrument subject to § 1.988–6, or an inflation-indexed debt instrument subject to § 1.1275–7 recognizes ordinary income on the debt instrument in accordance with the rules in § 1.1275–4(b), § 1.988–6(b)(2), or § 1.1275–7(f), whichever is applicable, the ordinary income is treated as interest income of the issuer. If a holder of a contingent payment debt instrument subject to § 1.1275–4(b), a nonfunctional currency contingent payment debt instrument subject to § 1.988–6, or an inflation-indexed debt instrument subject to § 1.1275–7 recognizes an ordinary loss on the debt instrument in accordance with the rules in § 1.1275–4(b), § 1.988–6(b)(2), or § 1.1275–7(f), whichever is applicable, the ordinary loss is treated as interest expense of the holder.

(C) *Substitute interest payments*. A substitute interest payment described in § 1.861–2(a)(7) is treated as interest expense to the payor or interest income to the recipient; in the case of a sale-repurchase agreement or a securities lending transaction relating to tax-exempt bonds, however, the recipient of a substitute payment does not receive tax-exempt interest income.

(D) *Section 1258 gain*. Any gain treated as ordinary gain under section 1258 is treated as interest income.

(E) *Amounts affecting a taxpayer's effective cost of borrowing*. Income, deduction, gain, or loss from a derivative, as defined in section 59A(h)(4)(A), that alters a taxpayer's effective cost of borrowing with respect to a liability of the taxpayer is treated as an adjustment to interest expense of the taxpayer. For example, a taxpayer that is obligated to pay interest at a floating rate on a note and enters into an interest rate swap that entitles the taxpayer to receive an amount that is equal to or that closely approximates the interest rate on the note in exchange for a fixed amount is, in effect, paying interest expense at a fixed rate by entering into the interest rate swap. Income, deduction, gain, or loss from the swap is treated as an adjustment to interest expense. Similarly, any gain or loss resulting from a termination or other disposition of the swap is an adjustment to interest expense, with the timing of gain or loss subject to the rules of § 1.446–4.

(F) *Yield adjustments*. Income, deduction, gain, or loss from a derivative, as defined in section 59A(h)(4)(A), that alters a taxpayer's effective yield with respect to a debt instrument held by the taxpayer is treated as an adjustment to interest income by the taxpayer.

(G) *Certain amounts labeled as fees*–(*1*) *Commitment fees*. Any fees in respect of a lender commitment to provide financing are treated as interest if any portion of such financing is actually provided.

(*2*) [Reserved]

(H) *Debt issuance costs*. Any debt issuance costs subject to § 1.446–5 are treated as interest expense of the issuer.

(I) *Guaranteed payments*. Any guaranteed payments for the use of capital under section 707(c) are treated as interest.

(J) *Factoring income*. The excess of the amount that a taxpayer collects on a factored receivable (or realizes upon the sale or other disposition of the factored receivable) over the amount paid for the factored receivable by the taxpayer is treated as interest income. For purposes of this paragraph (b)(20)(iii)(J), the term *factored receivable* includes any account receivable or other evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition of property or the performance of services by any person, if such account receivable or evidence of indebtedness is acquired by a person other than the person who disposed of the property or provided the services that gave rise to the account receivable or evidence of indebtedness.

(iv) *Anti-avoidance rule for amounts predominantly associated with the time value of money*. Any expense or loss, to the extent deductible, incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time is treated as interest expense of the taxpayer if such expense or loss is predominantly incurred in consideration of the time value of money.

(v) *Examples*. The examples in this paragraph (b)(20)(v) illustrate the application of paragraphs (b)(20)(i) through (iv) of this section. Unless otherwise indicated, assume the following: A, B, C, D, and Bank are domestic C corporations that are publicly traded; the exemption for certain small businesses in § 1.163(j)–2(d) does not apply; A is not engaged in an excepted trade or business; and all amounts of interest expense are deductible except for the potential application of section 163(j).

(A) *Example 1*–(*1*) *Facts*. (*i*) A is a calendar year taxpayer that is engaged in a manufacturing business. In January 2019, A, which has an investment-grade credit rating, enters into the following transactions (the transactions): Bank transfers a portfolio of U.S. Treasury bonds (the Treasury portfolio) to A; A agrees to pay Bank an amount equivalent to any interest paid on the Treasury portfolio during the transactions and a fee for lending the Treasury portfolio to A; A agrees to return to Bank securities that are substantially identical to the Treasury portfolio upon request, regardless of any value increases or decreases in the market value of the Treasury portfolio; A rehypothecates the Treasury portfolio in exchange for cash, which A uses to purchase a portfolio of corporate bonds (the debt portfolio); and the transactions remain in place for the duration of the 2019 calendar year until Bank delivers a notice to A recalling the Treasury portfolio 5 business days before December 31, 2019.

(*ii*) The obligations undertaken with respect to the transactions are not collateralized. Assume that the transactions do not result in a sale-repurchase agreement treated as indebtedness under Federal tax principles. During the course of the transactions, the debt portfolio generates $70x of interest income. The Treasury portfolio generates $60x of interest income during the course of the transactions and A pays $60x to Bank under its obligation to pay amounts equivalent to the interest paid on the Treasury portfolio.

(*2*) *Analysis*. The transactions involving Bank and A are transactions described in paragraph (b)(20)(iii)(C) of this section. Consequently, the $60x of substitute interest payments that A paid to Bank in 2019 is treated as interest expense for purposes of section 163(j). In addition, the $70x of interest income generated by the debt portfolio is interest income to A.

(B) *Example 2*–(*1*) *Facts*. A is a calendar year taxpayer that is engaged in a manufacturing business. In early 2019, A enters into the following transactions:

(*i*) A enters into a loan obligation in which A borrows Japanese yen from Bank in an amount equivalent to $2000x with an interest rate of 1 percent (at the time of the loan, the U.S. dollar equivalent interest rate on a loan of $2,000x is 5 percent); and

(*ii*) A enters into a foreign currency swap transaction (FX Swap) with Bank with a notional principal amount of $2000x under which A receives Japanese yen at 1 percent multiplied by the amount of Japanese yen borrowed from Bank (which for 2019 equals $20x) and pays U.S. dollars at 5 percent multiplied by a notional amount of $2000x ($100x per year). The FX Swap is not integrated with the loan obligation under § 1.988–5.

(*2*) *Analysis*. The FX Swap alters A's cost of borrowing within the meaning of paragraph (b)(20)(iii)(E) of this section. As a result, for purposes of section 163(j), the $100x paid by A to Bank on the FX Swap is treated by A as interest expense and the $20x paid by Bank to A on the FX Swap is treated by A as a reduction of interest expense.

(C) *Example 3*–(*1*) *Facts*. A borrows from B two ounces of gold at a time when the spot price for gold is $500x per ounce. A agrees to return the two ounces of gold in six months. A sells the two ounces of gold to C for $1,000x. A then enters into a contract with D to purchase two ounces of gold six months in the future for $1,013x. In exchange for the use of $1,000x in cash, A has sustained a loss of $13x on related transactions.

(*2*) *Analysis*. A has obtained the use of $1,000x and, in a series of related transactions, created a loss of $13x predominantly associated with the time value of money. As a result, for purposes of section 163(j), the loss of $13x is treated as interest expense under paragraph (b)(20)(iv) of this section.

(21) *Interest expense*. The term *interest expense* means interest that is paid or accrued, or treated as paid or accrued, for the taxable year.

(22) *Interest income*. The term *interest income* means interest that is included in gross income for the taxable year.

(23) *Inventory*. The term *inventory* means property held for sale or for lease, or both, by a taxpayer in the ordinary course of its trade or business.

(24) *Member*. The term *member* has the meaning provided in § 1.1502–1(b).

(25) *Motor vehicle*. The term *motor vehicle* means a motor vehicle as defined in section 163(j)(9)(C).

(26) *Old section 163(j)*. The term *old section 163(j)* means section 163(j) immediately prior to its amendment by Public Law 115–97, 131 Stat. 2054 (2017).

(27) *Real estate investment trust*. The term *real estate investment trust* (REIT) has the meaning provided in section 856.

(28) *Real property*. The term *real property* includes–

(i) Real property as defined in § 1.469–9(b)(2); and

(ii) Any direct or indirect right, including a license or other contractual right, to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property, including net proceeds or profits associated with tolls, rents or other similar fees.

(29) *Regulated investment company*. The term *regulated investment company* (RIC) has the meaning provided in section 851.

(30) *S corporation*. The term *S corporation* has the meaning provided in section 1361(a)(1).

(31) *Section 163(j) limitation*. The term *section 163(j) limitation* means the limit on the amount of business interest expense that a taxpayer may deduct in a taxable year under section 163(j) and § 1.163(j)–2(b).

(32) *Section 163(j) regulations*. The term *section 163(j) regulations* means this section and §§ 1.163(j)–2 through 1.163(j)–11.

(33) *Separate return limitation year*. The term *separate return limitation year* (SRLY) has the meaning provided in § 1.1502–1(f).

(34) *Separate return year*. The term *separate return year* has the meaning provided in § 1.1502–1(e).

(35) *Separate taxable income*. The term *separate taxable income* has the meaning provided in § 1.1502–12.

(36) *Tax-exempt corporation*. The term *tax-exempt corporation* means any corporation subject to tax under section 511.

(37) *Taxable income*–(i) *In general*. The term *taxable income*, with respect to a taxpayer and a taxable year, has the meaning provided in section 63, but for this purpose computed without regard to the application of section 163(j) and the section 163(j) regulations.

(ii) *General rules to coordinate the application of sections 163(j) and 250*. If for a taxable year a taxpayer is allowed a deduction under section 250(a)(1) that is properly allocable to a non-excepted trade or business, then taxable income for the taxable year is determined without regard to the limitation in section 250(a)(2). For this purpose, the amount of the deduction allowed under section 250(a)(1), without regard to the limitation in section 250(a)(2), is determined without regard to the application of section 163(j) and the section 163(j) regulations.

(iii) [Reserved]

(iv) *Special rules for defining taxable income*. (A) For special rules defining the taxable income of a RIC or REIT, see § 1.163(j)–4(b)(4)(ii).

(B) For special rules defining the taxable income of consolidated groups, see § 1.163(j)–4(d)(2)(iv).

(C) For special rules defining the taxable income of a partnership, see § 1.163(j)–6(d)(1).

(D) For special rules defining the taxable income of an S corporation, see § 1.163(j)–6(l)(3).

(E) For special rules defining the taxable income of certain controlled foreign corporations, see § 1.163(j)–7(c)(1).

(38) *Trade or business*–(i) *In general*. The term *trade or business* means a trade or business within the meaning of section 162.

(ii) *Excepted trade or business*. The term *excepted trade or business* means a trade or business that is described in paragraphs (b)(38)(ii)(A) through (D) of this section. For additional rules related to excepted trades or businesses, including elections made under section 163(j)(7)(B) and (C), see § 1.163(j)–9.

(A) The trade or business of performing services as an employee.

(B) Any electing real property trade or business.

(C) Any electing farming business.

(D) Any excepted regulated utility trade or business.

(iii) *Non-excepted trade or business*. The term *non-excepted trade or business* means any trade or business that is not an excepted trade or business.

(39) *Unadjusted basis*. The term *unadjusted basis* means the basis as determined under section 1012 or other applicable sections of chapter 1 of subtitle A of the Code, including subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses) of the Code. Unadjusted basis is determined without regard to any adjustments described in section 1016(a)(2) or (3), to any adjustments for tax credits claimed by the taxpayer (for example, under section 50(c)), or to any adjustments for any portion of the basis for which the taxpayer has elected to treat as an expense (for example, under section 179, 179B, or 179C).

(c) *Applicability date*. This section applies to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99, (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–2 Deduction for business interest expense limited.

(a) *Overview*. This section provides general rules regarding the section 163(j) limitation. Paragraph (b) of this section provides rules regarding the basic computation of the section 163(j) limitation. Paragraph (c) of this section provides rules for disallowed business interest expense carryforwards. Paragraph (d) of this section provides rules regarding the small business exemption from the section 163(j) limitation. Paragraph (e) of this section provides rules regarding real estate mortgage investment conduits (REMICs). Paragraph (f) of this section provides examples illustrating the application of this section. Paragraph (g) of this section provides an anti-avoidance rule.

(b) *General rule*. Except as otherwise provided in this section or in §§ 1.163(j)–3 through 1.163(j)–11, the amount allowed as a deduction for business interest expense for the taxable year cannot exceed the sum of–

(1) The taxpayer's business interest income for the taxable year;

(2) 30 percent of the taxpayer's ATI for the taxable year, or zero if the taxpayer's ATI for the taxable year is less than zero; and

(3) The taxpayer's floor plan financing interest expense for the taxable year.

(c) *Disallowed business interest expense carryforward*–(1) *In general*. Under section 163(j)(2), any business interest expense disallowed under paragraph (b) of this section, or any disallowed disqualified interest that is properly allocable to a non-excepted trade or business under § 1.163(j)–10, is carried forward to the succeeding taxable year as business interest expense that is subject to paragraph (b) of this section in such succeeding taxable year (a disallowed business interest expense carryforward).

(2) *Coordination with small business exemption*. If disallowed business interest expense is carried forward under the rules of paragraph (c)(1) of this section to a taxable year in which the small business exemption in paragraph (d) of this section applies to the taxpayer, then the general rule in paragraph (b) of this section does not apply to limit the deduction of the disallowed business interest expense carryforward in that taxable year.

(3) *Cross-references*–(i) For special rules regarding disallowed business interest expense carryforwards for taxpayers that are C corporations, including members of a consolidated group, see § 1.163(j)–5.

(ii) For special rules regarding disallowed business interest expense carryforwards of S corporations, see §§ 1.163(j)–5(b)(2) and 1.163(j)–6(l)(5).

(iii) For special rules regarding disallowed business interest expense carryforwards from partnerships, see § 1.163(j)–6.

(iv) For special rules regarding disallowed business interest expense carryforwards from partnerships engaged in a U.S. trade or business, see § 1.163(j)–8(c)(2).

(d) *Small business exemption*–(1) *Exemption*. The general rule in paragraph (b) of this section does not apply to any taxpayer, other than a tax shelter as defined in section 448(d)(3), in any taxable year if the taxpayer meets the gross receipts test of section 448(c) and the regulations thereunder for the taxable year.

(2) *Application of the gross receipts test*–(i) *In general*. In the case of any taxpayer that is not a corporation or a partnership, and except as provided in paragraphs (d)(2)(ii), (iii), and (iv) of this section, the gross receipts test and aggregation rules of section 448(c) and the regulations thereunder are applied in the

same manner as if such taxpayer were a corporation or partnership.

(ii) *Gross receipts of individuals*. Except as provided in paragraph (d)(2)(iii) of this section regarding partnership and S corporation interests and when the aggregation rules of section 448(c) apply, an individual taxpayer's gross receipts include all items specified as gross receipts in regulations under section 448(c), whether or not derived in the ordinary course of the taxpayer's trade or business. For purposes of section 163(j), an individual taxpayer's gross receipts do not include inherently personal amounts, including, but not limited to, personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W–2.

(iii) *Partners and S corporation shareholders*. Except when the aggregation rules of section 448(c) apply, each partner in a partnership includes a share of partnership gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Additionally, each shareholder in an S corporation includes a pro rata share of S corporation gross receipts.

(iv) *Tax-exempt organizations*. For purposes of section 163(j), the gross receipts of an organization subject to tax under section 511 includes only gross receipts taken into account in determining its unrelated business taxable income.

(e) *REMICs*. For the treatment of interest expense by a REMIC as defined in section 860D, see § 1.860C–2(b)(2)(ii).

(f) *Calculation of ATI with respect to certain beneficiaries*. The ATI of a trust or estate beneficiary is reduced by any income (including any distributable net income) received from the trust or estate by the beneficiary to the extent such income supported a deduction for business interest expense under section 163(j)(1)(B) or § 1.163(j)–2(b)(2) in computing the trust or estate's taxable income.

(g) *Examples*. The examples of this paragraph (g) illustrate the application of section 163(j) and the provisions of this section. Unless otherwise indicated, assume the following: X and Y are domestic C corporations; C and D are U.S. resident individuals not subject to any foreign income tax; PRS is a domestic partnership with partners who are all individuals; all taxpayers use a calendar taxable year; the exemption for certain small businesses in section 163(j)(3) and paragraph (d) of this section does not apply; and the interest expense would be deductible but for section 163(j).

(1) *Example 1: Limitation on business interest expense deduction*–(i) *Facts*. During its taxable year ending December 31, 2019, X has ATI of $100x. X has business interest expense of $50x, which includes $10x of floor plan financing interest expense, and business interest income of $20x.

(ii) *Analysis*. X's section 163(j) limitation is $60x, which is the sum of its business interest income ($20x), plus 30 percent of its ATI ($100x x 30 percent = $30x), plus its floor plan financing interest expense ($10x). See § 1.163(j)–2(b). Because X's business interest expense ($50x) does not exceed X's section 163(j) limitation ($60x), X can deduct all $50x of its business interest expense for the 2019 taxable year.

(2) *Example 2: Carryforward of business interest expense*–(i) *Facts*. The facts are the same as in *Example 1* in paragraph (g)(1)(i) of this section, except that X has $80x of business interest expense, which includes $10x of floor plan financing interest expense.

(ii) *Analysis*. As in *Example 1* in paragraph (g)(1)(ii) of this section, X's section 163(j) limitation is $60x. Because X's business interest expense ($80x) exceeds X's section 163(j) limitation ($60x), X may only deduct $60x of its business interest expense for the 2019 taxable year, and the remaining $20x of its business interest expense will be carried forward to the succeeding taxable year as a disallowed business interest expense carryforward. See § 1.163(j)–2(c).

(3) *Example 3: ATI computation*–(i) *Facts*. During the 2019 taxable year, Y has taxable income of $30x (without regard to the application of section 163(j)), which includes the following: $20x of business interest income; $50x of business interest expense, which includes $10x of floor plan financing interest expense; $25x of net operating loss deduction under section 172; and $15x of depreciation deduction under section 167.

(ii) *Analysis*. (A) For purposes of determining the section 163(j) limitation, Y's ATI is $90x, calculated as follows:

Table 1 to paragraph (g)(3)(ii)(A)	
Taxable income:	$30x
Less:	
Floor plan financing interest	10x
Business interest income	20x
	0x

(B) Plus:

Table 1 to paragraph (g)(3)(ii)(B)	
Business interest expense	$50x
Net operating loss deduction	25x
Depreciation deduction	15x
ATI	$90x

(4) *Example 4: Floor plan financing interest expense*–(i) *Facts*. C is the sole proprietor of an automobile dealership that uses a cash method of accounting. In the 2019 taxable year, C paid $30x of interest on a loan that was obtained to purchase sedans for sale by the dealership. The indebtedness is secured by the sedans purchased with the loan proceeds. In addition, C paid $20x of interest on a loan, secured by the dealership's office equipment, which C obtained to purchase convertibles for sale by the dealership.

(ii) *Analysis*. For the purpose of calculating C's section 163(j) limitation, only the $30x of interest paid on the loan to purchase the sedans is floor plan financing interest expense. The $20x paid on the loan to purchase the convertibles is not floor plan financing interest expense for purposes of section 163(j) because the indebtedness was not secured by the inventory of convertibles. However, because under § 1.163(j)–10 the interest paid on the loan to purchase the convertibles is properly allocable to C's dealership trade or business, and because floor plan financing interest expense is also business interest expense, C has $50x of business interest expense for the 2019 taxable year.

(5) *Example 5: Interest not properly allocable to non-excepted trade or business*–(i) *Facts*. The facts are the same as in *Example 4* in paragraph (g)(4)(i) of this section, except that the $20x of interest C pays is on acquisition indebtedness obtained to purchase C's personal residence and not to purchase convertibles for C's dealership trade or business.

(ii) *Analysis*. Because the $20x of interest expense is not properly allocable to a non-excepted trade or business, and therefore is not business interest expense as defined in § 1.163(j)–1(b)(2), C's only business interest expense is the $30x that C pays on the loan used to purchase sedans for sale in C's dealership trade or business. C deducts the $20x of interest related to his residence under the rules of section 163(h), without regard to section 163(j).

(6) *Example 6: Small business exemption*–(i) *Facts*. During the 2019 taxable year, D, the sole proprietor of a trade or business reported on Schedule C, has interest expense properly allocable to that trade or business. D also earns gross income from providing services as an employee that is reported on a Form W–2. Under section 448(c) and the regulations thereunder, D has average annual gross receipts of $21 million, including $1 million of wages in each of the three prior taxable years and $2 million of income from investments not related to a trade or

business in each of the three prior taxable years. Also, in each of the three prior taxable years, D received $5 million in periodic payments of compensatory damages awarded in a personal injury lawsuit.

(ii) *Analysis*. Section 163(j) does not apply to D for the taxable year, because D qualifies for the small business exemption under § 1.163(j)–2(d). The wages that D receives as an employee and the compensatory damages that D received from D's personal injury lawsuit are not gross receipts, as provided in § 1.163(j)–2(d)(2)(ii). D may deduct all of its business interest expense for the 2019 taxable year without regard to section 163(j).

(7) *Example 7: Aggregation of gross receipts*–(i) *Facts*. X and Y are domestic C corporations under common control, within the meaning of section 52(a) and § 1.52–1(b). X's only trade or business is a farming business described in § 1.263A–4(a)(4). During the taxable year ending December 31, 2019, X has average annual gross receipts under section 448(c) of $6 million. During the same taxable year, Y has average annual gross receipts under section 448(c) of $21 million.

(ii) *Analysis*. Because X and Y are under common control, they must aggregate gross receipts for purposes of section 448(c) and the small business exemption in § 1.163(j)–2(d). See section 448(c)(2). Therefore, X and Y are both considered to have $27 million in average annual gross receipts for 2019. X and Y must separately apply section 163(j) to determine any limitation on the deduction for business interest expense. Assuming X otherwise meets the requirements in § 1.163(j)–9 in 2019, X may elect for its farming business to be an excepted trade or business.

(h) *Anti-avoidance rule*. Arrangements entered into with a principal purpose of avoiding the rules of section 163(j) or the section 163(j) regulations, including the use of multiple entities to avoid the gross receipts test of section 448(c), may be disregarded or recharacterized by the Commissioner of the IRS to the extent necessary to carry out the purposes of section 163(j).

(i) *Applicability date*. This section applies to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99, (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–3 Relationship of business interest deduction limitation to other provisions affecting interest.

(a) *Overview*. This section contains rules regarding the relationship between section 163(j) and certain other provisions of the Code. Paragraph (b) of this section provides the general rules concerning the relationship between section 163(j) and certain other provisions of the Code. Paragraph (c) of this section provides examples illustrating the application of this section. For rules regarding the relationship between sections 163(j) and 704(d), see § 1.163(j)–6(h)(1) and (2).

(b) *Coordination of section 163(j) with certain other provisions*–(1) *In general*. Section 163(j) and the section 163(j) regulations generally apply only to business interest expense that would be deductible in the current taxable year without regard to section 163(j). Except as otherwise provided in this section, section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization, or other limitation. For the rules that must be applied in determining whether excess business interest is paid or accrued by a partner, see section 163(j)(4)(B)(ii) and § 1.163(j)–6.

(2) *Disallowed interest provisions*. For purposes of section 163(j), business interest expense does not include interest expense that is permanently disallowed as a deduction under another provision of the Code, such as in section 163(e)(5)(A)(i), (f), (l), or (m), or section 264(a), 265, 267A, or 279.

(3) *Deferred interest provisions*. Other than sections 461(l), 465, and 469, Code provisions that defer the deductibility of interest expense, such as section 163(e)(3) and (e)(5)(A)(ii), 267(a)(2) and (3), 1277, or 1282, apply before the application of section 163(j). For purposes other than sections 465 and 469, interest expense is taken into account for section 163(j) purposes in the taxable year when it is no longer deferred under another section of the Code.

(4) *At risk rules, passive activity loss provisions, and limitation on excess business losses of noncorporate taxpayers*. Section 163(j) applies before the application of sections 461(l), 465, and 469.

(5) *Capitalized interest expenses under sections 263A and 263(g)*. Sections 263A and 263(g) apply before the application of section 163(j). Capitalized interest expense under those sections is not treated as business interest expense for purposes of section 163(j). For ordering rules that determine whether interest expense is capitalized under section 263A(f), see the regulations under section 263A(f), including § 1.263A–9(g).

(6) *Reductions under section 246A*. Section 246A applies before section 163(j). Any reduction in the dividends received deduction under section 246A reduces the amount of business interest expense taken into account under section 163(j).

(7) *Section 381*. Disallowed business interest expense carryforwards are items to which an acquiring corporation succeeds under section 381(a). See section 381(c)(20), and §§ 1.163(j)–5(c) and 1.381(c)(20)–1.

(8) *Section 382*. For rules governing the interaction of sections 163(j) and 382, see section 382(d)(3) and (k)(1), §§ 1.163(j)–5(e) and 1.163(j)–11(b), the regulations under sections 382 and 383, and §§ 1.1502–91 through 1.1502–99.

(9) *Other types of interest provisions*. Except as otherwise provided in the section 163(j) regulations, provisions that characterize interest expense as something other than business interest expense under section 163(j), such as section 163(d), govern the treatment of that interest expense, and such interest expense will not be treated as business interest expense for any purpose under section 163(j).

(10) [Reserved]

(c) *Examples*. The examples of this paragraph (c) illustrate the application of section 163(j) and the provisions of this section. Unless otherwise indicated, assume the following: X and Y are domestic C corporations with a calendar taxable year; D is a U.S. resident individual not subject to any foreign income tax; none of the taxpayers have floor plan financing interest expense; and the exemption for small businesses in § 1.163(j)–2(d) does not apply.

(1) *Example 1: Disallowed interest expense*–(i) *Facts*. In 2019, X has $30x of interest expense. Of

X's interest expense, $10x is permanently disallowed under section 265. X's business interest income is $3x and X's ATI is $90x.

(ii) *Analysis*. Under paragraph (b)(2) of this section, the $10x interest expense that is permanently disallowed under section 265 cannot be taken into consideration for purposes of section 163(j) in the 2019 taxable year. X's section 163(j) limitation, or the amount of business interest expense that X may deduct is limited to $30x under § 1.163(j)–2(b), determined by adding X's business interest income ($3x) and 30 percent of X's 2018 ATI ($27x). Therefore, in the 2019 taxable year, none of the $20x of X's deduction for its business interest expense is disallowed under section 163(j).

(2) *Example 2: Deferred interest expense*–(i) *Facts*. In 2019, Y has no business interest income, $120x of ATI, and $70x of interest expense. Of Y's interest expense, $30x is not currently deductible under section 267(a)(2). Assume that the $30x expense will be allowed as a deduction under section 267(a)(2) in 2020.

(ii) *Analysis*. Under paragraph (b)(3) of this section, section 267(a)(2) is applied before section 163(j). Accordingly, $30x of Y's interest expense cannot be taken into consideration for purposes of section 163(j) in 2019 because it is not currently deductible under section 267(a)(2). Accordingly, in 2019, if the interest expense is properly allocable to a non-excepted trade or business, Y will have $4x of disallowed business interest expense because the $40x of business interest expense in 2019 ($70x - $30x) exceeds 30 percent of its ATI for the taxable year ($36x). The $30x of interest expense not allowed as a deduction in the 2019 taxable year under section 267(a)(2) will be taken into account in determining the business interest expense deduction under section 163(j) in 2020, the taxable year in which it is allowed as a deduction under section 267(a)(2), if it is allocable to a trade or business. Additionally, the $4x of disallowed business interest expense in 2019 will be carried forward to 2020 as a disallowed business interest expense carryforward. See § 1.163(j)–2(c).

(3) *Example 3: Passive activity loss*–(i) *Facts*. D is engaged in a rental activity treated as a passive activity within the meaning of section 469. For tax year 2019, D receives $200x of rental income and incurs $300x of expenses all properly allocable to the rental activity, consisting of $150x of interest expense, $60x of maintenance expenses, and $90x of depreciation expense. D's ATI is $400x.

(ii) *Analysis*. Under paragraph (b)(4) of this section, section 163(j) is applied before the section 469 passive loss rules apply. D's section 163(j) limitation is $120x, determined by adding to D's business interest income ($0), floor plan financing ($0), and 30 percent of D's ATI ($120x). See § 1.163(j)–2(b). Because D's business interest expense of $150x exceeds D's section 163(j) limitation for 2019, $30x of D's business interest expense is disallowed under section 163(j) and will be carried forward as a disallowed business interest expense carryforward. See § 1.163(j)–2(c). Because the section 163(j) limitation is applied before the limitation under section 469, only $120x of the business interest expense allowable under section 163(j) is included in determining D's passive activity loss limitation for the 2019 tax year under section 469. The $30x of disallowed business interest expense is not an allowable deduction under section 163(j) and, therefore, is not a deduction under section 469 in the current taxable year. See § 1.469–2(d)(8).

(4) *Example 4: Passive activity loss by taxpayer that also participates in a non-passive activity*–(i) *Facts*. For 2019, D has no business interest income and ATI of $1,000x, entirely attributable to a passive activity within the meaning of section 469. D has business interest expense of $1,000x, $900x of which is properly allocable to a passive activity and $100x of which is properly allocable to a non-passive activity in which D materially participates. D has other business deductions that are not subject to section 469 of $600x, and a section 469 passive loss from the previous year of $250x.

(ii) *Analysis*. Under paragraph (b)(4) of this section, section 163(j) is applied before the section 469 passive loss rules apply. D's section 163(j) limitation is $300x, determined by adding D's business interest income ($0), floor plan financing ($0), and 30 percent of D's ATI ($300x)). Next, applying the limitation under section 469 to the $300x business interest expense deduction allowable under sections 163(a) and (j), $270x (a proportionate amount of the $300x (0.90 x $300x)) is business interest expense included in determining D's passive activity loss limitation under section 469, and $30x (a proportionate amount of the $300x (0.10 x $300)) is business interest expense not included in determining D's passive activity loss limitation under section 469. Because D's interest expense of $1,000x exceeds 30 percent of its ATI for 2019, $700x of D's interest expense is disallowed under section 163(j) and will be carried forward as a disallowed business interest expense carryforward. Section 469 does not apply to any portion of the $700x disallowed business interest expense because that business interest expense is not an allowable deduction under section 163(j) and, therefore, is not an allowable deduction under section 469 in the current taxable year. See § 1.469–2(d)(8).

(d) *Applicability date*. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–4 General rules applicable to C corporations (including REITs, RICs, and members of consolidated groups) and tax-exempt corporations.

(a) *Scope*. This section provides certain rules regarding the computation of items of income and expense under section 163(j) for taxpayers that are C corporations (including members of a consolidated group, REITs, and RICs) and tax-exempt corporations. Paragraph (b) of this section provides rules regarding the characterization of items of income, gain, deduction, or loss. Paragraph (c) of this section provides rules regarding adjustments to earnings and profits. Paragraph (d) of this section provides special rules applicable to members of a consolidated group. Paragraph (e) of this section provides cross-references to other rules within the 163(j) regulations that may be applicable to C corporations.

(b) *Characterization of items of income, gain, deduction, or loss*–(1) *Interest expense and interest income*. Solely for purposes of section 163(j), all interest expense of a taxpayer that is a C corporation is treated as properly allocable to a trade or business. Similarly, solely for purposes of section 163(j), all interest income of a taxpayer that is a C corporation is treated as properly allocable to a trade or business. For rules governing the allocation of interest expense and interest income between excepted and non-excepted trades or businesses, see § 1.163(j)–10.

(2) *Adjusted taxable income*. Solely for purposes of section 163(j), all items of income, gain, deduction, or loss of a taxpayer that is a C corporation are treated as properly allocable to a trade or business. For rules governing the allocation of tax items between excepted and non-excepted trades or businesses, see § 1.163(j)–10.

(3) *Investment interest, investment income, and investment expenses of a partnership with a C corporation partner*–(i) *Characterization as expense or income properly allocable to a trade or business*. For purposes of section 163(j), any investment interest, within the meaning of section 163(d), that a partnership pays or accrues and that is allocated to a C corporation partner is treated by the C corporation as interest expense that is properly allocable to a trade or business of that

partner. Similarly, for purposes of section 163(j), except as provided in § 1.163(j)–7(d)(1)(ii), any investment income or investment expenses, within the meaning of section 163(d), that a partnership receives, pays, or accrues and that is allocated to a C corporation partner is treated by the C corporation as properly allocable to a trade or business of that partner.

(ii) *Impact of characterization on partnership*. The characterization of a partner's investment interest, investment income, or investment expenses pursuant to paragraph (b)(3)(i) of this section will not affect the characterization of these items as investment interest, investment income, or investment expenses at the partnership level.

(iii) *Investment interest expense and investment interest income of a partnership not treated as excess business interest expense or excess taxable income of a C corporation partner*. Investment interest expense of a partnership that is treated as business interest expense by a C corporation partner is not treated as excess business interest expense. Investment interest income of a partnership that is treated as business interest income by a C corporation partner is not treated as excess taxable income. For rules governing excess business interest expense and excess taxable income, see § 1.163(j)–6.

(4) *Application to RICs and REITs*–(i) *In general*. Except as otherwise provided in paragraphs (b)(4)(ii) and (iii) of this section, the rules in this paragraph (b) apply to RICs and REITs.

(ii) *Taxable income for purposes of calculating the adjusted taxable income of RICs and REITs*. The taxable income of a RIC or REIT for purposes of calculating adjusted taxable income (ATI) is the taxable income of the corporation, without any adjustment that would be made under section 852(b)(2) or 857(b)(2) to compute investment company taxable income or real estate investment trust taxable income, respectively. For example, the taxable income of a RIC or REIT is not reduced by the deduction for dividends paid, but is reduced by the dividends received deduction (DRD) and the other deductions described in sections 852(b)(2)(C) and 857(b)(2)(A), taking into account § 1.163(j)–1(b)(37)(ii). See paragraph (b)(4)(iii) of this section for an adjustment to adjusted taxable income in respect of these items.

(iii) *Other adjustments to adjusted taxable income for RICs and REITs*. In the case of a taxpayer that, for a taxable year, is a RIC to which section 852(b) applies or a REIT to which section 857(b) applies, the taxpayer's ATI for the taxable year is increased by the amounts of any deductions described in section 852(b)(2)(C) or 857(b)(2)(A), taking into account § 1.163(j)–1(b)(37)(ii).

(5) *Application to tax-exempt corporations*. The rules in this paragraph (b) apply to a corporation that is subject to the unrelated business income tax under section 511 only with respect to that corporation's items of income, gain, deduction, or loss that are taken into account in computing the corporation's unrelated business taxable income, as defined in section 512.

(6) *Examples*. The principles of this paragraph (b) are illustrated by the following examples. For purposes of the examples in this paragraph (b)(6), T is a taxable domestic C corporation whose taxable year ends on December 31; T is neither a consolidated group member nor a RIC or a REIT; neither T nor PS1, a domestic partnership, owns at least 80 percent of the stock of any corporation; neither T nor PS1 qualifies for the small business exemption in § 1.163(j)–2(d) or is engaged in an excepted trade or business; T has no floor plan financing expense; all interest expense is deductible except for the potential application of section 163(j); and the facts set forth the only corporate or partnership activity.

(i) *Example 1: C corporation items properly allocable to a trade or business*—(A) *Facts*. In taxable year 2019, T's taxable income (without regard to the application of section 163(j)) is $320x. This amount is comprised of the following tax items: $1,000x of revenue from inventory sales; $500x of ordinary and necessary business expenses (excluding interest and depreciation); $200x of interest expense; $50x of interest income; $50x of depreciation deductions under section 168; and a $20x gain on the sale of stock.

(B) *Analysis*. For purposes of section 163(j), each of T's tax items is treated as properly allocable to a trade or business. Thus, T's ATI for the 2019 taxable year is $520x ($320x of taxable income + $200x business interest expense - $50x business interest income + $50x depreciation deductions = $520x), and its section 163(j) limitation for the 2019 taxable year is $206x ($50x of business interest income + 30 percent of its ATI (30 percent x $520x) = $206x). As a result, all $200x of T's interest expense is deductible in the 2019 taxable year under section 163(j).

(C) *Taxable year beginning in 2022*. The facts are the same as in *Example 1* in paragraph (b)(6)(i)(A) of this section, except that the taxable year is 2022 and therefore depreciation deductions are not added back to ATI under § 1.163(j)–1(b)(1)(i)(E). As a result, T's ATI for 2022 is $470x ($320x of taxable income + $200x business interest expense - $50x business interest income = $470x), and its section 163(j) limitation for the 2022 taxable year is $191x ($50x of business interest income + 30 percent of its ATI (30 percent x $470x) = $191x). As a result, T may only deduct $191x of its business interest expense for the taxable year, and the remaining $9x will be carried forward to the 2023 taxable year as a disallowed business interest expense carryforward. See § 1.163(j)–2(c).

(ii) *Example 2: C corporation partner*—(A) *Facts*. T and individual A each own a 50 percent interest in PS1, a general partnership. PS1 borrows funds from a third party (Loan 1) and uses those funds to buy stock in publicly-traded corporation X. PS1's only activities are holding X stock (and receiving dividends) and making payments on Loan 1. In the 2019 taxable year, PS1 receives $150x in dividends and pays $100x in interest on Loan 1.

(B) *Analysis*. For purposes of section 163(d) and (j), PS1 has investment interest expense of $100x and investment income of $150x, and PS1 has no interest expense or interest income that is properly allocable to a trade or business. PS1 allocates its investment interest expense and investment income to its two partners pursuant to § 1.163(j)–6(j). Pursuant to paragraph (b)(3) of this section, T's allocable share of PS1's investment interest expense is treated as a business interest expense of T, and T's allocable share of PS1's investment income is treated as properly allocable to a trade or business of T. This business interest expense is not treated as excess business interest expense, and this income is not treated as excess taxable income. See paragraph (b)(3)(iii) of this section. T's treatment of its allocable share of PS1's investment interest expense and investment income as business interest expense and income properly allocable to a trade or business, respectively, does not affect the character of these items at the PS1 level and does not affect the character of A's allocable share of PS1's investment interest and investment income.

(C) *Partnership engaged in a trade or business*. The facts are the same as in *Example 2* in paragraph (b)(6)(ii)(A) of this section, except that PS1 also is engaged in Business 1, and PS1 borrows funds from a third party to finance Business 1 (Loan 2). In 2019, Business 1 earns $150x of net income (excluding interest expense and depreciation), and PS1 pays $100x of interest on Loan 2. For purposes of § 1.163–8T, the interest paid on Loan 2 is allocated to a trade or business (and is therefore not treated as investment interest expense under section 163(d)). As a result, PS1 has investment interest expense of $100x (attributable to Loan 1), business interest expense of $100x (attributable to Loan 2), $150x of investment income, and $150x of income from Business 1. PS1's ATI is $150x (its net income from Business 1 excluding interest and depreciation), and its section 163(j) limitation is $45x (30 percent x

$150x). Pursuant to § 1.163(j)–6, PS1 has $55x of excess business interest expense ($100x - $45x), half of which ($27.5x) is allocable to T. Additionally, pursuant to paragraph (b)(3)(i) of this section, T's allocable share of PS1's investment interest expense ($50x) is treated as a business interest expense of T for purposes of section 163(j), and T's allocable share of PS1's investment income ($75x) is treated as properly allocable to a trade or business of T. Therefore, with respect to T's interest in PS1, T is treated as having $50x of business interest expense that is not treated as excess business interest expense, $75x of income that is properly allocable to a trade or business, and $27.5x of excess business interest expense.

(c) *Effect on earnings and profits*–(1) *In general*. In the case of a taxpayer that is a C corporation, except as otherwise provided in paragraph (c)(2) of this section, the disallowance and carryforward of a deduction for the taxpayer's business interest expense under § 1.163(j)–2 will not affect whether or when the business interest expense reduces the taxpayer's earnings and profits.

(2) *Special rule for RICs and REITs*. In the case of a taxpayer that is a RIC or a REIT for the taxable year in which a deduction for the taxpayer's business interest expense is disallowed under § 1.163(j)–2(b), or in which the RIC or REIT is allocated any excess business interest expense from a partnership under section 163(j)(4)(B)(i) and § 1.163(j)–6, the taxpayer's earnings and profits are adjusted in the taxable year or years in which the business interest expense is deductible or, if earlier, in the first taxable year for which the taxpayer no longer is a RIC or a REIT.

(3) *Special rule for partners that are C corporations*. If a taxpayer that is a C corporation is allocated any excess business interest expense from a partnership under section 163(j)(4)(B)(i) and § 1.163(j)–6, and if any amount of the excess business interest expense has not yet been treated as business interest expense by the taxpayer at the time of the taxpayer's disposition of all or substantially all of its interest in the partnership, then the taxpayer must increase its earnings and profits by that amount immediately prior to its disposition of the partnership interest.

(4) *Examples*. The principles of this paragraph (c) are illustrated by the following examples. For purposes of the examples in this paragraph (c)(4), except as otherwise provided in the examples, X is a taxable domestic C corporation whose taxable year ends on December 31; X is not a member of a consolidated group; X does not qualify for the small business exemption under § 1.163(j)–2(d); X is not engaged in an excepted trade or business; X has no floor plan financing indebtedness; all interest expense is deductible except for the potential application of section 163(j); X has no accumulated earnings and profits at the beginning of the 2019 taxable year; and the facts set forth the only corporate activity.

(i) *Example 1: Earnings and profits of a taxable domestic C corporation other than a RIC or a REIT*—(A) *Facts*. X is a corporation that does not intend to qualify as a RIC or a REIT for its 2019 taxable year. In that year, X has taxable income (without regard to the application of section 163(j)) of $0, which includes $100x of gross income and $100x of interest expense on a loan from an unrelated third party. X also makes a $100x distribution to its shareholders that year.

(B) *Analysis*. The $100x of interest expense is business interest expense for purposes of section 163(j) (see paragraph (b)(1) of this section). X's ATI in the 2019 taxable year is $100x ($0 of taxable income computed without regard to $100x of business interest expense). Thus, X may deduct $30x of its $100x of business interest expense in the 2019 taxable year under § 1.163(j)–2(b) (30 percent x $100x), and X may carry forward the remainder ($70x) to X's 2020 taxable year as a disallowed business interest expense carryforward under § 1.163(j)–2(c). Although X may not currently deduct all $100x of its business interest expense in the 2019 taxable year, X must reduce its earnings and profits in that taxable year by the full amount of its business interest expense ($100x) in that taxable year. As a result, no portion of X's distribution of $100x to its shareholders in the 2019 taxable year is a dividend within the meaning of section 316(a).

(ii) *Example 2: RIC adjusted taxable income and earnings and profits*–(A) *Facts*. X is a corporation that intends to qualify as a RIC for its 2019 taxable year. In that taxable year, X's only items are $100x of interest income, $50x of dividend income from C corporations that only issue common stock and in which X has less than a twenty percent interest (by vote and value), $10x of net capital gain, and $125x of interest expense. None of the dividends are received on debt financed portfolio stock under section 246A. The DRD determined under section 243(a) with respect to X's $50x of dividend income is $25x. X pays $42x in dividends to its shareholders, meeting the requirements of section 562 during X's 2019 taxable year, including $10x that X reports as capital gain dividends in written statements furnished to X's shareholders.

(B) *Analysis*. (*1*) Under paragraph (b) of this section, all of X's interest expense is considered business interest expense, all of X's interest income is considered business interest income, and all of X's other income is considered to be properly allocable to a trade or business. Under paragraph (b)(4)(ii) of this section, prior to the application of section 163(j), X's taxable income is $10x ($100x business interest income + $50x dividend income + $10x net capital gain - $125x business interest expense - $25x DRD = $10x). Under paragraph (b)(4)(iii) of this section, X's ATI is increased by the DRD. As such, X's ATI for the 2019 taxable year is $60x ($10x taxable income + $125x business interest expense - $100x business interest income + $25x DRD = $60x).

(*2*) X may deduct $118x of its $125x of business interest expense in the 2019 taxable year under section 163(j)(1) ($100x business interest income + (30 percent x $60x of ATI) = $118x), and X may carry forward the remainder ($7x) to X's taxable year ending December 31, 2020. See § 1.163(j)–2(b) and (c).

(*3*) After the application of section 163(j), X has taxable income of $17x ($100x interest income + $50x dividend income + $10x capital gain - $25x DRD - $118x allowable interest expense = $17x) for the 2019 taxable year. X will have investment company taxable income (ICTI) in the amount of $0 ($17x taxable income - $10x capital gain + $25x DRD - $32x dividends paid deduction for ordinary dividends = 0). The excess of X's net capital gain ($10x) over X's dividends paid deduction determined with reference to capital gain dividends ($10x) is also $0.

(*4*) Under paragraph (c)(2) of this section, X will not reduce its earnings and profits by the amount of interest expense disallowed as a deduction in the 2019 taxable year under section 163(j). Thus, X has current earnings and profits in the amount of $42x ($100x interest income + $50x dividend income + $10x capital gain - $118x allowable business interest expense = $42x) before giving effect to dividends paid during the 2019 taxable year.

(iii) *Example 3: Carryforward of disallowed interest expense*–(A) *Facts*. The facts are the same as the facts in *Example 2* in paragraph (c)(4)(ii)(A) of this section for the 2019 taxable year. In addition, X has $50x of interest income and $20x of interest expense for the 2020 taxable year.

(B) *Analysis*. Under paragraph (b) of this section, all of X's interest expense is considered business interest expense, all of X's interest income is considered business interest income, and all of X's other income is considered to be properly allocable to a trade or business. Because X's $50x of business interest income exceeds the $20x of business interest expense from the 2020 taxable year and the $7x of disallowed business interest expense carryforward from the 2019 taxable year, X may deduct $27x of business interest expense in the 2020 taxable year. Under paragraph (c)(2) of this section, X must reduce its current earnings and profits for the 2020 taxable year by the full amount of the deductible business interest expense ($27x).

(iv) *Example 4: REIT adjusted taxable income and earnings and profits*–(A) *Facts*. X is a corporation that intends to qualify as a REIT for its 2019 taxable year. X is not engaged in an excepted trade or business and is not engaged in a trade or business that is eligible to make any election under section 163(j)(7). In that year, X's only items are $100x of mortgage interest income, $30x of dividend income from C corporations that only issue common stock and in which X has less than a ten percent interest (by vote and value) in each C corporation, $10x of net capital gain from the sale of mortgages on real property that is not property described in section

1221(a)(1), and $125x of interest expense. None of the dividends are received on debt financed portfolio stock under section 246A. The DRD determined under section 243(a) with respect to X's $30x of dividend income is $15x. X pays $28x in dividends meeting the requirements of section 562 during X's 2019 taxable year, including $10x that X properly designates as capital gain dividends under section 857(b)(3)(B).

(B) *Analysis*. (*1*) Under paragraph (b) of this section, all of X's interest expense is considered business interest expense, all of X's interest income is considered business interest income, and all of X's other income is considered to be properly allocable to a trade or business. Under paragraph (b)(4)(ii) of this section, prior to the application of section 163(j), X's taxable income is $0 ($100x business interest income + $30x dividend income + $10x net capital gain - $125x business interest expense - $15x DRD = $0). Under paragraph (b)(4)(iii) of this section, X's ATI is increased by the DRD. As such, X's ATI for the 2019 taxable year is $40x ($0 taxable income + $125x business interest expense - $100x business interest income + $15x DRD = $40x).

(*2*) X may deduct $112x of its $125x of business interest expense in the 2019 taxable year under section 163(j)(1) ($100x business interest income + (30 percent x $40x of ATI) = $112x), and X may carry forward the remainder of its business interest expense ($13x) to X's 2020 taxable year.

(*3*) After the application of section 163(j), X has taxable income of $13x ($100x business interest income + $30x dividend income + $10x capital gain - $15x DRD - $112x allowable business interest expense = $13x) for the 2019 taxable year. X will have real estate investment trust taxable income (REITTI) in the amount of $0 ($13x taxable income + $15x of DRD - $28x dividends paid deduction = $0).

(*4*) Under paragraph (c)(2) of this section, X will not reduce earnings and profits by the amount of business interest expense disallowed as a deduction in the 2019 taxable year. Thus, X has current earnings and profits in the amount of $28x ($100x business interest income + $30x dividend income + $10x capital gain - $112x allowable business interest expense = $28x) before giving effect to dividends paid during X's 2019 taxable year.

(v) *Example 5: Carryforward of disallowed interest expense*–(A) *Facts*. The facts are the same as in *Example 4* in paragraph (c)(4)(iv)(A) of this section for the 2019 taxable year. In addition, X has $50x of mortgage interest income and $20x of interest expense for the 2020 taxable year. X has no other tax items for the 2020 taxable year.

(B) *Analysis*. Because X's $50x of business interest income exceeds the $20x of business interest expense from the 2020 taxable year and the $13x of disallowed business interest expense carryforwards from the 2019 taxable year, X may deduct $33x of business interest expense in 2020. Under paragraph (c)(2) of this section, X must reduce its current earnings and profits for 2020 by the full amount of the deductible interest expense ($33x).

(d) *Special rules for consolidated groups*–(1) *Scope*. This paragraph (d) provides certain rules applicable to members of a consolidated group. For all members of a consolidated group for a consolidated return year, the computations required by section 163(j) and the section 163(j) regulations are made in accordance with the rules of this paragraph (d) unless otherwise provided elsewhere in the section 163(j) regulations. For rules governing the carryforward of disallowed business interest expense, including rules governing the treatment of disallowed business interest expense carryforwards when members enter or leave a group, see § 1.163(j)–5.

(2) *Calculation of the section 163(j) limitation for members of a consolidated group*–(i) *In general*. A consolidated group has a single section 163(j) limitation, the absorption of which is governed by § 1.163(j)–5(b)(3)(ii).

(ii) *Interest*. For purposes of determining whether amounts, other than amounts in respect of intercompany obligations, as defined in § 1.1502–13(g)(2)(ii), intercompany items, as defined in § 1.1502–13(b)(2), or corresponding items, as defined in § 1.1502–13(b)(3), are treated as interest within the meaning of § 1.163(j)–1(b)(20), all members of a consolidated group are treated as a single taxpayer.

(iii) *Calculation of business interest expense and business interest income for a consolidated group*. For purposes of calculating the section 163(j) limitation for a consolidated group, the consolidated group's current-year business interest expense (as defined in § 1.163(j)–5(a)(2)(i)) and business interest income, respectively, are the sum of each member's current-year business interest expense and business interest income, including amounts treated as business interest expense and business interest income under paragraph (b)(3) of this section.

(iv) *Calculation of adjusted taxable income*. For purposes of calculating the ATI for a consolidated group, the relevant taxable income is the consolidated group's consolidated taxable income, determined under § 1.1502–11 without regard to any carryforwards or disallowances under section 163(j). Additionally, if for a taxable year a member of a consolidated group is allowed a deduction under section 250(a)(1) that is properly allocable to a non-excepted trade or business, then, for purposes of calculating ATI, consolidated taxable income for the taxable year is determined as if the deduction were not subject to the limitation in section 250(a)(2). For this purpose, the amount of the deduction allowed under section 250(a)(1) is determined without regard to the application of section 163(j) and the section 163(j) regulations. Further, for purposes of calculating the ATI of the group, intercompany items and corresponding items are disregarded to the extent that they offset in amount. Thus, for example, certain portions of the intercompany items and corresponding items of a group member engaged in a non-excepted trade or business will not be included in ATI to the extent that the counterparties to the relevant intercompany transactions are engaged in one or more excepted trades or businesses.

(v) *Treatment of intercompany obligations*. For purposes of determining a member's business interest expense and business interest income, and for purposes of calculating the consolidated group's ATI, all intercompany obligations, as defined in § 1.1502–13(g)(2)(ii), are disregarded. Therefore, interest expense and interest income from intercompany obligations are not treated as business interest expense and business interest income.

(3) *Investment adjustments*. For rules governing investment adjustments within a consolidated group, see § 1.1502–32(b).

(4) *Ownership of partnership interests by members of a consolidated group*–(i) *Dispositions of partnership interests*. The transfer of a partnership interest in an intercompany transaction that does not result in the termination of the partnership is treated as a disposition for purposes of the basis adjustment rule in section 163(j)(4)(B)(iii)(II), regardless of whether the transfer is one in which gain or loss is recognized. See § 1.1502–13 for rules applicable to the redetermination of attributes of group members. A change in status of a member (becoming or ceasing to be a member) is not treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II).

(ii) *Basis adjustments under § 1.1502–32*. A member's allocation of excess business interest expense from a partnership and the resulting decrease in basis in the partnership interest under section 163(j)(4)(B) is not a noncapital, nondeductible expense for purposes of § 1.1502–32(b)(3)(iii). Additionally, an increase in a member's basis in a partnership interest under section 163(j)(4)(B)(iii)(II) to reflect excess business interest expense not deducted by the consolidated group is not tax-exempt income for purposes of § 1.1502–32(b)(3)(ii). Investment adjustments are made under § 1.1502–32(b)(3)(i) when the excess business interest expense from the partnership is absorbed by the consolidated group. See § 1.1502–32(b).

(iii) [Reserved]

(5) *Examples*. The principles of this paragraph (d) are illustrated by the following examples (see also § 1.1502–13(c)(7)(ii)(R) and (S)). For purposes of the examples in this paragraph (d)(5), S is a member of the calendar-year consolidated group of which P is the common parent; the P group does not qualify for the small business exemption in § 1.163(j)–2(d); no member of the P group is engaged in an excepted trade or business; all interest expense is deductible except for the potential application of section 163(j); and the facts set forth the only corporate activity.

(i) *Example 1: Calculation of the section 163(j) limitation*—(A) *Facts*. In the 2019 taxable year, P has $50x of separate taxable income after taking into account $65x of interest paid on a loan from a third party (without regard to any disallowance under section 163(j)) and $35x of depreciation deductions under section 168. In turn, S has $40x of separate taxable income in the 2019 taxable year after taking into account $10x of depreciation deductions under section 168. S has no interest expense in the 2019 taxable year. The P group's consolidated taxable income for the 2019 taxable year is $90x, determined under § 1.1502–11 without regard to any disallowance under section 163(j).

(B) *Analysis*. As provided in paragraph (b)(1) of this section, P's interest expense is treated as business interest expense for purposes of section 163(j). If P and S were to apply the section 163(j) limitation on a separate-entity basis, then P's ATI would be $150x ($50x + $65x + $35x = $150x), its section 163(j) limitation would be $45x (30 percent x $150x = $45x), and a deduction for $20x of its $65x of business interest expense would be disallowed in the 2019 taxable year under section 163(j). However, as provided in paragraph (d)(2) of this section, the P group computes a single section 163(j) limitation, and that computation begins with the P group's consolidated taxable income (as determined prior to the application of section 163(j)), or $90x. The P group's ATI is $200x ($50x + $40x + $65x + $35x + $10x = $200x). Thus, the P group's section 163(j) limitation for the 2019 taxable year is $60x (30 percent x $200x = $60x). As a result, all but $5x of the P group's business interest expense is deductible in the 2019 taxable year. P carries over the $5x of disallowed business interest expense to the succeeding taxable year.

(ii) *Example 2: Intercompany obligations*—(A) *Facts*. On January 1, 2019, G, a corporation unrelated to P and S, lends P $100x in exchange for a note that accrues interest at a 10 percent annual rate. A month later, P lends $100x to S in exchange for a note that accrues interest at a 12 percent annual rate. In 2019, P accrues and pays $10x of interest to G on P's note, and S accrues and pays $12x of interest to P on S's note. For that year, the P group's only other items of income, gain, deduction, and loss are $40x of income earned by S from the sale of inventory, and a $30x deductible expense arising from P's payment of tort liability claims.

(B) *Analysis*. As provided in paragraph (d)(2)(v) of this section, the intercompany obligation between P and S is disregarded in determining P and S's business interest expense and business interest income and in determining the P group's ATI. For purposes of section 163(j), P has $10x of business interest expense and a $30x deduction for the payment of tort liability claims, and S has $40x of income. The P group's ATI is $10x ($40x - $30x = $10x), and its section 163(j) limitation is $3x (30 percent x $10x = $3x). The P group may deduct $3x of its business interest expense in the 2019 taxable year. A deduction for P's remaining $7x of business interest expense is disallowed in the 2019 taxable year, and this amount is carried forward to the 2020 taxable year.

(e) *Cross-references*. For rules governing the treatment of disallowed business interest expense carryforwards for C corporations, see § 1.163(j)–5. For rules governing the application of section 163(j) to a C corporation or a consolidated group engaged in both excepted and non-excepted trades or businesses, see § 1.163(j)–10.

(f) *Applicability date*. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–5 General rules governing disallowed business interest expense carryforwards for C corporations.

(a) *Scope and definitions*–(1) *Scope*. This section provides certain rules regarding disallowed business interest expense carryforwards for taxpayers that are C corporations, including members of a consolidated group. Paragraph (b) of this section provides rules regarding the treatment of disallowed business interest expense carryforwards. Paragraph (c) of this section provides cross-references to other rules regarding disallowed business interest expense carryforwards in transactions to which section 381(a) applies. Paragraph (d) of this section provides rules regarding limitations on disallowed business interest expense carryforwards from separate return limitation years (SRLYs). Paragraph (e) of this section provides cross-references to other rules regarding the application of section 382 to disallowed business interest expense carryforwards. Paragraph (f) of this section provides rules regarding the overlap of the SRLY limitation with section 382.

(2) *Definitions*–(i) *Current-year business interest expense*. The term *current-year business interest expense* means business interest expense (as defined in § 1.163(j)–1(b)(2)) that would be deductible in the current taxable year without regard to section 163(j) and that is not a disallowed business interest expense carryforward (as defined in § 1.163(j)–1(b)(9)) from a prior taxable year.

(ii) *Allocable share of the consolidated group's remaining section 163(j) limitation*. The term *allocable share of the consolidated group's remaining section 163(j) limitation* means, with respect to any member of a consolidated group, the product of the consolidated group's remaining section 163(j) limitation and the member's remaining current-year interest ratio.

(iii) *Consolidated group's remaining section 163(j) limitation*. The term *consolidated group's remaining section 163(j) limitation* means the amount of the consolidated group's section 163(j) limitation calculated pursuant to § 1.163(j)–4(d)(2), reduced by the amount of interest deducted by members of the consolidated group pursuant to paragraph (b)(3)(ii)(C)(*2*) of this section.

(iv) *Remaining current-year interest ratio*. The term *remaining current-year interest ratio* means, with respect to any member of a consolidated group for a particular taxable year, the ratio of the remaining current-year business interest expense of the member after applying the rule in paragraph (b)(3)(ii)(C)(*2*) of this section, to the sum of the amounts of remaining current-year business interest expense for all members of the consolidated group after applying the rule in paragraph (b)(3)(ii)(C)(*2*) of this section.

(b) *Treatment of disallowed business interest expense carryforwards*–(1) *In general*. The amount of any business interest expense of a C corporation not allowed as a deduction for any taxable year as a result of the limitation under section 163(j)(1) and § 1.163(j)–2(b) is carried forward to the succeeding taxable year as a disallowed business interest expense carryforward under section 163(j)(2) and § 1.163(j)–2(c).

(2) *Deduction of business interest expense*. For a taxpayer that is a C corporation, current-year business interest expense is deducted in the current taxable year before any disallowed business interest expense carryforwards from a prior taxable year are deducted in that year. Disallowed business interest expense carryforwards are deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, subject to certain limitations (for example, the limitation under section 382). For purposes of section 163(j), disallowed disqualified interest is treated as carried forward from the taxable year in which a deduction was disallowed under old section 163(j).

(3) *Consolidated groups*–(i) *In general*. A consolidated group's disallowed business interest expense carryforwards for the current consolidated return year (the current year) are the carryforwards from the group's prior consolidated return years plus any carryforwards from separate return years.

(ii) *Deduction of business interest expense*–(A) *General rule*. All current-year business interest expense of members of a consolidated group is deducted in the current year before any disallowed business interest expense carryforwards from prior taxable years are deducted in the current year. Disallowed business interest expense carryforwards from prior taxable years are deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, subject to the limitations described in this section.

(B) *Section 163(j) limitation is equal to or exceeds the current-year business interest expense and disallowed business interest expense carryforwards from prior taxable years*. If a consolidated group's section 163(j) limitation for the current year is equal to or exceeds the aggregate amount of its members' current-year business interest expense and disallowed business interest expense carryforwards from prior taxable years that are available for deduction, then none of the current-year business interest expense or disallowed business interest expense carryforwards will be subject to disallowance in the current year under section 163(j). However, a deduction for the members' business interest expense may be subject to limitation under other provisions of the Code or the regulations promulgated thereunder (see, for example, paragraphs (c), (d), (e), and (f) of this section).

(C) *Current-year business interest expense and disallowed business interest expense carryforwards exceed section 163(j) limitation*. If the aggregate amount of members' current-year business interest expense and disallowed business interest expense carryforwards from prior taxable years exceeds the consolidated group's section 163(j) limitation for the current year, then the following rules apply in the order provided.

(*1*) The group first determines whether its section 163(j) limitation for the current year equals or exceeds the aggregate amount of the members' current-year business interest expense.

(*i*) If the group's section 163(j) limitation for the current year equals or exceeds the aggregate amount of the members' current-year business interest expense, then no amount of the group's current-year business interest expense will be subject to disallowance in the current year under section 163(j). Once the group has taken into account its members' current-year business interest expense, the group applies the rules of paragraph (b)(3)(ii)(C)(*4*) of this section.

(*ii*) If the aggregate amount of members' current-year business interest expense exceeds the group's section 163(j) limitation for the current year, then the group applies the rule in paragraph (b)(3)(ii)(C)(*2*) of this section.

(*2*) If this paragraph (b)(3)(ii)(C)(*2*) applies (see paragraph (b)(3)(ii)(C)(*1*)(*ii*) of this section), then each member with current-year business interest expense and with current-year business interest income or floor plan financing interest deducts current-year business interest expense in an amount that does not exceed the sum of the member's business interest income and floor plan financing interest expense for the current year.

(*3*) After applying the rule in paragraph (b)(3)(ii)(C)(*2*) of this section, if the group has any section 163(j) limitation remaining for the current year, then each member with remaining current-year business interest expense deducts a portion of its expense based on its allocable share of the consolidated group's remaining section 163(j) limitation.

(*4*) If this paragraph (b)(3)(ii)(C)(*4*) applies (see paragraph (b)(3)(ii)(C)(*1*)(*i*) of this section), and if the group has any section 163(j) limitation remaining for the current year after applying the rules in paragraph (b)(3)(ii)(C)(*1*) of this section, then disallowed business interest expense carryforwards permitted to be deducted in the current year will be deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year. Disallowed business interest expense carryforwards from taxable years ending on the same date that are available to offset consolidated taxable income for the current year generally will be deducted on a pro rata basis, under the principles of paragraph (b)(3)(ii)(C)(*3*) of this section. For example, assume that P and S are the only members of a consolidated group with a section 163(j) limitation for the current year (Year 2) of $200x; the amount of current-year business interest expense deducted in Year 2 is $100x; and P and S, respectively, have $140x and $60x of disallowed business interest expense carryforwards from Year 1 that are not subject to limitation under paragraph (c), (d), or (e) of this section. Under these facts, P would be allowed to deduct $70x of its carryforwards from Year 1 ($100x x ($140x / ($60x + $140x)) = $70x), and S would be allowed to deduct $30x of its carryforwards from Year 1 ($100x x ($60x / ($60x + $140x)) = $30x). But see § 1.383–1(d)(1)(ii), providing that, if losses subject to and not subject to the section 382 limitation are carried from the same taxable year, losses subject to the limitation are deducted before losses not subject to the limitation.

(*5*) Each member with remaining business interest expense after applying the rules of this paragraph (b)(3)(ii), taking into account the limitations in paragraphs (c), (d), (e), and (f) of this section, will carry the expense forward to the succeeding taxable year as a disallowed business interest expense carryforward under section 163(j)(2) and § 1.163(j)–2(c).

(iii) *Departure from group*. If a corporation ceases to be a member during a consolidated return year, the corporation's current-year business interest expense from the taxable period ending on the day of the corporation's change in status as a member, as well as the corporation's disallowed business interest expense carryforwards from prior taxable years that are available to offset consolidated taxable income in the consolidated return year, are first made available for deduction during that consolidated return year. See § 1.1502–76(b)(1)(i); see also § 1.1502–36(d) (regarding reductions of deferred deductions on the transfer of loss shares of subsidiary stock). Only the amount that is neither deducted by the group in that consolidated return year nor otherwise reduced under the Code or regulations may be carried to the corporation's first separate return year after its change in status.

(iv) *Example: Deduction of interest expense*—(A) *Facts*. (*1*) P wholly owns A, which is a member of the consolidated group of which P is the common parent. P and A each borrow money from Z, an unrelated third party. The business interest expense of P and A in Years 1, 2, and 3, and the P group's section 163(j) limitation for those years, are as follows:

Table 1 to paragraph (b)(3)(iv)(A)(*1*)

Year	P's business interest expense	A's business interest expense	P group's section 163(j) limitation
1	$150x	$50x	$100x
2	60x	90x	120x
3	25x	50x	185x

(*2*) P and A have neither business interest income nor floor plan financing interest expense in Years 1, 2, and 3. Additionally, the P group is neither eligible for the small business exemption in § 1.163(j)–2(d) nor engaged in an excepted trade or business within the meaning of § 1.163(j)–1(b)(38)(ii).

(B) *Analysis*–(*1*) *Year 1*. In Year 1, the aggregate amount of the P group members' current-year business interest expense ($150x + $50x) exceeds the P group's section 163(j) limitation ($100x). As a result, the rules of paragraph (b)(3)(ii)(C) of this section apply. Because the P group members' current-year business interest expense exceeds the group's section 163(j) limitation for Year 1, P and A must apply the rule in paragraph (b)(3)(ii)(C)(*2*) of this section. Pursuant to paragraph (b)(3)(ii)(C)(*2*) of this section, each of P and A must deduct its current-year business interest expense to the extent of its business interest income and floor plan financing interest expense. Neither P nor A has business interest income or floor plan financing interest expense in Year 1. Next, pursuant to paragraph (b)(3)(ii)(C)(*3*) of this section, each of P and A must deduct a portion of its current-year business interest expense based on its allocable share of the consolidated group's remaining section 163(j) limitation ($100x). P's allocable share is $75x ($100x x ($150x / $200x) = $75x), and A's allocable share is $25x ($100x x ($50x / $200x) = $25x). Accordingly, in Year 1, P deducts $75x of its current-year business interest expense, and A deducts $25x of its current-year business interest expense. P has a disallowed business interest expense carryforward from Year 1 of $75x ($150x - $75x = $75x), and A has a disallowed business interest expense carryforward from Year 1 of $25x ($50x - $25x = $25x).

(*2*) *Year 2*. In Year 2, the aggregate amount of the P group members' current-year business interest expense ($60x + $90x) and disallowed business interest expense carryforwards ($75x + $25x) exceeds the P group's section 163(j) limitation ($120x). As a result, the rules of paragraph (b)(3)(ii)(C) of this section apply. Because the P group members' current-year business interest expense exceeds the group's section 163(j) limitation for Year 2, P and A must apply the rule in paragraph (b)(3)(ii)(C)(*2*) of this section. Pursuant to paragraph (b)(3)(ii)(C)(2) of this section, each of P and A must deduct its current-year business interest expense to the extent of its business interest income and floor plan financing interest expense. Neither P nor A has business interest income or floor plan financing interest expense in Year 2. Next, pursuant to paragraph (b)(3)(ii)(C)(*3*) of this section, each of P and A must deduct a portion of its current-year business interest expense based on its allocable share of the consolidated group's remaining section 163(j) limitation ($120x). P's allocable share is $48x (($120x x ($60x / $150x)) = $48x), and A's allocable share is $72x (($120x x ($90x / $150x)) = $72x). Accordingly, in Year 2, P deducts $48x of current-year business interest expense, and A deducts $72x of current-year business interest expense. P has a disallowed business interest expense carryforward from Year 2 of $12x ($60x - $48x = $12x), and A has a disallowed business interest expense carryforward from Year 2 of $18x ($90x - $72x = $18x). Additionally, because the P group has no section 163(j) limitation remaining after deducting current-year business interest expense in Year 2, the full amount of P and A's disallowed business interest expense carryforwards from Year 1 ($75x and $25x, respectively) also are carried forward to Year 3. As a result, at the beginning of Year 3, P and A's respective disallowed business interest expense carryforwards are as follows:

Table 1 to paragraph (b)(3)(iv)(B)(*2*)

	Year 1 disallowed business interest expense carryforwards	Year 2 disallowed business interest expense carryforwards	Total disallowed business interest expense carryforwards
P	$75x	$12x	$87x
A	*25x*	*18x*	*43x*
Total	100x	30x	130x

(*3*) *Year 3*. In Year 3, the aggregate amount of the P group members' current-year business interest expense ($25x + $50x = $75x) and disallowed business interest expense carryforwards ($130x) exceeds the P group's section 163(j) limitation ($185x). As a result, the rules of paragraph (b)(3)(ii)(C) of this section apply. Because the P group's section 163(j) limitation for Year 3 equals or exceeds the P group members' current-year business interest expense, no amount of the members' current-year business interest expense will be subject to disallowance under section 163(j) (see paragraph (b)(3)(ii)(C)(*1*) of this section). After each of P and A deducts its current-year business interest expense, the P group has $110x of section 163(j) limitation remaining for Year 3 ($185x - $25x -

$50x = $110x). Next, pursuant to paragraph (b)(3)(ii)(C)(*4*) of this section, $110x of disallowed business interest expense carryforwards are deducted on a pro rata basis, beginning with carryforwards from Year 1. Because the total amount of carryforwards from Year 1 ($100x) is less than the section 163(j) limitation remaining after the deduction of Year 3 business interest expense ($110x), all of the Year 1 carryforwards are deducted in Year 3. After current-year business interest expense and Year 1 carryforwards are deducted, the P group's remaining section 163(j) limitation in Year 3 is $10x. Because the Year 2 carryforwards ($30x) exceed the remaining section 163(j) limitation ($10x), under paragraph (b)(3)(ii)(C)(*4*) of this section, each of P and A will deduct a portion of its Year 2 carryforwards based on its allocable share of the consolidated group's remaining section 163(j) limitation. P's allocable share is $4x (($10x x ($12x / $30x)) = $4x), and A's allocable share is $6x (($10x x ($18x / $30x)) = $6x). Accordingly, P and A may deduct $4x and $6x, respectively, of their Year 2 carryforwards. For Year 4, P and A have $8x and $12x of disallowed business interest expense carryforwards from Year 2, respectively.

(c) *Disallowed business interest expense carryforwards in transactions to which section 381(a) applies*. For rules governing the application of section 381(c)(20) to disallowed business interest expense carryforwards, including limitations on an acquiring corporation's use of the disallowed business interest expense carryforwards of the transferor or distributor corporation in the acquiring corporation's first taxable year ending after the date of distribution or transfer, see § 1.381(c)(20)–1.

(d) *Limitations on disallowed business interest expense carryforwards from separate return limitation years*–(1) *General rule*. Except as provided in paragraph (f) of this section (relating to an overlap with section 382), the disallowed business interest expense carryforwards of a member arising in a separate return limitation year (or SRLY (see § 1.1502–1(f))) that are included in the consolidated group's business interest expense deduction for any taxable year under paragraph (b) of this section may not exceed the group's section 163(j) limitation for that year, determined by reference only to the member's items of income, gain, deduction, and loss for that year (section 163(j) SRLY limitation). For purposes of this paragraph (d), the SRLY subgroup principles of § 1.1502–21(c)(2) apply with appropriate adjustments.

(2) *Deduction of disallowed business interest expense carryforwards arising in a SRLY*. Notwithstanding paragraph (d)(1) of this section, disallowed business interest expense carryforwards of a member arising in a SRLY are available for deduction by the consolidated group in the current year only to the extent the group has any remaining section 163(j) limitation for the current year after the deduction of current-year business interest expense and disallowed business interest expense carryforwards from earlier taxable years that are permitted to be deducted in the current year (see paragraph (b)(3)(ii)(A) of this section), and only to the extent the section 163(j) SRLY limitation for the current year exceeds the amount of the member's business interest expense already deducted by the group in that year under paragraph (b)(3)(ii) of this section. SRLY-limited disallowed business interest expense carryforwards are deducted on a pro rata basis (under the principles of paragraph (b)(3)(ii)(C)(*3*) of this section) with non-SRLY limited disallowed business interest expense carryforwards from taxable years ending on the same date.

(3) *Examples*. The principles of this paragraph (d) are illustrated by the following examples. For purposes of the examples in this paragraph (d)(3), unless otherwise stated, P, R, S, and T are taxable domestic C corporations that are not regulated investment companies (RICs) or real estate investment trusts (REITs) and that file their tax returns on a calendar-year basis; none of P, R, S, or T qualifies for the small business exemption under section 163(j)(3) or is engaged in an excepted trade or business; all interest expense is deductible except for the potential application of section 163(j); and the facts set forth the only corporate activity.

(i) *Example 1: Determination of SRLY limitation*—(A) *Facts*. Individual A owns P. In 2019, A forms T, which pays or accrues a $100x business interest expense for which a deduction is disallowed under section 163(j) and that is carried forward to 2020. P does not pay or accrue business interest expense in 2019, and P has no disallowed business interest expense carryforwards from prior taxable years. At the close of 2019, P acquires all of the stock of T, which joins with P in filing a consolidated return beginning in 2020. Neither P nor T pays or accrues business interest expense in 2020, and the P group has a section 163(j) limitation of $300x in that year. This limitation would be $70x if determined by reference solely to T's items for 2020.

(B) *Analysis*. T's $100x of disallowed business interest expense carryforwards from 2019 arose in a SRLY. P's acquisition of T was not an ownership change as defined by section 382(g); thus, T's disallowed business interest expense carryforwards are subject to the SRLY limitation in paragraph (d)(1) of this section. The section 163(j) SRLY limitation for 2020 is the P group's section 163(j) limitation, determined by reference solely to T's items for 2020 ($70x). See paragraph (d)(1) of this section. Thus, $70x of T's disallowed business interest expense carryforwards are available to be deducted by the P group in 2020, and the remaining $30x of T's disallowed business interest expense carryforwards are carried forward to 2021.

(C) *Section 163(j) limitation of $0*. The facts are the same as in paragraph (A) of this *Example 1*, except that the section 163(j) SRLY limitation for 2020 (computed by reference solely to T's items for that year) is $0. Because the amount of T's disallowed business interest expense carryforwards that may be deducted by the P group in 2020 may not exceed the section 163(j) SRLY limitation for that year, none of T's carryforwards from 2019 may be deducted by the P group in 2020.

(ii) *Example 2: Deduction of disallowed business interest expense carryforwards arising in a SRLY*–(A) *Facts*. P and S are the only members of a consolidated group. P has neither current-year business interest expense nor disallowed business interest expense carryforwards. S has $100x of disallowed business interest expense carryforwards that arose in a SRLY and $150x of current-year business interest. The section 163(j) SRLY limitation for the current year (computed by reference solely to S's items for that year) is $200x. Assume that the P group's section 163(j) limitation for the current year would permit all of S's current-year business interest expense and disallowed business interest expense carryforwards to be deducted in the current year but for the rules of this paragraph (d).

(B) *Analysis*. Under paragraph (d)(1) of this section, the section 163(j) SRLY limitation for the current year of $200x (computed by reference solely to S's items for that year) exceeds the amount of S's business interest expense taken into account by the P group in the current year under paragraph (b)(3)(ii) of this section ($150x) by $50x. Thus, $50x of S's disallowed business interest expense carryforwards that arose in a SRLY may be taken into account by the P group in the current year.

(e) *Application of section 382*–(1) *Pre-change loss*. For rules governing the treatment of a disallowed business interest expense as a pre-change loss for purposes of section 382, see §§ 1.382–2(a) and 1.382–6. For rules governing the application of section 382 to disallowed disqualified interest carryforwards, see § 1.163(j)–11(b)(4).

(2) *Loss corporation*. For rules governing when a disallowed business interest expense causes a corporation to be a loss corporation within the meaning of section 382(k)(1), see § 1.382–2(a). For the application of section 382 to disallowed disqualified interest carryforwards, see § 1.163(j)–11(b)(4).

(3) *Ordering rules for utilization of pre-change losses and for absorption of the section 382 limitation*. For ordering

rules for the utilization of disallowed business interest expense, net operating losses, and other pre-change losses, and for the absorption of the section 382 limitation, see § 1.383–1(d).

(4) *Disallowed business interest expense from the pre-change period in the year of a testing date*. For rules governing the treatment of disallowed business interest expense from the pre-change period (within the meaning of § 1.382–6(g)(2)) in the year of a testing date, see § 1.382–2.

(f) *Overlap of SRLY limitation with section 382*. The limitation provided in paragraph (d) of this section does not apply to disallowed business interest expense carryforwards when the application of paragraph (d) of this section results in an overlap with the application of section 382. For purposes of applying this paragraph (f), the principles of § 1.1502–21(g) apply with appropriate adjustments.

(g) *Additional limitations*. Additional rules provided under the Code or regulations also apply to limit the use of disallowed business interest expense carryforwards. For rules governing the relationship between section 163(j) and other provisions affecting the deductibility of interest, see § 1.163(j)–3.

(h) *Applicability date*. This section applies to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–6 Application of the business interest deduction limitation to partnerships and subchapter S corporations.

(a) *Overview*. If a deduction for business interest expense of a partnership or S corporation is subject to limitation under section 163(j), section 163(j)(4) provides that the section 163(j) limitation applies at the partnership or S corporation level and any deduction for business interest expense within the meaning of section 163(j) is taken into account in determining the nonseparately stated taxable income or loss of the partnership or S corporation. Once a partnership or S corporation determines its business interest expense, business interest income, ATI, and floor plan financing interest expense, the partnership or S corporation calculates its section 163(j) limitation by applying the rules of § 1.163(j)–2(b) and this section. Paragraph (b) of this section provides definitions used in this section. Paragraph (c) of this section provides rules regarding the character of a partnership's deductible business interest expense and excess business interest expense. Paragraph (d) of this section provides rules regarding the calculation of a partnership's ATI and floor plan financing interest expense. Paragraph (e) of this section provides rules regarding a partner's ATI and business interest income. Paragraph (f) of this section provides an eleven-step computation necessary for properly allocating a partnership's deductible business interest expense and section 163(j) excess items to its partners. Paragraph (g) of this section applies carryforward rules at the partner level if a partnership has excess business interest expense, as defined in § 1.163(j)–1(b)(14). Paragraph (h) of this section provides basis adjustment rules and paragraph (j) of this section provides rules regarding investment items of a partnership. Paragraph (l) of this section provides rules regarding S corporations. Paragraph (m) of this section provides rules for partnerships and S corporations not subject to section 163(j). Paragraph (o) of this section provides examples illustrating the rules of this section. Paragraph (p) provides the applicability date of the rules in this section.

(b) *Definitions*. In addition to the definitions contained in § 1.163(j)–1, the following definitions apply for purposes of this section.

(1) *Section 163(j) items*. The term *section 163(j) items* means the partnership or S corporation's business interest expense, business interest income, and items comprising ATI, as defined in § 1.163(j)–1(b)(1).

(2) *Partner basis items*. The term *partner basis items* means any items of income, gain, loss, or deduction resulting from either an adjustment to the basis of partnership property used in a non-excepted trade or business made pursuant to section 743(b) or the operation of section 704(c)(1)(C)(i) with respect to such property. Partner basis items also include section 743(b) basis adjustments used to increase or decrease a partner's share of partnership gain or loss on the sale of partnership property used in a non-excepted trade or business (as described in § 1.743–1(j)(3)(i)) and amounts resulting from the operation of section 704(c)(1)(C)(i) used to decrease a partner's share of partnership gain or increase a partner's share of partnership loss on the sale of such property.

(3) *Remedial items*. The term *remedial items* means any allocation to a partner of remedial items of income, gain, loss, or deduction pursuant to section 704(c) and § 1.704–3(d).

(4) *Excess business interest income*. The term *excess business interest income* means the amount by which a partnership's or S corporation's business interest income exceeds its business interest expense in a taxable year.

(5) *Deductible business interest expense*. The term *deductible business interest expense* means the amount of a partnership's or S corporation's business interest expense that is deductible under section 163(j) in the current taxable year following the application of the limitation contained in § 1.163(j)–2(b).

(6) *Section 163(j) excess items*. The term *section 163(j) excess items* means the partnership's excess business interest expense, excess taxable income, and excess business interest income.

(7) *Non-excepted assets*. The term *non-excepted assets* means assets from a trade or business other than assets from an excepted regulated utility trade or business, electing farming business, or electing real property trade or business, as such terms are defined in § 1.163(j)–1.

(8) *Excepted assets*. The term *excepted assets* means assets from an excepted regulated utility trade or business, electing farming business, or electing real property

trade or business, as such terms are defined in § 1.163(j)–1.

(c) *Character of business interest expense*. If a partnership has deductible business interest expense, such deductible business interest expense is not subject to any additional application of section 163(j) at the partner-level because it is taken into account in determining the nonseparately stated taxable income or loss of the partnership. For all other purposes of the Code, however, deductible business interest expense and excess business interest expense retain their character as business interest expense at the partner-level. For example, for purposes of section 469, such business interest expense retains its character as either passive or non-passive in the hands of the partner. Additionally, for purposes of section 469, deductible business interest expense and excess business interest expense from a partnership remain interest derived from a trade or business in the hands of a partner even if the partner does not materially participate in the partnership's trade or business activity. For additional rules regarding the interaction between sections 465, 469, and 163(j), see § 1.163(j)–3.

(d) *Adjusted taxable income of the partnership*–(1) *Modification of adjusted taxable income for partnerships*. The ATI of the partnership generally is determined in accordance with § 1.163(j)–1(b)(1). For purposes of computing the partnership's ATI, the taxable income of the partnership is determined under section 703(a) and includes any items described in section 703(a)(1) to the extent such items are otherwise included under § 1.163(j)–1(b)(1).

(2) *Section 734(b), partner basis items, and remedial items*. A partnership takes into account items resulting from adjustments made to the basis of its property pursuant to section 734(b) for purposes of calculating its ATI pursuant to § 1.163(j)–1(b)(1). However, partner basis items and remedial items are not taken into account in determining a partnership's ATI under § 1.163(j)–1(b)(1). Instead, partner basis items and remedial items are taken into account by the partner in determining the partner's ATI pursuant to § 1.163(j)–1(b)(1). See *Example 8* in paragraph (o)(8) of this section.

(e) *Adjusted taxable income and business interest income of partners*–(1) *Modification of adjusted taxable income for partners*. The ATI of a partner in a partnership generally is determined in accordance with § 1.163(j)–1(b)(1) without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, and is increased by such partner's distributive share of such partnership's excess taxable income determined under paragraph (f) of this section. For rules regarding corporate partners, see § 1.163(j)–4(b)(3).

(2) *Partner basis items and remedial items*. Partner basis items and remedial items are taken into account as items derived directly by the partner in determining the partner's ATI for purposes of the partner's section 163(j) limitation. If a partner is allocated remedial items, such partner's ATI is increased or decreased by the amount of such items. Additionally, to the extent a partner is allocated partner basis items, such partner's ATI is increased or decreased by the amount of such item. See *Example 8* in paragraph (o)(8) of this section.

(3) *Disposition of partnership interests*. If a partner recognizes gain or loss upon the disposition of interests in a partnership, and the partnership in which the interest is being disposed owns only non-excepted trade or business assets, the gain or loss on the disposition of the partnership interest is included in the partner's ATI. For dispositions of interests in partnerships that own:

(i) Non-excepted assets and excepted assets; or

(ii) Investment assets; or

(iii) Both. See § 1.163(j)–10(b)(4)(ii).

(4) *Double counting of business interest income and floor plan financing interest expense prohibited*. For purposes of calculating a partner's section 163(j) limitation, the partner does not include–

(i) Business interest income from a partnership that is subject to section 163(j) except to the extent it is allocated excess business interest income from that partnership pursuant to paragraph (f)(2) of this section; and

(ii) The partner's allocable share of the partnership's floor plan financing interest expense because such floor plan financing interest expense has already been taken into account by the partnership in determining its nonseparately stated taxable income or loss for purposes of section 163(j).

(f) *Allocation and determination of section 163(j) excess items made in the same manner as nonseparately stated taxable income or loss of the partnership*–(1) *Overview*–(i) *In general*. The purpose of this section is to provide guidance regarding how a partnership must allocate its deductible business interest expense and section 163(j) excess items, if any, among its partners. For purposes of section 163(j)(4) and this section, allocations and determinations of deductible business interest expense and section 163(j) excess items are considered made in the same manner as the nonseparately stated taxable income or loss of the partnership if, and only if, such allocations and determinations are made in accordance with the eleven-step computation set forth in paragraphs (f)(2)(i) through (xi) of this section. A partnership first determines its section 163(j) limitation, total amount of deductible business interest expense, and section 163(j) excess items under paragraph (f)(2)(i) of this section. The partnership then applies paragraphs (f)(2)(ii) through (xi) of this section, in that order, to determine how those items of the partnership are allocated among its partners. At the conclusion of the eleven-step computation set forth in paragraphs (f)(2)(i) through (xi) of this section, the total amount of deductible business interest expense and section 163(j) excess items allocated to each partner will equal the partnership's total amount of deductible business interest expense and section 163(j) excess items.

(ii) *Relevance solely for purposes of section 163(j)*. No rule set forth in paragraph (f)(2) of this section prohibits a partnership from making an allocation to a partner of any item of partnership income, gain, loss, or deduction that is otherwise permitted under section 704 and the regulations thereunder. Accordingly, any calculations in paragraphs (f)(2)(i) through (xi) of this section are solely for the purpose of determining each partner's deductible business interest expense and section 163(j) excess items, and do not otherwise affect any other provision under the Code, such as section 704(b). Additionally, floor plan financing interest expense is not allocated in accordance with paragraph (f)(2) of this section. Instead, floor plan financing interest expense of a partnership is allocated to its partners under section 704(b) and is taken into account as a nonseparately stated item of loss for purposes of section 163(j).

(2) *Steps for allocating deductible business interest expense and section 163(j) excess items*–(i) *Partnership-level calculation required by section 163(j)(4)(A).* First, a partnership must determine its section 163(j) limitation pursuant to § 1.163(j)–2(b). This calculation determines a partnership's total amounts of excess business interest income, excess taxable income, excess business interest expense (that is, the partnership's section 163(j) excess items), and deductible business interest expense under section 163(j) for a taxable year.

(ii) *Determination of each partner's relevant section 163(j) items*. Second, a partnership must determine each partner's allocable share of each section 163(j) item under section 704(b) and the regulations thereunder including any allocations under section 704(c), other than remedial items as defined in paragraph (b)(3) of this section. Only section 163(j) items that were actually taken into account in the partnership's section 163(j) calculation under paragraph (f)(2)(i) of this section are taken into account for purposes of this paragraph (f)(2)(ii). Partner basis items, allocations of investment income and expense, remedial items, and amounts determined for the partner under § 1.163(j)–8T are not taken into account for purposes of this paragraph (f)(2)(ii). For purposes of paragraphs (f)(2)(ii) through (xi) of this section, the term *allocable ATI* means a partner's distributive share of the partnership's ATI (i.e., a partner's distributive share of gross income and gain items comprising ATI less such partner's distributive share of gross loss and deduction items comprising ATI), the term *allocable business interest income* means a partner's distributive share of the partnership's business interest income, and the term *allocable business interest expense* means a partner's distributive share of the partnership's business interest expense that is not floor plan financing interest expense.

(iii) *Partner-level comparison of business interest income and business interest expense*. Third, a partnership must compare each partner's allocable business interest income to such partner's allocable business interest expense. Paragraphs (f)(2)(iii) through (v) of this section determine how a partnership must allocate its excess business interest income among its partners, as well as the amount of each partner's allocable business interest expense that is not deductible business interest expense after taking the partnership's business interest income into account. To the extent a partner's allocable business interest income exceeds its allocable business interest expense, the partner has an *allocable business interest income excess*. The aggregate of all the partners' allocable business interest income excess amounts is the *total allocable business interest income excess*. To the extent a partner's allocable business interest expense exceeds its allocable business interest income, the partner has an *allocable business interest income deficit*. The aggregate of all the partners' allocable business interest income deficit amounts is the *total allocable business interest income deficit*. These amounts are required to perform calculations in paragraphs (f)(2)(iv) and (v) of this section, which appropriately reallocate allocable business interest income excess to partners with allocable business interest income deficits in order to reconcile the partner-level calculation under paragraph (f)(2)(iii) of this section with the partnership-level result under paragraph (f)(2)(i) of this section.

(iv) *Matching partnership and aggregate partner excess business interest income*. Fourth, a partnership must determine each partner's final allocable business interest income excess. A partner's *final allocable business interest income excess* is determined by reducing, but not below zero, such partner's allocable business interest income excess (if any) by the partner's step four adjustment amount. A partner's *step four adjustment amount* is the product of the total allocable business interest income deficit and the ratio of such partner's allocable business interest income excess to the total allocable business interest income excess. The rules of this paragraph (f)(2)(iv) ensure that, following the application of paragraph (f)(2)(xi) of this section, the aggregate of all the partners' allocations of excess business interest income equals the total amount of the partnership's excess business interest income as determined in paragraph (f)(2)(i) of this section.

(v) *Remaining business interest expense determination*. Fifth, a partnership must determine each partner's remaining business interest expense. A partner's *remaining business interest expense* is calculated by reducing, but not below zero, such partner's allocable business interest income deficit (if any) by such partner's step five adjustment amount. A partner's *step five adjustment amount* is the product of the total allocable business interest income excess and the ratio of such partner's allocable business interest income deficit to the total allocable business interest income deficit. Generally, a partner's remaining business interest expense is a partner's allocable business interest income deficit adjusted to reflect a reallocation of allocable business interest income excess from other partners. Determining a partner's remaining business interest expense is necessary to perform an ATI calculation that begins in paragraph (f)(2)(vii) of this section.

(vi) *Determination of final allocable ATI*. Sixth, a partnership must determine each partner's final allocable ATI. Paragraphs (f)(2)(vi) through (x) of this section determine how a partnership must allocate its excess taxable income and excess business interest expense among its partners.

(A) *Positive allocable ATI*. To the extent a partner's income and gain items comprising its allocable ATI exceed its deduction and loss items comprising its allocable ATI, the partner has *positive allocable ATI*. The aggregate of all the partners' positive allocable ATI amounts is the *total positive allocable ATI*.

(B) *Negative allocable ATI*. To the extent a partner's deduction and loss items comprising its allocable ATI exceed its income and gain items comprising its allocable ATI, the partner has negative allocable ATI. The aggregate of all the partners' negative allocable ATI amounts is the *total negative allocable ATI*.

(C) *Final allocable ATI*. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Any partner with a positive allocable ATI of $0 has a final allocable ATI of $0. The final allocable ATI of any partner with a positive allocable ATI greater than $0 is such partner's positive allocable ATI reduced, but not below zero, by the partner's step six adjustment amount. A partner's *step six adjustment amount* is the product of the total negative allocable ATI and the ratio of such partner's positive allocable ATI to the total positive allocable ATI. The total of the partners' final allocable ATI amounts must equal the partnership's ATI amount used to compute its section 163(j) limitation pursuant to § 1.163(j)–2(b).

(vii) *Partner-level comparison of thirty percent of adjusted taxable income and remaining business interest expense*. Seventh, a partnership must compare each partner's ATI capacity to such partner's remaining business interest expense as determined under paragraph (f)(2)(v) of this section. A partner's *ATI capacity* is the amount that is thirty percent of such partner's final allocable ATI as determined under paragraph (f)(2)(vi) of this section. A partner's final allocable ATI is grossed down to thirty percent prior to being compared to its remaining business interest expense in this calculation to parallel the partnership's adjustment to its ATI under section 163(j)(1)(B). To the extent a partner's ATI capacity exceeds its remaining business interest expense, the partner has an *ATI capacity excess*. The aggregate of all the partners' ATI capacity excess amounts is the *total ATI capacity excess*. To the extent a partner's remaining business interest expense exceeds its ATI capacity, the partner has an *ATI capacity deficit*. The aggregate of all the partners' ATI capacity deficit amounts is the *total ATI capacity deficit*. These amounts (which may be subject to adjustment under paragraph (f)(2)(viii) of this section) are required to perform calculations in paragraphs (f)(2)(ix) and (x) of this section, which appropriately reallocate ATI capacity excess to partners with ATI capacity deficits in order to reconcile the partner-level calculation under paragraph (f)(2)(vii) of this section with the partnership-level result under paragraph (f)(2)(i) of this section.

(viii) *Partner priority right to ATI capacity excess determination*–(A) Eighth, the partnership must determine whether it is required to make any adjustments described in this paragraph (f)(2)(viii) and, if it is, make such adjustments. The rules of this paragraph (f)(2)(viii) are necessary to account for adjustments made to a partner's allocable ATI in paragraph (f)(2)(vi) of this section to ensure that the partners who had a negative allocable ATI do not inappropriately benefit under the rules of paragraphs (f)(2)(ix) through (xi) of this section to the detriment of the partners who had positive allocable ATI. The partnership must perform the calculations and make the necessary adjustments described under paragraphs (f)(2)(viii)(B) and (C) or paragraph (f)(2)(viii)(D) of this section if, and only if, there is–

(*1*) An excess business interest expense amount greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI amount greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATI capacity excess amount greater than $0 under paragraph (f)(2)(vii) of this section.

(B) A partnership must determine each partner's priority amount and usable priority amount. A partner's *priority amount* is thirty percent of the amount by which a partner's positive allocable ATI under paragraph (f)(2)(vi)(A) of this section exceeds such partner's final allocable ATI under paragraph (f)(2)(vi)(C) of this section. However, only partners with an ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section can have a priority amount greater than $0. The aggregate of all the partners' priority amounts is the *total priority amount*. A partner's *usable priority amount* is the lesser of such partner's priority amount and such partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section. The aggregate of all the partners' usable priority amounts is the *total usable priority amount*. If the total ATI capacity excess amount, as determined under paragraph (f)(2)(vii) of this section, is greater than or equal to the total usable priority amount, then the partnership must perform the adjustments described in paragraph (f)(2)(viii)(C) of this section. If the total usable priority amount is greater than the total ATI capacity excess amount, as determined under paragraph (f)(2)(vii) of this section, then the partnership must perform the adjustments described in paragraph (f)(2)(viii)(D) of this section.

(C) For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATI capacity excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, the following terms have the following meanings for each partner:

(*1*) Each partner's *ATI capacity deficit* is such partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section reduced by such partner's usable priority amount.

(*2*) The *total ATI capacity deficit* is the total ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section reduced by the total usable priority amount.

(*3*) The *total ATI capacity excess* is the total ATI capacity excess as determined under paragraph (f)(2)(vii) of this section reduced by the total usable priority amount.

(D) Any partner with a priority amount greater than $0 is a *priority partner*. Any partner that is not a priority partner is a *non-priority partner*. For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATI capacity excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, each non-priority partner's final ATI capacity deficit amount is such partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section. For purposes of paragraph (f)(2)(x) of this section, the following terms have the following meanings for priority partners.

(*1*) Each priority partner must determine its step eight excess share. A partner's *step eight excess share* is the product of the total ATI capacity excess as determined under paragraph (f)(2)(vii) of this section and the ratio of the partner's priority amount to the total priority amount.

(*2*) To the extent a priority partner's step eight excess share exceeds its ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section, such excess amount is the priority partner's *ATI capacity excess* for purposes of paragraph (f)(2)(x) of this section. The *total ATI capacity excess* is the aggregate of the priority partners' ATI capacity excess amounts as determined under this paragraph (f)(2)(viii)(D)(*2*).

(*3*) To the extent a priority partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section exceeds its step eight excess share, such excess amount is the priority partner's *ATI capacity deficit* for purposes of paragraph (f)(2)(x) of this section. The *total ATI capacity deficit* is the aggregate of the priority partners' ATI capacity deficit amounts as determined under this paragraph (f)(2)(viii)(D)(*3*).

(ix) *Matching partnership and aggregate partner excess taxable income*. Ninth, a partnership must determine each partner's final ATI capacity excess. A partner's *final ATI capacity excess* amount is determined by reducing, but not below zero, such partner's ATI capacity excess (if any) by the partner's step nine adjustment amount. A partner's *step nine adjustment amount* is the product of the total ATI capacity deficit and the ratio of such partner's ATI capacity excess to the total ATI capacity excess. The rules of this paragraph (f)(2)(ix) ensure that, following the application of paragraph (f)(2)(xi) of this section, the aggregate of all the partners' allocations of excess taxable income equals the total amount of the partnership's excess taxable income as determined in paragraph (f)(2)(i) of this section.

(x) *Matching partnership and aggregate partner excess business interest expense*. Tenth, a partnership must determine each partner's final ATI capacity deficit. A partner's *final ATI capacity deficit* amount is determined by reducing, but not below zero, such partner's ATI capacity deficit (if any) by the partner's step ten adjustment amount. A partner's *step ten adjustment amount* is the product of the total ATI capacity excess and the ratio of such partner's ATI capacity deficit to the total ATI capacity deficit. Generally, a partner's final ATI capacity deficit is a partner's ATI capacity deficit adjusted to reflect a reallocation of ATI capacity excess from other partners. The rules of this paragraph (f)(2)(x) ensure that, following the application of paragraph (f)(2)(xi) of this section, the aggregate of all the partners' allocations of excess business interest expense equals the total amount of the partnership's excess business interest expense as determined in paragraph (f)(2)(i) of this section.

(xi) *Final section 163(j) excess item and deductible business interest expense allocation*. Eleventh, a partnership must allocate section 163(j) excess items and deductible business interest expense to its partners. Excess business interest income calculated under paragraph (f)(2)(i) of this section, if any, is allocated dollar for dollar by the partnership to its partners with final allocable business interest income excess amounts. Excess business interest expense calculated under paragraph (f)(2)(i) of this section, if any, is allocated dollar for dollar to partners with final ATI capacity deficit amounts. After grossing up each partner's final ATI capacity excess amount by ten-thirds, excess taxable income calculated under paragraph (f)(2)(i) of this section, if any, is allocated dollar for dollar to partners with final ATI capacity excess amounts. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. See paragraphs (o)(11) through (15) of this section.

(g) *Carryforwards*–(1) *In general*. The amount of any business interest expense not allowed as a deduction to a partnership by reason of § 1.163(j)–2(b) and paragraph (f)(2) of this section for any taxable year is–

(i) Not treated as business interest expense of the partnership in the succeeding taxable year; and

(ii) Subject to paragraph (g)(2) of this section, treated as excess business interest expense which is allocated to each partner pursuant to paragraph (f)(2) of this section.

(2) *Treatment of excess business interest expense allocated to partners*. If a partner is allocated excess business interest expense from a partnership under paragraph (f)(2) of this section for any taxable year –

(i) Solely for purposes of section 163(j), such excess business interest expense is treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income or excess business interest income from such partnership, but only to the extent of such excess taxable income or excess business interest income; and

(ii) Any portion of such excess business interest expense remaining after the application of paragraph (g)(2)(i) of this section is excess business interest expense that is subject to the limitations of paragraph (g)(2)(i) of this section in succeeding years, unless paragraph (m)(3) of this section applies. See paragraphs (o)(1) through (10) of this section.

(3) *Excess taxable income and excess business interest income ordering rule*. In the event a partner has excess business interest expense from a prior taxable year and is allocated excess taxable income or excess business interest income from the same partnership in a succeeding taxable year, the partner must treat, for purposes of section 163(j), the excess business interest expense as business interest expense paid or accrued by the partner in an amount equal to the partner's share of the partnership's excess taxable income or excess business interest income in such succeeding taxable year. See paragraphs (o)(2) through (10) of this section.

(h) *Basis adjustments*–(1) *Section 704(d) ordering*. Deductible business interest expense and excess business interest expense are subject to section 704(d). If a partner is subject to a limitation on loss under section 704(d) and a partner is allocated losses from a partnership in a taxable year, § 1.704–1(d)(2) requires that the limitation on losses under section 704(d) be apportioned amongst these losses based on the character of each loss (each grouping of loses based on character being a "section 704(d) loss class"). If there are multiple section 704(d) loss classes in a given year, § 1.704–1(d)(2) requires the partner to apportion the limitation on losses under section 704(d) to each section 704(d) loss class proportionately. For purposes of applying this proportionate rule, any deductible business interest expense (whether allocated to the partner in the current taxable year or suspended under section 704(d) in a prior taxable year), any excess business interest expense allocated to the partner in the current taxable year, and any excess business interest expense from a prior taxable year that was suspended under section 704(d) ("negative section 163(j) expense") shall comprise the same section 704(d) loss class. Once the partner determines the amount of limitation on losses apportioned to this section 704(d) loss class, any deductible business interest expense is taken into account before any excess business interest expense or negative section 163(j) expense. See paragraph (o)(9) of this section.

(2) *Excess business interest expense basis adjustments.* The adjusted basis of a partner in a partnership interest is reduced, but not below zero, by the amount of excess business interest expense allocated to the partner pursuant to paragraph (f)(2) of this section. Negative section 163(j) expense is not treated as excess business interest expense in any subsequent year until such negative section 163(j) expense is no longer suspended under section 704(d). Therefore, negative section 163(j) expense does not affect, and is not affected by, any allocation of excess taxable income to the partner. Accordingly, any excess taxable income allocated to a partner from a partnership while the partner still has negative section 163(j) expense will be included in the partner's ATI. However, once the negative section 163(j) expense is no longer suspended under section 704(d), it becomes excess business interest expense, which is subject to the general rules in paragraph (g) of this section. See paragraph (o)(10) of this section.

(3) *Basis adjustments upon disposition of partnership interest*–(i) *Complete disposition of partnership interest*. If a partner disposes of all or substantially all of a partnership interest (whether by sale, exchange, or redemption), the adjusted basis of the partnership interest is increased immediately before the disposition by the amount of the excess (if any) of the amount of the basis reduction under paragraph (h)(2) of this section over the portion of any excess business interest expense allocated to the partner under paragraph (f)(2) of this section which has previously been treated under paragraph (g) of this section as business interest expense pair or accrued by the partner, regardless of whether the disposition was a result of a taxable or non-taxable transaction. Therefore, the adjusted basis of a partner in a partnership interest is not increased by any negative section 163(j) expense upon the disposition of a partnership interest. No deduction under section 163(j) is allowed to the transferor or transferee under chapter 1 of subtitle A of the Code for any excess business interest expense resulting in a basis increase under this section or any negative section 163(j) expense.

(ii) *Partial disposition of partnership interest*. If a partner disposes of less than substantially all of its interest in a partnership (whether by sale, exchange, or redemption), a partner shall not increase its basis in its partnership interest by the amount of any excess business interest expense that has not yet been treated as business interest expense paid or accrued by the partner in accordance with paragraph (g) of this section. Any such excess business interest expense shall remain excess business interest expense of the transferor partner until such time as the transferor partner is allocated an appropriate amount of excess taxable income or excess business interest income from the partnership or the partner disposes of its partnership interest in accordance with paragraph (h)(2)(i) of this section. Additionally, any negative section 163(j) expense shall remain negative section 163(j) expense of the transferor partner until such negative section 163(j) expense is no longer suspended under section 704(d).

(i) [Reserved]

(j) *Investment items*. Any item of a partnership's income, gain, deduction, or loss that is investment interest income or expense pursuant to § 1.163–8T is allocated to each partner in accordance with section 704(b) and the regulations thereunder and the effect of such allocation for purposes of section 163 is determined at the partner-level. See § 1.163(j)–4(b)(3), section 163(d), and § 1.163–8T.

(k) [Reserved]

(l) *S corporations*–(1) *In general*. In the case of any S corporation, the section 163(j) limitation is applied at the S corporation level, and any deduction allowed for business interest expense is taken into account in determining the nonseparately stated taxable income or loss of the S corporation. An S corporation determines its section 163(j) limitation in the same manner as set forth in § 1.163(j)–2(b). Allocations of excess taxable income and excess business interest income are made in accordance with the shareholders' respective pro rata interests in the S corporation pursuant to section 1366(a)(1) after determining the S corporation's section 163(j) limitation pursuant to § 1.163(j)–2(b).

(2) *Character of deductible business interest expense*. If an S corporation has deductible business interest expense, such deductible business interest expense is not subject to any additional application of section 163(j) at the shareholder-level because such deductible business interest expense is taken into account in determining the nonseparately stated taxable income or loss of the S corporation. For all other purposes of the Code, however, deductible business interest expense retains its character as business interest expense at the shareholder-level. For example, for purposes of section 469, such deductible business interest expense retains its character as either passive or non-passive in the hands of the shareholder. Additionally, for purposes of section 469, deductible business interest expense from an S corporation remains interest derived from a trade or business in the hands of a shareholder even if the shareholder does not materially participate in the S corporation's trade or business activity. For additional rules regarding the interaction between sections 465, 469, and 163(j), see § 1.163(j)–3.

(3) *Adjusted taxable income of an S corporation*. The ATI of an S corporation generally is determined in accordance with § 1.163(j)–1(b)(1). For purposes of computing the S corporation's ATI, the taxable income of the S corporation is determined under section 1363(b) and includes–

(i) Any item described in section 1363(b)(1); and

(ii) Any item described in § 1.163(j)–1(b)(1), to the extent such item is consistent with subchapter S of the Code.

(4) *Adjusted taxable income and business interest income of S corporation shareholders*–(i) *Adjusted taxable income of S corporation shareholders*. The ATI of an S corporation shareholder is determined in accordance with § 1.163(j)–1(b)(1) without regard to such shareholder's distributive share of any items of income, gain, deduction, or loss of such S corporation, and is increased by such shareholder's distributive share of such S corporation's excess taxable income, as defined in § 1.163(j)–1(b)(15).

(ii) *Disposition of S corporation stock*. If a shareholder of an S corporation recognizes gain or loss upon the disposition of stock of the S corporation, and the corporation in which the stock is being disposed only owns non-excepted trade or business assets, the gain or loss on the disposition of the stock is included in the shareholder's ATI. For dispositions of stock of S corporations that own:

(A) Non-excepted assets and excepted assets; or

(B) Investment assets; or

(C) Both. See § 1.163(j)–10(b)(4)(ii).

(iii) *Double counting of business interest income and floor plan financing interest expense prohibited*. For purposes of calculating an S corporation shareholder's section 163(j) limitation, the shareholder does not include–

(A) Business interest income from an S corporation that is subject to section 163(j) except to the extent it is allocated excess business interest income from that S corporation pursuant to paragraph (l)(1) of this section; and

(B) The shareholder's share of the S corporation's floor plan financing interest expense because such floor plan financing interest expense has already been taken into account by the S corporation in determining its nonseparately stated taxable income or loss for purposes of section 163(j).

(5) *Carryforwards*. The amount of any business interest expense not allowed as a deduction for any taxable year by reason of the limitation contained in § 1.163(j)–2(b) is carried forward in the succeeding taxable year as a disallowed business interest expense carryforward under the rules set forth in § 1.163(j)–2(c) (whether to an S corporation or C corporation taxable year). S corporations are subject to:

(i) The same ordering rules as a C corporation that is not a member of a consolidated group; and

(ii) The limitation under section 382. See § 1.163(j)–5(b)(2) and (e).

(6) *Basis adjustments and disallowed business interest expense carryforwards*. An S corporation shareholder's adjusted basis in its S corporation stock is reduced, but not below zero, when a disallowed business interest expense carryforward becomes deductible under section 163(j).

(7) *Accumulated adjustment accounts*. The accumulated adjustment account of an S corporation is adjusted to take into account business interest expense in the year in which the S corporation treats such business interest expense as deductible under the section 163(j) limitation. See section 1368(e)(1).

(8) *Termination of qualified subchapter S subsidiary election*. If a corporation's qualified subchapter S subsidiary election terminates and any disallowed business interest expense carryforward is attributable to the activities of the qualified subchapter S subsidiary at the time of termination, such disallowed business interest expense carryforward remains with the parent S corporation and no portion of these items is allocable to the former qualified subchapter S subsidiary.

(9) *Investment items*. Any item of an S corporation's income, gain, deduction, or loss that is investment interest income or expense pursuant to § 1.163–8T is allocated to each shareholder in accordance with the shareholders' pro rata interests in the S corporation pursuant to section 1366(a)(1). See section 163(d), § 1.163–8T.

(m) *Partnerships and S corporations not subject to section 163(j)*–(1) *Partnerships and S corporations not subject to section 163(j) by reason of the small business exemption*. If a partnership or S corporation is not subject to section 163(j) by reason of § 1.163(j)–2(d) (exempt entity), the exempt entity does not calculate the section 163(j) limitation under § 1.163(j)–2 and these regulations. Because an exempt entity is not subject to section 163(j)(4), it does not take its deduction for business interest expense into account in determining its nonseparately stated taxable income or loss within the meaning of section 163(j)(4)(A)(i) and retains its character as business interest expense. See § 1.163(j)–6(c). Thus, if a partner or S corporation shareholder is allocated business interest expense from an exempt entity, that allocated business interest expense will be subject to the partner's or S corporation shareholder's section 163(j) limitations. Additionally, contrary to the general rule in § 1.163(j)–6(e)(1), a partner or S corporation shareholder includes items of income, gain, loss, or deduction of such exempt entity when calculating its ATI. Finally, business interest income of such exempt entity is included in the partner's or S corporation shareholder's section 163(j) limitation regardless of the exempt entity's business interest expense amount.

(2) *Partnerships and S corporations not subject to section 163(j) by reason of an excepted trade or business*. To the extent a partnership or S corporation is not subject to section 163(j) because it has an excepted trade or business as defined in § 1.163(j)–1(b)(38)(ii) (excepted entity), the entity does not apply its section 163(j) limitation under § 1.163(j)–2 and this section with respect to the business interest expense that is allocable to such excepted trade or business. If a partner or S corporation shareholder is allocated any section 163(j) item that is allocable to the partnership's or S corporation's excepted trade or business (excepted 163(j) items), such excepted 163(j) items are excluded from the partner or shareholder's section 163(j) deduction calculation. See § 1.163(j)–10(c) (regarding the allocation of items between excepted and non-excepted trades or businesses).

(3) *Partnerships that allocated excess business interest expense prior to becoming not subject to section 163(j)*. If a partnership allocates excess business interest expense to one or more of its partners, and in a succeeding taxable year becomes not subject to the requirements of section 163(j), the excess business interest expense from the prior taxable years is treated as paid or accrued by the partner in such succeeding taxable year. See paragraphs (o)(6) and (7) of this section.

(4) *S corporations with disallowed business interest expense carryforwards prior to becoming not subject to section 163(j)*. If an S corporation has a disallowed business interest expense carryforward for a taxable year, and in the succeeding taxable year becomes not subject to the requirements of section 163(j), then such disallowed business interest expense carryforward—

(i) Continues to be carried forward at the S corporation level;

(ii) Is no longer subject to the section 163(j) limitation; and

(iii) Is taken into account in determining the nonseparately stated taxable income or loss of the S corporation.

(n) [Reserved]

(o) *Examples*. The examples in this paragraph illustrate the provisions of section 163(j) as applied to partnerships and subchapter S corporations. For purposes of these examples, each partnership is subject to the provisions of section 163(j), was created or organized in the United States, and is a calendar year taxpayer. Unless stated otherwise, all partners are subject to the provisions of section 163(j), are not subject to a limitation under section 704(d) or 1366(d), have no tax items other than those listed in the example, are U.S. citizens, and are calendar year taxpayers. The phrase "section 163(j) limit" shall equal the maximum potential deduction allowed under section 163(j)(1). Unless stated otherwise, business interest expense means business interest expense that is not floor plan financing interest expense. With respect to partnerships, all allocations are in accordance with section 704(b) and the regulations thereunder.

(1) *Example 1*–(i) *Facts*. X and Y are equal partners in partnership PRS. In Year 1, PRS has $100 of ATI and $40 of business interest expense. PRS allocates the items comprising its $100 of ATI $50 to X and $50 to Y. PRS allocates its $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level*. In Year 1, PRS's section 163(j) limit is 30 percent of its ATI, or $30 ($100 x 30 percent). Thus, PRS has $30 of deductible business interest expense and $10 of excess business interest expense. Such $30 of deductible business interest expense is includable in PRS's non-separately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations*. Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $15 of deductible business interest expense and $5 of excess business interest expense. At the end of Year 1, X and Y each have $5 of excess business interest expense from PRS, which is not treated as paid or accrued by the partner until such partner is allocated excess taxable income or excess business interest income from PRS in a succeeding taxable year. Pursuant to § 1.163(j)–6(e)(1), X and Y, in computing their limit under section 163(j), do not increase any of their section 163(j) items by any of PRS's section 163(j) items. X and Y each increase their outside basis in PRS by $30 ($50 - $20).

(iv) *Partner-level computations*. X, in computing its limit under section 163(j), has $100 of ATI and $20 of business interest expense from its sole proprietorship. X's section 163(j) limit is $30 ($100 x 30 percent). Thus, X's $20 of business interest expense is deductible business interest expense. Y, in computing its limit under section 163(j), has $20 of business interest expense from its sole proprietorship. Y's section 163(j) limit is $0 ($0 x 30 percent). Thus, Y's $20 of business interest expense is not allowed as a deduction and is treated as business interest expense paid or accrued by Y in Year 2.

(2) *Example 2*–(i) *Facts*. The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section. In Year 2, PRS has $200 of ATI, $0 of business interest income, and $30 of business interest expense. PRS allocates the items comprising its $200 of ATI $100 to X and $100 to Y. PRS allocates its $30 of business interest expense $15 to X and $15 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level*. In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $60 ($200 x 30 percent). Thus, PRS has $100 of excess taxable income, $30 of deductible business interest expense, and $0 of excess business interest expense. Such $30 of deductible business interest expense is includable in PRS's non-separately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations*. Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $50 of excess taxable income, $15 of deductible business interest expense, and $0 of excess business interest expense. As a result, X and Y each increase their ATI by $50. Because X and Y are each allocated $50 of excess taxable income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, X and Y each treat $5 of excess business interest expense (the carryforward from Year 1) as paid or accrued in Year 2. X and Y each increase their outside basis in PRS by $85 ($100 - $15).

(iv) *Partner-level computations*. X, in computing its limit under section 163(j), has $150 of ATI ($100 from its sole proprietorship, plus $50 excess taxable income) and $25 of business interest expense ($20 from its sole proprietorship, plus $5 excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $45 ($150 x 30 percent). Thus, X's $25 of business interest expense is deductible business interest expense. At the end of Year 2, X has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2). Y, in computing its limit under section 163(j), has $50 of ATI ($0 from its sole proprietorship, plus $50 excess taxable income) and $45 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $5 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $15 ($50 x 30 percent). Thus, $15 of Y's business interest expense is deductible business interest expense. The $30 of Y's business interest expense not allowed as a deduction ($45 business interest expense, less $15 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2).

(3) *Example 3*–(i) *Facts*. The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section. In Year 2, PRS has $0 of ATI, $60 of business interest income, and $40 of business interest expense. PRS allocates its $60 of business interest income $30 to X and $30 to Y. PRS allocates its $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level*. In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $60 (($0 x 30 percent) + $60). Thus, PRS has $20 of excess business interest income, $0 of excess taxable income, $40 of deductible business interest expense, and $0 of excess business interest expense. Such $40 of deductible business interest expense is includable in PRS's non-separately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations*. Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $10 of excess business interest income, and $20 of deductible business interest expense. As a result, X and Y each increase their business interest income by $10. Because X and Y are each allocated $10 of excess business interest income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, X and Y each treat $5 of excess business interest expense (the carryforward from Year 1) as paid or accrued in Year 2. X and Y each increase their outside basis in PRS by $10 ($30 - $20).

(iv) *Partner-level computations*. X, in computing its limit under section 163(j), has $100 of ATI (from its sole proprietorship), $10 of business interest income (from the allocation of $10 of excess business interest income from PRS), and $25 of business interest expense ($20 from its sole proprietorship, plus $5 excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $40 (($100 x 30 percent) + $10). Thus, X's $25 of business interest expense is deductible business interest expense. At the end of Year 2, X has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2). Y, in computing its limit under section 163(j), has $0 of ATI (from its sole proprietorship), $10 of business interest income, and $45 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $5 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $10 (($0 x 30 percent) + $10). Thus, $10 of Y's business interest expense is deductible business interest expense. The $35 of Y's business interest expense not allowed as a deduction ($45 business interest expense, less $10 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2).

(4) *Example 4*–(i) *Facts*. The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section. In Year 2, PRS has $100 of ATI, $60 of business interest income, and $40 of business interest expense. PRS allocates the items comprising its $100 of ATI $50 to X and $50 to Y. PRS allocates its $60 of business interest income $30 to X and $30 to Y. PRS allocates its $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level*. In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $90 (($100 x 30 percent)) + $60). Thus, PRS has $20 of excess business interest income, $100 of excess taxable income, $40 of deductible business interest expense, and $0 of excess business interest expense. Such $40 of deductible business interest expense is includable in PRS's non-separately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations*. Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $10 of excess business interest income, $50 of excess taxable income, and $20 of deductible business interest expense. As a result, X and Y each increase their business interest income by $10 and ATI by $50. Because X and Y are each allocated $10 of excess business interest income and $50 of excess taxable income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, X and Y each treat $5 of excess business interest expense (the carryforward from Year 1) as paid or accrued in Year 2. X and Y each increase their outside basis in PRS by $60 ($80 – $20).

(iv) *Partner-level computations*. X, in computing its limit under section 163(j), has $150 of ATI ($100 from its sole proprietorship, plus $50 excess taxable income), $10 of business interest income, and $25 of business interest expense ($20 from its sole proprietorship, plus $5 excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $55 (($150 x 30 percent) + $10). Thus, $25 of X's business interest expense is deductible business interest expense. At the end of Year 2, X has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2). Y, in computing its limit under section 163(j), has $50 of ATI ($0 from its sole proprietorship, plus $50 excess taxable income), $10 of business interest income, and $45 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $5 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $25 (($50 x 30 percent) + $10). Thus, $25 of Y's business interest expense is deductible business interest expense. Y's $20 of business interest expense not allowed as a deduction ($45 business interest expense, less $25 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2).

(5) *Example 5*–(i) *Facts*. The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section. In Year 2, PRS has $100 of ATI, $11.20 of business interest income, and $40 of business interest expense. PRS allocates the items comprising its $100 of ATI $50 to X and $50 to Y. PRS allocates its $11.20 of business interest income $5.60 to X and $5.60 to Y. PRS allocates its $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level*. In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $41.20 (($100 x 30 percent) + $11.20). Thus, PRS has $0 of excess business interest income, $4 of excess taxable income, and $40 of deductible business interest expense. Such $40 of deductible business interest expense is includable in PRS's non-separately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations*. Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $2 of excess taxable income, $20 of deductible business interest expense, and $0 of excess business interest expense. As a result, X and Y each increase their ATI by $2. Because X and Y are each allocated $2 of excess taxable income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, X and Y each treat $2 of excess business interest expense (a portion of the carryforward from Year 1) as paid or accrued in Year 2. X and Y each increase their outside basis in PRS by $35.60 ($55.60 - $20).

(iv) *Partner-level computations*. X, in computing its limit under section 163(j), has $102 of ATI ($100 from its sole proprietorship, plus $2 excess taxable income), $0 of business interest income, and $22 of business interest expense ($20 from its sole proprietorship, plus $2 excess business interest expense treated as paid or accrued). X's section 163(j) limit is $30.60 ($102 x 30 percent). Thus, X's $22 of business interest expense is deductible business interest expense. At the end of Year 2, X has $3 of excess business interest expense from PRS ($5 from Year 1, less $2 treated as paid or accrued in Year 2). Y, in computing its limit under section 163(j), has $2 of ATI ($0 from its sole proprietorship, plus $2 excess taxable income), $0 of business interest income, and $42 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $2 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $0.60 ($2 x 30 percent). Thus, $0.60 of Y's business interest expense is deductible business interest expense. Y's $41.40 of business interest expense not allowed as a deduction ($42 business interest expense, less $0.60 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $3 of excess business interest expense from PRS ($5 from Year 1, less $2 treated as paid or accrued in Year 2).

(6) *Example 6*–(i) *Facts*. The facts are the same as in *Example 5* in paragraph (o)(5)(i) of this section, except in Year 2 Y becomes not subject to section 163(j) under section 163(j)(3).

(ii) *Partnership-level*. Same analysis as *Example 5* in paragraph (o)(5)(ii) of this section.

(iii) *Partner-level allocations*. Same analysis as *Example 5* in paragraph (o)(5)(iii) of this section.

(iv) *Partner-level computations*. For X, same analysis as *Example 5* in paragraph (o)(5)(iv) of this section. Y is not subject to section 163(j) under section 163(j)(3). Thus, all $42 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $2 excess business interest expense treated as paid or accrued in Year 2) is not subject to limitation under § 1.163(j)–2(d). At the end of Year 2, Y has $3 of excess business interest expense from PRS ($5 from Year 1, less $2 treated as paid or accrued in Year 2).

(7) *Example 7*–(i) *Facts*. The facts are the same as in *Example 5* in paragraph (o)(5)(i) of this section, except in Year 2 PRS and Y become not subject to section 163(j) under section 163(j)(3).

(ii) *Partnership-level*. In Year 2, PRS becomes not subject to section 163(j)(4) by reason of section 163(j)(3). As a result, none of PRS's $30 of business interest expense is subject to limitation at the partnership level.

(iii) *Partner-level allocations*. Because section 163(j) does not apply, PRS's $30 of business interest expense is not taken into account in determining its non-separately stated taxable income or loss. Thus, PRS's $30 of business interest expense retains its character as business interest expense for purposes of section 163(j), and is potentially subject to limitation at the partners' level. As a result, X and Y each increase their business interest expense by $15. Further, because PRS is not subject to section 163(j)(4) by reason of section 163(j)(3), the provision requiring each partner of the partnership to determine their ATI without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership (section 163(j)(4)(ii)(I)) is no longer applicable under § 1.163(j)–6(m)(1). As a result, X and Y each increase their ATI by $100. Further, because PRS is not subject to section 163(j)(4) by reason of section 163(j)(3), the excess business interest expense from Year 1 is treated as paid or accrued by the partners pursuant to § 1.163(j)–6(m)(3). As a result, X and Y each treat their $5 of excess business interest expense from Year 1 as paid or accrued in Year 2, and increase their business interest expense by $5.

(iv) *Partner-level computations*. X, in computing its limit under section 163(j), has $200 of ATI ($100 from its sole proprietorship, plus $100 ATI from PRS) and $40 of business interest expense ($20 from its sole proprietorship, plus $15 from PRS, plus $5 of excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $60 ($200 x 30 percent). Thus, $40 of X's business interest expense is deductible business interest expense. Y is not subject to section 163(j) under section 163(j)(3). As a result, Y's business interest expense is not subject to limitation under section 163(j). Thus, all $60 of Y's business interest expense ($20 from its sole proprietorship, plus $20 disallowed from year 1, plus $15 from PRS from year 2, plus $5 of excess business interest expense treated as paid or accrued in Year 2) is not subject to limitation under section 163(j).

(8) *Example 8*–(i) *Facts*. In Year 1, X, Y, and Z formed partnership PRS. Upon formation, X and Y each contributed $100, and Z contributed non-excepted and non-depreciable trade or business property with a basis of $0 and fair market value of $100 (Blackacre). PRS allocates all items pro rata between its partners. Immediately after the formation of PRS, Z sold all of its interest in PRS to A for $100

(assume the interest sale is respected for U.S. federal income tax purposes). In connection with the interest transfer, PRS made a valid election under section 754. Therefore, after the interest sale, A had a $100 positive section 743(b) adjustment in Blackacre. In Year 1, PRS had $0 of ATI, $15 of business interest expense, and $0 of business interest income. Pursuant to § 1.163(j)–6(f)(2), PRS allocated each of the partners $5 of excess business interest expense. In Year 2, PRS sells Blackacre for $100 which generated $100 of ATI. The sale of Blackacre was PRS's only item of income in Year 2. In accordance with section 704(c), PRS allocates all $100 of gain resulting from the sale of Blackacre to A. Additionally, PRS has $15 of business interest expense, all of which it allocates to X. A has $50 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level*. In Year 2, PRS's section 163(j) limit is 30 percent of its ATI, or $30 ($100 x 30 percent). Thus, PRS has $15 of deductible business interest expense and $50 of excess taxable income. Such $15 of deductible business interest expense is includable in PRS's non-separately stated income or loss, and is not subject to further limitation under section 163(j) at X's level.

(iii) *Partner-level allocations*. Pursuant to § 1.163(j)–6(f)(2), X is allocated $15 of deductible business interest expense and X's outside basis in PRS is reduced by $15. A is allocated $50 of excess taxable income and, as a result, A increases its ATI by $50. Because A is allocated $50 of excess taxable income, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, A treats $5 of excess business interest expense (the carryforward from Year 1) as paid or accrued in Year 2. PRS's $100 of gain allocated to A in Year 2 is fully reduced by A's $100 section 743(b) adjustment. Therefore, at the end of Year 2, there is no change to A's outside basis in PRS.

(iv) *Partner-level*. A, in computing its limit under section 163(j), has $0 of ATI ($50 from its sole proprietorship, plus $50 excess taxable income, less $100 ATI reduction as a result of A's section 743(b) adjustment under § 1.163(j)–6(e)(2)) and $25 of business interest expense ($20 from its sole proprietorship, plus $5 excess business interest expense treated as paid or accrued in Year 2). A's section 163(j) limit is $0 ($0 x 30 percent). Thus, all $25 of A's business interest expense is not allowed as a deduction and is treated as business interest expense paid or accrued by A in Year 3.

(9) *Example 9*–(i) *Facts*. X and Y are equal partners in partnership PRS. At the beginning of Year 1, X and Y each have an outside basis in PRS of $5. In Year 1, PRS has $0 of ATI, $20 of business interest income, and $40 of business interest expense. PRS allocates its $20 of business interest income $10 to X and $10 to Y. PRS allocates $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level*. In Year 1, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $20 (($0 x 30 percent) + $20). Thus, PRS has $0 of excess business interest income, $0 of excess taxable income, $20 of deductible business interest expense, and $20 of excess business interest expense. Such $20 of deductible business interest expense is includable in non-separately stated income or loss of PRS, and not subject to further limitation under section 163(j) by the partners.

(iii) *Partner-level allocations*. Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $10 of deductible business interest expense and $10 of excess business interest expense. After adjusting each partners respective basis for business interest income under section 705(a)(1)(A), pursuant to § 1.163(j)–6(h)(1), X and Y each take their $10 of deductible business interest expense into account when reducing their outside basis in PRS before taking the $10 of excess business interest expense into account. Following each partner's reduction in outside basis due to the $10 of deductible business interest expense, each partner has $5 of outside basis remaining in PRS. Pursuant to § 1.163(j)–6(h)(2), each partner has $5 of excess business interest expense and $5 of negative section 163(j) expense. In sum, at the end of Year 1, X and Y each have $5 of excess business interest expense from PRS which reduces each partner's outside basis to $0 (and is not treated as paid or accrued by the partners until such partner is allocated excess taxable income or excess business interest income from PRS in a succeeding taxable year), and $5 of negative section 163(j) expense (which is suspended under section 704(d) and not treated as excess business interest expense of the partners until such time as the negative section 163(j) expense is no longer subject to a limitation under section 704(d)).

(iv) *Partner-level computations*. X, in computing its limit under section 163(j), has $100 of ATI (from its sole proprietorship) and $20 of business interest expense (from its sole proprietorship). X's section 163(j) limit is $30 ($100 x 30 percent). Thus, $20 of X's business interest expense is deductible business interest expense. Y, in computing its limit under section 163(j), has $20 of business interest expense (from its sole proprietorship). Y's section 163(j) limit is $0 ($0 x 30 percent). Thus, $20 of Y's business interest expense is not allowed as a deduction in Year 1, and is treated as business interest expense paid or accrued by Y in Year 2.

(10) *Example 10*–(i) *Facts*. The facts are the same as in *Example 9* in paragraph (o)(9)(i) of this section. In Year 2, PRS has $20 of gross income that is taken into account in determining PRS's ATI (i.e., properly allocable to a trade or business), $30 of gross deductions from an investment activity, and $0 of business interest expense. PRS allocates the items comprising its $20 of ATI $10 to X and $10 to Y. PRS allocates the items comprising its $30 of gross deductions $15 to X and $15 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level*. In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $6 ($20 x 30 percent). Because PRS has no business interest expense, all $20 of its ATI is excess taxable income.

(iii) *Partner-level allocations*. Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $10 of excess taxable income. Because X and Y are each allocated $10 of excess taxable income from PRS, X and Y each increase their ATI by $10. Pursuant to § 1.704–(1)(d)(2), each partner's limitation on losses under section 704(d) must be allocated to its distributive share of each such loss. Thus, each partner reduces its adjusted basis of $10 (attributable to the allocation of items comprising PRS's ATI in Year 2) by $7.50 of gross deductions from Year 2 ($10 x ($15 of total gross deductions from Year 2 / $20 of total losses disallowed)), and $2.50 of excess business interest expense that was carried over as negative section 163(j) expense from Year 1 ($10 x ($5 of negative section 163(j) expense treated as excess business interest expense solely for the purposes of section 704(d) / $20 of total losses disallowed)). Following the application of section 704(d), each partner has $7.50 of excess business interest expense from PRS ($5 excess business interest expense from Year 1, plus $2.50 of excess business interest expense that was formerly negative section 163(j) expense carried over from Year 1). Excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to the partner. As a result, X and Y each treat $7.50 of excess business interest expense as paid or accrued in Year 2.

(iv) *Partner-level computations*. X, in computing its limit under section 163(j), has $110 of ATI ($100 from its sole proprietorship, plus $10 excess taxable income) and $27.50 of business interest expense ($20 from its sole proprietorship, plus $7.50 excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $33 ($110 x 30 percent). Thus, $27.50 of X's business interest expense is deductible business interest expense. At the end of Year 2, X has $0 of excess business interest expense from PRS ($5 from Year 1, plus $2.50 treated as excess business interest expense in Year 2, less $7.50 treated as paid or accrued in Year 2), and $2.50 of negative section 163(j) expense from PRS. Y, in computing its limit under section 163(j), has $10 of ATI ($0 from its sole proprietorship, plus $10 excess taxable income) and $47.50 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $7.50 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $3 ($10 x 30 percent). Thus, $3 of Y's business interest expense is deductible business interest expense. The $44.50 of Y's business interest expense not allowed as a deduction ($47.50 business interest expense, less $3 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $0 of excess business interest expense from PRS ($5 from Year 1, plus $2.50 treated as excess business interest expense in Year 2, less $7.50 treated as paid or accrued in Year 2), and $2.50 of negative section 163(j) expense from PRS.

(11) *Example 11: Facts*. A (an individual) and B (a corporation) own all of the interests in partnership PRS. In Year 1, PRS has $100 of ATI, $10 of investment interest income, $20 of business interest income (BII), $60 of business interest expense (BIE), and $10 of floor plan financing interest expense. PRS's ATI consists of $100 of gross income and $0 of gross deductions. PRS allocates its items comprising ATI $100 to A and $0 to B. PRS allocates its business interest income $10 to A and $10 to B. PRS allocates its business interest expense $30 to A and $30 to B. PRS allocates all $10 of its investment interest income and all $10 of its floor plan financing interest expense to B. A has ATI from a sole proprietorship, unrelated to PRS, in the amount of $300.

(i) First, PRS determines its limitation pursuant to § 1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $50 (($100 x 30 percent) + $20). Thus, PRS has $0 of excess business interest income (EBII), $0 of excess taxable income, $50 of deductible business interest expense, and $10 of excess business interest expense. PRS takes its $10 of floor plan financing into account in determining its nonseparately stated taxable income or loss.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation. B's $10 of investment interest income is not included in B's allocable business interest income amount because the $10 of investment interest income was not taken into account in PRS's section 163(j) calculation. B's $10 of floor plan financing interest expense is not included in B's allocable business interest expense. The $300 of ATI from A's sole proprietorship is not included in A's allocable ATI amount because the $300 was not taken into account in PRS's section 163(j) calculation.

Table 1 to paragraph (o)(11)(ii)

	A	B	Total
Allocable ATI	$100	$0	$100
Allocable BII	$10	$10	$20
Allocable BIE	$30	$30	$60

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. Because each partner's allocable business interest expense exceeds its allocable business interest income by $20 ($30 – $10), each partner has an allocable business interest income deficit of $20. Thus, the total allocable business interest income deficit is $40 ($20 + $20). No partner has allocable business interest income excess because no partner has allocable business interest income in excess of its allocable business interest expense. Thus, the total allocable business interest income excess is $0.

Table 1 to paragraph (o)(11)(iii)

	A	B	Total
Allocable BII	$10	$10	N/A
Allocable BIE	$30	$30	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	$0	$0	$0
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	$20	$20	$40

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because no partner had any allocable business interest income excess, each partner has final allocable business interest income excess of $0.

(v) Fifth, PRS determines each partner's remaining business interest expense. PRS determines A's remaining business interest expense by reducing, but not below $0, A's allocable business interest income deficit ($20) by the product of the total allocable business interest income excess ($0) and the ratio of A's allocable business interest income deficit to the total business interest income deficit ($20/$40). Therefore, A's allocable business interest income deficit of $20 is reduced by $0 ($0 x 50 percent). As a result, A's remaining business interest expense is $20. PRS determines B's remaining business interest expense by reducing, but not below $0, B's allocable business interest income deficit ($20) by the product of the total allocable business interest income excess ($0) and the ratio of B's allocable business interest income deficit to the total business interest income deficit ($20/$40). Therefore, B's allocable business interest income deficit of $20 is reduced by $0 ($0 x 50 percent). As a result, B's remaining business interest expense is $20.

Table 1 to paragraph (o)(11)(v)

	A	B	Total
Allocable BII deficit	$20	$20	$40
Less: (Total allocable BII excess) x (Allocable BII deficit / Total allocable BII deficit)	$0	$0	N/A
= Remaining BIE	$20	$20	$40

(vi) Sixth, PRS determines each partner's final allocable ATI. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, B has a positive allocable ATI of $0. Because A's allocable ATI is comprised of $100 of income and gain and $0 of deduction and loss, A has positive allocable ATI of $100. Thus, the total positive allocable ATI is $100 ($100 + $0). PRS determines A's final allocable ATI by reducing, but not below $0, A's positive allocable ATI ($100) by the product of total negative allocable ATI ($0) and the ratio of A's positive allocable ATI to the total positive allocable ATI ($100/$100). Therefore, A's positive allocable ATI is reduced by $0 ($0 x 100 percent). As a result, A's final allocable ATI is $100. Because B has a positive allocable ATI of $0, B's final allocable ATI is $0.

Table 1 to paragraph (o)(11)(vi)

	A	B	Total
Allocable ATI	$100	$0	$100
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	$0	$0	$0
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	$100	$0	$100

Table 2 to paragraph (o)(11)(vi)

	A	B	Total
Positive allocable ATI	$100	$0	$100
Less: (Total negative allocable ATI) x (Positive allocable ATI / Total positive allocable ATI)	$0	$0	N/A
= Final allocable ATI	$100	$0	$100

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $30 ($100 x 30 percent) and B's ATIC amount is $0 ($0 x 30 percent). Because A's ATIC amount exceeds its remaining business interest expense by $10 ($30 - $20), A has an ATIC excess of $10. B does not have any ATIC excess. Thus, the total ATIC excess is $10 ($10 + $0). A does not have any ATIC deficit. Because B's remaining business interest expense exceeds its ATIC amount by $20 ($20 - $0), B has an ATIC deficit of $20. Thus, the total ATIC deficit is $20 ($0 + $20).

Table 1 to paragraph (o)(11)(vii)

	A	B	Total
ATIC (Final allocable ATI x 30 percent)	$30	$0	N/A
Remaining BIE	$20	$20	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	$10	$0	$10
If remaining BIE exceeds ATIC, then such excess = ATIC deficit	$0	$20	$20

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has:

(*1*) An excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATIC excess amount greater than $0 under paragraph (f)(2)(vii) of this section.

(B) Because PRS does not meet all three requirements in paragraph (o)(11)(viii)(A) of this section, PRS does not perform the calculations or adjustments described in paragraph (f)(2)(viii) of this section. In sum, the correct amounts to be used in paragraphs (o)(11)(ix) and (x) of this section are as follows.

Table 1 to paragraph (o)(11)(viii)(B)

	A	B	Total
ATIC excess	$10	$0	$10
ATIC deficit	$0	$20	$20

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Because A has an ATIC excess, PRS must determine A's final ATIC excess amount. A's final ATIC excess amount is A's ATIC excess ($10), reduced, but not below $0, by the product of the total ATIC deficit ($20) and the ratio of A's ATIC excess to the total ATIC excess ($10/$10). Therefore, A has $0 of final ATIC excess ($10 – ($20 x 100 percent)).

Table 1 to paragraph (o)(11)(ix)

	A	B	Total
ATIC excess	$10	$0	N/A

Table 1 to paragraph (o)(11)(ix)	A	B	Total
Less: (Total ATIC deficit) x (ATIC excess / Total ATIC excess)	$20	$0	N/A
= Final ATIC excess	$0	$0	$0

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because B has an ATIC deficit, PRS must determine B's final ATIC deficit amount. B's final ATIC deficit amount is B's ATIC deficit ($20), reduced, but not below $0, by the product of the total ATIC excess ($10) and the ratio of B's ATIC deficit to the total ATIC deficit ($20/ $20). Therefore, B has $10 of final ATIC deficit ($20 – ($10 x 100 percent)).

Table 1 to paragraph (o)(11)(x)	A	B	Total
ATIC deficit	$0	$20	N/A
Less: (Total ATIC excess) x (ATIC deficit / Total ATIC deficit)	$0	$10	N/A
= Final ATIC deficit	$0	$10	$10

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $10 of excess business interest expense. PRS allocates the excess business interest expense dollar for dollar to the partners with final ATIC deficits amounts. Thus, PRS allocates all $10 of its excess business interest expense to B. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. Therefore, A has deductible business interest expense of $30 ($30 - $0) and B has deductible business interest expense of $20 ($30 - $10).

Table 1 to paragraph (o)(11)(xi)	A	B	Total
Deductible BIE	$30	$20	$50
EBIE allocated	$0	$10	$10
ETI allocated	$0	$0	$0
EBII allocated	$0	$0	$0

(12) *Example 12: Facts*. A, B, and C own all of the interests in partnership PRS. In Year 1, PRS has $150 of ATI, $10 of business interest income, and $40 of business interest expense. PRS's ATI consists of $200 of gross income and $50 of gross deductions. PRS allocates its items comprising ATI ($50) to A, $200 to B, and $0 to C. PRS allocates its business interest income $0 to A, $0 to B, and $10 to C. PRS allocates its business interest expense $30 to A, $10 to B, and $0 to C.

(i) First, PRS determines its limitation pursuant to § 1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $55 (($150 x 30 percent) + $10). Thus, PRS has $0 of excess business interest income, $50 of excess taxable income, $40 of deductible business interest expense, and $0 of excess business interest expense.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation.

Table 1 to paragraph (o)(12)(ii)	A	B	C	Total
Allocable ATI	($50)	$200	$0	$150
Allocable BII	$0	$0	$10	$10
Allocable BIE	$30	$10	$0	$40

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. Because A's allocable business interest expense exceeds its allocable business interest income by $30 ($30 – $0), A has an allocable business interest income deficit of $30. Because B's allocable business interest expense exceeds its allocable business interest income by $10 ($10 - $0), B has an allocable business interest income deficit of $10. C does not have any allocable business interest income deficit. Thus, the total allocable business interest income deficit is $40 ($30 + $10 + $0). A and B do not have any allocable business interest income excess. Because C's allocable business interest income exceeds its allocable business interest expense by $10 ($10 - $0), C has an allocable business interest income excess of $10. Thus, the total allocable business interest income excess is $10 ($0 + $0 + $10).

Table 1 to paragraph (o)(12)(iii)

	A	B	C	Total
Allocable BII	$0	$0	$10	N/A
Allocable BIE	$30	$10	$0	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	$0	$0	$10	$10
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	$30	$10	$0	$40

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because A and B do not have any allocable business interest income excess, each partner has final allocable business interest income excess of $0. PRS determines C's final allocable business interest income excess by reducing, but not below $0, C's allocable business interest income excess ($10) by the product of the total allocable business interest income deficit ($40) and the ratio of C's allocable business interest income excess to the total allocable business interest income excess ($10/$10). Therefore, C's allocable business interest income excess of $10 is reduced by $10 ($40 x 100 percent). As a result, C's allocable business interest income excess is $0.

Table 1 to paragraph (o)(12)(iv)

	A	B	C	Total
Allocable BII excess	$0	$0	$10	N/A
Less: (Total allocable BII deficit) x (Allocable BII excess / Total allocable BII excess)	$0	$0	$40	N/A
= Final Allocable BII Excess	$0	$0	$0	$10

(v) Fifth, PRS determines each partner's remaining business interest expense. PRS determines A's remaining business interest expense by reducing, but not below $0, A's allocable business interest income deficit ($30) by the product of the total allocable business interest income excess ($10) and the ratio of A's allocable business interest income deficit to the total business interest income deficit ($30/$40). Therefore, A's allocable business interest income deficit of $30 is reduced by $7.50 ($10 x 75 percent). As a result, A's remaining business interest expense is $22.50. PRS determines B's remaining business interest expense by reducing, but not below $0, B's allocable business interest income deficit ($10) by the product of the total allocable business interest income excess ($10) and the ratio of B's allocable business interest income deficit to the total business interest income deficit ($10/$40). Therefore, B's allocable business interest income deficit of $10 is reduced by $2.50 ($10 x 25 percent). As a result, B's remaining business interest expense is $7.50. Because C does not have any allocable business interest income deficit, C's remaining business interest expense is $0.

Table 1 to paragraph (o)(12)(v)

	A	B	C	Total
Allocable BII deficit	$30	$10	$0	$40
Less: (Total allocable BII excess) x (Allocable BII deficit / Total allocable BII deficit)	$7.50	$2.50	$0	N/A
= Remaining BIE	$22.50	$7.50	$0	N/A

(vi) Sixth, PRS determines each partner's final allocable ATI. Because A's allocable ATI is comprised of $50 of items of deduction and loss and $0 of income and gain, A has negative allocable ATI of $50. A is the only partner with negative allocable ATI. Thus, the total negative allocable ATI amount is $50. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, A and C have a positive allocable ATI of $0. Because B's allocable ATI is comprised of $200 of items of income and gain and $0 of deduction and loss, B has positive allocable ATI of $200. Thus, the total positive allocable ATI is $200 ($0 + $200 + $0). PRS determines B's final allocable ATI by reducing, but not below $0, B's positive allocable ATI ($200) by the product of total negative allocable ATI ($50) and the ratio of B's positive allocable ATI to the total positive allocable ATI ($200/$200). Therefore, B's positive allocable ATI is reduced by $50 ($50 x 100 percent). As a result, B's final allocable ATI is $150.

Table 1 to paragraph (o)(12)(vi)

	A	B	C	Total
Allocable ATI	($50)	$200	$0	$150
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	$50	$0	$0	$50

Table 1 to paragraph (o)(12)(vi)	A	B	C	Total
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	$0	$200	$0	$200

Table 2 to paragraph (o)(12)(vi)	A	B	C	Total
Positive allocable ATI	$0	$200	$0	$200
Less: (Total negative allocable ATI) x (Positive allocable ATI / Total positive allocable ATI)	$0	$50	$0	N/A
= Final allocable ATI	$0	$150	$0	$150

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $0 ($0 x 30 percent), B's ATIC amount is $45 ($150 x 30 percent), and C's ATIC amount is $0 ($0 x 30 percent). A does not have any ATIC excess. Because B's ATIC amount exceeds its remaining business interest expense by $37.50 ($45 - $7.50), B has an ATIC excess amount of $37.50. C does not have any ATIC excess. Thus, the total ATIC excess amount is $37.50 ($0 + $37.50 + $0). Because A's remaining business interest expense exceeds its ATIC amount by $22.50 ($22.50 - $0), A has an ATIC deficit of $22.50. B and C do not have any ATIC deficit. Thus, the total ATIC deficit is $22.50 ($22.50 + $0 + $0).

Table 1 to paragraph (o)(12)(vii)	A	B	C	Total
ATIC (Final allocable ATI x 30 percent)	$0	$45	$0	N/A
Remaining BIE	$22.50	$7.50	$0	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	$0	$37.50	$0	$37.50
If remaining BIE exceeds ATIC, then such excess = ATIC deficit	$22.50	$0	$0	$22.50

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has:

(*1*) An excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATIC excess amount greater than $0 under paragraph (f)(2)(vii) of this section.

(B) Because PRS does not meet all three requirements in paragraph (o)(12)(viii)(A) of this section, PRS does not perform the calculations or adjustments described in paragraph (f)(2)(viii) of this section. In sum, the correct amounts to be used in paragraphs (o)(12)(ix) and (x) of this section are as follows.

Table 1 to paragraph (o)(12)(viii)(B)	A	B	C	Total
ATIC excess	$0	$37.50	$0	$37.50
ATIC deficit	$22.50	$0	$0	$22.50

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Because B has ATIC excess, PRS must determine B's final ATIC excess amount. B's final ATIC excess amount is B's ATIC excess ($37.50), reduced, but not below $0, by the product of the total ATIC deficit ($22.50) and the ratio of B's ATIC excess to the total ATIC excess ($37.50/ $37.50). Therefore, B has $15 of final ATIC excess ($37.50 – ($22.50 x 100 percent)).

Table 1 to paragraph (o)(12)(ix)	A	B	C	Total
ATIC excess	$0	$37.50	$0	N/A
Less: (Total ATIC deficit) x (ATIC excess / Total ATIC excess)	$0	$22.50	$0	N/A
= Final ATIC excess	$0	$15	$0	$15

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because A has an ATIC deficit, PRS must determine A's final ATIC deficit amount. A's final ATIC deficit amount is A's ATIC deficit ($22.50), reduced, but not below $0, by the product of the total ATIC excess ($37.50) and the ratio of A's ATIC deficit to the total ATIC deficit ($22.50/$22.50). Therefore, A has $0 of final ATIC deficit ($22.50 – ($37.50 x 100 percent)).

Table 1 to paragraph (o)(12)(x)

	A	B	C	Total
ATIC deficit	$22.50	$0	$0	N/A
Less: (Total ATIC excess) x (ATIC deficit / Total ATIC deficit)	$37.50	$0	$0	N/A
= Final ATIC deficit	$0	$0	$0	$0

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $50 of excess taxable income and $40 of deductible business interest expense. After grossing up each partner's final ATIC excess amounts by ten-thirds, excess taxable income is allocated dollar for dollar to partners with final ATIC excess amounts. Thus, PRS allocates its excess taxable income (ETI) $50 to B. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense (EBIE). Therefore, A has deductible business interest expense of $30 ($30 - $0), B has deductible business interest expense of $10 ($10 - $0), and C has deductible business interest expense of $0 ($0 - $0).

Table 1 to paragraph (o)(12)(xi)

	A	B	C	Total
Deductible BIE	$30	$10	$0	$40
EBIE allocated	$0	$0	$0	$0
ETI allocated	$0	$50	$0	$50
EBII allocated	$0	$0	$0	$0

(13) *Example 13: Facts*. A, B, and C own all of the interests in partnership PRS. In Year 1, PRS has $100 of ATI, $0 of business interest income, and $50 of business interest expense. PRS's ATI consists of $200 of gross income and $100 of gross deductions. PRS allocates its items comprising ATI $100 to A, $100 to B, and ($100) to C. PRS allocates its business interest expense $0 to A, $25 to B, and $25 to C.

(i) First, PRS determines its limitation pursuant to § 1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $30 ($100 x 30 percent). Thus, PRS has $30 of deductible business interest expense and $20 of excess business interest expense.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation.

Table 1 to paragraph (o)(13)(ii)

	A	B	C	Total
Allocable ATI	$100	$100	($100)	$100
Allocable BII	$0	$0	$0	$0
Allocable BIE	$0	$25	$25	$50

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. No partner has allocable business interest income. Consequently, each partner's allocable business interest income deficit is equal to such partner's allocable business interest expense. Thus, A's allocable business interest income deficit is $0, B's allocable business interest income deficit is $25, and C's allocable business interest income deficit is $25. The total allocable business interest income deficit is $50 ($0 + $25 + $25). No partner has allocable business interest income excess because no partner has allocable business interest income in excess of its allocable business interest expense. Thus, the total allocable business interest income excess is $0.

Table 1 to paragraph (o)(13)(iii)

	A	B	C	Total
Allocable BII	$0	$0	$0	N/A
Allocable BIE	$0	$25	$25	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	$0	$0	$0	$0
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	$0	$25	$25	$50

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because no partner had any allocable business interest income excess, each partner has final allocable business interest income excess of $0.

(v) Fifth, PRS determines each partner's remaining business interest expense. Because no partner has any allocable business interest income excess, each partner's remaining business interest expense equals its allocable business interest income deficit. Thus, A's remaining business interest expense is $0, B's remaining business interest expense is $25, and C's remaining business interest expense is $25.

Table 1 to paragraph (o)(13)(v)	A	B	C	Total
Allocable BII deficit	$0	$25	$25	$50
Less: (Total allocable BII excess) x (Allocable BII deficit / Total allocable BII deficit)	$0	$0	$0	N/A
= Remaining BIE	$0	$25	$25	N/A

(vi) Sixth, PRS determines each partner's final allocable ATI. Because C's allocable ATI is comprised of $100 of items of deduction and loss and $0 of income and gain, C has negative allocable ATI of $100. C is the only partner with negative allocable ATI. Thus, the total negative allocable ATI amount is $100. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, C has a positive allocable ATI of $0. Because A's allocable ATI is comprised of $100 of items of income and gain and $0 of deduction and loss, A has positive allocable ATI of $100. Because B's allocable ATI is comprised of $100 of items of income and gain and $0 of deduction and loss, B has positive allocable ATI of $100. Thus, the total positive allocable ATI is $200 ($100 + $100 + $0). PRS determines A's final allocable ATI by reducing, but not below $0, A's positive allocable ATI ($100) by the product of total negative allocable ATI ($100) and the ratio of A's positive allocable ATI to the total positive allocable ATI ($100/$200). Therefore, A's positive allocable ATI is reduced by $50 ($100 x 50 percent). As a result, A's final allocable ATI is $50. PRS determines B's final allocable ATI by reducing, but not below $0, B's positive allocable ATI ($100) by the product of total negative allocable ATI ($100) and the ratio of B's positive allocable ATI to the total positive allocable ATI ($100/$200). Therefore, B's positive allocable ATI is reduced by $50 ($100 x 50 percent). As a result, B's final allocable ATI is $50. Because C has a positive allocable ATI of $0, C's final allocable ATI is $0.

Table 1 to paragraph (o)(13)(vi)	A	B	C	Total
Allocable ATI	$100	$100	($100)	$100
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	$0	$0	$100	$100
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	$100	$100	$0	$200

Table 2 to paragraph (o)(13)(vi)	A	B	C	Total
Positive allocable ATI	$100	$100	$0	$200
Less: (Total negative allocable ATI) x (Positive allocable ATI / Total positive allocable ATI)	$50	$50	$0	N/A
= Final allocable ATI	$50	$50	$0	$100

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $15 ($50 x 30 percent), B's ATIC amount is $15 ($50 x 30 percent), and C's ATIC amount is $0 ($0 x 30 percent). Because A's ATIC amount exceeds its remaining business interest expense by $15 ($15 - $0), A has an ATIC excess of $15. B and C do not have any ATIC excess. Thus, the total ATIC excess is $15 ($15 + $0 + $0). A does not have any ATIC deficit. Because B's remaining business interest expense exceeds its ATIC amount by $10 ($25 - $15), B has an ATIC deficit of $10. Because C's remaining business interest expense exceeds its ATIC amount by $25 ($25 - $0), C has an ATIC deficit of $25. Thus, the total ATIC deficit is $35 ($0 + $10 + $25).

Table 1 to paragraph (o)(13)(vii)	A	B	C	Total
ATIC (Final allocable ATI x 30 percent)	$15	$15	$0	N/A
Remaining BIE	$0	$25	$25	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	$15	$0	$0	$15
If remaining BIE exceeds ATIC, then such excess = ATIC deficit	$0	$10	$25	$35

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has:

(*1*) An excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATIC excess greater than $0 under paragraph (f)(2)(vii) of this section. Because PRS satisfies each of these three requirements, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii)(B) and (C) or (D) of this section.

(B) PRS must determine each partner's priority amount and usable priority amount. Only partners with an ATIC deficit under paragraph (f)(2)(vii) of this section can have a priority amount greater than $0. Thus, only partners B and C can have a priority amount greater than $0. PRS determines a partner's priority amount as thirty percent of the amount by which such partner's allocable positive ATI exceeds its final allocable ATI. Therefore, A's priority amount is $0, B's priority amount is $15 (($100 - $50) x 30 percent), and C's priority amount is $0 (($0 - $0) x 30 percent). Thus, the total priority amount is $15 ($0 + $15 + $0). Next, PRS must determine each partner's usable priority amount. Each partner's usable priority amount is the lesser of such partner's priority amount or ATIC deficit. Thus, A has a usable priority amount of $0, B has a usable priority amount of $10, and C has a usable priority amount of $0. As a result, the total usable priority amount is $10 ($0 + $10 + $0). Because the total ATIC excess under paragraph (f)(2)(vii) of this section ($15) is greater than the total usable priority amount ($10), PRS must perform the adjustments described in paragraph (f)(2)(viii)(C) of this section.

Table 1 to paragraph (o)(13)(viii)(B)

	A	B	C	Total
(Positive allocable ATI - Final allocable ATI)	$0	$50	$0	N/A
Multiplied by 30 percent	30 percent	30 percent	30 percent	N/A
= Priority amount	$0	$15	$0	$15

Table 2 to paragraph (o)(13)(viii)(B)

	A	B	C	Total
Priority amount	$0	$15	$0	N/A
ATIC deficit	$0	$10	$25	N/A
Lesser of priority amount or ATIC deficit = Usable priority amount	$0	$10	$0	$10

(C) For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATIC excess is $0. For purposes of paragraph (f)(2)(x) of this section, the following terms shall have the following meanings. Each partner's ATIC deficit is such partner's ATIC deficit as determined pursuant to paragraph (f)(2)(vii) of this section reduced by such partner's usable priority amount. Thus, A's ATIC deficit is $0 ($0 - $0), B's ATIC deficit is $0 ($10 - $10), and C's ATIC deficit is $25 ($25 - $0). The total ATIC deficit is the total ATIC deficit determined pursuant to paragraph (f)(2)(vii) ($35) reduced by the total usable priority amount ($10). Thus, the total ATIC deficit is $25 ($35 - $10). The total ATIC excess is the total ATIC excess determined pursuant to paragraph (f)(2)(vii) of this section ($15) reduced by the total usable priority amount ($10). Thus, the total ATIC excess is $5 ($15 - $5).

Table 1 to paragraph (o)(13)(viii)(C)

	A	B	C	Total
ATIC deficit	$0	$10	$25	N/A
Less: Usable priority amount	$0	$10	$0	N/A
= ATIC deficit for purposes of paragraph (f)(2)(x) of this section	$0	$0	$25	$25

(D) In light of the fact that the total ATIC excess was greater than the total usable priority amount under paragraph (f)(2)(viii)(B) of this section, paragraph (f)(2)(viii)(D) of this section does not apply. In sum, the correct amounts to be used in paragraph (f)(2)(x) of this section are as follows.

Table 1 to paragraph (o)(13)(viii)(C)

	A	B	C	Total
ATIC excess	$5	$0	$0	$5
ATIC deficit	$0	$0	$25	$25

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Pursuant to paragraph (f)(2)(viii)(C) of this section, each partner's final ATIC excess amount is $0.

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because C has an ATIC deficit, PRS must determine C's final ATIC deficit amount. C's final ATIC deficit amount is C's ATIC deficit ($25), reduced, but not below $0, by the product of the total ATIC excess ($5) and the ratio of C's ATIC deficit to the total ATIC deficit ($25/$25). Therefore, C has $20 of final ATIC deficit ($25 – ($5 x 100 percent)).

Table 1 to paragraph (o)(13)(x)

	A	B	C	Total
ATIC deficit	$0	$0	$25	N/A

Table 1 to paragraph (o)(13)(x)	A	B	C	Total
Less: (Total ATIC excess) x (ATIC deficit / Total ATIC deficit)	$0	$0	$5	N/A
= Final ATIC deficit	$0	$0	$20	$20

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $20 of excess business interest expense. PRS allocates the excess business interest expense dollar for dollar to the partners with final ATIC deficits. Thus, PRS allocates its excess business interest expense $20 to C. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. Therefore, A has deductible business interest expense of $0 ($0 - $0), B has deductible business interest expense of $25 ($25 - $0), and C has deductible business interest expense of $5 ($25 - $20).

Table 1 to paragraph (o)(13)(xi)	A	B	C	Total
Deductible BIE	$0	$25	$5	$30
EBIE allocated	$0	$0	$20	$20
ETI allocated	$0	$0	$0	$0
EBII allocated	$0	$0	$0	$0

(14) *Example 14: Facts*. A, B, C, and D own all of the interests in partnership PRS. In Year 1, PRS has $200 of ATI, $0 of business interest income, and $140 of business interest expense. PRS's ATI consists of $600 of gross income and $400 of gross deductions. PRS allocates its items comprising ATI $100 to A, $100 to B, $400 to C, and ($400) to D. PRS allocates its business interest expense $0 to A, $40 to B, $60 to C, and $40 to D.

(i) First, PRS determines its limitation pursuant to § 1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $60 ($200 x 30 percent). Thus, PRS has $60 of deductible business interest expense and $80 of excess business interest expense.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation.

Table 1 to paragraph (o)(14)(ii)	A	B	C	D	Total
Allocable ATI	$100	$100	$400	($400)	$200
Allocable BII	$0	$0	$0	$0	$0
Allocable BIE	$0	$40	$60	$40	$140

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. No partner has allocable business interest income. Consequently, each partner's allocable business interest income deficit is equal to such partner's allocable business interest expense. Thus, A's allocable business interest income deficit is $0, B's allocable business interest income deficit is $40, C's allocable business interest income deficit is $60, and D's allocable business interest income deficit is $40. The total allocable business interest income deficit is $140 ($0 + $40 + $60 + $40). No partner has allocable business interest income excess because no partner has allocable business interest income in excess of its allocable business interest expense. Thus, the total allocable business interest income excess is $0.

Table 1 to paragraph (o)(14)(iii)	A	B	C	D	Total
Allocable BII	$0	$0	$0	$0	N/A
Allocable BIE	$0	$40	$60	$40	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	$0	$0	$0	$0	$0
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	$0	$40	$60	$40	$140

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because no partner has any allocable business interest income excess, each partner has final allocable business interest income excess of $0.

(v) Fifth, PRS determines each partner's remaining business interest expense. Because no partner has any allocable business interest income excess, each partner's remaining business interest expense equals its allocable business interest income deficit. Thus, A's remaining business interest expense is $0, B's remaining business interest expense is $40, C's remaining business interest expense is $60, and D's remaining business interest expense is $40.

Table 1 to paragraph (o)(14)(v)

	A	B	C	D	Total
Allocable BII deficit	$0	$40	$60	$40	$140
Less: (Total allocable BII excess) x (Allocable BII deficit / Total allocable BII deficit)	$0	$0	$0	$0	N/A
= Remaining BIE	$0	$40	$60	$40	N/A

(vi) Sixth, PRS determines each partner's final allocable ATI. Because D's allocable ATI is comprised of $400 of items of deduction and loss and $0 of income and gain, D has negative allocable ATI of $400. D is the only partner with negative allocable ATI. Thus, the total negative allocable ATI amount is $400. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, D has a positive allocable ATI of $0. PRS determines A's final allocable ATI by reducing, but not below $0, A's positive allocable ATI ($100) by the product of total negative allocable ATI ($400) and the ratio of A's positive allocable ATI to the total positive allocable ATI ($100/$600). Therefore, A's positive allocable ATI is reduced by $66.67 ($400 x 16.67 percent). As a result, A's final allocable ATI is $33.33. PRS determines B's final allocable ATI by reducing, but not below $0, B's positive allocable ATI ($100) by the product of total negative allocable ATI ($400) and the ratio of B's positive allocable ATI to the total positive allocable ATI ($100/$600). Therefore, B's positive allocable ATI is reduced by $66.67 ($400 x 16.67 percent). As a result, B's final allocable ATI is $33.33. PRS determines C's final allocable ATI by reducing, but not below $0, C's positive allocable ATI ($400) by the product of total negative allocable ATI ($400) and the ratio of C's positive allocable ATI to the total positive allocable ATI ($400/$600). Therefore, C's positive allocable ATI is reduced by $266.67 ($400 x 66.67 percent). As a result, C's final allocable ATI is $133.33. Because D has a positive allocable ATI of $0, D's final allocable ATI is $0.

Table 1 to paragraph (o)(14)(vi)

	A	B	C	D	Total
Allocable ATI	$100	$100	$400	($400)	$200
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	$0	$0	$0	$400	$400
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	$100	$100	$400	$0	$600

Table 2 to paragraph (o)(14)(vi)

	A	B	C	D	Total
Positive allocable ATI	$100	$100	$400	$0	$600
Less: (Total negative allocable ATI) x (Positive allocable ATI / Total positive allocable ATI)	$66.67	$66.67	$266.67	$0	N/A
= Final allocable ATI	$33.33	$33.33	$133.33	$0	$200

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $10 ($33.33 x 30 percent), B's ATIC amount is $10 ($33.33 x 30 percent), C's ATIC amount is $40 ($133.33 x 30 percent), and D's ATIC amount is $0 ($0 x 30 percent). Because A's ATIC amount exceeds its remaining business interest expense by $10 ($10 - $0), A has an ATIC excess of $10. B, C, and D do not have any ATIC excess. Thus, the total ATIC excess is $10 ($10 + $0 + $0 + $0). A does not have any ATIC deficit. Because B's remaining business interest expense exceeds its ATIC amount by $30 ($40 - $10), B has an ATIC deficit of $30. Because C's remaining business interest expense exceeds its ATIC amount by $20 ($60 - $40), C has an ATIC deficit of $20. Because D's remaining business interest expense exceeds its ATIC amount by $40 ($40 - $0), D has an ATIC deficit of $40. Thus, the total ATIC deficit is $90 ($0 + $30 + $20 + $40).

Table 1 to paragraph (o)(14)(vii)

	A	B	C	D	Total
ATIC (Final allocable ATI x 30 percent)	$10	$10	$40	$0	N/A
Remaining BIE	$0	$40	$60	$40	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	$10	$0	$0	$0	$10
If remaining BIE exceeds ATIC, then such excess = ATIC deficit	$0	$30	$20	$40	$90

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has (1) an excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section, (2) a total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section, and (3) a total ATIC excess amount greater than $0 under paragraph (f)(2)(vii) of this section. Because

PRS satisfies each of these three requirements, PRS must perform the calculations and make the necessary adjustments described under paragraphs (f)(2)(viii)(B) and (C) or paragraph (f)(2)(viii)(D) of this section.

(B) PRS must determine each partner's priority amount and usable priority amount. Only partners with an ATIC deficit under paragraph (f)(2)(vii) of this section can have a priority amount greater than $0. Thus, only partners B, C, and D can have a priority amount greater than $0. PRS determines a partner's priority amount as thirty percent of the amount by which such partner's allocable positive ATI exceeds its final allocable ATI. Therefore, B's priority amount is $20 (($100 - $33.33) x 30 percent), C's priority amount is $80 (($400 - $133.33) x 30 percent), and D's priority amount is $0 (($0 - $0) x 30 percent). Thus, the total priority amount is $100 ($0 + $20 + $80 + $0). Next, PRS must determine each partner's usable priority amount. Each partner's usable priority amount is the lesser of such partner's priority amount or ATIC deficit. Thus, A has a usable priority amount of $0, B has a usable priority amount of $20, C has a usable priority amount of $20, and D has a usable priority amount of $0. As a result, the total usable priority amount is $40 ($0 + $20 + $20 + $0). Because the total usable priority amount ($40) is greater than the total ATIC excess under paragraph (f)(2)(vii) ($10), PRS must perform the adjustments described in paragraph (f)(2)(viii)(D) of this section.

Table 1 to paragraph (o)(14)(viii)(B)

	A	B	C	D	Total
(Positive allocable ATI - Final allocable ATI)	$0	$66.67	$266.67	$0	N/A
Multiplied by 30 percent	30 percent	30 percent	30 percent	30 percent	N/A
= Priority amount	$0	$20	$80	$0	$100

Table 2 to paragraph (o)(14)(viii)(B)

	A	B	C	D	Total
Priority amount	$0	$20	$80	$0	N/A
ATIC deficit	$0	$30	$20	$40	N/A
Lesser of priority amount or ATIC deficit = Usable priority amount	$0	$20	$20	$0	$40

(C) In light of the fact that the total usable priority amount is greater than the total ATIC excess under paragraph (f)(2)(viii)(B) of this section, paragraph (f)(2)(viii)(C) of this section does not apply.

(D)(*1*) Because B and C are the only partners with priority amounts greater than $0, B and C are priority partners, while A and D are non-priority partners. For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATIC excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, each non-priority partner's final ATIC deficit amount is such partner's ATIC deficit determined pursuant to paragraph (f)(2)(vii) of this section. Therefore, A has a final ATIC deficit of $0 and D has a final ATIC deficit of $40. Additionally, for purposes of paragraph (f)(2)(x) of this section, PRS must determine each priority partner's step eight excess share. A priority partner's step eight excess share is the product of the total ATIC excess and the ratio of the partner's priority amount to the total priority amount. Thus, B's step eight excess share is $2 ($10 x ($20/$100)) and C's step eight excess share is $8 ($10 x ($80/$100)). To the extent a priority partner's step eight excess share exceeds its ATIC deficit, the excess shall be the partner's ATIC excess for purposes of paragraph (f)(2)(x) of this section. Thus, B and C each have an ATIC excess of $0, resulting in a total ATIC excess is $0. To the extent a priority partner's ATIC deficit exceeds its step eight excess share, the excess shall be the partner's ATIC deficit for purposes of paragraph (f)(2)(x) of this section. Because B's ATIC deficit ($30) exceeds its step eight excess share ($2), B's ATIC deficit for purposes of paragraph (f)(2)(x) of this section is $28 ($30 - $2). Because C's ATIC deficit ($20) exceeds its step eight excess share ($8), C's ATIC deficit for purposes of paragraph (f)(2)(x) of this section is $12 ($20 - $8). Thus, the total ATIC deficit is $40 ($28 + $12).

Table 1 to paragraph (o)(14)(viii)(D)(*1*)

	A	B	C	D	Total
Non-priority partners ATIC deficit in paragraph (f)(2)(vii) = Final ATIC deficit for purposes of paragraph (f)(2)(x) of this section	$0	N/A	N/A	$40	N/A

Table 2 to paragraph (o)(14)(viii)(D)(*1*)

	A	B	C	D	Total
Priority partners step eight excess share = (Total ATIC excess) x (Priority / Total priority)	N/A	$2	$8	N/A	N/A
ATIC deficit	N/A	$30	$20	N/A	N/A
If step eight excess share exceeds ATIC deficit, then such excess = ATIC excess for purposes of paragraph (f)(2)(x) of this section	N/A	$0	$0	N/A	$0
If ATIC deficit exceeds step eight excess share, then such excess = ATIC deficit for purposes of paragraph (f)(2)(x) of this section	N/A	$28	$12	N/A	$40

(2) In sum, the correct amounts to be used in paragraph (f)(2)(x) of this section are as follows:

Table 1 to paragraph (o)(14)(viii)(D)(2)

	A	B	C	D	Total
ATIC excess	$0	$0	$0	$0	$0
ATIC deficit	$0	$28	$12	$0	$40
Non-priority partner final ATIC deficit	$0	$0	$0	$40	N/A

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Pursuant to paragraph (f)(2)(viii)(D) of this section, each priority and non-priority partner's final ATIC excess amount is $0.

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because B has an ATIC deficit, PRS must determine B's final ATIC deficit amount. B's final ATIC deficit amount is B's ATIC deficit ($28), reduced, but not below $0, by the product of the total ATIC excess ($0) and the ratio of B's ATIC deficit to the total ATIC deficit ($28/$40). Therefore, B has $28 of final ATIC deficit ($28 – ($0 x 70 percent)). Because C has an ATIC deficit, PRS must determine C's final ATIC deficit amount. C's final ATIC deficit amount is C's ATIC deficit ($12), reduced, but not below $0, by the product of the total ATIC excess ($0) and the ratio of C's ATIC deficit to the total ATIC deficit ($12/$40). Therefore, C has $12 of final ATIC deficit ($12 – ($0 x 30 percent)). Pursuant to paragraph (f)(2)(viii)(D) of this section, D's final ATIC deficit amount is $40.

Table 2 to paragraph (o)(14)(x)

	A	B	C	D	Total
ATIC deficit	N/A	$28	$12	N/A	N/A
Less: (Total ATIC excess) x (ATIC deficit / Total ATIC deficit)	N/A	$0	$0	N/A	N/A
= Final ATIC deficit	$0	$28	$12	$40	$80

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $80 of excess business interest expense. PRS allocates the excess business interest expense dollar for dollar to the partners with final ATIC deficits. Thus, PRS allocates its excess business interest expense $28 to B, $12 to C, and $40 to D. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. Therefore, A has deductible business interest expense of $0 ($0 - $0), B has deductible business interest expense of $12 ($40 - $28), C has deductible business interest expense of $48 ($60 - $12), and D has deductible business interest expense of $0 ($40 - $40).

Table 1 to paragraph (o)(14)(xi)

	A	B	C	D	Total
Deductible BIE	$0	$12	$48	$0	$60
EBIE allocated	$0	$28	$12	$40	$80
ETI allocated	$0	$0	$0	$0	$0
EBII allocated	$0	$0	$0	$0	$0

(15) *Example 15: Facts*. A, B, C, and D own all of the interests in partnership PRS. In Year 1, PRS has $200 of ATI, $0 of business interest income, and $150 of business interest expense. PRS's ATI consists of $500 of gross income and $300 of gross deductions. PRS allocates its items comprising ATI $50 to A, $50 to B, $400 to C, and ($300) to D. PRS allocates its business interest expense $0 to A, $50 to B, $50 to C, and $50 to D.

(i) First, PRS determines its limitation pursuant to § 1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $60 ($200 x 30 percent). Thus, PRS has $60 of deductible business interest expense, and $90 of excess business interest expense.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation.

Table 1 to paragraph (o)(15)(ii)

	A	B	C	D	Total
Allocable ATI	$50	$50	$400	($300)	$200
Allocable BII	$0	$0	$0	$0	$0
Allocable BIE	$0	$50	$50	$50	$150

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. No partner has allocable business interest income. Consequently, each partner's allocable business interest income deficit is equal to such partner's allocable business interest expense. Thus, A's allocable business interest income deficit is $0, B's allocable business interest income deficit is $50, C's allocable business interest income deficit is $50, and D's allocable business interest income deficit is $50. The total allocable business interest income deficit is $150 ($0 + $50 + $50 + $50). No partner has allocable business interest income excess because no partner has allocable business interest income in excess of its allocable business interest expense. Thus, the total allocable business interest income excess is $0.

Table 1 to paragraph (o)(15)(iii)

	A	B	C	D	Total
Allocable BII	$0	$0	$0	$0	N/A
Allocable BIE	$0	$50	$50	$50	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	$0	$0	$0	$0	$0
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	$0	$50	$50	$50	$150

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because no partner has any allocable business interest income excess, each partner has final allocable business interest income excess of $0.

(v) Fifth, PRS determines each partner's remaining business interest expense. Because no partner has any allocable business interest income excess, each partner's remaining business interest expense equals its allocable business interest income deficit. Thus, A's remaining business interest expense is $0, B's remaining business interest expense is $50, C's remaining business interest expense is $50, and D's remaining business interest expense is $50.

Table 1 to paragraph (o)(15)(v)

	A	B	C	D	Total
Allocable BII deficit	$0	$50	$50	$50	$150
Less: (Total allocable BII excess) x (Allocable BII deficit / Total allocable BII deficit)	$0	$0	$0	$0	N/A
= Remaining BIE	$0	$50	$50	$50	N/A

(vi) Sixth, PRS determines each partner's final allocable ATI. Because D's allocable ATI is comprised of $300 of items of deduction and loss and $0 of income and gain, D has negative allocable ATI of $300. D is the only partner with negative allocable ATI. Thus, the total negative allocable ATI amount is $300. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, D has a positive allocable ATI of $0. PRS determines A's final allocable ATI by reducing, but not below $0, A's positive allocable ATI ($50) by the product of total negative allocable ATI ($300) and the ratio of A's positive allocable ATI to the total positive allocable ATI ($50/$500). Therefore, A's positive allocable ATI is reduced by $30 ($300 x 10 percent). As a result, A's final allocable ATI is $20. PRS determines B's final allocable ATI by reducing, but not below $0, B's positive allocable ATI ($50) by the product of total negative allocable ATI ($300) and the ratio of B's positive allocable ATI to the total positive allocable ATI ($50/$500). Therefore, B's positive allocable ATI is reduced by $30 ($300 x 10 percent). As a result, B's final allocable ATI is $20. PRS determines C's final allocable ATI by reducing, but not below $0, C's positive allocable ATI ($400) by the product of total negative allocable ATI ($300) and the ratio of C's positive allocable ATI to the total positive allocable ATI ($400/$500). Therefore, C's positive allocable ATI is reduced by $240 ($300 x 80 percent). As a result, C's final allocable ATI is $160. Because D has a positive allocable ATI of $0, D's final allocable ATI is $0.

Table 1 to paragraph (o)(15)(vi)

	A	B	C	D	Total
Allocable ATI	$50	$50	$400	($300)	$200
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	$0	$0	$0	$300	$300
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	$50	$50	$400	$0	$500

Table 2 to paragraph (o)(15)(vi)

	A	B	C	D	Total
Positive allocable ATI	$50	$50	$400	$0	$500
Less: (Total negative allocable ATI) x (Positive allocable ATI / Total positive allocable ATI)	$30	$30	$240	$0	N/A

Table 2 to paragraph (o)(15)(vi)	A	B	C	D	Total
= Final allocable ATI	$20	$20	$160	$0	$200

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $6 ($20 x 30 percent), B's ATIC amount is $6 ($20 x 30 percent), C's ATIC amount is $48 ($160 x 30 percent), and D's ATIC amount is $0 ($0 x 30 percent). Because A's ATIC amount exceeds its remaining business interest expense by $6 ($6 - $0), A has an ATIC excess of $6. B, C, and D do not have any ATIC excess. Thus, the total ATIC excess amount is $6 ($6 + $0 + $0 + $0). A does not have any ATIC deficit. Because B's remaining business interest expense exceeds its ATIC amount by $44 ($50 - $6), B has an ATIC deficit of $44. Because C's remaining business interest expense exceeds its ATIC amount by $2 ($50 - $48), C has an ATIC deficit of $2. Because D's remaining business interest expense exceeds its ATIC amount by $50 ($50 - $0), D has an ATIC deficit of $50. Thus, the total ATIC deficit is $96 ($0 + $44 + $2 + $50).

Table 1 to paragraph (o)(15)(vii)	A	B	C	D	Total
ATIC (Final allocable ATI x 30 percent)	$6	$6	$48	$0	N/A
Remaining BIE	$0	$50	$50	$50	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	$6	$0	$0	$0	$6
If remaining BIE exceeds ATIC, then such excess = ATIC deficit	$0	$44	$2	$50	$96

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has:

(*1*) An excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATIC excess amount greater than $0 under paragraph (f)(2)(vii) of this section. Because PRS satisfies each of these three requirements, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section.

(B) PRS must determine each partner's priority amount and usable priority amount. Only partners with an ATIC deficit under paragraph (f)(2)(vii) of this section of this section can have a priority amount greater than $0. Thus, only partners B, C, and D can have a priority amount greater than $0. PRS determines a partner's priority amount as thirty percent of the amount by which such partner's allocable positive ATI exceeds its final allocable ATI. Therefore, B's priority amount is $9 (($50 - $20) x 30 percent), C's priority amount is $72 (($400 - $160) x 30 percent), and D's priority amount is $0 (($0 - $0) x 30 percent). Thus, the total priority amount is $81 ($0 + $9 + $72 + $0). Next, PRS must determine each partner's usable priority amount. Each partner's usable priority amount is the lesser of such partner's priority amount or ATIC deficit. Thus, B has a usable priority amount of $9, C has a usable priority amount of $2, and D has a usable priority amount of $0. As a result, the total usable priority amount is $11 ($0 + $9 + $2 + $0). Because the total usable priority amount ($11) is greater than the total ATIC excess ($6) under paragraph (f)(2)(vii) of this section, PRS must perform the adjustments described in paragraph (f)(2)(viii)(D) of this section.

Table 1 to paragraph (o)(15)(viii)(B)	A	B	C	D	Total
(Positive allocable ATI - Final allocable ATI)	$0	$30	$240	$0	N/A
Multiplied by 30 percent	30 percent	30 percent	30 percent	30 percent	N/A
= Priority amount	$0	$9	$72	$0	$81

Table 2 to paragraph (o)(15)(viii)(B)	A	B	C	D	Total
Priority amount	$0	$9	$72	$0	N/A
ATIC deficit	$0	$44	$2	$50	N/A
Lesser of priority amount or ATIC deficit = Usable priority amount	$0	$9	$2	$0	$11

(C) In light of the fact that the total usable priority amount is greater than the total ATIC excess under paragraph (f)(2)(viii)(B) of this section, paragraph (f)(2)(viii)(C) of this section does not apply.

(D)(*1*) Because B and C are the only partners with priority amounts greater than $0, B and C are priority partners, while A and D are non-priority partners. For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATIC excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, each non-priority partner's final ATIC deficit amount is such partner's ATIC deficit determined pursuant to paragraph (f)(2)(vii) of this section. Therefore, A has a final ATIC deficit of $0 and D has a final ATIC deficit of $50. Additionally, for purposes of paragraph (f)(2)(x) of this section, PRS must determine each priority partner's step eight excess share. A priority partner's step eight excess share is the product of the total ATIC excess and the ratio of the partner's priority amount to the total priority amount. Thus, B's step eight excess share is $0.67 ($6 x ($9/$81)) and C's step eight excess share is $5.33 ($6 x ($72/$81)). To the extent a priority partner's step eight excess share exceeds its ATIC deficit, the excess shall be the partner's ATIC excess for purposes of paragraph (f)(2)(x) of this section. B's step eight excess share does not exceed its ATIC deficit. Because C's step eight excess share ($5.33) exceeds its ATIC deficit ($2), C's ATIC excess for purposes of paragraph (f)(2)(x) of this section is $3.33 ($5.33 - $2). Thus, the total ATIC excess for purposes of paragraph (f)(2)(x) of this section is $3.33 ($0 + $3.33). To the extent a priority partner's ATIC deficit exceeds its step eight excess share, the excess shall be the partner's ATIC deficit for purposes of paragraph (f)(2)(x) of this section. Because B's ATIC deficit ($44) exceeds its step eight excess share ($0.67), B's ATIC deficit for purposes of paragraph (f)(2)(x) of this section is $43.33 ($44 - $0.67). C's ATIC deficit does not exceed its step eight excess share. Thus, the total ATIC deficit for purposes of paragraph (f)(2)(x) of this section is $43.33 ($43.33 + $0).

Table 1 to paragraph (o)(15)(viii)(D)(*1*)

	A	B	C	D	Total
Non-priority partners ATIC deficit in paragraph (f)(2)(vii) = Final ATIC deficit for purposes of paragraph (f)(2)(x) of this section	$0	N/A	N/A	$50	N/A

Table 2 to paragraph (o)(15)(viii)(D)(*1*)

	A	B	C	D	Total
Priority partners step eight excess share = (Total ATIC excess) x (Priority / Total priority)	N/A	$0.67	$5.33	N/A	N/A
ATIC deficit	N/A	$44	$2	N/A	N/A
If step eight excess share exceeds ATIC deficit, then such excess = ATIC excess for purposes of paragraph (f)(2)(x) of this section	N/A	$0	$3.33	N/A	$3.33
If ATIC deficit exceeds step eight excess share, then such excess = ATIC deficit for purposes of paragraph (f)(2)(x) of this section	N/A	$43.33	$0	N/A	$43.33

(*2*) In sum, the correct amounts to be used in paragraph (f)(2)(x) of this section are as follows.

Table 1 to paragraph (o)(15)(viii)(D)(*2*)

	A	B	C	D	Total
ATIC excess	$0	$0	$3.33	$0	$3.33
ATIC deficit	$0	$43.33	$0	$0	$43.33
Non-priority partner final ATIC deficit	$0	$0	$0	$50	N/A

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Pursuant to paragraph (f)(2)(viii)(D) of this section, each priority and non-priority partner's final ATIC excess amount is $0.

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because B has an ATIC deficit, PRS must determine B's final ATIC deficit amount. B's final ATIC deficit amount is B's ATIC deficit ($43.33), reduced, but not below $0, by the product of the total ATIC excess ($3.33) and the ratio of B's ATIC deficit to the total ATIC deficit ($43.33/$43.33). Therefore, B has $40 of final ATIC deficit ($43.33 – ($3.33 x 100 percent)). Pursuant to paragraph (f)(2)(viii)(D) of this section, D's final ATIC deficit amount is $40.

Table 1 to paragraph (o)(15)(x)

	A	B	C	D	Total
ATIC deficit	$0	$43.33	$0	N/A	N/A
Less: (Total ATIC excess) x (ATIC deficit / Total ATIC deficit)	$0	$3.33	$0	N/A	N/A
= Final ATIC deficit	$0	$40	$0	$50	$90

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $90 of excess business interest expense. PRS allocates the excess business interest expense dollar for dollar to the partners with final ATIC deficits. Thus, PRS allocates its excess business interest expense $40 to B and $50 to D. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. Therefore, A has deductible business interest expense of $0 ($0 - $0), B has deductible business interest expense of $10 ($50 - $40), C has deductible business interest expense of $50 ($50 - $0), and D has deductible business interest expense of $0 ($50 - $50).

Table 1 to paragraph (o)(15)(xi)

	A	B	C	D	Total
Deductible BIE	$0	$10	$50	$0	$60
EBIE allocated	$0	$40	$0	$50	$90
ETI allocated	$0	$0	$0	$0	$0
EBII allocated	$0	$0	$0	$0	$0

(16) *Example 16*–(i) *Facts*. A and B are equal shareholders in X, a subchapter S corporation. In Year 1, X has $100 of ATI and $40 of business interest expense. A has $100 of ATI and $20 of business interest expense from its sole proprietorship. B has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *S corporation-level*. In Year 1, X's section 163(j) limit is 30 percent of its ATI, or $30 ($100 x 30 percent). Thus, X has $30 of deductible business interest expense and $10 of disallowed business interest expense. Such $30 of deductible business interest expense is includable in X's non-separately stated income or loss, and is not subject to further limitation under section 163(j). X carries forward the $10 of disallowed business interest expense to Year 2 as a disallowed business interest expense carryforward under § 1.163(j)–2(c). X may not currently deduct all $40 of its business interest expense in Year 1. X only reduces its accumulated adjustments account in Year 1 by the $30 of deductible business interest expense in Year 1 under § 1.163(j)–6(l)(7).

(iii) *Shareholder allocations*. A and B are each allocated $35 of nonseparately stated taxable income ($50 items of income or gain, less $15 of deductible business interest expense) from X. A and B do not reduce their basis in X by the $10 of disallowed business interest expense.

(iv) *Shareholder-level computations*. A, in computing its limit under section 163(j), has $100 of ATI and $20 of business interest expense from its sole proprietorship. A's section 163(j) limit is $30 ($100 x 30 percent). Thus, A's $20 of business interest expense is deductible business interest expense. B, in computing its limit under section 163(j), has $20 of business interest expense from its sole proprietorship. B's section 163(j) limit is $0 ($0 x 30 percent). Thus, B's $20 of business interest expense is not allowed as a deduction and is treated as business interest expense paid or accrued by B in Year 2.

(17) *Example 17*–(i) *Facts*. The facts are the same as in *Example 16* in paragraph (o)(16) of this section. In Year 2, X has $233.33 of ATI, $0 of business interest income, and $30 of business interest expense. A has $100 of ATI and $20 of business interest expense from its sole proprietorship. B has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *S corporation-level*. In Year 2, X's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $70 ($233.33 x 30 percent). Because X's section 163(j) limit exceeds X's $40 of business interest expense ($30 from Year 2, plus the $10 disallowed business interest expense carryforwards from Year 1), X may deduct all $40 of business interest expense in Year 2. Such $40 of deductible business interest expense is includable in X's non-separately stated income or loss, and is not subject to further limitation under section 163(j). Pursuant to § 1.163(j)–6(l)(7), X must reduce its accumulated adjustments account by $40. Additionally, X has $100 of excess taxable income under § 1.163(j)–1(b)(15).

(iii) *Shareholder allocations*. A and B are each allocated $96.67 of nonseparately stated taxable income ($116.67 items of income or gain, less $20 of deductible business interest expense) from X. Additionally, A and B are each allocated $50 of excess taxable income under § 1.163(j)–6(l)(4). As a result, A and B each increase their ATI by $50.

(iv) *Shareholder-level computations*. A, in computing its limit under section 163(j), has $150 of ATI ($100 from its sole proprietorship, plus $50 excess taxable income) and $20 of business interest expense (from its sole proprietorship). A's section 163(j) limit is $45 ($150 x 30 percent). Thus, A's $20 of business interest expense is deductible business interest expense. B, in computing its limit under section 163(j), has $50 of ATI ($0 from its sole proprietorship, plus $50 excess taxable income) and $40 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from its sole proprietorship in Year 1). B's section 163(j) limit is $15 ($50 x 30 percent). Thus, $15 of B's business interest expense is deductible business interest expense. The $25 of B's business interest expense not allowed as a deduction ($40 business interest expense, less $15 section 163(j) limit) is treated as business interest expense paid or accrued by B in Year 3.

(p) *Applicability date*. This section applies to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–7 Application of the business interest deduction limitation to foreign corporations and United States shareholders.

(a) *Overview*. This section provides rules for the application of section 163(j) to foreign corporations with shareholders that are United States persons. Paragraph (b) of this section provides rules regarding the application of section 163(j) to certain controlled foreign corporations. Paragraph (c) of this section provides rules concerning the computation of adjusted taxable income (ATI) of certain controlled foreign corporations. Paragraph (d) of this section provides rules concerning the computation of ATI of a United States shareholder of certain controlled foreign corporations (CFC). Paragraph (e) of this section provides a rule regarding the effect of section 163(j) on the earnings and profits of foreign corporations. Paragraph (f) of this section provides definitions that apply for purposes of this section. Paragraph (g) of this section provides examples illustrating the application of this section. Paragraph (h) of this section provides dates of applicability.

(b) *Application of section 163(j) to an applicable CFC and certain partnerships*–(1) *Scope*. This paragraph (b) provides rules regarding the application of section 163(j) to an applicable CFC and certain partnerships. Paragraph (b)(2) of this section describes the general application of section 163(j) to an applicable CFC and certain partnerships in which an applicable CFC is a partner. Paragraph (b)(3) of this section provides an election to use an alternative method for computing the deduction for business interest expense of a member of a CFC group. Paragraph (b)(4) of this section treats certain partnerships as members of a CFC group for purposes of this paragraph (b). Paragraph (b)(5) of this section provides the rules regarding an election to apply paragraph (b)(3) of this section.

(2) *General application of section 163(j) to an applicable CFC and a partnership with at least one partner that is an applicable CFC*. Except as otherwise provided in this paragraph (b) or in the section 163(j) regulations, section 163(j) and the section 163(j) regulations apply to determine the deductibility of an applicable CFC's business interest expense for purposes of computing its taxable income in the same manner as those provisions apply to determine the deductibility of a domestic C corporation's business interest expense for purposes of computing its taxable income. Furthermore, if an applicable CFC is a partner in a partnership, except as otherwise provided in this paragraph (b) or in the section 163(j) regulations, section 163(j) and the section 163(j) regulations apply to the partnership in the same manner as those provisions would apply if the applicable CFC were a domestic C corporation. If an applicable CFC has income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States or if a partnership is engaged in a trade or business conducted in the United States, see also §§ 1.163(j)–8(d) and 1.882–5 for additional rules concerning the deduction for interest.

(3) *Alternative approach for computing the deduction for business interest expense*. If a CFC group election is properly made and in effect with respect to a specified taxable year of a CFC group member of a CFC group, then—

(i) The portion of the CFC group member's business interest expense that is subject to the general rule under § 1.163(j)–2(b) is the amount equal to the CFC group member's allocable share of the CFC group's applicable net business interest expense, or, in the case in which the CFC group member is also a member of a financial services subgroup, the allocable share of the applicable subgroup net business interest expense; and

(ii) The limitation provided in § 1.163(j)–2(b) is applied without regard to § 1.163(j)–2(b)(1) and (3).

(4) *Treatment of certain partnerships as a CFC group member*–(i) *General rule*. If one or more CFC group members of the same CFC group, in the aggregate, own more than 80 percent of the interests in the capital or profits in a partnership, then, except as provided in paragraph (b)(4)(ii) of this section, the partnership is treated as a CFC group member. If there is a financial services subgroup with respect to the CFC group, this paragraph (b)(4) will apply only if all of the CFC group members described in the preceding sentence are financial services subgroup members or none of them are financial services subgroup members. If a partnership is treated as a CFC group member, then an interest in the partnership is treated as stock for purposes of applying this section.

(ii) *Exception for certain partnerships engaged in a United States trade or business*. Notwithstanding paragraph (b)(4)(i) of this section, a partnership is not treated as a CFC group member if the partnership is engaged in a trade or business in the United States, directly or indirectly through another passthrough entity, and one or more partners has income that is effectively connected with the conduct of a trade or business in the United States, including any income that is treated as effectively connected income under an applicable provision of the Code or regulations, and at least one of the partners is not exempt from U.S. tax by reason of a U.S. income tax treaty. Notwithstanding the preceding sentence, a partnership that, without regard to this paragraph (b)(4)(ii), would be treated as a CFC group member under paragraph (b)(4)(i) of this section, is treated as a CFC group member solely for purposes of determining if another entity is a CFC group member with respect to the CFC group.

(5) *CFC group election*–(i) *Manner of making a CFC group election*. Subject to paragraph (b)(5)(ii) of this section, a CFC group election is made by applying paragraph (b)(3) of this section for purposes of computing the amount of a CFC group member's deduction for business interest expense. Except as otherwise provided in publications, forms, instructions, or other guidance, a separate statement or form evidencing the election need not be filed.

(ii) *Consistency requirement*. An election under paragraph (b)(5)(i) of this section is not effective unless all CFC group members of the CFC group make the election. If an entity becomes a CFC group member of a CFC group for which a CFC group election is in effect, the entity must make the CFC group election.

(iii) *Duration of a CFC group election*. A CFC group election is irrevocable. If an entity ceases to be a CFC group member of a CFC group for which a CFC group election is in effect, the election terminates solely with respect to such entity. If a CFC group ceases to exist, a CFC group election terminates with respect to all CFC group members of the CFC group.

(c) *Rules concerning the computation of adjusted taxable income of an applicable CFC and certain CFC group members*--(1) *Computation of taxable income*. For purposes of computing taxable income of an applicable CFC for a taxable year, the applicable CFC's gross income and allowable deductions are determined under the principles of § 1.952–2 or the rules of section 882 for determining taxable income that is effectively connected with the conduct of a trade or business in the United States, as applicable.

(2) *Treatment of certain dividends*. For purposes of computing the ATI of an applicable CFC for a taxable year, any dividend included in gross income that is received from a related person, within the meaning of section 954(d)(3), with respect to the distributee is subtracted from taxable income.

(3) *Treatment of CFC excess taxable income*–(i) *In general*. If a CFC group election is in effect for a specified taxable year of a CFC group member and if the CFC group member (*upper-tier member*) directly owns stock in one or more other CFC group members (*lower-tier member*), then, for purposes of computing ATI of the upper-tier member for the specified taxable year, there is added to taxable income the sum of the products of the following amounts with respect to each lower-tier member—

(A) The CFC excess taxable income (if any) of the lower-tier member for the lower-tier member's specified taxable year; and

(B) The percentage (by value) of the stock of the lower-tier member that is directly owned by the upper-tier member on the last day of the lower-tier member's specified taxable year.

(ii) *Ordering rules*. For purposes of applying paragraph (c)(3)(i) of this section, if a CFC group member is an upper-tier member with respect to a CFC group member and a lower-tier member with respect to another CFC group member, paragraph (c)(3)(i) of this section is applied starting with the lowest-tier CFC group member in the chain of ownership. If an upper-tier member is a partner in a lower-tier member that is a partnership, which is an entity that does not have CFC excess taxable income but that may have excess taxable income (as defined in § 1.163(j)–1(b)(15)), see § 1.163(j)–6(f) for determining the upper–tier member's share of the lower-tier member's excess taxable income (if any).

(d) *Rules concerning the computation of adjusted taxable income of a United States shareholder*–(1) *In general*–(i) *Treatment of gross income inclusions that are properly allocable to a non-excepted trade or business*. If for a taxable year a United States shareholder with respect to one or more applicable CFCs includes amounts in gross income under section 78, 951(a), or 951A(a) that are properly allocable to a non-excepted trade or business (each amount, a *specified deemed inclusion* and such amounts, collectively *specified deemed inclusions*), then, for purposes of computing ATI of the United States shareholder, there is subtracted from taxable income an amount equal to the specified deemed inclusions, reduced by the portion of the deduction allowed under section 250(a)(1), without regard to the taxable income limitation of section 250(a)(2), by reason of the specified deemed inclusions (such a deduction, a *specified section 250 deduction*). For rules concerning inclusions under sections 78, 951(a), and 951A(a) and deductions allowable under section 250 that are not properly allocable to a non-excepted trade or business, see § 1.163(j)–1(b)(1)(ii)(F) and (b)(1)(i)(H), respectively.

(ii) *Treatment of deemed inclusions of a domestic partnership that are not allocable to any trade or business*. If a United States shareholder that is a domestic partnership includes amounts in gross income under section 951(a) or 951A(a) that are not properly allocable to trade or business of the domestic partnership, then, notwithstanding § 1.163(j)–4(b)(3), to the extent a C corporation partner, including an indirect partner in the case of tiered partnerships, takes such amounts into account as a distributive share in accordance with section 702 and § 1.702–1(a)(8)(ii), the C corporation partner may not treat such amounts as properly allocable to a trade or business of the C corporation partner.

(2) *Additional rule after application of paragraph (d)(1) of this section for a United States shareholder of a CFC group member with a CFC group election in effect*–(i) *In general*. Subject to paragraph (d)(3) of this section, if for a taxable year, a United States shareholder owns directly, or indirectly through one or more foreign pass-through entities, stock of one or more CFC group members of a CFC group for which a CFC group election is in effect for the specified taxable year of each CFC group member that ends with or within the taxable year of the United States shareholder, then, for purposes of computing ATI of the United States shareholder, in addition to the subtraction described in paragraph (d)(1) of this section, there is added to taxable income the amount equal to the sum of the amounts of eligible CFC group ETI, as defined in paragraph (d)(2)(ii) of this section, with respect to each specified highest-tier member of the United States shareholder, but not in excess of the amount of the CFC group inclusions, as defined in paragraph (d)(2)(iii) of this section, of the United States shareholder for the taxable year. For purposes of this paragraph (d)(2)(i), members of a consolidated group are treated as a single United States shareholder.

(ii) *Eligible CFC group ETI*. The term *eligible CFC group ETI* means, with respect to a specified highest-tier member and a specified taxable year, the amount equal to the product of the following three amounts—

(A) The specified highest-tier member's CFC excess taxable income for the specified taxable year, taking into account the application of paragraph (c)(3) of this section;

(B) The specified highest-tier member's specified ETI ratio for the specified taxable year; and

(C) The percentage, by value, of the stock of the specified highest-tier member that is owned directly, or indirectly through one or more foreign passthrough entities, by the United States shareholder on the last day of the specified taxable year.

(iii) *CFC group inclusions*. The term *CFC group inclusions* means, with respect to a United States shareholder and a taxable year, the amounts of the specified deemed inclusions subtracted from taxable income under paragraph (d)(1)(i) of this section that are with respect to CFC group members, other than amounts included in gross income by reason of section 78, reduced by the portion of any specified section 250 deduction described in paragraph (d)(1)(i) of this section that is allowable by reason of such specified deemed inclusions.

(3) *Special rules if a domestic partnership is a United States shareholder of a CFC group member with a CFC group election in effect*. Paragraph (d)(2) of this section does not apply with respect to a United States shareholder described in paragraph (d)(2) of this section that is a domestic partnership (such a partnership, a *U.S. shareholder partnership*). If a U.S. shareholder partnership has a domestic C corporation partner, including an indirect partner in the case of tiered partnerships, (such a partner, a *U.S. corporate partner*), then, for purposes of computing ATI of the U.S. corporate partner, paragraph (d)(2) of this section is applied by treating the U.S. shareholder partnership, and in case of tiered partnerships, any tiered partnership that is a domestic partnership, as if it were a foreign partnership and by making the following modifications–

(i) The term "U.S. corporate partner" is substituted for the term "United States shareholder" each place it appears in paragraph (d)(2) of this section; and

(ii) If a U.S. shareholder partnership includes an amount in gross income under section 951(a) or 951(A) with respect to a CFC group member, then to the extent the amount is taken into account by a U.S. corporate partner as a distributive share in accordance with section 702 and § 1.702–1(a)(8)(ii), such amount is treated as a specified deemed inclusion of the U.S. corporate partner with respect to the CFC group member for purposes of applying paragraph (d)(2)(iii) of this section.

(4) *Inclusions under section 951A(a)*. For purposes of applying paragraph (d) of this section, the portion of a United States shareholder's inclusion under section 951A(a) treated as being with respect to a CFC group member is determined under section 951A(f)(2) and § 1.951A–6(b)(2).

(e) *Effect on earnings and profits*. In the case of a foreign corporation, the disallowance and carryforward of a deduction for the corporation's business interest expense under § 1.163(j)–2 will not affect whether and when such business interest expense reduces the corporation's earnings and profits. Thus, for example, if a United States person has elected under section 1295 to treat a passive foreign investment company (as defined in section 1297) (PFIC) as a qualified electing fund, then the disallowance and carryforward of a deduction for the PFIC's business interest expense under § 1.163(j)–2 will not affect whether or when such business interest expense reduces the PFIC's earnings and profits. Similarly, the disallowance and carryforward of a deduction for an applicable CFC's business interest expense will not affect the earnings and profits limitation for subpart F income under section 952(c). See also § 1.163(j)–4(c).

(f) *Definitions*. The following definitions apply for purposes of this section.

(1) *Allocable share*–(i) *General rule*. The term *allocable share* means, with respect to a CFC group member of a CFC group and a specified taxable year, the amount equal to the product of the CFC group's applicable net business interest expense (multiplicand), if any, and a fraction, the numerator of which is equal to the amount of the CFC group member's net business interest expense, and the denominator of which is equal to the sum of the amounts of the net business interest expense of each CFC group member.

(ii) *Special rule if there is a financial services subgroup*. If there is a financial services subgroup with respect to a CFC group, then paragraph (f)(1)(i) of this section is applied with the following modifications—

(A) With respect to a CFC group member that is also a financial services subgroup member—

(*1*) The multiplicand is equal to the amount of the applicable subgroup net business interest expense; and

(*2*) The denominator of the fraction is determined by replacing the term "CFC group member" with the term "financial services subgroup member."

(B) With respect to a CFC group member this is not a financial services subgroup member—

(*1*) The multiplicand is reduced by the amount of the applicable subgroup net business interest expense; and

(*2*) The denominator of the fraction is reduced by the sum of the amounts of the net business interest expense of each financial services subgroup member.

(2) *Applicable CFC*. The term *applicable CFC* means a controlled foreign corporation described in section 957, but only if the foreign corporation has at least one United States shareholder that owns, within the meaning of section 958(a), stock of the foreign corporation.

(3) *Applicable net business interest expense*. The term *applicable net business interest expense* means, with respect to a CFC group and a majority U.S. shareholder taxable year, the excess, if any, of the sum of the amounts of the business interest expense of each CFC group member for the specified taxable year, over the sum of the amounts of the business interest income of each CFC group member for the specified taxable year.

(4) *Applicable subgroup net business interest expense*. The term *applicable subgroup net business interest expense* means, with respect to a financial services subgroup of a CFC group and a majority U.S. shareholder taxable year, the excess, if any, of the sum of the amounts of the business interest expense of each financial services subgroup member for the specified taxable year, over the sum of the amounts of the business interest income of each financial services subgroup member for the specified taxable year.

(5) *CFC excess taxable income*–(i) *In general*. The term *CFC excess taxable income* means, with respect to a CFC group member, other than a partnership described in paragraph (b)(4)(i) of this section, and a specified taxable year, the amount which bears the same ratio to the CFC group member's ATI, as—

(A) The excess (if any) of–

(*1*) The amount determined for the CFC group member under § 1.163(j)–2(b)(2); over

(*2*) The CFC group member's allocable share of either the applicable net business interest expense or the applicable subgroup net business interest expense, as applicable; bears to

(B) The amount determined for the CFC group member under § 1.163(j)–2(b)(2).

(ii) *CFC group member is a partnership*. If a CFC group member is a partnership, see § 1.163(j)–1(b)(15) for determining the extent to which the partnership has excess taxable income. For rules concerning a partner's share of a partnership's excess taxable income, see § 1.163(j)–6(f).

(6) *CFC group*–(i) *In general*. The term *CFC group* means two or more applicable CFCs if 80 percent or more of the total value of shares of all classes of stock of each applicable CFC is owned, within the meaning of section 958(a), either by a single United States shareholder or by multiple U.S. shareholders that are related persons, within the meaning of section 267(b) or 707(b)(1), (each a *related United States shareholder* and collectively *related United States shareholders*), provided the stock of each applicable CFC is owned in the same proportion by each related United States shareholder.

(ii) *Aggregation rules*. The following rules apply for the purpose of applying paragraph (f)(6)(i) of this section—

(A) Members of a consolidated group and individuals described in section 318(a)(1)(A)(i) who file a joint tax return are treated as a single person; and

(B) If a single United States person, as defined in section 957(c), taking into account the application of paragraph (f)(6)(ii)(A) of this section, owns, directly or indirectly through one or more pass-through entities, more than 80 percent of the interests in a pass-through entity that is a United States shareholder that owns, within the meaning of section 958(a), stock in an applicable CFC, then that United States person is treated as owning the stock of the applicable CFC that is owned by the passthrough entity. For purposes of applying the 80-percent threshold described in the preceding sentence, if the pass-through entity is a partnership, then the 80-percent threshold is satisfied if the United States person owns at least 80 percent of the interests in the capital or the profits of the partnership, and if the pass-through entity is not a partnership, then the 80-percent threshold is satisfied if the United States person owns at least 80 percent of the value of all interests of the passthrough entity.

(7) *CFC group election*. The term *CFC group election* means an election to apply paragraph (b)(3) of this section.

(8) *CFC group member*. The term *CFC group member* means, with respect to a CFC group, an entity included in the CFC group. An entity that has, including through ownership of an interest in a passthrough entity, income which is effectively connected with a trade or business conducted in the United States, including any income that is treated as effectively connected income under an applicable provision of the Code or regulations, and not exempt from U.S. tax by reason of a U.S. income tax treaty is not treated as a member of a CFC group, other than solely for purposes of determining if another entity is a CFC group member with respect to the CFC group.

(9) *Financial services subgroup*. The term *financial services subgroup* means, with respect to a CFC group, a group comprised of each CFC group member of the CFC group that is an eligible controlled foreign corporation (as defined in section 954(h)(2)(A)), a qualified insurance company (as defined in section 953(e)(3)), or eligible for the dealer exception in computing foreign personal holding company income (as described in section 954(c)(2)(C)).

(10) *Financial services subgroup member*. The term *financial services subgroup member* means, with respect to a financial services subgroup of a CFC group, a CFC group member that is also a member of the financial services subgroup.

(11) *Majority U.S. shareholder taxable year*. The term *majority U.S. shareholder taxable year* means, with respect to a CFC group, one of the following taxable years, applied sequentially—

(i) If there is a single United States shareholder of the CFC group for purposes of paragraph (f)(6)(i) of this section, then the taxable year of the United States shareholder;

(ii) If paragraph (f)(11)(i) of this section does not apply and a related United States shareholder owns, within the meaning of section 958(a), more stock of the members of the CFC group, by value, than is owned, within the meaning of section 958(a), by any other related United States shareholder, then the taxable year of the first-mentioned related United States shareholder;

(iii) If paragraphs (f)(11)(i) and (ii) of this section do not apply and if one or more related United States shareholders with the same taxable year, in aggregate, own, within the meaning of section 958(a), more stock of the members of the CFC group (by value) than is, in aggregate, owned, within the meaning of section 958(a), by other related United States shareholders with the same taxable year, then the taxable year of the first-mentioned related United States shareholders; and

(iv) If paragraphs (f)(11)(i), (ii), and (iii) of this section do not apply, then the calendar year.

(12) *Net business interest expense*. The term *net business interest expense* means, with respect to a CFC group member of a CFC group and a specified taxable year, the excess, if any, of the amount of the CFC group member's business interest expense over the amount of the CFC group member's business interest income, in each case determined without regard to section 163(j) and the section 163(j) regulations.

(13) *Passthrough entity*. The term *passthrough entity* means a partnership, S corporation, or any other entity (domestic or foreign) that is not a corporation if all items of income and deduction of the entity are included in the income of its owners or beneficiaries. An *interest in a passthrough entity* means an interest in the capital or profits of the entity or stock of an S corporation, as applicable.

(14) *Specified ETI ratio*–(i) *In general*. The term *specified ETI ratio* means, with respect to a specified highest-tier member of a CFC group and a specified taxable year, the ratio computed as a fraction (expressed as a percentage), the numerator of which is the sum of the amounts described in paragraph (f)(14)(iii) of this section with respect to each CFC group member described in paragraph (f)(14)(ii) of this section, and the denominator of which is the sum of the amounts described in paragraph (f)(14)(iv) of this section with respect to each CFC group member described in paragraph (f)(14)(ii) of this section that has amounts included in the numerator. The specified ETI ratio may not exceed 100 percent. If the numerator and the denominator of the fraction are not both greater than zero, the specified ETI ratio is treated as being equal to zero.

(ii) *Includable CFC group members*. For purposes of applying paragraph (f)(14)(i) of this section, a CFC group member is described in this paragraph (f)(14)(ii) if—

(A) The CFC group member is the specified highest-tier member or a specified lower-tier member with respect to the specified highest-tier member; and

(B) The CFC group member has CFC excess taxable income without regard to paragraph (c)(3) of this section.

(iii) *Numerator*. For purposes of applying (f)(14)(i) of this section, the amount described in this paragraph (f)(14)(iii) is, with respect to a CFC group member and a specified taxable year, the sum of the amounts included in gross income under sections 951(a) and 951A(a) of each United States shareholder with respect to the CFC group member for the taxable years of the United States shareholders in which or with which the specified taxable year of the CFC group member ends. For purposes of this paragraph (f)(14)(iii), the portion of a United States shareholder's inclusion under section 951A(a) treated as being with respect to a CFC group member is determined under section 951A(f)(2) and § 1.951A–6(b)(2).

(iv) *Denominator*. For purposes of applying (f)(14)(i) of this section, the amount described in this paragraph (f)(14)(iv) is, with respect to a CFC group member and a specified taxable year, the taxable income of the CFC group member for the specified taxable year.

(15) *Specified highest-tier member*. The term *specified highest-tier member* means, with respect to a CFC group, a CFC group member in which a United States shareholder owns directly, or indirectly through one or more foreign passthrough entities, stock of the CFC group member.

(16) *Specified lower-tier member*. The term *specified lower-tier member* means, with respect to a specified highest-tier member of a CFC group, a CFC group member in which the specified highest-tier member owns stock directly or indirectly through a chain of ownership.

(17) *Specified taxable year*. The term *specified taxable year* means, with respect to a CFC group member of a CFC group,

the taxable year that ends with or within a majority U.S. shareholder year.

(18) *United States shareholder*. The term *United States shareholder* has the meaning provided in section 951(b).

(g) *Examples*. The following examples illustrate the application of this section. For each example, unless otherwise stated, the referenced business interest expense is deductible but for the application of section 163(j), no exemptions from the application of section 163(j) are available, none of the business interest expense is floor plan financing interest expense, and no foreign corporation has income that is effectively connected with a trade or business conducted in the United States or is an entity described in paragraph (f)(9) of this section (regarding entities that provide certain types of financial services).

(1) *Example 1: Computation of section 163(j) limitation of CFC group members*–(i) *Facts*. USP, a domestic C corporation, wholly owns US1 and US2, each of which is a domestic C corporation. USP, US1, and US2 are members of a consolidated group of which USP is the common parent (USP group). US1 wholly owns CFC1, a foreign corporation, and US2 wholly owns CFC2 and CFC3, each of which is a foreign corporation. The USP group has a calendar year taxable year. For U.S. tax purposes, CFC1, CFC2, and CFC3 each have a fiscal taxable year ending on November 30. CFC1 has an outstanding loan of $1,000x from a third-party (CFC1 note). CFC1 has a receivable of $500x from each of CFC2 and CFC3 (CFC2 note and CFC3 note, respectively). Interest on all debt is paid and accrued annually on November 30. During the taxable year ending November 30, 2019, CFC1 has business interest expense of $90x attributable to CFC1 note and business interest income of $100x attributable to CFC2 note and CFC3 note, and CFC2 and CFC3 each have $50x of business interest expense attributable to CFC2 note and CFC3 note, respectively. Assume that each of CFC1, CFC2, and CFC3 has ATI of $100x computed on a separate company basis for the taxable year ending November 30, 2019. The USP group has no business interest expense.

(ii) *Analysis*–(A) *Determination of CFC group*. US1 owns (within the meaning of section 958(a)) all of the stock of CFC1, and US2 owns (within the meaning of section 958(a)) all of the stock of each of CFC2 and CFC3. Under paragraph (f)(2) of this section, each of CFC1, CFC2, and CFC3 is an applicable CFC. Under paragraph (f)(6)(ii)(A) of this section, because US1 and US2 are members of a consolidated group, US1 and US2 are treated as a single person for purposes determining a CFC group under paragraph (f)(6)(i) of this section. Therefore, because 80 percent or more of the stock of each of CFC1, CFC2, and CFC3 is owned (within the meaning of section 958(a)) by a single United States shareholder, under paragraph (f)(6)(i) of this section, CFC1, CFC2, and CFC3 are members of a CFC group (USP CFC group).

(B) *CFC group election is made*. Assume a CFC group election is properly made. Under paragraph (f)(11)(i) of this section, because there is a single United States shareholder of the USP CFC group with a calendar taxable year, the majority U.S. shareholder taxable year with respect to the USP CFC group ends on December 31, 2019. Under paragraph (f)(17) of this section, the specified taxable year of each of CFC1, CFC2, and CFC3 is November 30, 2019, which is the taxable year that ends with or within the majority U.S. shareholder taxable year ending on December 31, 2019. Under paragraph (f)(3) of this section, the applicable net business interest expense of the USP CFC group is $90x. The $90x is the excess of $190x, which is the sum of the amounts of the business interest expense of each of CFC1, CFC2, and CFC3 ($90x, $50x, and $50x, respectively), over $100x, which is the sum of the amounts of the business interest income of each of CFC1, CFC2, and CFC3 ($100x, $0, and $0, respectively). Under paragraph (f)(12) of this section, CFC1 has $0 of net business interest expense ($90x business interest expense does not exceed $100x of business interest income), and CFC2 and CFC3 each have $50x of net business interest expense (each has $50x business interest expense and $0 business interest income). Because CFC2 and CFC3 each has net business interest expense, under paragraph (f)(1) of this section, each has an allocable share of the applicable net business interest expense of the USP CFC group. The allocable share of each of CFC2 and CFC3 is $45x, computed as $90x (the applicable net business interest expense) multiplied by the fraction equal to $50x / $100x (the net business interest expense of the member and the sum of the amounts of net business interest expense of all members, respectively). Under paragraph (b)(3)(i) of this section, none of CFC1's $90x of business interest expense and $45x of each of CFC2's and CFC3's $50x of business interest expense is subject to the general rule under § 1.163(j)–2(b) (and $5x of each of CFC2's and CFC3's business interest expense is not subject to limitation under § 1.163(j)–2(b)), and, under paragraph (b)(3)(ii) of this section, the general rule under § 1.163(j)–2(b), as applied to CFC2 and CFC3, is computed without regard to § 1.163(j)–2(b)(1) and (3). Thus, under § 1.163(j)–2(b), CFC2's limitation is $30x ($100x ATI computed on a separate company basis x 30 percent). The amount of CFC2's business interest expense subject to limitation under paragraph (b)(3) of this section, $45x, exceeds CFC2's limitation under § 1.163(j)–2(b), $30x. Accordingly, $35x ($5x not subject to limitation + $30x) of CFC2's business interest expense is deductible, and under § 1.163(j)–2(c), the remaining $15x of business interest expense is not deductible and will be carried forward as a disallowed business interest expense carryforward. The analysis for CFC3 is the same as for CFC2. Because the USP group has no business interest expense, the application of paragraph (d) of this section is not relevant.

(C) *CFC group election is not made*. Instead, assume a CFC group election is not made. In this case, each of CFC1, CFC2, and CFC3 must compute its interest deduction limitation under § 1.163(j)–2(b), without regard to paragraph (b)(3) of this section. CFC1's business interest expense of $90x is deductible because it has business interest income of $100x. CFC2's business interest expense limitation is $30x ($100x ATI computed on a separate company basis x 30 percent). Accordingly, $30x of CFC2's business interest expense is deductible, and under § 1.163(j)–2(c), the remaining $20x of business interest expense is disallowed business interest expense and will be carried forward as a disallowed business interest expense carryforward. The analysis for CFC3 is the same as for CFC2.

(2) *Example 2: Computation and allocation of CFC excess taxable income*–(i) *Facts*. USP, a domestic C corporation, wholly owns CFC1, a foreign corporation. CFC1 wholly owns CFC2, a foreign corporation, and CFC2 wholly owns each of CFC3 and CFC4, both of which are foreign corporations (CFC1, CFC2, CFC3, and CFC4, collectively, the USP CFC group). All entities have a calendar year for U.S. tax purposes. For Year 1, assume the following additional facts: Prior to the application of section 163(j), CFC1 has no items of income, gain, deduction, or loss; CFC2 has a taxable loss of $5x (including $5x of business interest expense); CFC3 has taxable income of $85x (including $15x of business interest expense); CFC4 has $60x of taxable income (including $40x of business interest expense); a CFC group election is in effect for the CFC group; there is no intercompany debt between any CFC group member; 50 percent of CFC3's items of income and gain are subpart F income (as defined in section 952), and 50 percent of CFC3's items of deduction and loss are properly allocable to subpart F income, and with respect to the remaining portion of CFC3's items of income, gain, deduction, and loss, no portion is taken into account in computing tested income (as defined in section 951A(c)(2)(A)) or tested loss (as defined in section 951A(c)(2)(B)) of CFC3; CFC4's items of income and gain are all tested income, and CFC4's items of deduction are all properly allocable to such income; no portion of CFC2's items of income, gain, deduction, or loss is taken into account in computing tested income or tested loss; no CFC group member has qualified business asset investment (as defined in section 951A(d)); for purposes of computing ATI, there are no subtractions or additions to taxable income described in § 1.163(j)–1(b)(1) with respect to any CFC group member of the USP CFC group other than for business interest expense; for simplicity, no foreign income taxes are paid by any CFC group member of the USP CFC group; in addition to the inclusions in gross income under sections 951(a)(1) and 951A(a) with respect to the CFC group members of the USP CFC group, USP has business interest expense of $20x.

(ii) *Analysis*–(A) *Application of section 163(j) to CFC group members of the USP CFC group; computation of USP CFC group's applicable net business interest expense*. Under paragraph (f)(3) of this section, the USP CFC group's applicable net business interest expense is $60x ($0 + $5x + $15x + $40x with respect to CFC1, CFC2, CFC3, and CFC4, respectively). Because there is no debt between the CFC group members of the USP CFC group, under paragraph (b)(3) of this section, each of the CFC group members allocable share of the $60x is equal to its separate company business interest expense. In particular, CFC1's allocable share of the USP CFC group's applicable net interest expense is zero, CFC2's allocable share is $5x, CFC3's allocable share is $15x, and CFC4's allocable share is $40x.

(B) *Application of section 163(j) to CFC4*. Under § 1.163(j)–1(b)(1), CFC4's ATI is $100x ($60x taxable income + $40x business interest expense). Under § 1.163(j)–2(b), CFC4's limitation is $30x ($100x ATI computed on a separate company basis x 30 percent). The amount of CFC4's business interest expense subject to limitation, $40x, exceeds CFC4's limitation, $30x. Accordingly, under § 1.163(j)–2(c), $10x of business interest expense is not deductible and will be carried forward as a disallowed business interest expense carryforward. Because $10x of business interest expense is not currently deductible, CFC4's tested income is $70x ($60x taxable income prior to application of section 163(j), increased by $10x of disallowed business interest expense).

(C) *Application of section 163(j) to CFC3*. Under § 1.163(j)–1(b)(1), CFC3's ATI is $100x ($85x taxable income + 15x business interest expense). Under § 1.163(j)–2(b), CFC3's limitation is $30x ($100x ATI computed on a separate company basis x 30 percent). Because the amount of CFC3's business interest expense subject to limitation, $15x, does not exceed CFC3's limitation, $30x, all of CFC3's business interest expense is currently deductible. Accordingly, CFC3's subpart F income is $42.50x ($85x taxable income x 50 percent). Furthermore, CFC3 has CFC excess taxable income of $50x ($100x x ($15x / $30x)).

(D) *Application of section 163(j) to CFC2*. Under § 1.163(j)–1(b)(1), taking into account the application of paragraph (c)(3) of this section, CFC2's ATI is $50x (($5x) taxable loss + $5x business interest expense + $50x (100 percent x $50x of CFC3's excess taxable income)). Under § 1.163(j)–2(b), CFC2's limitation is $15x ($50x ATI x 30 percent). Because the amount of CFC2's business interest expense subject to limitation, $5x, does not exceed CFC2's limitation, $15x, all of CFC2's business interest expense is currently deductible. Furthermore, CFC2 has CFC excess taxable income of $33.33x ($50x x ($10x / $15x)).

(E) *Application of section 163(j) to CFC1*. Under § 1.163(j)–1(b)(1), taking into account the application of paragraph (c)(3) of this section, CFC1's ATI is $33.33x ($0 taxable income + $33.33x (100 percent x $33.33x of CFC2's excess taxable income)). CFC1 has no business interest expense subject to limitation and therefore CFC1 has CFC excess taxable income of $33.33x.

(F) *Application of section 163(j) to USP*. Under section 951(a)(1), USP includes $42.50x in gross income with respect to CFC3. Under section 951A(a), USP includes $70x in gross income, all of which is allocable to CFC4 under section 951A(f)(2), and under section 250(a)(1)(B), USP is allowed a deduction of $35x. Thus, the amount of USP's CFC group inclusions is $77.50x ($42.50 + $70x – $35x), and USP's taxable income prior to the application of section 163(j) is $57.50x ($77.50x - $20x business interest expense). Under § 1.163(j)–1(b)(1), taking into account the application of paragraph (d)(2) of this section, USP's ATI is $16.67x. USP's ATI, $16.67x, is equal to $57.50x of taxable income + $20x of business interest expense - $77.50x of CFC group inclusions + $16.67x of eligible CFC group ETI. The eligible CFC group ETI, $16.67x, is determined as $33.33x (CFC1's excess taxable income) x 50 percent (CFC1's specified ETI ratio) x 100 percent (percentage of stock of CFC1 owned directly by USP)). Under paragraph (f)(14) of this section, the specified ETI ratio of CFC1 is 50 percent ($42.50x / $85x). The numerator of the fraction, $42.50x, is equal to the amount of USP's gross income inclusion under section 951(a) with respect to CFC3. The denominator of the fraction, $85x, is equal to the amount of the taxable income of CFC3. The numerator and the denominator of the fraction do not include amounts with respect to CFC1, CFC2, and CFC4, because none of them has CFC excess taxable income without regard to the application of paragraph (c)(3) of this section. Furthermore, USP includes no amounts in gross income under section 951(a) or 951A(a) with respect to CFC1 or CFC2. Under § 1.163(j)–2(b), USP's section 163(j) limitation is $5x ($16.67x ATI x 30 percent). The amount of USP's business interest expense, $20x, exceeds USP's section 163(j) limitation, $5x. Accordingly, under § 1.163(j)–2(c), $15x of business interest expense is not deductible and is carried forward as a disallowed business interest expense carryforward.

(h) *Applicability date*. This section applies to a taxable year of a foreign corporation ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register** and to a taxable year of a shareholder of the foreign corporation ending with or within the taxable year of the foreign corporation. However, a foreign corporation and its shareholders and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply this section to a taxable year of the foreign corporation beginning after December 31, 2017, and to a taxable year of a shareholder of the foreign corporation ending with or within the taxable year of the foreign corporation, if the foreign corporation and its shareholders and their related parties consistently apply all of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–8 Application of the business interest deduction limitation to foreign persons with effectively connected income.

(a) *Overview*. This section provides rules concerning the application of section 163(j) to foreign persons engaged in a trade or business in the United States. Paragraph (b) of this section modifies the application of section 163(j) for specified foreign persons with effectively connected taxable income. Paragraph (c) of this section modifies the application of section 163(j) for specified foreign partners in a partnership engaged in a trade or business in the United States. Paragraph (d) of this section provides rules for certain controlled foreign corporations with effectively connected taxable income. Paragraph (e) of this section coordinates the application of section 163(j) and § 1.882–5. Paragraph (f) of this section provides a coordination rule for determining effectively connected earnings and profits for purposes of the branch profits tax under section 884. Paragraph (g) of this section provides definitions that apply for purposes of this section. Paragraph (h) of this section provides examples that illustrate the application of this section. Paragraph (i) of this section provides dates of applicability.

(b) *Application of section 163(j) and the section 163(j) regulations to specified foreign persons with effectively connected taxable income*–(1) *In general*. If a taxpayer is a specified foreign person, then the modifications described in this paragraph (b) are made to the application of section 163(j) and the section 163(j) regulations. If a specified foreign person is also a specified foreign partner, then the modifications described in this paragraph (b) are subject to the partner-level modifications described in paragraph (c) of this section.

(2) *Modification of adjusted taxable income*. ATI for a specified foreign person for a taxable year means the specified foreign person's effectively connected taxable income for the taxable year, adjusted for the items described in § 1.163(j)–1(b)(1)(i) through (iv) that are taken into account in determining effectively connected taxable income.

(3) *Modification of business interest expense*–(i) *General rule*. Business interest expense for a specified foreign person means interest described in § 1.163(j)–1(b)(2) that is determined under § 1.882–5, in the case of a foreign corporation, or under § 1.861–9T(d)(2), in the case of a nonresident alien individual, and allocable to income which is effectively connected taxable income.

(ii) *Exclusion of certain business interest expense of a specified foreign partner*. If a foreign corporation is a specified foreign partner in a partnership engaged in a trade or business in the United States, then, for purposes of paragraph (b)(3)(i) of this section, business interest expense excludes the portion of interest expense determined under § 1.882–5 that is attributable to interest on U.S. booked liabilities of the partnership determined under § 1.882–5(d)(2)(vii).

(4) *Modification of business interest income*. The business interest income of a specified foreign person means interest described in § 1.163(j)–1(b)(3) that is effectively connected taxable income.

(5) *Modification of floor plan financing interest expense*. The floor plan financing interest expense of a specified foreign person means interest described § 1.163(j)–1(b)(17) that is allocable to income which is effectively connected taxable income.

(6) *Modification of allocation of interest expense and interest income that is properly allocable to a trade or business*. For purposes of § 1.163(j)–10(c), a specified foreign person's interest expense and interest income that is properly allocable to a trade or business is only allocated to the specified foreign person's excepted or non-excepted trades or business that have effectively connected taxable income. If the specified foreign person is also a specified foreign partner, this rule only applies to the trades or business not in the partnership.

(c) *Partner-level modifications to § 1.163(j)–6 for partnerships engaged in a U.S. trade or business*–(1) *Modification related to a partnership's excess taxable income*. If for a taxable year a specified foreign partner, other than an applicable CFC, has allocable excess taxable income with respect to a partnership, then, for purposes of computing the specified foreign partner's ATI for the taxable year, the excess, if any, of the amount of the allocable excess taxable income over the amount of the specified excess taxable income is subtracted from ATI.

(2) *Modification related to a partnership's excess business interest expense*. If for a taxable year a specified foreign partner, other than an applicable CFC, has allocable excess business interest expense with respect to a partnership, then, for purposes of determining the specified foreign partner's business interest expense for a succeeding taxable year, the amount of the allocable excess business interest expense treated as disallowed business interest expense carryforward under § 1.163(j)–6(f) is determined by taking into account only the portion of allocable excess business interest expense that is specified excess business interest expense and such excess business interest expense is limited to the portion of allocable excess taxable income for the succeeding taxable year that is specified excess taxable income.

(3) *Modification related to a partnership's excess business interest income*. If for a taxable year a specified foreign partner, other than an applicable CFC, has allocable excess business interest income (as defined in § 1.163(j)–6(b)(4)) with respect to a partnership, then, for purposes of determining the specified foreign partner's section 163(j) limitation, the amount of allocable excess business interest income that can be used by the specified foreign partner cannot exceed the amount of ECI excess business interest income.

(d) *An applicable CFC with effectively connected taxable income*. If an applicable CFC has effectively connected taxable income for a taxable year in which the applicable CFC has disallowed business interest expense, then a portion of the disallowed business interest expense is treated as being with respect to the applicable CFC's interest expense determined under § 1.882–5. That portion is equal to the amount of the applicable CFC's disallowed business interest expense multiplied by a fraction, the numerator of which is the applicable CFC's effectively connected taxable income for the taxable year, adjusted for the items described in § 1.163(j)–1(b)(1)(i) through (iv) that are taken into account in determining effectively connected taxable income, and the denominator of which is the applicable CFC's ATI for the taxable year. However, in no case will such portion exceed the amount of interest expense determined under § 1.882–5. See also § 1.163(j)–7(b)(2) (concerning the general application of section 163(j) to an applicable CFC).

(e) *Coordination of section 163(j) and § 1.882–5*–(1) *General rules*–(i) *Ordering rule*. A foreign corporation first determines its interest expense under § 1.882–5 and then determines the amount of disallowed business interest expense.

(ii) *Treatment of disallowed business interest expense carryforward*. If a foreign corporation has a disallowed business interest expense carryforward from a taxable year, then such carryforward is not taken into account for purposes of determining interest expense under § 1.882–5 in the succeeding taxable year.

(iii) *Treatment of allocable excess business interest expense*. If a foreign corporation has allocable excess business interest expense from a taxable year that is treated under § 1.163(j)–6(g)(2) as disallowed business interest expense carryforward, such interest is not taken into account for purposes of determining interest expense under § 1.882–5 in the succeeding taxable year.

(iv) *Scaling ratio*. If a foreign corporation determines its interest expense under the method described in § 1.882–5(b) through (d) and has U.S. booked liabilities in excess of U.S. connected liabilities, the foreign corporation must apply the scaling ratio (as defined in § 1.882–5(d)(4)(ii)) pro rata to all interest expense paid or accrued by the foreign corporation consistent with § 1.882–5(d)(4)(i), including for purposes of paragraph (b)(3)(ii) of this section.

(2) *Amount of interest determined under § 1.882–5 that is disallowed business interest expense*–(i) *Foreign corporation is not a specified foreign partner*. If a foreign corporation is not a specified foreign partner for a taxable year, then the amount of the foreign corporation's interest expense determined under § 1.882–5 for which a deduction is disallowed for the taxable year is either—

(A) The amount of disallowed business interest expense computed under § 1.163(j)–2(b) with respect to business interest expense described in paragraph (b)(3)(i) of this section, in the case of a foreign corporation that is not an applicable CFC; or

(B) The amount of disallowed business interest expense determined under paragraph (d) of this section, in the case of an applicable CFC.

(ii) *Foreign corporation is a specified foreign partner*. If a foreign corporation is a specified foreign partner with respect to one or more partnerships engaged in a trade or business in the United States for a taxable year, then the portion of the foreign corporation's business interest expense determined under § 1.882–5 for which a deduction is disallowed for the taxable year is equal to the sum of the following amounts—

(A) Either–

(*1*) The amount described in paragraph (e)(2)(i)(A) of this section, in the case of a foreign corporation that is not an applicable CFC; or

(*2*) The amount described in paragraph (e)(2)(i)(B) of this section, in the case of an applicable CFC; and

(B) With respect to each partnership that has excess business interest expense for the taxable year that ends with or within the foreign corporation's taxable year, the amount of the foreign corporation's specified excess business interest expense.

(f) *Coordination with branch profits tax*–(1) *Effect on effectively connected earnings and profits*. The disallowance and carryforward of business interest expense under § 1.163(j)–2(b) and (c) will not affect when such business interest expense reduces the effectively connected earnings and profits of a foreign corporation, as defined in § 1.884–1(f).

(2) *Effect on U.S. net equity*. The disallowance and carryforward of business interest expense under § 1.163(j)–2(b) and (c) will not affect the computation of the U.S. net equity of a foreign corporation, as defined in § 1.884–1(c).

(g) *Definitions*. The following definitions apply for purposes of this section.

(1) *Applicable CFC*. The term *applicable CFC* means a foreign corporation described in section 957, but only if the foreign corporation has at least one United States shareholder that owns, within the meaning of section 958(a), stock of the foreign corporation.

(2) *ECI excess business interest income*. The term *ECI excess business interest income* means, with respect to a specified foreign partner and a partnership, the excess, if any, of the specified foreign partner's allocable business interest income (as defined in § 1.163(j)–6(f)(2)(ii)) over its allocable business interest expense (as defined in § 1.163(j)–6(f)(2)(ii)), but, for purposes of determining a specified foreign partner's allocable business interest income and allocable business interest expense, taking into account only the portion of the partnership's business interest income determined under paragraph (b)(4) of this section as if the partnership were a specified foreign person, over the business interest expense on the U.S. booked liabilities of the partnership as determined under § 1.882–5(d)(2)(vii).

(3) *Effectively connected taxable income*. The term *effectively connected taxable income* means taxable income of a person that is, or is treated as. effectively connected with the conduct of a trade business in the United States under an applicable provision of the Code or regulations or, if an income tax treaty applies, business profits attributable to a U.S. permanent establishment of a tax treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country.

(4) *Specified excess business interest expense*. The term *specified excess business interest expense* means, with respect to a specified foreign partner and a partnership, the amount determined by multiplying the specified foreign partner's allocable excess business interest expense (as determined under § 1.163(j)–6(f)) by the partnership's specified ratio for the taxable year.

(5) *Specified excess taxable income*. The term *specified excess taxable income* means, with respect to a specified foreign partner and a partnership, the amount determined by multiplying the amount of the specified foreign partner's allocable excess taxable income (as determined under § 1.163(j)–6(f)) by the amount of the partnership's specified ratio for the taxable year.

(6) *Specified foreign partner*. The term *specified foreign partner* means, with respect to a partnership that is engaged in a U.S. trade or business, a partner that is a specified foreign person or an applicable CFC.

(7) *Specified foreign person*. The term *specified foreign person* means a nonresident alien individual, as defined in section 7701(b) and the regulations thereunder, or a foreign corporation other than an applicable CFC.

(8) *Specified ratio*. The term *specified ratio* means, with respect to a partnership, a fraction (expressed as a percentage), the numerator of which is the ATI for the partnership determined under paragraph (b)(2) of this section as if the partnership were a specified foreign person, and the denominator of which is the ATI for the partnership determined under § 1.163(j)–6(d).

(h) *Examples*. The following examples illustrate the application of this section. For all examples, assume that all referenced interest expense is deductible but for the application of section 163(j), the small business exemption under § 1.163(j)–2(d) is not available, no party is engaged in an excepted trade or business, and no business interest expense is floor plan financing interest expense.

(1) *Example 1: Limitation on business interest deduction of a foreign corporation*–(i) *Facts*. FC, a foreign corporation that is not an applicable CFC, has $100x of gross income that is effectively connected income. FC has $60x of other income which is not effectively connected income. FC has total expenses of $100x. Assume that under § 1.882–5, FC has $30x of interest expense allocable to income which is effectively connected income. Under section 882(c) and the regulations thereunder, FC has $40x of other expenses properly allocated and apportioned to income which is effectively connected taxable income. FC does not have any business interest income.

(ii) *Analysis*. FC is a specified foreign person under paragraph (g)(7) of this section. Under paragraph (e)(2) of this section, the amount of FC's interest expense determined under § 1.882–5 that is disallowed is the disallowed business interest expense computed under § 1.163(j)–2(b) with respect to interest expense described in paragraph (b)(3) of this section. Under § 1.163(j)–4(b)(1), all interest paid or accrued by FC is properly allocable to a trade or business and therefore under paragraph (b)(3) of this section, FC has business interest expense of $30x. FC has $30x of effectively connected taxable income described in paragraph (g)(3) of this section ($100x - $30x - $40x). Under paragraph (b)(2) of this section, FC has ATI of $60x, determined as $30x of effectively connected taxable income, increased by $30x of business interest expense. Accordingly, FC's section 163(j) limitation is $18x ($60x x 30 percent). Because FC's business interest expense ($30x) exceeds the section 163(j) limitation ($18x), FC may only deduct $18x of business interest expense. Under § 1.163(j)–2(c), the remaining $12x is disallowed business interest expense carryforward and under paragraph (e)(1)(ii) of this section, the $12x is not taken into account for purposes of applying § 1.882–5 in the succeeding taxable year.

(2) *Example 2: Use of a disallowed business interest expense carryforward*–(i) *Facts*. The facts are the same as in *Example 1* in paragraph (h)(1)(i) of this section except that FC has $300x of gross income which is all effectively connected income. Furthermore assume that FC has a disallowed busi-

ness interest expense carryforward of $25x from the prior taxable year.

(ii) *Analysis*. Under paragraph (e)(1)(ii) of this section, FC's $25x of disallowed business interest expense carryforward is not taken into account for purposes of determining FC's interest under § 1.882–5. Therefore, FC has $30x of business interest expense determined under § 1.882–5. Under paragraph (g)(3) of this section, FC has effectively connected taxable income of $205x ($300x gross income - $55x interest expense ($30x + $25x) - $40x other expenses). Under paragraph (b)(2) of this section, FC has ATI of $260x, determined as $205x of effectively connected taxable income, increased by $55x of business interest expense. Accordingly, FC's section 163(j) limitation is $78x ($260x x 30 percent). Under paragraph (b)(3) of this section, FC has business interest expense of $55x ($30x + $25x disallowed interest carryforward) for the taxable year. Because FC's business interest expense ($55x) does not exceed the section 163(j) limitation ($78x), FC may deduct all $55x of business interest expense.

(3) *Example 3: Foreign corporation is engaged in a U.S. trade or business and a specified foreign partner in a partnership engaged in a U.S. trade or business*–(i) *Facts*. FC, a foreign corporation that is not an applicable CFC, owns a 50-percent interest in ABC, a foreign partnership that is engaged in a trade or business in the United States. ABC has two lines of businesses, Business A and Business B. Business A produces $120x of taxable income (including interest expense) and Business B produces $80x of taxable income. FC is allocated 50 percent of all items of income and expense of Business A and Business B. Business A has business interest expense of $20x on $400x of liabilities but has no business interest income. Business B does not have any business interest expense or business interest income. With respect to FC, only Business A produces effectively connected income. FC has an outside basis of $500x in the ABC partnership for purposes of § 1.882–5(b), step 1. All of the liabilities of Business A are U.S. booked liabilities for purposes of § 1.882–5(d). In addition to owning a 50-percent interest in ABC, FC conducts a separate business that is engaged in a trade or business in the United States (Business X). Business X has effectively connected taxable income of $50x, U.S. assets with an adjusted basis of $300x, U.S. booked liabilities of $160x, and interest on U.S. booked liabilities of $15x. FC computes its interest expense under the three-step method described in § 1.882–5(b) through (d) and uses the fixed ratio of 50 percent for purposes of § 1.882–5(c), step 2. Assume the interest rate on excess U.S. connected liabilities is 5 percent. For the taxable year, FC has total interest expense of 500x for purposes of § 1.882–5(a)(3).

(ii) *Analysis*–(A) *Application of section 163(j) to ABC*. Under § 1.163(j)–6(a), ABC computes a section 163(j) limitation at the partnership level. Under § 1.163(j)–6(d), ABC has ATI of $220x, determined as $200x of taxable income ($120x from Business A + $80x from Business B), increased by $20x of business interest expense of Business A. Under § 1.163(j)–2(b), ABC's section 163(j) limitation is $66x ($220x x 30 percent). Because ABC's business interest expense ($20x) does not exceed the section 163(j) limitation ($66x), ABC can deduct all of its business interest expense for the taxable year. Under § 1.163(j)–1(b)(15), ABC has excess taxable income of $153.33x ($220x x ($46x/$66x)). Under § 1.163(j)–6(f), FC is allocated 50 percent of the $153.33x of ABC's excess taxable income, or $76.67x of allocable excess taxable income, but, under paragraph (c)(1) of this section, the amount by which the allocable excess taxable income exceeds FC's specified excess taxable income (as defined in paragraph (g)(5) of this section) is a subtraction from FC's ATI. Under paragraph (g)(5) of this section, FC's specified excess taxable income is $48.79x, which is equal to the product of $76.67x and ABC's specified ratio of 63.64 percent. Under paragraph (g)(8) of this section, ABC's specified ratio of 63.64 percent is determined as $140x / $220x (where the numerator of $140x is the ATI of ABC determined under paragraph (b)(2) of this section as if ABC were a specified foreign person ($120x taxable income of Business A, increased by $20x of business interest expense), and the denominator of $220x is the ATI of ABC under § 1.163(j)–6(d)). FC's allocable excess taxable income ($76.67x) exceeds its specified excess taxable income ($48.79x) by $27.88x.

(B) *Application of § 1.882–5 to FC*. FC is a specified foreign partner under paragraph (g)(6) of this section. Under paragraph (e)(1) of this section, FC first determines its interest expense under § 1.882–5 and then determines its disallowed business interest expense. Under § 1.882–5(b), step 1, FC has U.S. assets of $800x ($500x (FC's basis in its interest in ABC) + $300x (FC's basis in Business X assets). Under § 1.882–5(c), step 2, applying the 50-percent safe harbor in § 1.882–5 for a non-banking business, FC has U.S. connected liabilities of $400x ($800x x 50 percent). Under § 1.882–5(d), step 3, FC has U.S. booked liabilities of $360x ($200x (50-percent share of Business A liabilities of ABC of $400x) + $160x (Business X liabilities) and interest on U.S. booked liabilities of $25x ($10x (50-percent share of $20x interest expense of Business A) + $15x (interest expense of Business X)). FC has excess U.S. connected liabilities of $40x ($400x – $360x) and interest on such excess liabilities of $2x ($40x x 5 percent). FC's interest expense determined under § 1.882–5 is $27x ($25x + $2x).

(C) *Application of section 163(j) to FC*. Under paragraph (e)(2)(ii) of this section, the amount of business interest expense that is disallowed for FC is equal to only the amount of interest described in paragraph (b)(3) of this section that is disallowed because there is no specified excess business interest expense with respect to ABC. Under paragraph (b)(3) of this section, FC's business interest expense (at the corporate level) is $17x, the amount determined under § 1.882–5 ($27x) less the amount of interest on U.S. booked liabilities from ABC determined under § 1.882–5(d)(2)(vii) ($10x), which was subject to the section 163(j) limitation at the ABC partnership level. Under § 1.163(j)–6(e)(1), FC's ATI is determined under § 1.163(j)–1(b)(1) without regard to FC's distributive share of any items of income, gain, deduction, or loss of ABC. Under paragraph (b)(2) of this section, taking into account the application of paragraph (c)(1) of this section, FC's ATI is $115.77x ($50x effectively connected taxable income with respect to Business X, + $17x (business interest expense under § 1.882–5 of 27x less the amount of interest on U.S. booked liabilities from ABC determined under § 1.882–5(d)(2)(vii) of $10x) + $76.65x (excess taxable income from ABC) - $27.88x (amount excess taxable income exceeds specified excess taxable income)). FC's section 163(j) limitation is $34.73x ($115.77x x 30 percent). Because FC's business interest expense ($17x) is less than FC's section 163(j) limitation ($34.73x) and all of its share of ABC's interest is deductible, FC may deduct all $27x of interest determined under § 1.882–5.

(4) *Example 4: Scaleback of interest expense under § 1.882–5*–(i) *Facts*. Assume the same facts in *Example 3* in paragraph (h)(3)(i) of this section except that Business X has U.S. booked liabilities of $300x and interest on U.S. booked liabilities of $20x.

(ii) *Analysis*–(A) *Application of section 163(j) to ABC*. The analysis is the same as *Example 3* in paragraph (h)(3)(ii)(A) of this section.

(B) *Application of § 1.882–5 to FC*. Under § 1.882–5(b), step 1, FC has U.S. assets of $800x ($500x (FC's basis in its interest in ABC) + $300x (FC's basis in Business X assets)). Under § 1.882–5(c), step 2, applying the 50-percent safe harbor in § 1.882–5 for a non-banking business, FC has U.S. connected liabilities of $400x ($800x x 50 percent). Under § 1.882–5(d), step 3, FC has U.S. booked liabilities of $500x ($200x (50-percent share of Business A liabilities of ABC of $400x) + $300x (Business X liabilities) and interest on U.S. booked liabilities of $30x ($10x (50-percent share of $20x interest expense of Business A) + $20x (interest expense of Business X)). FC has excess U.S. booked liabilities of $100x ($500x – $400x) and the interest expense on U.S. booked liabilities must be reduced by the scaling ratio as provided in § 1.882–5(d)(4). FC's interest expense determined under § 1.882–5 is $24x ($30x x (400/500 scaling ratio)).

(C) *Application of section 163(j) to FC*. Under paragraph (b)(3) of this section, FC's business interest expense is $16x, the amount determined under § 1.882–5 ($24x) less the amount of interest on U.S. booked liabilities from ABC determined under § 1.882–5(d)(2)(vii) after applying the scaling ratio ($8x, determined as interest expense of Business A of $10x x scaling ratio of 400/500), which was subject to the section 163(j) limitation at the ABC partnership level. Under § 1.163(j)–6(e)(1), FC's ATI is determined under § 1.163(j)–1(b)(1) without regard to FC's distributive share of any items of income, gain, deduction, or loss of ABC. Under paragraph (b)(2) of this section, taking into account the application of paragraph (c)(1) of this section, FC's ATI is $114.79x ($50x effectively connected taxable income with respect to Business X + $16x (business interest expense under § 1.882–5 of 24x less the amount of interest on U.S. booked liabilities from ABC determined under § 1.882–5(d)(2)(vii), after applying the scaleback, of $8x) + $76.67x (excess taxable income from ABC) - $27.88x (amount excess taxable income exceeds specified excess taxable income)). FC's section 163(j) limitation is $34.44x ($114.79x x 30 percent). Because FC's business interest expense ($16x) is less than FC's section 163(j) limitation ($34.44x) and all of

ABC's interest is deductible, FC may deduct all $24x of interest determined under § 1.882–5.

(5) *Example 5: Separate currency pools method*–(i) *Facts*. Assume the same facts in *Example 3* in paragraph (h)(3)(i) of this section except that FC does not conduct Business X; the value of FC's interest in ABC for purposes of § 1.882–5(e)(i), step 1, is $1,000x; and FC computes its interest expense under the separate currency pools method in § 1.882–5(e) and for purposes of applying such method, the prescribed interest rate is 5 percent.

(ii) *Analysis*–(A) *Application of section 163(j) to ABC*. The analysis is the same as in *Example 3* in paragraph (h)(1)(ii)(A) of this section.

(B) *Application of § 1.882–5 to FC*. Under § 1.882–5(e)(i), step 1, FC has U.S. assets of $1,000x (FC's basis in its partnership interest in ABC). Under § 1.882–5(e)(1)(ii), step 2, FC has U.S. connected liabilities of $500x ($1,000x x 50 percent) applying the 50 percent safe harbor for non-banking business. Under § 1.882–5(e)(1)(iii), step 3, the interest expense under § 1.882–5 is $25x ($500x x 5 percent).

(C) *Application of section 163(j) to FC*. Under paragraph (b)(3) of this section, FC's business interest expense is $15x, the amount determined under § 1.882–5 ($25x) less the amount of interest on U.S. booked liabilities from ABC determined under § 1.882–5(d)(2)(vii) of $10x, which was subject to the section 163(j) limitation at the ABC partnership level. Under § 1.163(j)–6(e)(1), FC's ATI is determined under § 1.163(j)–1(b)(1) without regard to FC's distributive share of any items of income, gain, deduction, or loss of ABC. Under paragraph (b)(2) of this section, taking into account the application of paragraph (c)(1) of this section, FC's ATI is $48.79x ($76.67x (excess taxable income from ABC) – $27.88x (amount excess taxable income exceeds specified excess taxable income)). FC's section 163(j) limitation is $14.64x ($48.79x x 30 percent). Because FC's business interest expense ($15x) exceeds the 163(j) limitation ($14.64x), FC may only deduct $14.64x of its business interest expense. Under § 1.163(j)–2(c), the remaining $0.36x is disallowed business interest expense carryforward and under paragraph (e)(1)(ii) of this section, the $0.36x is not taken into account for purposes of applying § 1.882–5 in the succeeding taxable year. Accordingly, FC may deduct 24.64x of the $25x interest determined under § 1.882–5.

(6) *Example 6: Specified foreign partner with excess business interest expense*–(i) *Facts - Year 1*. FC, a foreign corporation that is not an applicable CFC, owns a 50-percent interest in XYZ, a foreign partnership that is engaged in a trade or business in the United States. XYZ has two lines of businesses, Business S and Business T. Business S produces $50x of taxable income (including interest expense), and Business T produces $40x of taxable income (including interest expense). FC is allocated 50 percent of all items of income and expenses of Business S and Business T. Business S has business interest expense of $30x on $500x of liabilities but has no business interest income. Business T has business interest expense of $50x on $500x of liabilities but has no business interest income. With respect to FC, only Business S produces effectively connected income. FC has an adjusted basis of $500x in XYZ for purposes of § 1.882–5(b), step 1. All of the liabilities of Business S are U.S. booked liabilities for purposes of § 1.882–5(d). FC computes its interest expense under the three-step method described in § 1.882–5(b) through (d) and uses the fixed ratio of 50 percent for purposes of § 1.882–5(c), step 2.

(ii) *Analysis with respect to Year 1*–(A) *Application of section 163(j) to XYZ*. Under § 1.163(j)–6(a), XYZ computes a section 163(j) limitation at the partnership-level. Under § 1.163(j)–6(d), XYZ has ATI of $170x, determined as $90x of taxable income ($50x from Business S + $40x from Business T), increased by $80x of business interest expense ($30x from Business S + $50x from Business T). Under § 1.163(j)–2(b), XYZ's section 163(j) limitation is $51x ($170x x 30 percent). Because XYZ's business interest expense ($80x) exceeds the section 163(j) limitation ($51x), XYZ may only deduct $51x of business interest expense and $29x is disallowed under section 163(j). Under § 1.163(j)–6(f), FC is allocated $14.5x of excess business interest expense (50 percent x $29x). Under paragraph (c)(2) of this section, the amount of allocable business interest expense that can be used by FC is equal to the amount of specified excess business interest, and the amount of such interest that is treated as paid or accrued by FC in the succeeding taxable year is limited to the amount of FC's specified excess taxable income allocated to FC in the succeeding taxable year.

(B) *Application of § 1.882–5 to FC*. FC is a specified foreign partner under paragraph (g)(6) of this section. Under paragraph (e)(1) of this section, FC first determines its interest expense under § 1.882–5 and then determines its disallowed business interest expense. Under § 1.882–5(b), step 1, FC has U.S. assets of $500x (FC's adjusted basis in its interest in XYZ). Under § 1.882–5(c), step 2, applying the 50- percent fixed ratio in § 1.882–5 for a non-banking business, FC has U.S. connected liabilities of $250x ($500x x 50 percent). Under § 1.882–5(d), step 3, FC has U.S. booked liabilities of $250x ($500x x 50-percent share of Business S liabilities of XYZ) and interest on U.S. booked liabilities of $15x (50 percent share of $30x interest expense of Business S). Because FC has U.S. connected liabilities equal to its U.S. booked liabilities, its interest expense under § 1.882–5 is $15x (the amount of interest expense on its U.S. booked liabilities).

(C) *Application of section 163(j) to FC*. Under paragraph (e)(2)(ii) of this section, the amount of business interest expense that is disallowed for FC is equal to the sum of the amount of interest described in paragraph (b)(3) of this section that is disallowed plus the amount of FC's specified excess business interest expense. FC's business interest expense (at the corporate level) under paragraph (b)(3) of this section is $0, the amount determined under § 1.882–5 ($15x) less the amount of interest on U.S. booked liabilities from XYZ determined under § 1.882–5(d)(2)(vii) ($15x), which was subject to the section 163(j) limitation at the XYZ partnership level. Because FC (at the corporate level) has no business interest expense, there is no business interest expense subject to the section 163(j) limitation. However, because FC has excess business interest expense with respect to XYZ, a deduction for a portion of the $15x of interest on U.S. booked liabilities from XYZ determined under § 1.882–5(d)(2)(vii) will be disallowed for the taxable year. The amount of such interest that is limited is equal to the amount of the FC's specified excess business interest expense determined under paragraph (g)(4) of this section. The specified excess business interest expense is $6.82x, determined by multiplying FC's distributive share of excess business interest expense ($14.5x) by XYZ's specified ratio of 47.06 percent, determined under paragraph (g)(8) of this section. The specified ratio of 47.06 percent is determined by dividing $80x ATI determined under paragraph (b)(2) of the section as if XYZ were a specified foreign person (determined as $50x taxable income from Business S + $30x business interest expense from Business S) by $170x of XYZ ATI. FC may only deduct $8.18x ($15x - $6.82x) of business interest expense. Under § 1.163(j)–2(c), the remaining $6.82x is disallowed business interest expense carryforward and under paragraph (e)(1)(ii) of this section, the $6.82x is not taken into account for purposes of applying § 1.882–5 in the succeeding taxable year.

(iii) *Facts - Year 2*. During Year 2, Business S produces $170x of taxable income (including interest expense) and Business T produces $150x (including interest expense) of taxable income. Business S has business interest expense of $30x on $500x of liabilities but has no business interest income. Business T has business interest expense of $50x on $500x of liabilities but no business interest income. With respect to FC, only Business S produces effectively connected taxable income. FC has an adjusted basis of $600x in XYZ for purposes of § 1.882–5(b), step 1. All of the liabilities of Business S are U.S. booked liabilities for purposes of § 1.882–5(d). FC computes its interest expense under the three-step method described in § 1.882–5(b) through (d) and uses the fixed ratio of 50 percent for purposes of § 1.882–5(c), step 2. The interest rate on excess U.S. connected liabilities is 5 percent. For the taxable year, FC has total interest expense of $1,000x for purposes of § 1.882–5(a)(3).

(iv) *Analysis with respect to Year 2*–(A) *Application of section 163(j) to XYZ*. Under § 1.163(j)–6(a), XYZ computes a section 163(j) limitation at the partnership-level. Under § 1.163(j)–6(d), XYZ has ATI of $400x, determined as $320x of taxable income ($170x from Business S + $150x from Business T), increased by $80x of business interest expense ($30x from Business S + $50x from Business T). Under § 1.163(j)–2(b), XYZ's section 163(j) limitation is $120x ($400x x 30 percent). Because XYZ's business interest expense ($80x) does not exceed the section 163(j) limitation ($120x), XYZ can deduct all of its business interest expense for the taxable year. Under § 1.163(j)–1(b)(15), XYZ has excess taxable income of $133.30x ($400x x ($40x/$120x)). Under § 1.163(j)–6(f), FC is allocated 50 percent of the $133.33x of XYZ's excess taxable income, or $66.66x of allocable excess taxable income, but, under paragraph (c)(1) of this section, the amount by which the allocable excess taxable income exceeds FC's specified excess taxable income (as defined in paragraph (g)(5) of this section) is a subtraction from FC's ATI. Under paragraph (g)(5) of this section, FC's specified excess taxable income is $33.33x, which is equal to the product of FC's allocable excess taxable income of $66.66x and XYZ's specified ratio of 50 percent. Under paragraph (g)(8) of this section, XYZ's specified ratio of 50 percent is determined as $200x / $400x (where the numerator of $200x is the ATI of XYZ determined under paragraph (b)(2) of this section as if XYZ were a specified foreign person ($170x taxable income of Business S, increased by $30x of business interest expense), and the denominator of $400x is the ATI of XYZ under § 1.163(j)–6(d)). FC's allocable excess taxable income ($66.66x) exceeds its specified excess taxable income ($33.33x) by $33.33x.

(B) *Treatment of excess business interest expense from Year 1*. In Year 1, XYZ had disallowed business interest expense of $29x and under § 1.163(j)–6(f), FC's allocable excess business interest expense was $14.50x. Under paragraph (c)(2) of this section, FC may use its allocable excess business interest expense in a succeeding taxable year only to the extent of its specified excess business interest expense, which, in this case, was determined to be $6.82x, and, with respect to Year 2, the amount of specified excess business interest expense treated as paid or accrued by FC is limited to FC's specified excess taxable income ($33.33x). Thus, FC can treat the entire $6.82x as business interest expense paid or accrued in Year 2.

(C) *Application of § 1.882–5 to FC*. Under § 1.882–5(b), step 1, FC has U.S. assets of $600x (FC's adjusted basis in its interest in XYZ). Under § 1.882–5(c), step 2, applying the 50 percent fixed ratio in § 1.882–5 for a non-banking business, FC has U.S. connected liabilities of $300x ($600x x 50 percent). Under § 1.882–5(d), step 3, FC has U.S. booked liabilities of $250x ($500x x 50-percent share of Business S liabilities of XYZ) and interest on U.S. booked liabilities of $15x (50 percent share of $30x interest expense of Business S). FC has excess U.S. connected liabilities of $50x ($300x – $250x) and interest on such excess liabilities of $2.5x ($50x x 5 percent). FC's interest expense determined under § 1.882–5 is $17.5x ($15x + $2.5x).

(D) *Application of section 163(j) to FC*. Under paragraph (e)(2)(ii) of this section, the amount of business interest expense that is disallowed for FC is equal to only the amount of interest described in paragraph (b)(3) of this section that is disallowed because there is no excess business interest expense with respect to XYZ. FC's business interest expense (at the corporate level) under paragraphs (b)(3) and (e)(1) of this section is $9.32x, determined as the sum of $2.50x (the amount determined under § 1.882–5 ($17.50x) less the amount of interest on U.S. booked liabilities from XYZ determined under § 1.882–5(d)(2)(vii) ($15x) that is excluded under paragraph (b)(3)(ii) of this section) + $6.82x (allocable business interest expense from Year 1 treated as paid or accrued in Year 2). Under § 1.163(j)–6(e)(1), FC's ATI is determined under § 1.163(j)–1(b)(1) without regard to FC's distributive share of any items of income, gain, deduction, or loss of XYZ. Under paragraph (b)(2) of this section, taking into account the application of paragraph (c)(1) of this section, FC's ATI is $33.33x, determined as $66.66x (excess taxable income from XYZ) – $33.33x (amount excess taxable income exceeds specified excess taxable income). FC's section 163(j) limitation is $10x ($33.33x x 30 percent). Because FC's business interest expense (at the corporate level) of $9.32x is less than FC's section 163(j) limitation of $10x, FC may deduct all $9.32x of business interest expense ($2.50x from Year 2 and $6.82x from Year 1). Because all of XYZ's business interest expense is deductible, FC may also deduct the $15x of business interest expense on U.S. booked liabilities of XYZ for Year 2.

(7) *Example 7: Coordination of section 163(j) and branch profits tax*–(i) *Facts*. FC, a foreign corporation that is not an applicable CFC, uses cash that is treated as a U.S. asset under § 1.884–1(d) in order to pay interest described in paragraph (b)(3) of this section for which a deduction for such interest is disallowed under § 1.163(j)–2(b).

(ii) *Analysis*. Assuming that FC's U.S. assets otherwise remain constant during the year, the U.S. assets of FC will have decreased by the amount of cash used to pay the interest expense, and the U.S. net equity of FC will be computed accordingly.

(i) *Applicability date*. This section applies to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply this section to a taxable year beginning after December 31, 2017, if the taxpayers and their related parties consistently apply all of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–9 Elections for excepted trades or businesses; safe harbor for certain REITs.

(a) *Overview*. This section provides rules and procedures for making an election under section 163(j)(7)(B) to be an electing real property trade or business, as defined in § 1.163(j)–1(b)(12), and an election under section 163(j)(7)(C) to be an electing farming business, as defined in § 1.163(j)–1(b)(11).

(b) *Scope and effect of election*–(1) *In general*. An election under this section is made with respect to each eligible trade or business of the taxpayer and applies only to such trade or business for which the election is made. An election under this section applies to the taxable year in which the election is made and to all subsequent taxable years, except as otherwise provided in this section.

(2) *Irrevocability*. An election under this section is irrevocable.

(c) *Time and manner of making election*–(1) *In general*. Subject to paragraph (e) of this section, a taxpayer makes an election under this section by attaching an election statement to the taxpayer's timely filed original Federal income tax return, including extensions. A taxpayer may make elections for multiple trades or businesses on a single election statement.

(2) *Election statement contents*. The election statement should be titled "Section 1.163(j)–9 Election" and must contain the following information for each trade or business:

(i) The taxpayer's name;

(ii) The taxpayer's address;

(iii) The taxpayer's social security number (SSN) or employer identification number (EIN);

(iv) A description of the taxpayer's electing trade or business, including the principal business activity code; and

(v) A statement that the taxpayer is making an election under section 163(j)(7)(B) or (C), as applicable.

(3) *Consolidated group's trade or business*. For a consolidated group's trade or business, the election under this section is made by the agent for the group, as defined in § 1.1502–77, on behalf of itself and members of the consolidated group. Only the name and taxpayer identification number (TIN) of the agent for the group, as defined in § 1.1502–77, must be provided on the election statement.

(4) *Partnership's trade or business*. An election for a partnership must be made on the partnership's return with respect to any trade or business that the partnership conducts. An election by a partnership does not apply to a trade or business conducted by a partner outside the partnership.

(d) *Termination of election*–(1) *In general*. An election under this section automatically terminates if a taxpayer ceases to engage in the electing trade or business. A taxpayer is considered to cease to engage in an electing trade or business if the taxpayer sells or transfers substantially all of the assets of the electing trade or business to an acquirer that is not a related party in a taxable asset transfer. A taxpayer is also considered to cease to engage in an electing trade or business if the taxpayer terminates its existence for Federal income tax purposes or ceases operation of the electing trade or business, except to the extent that such termination or cessation results in the sale or transfer of substantially all of the assets of the electing trade or business to an acquirer that is a related party, or in a transaction that is not a taxable asset transfer.

(2) *Taxable asset transfer defined*. For purposes of this paragraph (d), the term taxable asset transfer means a transfer in which the acquirer's basis or adjusted basis in the assets is not determined, directly or indirectly, in whole or in part, by reference to the transferor's basis in the assets.

(3) *Related party defined*. For purposes of this paragraph (d), the term *related party* means any person who bears a relationship to the taxpayer which is described section 267(b) or 707(b)(1).

(4) *Anti-abuse rule*. If, within 60 months of a sale or transfer of assets described in paragraph (d)(1) of this section, the taxpayer or a related party reacquires substantially all of the assets that were used in the taxpayer's prior electing trade or business, or substantially similar assets, and resumes conducting such prior electing trade or business, the taxpayer's previously terminated election under this section is reinstated and is effective on the date the prior electing trade or business is reacquired.

(e) *Additional guidance*. The rules and procedures regarding the time and manner of making an election under this section and the election statement contents in paragraph (c) of this section may be modified through other guidance (see §§ 601.601(d) and 601.602 of this chapter). Additional situations in which an election may terminate under paragraph (d) of this section may be provided through guidance published in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(f) *Examples*. The examples of this paragraph (f) illustrate the application of this section. Unless otherwise indicated, assume the following: X and Y are domestic C corporations; D and E are U.S. resident individuals not subject to any foreign income tax; and the exemption for certain small businesses in § 1.163(j)–2(d) does not apply.

(1) *Example 1: Scope of election*–(i) *Facts*. During her taxable year ending December 31, 2019, D, a sole proprietor, owned and operated a dairy farm and a tree farm as separate farming businesses described in section 263A(e)(4). D filed its original Federal income tax return for the 2019 taxable year on August 1, 2020, and included with the return an election statement meeting the requirements of paragraph (c)(2) of this section. The election statement identified D's dairy farm business as an electing trade or business under this section. On March 1, 2021, D sold some but not all or substantially all of the assets from her dairy farm business to her neighbor, E, who is unrelated to D. After the sale, D continued to operate the dairy farm trade or business.

(ii) *Analysis*. D's election under this section was properly made and is effective for the 2019 taxable year and subsequent years. D's dairy farm business is an excepted trade or business because D made the election with her timely filed Federal income tax return. D's tree farm business is a non-excepted trade or business. The sale of some but not all or substantially all of the assets from D's dairy farm business has no impact on D's election under this section.

(2) *Example 2: Cessation of entire trade or business*–(i) *Facts*. X has a real property trade or business for which X made an election under this section by attaching an election statement to A's 2019 Federal income tax return. On March 1, 2020, X sold all of the assets used in its real property trade or business to Y, an unrelated party, and ceased to engage in the electing trade or business. On June 1, 2027, X started a new real property trade or business that was substantially similar to X's prior electing trade or business.

(ii) *Analysis*. X's election under this section terminated on March 1, 2020, under paragraph (d)(1) of this section. X may choose whether to make an election under this section for X's new real property trade or business that A started in 2027.

(3) *Example 3: Anti-abuse rule*–(i) *Facts*. The same facts are the same as in *Example 2* in paragraph (f)(2)(i) of this section, except that X re-started her previous real property trade or business on February 1, 2021, when X reacquired substantially all of the assets that X had sold on March 1, 2020.

(ii) *Analysis*. X's election under this section terminated on March, 1, 2020, under paragraph (d)(1) of this section. On February 1, 2021, X's election was reinstated under paragraph (d)(4) of this section. X's new real property trade or business is treated as a resumption of X's prior electing trade or business and is therefore treated as an electing real property trade or business.

(4) *Example 4: Trade or business continuing after acquisition*–(i) *Facts*. X has a farming business for which X made an election under this section by attaching an election statement to X's timely filed 2019 Federal income tax return. Y, unrelated to X, also has a farming business, but Y has not made an election under this section. On July 1, 2020, X transferred all of its assets to Y in a transaction described in section 368(a)(1)(D) (a "D reorganization"). After the transfer, Y continues to operate the farming trade or business acquired from X.

(ii) *Analysis*. Under paragraph (d)(1) of this section, Y is subject to X's election under this section for the trade or business that uses X's assets because the sale or transfer was not in a taxable transaction. Y cannot revoke X's election, but X's election has no effect on Y's existing farming business for which Y has not made an election under this section.

(5) *Example 5: Trade or business merged after acquisition*–(i) *Facts*. The facts are the same as in *Example 4* in paragraph (f)(4)(i) of this section, except that Y uses the assets acquired from X in a trade or business that is neither a farming business (as defined in section 263A(e)(4) or § 1.263A–4(a)(4)) nor a trade or business of a specified agricultural or horticultural cooperative (as defined in section 199A(g)(4)).

(ii) *Analysis*. Y is not subject to X's election for Y's farming business because the farming trade or business ceased to exist after the acquisition.

(g) *Safe harbor for REITs*–(1) *In general*. If a REIT holds real property, as defined in § 1.856–10, interests in partnerships holding real property, as defined in § 1.856–10, or shares in other REITs holding real property, as defined in § 1.856–10, the REIT is eligible to make the election described in paragraph (b)(1) of this section to be an electing real property trade or business for purposes of sections 163(j)(7)(B) and 168(g)(1)(F) for all or part of its assets. The portion of the REIT's assets eligible for this election is determined under paragraph (g)(2) or (3) of this section.

(2) *REITs that do not significantly invest in real property financing assets*. If a REIT makes an election described in paragraph (g)(1) of this section and the value of the REIT's real property financing assets, as defined in paragraphs (g)(5) and (6) of this section, at the close of the taxable year is 10 percent or less of the value of the REIT's total assets at the close of the taxable year, as determined under section 856(c)(4)(A), then all of the REIT's assets are treated as assets of an excepted trade or business.

(3) *REITs that significantly invest in real property financing assets*. If a REIT makes an election described in paragraph (g)(1) of this section and the value of the REIT's real property financing assets, as defined in paragraphs (g)(5) and (6) of this section, at the close of the taxable year is more than 10 percent of the value of the REIT's total assets at the close of the taxable year, as determined under section 856(c)(4)(A), then for allocation of interest expense, interest income, and other items of expense and gross income to ex-

cepted and non-excepted trades or businesses, the REIT must apply the rules set forth in § 1.163(j)–10 as modified by paragraph (g)(4) of this section.

(4) *REIT real property assets, interests in partnerships, and shares in other REITs*–(i) *Real property assets*. Assets held by a REIT described in paragraph (g)(3) of this section that meet the definition of real property under § 1.856–10 are treated as assets of an excepted trade or business.

(ii) *Partnership interests*. If a REIT described in paragraph (g)(3) of this section holds an interest in a partnership, in applying the partnership look-through rule described in § 1.163(j)–10(c)(5)(ii)(A)(*2*), the REIT treats assets of the partnership that meet the definition of real property under § 1.856–10 as assets of an excepted trade or business. This application of the definition of real property under § 1.856–10 does not affect the characterization of the partnership's assets at the partnership level or for any non-REIT partner.

(iii) *Shares in other REITs*. If a REIT (shareholder REIT) described in paragraph (g)(3) of this section holds an interest in another REIT, then for purposes of applying the allocation rules in § 1.163(j)–10, the partnership look-through rule described in § 1.163(j)–10(c)(5)(ii)(A)(*2*) applies to the assets of the other REIT (as if the other REIT were a partnership) in determining the extent to which shareholder REIT's adjusted basis in the shares of the other REIT is allocable to an excepted or non-excepted trade or business of shareholder REIT. However, no portion of the adjusted basis of shareholder REIT's shares in the other REIT is allocated to a non-excepted trade or business if all of the other REIT's assets are treated as assets of an excepted trade or business under paragraph (g)(2) of this section. If shareholder REIT does not receive from the other REIT the information necessary to determine whether and the extent that the assets of the other REIT are investments in real property financing assets, then shareholder REIT's shares in the other REIT are treated as assets of a non-excepted trade or business under § 1.163(j)–10(c).

(5) *Value of shares in other REITs*. If a REIT (shareholder REIT) holds shares in another REIT, then for purposes of applying the value tests under paragraphs (g)(2) and (3) of this section, the value of shareholder REIT's real property financing assets includes the portion of the value of shareholder REIT's shares in the other REIT that is attributable to the other REIT's investments in real property financing assets. However, no portion of the value of shareholder REIT's shares in the other REIT is included in the value of shareholder REIT's real property financing assets if all of the other REIT's assets are treated as assets of an excepted trade or business under paragraph (g)(2) of this section. If shareholder REIT does not receive from the other REIT the information necessary to determine whether and the extent that the assets of the other REIT are investments in real property financing assets, then shareholder REIT's shares in the other REIT are treated as real property financing assets for purposes of paragraphs (g)(2) and (3) of this section.

(6) *Real property financing assets*. For purposes of this paragraph (g), *real property financing assets* include interests, including participation interests, in the following: mortgages, deeds of trust, and installment land contracts; mortgage pass-thru certificates guaranteed by Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), or Canada Mortgage and Housing Corporation (CMHC); REMIC regular interests; other interests in investment trusts classified as trusts under § 301.7701–4(c) of this chapter that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be permitted investments if the investment trust were a REMIC; obligations secured by manufactured housing treated as single family residences under section 25(e)(10), without regard to the treatment of the obligations or the properties under state law; and debt instruments issued by publicly offered REITs.

(h) *Special anti-abuse rule for certain real property trades or businesses*–(1) *In general*. Except as provided in paragraph (h)(2) of this section, a real property trade or business does not constitute a trade or business eligible for an election described in paragraph (b)(1) of this section to be an electing real property trade or business if at least 80 percent, determined by fair market value, of the business's real property is leased, whether or not the arrangement is pursuant to a written lease or pursuant to a service contract or another agreement that is not denominated as a lease, to a trade or business under common control with the real property trade or business. For purposes of this paragraph (h), two trades or businesses are under common control if 50 percent of the direct and indirect ownership of both businesses are held by related parties within the meaning of sections 267(b) and 707(b).

(2) *Exception for certain REITs*. The special anti-abuse rule in paragraph (h)(1) does not apply to REITs that lease qualified lodging facilities, as defined in section 856(d)(9)(D), and qualified health care properties, as defined in section 856(e)(6)(D).

(i) *Applicability date*. This section applies to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–10 Allocation of interest expense, interest income, and other items of expense and gross income to an excepted trade or business.

(a) *Overview*–(1) *In general*–(i) *Purposes*. This section provides the exclusive rules for allocating tax items that are properly allocable to a trade or business between excepted trades or businesses and non-excepted trades or businesses for purposes of section 163(j). The amount of a taxpayer's interest expense that is properly allocable to excepted trades or businesses is not subject to limitation under section 163(j). The amount of a taxpayer's other items of income, gain, deduction, or loss, including interest income, that is properly allocable to excepted trades or businesses is excluded from the calculation of the taxpayer's section 163(j) limitation. See section 163(j)(6) and (j)(8)(A)(i); see also § 1.163(j)–1(b)(1)(i)(H), (b)(1)(ii)(F), and (b)(3). The general method of allocation set forth in paragraph (c) of this section is based on the approach that money is fungible and that interest expense is attributable to all activities and property, regardless of any specific purpose for incurring an obligation on which interest is paid. In no event may the amount of interest expense allocated under this section exceed the amount of interest paid or accrued, or treated as paid or accrued, by the taxpayer within the taxable year.

(ii) *Application of section*. The amount of a taxpayer's tax items properly allocable to a trade or business, other than interest expense and interest income, that is properly allocable to excepted trades or businesses for purposes of section 163(j) is determined as set forth in paragraph (b) of this section. The amount of a taxpayer's interest expense and interest income that is properly allocable to excepted trades or businesses for purposes of section 163(j) generally is determined as set forth in paragraph (c) of this section, except as otherwise provided in paragraph (d) of this section. For purposes of this section, a taxpayer's activities are not treated as a trade or business if those activities do not involve the provision of services or products to a person other than the taxpayer. For example, if a taxpayer engaged in a manufacturing trade or business has in-house legal personnel that provide legal services solely to the taxpayer, the taxpayer is not treated as also engaged in the trade or business of providing legal services.

(2) *Coordination with other rules*–(i) *In general*. The rules of this section apply after a taxpayer has determined whether any interest expense or interest income paid, received, or accrued is properly allocable to a trade or business. Similarly, the rules of this section apply to other tax items after a taxpayer has determined whether those items are properly allocable to a trade or business. For instance, a taxpayer must apply § 1.163–8T to determine which items of interest expense are investment interest under section 163(d) before applying the rules in paragraph (c) of this section to allocate interest expense between excepted and non-excepted trades or businesses. After determining whether its tax items are properly allocable to a trade or business, a taxpayer that is engaged in both excepted and non-excepted trades or businesses must apply the rules of this section to determine the amount of interest expense that is business interest expense subject to limitation under section 163(j) and to determine which items are included or excluded in computing its section 163(j) limitation.

(ii) *Treatment of investment interest, investment income, and investment expenses of a partnership with a C corporation or tax-exempt corporation as a partner*. For rules governing the treatment of investment interest, investment income, and investment expenses of a partnership with a C corporation or tax-exempt corporation as a partner, see §§ 1.163(j)–4(b)(3) and 1.163(j)–6(j).

(3) *Application of allocation rules to foreign corporations and foreign partnerships*. The rules of this section apply to foreign corporations and foreign partnerships. See §§ 1.163(j)–7 and 1.163(j)–8.

(4) *Application of allocation rules to members of a consolidated group*–(i) *In general*. As provided in § 1.163(j)–4(d), the computations required by section 163(j) and the section 163(j) regulations generally are made for a consolidated group on a consolidated basis. In this regard, for purposes of applying the allocation rules of this section, all members of a consolidated group are treated as one corporation. Therefore, the rules of this section apply to the activities conducted by the group as if those activities were conducted by a single corporation. For example, the group (rather than a particular member) is treated as engaged in excepted or non-excepted trades or businesses. In the case of intercompany obligations, within the meaning of § 1.1502–13(g)(2)(ii), for purposes of allocating asset basis between excepted and non-excepted trades or businesses, the obligation of the member borrower is not considered an asset of the creditor member. Similarly, intercompany transactions, within the meaning of § 1.1502–13(b)(1)(i), are disregarded for purposes of this section, as are the resulting offsetting items, and property is not treated as used in a trade or business to the extent the use of such property in that trade or business derives from an intercompany transaction. Further, stock of a group member that is owned by another member of the same group is not treated as an asset for purposes of this section, and the transfer of any amount of member stock to a non-member is treated by the group as a transfer of the member's assets proportionate to the amount of member stock transferred. Additionally, stock of a corporation that is not a group member is treated as owned by the group.

(ii) *Application of excepted business percentage to members of a consolidated group*. After a consolidated group has determined the percentage of the group's interest expense allocable to excepted trades or businesses for the taxable year (and thus not subject to limitation under section 163(j)), this exempt percentage is applied to the interest paid or accrued by each member during the taxable year to any lender that is not a group member. Therefore, except to the extent paragraph (d) of this section (providing rules for certain qualified nonrecourse indebtedness) applies, an identical percentage of the interest paid or accrued by each member of the group to any lender that is not a group member will be treated as allocable to excepted trades or businesses, regardless of whether any particular member actually engaged in an excepted trade or business.

(iii) *Basis in assets transferred in an intercompany transaction*. For purposes of allocating interest expense and interest income under paragraph (c) of this section, the basis of property does not include any gain or loss realized with respect to the property by another member in an intercompany transaction, as defined in § 1.1502–13(b), whether or not the gain or loss is deferred.

(5) *Tax-exempt organizations*. For organizations subject to tax under section 511, section 512 and the regulations thereunder determine the rules for allocating all income and expenses among multiple trades or businesses.

(6) [Reserved]

(7) *Examples*. The following examples illustrate the principles of this paragraph (a).

(i) *Example 1: Items properly allocable to a trade or business*–(A) *Facts*. Individual T operates Business X, a non-excepted trade or business, as a sole proprietor. In Year 1, T pays or accrues $40x of interest expense and receives $100x of gross income with respect to Business X that is not eligible for a section 199A deduction. T borrows money to buy a car for personal use, and T pays or accrues $20x of interest expense with respect to the car loan. T also invests in corporate bonds, and, in Year 1, T receives $50x of interest income on those bonds.

(B) *Analysis*. Under paragraphs (a)(1) and (2) of this section, T must determine which items of income and expense, including items of interest income and interest expense, are properly allocable to a trade or business. T's $100x of gross income and T's $40x of interest expense with respect to Business X are properly allocable to a trade or business. However, the interest expense on T's car loan is personal interest within the meaning of section 163(h)(2) rather than interest properly allocable to a trade or business. Similarly, T's interest income from corporate bonds is not properly allocable to a trade or business because it is interest from investment activity. See section 163(d)(4)(B).

(ii) *Example 2: Intercompany transaction*–(A) *Facts*. S is a member of a consolidated group of which P is the common parent. P conducts an electing real property trade or business (Business X), and S conducts a non-excepted trade or business (Business Y). P leases Building V (which P owns) to S for use in Business Y.

(B) *Analysis*. Under paragraph (a)(4)(i) of this section, a consolidated group is treated as a single corporation for purposes of applying the allocation rules of this section, and the consolidated group (rather than a particular member of the group) is treated as engaged in excepted and non-excepted trades or businesses. Thus, intercompany transactions are disregarded for purposes of this section. As a result, the lease of Building V by P to S is disregarded. Moreover, because Building V is used in Business Y, basis in this asset is allocated to Business Y rather than Business X for purposes of these allocation rules, regardless of which member (P or S) owns the building.

(b) *Allocation of tax items other than interest expense and interest income*–(1) *In general*. For purposes of calculating ATI, tax items other than interest expense and interest income are allocated to a particular trade or business in the manner described in this paragraph (b). It is not necessary to allocate items under this paragraph (b) for purposes of calculating ATI if all of the taxpayer's items subject to allocation under this paragraph (b) are allocable to excepted trades or businesses, or if all of those items are allocable to non-excepted trades or businesses.

(2) *Gross income other than dividends and interest income*. A taxpayer's gross income other than dividends and interest income is allocated to the trade or business that generated the gross income.

(3) *Dividends*–(i) *Look-through rule*. If a taxpayer receives a dividend, within the meaning of section 316, that is not investment income, within the meaning of section 163(d), and if the taxpayer looks through to the assets of the payor corporation under paragraph (c)(5)(ii) of this section for the taxable year, then, solely for purposes of allocating amounts received as a dividend during the taxable year to excepted or non-excepted trades or businesses under this paragraph (b), the dividend income is treated as allocable to excepted or non-excepted trades or businesses based upon the relative amounts of the payor corporation's adjusted basis in the assets used in its trades or businesses, determined pursuant to paragraph (c) of this section. If at least 90 percent of the payor corporation's adjusted basis in its assets during the taxable year, determined pursuant to paragraph (c) of this section, is allocable to either excepted trades or businesses or to non-excepted trades or businesses, all of the taxpayer's dividend income from the payor corporation for the taxable year is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(ii) *Inapplicability of the look-through rule*. If a taxpayer receives a dividend that is not investment income, within the meaning of section 163(d), and if the taxpayer does not look through to the assets of the payor corporation under paragraph (c)(5)(ii) of this section for the taxable year, then the taxpayer must treat the dividend as allocable to a non-excepted trade or business.

(4) *Gain or loss from the disposition of non-consolidated C corporation stock, partnership interests, or S corporation stock*–(i) *Non-consolidated C corporations*. If a taxpayer recognizes gain or loss upon the disposition of stock in a non-consolidated C corporation that is not property held for investment, within the meaning of section 163(d)(5), and if the taxpayer looks through to the assets of the C corporation under paragraph (c)(5)(ii) of this section for the taxable year, then the taxpayer must allocate gain or loss from the disposition of stock to excepted or non-excepted trades or businesses based upon the relative amounts of the corporation's adjusted basis in the assets used in its trades or businesses, determined pursuant to paragraph (c) of this section. However, if a taxpayer recognizes gain or loss upon the disposition of stock in a non-consolidated C corporation that is not property held for investment, within the meaning of section 163(d)(5), and if the taxpayer does not look through to the assets of the C corporation under paragraph (c)(5)(ii) of this section for the taxable year, then the taxpayer must treat the gain or loss from the disposition of stock as allocable to a non-excepted trade or business. For rules governing the transfer of stock of a member of a consolidated group, see paragraph (a)(4)(i) of this section.

(ii) *Partnerships and S corporations*. (A) If a taxpayer recognizes gain or loss upon the disposition of interests in a partnership or stock in an S corporation that owns:

(*1*) Non-excepted assets and excepted assets;

(*2*) Investment assets; or

(*3*) Both;

(B) The taxpayer determines a proportionate share of the amount properly allocable to a non-excepted trade or business in accordance with the allocation rules set forth in paragraph (c)(5)(ii)(A) or (c)(5)(ii)(B)(3) of this section, as appropriate, and includes such proportionate share of gain or loss in the taxpayer's ATI. This rule also applies to tiered passthrough entities, as defined in § 1.163(j)–7(f)(13), by looking through each passthrough entity tier (for example, an S corporation that is the partner of the highest-tier partnership would look through each lower-tier partnership), subject to paragraph (c)(5)(ii)(D) of this section. With respect to a partner that is a C corporation or tax-exempt corporation, a partnership's investment assets are taken into account and treated as non-excepted trade or business assets.

(5) *Expenses, losses, and other deductions*–(i) *Expenses, losses, and other deductions that are definitely related to a trade or business*. Expenses (other than interest expense), losses, and other deductions (collectively, *deductions* for purposes of this paragraph (b)(5)) that are definitely related to a trade or business are allocable to the trade or business to which they relate. A deduction is considered definitely related to a trade or business if the item giving rise to the deduction is incurred as a result of, or incident to, an activity of the trade or business or in connection with property used in the trade or business (see § 1.861–8(b)(2)). If a deduction is definitely related to one or more

excepted trades or businesses and one or more non-excepted trades or businesses, the deduction is apportioned between the excepted and non-excepted trades or businesses based upon the relative amounts of the taxpayer's adjusted basis in the assets used in those trades or businesses, as determined under paragraph (c) of this section.

(ii) *Other deductions*. Deductions that are not described in paragraph (b)(5)(i) of this section are ratably apportioned to all gross income.

(6) *Treatment of certain investment items of a partnership with a C corporation partner*. Any investment income or investment expenses that a partnership receives, pays, or accrues and that is treated as properly allocable to a trade or business of a C corporation partner under § 1.163(j)–4(b)(3)(i) is treated as properly allocable to a non-excepted trade or business of the C corporation partner.

(7) *Example: Allocation of income and expense.* The following example illustrates the principles of this paragraph (b):

(i) *Facts*. T conducts an electing real property trade or business (Business Y), which is an excepted trade or business. T also operates a lumber yard (Business Z), which is a non-excepted trade or business. In Year 1, T receives $100x of gross rental income from real property leasing activities. T also pays or accrues $60x of expenses in connection with its real property leasing activities and $20x of legal services performed on behalf of both Business Y and Business Z. T receives $60x of gross income from lumber yard customers and pays or accrues $50x of expenses related to the lumber yard business. For purposes of expense allocations under paragraphs (b) and (c) of this section, T has $240x of adjusted basis in its Business Y assets and $80x of adjusted basis in its Business Z assets.

(ii) *Analysis*. Under paragraph (b)(2) of this section, for Year 1, $100x of rental income is allocated to Business Y, and $60x of income from lumber yard customers is allocated to Business Z. Under paragraph (b)(5)(i) of this section, $60x of expenses paid or accrued in connection with real property leasing activities are allocated to Business Y, and $50x of expenses related to the lumber yard are allocated to Business Z. The $20x of remaining expenses for legal services performed on behalf of both Business Y and Business Z are allocated according to the relative amounts of T's basis in the assets used in each business. The total amount of T's basis in the assets used in Businesses Y and Z is $320x, of which 75 percent ($240x / $320x) is used in Business Y and 25 percent ($80x / $320x) is used in Business Z. Accordingly, $15x of the expenses for legal services are allocated to Business Y and $5x are allocated to Business Z.

(c) *Allocating interest expense and interest income that is properly allocable to a trade or business*–(1) *General rule*–(i) *In general*. Except as otherwise provided in this section, the amount of a taxpayer's interest expense and interest income that is properly allocable to a trade or business is allocated to the taxpayer's excepted or non-excepted trades or businesses for purposes of section 163(j) based upon the relative amounts of the taxpayer's adjusted basis in the assets, as determined under paragraph (c)(5) of this section, used in its excepted or non-excepted trades or businesses. The taxpayer must determine the adjusted basis in its assets as of the close of each determination date, as defined in paragraph (c)(6) of this section, in the taxable year and average those amounts to determine the relative amounts of asset basis for its excepted and non-excepted trades or businesses for that year. It is not necessary to allocate interest expense or interest income under this paragraph (c) for purposes of determining a taxpayer's business interest expense and business interest income if all of the taxpayer's interest income and expense is allocable to excepted trades or businesses (in which case the taxpayer is not subject to the section 163(j) limitation) or if all of the taxpayer's interest income and expense is allocable to non-excepted trades or businesses.

(ii) *De minimis exception*. If 90 percent or more of the taxpayer's basis in its assets for the taxable year is allocable to either excepted or non-excepted trades or businesses pursuant to this paragraph (c), then all of the taxpayer's interest expense and interest income for that year that is properly allocable to a trade or business is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(2) *Example*. The following example illustrates the principles of paragraph (c)(1) of this section: T is a calendar-year C corporation engaged in an electing real property trade or business, the business of selling wine, and the business of selling hand-carved wooden furniture. In Year 1, T has $100x of interest expense that is deductible except for the potential application of section 163(j). Based upon determinations made on the determination dates of March 31, June 30, September 30, and December 31, T's average adjusted basis in the assets used in the electing real property trade or business (an excepted trade or business) in Year 1 is $800x, and T's total average adjusted basis in the assets used in the other two businesses in Year 1 is $200x. Thus, $80x (($800x / ($800x + $200x)) x $100x) of T's interest expense for Year 1 is allocable to T's electing real property trade or business and is not business interest expense subject to limitation under section 163(j). The remaining $20x of T's interest expense is business interest expense for Year 1 that is subject to limitation under section 163(j).

(3) *Asset used in more than one trade or business*–(i) *General rule*. If an asset is used in more than one trade or business during a determination period, as defined in paragraph (c)(6) of this section, the taxpayer's adjusted basis in the asset is allocated to each trade or business using the permissible methodology under this paragraph (c)(3) that most reasonably reflects the use of the asset in each trade or business during that determination period. An allocation methodology most reasonably reflects the use of the asset in each trade or business if it most properly reflects the proportionate benefit derived from the use of the asset in each trade or business. If none of the permissible methodologies set forth in paragraph (c)(3)(ii) of this section reasonably reflects the use of the asset in each trade or business, the taxpayer's basis in the asset is not taken into account for purposes of this paragraph (c).

(ii) *Permissible methodologies for allocating asset basis between or among two or more trades or businesses*. Subject to the special rules in paragraphs (c)(3)(iii) and (c)(5) of this section, a taxpayer's basis in an asset used in two or more trades or businesses during a determination period may be allocated to those trades or businesses based upon–

(A) The relative amounts of gross income that an asset generates, has generated, or may reasonably be expected to generate, within the meaning of § 1.861–9T(g)(3), with respect to the trades or businesses;

(B) If the asset is land or an inherently permanent structure, the relative amounts of physical space used by the trades or businesses; or

(C) If the trades or businesses generate the same unit of output, the relative amounts of output of those trades or businesses (for example, if an asset is used in two trades or businesses, one of which is an excepted regulated utility trade or business, and the other of which is a non-excepted regulated utility trade or business, the taxpayer may allocate basis in the asset based upon the relative amounts of kilowatt-hours generated by each trade or business).

(iii) *Special rules*–(A) *Consistent allocation methodologies*–(*1*) *In general*. Except as otherwise provided in paragraph (c)(3)(iii)(A)(*2*) of this section, a taxpayer may not vary its allocation methodology from one determination period to the next within a taxable year or from one taxable year to the next.

(*2*) *Consent to change allocation methodology*. If a taxpayer determines that a different allocation methodology properly reflects the proportionate benefit derived from the use of assets in its trades or businesses, the taxpayer may change its method of allocation under paragraphs (c)(3)(i) and (ii) of this section with the consent of the Commissioner. To obtain consent, a taxpayer must submit a request for a letter ruling under the applicable administrative procedures, and consent only will be granted in extraordinary circumstances.

(B) *De minimis exceptions*–(*1*) *De minimis amount of gross income from trades or businesses*. If at least 90 percent of gross income that an asset generates, has generated, or may reasonably be expected to generate, within the meaning of § 1.861–9T(g)(3), during a determination period is with respect to either excepted trades or businesses or non-excepted trades or businesses, the taxpayer's entire basis in the asset for the determination period must be allocated to either excepted or non-excepted trades or businesses, respectively.

(*2*) *De minimis amount of asset basis allocable to a trade or business*. If 90 percent or more of the taxpayer's basis in an asset would be allocated to either excepted trades or businesses or non-excepted trades or businesses during a determination period pursuant to this paragraph (c)(3), the taxpayer's entire basis in the asset for the determination period must be allocated to either excepted or non-excepted trades or businesses, respectively.

(C) *Allocations of excepted regulated utility trades or businesses*–(*1*) *In general*. Except as provided in the de minimis rule in paragraph (c)(3)(iii)(C)(*3*) of this section, if a taxpayer is engaged in the trade or business of the furnishing or sale of items described in § 1.163(j)–1(b)(13)(i)(A), the taxpayer is engaged in an excepted regulated utility trade or business only to the extent the rates for the items furnished and sold are described in § 1.163(j)–1(b)(13)(i)(B). Thus, for example, electricity sold at market rates rather than on a cost of service and rate of return basis must be treated as electricity sold by a non-excepted regulated utility trade or business. The taxpayer must allocate under this paragraph (c) the basis of assets used in the utility trade or business between its excepted and non-excepted trades or businesses.

(*2*) *Permissible method for allocating asset basis for utility trades or businesses*. In the case of a utility trade or business described in paragraph (c)(3)(iii)(C)(*1*) of this section, and except as provided in the de minimis rule in paragraph (c)(3)(iii)(C)(*3*) of this section, the method described in paragraph (c)(3)(ii)(C) of this section is the only permissible method for allocating the taxpayer's basis in assets used in the trade or business between the taxpayer's excepted and non-excepted trades or businesses of selling or furnishing the items described in § 1.163(j)–1(b)(13)(i)(A).

(*3*) *De minimis rule for excepted utility trades or businesses*. If a taxpayer is engaged in a utility trade or business described in paragraph (c)(3)(iii)(C)(*1*) of this section, and if more than 90 percent of the items described in § 1.163(j)–1(b)(13)(i)(A) are furnished or sold at rates determined in the manner described in § 1.163(j)–1(b)(13)(i)(B), the taxpayer's entire trade or business is an excepted regulated utility trade or business, and paragraph (c)(3)(iii)(C)(*2*) of this section does not apply.

(*4*) *Example*. The following example illustrates the principles of this paragraph (c)(3)(iii)(C):

(*i*) *Facts*. X, a C corporation, is engaged in the trade or business of generating electrical energy. During each determination period in the taxable year, 80 percent of the kilowatts generated in the electricity generation trade or business is sold at rates established by a public utility commission on a rate of return basis. The remaining 20 percent of the kilowatts is sold on the wholesale markets at rates not established on a rate of return basis or by the governing or ratemaking body of an electric cooperative. None of the assets used in X's utility generation trade or business are used in any other trade or business.

(*ii*) *Analysis*. For purposes of section 163(j), under paragraph (c)(3)(iii)(C)(*1*) of this section, 80 percent of X's electricity generation business is an excepted regulated utility trade or business, and the remaining 20 percent of X's business is a non-excepted utility trade or business. Under paragraph (c)(3)(iii)(C)(*2*) of this section, X must allocate 80 percent of the basis of the assets used in its utility business to excepted trades or business and the remaining 20 percent of the basis in its assets to non-excepted trades or businesses.

(4) *Disallowed business interest expense carryforwards; floor plan financing interest expense*. Disallowed business interest expense carryforwards (which were treated as allocable to a non-excepted trade or business in a prior taxable year) are not re-allocated between non-excepted and excepted trades or businesses in a succeeding taxable year. Instead, the carryforwards continue to be treated as allocable to a non-excepted trade or business. Floor plan financing interest expense also is not subject to allocation between excepted and non-excepted trades or businesses (see § 1.163(j)–1(b)(17)) and is always treated as allocable to non-excepted trades or businesses.

(5) *Additional rules relating to basis*–(i) *Calculation of adjusted basis*–(A) *Non-depreciable property other than land*. Except as otherwise provided in paragraph (c)(5)(i)(E) of this section, for purposes of this section, the adjusted basis of an asset other than land with respect to which no deduction is allowable under section 167, section 168 of the Internal Revenue Code of 1954 (former section 168), or section 197, as applicable, is the adjusted basis of the asset for determining gain or loss from the sale or other disposition of that asset as provided in § 1.1011–1. Self-created intangible assets are not taken into account for purposes of this paragraph (c).

(B) *Depreciable property other than inherently permanent structures*. For purposes of this section, the adjusted basis of any tangible asset with respect to which a deduction is allowable under section 167, other than inherently permanent structures, is determined by using the alternative depreciation system under section 168(g) before any application of the additional first-year depreciation deduction (for example, under section 168(k) or (m)), and the adjusted basis of any tangible asset with respect to which a deduction is allowable under former section 168, other than inherently permanent structures, is determined by using the taxpayer's method of computing depreciation for the asset under former section 168. The depreciation deduction with respect to the property described in this paragraph (c)(5)(i)(B) is allocated ratably to each day during the period in the taxable year to which the depreciation relates.

(C) *Special rule for land and inherently permanent structures*. Except as otherwise provided in paragraph (c)(5)(i)(E) of this section, for purposes of this section, the adjusted basis of any asset that is land, including nondepreciable improvements to land, or an inherently permanent structure is its unadjusted basis.

(D) *Depreciable or amortizable intangible property and depreciable income forecast method property*. For purposes of this section, the adjusted basis of any intangible asset with respect to which a deduction is allowable under section 167 or 197, as applicable, is determined in accordance with section 167 or 197, as applicable, and the adjusted basis of any asset described in section 167(g)(6) for which the deduction allowable under section 167 is determined by the taxpayer under section 167(g), is determined in accordance with section 167(g). The depreciation or amortization deduction with respect to the property described in this paragraph (c)(5)(i)(D) is allocated ratably to each day during the period in the taxable year to which the depreciation or amortization relates.

(E) *Assets not yet used in a trade or business*. Assets that have been acquired or that are under development but that are not yet used in a trade or business are not taken into account for purposes of this paragraph (c). For example, construction works in progress (such as buildings, airplanes, or ships) are not taken into account for purposes of this paragraph (c). Similarly, land acquired by a taxpayer for construction of a building by the taxpayer to be used in a trade or business is not taken into account for purposes of this paragraph (c) until the building is placed in service. This rule does not apply to interests in a partnership or stock in a corporation.

(F) *Trusts established to fund specific liabilities*. Trusts required by law to fund specific liabilities (for example, pension trusts and plant decommissioning trusts) are not taken into account for purposes of this paragraph (c).

(G) *Inherently permanent structure.* For purposes of this section, the term *inherently permanent structure* has the meaning provided in § 1.856–10(d)(2).

(ii) *Partnership interests; stock in nonconsolidated domestic corporations*–(A) *Partnership interests*–(*1*) *Calculation of asset basis*. For purposes of this section, a partner's interest in a partnership is treated as an asset of the partner. For these purposes, the partner's adjusted basis in a partnership interest is reduced, but not below zero, by the partner's share of partnership liabilities, as determined under section 752, and is further reduced as provided in paragraph (c)(5)(ii)(A)(*2*)(*iii*) of this section.

(*2*) *Allocation of asset basis*–(*i*) *In general*. For purposes of determining the extent to which a partner's adjusted basis in its partnership interest is allocable to an excepted or non-excepted trade or business, the partner may look through to such partner's share of the partnership's basis in the partnership's assets, taking into account any adjustments under sections 734(b) and 743(b), and adjusted to the extent required under paragraph (d)(4) of this section, except as otherwise provided in paragraph (c)(5)(ii)(D) of this section. For purposes of the preceding sentence, such partner's share of partnership assets is determined using a reasonable method taking into account special allocations under section 704(b). Notwithstanding paragraph (c)(7) of this section, if a partner's direct and indirect interest in a partnership is greater than or equal to 80 percent of the partnership's capital or profits, the partner must apply the rules in this paragraph (c)(5)(ii)(A) to look through to the partnership's basis in the partnership's assets.

(*ii*) *De minimis rule*. If, after applying paragraph (c)(5)(ii)(A)(*2*)(*iii*) of this section, at least 90 percent of a partner's share of a partnership's basis in its assets (including adjustments under sections 734(b) and 743(b)) is allocable to either excepted trades or businesses or non-excepted trades or businesses, without regard to assets not properly allocable to a trade or business, the partner's entire basis in its partnership interest is treated as allocable to either excepted or non-excepted trades or businesses, respectively. For purposes of the preceding sentence, such partner's share of partnership assets is determined using a reasonable method taking into account special allocations under section 704(b).

(*iii*) *Partnership assets not properly allocable to a trade or business*. For purposes of applying paragraphs (c)(5)(ii)(A)(*2*)(*i*) and (*ii*) of this section with respect to a partner that is a C corporation or tax-exempt corporation, such partner's share of a partnership's assets that are not properly allocable to a trade or business is treated as properly allocable to an excepted or non-excepted trade or business with respect to such partner in the same manner that such assets would be treated if held directly by such partner. With respect to a partner other than a C corporation or tax-exempt corporation, a partnership's assets that are not properly allocable to a trade or business are treated as neither excepted nor non-excepted trade or business assets, and such partner's adjusted basis in its partnership interest is reduced by that partner's share of the partnership's asset basis with respect to those assets. For purposes of this paragraph (c)(5)(ii)(A)(*2*)(*iii*), such partner's share of a partnership's assets is determined under a reasonable method taking into account special allocations under section 704(b).

(*iv*) *Inapplicability of partnership look-through rule*. If a partner, other than a C corporation or a tax-exempt corporation, chooses not to look through to the partnership's basis in the partnership's assets under paragraph (c)(5)(ii)(A)(*2*)(*i*) of this section or is precluded by paragraph (c)(5)(ii)(D) of this section from applying such partnership look-through rule, the partner generally will treat its basis in the partnership interest as either an asset held for investment or a non-excepted trade or business asset as determined under section 163(d). If a partner that is a C corporation or a tax-exempt corporation chooses not to look through to the partnership's basis in the partnership's assets under paragraph (c)(5)(ii)(A)(*2*)(*i*) of this section or is precluded by paragraph (c)(5)(ii)(D) of this section from applying such partnership look-through rule, the taxpayer must treat its entire basis in the partnership interest as allocable to a non-excepted trade or business.

(B) *Stock in non-consolidated domestic corporations*–(*1*) *In general*. For purposes of this section, if a taxpayer owns stock in a domestic C corporation that is not a member of the taxpayer's consolidated group, or if the taxpayer owns stock in an S corporation, the stock is treated as an asset of the taxpayer.

(*2*) *Domestic non-consolidated C corporations*–(*i*) *Allocation of asset basis*. If a shareholder satisfies the minimum ownership threshold in paragraph (c)(7) of this section, then, for purposes of determining the extent to which the shareholder's basis in its stock in the domestic non-consolidated C corporation is allocable to an excepted or non-excepted trade or business, the shareholder must look through to the corporation's basis in the corporation's assets, adjusted to the extent required under paragraph (d)(4) of this section, except as otherwise provided in paragraph (c)(5)(ii)(D) of this section.

(*ii*) *De minimis rule*. If at least 90 percent of the domestic non-consolidated C corporation's basis in the corporation's assets is allocable to either excepted trades or businesses or non-excepted trades or businesses, the shareholder's entire interest in the corporation's stock is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(*iii*) *Inapplicability of corporate look-through rule*. If a shareholder other than a C corporation or a tax-exempt corporation does not satisfy the minimum ownership threshold in paragraph (c)(7) of this section or is precluded by paragraph (c)(5)(ii)(D) of this section from applying the corporation look-through rule of paragraph (c)(5)(ii)(B)(*2*)(*i*) of this section, the shareholder generally will treat its entire basis in the corporation's stock as an asset held for investment. If a shareholder that is a C corporation or a tax-exempt corporation does not satisfy the minimum ownership threshold in paragraph (c)(7) of this section or is precluded by paragraph (c)(5)(ii)(D) of this section from applying the corporation look-through rule of paragraph (c)(5)(ii)(B)(*2*)(*i*) of this section, the shareholder must treat its entire basis in the corporation's stock as allocable to a non-excepted trade or business.

(*3*) *S corporations*–(*i*) *Calculation of asset basis*. For purposes of this section, a shareholder's share of stock in an S corporation is treated as an asset of the shareholder. Additionally, for these purposes, the shareholder's adjusted basis in a share of S corporation stock is adjusted to take into account the modifications in paragraph (c)(5)(i)(A) of this section with respect to the assets of the S corporation (for example, a shareholder's adjusted basis in its S corporation stock is increased by the shareholder's share of depreciation with respect to an inherently permanent structure owned by the S corporation).

(*ii*) *Allocation of asset basis*. For purposes of determining the extent to which a shareholder's basis in its stock of an S corporation is allocable to an excepted or non-excepted trade or business, the shareholder may look through to such shareholder's share of the S corporation's basis in the S corporation's assets, allocated on a pro rata basis, adjusted to the extent required under paragraph (d)(4) of this section, except as otherwise provided in paragraph (c)(5)(ii)(D) of this section. Notwithstanding paragraph (c)(7) of this section, if a shareholder's direct and indirect interest in an S corporation is greater than or equal to 80 percent of the S corporation's stock by vote and value, the shareholder must apply the rules in this paragraph (c)(5)(ii)(B)(*3*) to look through to the S corporation's basis in the S corporation's assets.

(*iii*) *De minimis rule*. If at least 90 percent of a shareholder's share of an S corporation's basis in its assets is allocable to either excepted trades or businesses or non-excepted trades or businesses, the shareholder's entire basis in its S corporation stock is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(*iv*) *Inapplicability of S corporation look-through rule*. If a shareholder chooses not to look through to the S corporation's basis in the S corporation's assets under paragraph (c)(5)(ii)(B)(*3*)(*ii*) of this section or is precluded by paragraph (c)(5)(ii)(D) of this section from applying such S corporation look-through rule, the shareholder generally will treat its basis in the S corporation stock as either an asset held for investment or a non-excepted trade or business asset as determined under section 163(d).

(C) *Stock in CFCs*. The rules applicable to domestic non-consolidated C corporations in paragraph (c)(5)(ii)(B) of this section also apply to CFCs.

(D) *Inapplicability of look-through rule to partnerships or non-consolidated corporations to which the small business exemption applies*. A taxpayer may not apply the look-through rules in paragraphs (b)(3) and (c)(5)(ii)(A), (B), and (C) of this section to a partnership, S corporation, or non-consolidated corporation that is eligible for the small business exemption under section 163(j)(3) and § 1.163(j)–2(d)(1).

(E) *Tiered entities*. If a taxpayer applies the look-through rules of this paragraph (c)(5)(ii), the taxpayer must do so for all lower-tier entities with respect to which the taxpayer satisfies, directly or indirectly, the minimum ownership threshold in paragraph (c)(7) of this section, subject to the limitation in paragraph (c)(5)(ii)(D) of this section, beginning with the lowest-tier entity.

(iii) *Cash and cash equivalents and customer receivables*. Except as otherwise provided in paragraph (d)(2) of this section, a taxpayer's basis in its cash and cash equivalents and customer receivables is not taken into account for purposes of this paragraph (c). This rule also applies to a lower-tier entity if a taxpayer looks through to the assets of that entity under paragraph (c)(5)(ii) of this section. For purposes of this paragraph (c)(5)(iii), the term *cash and cash equivalents* includes cash, foreign currency, commercial paper, any interest in an investment company registered under the Investment Company Act of 1940 (1940 Act) and regulated as a money market fund under 17 CFR 270.2a–7 (Rule 2a–7 under the 1940 Act), any obligation of a government, and any derivative that is substantially secured by an obligation of a government, or any similar asset. For purposes of this paragraph (c)(5)(iii), a *derivative* is a derivative described in section 59A(h)(4)(A), without regard to section 59A(h)(4)(C). For purposes of this paragraph (c)(5)(iii), the term *government* means the United States or any agency or instrumentality of the United States; a State or any political subdivision thereof, including the District of Columbia and any possession or territory of the United States, within the meaning of section 103 and § 1.103–1; or any foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one of the foregoing within the meaning of § 1.1471–6(b).

(iv) *Deemed asset sale*. Solely for purposes of determining the amount of basis allocable to excepted and non-excepted trades or businesses under this section, an election under section 336, 338, or 754, as applicable, is deemed to have been made for any acquisition of corporate stock or partnership interests with respect to which the taxpayer demonstrates to the satisfaction of the Commissioner, in the information statement required by paragraph (c)(6)(iii)(B) of this section, that the taxpayer was eligible to make an election but was actually or effectively precluded from doing so by a regulatory agency with respect to an excepted regulated utility trade or business. Any additional basis taken into account under this rule is reduced ratably over a 15-year period beginning with the month of the acquisition and is not subject to the anti-abuse rule in paragraph (c)(8) of this section.

(v) *Other adjustments*. The Commissioner may make appropriate adjustments to prevent a taxpayer from intentionally and artificially increasing its basis in assets attributable to an excepted trade or business.

(6) *Determination dates; determination periods; reporting requirements*–(i) *Definitions*. For purposes of this section, the term *determination date* means the last day of each quarter of the taxpayer's taxable year (and the last day of the taxpayer's taxable year, if the taxpayer has a short taxable year), and the term *determination period* means the period beginning the day after one determination date and ending on the next determination date.

(ii) *Application of look-through rules*. If a taxpayer that applies the look-through rules of paragraph (c)(5)(ii) of this section has a different taxable year than the partnership or non-consolidated corporation to which the taxpayer is applying those rules, then, for purposes of this paragraph (c)(6), the taxpayer must use the most recent quarterly figures from the partnership or non-consolidated corporation. For example, assume that PS1 is a partnership with a May 31 taxable year, and that C (a calendar-year C corporation) is a partner whose ownership interest satisfies the ownership threshold in paragraph (c)(7) of this section. PS1's determination dates are February 28, May 31, August 31, and November 30. In turn, C's determination dates are March 31, June 30, September 30, and December 31. If C looks through to PS1's basis in its assets under paragraph (c)(5)(ii) of this section, then, for purposes of determining the amount of C's asset basis that is attributable to its excepted and non-excepted businesses on March 31, C must use PS1's asset basis calculations for February 28.

(iii) *Reporting requirements*–(A) *Books and records*. A taxpayer must maintain books of account and other records and data as necessary to substantiate the taxpayer's use of an asset in an excepted trade or business and to substantiate the adjustments to asset basis for purposes of applying paragraph (c) of this section. One indication demonstrating that a particular asset is used in a particular trade or business is if the taxpayer maintains separate books and records for all of its excepted and non-excepted trades or businesses, and can show the asset in the books and records of a particular excepted or non-excepted trade or business. For rules governing record retention, see § 1.6001–1.

(B) *Information statement*. Except as otherwise provided in publications, forms, instructions, or other guidance, each taxpayer that is making an allocation under this paragraph (c) must prepare a statement containing the information described in this paragraph (c)(6)(iii) and must attach the statement to its timely filed Federal income tax return for the taxable year. The statement, which must be titled "Section 163(j) Asset Basis Calculations," must include the following information:

(*1*) The taxpayer's adjusted basis in the assets used in its excepted and non-excepted businesses, determined on a quarterly basis as set forth in this section, including detailed information for the different groups of assets identified in paragraphs (c)(5)(i), (c)(5)(ii), and (d) of this section;

(*2*) The determination dates on which asset basis was measured during the taxable year;

(*3*) The names and taxpayer identification numbers (TINs) of all entities for which basis information is being provided, including partnerships and corporations if the taxpayer that owns an interest in a partnership or corporation looks through to the partnership's or corporation's basis in the partnership's or corporation's assets under paragraph (c)(5)(ii) of this section. If the taxpayer is a member of a consolidated group, the name and TIN of the agent for the group, as defined in § 1.1502–77, must be provided, but the taxpayer need not provide the names and TINs of all other consolidated group members;

(*4*) Asset basis information for corporations or partnerships if the taxpayer looks through to the corporation's or partnership's basis in the corporation's or partnership's assets under paragraph (c)(5)(ii) of this section; and

(*5*) A summary of the method or methods used to determine asset basis in property used in both excepted and non-excepted businesses, as well as information regarding any deemed sale under paragraph (c)(5)(iv) of this section.

(iv) *Failure to file statement*. If a taxpayer fails to file the statement described in paragraph (c)(6)(iii) of this section or files a statement that does not comply with the requirements of paragraph (c)(6)(iii) of this section, the Commissioner may treat the taxpayer as if all of its interest expense is properly allocable to a non-excepted trade or business, unless the taxpayer shows that there was reasonable cause for failing to comply with, and the taxpayer acted in good faith with respect to, the requirements of paragraph (c)(6)(iii) of this section, taking into account all pertinent facts and circumstances.

(7) *Ownership threshold for look-through rules*–(i) *Corporations*–(A) *Asset basis*. A shareholder must look through to the assets of a non-consolidated domestic C corporation or a CFC under paragraph (c)(5)(ii) of this section for purposes of allocating the shareholder's basis in its stock in the corporation between excepted and non-excepted trades or businesses if the shareholder's direct and indirect interest in the corporation satisfies the ownership requirements of section 1504(a)(2). A shareholder may look through to the assets of an S corporation under paragraph

(c)(5)(ii) of this section for purposes of allocating the shareholder's basis in its stock in the S corporation between excepted and non-excepted trades or businesses regardless of the shareholder's direct and indirect interest in the S corporation.

(B) *Dividends*. A shareholder must look through to the activities of a non-consolidated domestic C corporation or a CFC under paragraph (b)(3) of this section if the shareholder's direct and indirect interest in the corporation satisfies the ownership requirements of section 1504(a)(2). A shareholder may look through to the activities of an S corporation under paragraph (b)(3) of this section regardless of the shareholder's direct and indirect interest in the S corporation.

(ii) *Partnerships*. A partner may look through to the assets of a partnership under paragraph (c)(5)(ii) of this section for purposes of allocating the partner's basis in its partnership interest between excepted and non-excepted trades or businesses regardless of the partner's direct and indirect interest in the partnership.

(iii) *Inapplicability of look-through rule*. For circumstances in which a taxpayer that satisfies the ownership threshold in this paragraph (c)(7) may not apply the look-through rules in paragraphs (b)(3) and (c)(5)(ii) of this section, see paragraph (c)(5)(ii)(D) of this section.

(8) *Anti-abuse rule*. If a principal purpose for the acquisition, disposition, or change in use of an asset was to artificially shift the amount of basis allocable to excepted or non-excepted trades or businesses on a determination date, the additional basis or change in use will not be taken into account for purposes of this section. For example, if an asset is used in a non-excepted trade or business for most of the taxable year, and if the taxpayer begins using the asset in an excepted trade or business towards the end of the year with a principal purpose of shifting the amount of basis in the asset that is allocable to the excepted trade or business, the change in use is disregarded for purposes of this section. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). In determining whether a taxpayer has a principal purpose described in this paragraph (c)(8), factors to be considered include, for example, the following: the business purpose for the acquisition, disposition, or change in use; the length of time the asset was used in a trade or business; whether the asset was acquired from a related person; and whether the taxpayer's aggregate basis in its assets increased or decreased temporarily on or around a determination date. A principal purpose is presumed to be present in any case in which the acquisition, disposition, or change in use lacks a substantial business purpose and increases the taxpayer's basis in assets used in its excepted trades or businesses by more than 10 percent during the taxable year.

(d) *Direct allocations*–(1) *In general*. For purposes of this section, a taxpayer with qualified nonrecourse indebtedness, within the meaning of § 1.861–10T(b), must directly allocate interest expense from the indebtedness to the taxpayer's assets in the manner and to the extent provided in § 1.861–10T(b).

(2) *Financial services entities*. For purposes of this section, a taxpayer that is engaged in the trade or business of banking, within the meaning of section 581, insurance, financing, or a similar business that derives active financing income as described in § 1.904–4(e)(2) (an active financing business) must directly allocate interest expense and interest income from that business to the taxpayer's assets used in that business. The special rule for cash and cash equivalents in paragraph (c)(5)(iii) of this section does not apply to an entity that qualifies as a financial services entity as described in § 1.904–4(e)(3).

(3) *Assets used in more than one trade or business*. If an asset is used in more than one trade or business, the taxpayer must apply the rules in paragraph (c)(3) of this section to determine the extent to which interest that is directly allocated under this paragraph (d) is allocable to excepted or non-excepted trades or businesses.

(4) *Adjustments to basis of assets to account for direct allocations*. In determining the amount of a taxpayer's basis in the assets used in its excepted and non-excepted trades or businesses for purposes of paragraph (c) of this section, adjustments must be made to reflect direct allocations under this paragraph (d). These adjustments consist of reductions in the amount of the taxpayer's basis in its assets for purposes of paragraph (c) of this section to reflect assets to which interest expense is directly allocated under this paragraph (d). These adjustments must be made before the taxpayer averages the adjusted basis in its assets as determined on each determination date during the taxable year.

(5) *Example: Direct allocation of interest expense*—(i) *Facts*. T conducts an electing real property trade or business (Business X) and operates a retail store that is a non-excepted trade or business (Business Y). In Year 1, T issues Note A to a third party in exchange for $1,000x for the purpose of acquiring Building B. Note A is qualified nonrecourse indebtedness (within the meaning of § 1.861–10T(b)) secured by Building B. T then uses those funds to acquire Building B for $1,200x, and T uses Building B in Business X. During Year 1, T pays $500x of interest, of which $100x is interest payments on Note A. For Year 1, T's basis in its assets used in Business X (as determined under paragraph (c) of this section) is $3,600x (excluding cash and cash equivalents), and T's basis in its assets used in Business Y (as determined under paragraph (c) of this section) is $800x (excluding cash and cash equivalents). Each of Business X and Business Y also has $100x of cash and cash equivalents.

(ii) *Analysis*. Because Note A is qualified nonrecourse indebtedness that is secured by Building B, in allocating interest expense between Businesses X and Y, T first must directly allocate the $100x of interest expense it paid with respect to Note A to Business X in accordance with paragraph (d)(1) of this section. Thereafter, T must allocate the remaining $400x of interest expense between Businesses X and Y under paragraph (c) of this section. After excluding T's $1,200x cost basis in Building B (see paragraph (d)(4) of this section), and without regard to T's $200x of cash and cash equivalents (see paragraph (c)(5)(iv) of this section), T's basis in assets used in Businesses X and Y is $2,400x and $800x (75 percent and 25 percent), respectively. Thus, $300x of the remaining $400x of interest expense would be allocated to Business X, and $100x would be allocated to Business Y.

(e) *Examples*. The examples in this paragraph (e) illustrate the principles of this section. For purposes of these examples, assume that no taxpayer is eligible for the small business exemption under section 163(j)(3) and § 1.163(j)–2(d), no taxpayer has floor plan financing interest expense, and no taxpayer has qualified nonrecourse indebtedness within the meaning of § 1.861–10T(b).

(1) *Example 1: Interest allocation within a consolidated group*—(i) *Facts*. S is a member of a consolidated group of which P is the common parent. P conducts an electing real property trade or business (Business X), and S conducts a non-excepted trade or business (Business Y). In Year 1, P pays or accrues (without regard to section 163(j)) $35x of interest expense and receives $10x of interest income, and S pays or accrues (without regard to section 163(j)) $115x of interest expense and receives $5x of interest income (for a total of $150x of

interest expense and $15x of interest income). For purposes of this example, assume that, pursuant to paragraph (c) of this section, $30x of the P group's interest expense and $3x of the P group's interest income is allocable to Business X, and the remaining $120x of interest expense and $12x of interest income is allocable to Business Y.

(ii) *Analysis*. Under paragraph (a)(4) of this section, 20 percent of the P group's Year 1 interest expense ($30x / $150x) and interest income ($3x / $15x) is allocable to an excepted trade or business. Thus, $7x ($35x x 20 percent) of P's interest expense and $2x ($10x x 20 percent) of P's interest income is allocable to an excepted trade or business. The remaining $28x of P's interest expense is business interest expense subject to limitation under section 163(j), and the remaining $8x of P's interest income is business interest income that increases the group's section 163(j) limitation. In turn, $23x ($115x x 20 percent) of S's interest expense and $1x ($5x x 20 percent) of S's interest income is allocable to an excepted trade or business. The remaining $92x of S's interest expense is business interest expense subject to limitation under section 163(j), and the remaining $4x of S's interest income is business interest income that increases the group's section 163(j) limitation.

(2) *Example 2: Interest allocation within a consolidated group with assets used in more than one trade or business*—(i) *Facts*. S is a member of a consolidated group of which P is the common parent. P conducts an electing real property trade or business (Business X), and S conducts a non-excepted trade or business (Business Y). In Year 1, P pays or accrues (without regard to section 163(j)) $50x of interest expense, and S pays or accrues $100x of interest expense (without regard to section 163(j)). P leases 40 percent of space in Building V (which P owns) to S for use in Business Y, and P leases the remaining 60 percent of space in Building V to third parties. For purposes of allocating interest expense under paragraph (c) of this section, the P group's basis in its assets (excluding Building V) used in Businesses X and Y is $180x and $620x, respectively. The P group's basis in Building V for purposes of allocating interest expense under paragraph (c) of this section is $200x.

(ii) *Analysis*. Under paragraph (c)(3)(ii) of this section, the P group's basis in Building V ($200x) is allocated to excepted and non-excepted trades or businesses in accordance with the use of space by Business Y (40 percent) and Business X (the remainder, or 60 percent). Accordingly, $120x of the basis in Building V is allocated to excepted trades or businesses (60 percent x $200x), and $80x is allocated to non-excepted trades or businesses (40 percent x $200x). After allocating the basis in Building V, the P group's total basis in the assets used in excepted and non-excepted trades or businesses is $300x and $700x, respectively. Under paragraphs (a)(4) and (c) of this section, 30 percent ($300x / $1000x) of the P group's Year 1 interest expense is properly allocable to an excepted trade or business. Thus, $15x ($50x x 30 percent) of P's interest expense is properly allocable to an excepted trade or business, and the remaining $35x of P's interest expense is business interest expense subject to limitation under section 163(j). In turn, $30x ($100x x 30 percent) of S's interest expense is properly allocable to an excepted trade or business, and the remaining $70x of S's interest expense is business interest expense subject to limitation under section 163(j).

(3) *Example 3: Application of look-through rules*—(i) *Facts*. (A) A and B are unrelated individual taxpayers. A owns 100 percent of the stock of Corp 1, a calendar-year domestic C corporation. The basis of A's stock in Corp 1 is $500x. Corp 1 owns 10 percent of the interests in PS1 (a domestic partnership), and B owns the remaining 90 percent. Corp 1's basis in its PS1 interests is $25x, and B's basis in its PS1 interests is $225x. PS1 owns 100 percent of the stock of Corp 2, a calendar-year domestic C corporation. PS1 has a basis of $1000x in its Corp 2 stock.

(B) In 2020, Corp 1 was engaged solely in a non-excepted trade or business. That same year, PS1's only activity was holding Corp 2 stock. In turn, Corp 2 was engaged in both an electing farming business and a non-excepted trade or business. Under the allocation rules in paragraph (c) of this section, 50 percent of Corp 2's asset basis in 2020 was allocable to the electing farming business. The remaining 50 percent was allocable to the non-excepted trade or business.

(C) Individuals A and B each paid or accrued (without regard to section 163(j)) $150x of interest expense allocable to a trade or business under § 1.163–8T (along with personal interest and investment interest). A's trade or business was an excepted trade or business, and B's trade or business was a non-excepted trade or business. A's basis in the assets used in its trade or business was $100x, and B's basis in the assets used in its trade or business was $112.5x.

(ii) *Analysis*. (A) As provided in paragraph (c)(5)(ii)(E) of this section, if a taxpayer applies the look-through rules of paragraph (c)(5)(ii) of this section, the taxpayer must begin with the lowest-tier entity to which it is eligible to apply the look-through rules. A directly owns 100 percent of the stock of Corp 1; thus, A satisfies the 80 percent minimum ownership threshold with respect to Corp 1. A also owns 10 percent of the interests in PS1. There is no minimum ownership threshold for partnerships; thus, A may apply the look-through rules to PS1. However, A does not directly or indirectly own at least 80 percent of the stock of Corp 2; thus, A may not look through its indirect interest in Corp 2. In turn, B directly owns 90 percent of the interests in PS1, and B indirectly owns at least 80 percent of the stock of Corp 2. Thus, B may apply the look-through rules to both PS1 and Corp 2.

(B) From A's perspective, PS1 is not engaged in a trade or business for purposes of section 163(j); instead, PS1 is merely holding its Corp 2 stock as an investment. Under paragraph (c)(5)(ii)(A)(*2*) of this section, if a partnership is not engaged in a trade or business, then its C corporation partner must treat its entire basis in the partnership interest as allocable to a non-excepted trade or business. Thus, for purposes of A's application of the look-through rules, Corp 1's entire basis in its PS1 interest ($25x) is allocable to a non-excepted trade or business. Corp 1's basis in its other assets also is allocable to a non-excepted trade or business (the only trade or business in which Corp 1 is engaged). Thus, under paragraph (c) of this section, A's $500x basis in its Corp 1 stock is allocable entirely to a non-excepted trade or business. A's $100x basis in its other business assets is allocable to an excepted trade or business. Thus, 5/6 (or $125x) of A's $150x of interest expense is properly allocable to a non-excepted trade or business and is business interest expense subject to limitation under section 163(j), and the remaining $25x of A's $150x of interest expense is allocable to an excepted trade or business and is not subject to limitation under section 163(j).

(C) From B's perspective, PS1 must look through its stock in Corp 2 to determine the extent to which PS1's basis in the stock is allocable to an excepted or non-excepted trade or business. Half of Corp 2's basis in its assets is allocable to an excepted trade or business, and the other half is allocable to a non-excepted trade or business. Thus, from B's perspective, $500x of PS1's basis in its Corp 2 stock (PS1's only asset) is allocable to an excepted trade or business, and the other half is allocable to a non-excepted trade or business. B's basis in its PS1 interests is $225x. Applying the look-through rules to B's PS1 interests, $112.5x of B's basis in its PS1 interests is allocable to an excepted trade or business, and $112.5x of B's basis in its PS1 interests is allocable to a non-excepted trade or business. Since B's basis in the assets used in its non-excepted trade or business also was $112.5x, two-thirds of B's interest expense ($100x) is properly allocable to a non-excepted trade or business and is business interest expense subject to limitation under section 163(j), and one-third of B's interest expense ($50x) is allocable to an excepted trade or business and is not subject to limitation under section 163(j).

(4) *Example 4: Excepted and non-excepted trades or businesses in a consolidated group*—(i) *Facts*. P is the common parent of a consolidated group of which A and B are the only other members. A conducts an electing real property trade or business (Business X), and B conducts a non-excepted trade or business (Business Y). In Year 1, A pays or accrues (without regard to section 163(j)) $50x of interest expense and earns $70x of gross income in the conduct of Business X, and B pays or accrues (without regard to section 163(j)) $100x of interest expense and earns $150x of gross income in the conduct of Business Y. B owns Building V, which it uses in Business Y. For purposes of allocating the P group's Year 1 business interest expense between excepted and non-excepted trades or businesses under paragraph (c) of this section, the P group's basis in its assets (other than Building V) used in Businesses X and Y is $180x and $620x, respectively, and the P group's basis in Building V is $200x. At the end of Year 1, B sells Building V to a third party and realizes a gain of $60x in addition to the $150x of gross income B earned that year from the conduct of Business Y.

(ii) *Analysis*. (A) Under paragraphs (a)(4) and (c) of this section, the P group's basis in its assets used in its trades or businesses is allocated between the P group's excepted trade or business (Business X) and its non-excepted trade or business (Business Y) as though these trades or businesses were conducted by a single corporation. Under paragraph (c) of this section, the P group's basis in its assets used in

Businesses X and Y is $180x and $820x, respectively. Accordingly, 18 percent ($180x / $1,000x) of the P group's total interest expense ($150x) is properly allocable to an excepted trade or business ($27x), and the remaining 82 percent of the P group's total interest expense is business interest expense properly allocable to a non-excepted trade or business ($123x).

(B) To determine the P group's section 163(j) limitation, paragraph (a) of this section requires that certain items of income and deduction be allocated to the excepted and non-excepted trades or businesses of the P group as though these trades or businesses were conducted by a single corporation. In Year 1, the P group's excepted trade or business (Business X) has gross income of $70x, and the P group's non-excepted trade or business (Business Y) has gross income of $150x. Because Building V was used exclusively in Business Y, the $60x of gain from the sale of Building V in Year 1 is attributed to Business Y under paragraph (b)(2) of this section. The P group's section 163(j) limitation is $63x (30 percent x $210x), which allows the P group to deduct $63x of its $123x of business interest expense allocated to the P group's non-excepted trades or businesses. The group's $27x of interest expense that is allocable to excepted trades or businesses may be deducted without limitation under section 163(j).

(iii) *Intercompany transaction*. The facts are the same as in *Example 4* in paragraph (e)(4)(i) of this section, except that A owns Building V and leases it to B in Year 1 for $20x for use in Business Y, and A sells Building V to a third party for a $60 gain at the end of Year 1. Under paragraphs (a)(4) and (c) of this section, all members of the P group are treated as a single corporation. As a result, the P group's basis in its assets used in its trades or businesses is allocated between the P group's excepted trade or business (Business X) and its non-excepted trade or business (Business Y) as though these trades or businesses were conducted by a single corporation. A lease between two divisions of a single corporation would produce no rental income or expense. Thus, the $20x of rent paid by B to A does not affect the P group's ATI. Moreover, under paragraph (c) of this section, Building V is an asset used in the P group's non-excepted trade or business (Business Y). Accordingly, although A owns Building V, the basis in Building V is added to the P group's basis in assets used in Business Y for purposes of allocating interest expense under paragraph (c) of this section. In the same vein, when A sells Building V to a third party at a gain of $60x, the gain is included in the P group's ATI because Building V was used in a non-excepted trade or business of the P group (Business Y) prior to its sale.

(5) *Example 5: Captive activities*—(i) *Facts*. S and T are members of a consolidated group of which P is the common parent. P conducts an electing real property trade or business (Business X), S conducts a non-excepted trade or business (Business Y), and T provides transportation services to Businesses X and Y but does not have any customers outside of the P group. For Year 1, T provides transportation services using a single bus with a basis of $120x.

(ii) *Analysis*. Under paragraph (a)(4) of this section, activities conducted by a consolidated group are treated as though those activities were conducted by a single corporation. Because the activities of T are limited to providing intercompany transportation services, T does not conduct a trade or business for purposes of section 163(j). Under paragraph (c)(3) of this section, business interest expense is allocated to excepted and non-excepted trades or businesses based on the relative basis of the assets used in those businesses. The basis in T's only asset, a bus, is therefore allocated between Business X and Business Y according to the use of T's bus by these businesses. Business X uses one-third of T's services, and Business Y uses two-thirds of T's services. Thus, $40x of the basis of T's bus is allocated to Business X, and $80x of the basis of T's bus is allocated to Business Y.

(f) *Applicability date*. This section applies to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

§ 1.163(j)–11 Transition rules.

(a) *Application of section 163(j) limitation if a corporation joins a consolidated group with a taxable year beginning before January 1, 2018*—(1) *In general*. If a corporation (S) joins a consolidated group whose taxable year began before January 1, 2018, and if S is subject to the section 163(j) limitation at the time of its change in status, then section 163(j) will apply to S's short taxable year that ends on the day of S's change in status, but section 163(j) will not apply to S's short taxable year that begins the next day (when S is a member of the acquiring consolidated group). Any business interest expense paid or accrued (without regard to section 163(j)) by S in its short taxable year ending on the day of S's change in status for which a deduction is disallowed under section 163(j) will be carried forward to the acquiring group's first taxable year beginning after December 31, 2017. Those disallowed business interest expense carryforwards may be subject to limitation under other provisions of these regulations (see, for example, § 1.163(j)–5(c), (d), (e), and (f)).

(2) *Example*. Acquiring Group is a consolidated group with a fiscal year end of November 30; Target is a stand-alone calendar-year C corporation. On May 31, 2018, Acquiring Group acquires Target in a transaction that is not an ownership change for purposes of section 382. Acquiring Group is not subject to the section 163(j) limitation during its taxable year beginning December 1, 2017. As a result of the acquisition, Target has a short taxable year beginning January 1, 2018 and ending May 31, 2018. Target is subject to the section 163(j) limitation during this short taxable year. However, Target (as a member of Acquiring Group) is not subject to the section 163(j) limitation during Acquiring Group's taxable year ending November 30, 2018. Any disallowed business interest expense carryforwards from Target's taxable year ending May 31, 2018, will not be available for use in Acquiring Group's taxable year ending November 30, 2018. However, that disallowed business interest expense is carried forward to Acquiring Group's taxable year beginning December 1, 2018, and can be deducted by the group, subject to the separate return limitation year (SRLY) limitation. See § 1.163(j)–5(d).

(b) *Treatment of disallowed disqualified interest*—(1) *In general*. Disallowed disqualified interest is carried forward to the taxpayer's first taxable year beginning after December 31, 2017, and is subject to disallowance as a disallowed business interest expense carryforward under section 163(j) and § 1.163(j)–2, except to the extent the interest is properly allocable to an excepted trade or business under § 1.163(j)–10. See § 1.163(j)–10(a)(6).

(2) *Earnings and profits*. A taxpayer may not reduce its earnings and profits in a taxable year beginning after December 31, 2017, to reflect any disallowed disqualified interest carryforwards to the extent the payment or accrual of the disallowed disqualified interest reduced the earnings and profits of the taxpayer in a prior taxable year.

(3) *Disallowed disqualified interest of members of an affiliated group*—(i) *Scope*. This paragraph (b)(3)(i) applies to corporations that were treated as a single taxpayer

under old section 163(j)(6)(C) and that had disallowed disqualified interest.

(ii) *Allocation of disallowed disqualified interest to members of the affiliated group*—(A) *In general*. Each member of the affiliated group is allocated its allocable share of the affiliated group's disallowed disqualified interest as provided in paragraph (b)(3)(ii)(B) of this section.

(B) *Definitions*. The following definitions apply for purposes of paragraph (b)(3)(ii) of this section.

(*1*) *Allocable share of the affiliated group's disallowed disqualified interest*. The term *allocable share of the affiliated group's disallowed disqualified interest* means, with respect to any member of an affiliated group for the member's last taxable year beginning before January 1, 2018, the product of the total amount of the disallowed disqualified interest of all members of the affiliated group under old section 163(j)(6)(C) and the member's disallowed disqualified interest ratio.

(*2*) *Disallowed disqualified interest ratio*. The term *disallowed disqualified interest ratio* means, with respect to any member of an affiliated group for the member's last taxable year beginning before January 1, 2018, the ratio of the exempt related person interest expense of the member for the last taxable year beginning before January 1, 2018, to the sum of the amounts of exempt related person interest expense for all members of the affiliated group.

(*3*) *Exempt related person interest expense*. The term *exempt related person interest expense* means interest expense that is, or is treated as, paid or accrued by a domestic C corporation, or by a foreign corporation with income, gain, or loss that is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States, to–

(*i*) Any person related to the taxpayer, within the meaning of sections 267(b) or 707(b)(1), applying the constructive ownership and attribution rules of section 267(c), if no U.S. tax is imposed with respect to the interest under subtitle A of the Internal Revenue Code, determined without regard to net operating losses or net operating loss carryovers, and taking into account any applicable treaty obligation of the United States. For this purpose, interest that is subject to a reduced rate of tax under any treaty obligation of the United States applicable to the recipient is treated as in part subject to the statutory tax rate under sections 871 or 881 and in part not subject to tax, based on the proportion that the rate of tax under the treaty bears to the statutory tax rate. Thus, for purposes of section 163(j), if the statutory tax rate is 30 percent, and pursuant to a treaty U.S. tax is instead limited to a rate of 10 percent, two-thirds of the interest is considered interest not subject to U.S. tax under subtitle A of the Internal Revenue Code;

(*ii*) A person that is not related to the taxpayer, within the meaning of sections 267(b) or 707(b)(1), applying the constructive ownership and attribution rules of section 267(c), with respect to indebtedness on which there is a disqualified guarantee, within the meaning of paragraph (6)(D) of old section 163(j), of such indebtedness, and no gross basis U.S. tax is imposed with respect to the interest. For purposes of this paragraph (b)(3)(ii)(B)(*3*)(*ii*), a *gross basis U.S. tax* means any tax imposed by this subtitle A of the Internal Revenue Code that is determined by reference to the gross amount of any item of income without any reduction for any deduction allowed by subtitle A of the Internal Revenue Code. Interest that is subject to a gross basis U.S. tax that is eligible for a reduced rate of tax under any treaty obligation of the United States applicable to the recipient is treated as, in part, subject to the statutory tax rate under sections 871 or 881 and, in part, not subject to a gross basis U.S. tax, based on the proportion that the rate of tax under the treaty bears to the statutory tax rate. Thus, for purposes of section 163(j), if the statutory tax rate is 30 percent, and pursuant to a treaty U.S. tax is instead limited to a rate of 10 percent, two-thirds of the interest is considered interest not subject to a gross basis U.S. tax under subtitle A of the Internal Revenue Code; or

(*iii*) A REIT, directly or indirectly, to the extent that the domestic C corporation, or a foreign corporation with income, gain, or loss that is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States, is a taxable REIT subsidiary, as defined in section 856(l), with respect to the REIT.

(iii) *Treatment of carryforwards*. The amount of disallowed disqualified interest allocated to a taxpayer pursuant to paragraph (b)(3)(ii) of this section is treated in the same manner as described in paragraph (b)(1) of this section.

(4) *Application of section 382*–(i) *Ownership change occurring before the date the Treasury decision adopting these regulations as final regulations is published in the* **Federal Register**–(A) *Pre-change loss*. For purposes of section 382(d)(3), unless the rules of § 1.382–2(a)(7) apply, disallowed disqualified interest is not a pre-change loss under § 1.382–2(a) subject to a section 382 limitation with regard to an ownership change on a change date occurring before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. But see section 382(h)(6)(B) (regarding built-in deduction items).

(B) *Loss corporation*. For purposes of section 382(k)(1), unless the rules of § 1.382–2(a)(7) apply, disallowed disqualified interest is not a carryforward of disallowed interest described in section 381(c)(20) with regard to an ownership change on a change date occurring before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. But see section 382(h)(6) (regarding built-in deductions).

(ii) *Ownership change occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the* **Federal Register**—(A) *Pre-change loss*. For rules governing the treatment of disallowed disqualified interest as a pre-change loss for purposes of section 382 with regard to an ownership change on a change date occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, see §§ 1.382–2(a)(2) and 1.382–6(c)(3).

(B) *Loss corporation*. For rules governing when disallowed disqualified interest causes a corporation to be a loss corporation with regard to an ownership change occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, see § 1.382–2(a)(1)(i)(A).

(iii) *Definitions*. For purposes of this paragraph (b)(4), the terms *ownership change* and *change date* have the meanings provided in section 382 and the regulations thereunder.

(5) [Reserved]

(6) *Treatment of excess limitation from taxable years beginning before January 1, 2018*. No amount of excess limitation under old section 163(j)(2)(B) may be carried forward to taxable years beginning after December 31, 2017.

(7) *Example: Members of an affiliated group*–(i) *Facts*. A, B, and C are calendar-year domestic C corporations that are members of an affiliated group (within the meaning of section 1504(a)) that was treated as a single taxpayer under old section 163(j)(6)(C) and the proposed regulations thereunder (see formerly proposed § 1.163(j)–5). For the taxable year ending December 31, 2017, the separately determined amounts of exempt related person interest expense of A, B, and C were $0, $600x, and $150x, respectively (for a total of $750x). The affiliated group has $200x of disallowed disqualified interest in that year.

(ii) *Analysis*. The affiliated group's disallowed disqualified interest expense for the 2017 taxable year ($200x) is allocated among A, B, and C based on the ratio of each member's exempt related person interest expense to the group's exempt related person interest expense. Because A has no exempt related person interest expense, no disallowed disqualified interest is allocated to A. Disallowed disqualified interest of $160x is allocated to B (($600x / $750x) x $200x), and disallowed disqualified interest of $40x is allocated to C (($150x / $750x) x $200x). Thus, B and C have $160x and $40x, respectively, of disallowed disqualified interest that is carried forward to the first taxable year beginning after December 31, 2017. No excess limitation that was allocated to A, B, or C under old section 163(j) will carry forward to the first taxable year beginning after December 31, 2017.

(iii) *Carryforward of disallowed disqualified interest to 2018 taxable year*. The facts are the same as in the *Example* in paragraph (b)(7)(i) of this section, except that, for the taxable year ending December 31, 2018, A, B, and C are members of a consolidated group that has a section 163(j) limitation of $140x, current-year business interest expense (as defined in § 1.163(j)–5(a)(2)(i)) of $80x, and no excepted trade or business. Under paragraph (b)(1) of this section, disallowed disqualified interest is carried to the taxpayer's first taxable year beginning after December 31, 2017, and is subject to disallowance under section 163(j) and § 1.163(j)–2. Under § 1.163(j)–5(b)(3)(ii)(D)(*1*), a consolidated group that has section 163(j) limitation remaining for the current year after deducting all current-year business interest expense deducts each member's disallowed disqualified interest carryforwards from prior taxable years, starting with the earliest taxable year, on a pro rata basis (subject to certain limitations). In accordance with paragraph (b)(1) of this section, the rule in § 1.163(j)–5(b)(3)(ii)(D)(*1*) applies to disallowed disqualified interest carried forward to the taxpayer's first taxable year beginning after December 31, 2017. Accordingly, after deducting $80x of current-year business interest expense in 2018, the group may deduct $60x of its $200x disallowed disqualified interest carryforwards. Under paragraph (b)(3) of this section, B has $160x of disallowed disqualified interest carryforwards, and C has $40x of disallowed disqualified interest carryforwards. Thus, $48x (($160x / $200x) x $60x) of B's disallowed disqualified interest carryforwards, and $12x (($40x / $200x) x $60x) of C's disallowed disqualified interest carryforwards, are deducted by the consolidated group in the 2018 taxable year.

(c) *Applicability date*. This section applies to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

Par. 4. Section 1.263A–9 is amended by revising the first and third sentences of paragraph (g)(1)(i) to read as follows:

§ 1.263A–9 The avoided cost method.

* * * * *

(g) * * *

(1) * * *

(i) Interest must be capitalized under section 263A(f) before the application of section 163(d) (regarding the investment interest limitation), section 163(j) (regarding the limitation on business interest expense), section 266 (regarding the election to capitalize carrying charges), section 469 (regarding the limitation on passive losses), and section 861 (regarding the allocation of interest to United States sources). * * * However, in applying section 263A(f) with respect to the excess expenditure amount, the taxpayer must capitalize all interest that is neither investment interest under section 163(d), business interest expense under section 163(j), nor passive interest under section 469 before capitalizing any interest that is either investment interest, business interest expense, or passive interest. * * *

*****

Par. 5. Section 1.381(c)(20)–1 is added to read as follows:

§ 1.381(c)(20)–1 Carryforward of disallowed business interest.

(a) *Carryover requirement*. Section 381(c)(20) provides that the acquiring corporation in a transaction described in section 381(a) will succeed to and take into account the carryover of disallowed business interest described in section 163(j)(2) to taxable years ending after the date of distribution or transfer.

(b) *Carryover of disallowed business interest described in section 163(j)(2)*. For purposes of section 381(c)(20) and this section, the term *carryover of disallowed business interest described in section 163(j)(2)* means the disallowed business interest expense carryforward (within the meaning of § 1.163(j)–1(b)(9)), including any disallowed disqualified interest (within the meaning of § 1.163(j)–1(b)(10)), and including the distributor or transferor corporation's disallowed business interest expense from the taxable year that ends on the date of distribution or transfer. For the application of section 382 to disallowed business interest expense described in section 163(j)(2), see the regulations under section 382, including but not limited to § 1.382–2.

(c) *Limitation on use of disallowed business interest expense carryforwards in the acquiring corporation's first taxable year ending after the date of distribution or transfer*—(1) *In general*. In determining the extent to which the acquiring corporation may use disallowed business interest expense carryforwards in its first taxable year ending after the date of distribution or transfer, the principles of §§ 1.381(c)(1)–1 and 1.381(c)(1)–2 apply with appropriate adjustments, including but not limited to the adjustments described in paragraphs (c)(2) and (3) of this section.

(2) *One date of distribution or transfer within the acquiring corporation's taxable year*. If the acquiring corporation succeeds to the disallowed business interest expense carryforwards of one or more distributor or transferor corporations on a single date of distribution or transfer within one taxable year of the acquiring corporation, then, for the acquiring corporation's first taxable year ending after the date of distribution or transfer, that part of the acquiring corporation's business interest expense deduction (if any) that is attributable to the disallowed business interest expense carryforwards of the distributor or transferor corporation is limited under this paragraph (c) to an amount equal to the post-acquisition portion of the acquiring corporation's section 163(j) limitation, as defined in paragraph (c)(4) of this section.

(3) *Two or more dates of distribution or transfer in the taxable year*. If the acquiring corporation succeeds to the disallowed business interest expense carryforwards of two or more distributor or transferor corporations on two or more dates of distribution or transfer within one taxable year of the acquiring corporation, the limitation to be applied under this paragraph (c) is determined by applying the principles of § 1.381(c)(1)–2(b) to the post-acquisition portion of the acquiring corporation's section 163(j) limitation, as defined in paragraph (c)(4) of this section.

(4) *Definition*. For purposes of this paragraph (c), the term *post-acquisition portion of the acquiring corporation's section 163(j) limitation* means the amount that bears the same ratio to the acquiring corporation's section 163(j) limitation (within the meaning of § 1.163(j)–1(b)(31)) (or, if the acquiring corporation is a member of a consolidated group, the consolidated group's section 163(j) limitation) for the first taxable year ending after the date of distribution or transfer (taking into account items to which the acquiring corporation succeeds under section 381, other than disallowed business interest expense carryforwards) as the number of days in that year after the date of distribution or transfer bears to the total number of days in that year.

(5) *Examples*. For purposes of this paragraph (c)(5), unless otherwise stated, X, Y, and Z are taxable domestic C corporations that were incorporated on January 1, 2018 and that file their tax returns on a calendar-year basis; none of X, Y, or Z is a member of a consolidated group; the small business exemption in § 1.163(j)–2(d) does not apply; interest expense is deductible except to the extent of the potential application of section 163(j); and the facts set forth the only corporate activity. The principles of this paragraph (c) are illustrated by the following examples.

(i) *Example 1: Transfer before last day of acquiring corporation's taxable year*—(A) *Facts*. On October 31, 2019, X transferred all of its assets to Y in a statutory merger to which section 361 applies. For the 2018 taxable year, X had $400x of disallowed business interest expense, and Y had $0 of disallowed business interest expense. For the taxable year ending October 31, 2019, X had an additional $350x of disallowed business interest expense (X did not deduct any of its 2018 carryforwards in its 2019 taxable year). For the taxable year ending December 31, 2019, Y had business interest expense of $100x, business interest income of $200x, and adjusted taxable income (ATI) of $1,000x. Y's section 163(j) limitation for the 2019 taxable year was $500x ($200x + (30 percent x $1,000x) = $500x).

(B) *Analysis*. Pursuant to § 1.163(j)–5(b)(2), Y deducts its $100x of current-year business interest expense (as defined in § 1.163(j)–5(a)(2)(i)) before any disallowed business interest expense carryforwards (including X's carryforwards) from a prior taxable year are deducted. The aggregate disallowed business interest expense of X carried forward under section 381(c)(20) to Y's taxable year ending December 31, 2019, is $750x. However, pursuant to paragraph (c)(2) of this section, for Y's first taxable year ending after the date of distribution or transfer, the maximum amount of X's disallowed business interest expense carryforwards that Y can deduct is equal to the post-acquisition portion of Y's section 163(j) limitation. Pursuant to paragraph (c)(4) of this section, the post-acquisition portion of Y's section 163(j) limitation means Y's section 163(j) limitation times the ratio of the number of days in the taxable year after the date of distribution or transfer to the total number of days in that year. Therefore, only $84x of the aggregate amount ($500x x (61/365) = $84x) may be deducted by Y in that year, and the remaining $666x ($750x - $84x = $666x) is carried forward to the succeeding taxable year.

(C) *Transfer on last day of acquiring corporation's taxable year*. The facts are the same as in *Example 1* in paragraph (c)(5)(i)(A) of this section, except that X's transfer of its assets to Y occurred on December 31, 2019. For the taxable year ending December 31, 2019, X had an additional $350x of disallowed business interest expense (X did not deduct any of its 2018 carryforwards in its 2019 taxable year). For the taxable year ending December 31, 2020, Y had business interest expense of $100x, business interest income of $200x, and ATI of $1,000x. Y's section 163(j) limitation for the 2020 taxable year was $500x ($200x + (30 percent x $1,000x) = $500x). The aggregate disallowed business interest expense of X carried under section 381(c)(20) to Y's taxable year ending December 31, 2020, is $750x. Paragraph (c)(2) of this section does not limit the amount of X's disallowed business interest expense carryforwards that may be deducted by Y in the 2020 taxable year. Since the amount of Y's section 163(j) limit for the 2020 taxable year was $500x, Y may deduct the full amount ($100x) of its own business interest expense for the 2020 taxable year, along with $400x of X's disallowed business interest expense carryforwards.

(ii) *Example 2: Multiple transferors on same date*—(A) *Facts*. On October 31, 2019, X and Y transferred all of their assets to Z in statutory mergers to which section 361 applies. For the 2018 taxable year, X had $300x of disallowed business interest expense, Y had $200x, and Z had $0. For the taxable year ending October 31, 2019, each of X and Y had an additional $125x of disallowed business interest expense (neither X nor Y deducted any of its 2018 carryforwards in 2019). For the taxable year ending December 31, 2019, Z had business interest expense of $100x, business interest income of $200x, and ATI of $1,000x. Z's section 163(j) limitation for the 2019 taxable year was $500x ($200x + (30 percent x $1,000x) = $500x).

(B) *Analysis*. The aggregate disallowed business interest expense of X and Y carried under section 381(c)(20) to Z's taxable year ending December 31, 2019, is $750x. However, pursuant to paragraph (c)(2) of this section, only $84x of the aggregate amount ($500x x (61/365) = $84x) may be deducted by Z in that year. Moreover, under paragraph (b)(2) of this section, this amount only may be deducted by Z in that year after Z has deducted its $100 of current-year business interest expense (as defined in § 1.163(j)–5(a)(2)(i)).

(d) *Applicability date*. This section applies to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of this section, the section 163(j) regulations (within the meaning of § 1.163(j)–1(b)(32)), and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

Par. 6. Section 1.382–1 is amended by:

1. Adding entries for § 1.382–2(a)(7) and (8);

2. Revising the entry for § 1.382–2(b)(3);

3. Adding entries for § 1.382–6(b)(4), (b)(4)(i), and (b)(4)(ii);

4. Revising the entry for § 1.382–6(h); and

5. Adding entries for § 1.382–6(h)(1) and (2).

The additions and revisions read as follows:

§ 1.382–1 Table of contents.

* * * * *

§ 1.382–2 General rules for ownership change.

(a) * * *

(7) Section 382 disallowed business interest carryforward.

(8) Testing period.

(b) * * *

(3) Rules provided in paragraphs (a)(1)(i)(A), (a)(1)(ii), (iv), and (v), (a)(2)(iv) through (vi), (a)(3)(i), and (a)(4) through (8) of this section.

* * * * *

§ 1.382–6 Allocation of income and loss to periods before and after the change date for purposes of section 382.

* * * * *

(b) * * *

(4) Allocation of business interest expense.

(i) In general.

(ii) Example.

* * * * *

(h) Applicability date.

(1) In general.

(2) Paragraphs (b)(1) and (4) of this section.

* * * * *

Par. 7. Section 1.382–2 is amended by:

1. Revising paragraph (a)(1)(i)(A);

2. Removing ", or" and adding "; or" in its place at the end of paragraph (a)(1)(i)(B);

3. Revising paragraphs (a)(1)(ii) introductory text and (a)(1)(ii)(A);

4. Removing ", and" and adding "; and" in its place at the end of paragraph (a)(1)(ii)(B);

5. Removing the last sentence in paragraphs (a)(1)(iv) and (v);

6. Removing the commas and adding semicolons in their place at the end of paragraphs (a)(2)(i) and (iii);

7. Removing the period and adding a semicolon in its place at the end of paragraph (a)(2)(ii);

8. Removing ", and" and adding a semicolon in its place at the end of paragraph (a)(2)(iv);

9. Removing "1.383–1T(c)(3)." and adding "§ 1.383–1T(c)(3); and" in its place in paragraph (a)(2)(v);

10. Adding paragraph (a)(2)(vi);

11. Removing the last sentence in paragraphs (a)(3)(i), (a)(4)(i), and (a)(5) and (6);

12. Adding paragraphs (a)(7) and (8); and

13. Revising paragraph (b)(3).

The revisions and additions read as follows:

§ 1.382–2 General rules for ownership change.

(a) * * *

(1) * * *

(i) * * *

(A) Is entitled to use a net operating loss carryforward, a capital loss carryover, a carryover of excess foreign taxes under section 904(c), a carryforward of a general business credit under section 39, a carryover of a minimum tax credit under section 53, or a section 382 disallowed business interest carryforward described in paragraph (a)(7) of this section;

* * * * *

(ii) *Distributor or transferor loss corporation in a transaction under section 381*. Notwithstanding that a loss corporation ceases to exist under state law, if its disallowed business interest expense carryforwards, net operating loss carryforwards, excess foreign taxes, or other items described in section 381(c) are succeeded to and taken into account by an acquiring corporation in a transaction described in section 381(a), such loss corporation shall be treated as continuing in existence until—

(A) Any pre-change losses (excluding pre-change credits described in § 1.383–1(c)(3)), determined as if the date of such transaction were the change date, are fully utilized or expire under section 163(j), 172, or 1212;

* * * * *

(2) * * *

(vi) Any section 382 disallowed business interest carryforward.

* * * * *

(7) *Section 382 disallowed business interest carryforward*. The term *section 382 disallowed business interest carryforward* includes the following items:

(i) The loss corporation's disallowed business interest expense carryforwards, as defined in § 1.163(j)–1(b)(9), including disallowed disqualified interest, within the meaning of § 1.163(j)–1(b)(10), as of the ownership change.

(ii) The carryforward of the loss corporation's disallowed business interest expense (within the meaning of § 1.163(j)–1(b)(8)) paid or accrued (without regard to section 163(j)) in the pre-change period (within the meaning of § 1.382–6(g)(2)) in the year of the testing date, determined by allocating an equal portion of the disallowed business interest expense paid or accrued (without regard to section 163(j)) in the year of the testing date to each day in that year, regardless of whether the loss corporation has made a closing-of-the-books election under § 1.382–6(b)(2).

(8) *Testing period*. Notwithstanding the temporal limitations provided in § 1.382–2T(d)(3)(i), the testing period for a loss corporation can begin as early as the first day of the first taxable year from which there is a section 382 disallowed business interest carryforward to the first taxable year ending after the testing date.

(b) * * *

(3) *Rules provided in paragraphs (a)(1)(i)(A), (a)(1)(ii), (iv), and (v), (a)(2)(iv) through (vi), (a)(3)(i), and (a)(4) through (8) of this section.* The rules provided in paragraphs (a)(1)(i)(A), (a)(1)(ii), (iv), and (v), (a)(2)(iv) through (vi), (a)(3)(i), and (a)(4) through (8) of this section apply to

testing dates occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. For loss corporations that have testing dates occurring before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, see § 1.382–2 as contained in 26 CFR part 1, revised April 1, 2018. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to testing dates occurring during a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of this section, the section 163(j) regulations (within the meaning of § 1.163(j)–1(b)(32)), §§ 1.382–5, 1.382–6, and 1.383–1, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4 to taxable years beginning after December 31, 2017.

Par. 8. Section 1.382–5 is amended by revising the first and second sentences of paragraph (d)(1) and by adding three sentences to the end of paragraph (f) to read as follows:

§ 1.382–5 Section 382 limitation.

* * * * *

(d) * * *

(1) * * * If a loss corporation has two (or more) ownership changes, any losses or section 382 disallowed business interest carryforwards (within the meaning of § 1.382–2(a)(7)) attributable to the period preceding the earlier ownership change are treated as pre-change losses with respect to both ownership changes. Thus, the later ownership change may result in a lesser (but never in a greater) section 382 limitation with respect to such pre-change losses. * * *

* * * * *

(f) * * * Paragraph (d)(1) of this section applies with respect to an ownership change occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. For loss corporations that have undergone an ownership change before or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, see § 1.382–5 as contained in 26 CFR part 1, revised April 1, 2018. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to testing dates occurring during a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of this section, the section 163(j) regulations (within the meaning of § 1.163(j)–1(b)(32)), §§ 1.382–2, 1.382–6, and 1.383–1, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4 to taxable years beginning after December 31, 2017.

Par. 9. Section 1.382–6 is amended by:

1. Removing “Subject to paragraphs (b)(3)(ii) and (d)” in the first sentence of paragraph (b)(1) and adding “Subject to paragraphs (b)(3)(ii), (b)(4), and (d)” in its place;
2. Adding paragraph (b)(4); and
3. Revising paragraph (h).

The addition and revision read as follows:

§ 1.382–6 Allocation of income and loss to periods before and after the change date for purposes of section 382.

* * * * *

(b) * * *

(4) *Allocation of business interest expense*—(i) *In general*. Regardless of whether a loss corporation has made a closing-of-the-books election pursuant to paragraph (b) of this section, for purposes of calculating the taxable income of a loss corporation attributable to the pre-change period, the amount of the loss corporation’s deduction for current-year business interest expense, within the meaning of § 1.163(j)–5(a)(2)(i), is calculated based on a single tax year and is allocated between the pre-change period and the post-change period by ratably allocating an equal portion to each day in the year.

(ii) *Example*–(A) *Facts*. X is a calendar-year C corporation that is not a member of a consolidated group. On May 26, 2019, X is acquired by Z (an unrelated third-party) in a transaction that qualifies as an ownership change under section 382(g). For calendar year 2019, X has paid or accrued $100x of current-year business interest expense (within the meaning of § 1.163(j)–5(a)(2)(i)) and has an $81x section 163(j) limitation (within the meaning of § 1.163(j)–1(b)(31)).

(B) *Analysis*. Pursuant to paragraph (b)(4)(i) of this section, regardless of whether X has made a closing-of-the-books election pursuant to paragraph (b) of this section, X’s business interest expense deduction is ratably allocated between the pre-change and post-change periods. For calendar year 2019, X may deduct $81x of business interest expense (see § 1.163(j)–2(b)), of which $32.4x ($81x x (146 days/365 days) = $32.4x) is allocable to the pre-change period. The remaining $19x of interest that was paid or accrued in calendar year 2019 is disallowed business interest expense, of which $7.6x ($19x x (146 days/365 days) = $7.6x) is allocable to the pre-change period. The $7.6x of disallowed business interest expense is treated as a section 382 disallowed business interest carryforward (see § 1.382–2(a)(7)), and thus is a pre-change loss within the meaning of § 1.382–2(a)(2).

* * * * *

(h) *Applicability date*–(1) *In general*. This section applies to ownership changes occurring on or after June 22, 1994.

(2) *Paragraphs (b)(1) and (4) of this section*. Paragraphs (b)(1) and (4) of this section apply with respect to an ownership change occurring during a taxable year ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. For ownership changes occurring during a taxable year ending before the date the Treasury decision adopting these regulations is published in the **Federal Register**, see § 1.382–6 as contained in 26 CFR part 1, revised April 1, 2018. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to testing dates occurring during a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of this section, and the section 163(j) regula-

tions (within the meaning of § 1.163(j)–1(b)(32)) and § 1.383–1, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to taxable years beginning after December 31, 2017.

Par. 10. Section 1.383–0 is amended by revising paragraph (a) to read as follows:

§ 1.383–0 Effective date.

(a) The regulations under section 383 (other than the regulations described in paragraph (b) of this section) reflect the amendments made to sections 382 and 383 by the Tax Reform Act of 1986 and the amendments made to section 382 by the Tax Cuts and Jobs Act of 2017. See § 1.383–1(j) for effective date rules.

* * * * *

Par. 11. Section 1.383–1 is amended by:

1. In paragraph (a):

a. Adding entries for paragraphs (d)(1)(i) and (ii);

b. Revising the entries for paragraphs (e)(3) and (j);

c. Adding entries for paragraphs (j)(1) and (2); and

d. Removing the entry for paragraph (k).

2. Removing "(iv)" and adding "(v)" in its place in paragraph (c)(6)(i)(B).

3. Revising paragraphs (c)(6)(ii) and (d)(1).

4. Removing the commas and adding semicolons in their place at ends of paragraphs (d)(2)(i) through (vi).

5. Revising paragraph (d)(2)(iii).

6. Redesignating paragraphs (d)(2)(iv) through (vii) as paragraphs (d)(2)(v) through (viii), respectively.

7. Adding a new paragraph (d)(2)(iv).

8. Revising newly redesignated paragraph (d)(2)(v) and paragraph (d)(3)(ii).

9. Removing "(iv)" and adding "(v)" in its place in paragraph (e)(1).

10. In paragraph (e)(2):

a. Removing "sections 11(b)(2) and (15)" and adding "section 15" in its place in the fourth sentence; and

b. Removing the last two sentences.

11. Removing and reserving paragraph (e)(3).

12. In paragraph (f):

a. Removing *Example 4*;

b. Designating *Examples 1* through *3* as paragraphs (f)(1) through (3), respectively; and

c. Revising newly designated paragraphs (f)(2) and (3).

13. In the last sentence of paragraph (g), removing "(e.g., 0.34 for taxable years beginning in 1989)".

14. In paragraph (j):

a. Revising the paragraph heading;

b. Designating the text of paragraph (j) as paragraph (j)(1) and adding a heading to newly designated paragraph (j)(1); and

c. Adding paragraph (j)(2).

15. Removing paragraph (k).

The revisions and additions read as follows:

§ 1.383–1 Special limitations on certain capital losses and excess credits.

(a) * * *

* * * * *

(d) * * *

(1) * * *

(i) In general.

(ii) Ordering rule for losses or credits from same taxable year.

* * * * *

(e) * * *

(3) [Reserved]

* * * * *

(j) Applicability date.

(1) In general.

(2) Interaction with section 163(j).

* * * * *

(c) * * *

(6) * * *

(ii) *Example*. L, a new loss corporation, is a calendar-year taxpayer. L has an ownership change on December 31, 2019. For 2020, L has taxable income (prior to the use of any pre-change losses) of $100,000. In addition, L has a section 382 limitation of $25,000, a pre-change net operating loss carryover of $12,000, a pre-change general business credit carryforward under section 39 of $50,000, and no items described in § 1.383–1(d)(2)(i) through (iv). L's section 383 credit limitation for 2020 is the excess of its regular tax liability computed after allowing a $12,000 net operating loss deduction (taxable income of $88,000; regular tax liability of $18,480), over its regular tax liability computed after allowing an additional deduction in the amount of L's section 382 limitation remaining after the application of paragraphs (d)(2)(i) through (v) of this section, or $13,000 (taxable income of $75,000; regular tax liability of $15,750). L's section 383 credit limitation is therefore $2,730 ($18,480 minus $15,750).

(d) * * *

(1) *In general*—(i) *In general*. The amount of taxable income of a new loss corporation for any post-change year that may be offset by pre-change losses shall not exceed the amount of the section 382 limitation for the post-change year. The amount of the regular tax liability of a new loss corporation for any post-change year that may be offset by pre-change credits shall not exceed the amount of the section 383 credit limitation for the post-change year.

(ii) *Ordering rule for losses or credits from same taxable year*. A loss corporation's taxable income is offset first by losses subject to a section 382 limitation, to the extent the section 382 limitation for that taxable year has not yet been absorbed, before being offset by losses of the same type from the same taxable year that are not subject to a section 382 limitation. For example, assume that Corporation X has an ownership change in Year 1 and carries over disallowed business interest expense within the meaning of § 1.163(j)–1(b)(8), some of which constitutes a section 382 disallowed business interest carryforward, from Year 1 to Year 2. To the extent of its section 163(j) limitation, within the meaning of § 1.163(j)–1(b)(31), and its remaining section 382 limitation, Corporation X offsets its Year 2 income with the section 382 disallowed business interest carryforward before using any of the disallowed business interest expense that is not a section 382 disallowed business interest carryforward. Similar principles apply to the use of tax credits.

(2) * * *

(iii) Pre-change losses that are described in § 1.382–2(a)(2)(iii), other than losses that are pre-change capital losses, that are recognized and are subject to the section 382 limitation in such post-change year;

(iv)(A) With respect to an ownership change date occurring prior to the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, but during the taxable year which includes the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, the pre-change loss described in section 382(d)(3);

(B) With respect to an ownership change date occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, section 382 disallowed business interest carryforwards (within the meaning of § 1.382–2(a)(7));

(v) Pre-change losses not described in paragraphs (d)(2)(i) through (iv) of this section;

* * * * *

(3) * * *

(ii) *Example.* L, a calendar-year taxpayer, has an ownership change on December 31, 2019. For 2020, L has taxable income of $300,000 and a regular tax liability of $63,000. L has no pre-change losses, but it has a business credit carryforward from 2018 of $25,000. L has a section 382 limitation for 2020 of $50,000. L's section 383 credit limitation is $10,500, an amount equal to the excess of L's regular tax liability ($63,000) over its regular tax liability calculated by allowing an additional deduction of $50,000 ($52,500). Pursuant to the limitation contained in section 38(c), however, L is entitled to use only $9,500 (($63,000 - $25,000) x 25 percent) of its business credit carryforward in 2020. The unabsorbed portion of L's section 382 limitation (computed pursuant to paragraph (e) of this section) is carried forward under section 382(b)(2). The unused portion of L's business credit carryforward, $1,000, is carried forward to the extent provided in section 39.

* * * * *

(f) * * *

(2) *Example 2*–(i) *Facts*. L, a calendar-year taxpayer, has an ownership change on December 31, 2019. For 2020, L has $750,000 of ordinary taxable income (before the application of carryovers) and a section 382 limitation of $1,500,000. L's only carryovers are from pre–2019 taxable years and consist of a $500,000 net operating loss (NOL) carryover, and a $200,000 foreign tax credit carryover (all of which may be used under the section 904 limitation). The NOL carryover is a pre-change loss, and the foreign tax credit carryover is a pre-change credit. L has no other pre-change losses or credits that can be used in 2020.

(ii) *Analysis*. The following computation illustrates the application of this section for 2020:

1. Taxable income before carryovers	$750,000
2. Pre-change NOL carryover	$500,000
3. Section 382 limitation	$1,500,000
4. Amount of pre-change NOL carryover that can be used (least of line 1, 2, or 3)	$500,000
5. Taxable income (line 1 minus line 4)	$250,000
6. Section 382 limitation remaining (line 3 minus line 4)	$1,000,000
7. Pre-change credit carryover	$200,000
8. Regular tax liability (line 5 x section 11 rates)	$52,500
9. Modified tax liability (line 5 minus line 6 (but not less than zero) x section 11 rates)	$0
10. Section 383 credit limitation (line 8 minus line 9)	$52,500
11. Amount of pre-change credits that can be used in 2020 (lesser of line 7 or line 10)	$52,500
12. Amount of pre-change credits to be carried over to 2021 under section 904(c) (line 7 minus line 11)	$147,500
13. Section 383 credit reduction amount: $52,500/0.21	$250,000
14. Section 382 limitation to be carried to 2021 under section 382(b)(2) (line 6 minus line 13)	$750,000

(3) *Example 3*–(i) *Facts*. L, a calendar-year taxpayer, has an ownership change on December 31, 2019. L has $80,000 of ordinary taxable income (before the application of carryovers) and a section 382 limitation of $25,000 for 2020, a post-change year. L's only carryover is from a pre–2019 taxable year and is a general business credit carryforward under section 39 in the amount of $10,000 (no portion of which is attributable to the investment tax credit under section 46). The general business credit carryforward is a pre-change credit. L has no other credits which can be used in 2020.

(ii) *Analysis*. The following computation illustrates the application of this section:

1. Taxable income before carryovers	$80,000
2. Section 382 limitation	$25,000
3. Pre-change credit carryover	$10,000
4. Regular tax liability (line 1 x section 11 rates)	$16,800
5. Modified tax liability ((line 1 minus line 2) x section 11 rates)	$11,550
6. Section 383 credit limitation (line 4 minus line 5)	$5,250
7. Amount of pre-change credits that can be used (lesser of line 3 or line 6)	$5,250
8. Amount of pre-change credits to be carried over to 2021 under sections 39 and 382(l)(2) (line 3 minus line 7)	$4,750
9. Regular tax payable (line 4 minus line 7)	$11,550
10. Section 383 credit reduction amount: $5,250/0.21	$25,000
11. Section 382 limitation to be carried to 2021 under section 382(b)(2) (line 2 minus line 10)	$0

* * * * *

(j) Applicability date–(1) *In general*. * * *

(2) *Interaction with section 163(j)*. Paragraphs (c)(6)(i)(B) and (c)(6)(ii), (d)(1), (d)(2)(iii) through (viii), (d)(3)(ii), (e)(1) through (3), (f), and (g) of this section apply with respect to ownership changes occurring during a taxable year ending after the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. For loss corporations that have undergone an ownership change during a taxable year ending before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, see § 1.383–1 as contained in 26 CFR part 1, revised April 1, 2018. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to an ownership change occurring during a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply either the rules of this section, except paragraph (d)(2)(iv)(B) of this section, the section 163(j) regulations, within the meaning of § 1.163(j)–1(b)(32), and § 1.382–6, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4; or the rules of this section (except paragraph (d)(2)(iv)(A) of this section), the section 163(j) regulations, within the meaning of § 1.163(j)–1(b)(32), and §§ 1.382–2, 1.382–5, 1.382–6, and 1.383–1, and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to those ownership changes.

Par. 12. Section 1.446–3 is amended by revising paragraphs (g)(4) and (j)(2) to read as follows:

§ 1.446–3 Notional principal contracts.

* * * * *

(g) * * *

(4) *Swaps with significant nonperiodic payments*. For swaps with significant nonperiodic payments, see § 1.163(j)–1(b)(20)(ii).

* * * * *

(j) * * *

(2) The rules provided in paragraph (g)(4) of this section apply to notional principal contracts entered into on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. Taxpayers may apply the rules provided in paragraph (g)(4) of this section to notional principal contracts entered into before the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register.**

Par. 13. Section 1.469–9 is amended by revising paragraph (b)(2) to read as follows:

§ 1.469–9 Rules for certain rental real estate activities.

* * * * *

(b) * * *

(2) *Real property trade or business*. The following terms have the following meanings in determining whether a trade or business is a real property trade or business for purposes of section 469(c)(7)(C) and this section.

(i) *Real property*–(A) *In general*. The term *real property* includes land, buildings, and other inherently permanent structures that are permanently affixed to land. Any interest in real property, including fee ownership, co-ownership, a leasehold, an option, or a similar interest is real property under this section. Tenant improvements to land, buildings, or other structures that are inherently permanent or otherwise classified as real property within the meaning of this section are real property for purposes of section 469(c)(7)(C). However, property produced for sale that is not real property in the hands of the producing taxpayer or a related person, but that may be incorporated into real property by an unrelated person, is not treated as real property of the producing taxpayer for purposes of section 469(c)(7)(C) and this section (for example, bricks, nails, paint, and windowpanes).

(B) *Land*. The term *land* includes water and air space superjacent to land and natural products and deposits that are unsevered from the land. Natural products and deposits, such as plants, crops, trees, water, ores, and minerals, cease to be real property when they are harvested, severed, extracted, or removed from the land. Accordingly, any trade or business that involves the cultivation and harvesting of plants, crops, or trees, or severing, extracting, or removing natural products or deposits from land is not a real property trade or business for purposes of section 469(c)(7)(C) and this section. The storage or maintenance of severed or extracted natural products or deposits, such as plants, crops, trees, water, ores, and minerals, in or upon real property does not cause the stored property to be recharacterized as real property, and any trade or business relating to or involving such storage or maintenance of severed or extracted natural products or deposits is not a real property trade or business, even though such storage or maintenance otherwise may occur upon or within real property.

(C) *Inherently permanent structure*. The term *inherently permanent structure* means any permanently affixed building or other permanently affixed structure. If the affixation is reasonably expected to last indefinitely, based on all the facts and circumstances, the affixation is considered permanent. However, an asset that serves an active function, such as an item of machinery or equipment (for example, HVAC system, elevator or escalator), is not a building or other inherently permanent structure, and therefore is not real property for purposes of section 469(c)(7)(C) and this section, even if such item of machinery or equipment is permanently affixed to or becomes incorporated within a building or other inherently permanent structure. Accordingly, a trade or business that involves the manufacture, installation, operation, maintenance, or repair of any asset that serves an active function will not be a real property trade or business, or a unit or component of another real property trade or business, for purposes of section 469(c)(7)(C) and this section.

(D) *Building*–(*1*) *In general*. A *building* encloses a space within its walls and is generally covered by a roof or other external upper covering that protects the walls and inner space from the elements.

(*2*) *Types of buildings*. Buildings include the following assets if permanently affixed to land: houses; townhouses; apartments; condominiums; hotels; motels; stadiums; arenas; shopping malls; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and stores.

(E) *Other inherently permanent structures*–(*1*) *In general*. Other inherently permanent structures include the following assets if permanently affixed to land: parking facilities; bridges; tunnels; roadbeds; railroad tracks; pipelines; storage structures such as silos and oil and gas storage tanks; and stationary wharves and docks.

(*2*) *Facts and circumstances determination*. The determination of whether an asset is an inherently permanent structure is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(*i*) The manner in which the asset is affixed to land and whether such manner of affixation allows the asset to be easily removed from the land;

(*ii*) Whether the asset is designed to be removed or to remain in place indefinitely on the land;

(*iii*) The damage that removal of the asset would cause to the asset itself or to the land to which it is affixed;

(*iv*) Any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the asset from the land upon the expiration of the lease); and

(*v*) The time and expense required to move the asset from the land.

(ii) *Other definitions*–(A) through (G) [Reserved]

(H) *Real property operation*. The term *real property operation* means handling, by a direct or indirect owner of the real property, the day-to-day operations of a trade or business, within the meaning of paragraph (b)(1) of this section, relating to the maintenance and occupancy of the real property that affect the availability and functionality of that real property used, or held out for use, by customers where payments received from customers are principally for the customers' use of the real property. The principal purpose of such business operations must be the provision of the use of the real property, or physical space accorded by or within the real property, to one or more customers, and not the provision of other significant or extraordinary personal services, within the meaning of § 1.469–1T(e)(3)(iv) and (v), to customers in conjunction with the customers' incidental use of the real property or physical space. If the real property or physical space is provided to a customer to be used to carry on the customer's trade or business, the principal purpose of the business operations must be to provide the customer with exclusive use of the real property or physical space in furtherance of the customer's trade or business, and not to provide other significant or extraordinary personal services to the customer in addition to or in conjunction with the use of the real property or physical space, regardless of whether the customer pays for the services separately. However, other incidental personal services may be provided to the customer in conjunction with the use of real property or physical space, as long as such services are insubstantial in relation to the customer's use of the real property or physical space and the receipt of such services is not a significant factor in the customer's decision to use the real property or physical space.

(I) *Real property management*. The term *real property management* means handling, by a professional manager, the day-to-day operations of a trade or business, within the meaning of paragraph (b)(1) of this section, relating to the maintenance and occupancy of real property that affect the availability and functionality of that property used, or held out for use, by customers where payments received from customers are principally for the customers' use of the real property. The principal purpose of such business operations must be the provision of the use of the real property, or physical space accorded by or within the real property, to one or more customers, and not the provision of other significant or extraordinary personal services, within the meaning of § 1.469–1T(e)(3)(iv) and (v), to customers in conjunction with the customers' incidental use of the real property or physical space. If the real property or physical space is provided to a customer to be used to carry on the customer's trade or business, the principal purpose of the business operations must be to provide the customer with exclusive use of the real property or physical space in furtherance of the customer's trade or business, and not to provide other significant or extraordinary personal services to the customer in addition to or in conjunction with the use of the real property or physical space, regardless of whether the customer pays for the services separately. However, other incidental personal services may be provided to the customer in conjunction with the use of real property or physical space, as long as such services are insubstantial in relation to the customer's use of the real property or physical space and the receipt of such services is not a significant factor in the customer's decision to use the real property or physical space. A professional manager is a person responsible, on a full-time basis, for the overall management and oversight of the real property or properties and who is not a direct or indirect owner of the real property or properties.

(J) *and (K)* [Reserved]

(iii) *Examples*. The following examples illustrate the operation of this paragraph (b)(2):

(A) *Example 1*. A owns farmland and uses the land in A's farming business to grow and harvest crops of various kinds. As part of this farming business, A utilizes a greenhouse that is an inherently permanent structure to grow certain crops during the winter months. Under the rules of this section, any trade or business that involves the cultivation and harvesting of plants, crops, or trees is not a real property trade or business for purposes of section 469(c)(7)(C) and this section, even though the cultivation and harvesting of crops occurs upon or within real property. Accordingly, under these facts, A is not engaged in a real property trade or business for purposes of section 469(c)(7)(C) and this section.

(B) *Example 2*. B is a retired farmer and owns farmland that B rents exclusively to C to operate a farm. The arrangement between B and C is a trade or business (within the meaning of paragraph (b)(1) of this section) where payments by C are principally for C's use of B's real property. B also provides certain farm equipment for C's use. However, C is solely responsible for the maintenance and repair of the farm equipment along with any costs associated with operating the equipment. B also occasionally provides oral advice to C regarding various aspects of the farm operation, based on B's prior experience as a farmer. Other than the provision of this occasional advice, B does not provide any significant or extraordinary personal services to C in connection with the rental of the farmland to C. Under these facts, B is engaged in a real property trade or business (which does not include the use or deemed rental of any farm equipment) for purposes of section 469(c)(7)(C) and this section, and B's oral advice is an incidental personal service that B provides in conjunction with C's use of the real property. Nevertheless, under these facts, C is not engaged in a real property trade or business for purposes of section 469(c)(7)(C) and this section because C is engaged in the business of farming.

(C) *Example 3*. D owns a building in which D operates a restaurant and bar. Even though D provides customers with use of the physical space inside the building, D is not engaged in a trade or business where payments by customers are principally for the use of real property or physical space. Instead, the payments by D's customers are principally for the receipt of significant or extraordinary personal services (within the meaning of § 1.469–1T(e)(3)(iv) and (v)), mainly food and beverage preparation and presentation services, and the use of the physical space by customers is incidental to the receipt of these personal services. Under the rules of this section, any trade or business that involves the provision of significant or extraordinary personal services to customers in conjunction with the customers' incidental use of real property or physical space is not a real property trade or business, even though the business operations occur upon or within real property. Accordingly, under these facts, D is not engaged in a real property trade or business for purposes of section 469(c)(7)(C) and this section.

(D) *Example 4*. E owns a majority interest in an S corporation, X, that is engaged in the trade or business of manufacturing industrial cooling systems for installation in commercial buildings and for other uses. E also owns a majority interest in an S corporation, Y, that purchases the industrial cooling systems from X and that installs, maintains, and repairs those systems in both existing commercial buildings and commercial buildings under construction. Under the rules of this section, any trade or business that involves the manufacture, installation, operation, maintenance, or repair of any machinery or equipment that serves an active function will not be a real property trade or business (or a unit or component of another real property trade or business) for purposes of section 469(c)(7)(C) and this section, even though the machinery or equipment will be permanently affixed to real property once it is installed. In this case, the industrial cooling systems are machinery or equipment that serves an active function. Accordingly, under these facts, E, X and Y will not be treated as engaged in one or more real property trades or businesses for purposes of section 469(c)(7)(C) and this section.

(E) *Example 5*. (*1*) F owns an interest in P, a limited partnership. P owns and operates a luxury hotel. In addition to providing rooms and suites for use by customers, the hotel offers many additional amenities such as in-room food and beverage service, maid and linen service, parking valet service, concierge service, front desk and bellhop service, dry cleaning and laundry service, and in-room barber and hairdresser service. P contracted with M to provide maid and janitorial services to P's hotel. M is an S corporation principally engaged in the trade or business of providing maid and janitorial services to various types of businesses, including hotels. G is a professional manager employed by M who handles the day-to-day business operations relating to M's provision of maid and janitorial services to M's various customers, including P.

(*2*) Even though the personal services that P provides to the customers of its hotel are significant personal services within the meaning of § 1.469–1T(e)(3)(iv), the principal purpose of P's hotel business operations is the provision of use of the hotel's rooms and suites to customers, and not the provision of the significant personal services to P's customers in conjunction with the customers' incidental use of those rooms or suites. The provision of these significant personal services by P to P's customers is incidental to the customers' use of the hotel's real property. Accordingly, under these facts, F and P are treated as engaged in a real property trade or business for purposes of section 469(c)(7)(C) and this section.

(*3*) With respect to the maid and janitorial services provided by M, M's operations affect the availability and functionality of real property used, or held out for use, by customers in a trade or business where payments by customers are principally for the use of real property (in this case, P's hotel). However, M does not operate or manage real property. Instead, M is engaged in a trade or business of providing maid and janitorial services to customers, such as P, that are engaged in real property trades or businesses. Thus, M's business operations are merely ancillary to real property trades or businesses. Therefore, M is not engaged in real property operations or management as defined in this section. Accordingly, under these facts, M is not engaged in a real property trade or business within the meaning of section 469(c)(7)(C) and this section.

(*4*) With respect to the day-to-day business operations that G handles as a professional manager of M, the business operations that G manages is not the provision of use of P's hotel rooms and suites to customers. G does not operate or manage real property. Instead, G manages the provision of maid and janitorial services to customers, including P's hotel. Therefore, G is not engaged in real property management as defined in this section. Accordingly, under these facts, G is not engaged in a real property trade or business within the meaning of section 469(c)(7)(C) and this section.

* * * * *

Par. 14. Section 1.469–11 is amended by:

1. Removing the period at the end of paragraph (a)(1) and adding a semicolon in its place;

2. Revising paragraph (a)(3);

3. Redesignating paragraphs (a)(4) and (5) as paragraphs (a)(5) and (6), respectively; and

4. Adding a new paragraph (a)(4).

The revision and addition read as follows:

§ 1.469–11 Effective date and transition rules.

(a) * * *

(3) The rules contained in § 1.469–9, other than paragraph (a)(4) of this section, apply for taxable years beginning on or after January 1, 1995, and to elections made under § 1.469–9(g) with returns filed on or after January 1, 1995, and the rules contained in § 1.469–11(a)(4) apply for taxable years beginning on or after the date of the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**;

(4) The rules contained in § 1.469–9(b)(2) apply to taxable years beginning after December 31, 2018. Paragraph (b) of this section applies to loss corporations that have undergone an ownership change during a taxable year ending after the date of the Treasury decision adopting these regulations as final regulations is published in the **Federal Register.** However, taxpayers and their related parties, within the meaning of sections 267(b) and

707(b)(1), may rely on the rules of this section if applied consistently by the taxpayers and their related parties, until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**;

* * * * *

Par. 15. Section 1.860C–2 is amended by revising paragraph (b)(2) to read as follows:

§ 1.860C–2 Determination of REMIC taxable income or net loss.

* * * * *

(b) * * *

(2) *Deduction allowable under section 163*–(i) A REMIC is allowed a deduction, determined without regard to section 163(d), for any interest expense accrued during the taxable year.

(ii) For taxable years beginning after December 31, 2017, a REMIC is allowed a deduction, determined without regard to section 163(j), for any interest expense accrued during the taxable year.

* * * * *

Par. 16. Section 1.882–5 is amended by adding a sentence to the end of paragraph (a)(5) to read as follows:

§ 1.882–5 Determination of interest deduction.

(a) * * *

(5) * * * For rules regarding the coordination of this section and section 163(j), see § 1.163(j)–8(e).

* * * * *

Par. 17. Section 1.1502–13 is amended by—

1. In paragraph (a)(6)(ii)—

a. Under the heading "Matching rule. (§ 1.1502–13(c)(7)(ii))":

i. Designating *Examples 1* through *17* as entries (A) through (Q).

ii. Adding entries (R) and (S).

b. Under the heading "Anti-avoidance rules. (§ 1.1502–13(h)(2))":

i. Designating *Examples 1* through *5* as entries (i) through (v).

ii. Adding an entry (vi).

2. In paragraph (c)(7)(ii):

a. Designating *Examples 1* through *17* as paragraphs (c)(7)(ii)(A) through (Q), respectively.

b. In newly designated paragraphs (c)(7)(ii)(A) through (Q):

i. Redesignating paragraphs (c)(7)(ii)(A)(a) through (i) as paragraphs (c)(7)(ii)(A)(*1*) through (*9*).

ii. Redesignating paragraphs (c)(7)(ii)(B)(a) and (b) as paragraphs (c)(7)(ii)(B)(*1*) and (*2*).

iii. Redesignating paragraphs (c)(7)(ii)(C)(a) through (d) as paragraphs (c)(7)(ii)(C)(*1*) through (*4*).

iv. Redesignating paragraphs (c)(7)(ii)(D)(a) through (e) as paragraphs (c)(7)(ii)(D)(*1*) through (*5*).

v. Redesignating paragraphs (c)(7)(ii)(E)(a) through (f) as paragraphs (c)(7)(ii)(E)(*1*) through (*6*).

vi. Redesignating paragraphs (c)(7)(ii)(F)(a) through (d) as paragraphs (c)(7)(ii)(F)(*1*) through (*4*).

v. Redesignating paragraphs (c)(7)(ii)(G)(a) through (d) as paragraphs (c)(7)(ii)(G)(*1*) through (*4*).

vi. Redesignating paragraphs (c)(7)(ii)(I)(a) through (e) as paragraphs (c)(7)(ii)(I)(*1*) through (*5*).

vii. Redesignating paragraphs (c)(7)(ii)(J)(a) through (d) as paragraphs (c)(7)(ii)(J)(*1*) through (*4*).

viii. Redesignating paragraphs (c)(7)(ii)(K)(a) through (d) as paragraphs (c)(7)(ii)(K)(*1*) through (*4*).

ix. Redesignating paragraphs (c)(7)(ii)(L)(a) and (b) as paragraphs (c)(7)(ii)(L)(*1*) and (*2*).

x. Redesignating paragraphs (c)(7)(ii)(N)(a) through (c) as paragraphs (c)(7)(ii)(N)(*1*) through (*3*).

xi. Redesignating paragraphs (c)(7)(ii)(O)(a) through (d) as paragraphs (c)(7)(ii)(O)(*1*) through (*4*).

xii. Redesignating paragraphs (c)(7)(ii)(P)(a) and (b) as paragraphs (c)(7)(ii)(P)(*1*) and (*2*).

xiii. Redesignating paragraphs (c)(7)(ii)(Q)(a) through (c) as paragraphs (c)(7)(Q)(*1*) through (*3*).

c. In the table below, for each newly redesignated paragraph listed in the "Paragraph" column, remove the text indicated in the "Remove" column and add in its place the text indicated in the "Add" column:

Paragraph	Remove	Add
(c)(7)(ii)(A)(*5*)	paragraph (a) of this *Example 1*	*Example 1* in paragraph (c)(7)(ii)(A)(*1*) of this section
(c)(7)(ii)(A)(*5*)	paragraphs (c) and (d) of this *Example 1*	*Example 1* in paragraphs (c)(7)(ii)(A)(*3*) and (*4*) of this section
(c)(7)(ii)(A)(*6*)	paragraph (a) of this *Example 1*	*Example 1* in paragraph (c)(7)(ii)(A)(*1*) of this section
(c)(7)(ii)(A)(*7*)	paragraph (a) of this *Example 1*	*Example 1* in paragraph (c)(7)(ii)(A)(*1*) of this section
(c)(7)(ii)(A)(*8*)	paragraph (a) of this *Example 1*	*Example 1* in paragraph (c)(7)(ii)(A)(*1*) of this section
(c)(7)(ii)(A)(*9*)	paragraph (a) of this *Example 1*	*Example 1* in paragraph (c)(7)(ii)(A)(*1*) of this section
(c)(7)(ii)(C)(*3*)	paragraph (a) of this *Example 3*	*Example 3* in paragraph (c)(7)(ii)(C)(*1*) of this section
(c)(7)(ii)(C)(*4*)	paragraph (c) of this *Example 3*	*Example 3* in paragraph (c)(7)(ii)(C)(*3*) of this section
(c)(7)(ii)(C)(*4*)	paragraph (b) of this *Example 3*	*Example 3* in paragraph (c)(7)(ii)(C)(2) of this section
(c)(7)(ii)(D)(*5*)	paragraph (a) of this *Example 4*	*Example 4* in paragraph (c)(7)(ii)(D)(*1*) of this section
(c)(7)(ii)(D)(*5*)	paragraphs (c) and (d) of this *Example 4*	*Example 4* in paragraphs (c)(7)(ii)(D)(*3*) and (*4*) of this section
(c)(7)(ii)(E)(*3*)	paragraph (a) of this *Example 5*	*Example 5* in paragraph (c)(7)(ii)(E)(*1*) of this section
(c)(7)(ii)(E)(*4*)	paragraph (a) of this *Example 5*	*Example 5* in paragraph (c)(7)(ii)(E)(*1*) of this section

Paragraph	Remove	Add
(c)(7)(ii)(E)(*5*)	paragraph (a) of this *Example 5*	*Example 5* in paragraph (c)(7)(ii)(E)(*1*) of this section
(c)(7)(ii)(E)(*6*)	paragraph (a) of this *Example 5*	*Example 5* in paragraph (c)(7)(ii)(E)(*1*) of this section
(c)(7)(ii)(F)(*3*)	paragraph (a) of this *Example 6*	*Example 6* in paragraph (c)(7)(ii)(F)(*1*) of this section
(c)(7)(ii)(F)(*4*)	paragraph (a) of this *Example 6*	*Example 6* in paragraph (c)(7)(ii)(F)(*1*) of this section
(c)(7)(ii)(G)(*4*)	paragraph (a) of this *Example 7*	*Example 7* in paragraph (c)(7)(ii)(G)(*1*) of this section
(c)(7)(ii)(G)(*4*)	paragraph (c) of this *Example 7*	*Example 7* in paragraph (c)(7)(ii)(G)(*3*) of this section
(c)(7)(ii)(I)(*3*)	paragraph (a) of this *Example 9*	*Example 9* in paragraph (c)(7)(ii)(I)(*1*) of this section
(c)(7)(ii)(I)(*4*)	paragraph (a) of this *Example 9*	*Example 9* in paragraph (c)(7)(ii)(I)(*1*) of this section
(c)(7)(ii)(I)(*5*)	paragraph (d) of this *Example 9*	*Example 9* in paragraph (c)(7)(ii)(I)(*4*) of this section
(c)(7)(ii)(J)(*3*)	paragraph (a) of this *Example 10*	*Example 10* in paragraph (c)(7)(ii)(J)(*1*) of this section
(c)(7)(ii)(J)(*4*)	paragraph (a) of this *Example 10*	*Example 10* in paragraph (c)(7)(ii)(J)(*1*) of this section
(c)(7)(ii)(K)(*4*)	paragraph (a) of this *Example 11*	*Example 11* in paragraph (c)(7)(ii)(K)(*1*) of this section
(c)(7)(ii)(N)(*2*)	paragraph (a) of this *Example 14*	*Example 14* in paragraph (c)(7)(ii)(N)(*1*) of this section
(c)(7)(ii)(O)(*4*)	paragraph (a) of this *Example 15*	*Example 15* in paragraph (c)(7)(ii)(O)(*1*) of this section
(c)(7)(ii)(Q)(*1*)	*Example 16*	*Example 16* in paragraph (c)(7)(ii)(P) of this section
(c)(7)(ii)(Q)(2)	paragraph (f)(7), *Example 2* of this section	*Example 2* in paragraph (f)(7) of this section
(c)(7)(iii)(A)	Paragraphs (c)(6)(ii)(C), (c)(6)(ii)(D), and (c)(7)(ii), Examples 16 and 17 of this section	Paragraphs (c)(6)(ii)(C) and (D) of this section, *Example 16* in paragraph (c)(7)(ii)(P) of this section, and *Example 17* in paragraph (c)(7)(ii)(Q) of this section

d. Adding paragraphs (c)(7)(ii)(R) and (S).

3. In paragraph (h)(2):

a. Designating *Examples 1* through *5* as paragraphs (h)(2)(i) through (v), respectively.

b. In newly designated paragraphs (h)(2)(i) through (v):

i. Redesignating paragraphs (h)(2)(i)(a) and (b) as paragraphs (h)(2)(i)(A) and (B).

ii. Redesignating paragraphs (h)(2)(ii)(a) and (b) as paragraphs (h)(2)(ii)(A) and (B).

iii. Redesignating paragraphs (h)(2)(iii)(a) and (b) as paragraphs (h)(2)(iii)(A) and (B).

iv. Redesignating paragraphs (h)(2)(iv)(a) and (b) as paragraphs (h)(2)(iv)(A) and (B).

v. Redesiganting paragraphs (h)(2)(v)(a) and (b) as paragraphs (h)(2)(iv)(A) and (B).

c. Adding paragraph (h)(2)(vi).

The additions read as follows:

§ 1.1502–13 Intercompany transactions.

(a) * * *

(6) * * *

(ii) * * *

Matching rule. (§ 1.1502–13(c)(7)(ii))

* * * * *

(R) Example 18. Transfer of partnership interests in an intercompany sale.

(S) Example 19. Intercompany transfer of partnership interests in a non-recognition transaction.

* * * * *

Anti-avoidance rules. (§ 1.1502–13(h)(2))

* * * * *

(vi) Example 6. Section 163 interest limitation.

* * * * *

(c) * * *

(7) * * *

(ii) * * *

(R) *Example 18: Transfer of partnership interests in an intercompany sale*—(*1*) *Facts*. P wholly owns S and B, both of which are members of the consolidated group of which P is the common parent. S and A (an unrelated third party) are equal partners in PS1, which was formed in Year 1. At the end of Year 1, the fair market value of PS1 is $200x, and S's adjusted basis in its partnership interest is $100x. During Year 2, PS1 borrows money, pays $100x of business interest expense, and repays the debt. PS1's section 163(j) limitation is $0; thus, the $100x of Year 2 business interest expense is disallowed as a deduction to PS1, is characterized as excess business interest expense, and is allocated proportionally to PS1's partners. S reduces its basis in its PS1 interest under § 1.163(j)–6(h) to reflect the $50x of excess business interest expense allocated to S, but the reduction is not treated as a noncapital, nondeductible expense (see § 1.163(j)–4(d)(4)(ii)). On the last day of Year 2, S sells its PS1 partnership interest to B for $50x. S has not used any of the excess business interest expense allocated from PS1; thus, immediately before the sale, S's basis in its PS1 interest is increased by $50x (to $100x) under § 1.163(j)–6(h). This basis increase is not treated as tax-exempt income (see § 1.163(j)–4(d)(4)(ii)). During Year 3, PS1 earns $50x of income, all of which is reported to the partners as excess taxable income, and $25x of which is allocated to B. B's basis in its PS1 interest is increased accordingly. Additionally, during Year 3, B earns $25x of business interest income and has no business interest expense other than its allocation of business interest expense from PS1. At the close of business on the last day of Year 4, B sells its PS1 partnership interest to Z (an unrelated third party) for $85x. At the time of the sale, B's basis in its PS1 interest is $75x.

(*2*) *Definitions*. Under paragraph (b)(1) of this section, S's sale of its PS1 interest to B in Year 2 is an intercompany transaction, with S as the selling member and B as the buying member. S's $50x capital loss on the sale is an intercompany item within the meaning of paragraph (b)(2)(i) of this section. B's $25 of ordinary income in Year 3 and its $10x gain on the sale of the PS1 interest to Z in Year 4 are both corresponding items within the meaning of paragraph (b)(3)(i) of this section.

(*3*) *Timing and attributes*. S takes its $50x loss into account to reflect the difference in each consolidated return year between B's corresponding items taken into account for the year and the recomputed corresponding item for the year. If S and B were divisions of a single corporation and the intercompany sale were a transfer between divisions, the single entity would have had zero income inclusion in Year 3, as the $25x of excess taxable income attributable to the single entity's interest in PS1 would have allowed the single entity to use $25x of the excess business interest expense allocation from

PS1 in Year 2. However, on a separate entity basis, B's corresponding item for Year 3 is $25x of ordinary income (the excess taxable income from PS1). As a result, under § 1.1502–13(c)(ii), S takes into account $25x of its loss in Year 3, the difference between the recomputed corresponding item and B's corresponding item in Year 3 ($0 - $25x = - $25x). Under paragraphs (c)(1)(i) and (c)(4)(i)(A) of this section, the $25x is redetermined to be ordinary. The remaining $25x of S's loss continues to be deferred. The recomputed corresponding item in Year 4 is a $15x capital loss ($85x of sales proceeds minus $100x basis (the original $100x basis, minus a $50 reduction in basis under § 1.163(j)–6(h), plus a $25x increase for its allocable share of PS1's income, plus a $25x increase under § 1.163(j)–6(h)). B's corresponding item is a $10x capital gain ($85x sales proceeds minus $75x basis). Accordingly, the remaining $25x of S's $50x Year 2 capital loss is taken into account in Year 4.

(S) *Example 19: Intercompany transfer of partnership interests in a non-recognition transaction*—(*1*) *Facts*. P wholly owns B, which is a member of the consolidated group of which P is the common parent. P and A (an unrelated third party) are equal partners in PS1, which was formed in Year 1. At the end of Year 1, the fair market value of PS1 is $200x, and P's adjusted basis in its partnership interest is $100x. At the beginning of Year 2, PS1 borrows money and purchases inventory. During Year 2, PS1 pays $100x of business interest expense, sells inventory for $100x (net of cost of goods sold), and repays the debt in full. PS1's section 163(j) limitation for Year 2 is $30x (30 percent x $100x). Thus, $70x of PS1's Year 2 business interest expense is disallowed as a deduction to PS1, is characterized as excess business interest, and is allocated proportionally to PS1's partners. P reduces its basis in its PS1 interest under § 1.163(j)–6(h) to reflect the $35x of excess business interest allocated to P. P's basis in its PS1 interest also is increased to reflect the $35x of income allocated to P, leaving P with a basis in its PS1 interest of $100x at the end of Year 2. On the first day of Year 3, P contributes its PS1 partnership interest to B in exchange for B stock in a nonrecognition exchange under section 351. At the time, P had not used any of the excess business interest expense allocated from PS1. During Year 4, B sells its PS1 partnership interest to Z (an unrelated third party) for $200x.

(*2*) *Analysis*. P's transfer of its interest in PS1 to B is an intercompany transaction. The transfer also is a disposition for purposes of § 1.163(j)–6(h). Therefore, immediately before the transfer, P increases its $100x basis in its PS1 interest by $35x (the amount of P's unused excess business interest expense). Under section 362, B receives a carryover basis of $135x in the PS1 interest. P has no intercompany item, but B's $65x of capital gain from its sale of the PS1 interest to Z is a corresponding item because the PS1 interest was acquired in an intercompany transaction. B takes the $65x of capital gain into account in Year 4.

* * * * *

(h) * * *

(2) * * *

(vi) *Example 6: Section163(j) interest limitation*–(A) *Facts*. S1 and S2 are members of a consolidated group of which P is the common parent. S1 is engaged in an excepted trade or business, and S2 is engaged in a non-excepted trade or business. If S1 were to lend funds directly to S2 in an intercompany transaction, under § 1.163(j)–10(a)(4)(i), the intercompany obligation of S2 would not be considered an asset of S1 for purposes of § 1.163(j)–10 (concerning allocations of interest and other taxable items between excepted and non-excepted trades or businesses for purposes of section 163(j)). With a principal purpose of avoiding treatment of a lending transaction between S1 and S2 as an intercompany transaction (and increasing the P group's basis in its assets allocable to excepted trades or businesses), S1 lends funds to X (an unrelated third party). X then on-lends funds to S2 on substantially similar terms.

(B) *Analysis*. A principal purpose of the steps undertaken was to avoid treatment of a lending transaction between S1 and S2 as an intercompany transaction. Therefore, under paragraph (h)(1) of this section, appropriate adjustments are made, and the X obligation in the hands of S1 is not treated as an asset of S1 for purposes of § 1.163(j)–10, to the extent of the loan from X to S2.

* * * * *

Par. 18. Section 1.1502–21 is amended by revising paragraph (d) to read as follows:

§ 1.1502–21 Net operating losses.

* * * * *

(d) *Cross-reference*. For rules governing the application of a SRLY limitation to business interest expense for which a deduction is disallowed under section 163(j), see § 1.163(j)–5(d) and (f).

* * * * *

Par. 19. Section 1.1502–36 is amended by:

1. Revising the second sentence of paragraph (f)(2);
2. Revising the paragraph (h) heading;
3. Designating the text of paragraph (h) as paragraph (h)(1) and adding a heading to newly designated paragraph (h)(1); and
4. Adding paragraph (h)(2).

The revisions and addition read as follows:

§ 1.1502–36 Unified loss rule.

* * * * *

(f) * * *

(2) * * * Such provisions include, for example, sections 163(j), 267(f), and 469, and § 1.1502–13. * * *

* * * * *

(h) *Applicability date*–(1) *In general*. * * *

(2) *Definition in paragraph (f)(2) of this section*. Paragraph (f)(2) of this section applies to taxable years ending after the date of the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. For taxable years ending before the date of the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, see § 1.1502–36 as contained in 26 CFR part 1, revised April 1, 2018. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of this section, the section 163(j) regulations (within the meaning of § 1.163(j)–1(b)(32)), and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6 and 1.383–1), and 1.1504–4 to those taxable years.

Par. 20. Section 1.1502–79 is amended by adding paragraph (f) to read as follows:

§ 1.1502–79 Separate return years.

* * * * *

(f) *Disallowed business interest expense carryforwards*. For the treatment of disallowed business interest expense carryforwards (within the meaning of § 1.163(j)–1) of a member arising in a separate return limitation year, see § 1.163(j)–5(d) and (f).

Par. 21. Section 1.1502–90 is amended by revising the entry for § 1.1502–98 and adding an entry for § 1.1502–99(d) to read as follows:

§ 1.1502–90 Table of contents.

* * * * *

§ 1.1502–98 Coordination with sections 383 and 163(j).

§ 1.1502–99 Effective dates.

* * * * *

(d) Application to section 163(j).

Par. 22. Section 1.1502–91 is amended by revising paragraph (e)(2) to read as follows:

§ 1.1502–91 Application of section 382 with respect to a consolidated group.

* * * * *

(e) * * *

(2) *Example*–(i) *Facts*. The L group has a consolidated net operating loss arising in Year 1 that is carried over to Year 2. The L loss group has an ownership change at the beginning of Year 2.

(ii) *Analysis*. The net operating loss carryover of the L loss group from Year 1 is a pre-change consolidated attribute because the L group was entitled to use the loss in Year 2 and therefore the loss was described in paragraph (c)(1)(i) of this section. Under paragraph (a)(2)(i) of this section, the amount of consolidated taxable income of the L group for Year 2 that may be offset by this loss carryover may not exceed the consolidated section 382 limitation of the L group for that year. See § 1.1502–93 for rules relating to the computation of the consolidated section 382 limitation.

(iii) *Business interest expense*. The facts are the same as in the *Example* in paragraph (e)(2)(i) of this section, except that, rather than a consolidated net operating loss, a member of the L group pays or accrues a business interest expense in Year 1 for which a deduction is disallowed in that year under section 163(j) and § 1.163(j)–2(b). The disallowed business interest expense is carried over to Year 2 under section 163(j)(2) and § 1.163(j)–2(c). Thus, the disallowed business interest expense carryforward is a pre-change loss. Under section 163(j), the L loss group is entitled to deduct the carryforward in Year 2; however, the amount of consolidated taxable income of the L group for Year 2 that may be offset by this carryforward may not exceed the consolidated section 382 limitation of the L group for that year. See § 1.1502–98(b) (providing that §§ 1.1502–91 through 1.1502–96 apply section 382 to business interest expense, with appropriate adjustments).

* * * * *

Par. 23. Section 1.1502–95 is amended in paragraph (b)(4) by:

1. Designating *Examples 1* and *2* as paragraphs (b)(4)(i) and (ii), respectively;

2. In newly designated paragraph (b)(4)(i), redesignating paragraphs (b)(4)(i)(i) and (ii) as paragraphs (b)(4)(i)(A) and (B), respectively;

3. In newly designated paragraph (b)(4)(ii), redesignating paragraphs (b)(4)(ii)(i) and (ii) as paragraphs (b)(4)(ii)(A) and (B), respectively; and

4. Adding two sentences at the end of newly redesignated paragraph (b)(4)(ii)(B).

The additions read follows:

§ 1.1502–95 Rules on ceasing to be a member of a consolidated group (or loss subgroup).

* * * * *

(b) * * *

(4) * * *

(ii) * * *

(B) * * * The analysis would be similar if the L loss group had an ownership change under § 1.1502–92 in Year 2 with respect to disallowed business interest expense paid or accrued by L2 in Year 1 and carried forward under section 163(j)(2) to Year 2 and Year 3. See § 1.1502–98(b) (providing that §§ 1.1502–91 through 1.1502–96 apply section 382 to business interest expense, with appropriate adjustments).

* * * * *

Par. 24. Section 1.1502–98 is amended by:

1. Revising the section heading;

2. Designating the undesignated text as paragraph (a) and adding a heading for newly designated paragraph (a); and

3. Adding paragraph (b).

The revision and additions read as follows:

§ 1.1502–98 Coordination with sections 383 and 163(j).

(a) *Coordination with section 383*. * * *

(b) *Application to section 163(j)*—(1) *In general*. The regulations under sections 163(j), 382, and 383 contain rules governing the application of section 382 to interest expense governed by section 163(j) and the regulations thereunder. See, for example, §§ 1.163(j)–11(b), 1.382–2, 1.382–6, and 1.383–1. The rules contained in §§ 1.1502–91 through 1.1502–96 apply these rules to members of a consolidated group, or corporations that join or leave a consolidated group, with appropriate adjustments. For example, for purposes of §§ 1.1502–91 through 1.1502–96, the term *loss group* includes a consolidated group in which any member is entitled to use a disallowed business interest expense carryforward, within the meaning of § 1.163(j)–1(b)(9), that did not arise, and is not treated as arising, in a SRLY with regard to that group. Additionally, a reference to net operating loss carryovers in §§ 1.1502–91 through 1.1502–96 generally includes a reference to disallowed business interest expense carryforwards. References to a loss or losses in §§ 1.1502–91 through 1.1502–96 include references to disallowed business interest expense carryforwards or section 382 disallowed business interest carryforwards, within the meaning of § 1.382–2(a)(7), as appropriate.

(2) *Appropriate adjustments*. For purposes of applying the rules in §§ 1.1502–91 through 1.1502–96 to current-year business interest expense (within the meaning of § 1.163(j)–5(a)(2)(i)), disallowed business interest expense carryforwards, and section 382 disallowed business interest carryforwards, appropriate adjustments are required.

Par. 25. Section 1.1502–99 is amended by adding paragraph (d) to read as follows:

§ 1.1502–99 Effective/applicability dates.

* * * * *

(d) *Application to section 163(j)*–(1) *Sections 1.382–2 and 1.382–5*. To the extent the rules of §§ 1.1502–91 through 1.1502–99 effectuate the rules of §§ 1.382–2 and 1.382–5, the provisions apply with respect to ownership changes occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. For loss corporations that have ownership changes occurring before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, see §§ 1.1502–91 through 1.1502–99 as contained in 26 CFR part 1, revised April 1, 2018. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of §§ 1.1502–91 through 1.1502–99 to the extent they apply the rules of §§ 1.382–2 and 1.382–5, to ownership changes occurring during a taxable year beginning after December 31, 2017, as well as consistently applying the rules of the §§ 1.1502–91 through 1.1502–99 to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, and 1.383–1, the section 163(j) regulations (within the meaning of § 1.163(j)–1(b)(32)), and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, and 1.1504–4 to taxable years beginning after December 31, 2017.

(2) *Sections 1.382–6 and 1.383–1*. To the extent the rules of §§ 1.1502–91 through 1.1502–98 effectuate the rules of §§ 1.382–6 and 1.383–1, the provisions apply with respect to ownership changes occurring during a taxable year ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. For the application of these rules to an ownership change with respect to an ownership change occurring during a taxable year ending before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, see §§ 1.1502–91 through 1.1502–99 as contained in 26 CFR part 1, revised April 1, 2018. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of §§ 1.1502–91 through 1.1502–99 (to the extent that those rules effectuate the rules of §§ 1.382–6 and 1.383–1), to ownership changes occurring during a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations (within the meaning of § 1.163(j)–1(b)(32)), and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, and 1.1504–4 to taxable years beginning after December 31, 2017.

Par. 26. Section 1.1504–4 is amended by:

1. Removing "163(j), 864(e)," from paragraph the first sentence of paragraph (a)(2) and adding "864(e)" in its place; and

2. Adding two sentences at the end of paragraph (i).

The addition reads as follows:

§ 1.1504–4 Treatment of warrants, options, convertible obligations, and other similar interests.

* * * * *

(i) * * * Paragraph (a)(2) of this section applies with respect to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of this section, the section 163(j) regulations (within the meaning of § 1.163(j)–1(b)(32)), and if applicable, §§ 1.263A–9, 1.381(c)(20)–1, 1.382–6, 1.383–1, 1.469–9, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, and 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–6, and 1.383–1), to those taxable years.

Dated: October 4, 2018.

Douglas W. O'Donnell,
Acting Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on December 21, 2018, 11:45 a.m., and published in the issue of the Federal Register for December 28, 2018, 83 F.R. 67490)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1]A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.

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