DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9905]

RIN 1545–BO73; RIN 1545–BP07

Limitation on Deduction for Business Interest Expense

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance about the limitation on the deduction for business interest expense after amendment of the Internal Revenue Code (Code) by the provisions commonly known as the Tax Cuts and Jobs Act, which was enacted on December 22, 2017, and the Coronavirus Aid, Relief, and Economic Security Act, which was enacted on March 27, 2020. The regulations provide guidance to taxpayers on how to calculate the limitation, what constitutes interest for purposes of the limitation, which taxpayers and trades or businesses are subject to the limitation, and how the limitation applies in consolidated group, partnership, international, and other contexts.

DATES:

Effective date: The regulations are effective on November 13, 2020. Sections 1.163(j)–1 through 1.163(j)–11 are generally applicable to taxable years beginning on or after November 13, 2020.

Applicability dates: For dates of applicability, see §§ 1.163(j)–1(c), 1.163(j)–2(k), 1.163(j)–3(d), 1.163(j)–4(g), 1.163(j)–5(h), 1.163(j)–6(p), 1.163(j)–9(k), 1.163(j)–10(f), 1.163(j)–11(d), 1.263A–15(a), 1.381(c)(20)–1(d), 1.382–2(b)(3), 1.382–5(f), 1.382–6(h), 1.383–1(j), 1.446–3(j)(2), 1.469–11(a)(3) and (4), 1.1502–36(h)(2), 1.1502–99(d), and 1.1504–4(i).

Pursuant to section 7805(b)(7), taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may apply the rules set forth in §§ 1.163(j)–1 through 1.163(j)–11, in their entirety, to a taxable year beginning after December 31, 2017, and before November 13, 2020, so long as the taxpayers and their related parties consistently apply these rules, and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1,469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–90, 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 that taxable year. However, see § 1.163(j)–1(c) for the applicability date rules relating to notional principal contracts and the interest anti-avoidance rule; see also part II(E)(2) (relating to notional principal contracts) and part II(E)(4) (relating to the interest anti-avoidance rule) of the Summary of Comments and Revisions section of this preamble.

Alternatively, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may rely on proposed §§ 1.163(j)–1 through 1.163(j)–11, which were issued in a notice of proposed rulemaking (REG–106089–18) and published on December 28, 2018, in the **Federal Register** (83 FR 67490), in their entirety, for a taxable year beginning after December 31, 2017, and before November 13, 2020, so long as the taxpayers and their related parties consistently apply proposed §§ 1.163(j)–1 through –11, and, if applicable, proposed §§ 1.263A–9, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 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 that taxable year. Notwithstanding the preceding sentence, taxpayers applying the provisions in the notice of proposed rulemaking may apply § 1.163(j)–1(b)(1)(iii) in these final regulations for taxable years beginning after December 31, 2017.

With respect to § 1.382–2 and, if applicable, §§ 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of § 1.382–2), and with respect to § 1.382–5 and, if applicable, §§ 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of § 1.382–5), the regulations apply to testing dates and ownership changes, respectively, occurring on or after November 13, 2020.

Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of § 1.382–2 and, if applicable, §§ 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of § 1.382–2), and § 1.382–5 and, if applicable, §§ 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of § 1.382–5), to a testing date or an ownership change, respectively, that occurs in a taxable year beginning after December 31, 2017, and before November 13, 2020, so long as the taxpayers and their related parties consistently apply the rules of §§ 1.163(j)–1 through –11, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, and 1.383–1, and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–90, 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 that taxable year.

Alternatively, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may rely on the rules of proposed § 1.382–2 and, if applicable, §§ 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of § 1.382–2), and § 1.382–5 and, if applicable, §§ 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of § 1.382–5), which were issued in a notice of proposed rulemaking (REG–106089–18) and published on December 28, 2018, in the **Federal Register** (83 FR 67490), with respect to a testing date or an ownership change, respectively, that occurs in a taxable year beginning after December 31, 2017, and before November 13, 2020, so long as the taxpayers and their related parties consistently apply the rules of proposed §§ 1.163(j)–1 through –11, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, and 1.383–1, and, if applicable, proposed §§ 1.263A–9, 1.381(c)(20)–1, 1.469–9, 1.469–11, 1.882–5, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–90, 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 that taxable year. As noted previously, taxpayers relying on the provisions in the notice of proposed rulemaking may apply § 1.163(j)–1(b)(1)(iii) in these final regulations for taxable years ending after December 31, 2017.

FOR FURTHER INFORMATION CONTACT:

Concerning § 1.163(j)–1, § 1.163(j)–2, § 1.163(j)–3, § 1.163(j)–9, § 1.263A–9, or § 1.263A–15, Sophia Wang, (202) 317–4890 or Justin Grill, (202) 317–4850; 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, § 1.382–7, § 1.383–0, § 1.383–1, § 1.1502–13, § 1.1502–21, § 1.1502–36, § 1.1502–79, § 1.1502–90, § 1.1502–91, § 1.1502–95, § 1.1502–98, § 1.1502–99, or § 1.1504–4, Russell Jones, (202) 317–5357, John Lovelace, (202) 317–5363, Aglaia Ovtchinnikova, (202) 317–6975, or Marie C. Milnes-Vasquez, (202) 317–3181; concerning § 1.163(j)–6, § 1.469–9(b)(2), § 1.469–11, § 1.704–1, § 1.1362–3, § 1.1368–1, or

§ 1.1377–1, William Kostak, (202) 317–6852, Anthony McQuillen, (202) 317–5027, or Adrienne Mikolashek, (202) 317–5050; concerning § 1.163(j)–7, § 1.163(j)–8, or § 1.882–5, Azeka Abramoff, (202) 317–3800, Angela Holland, (202) 317–5474, or Steve Jensen, (202) 317–6938; concerning § 1.446–3, § 1.860C–2, RICs, REITs, REMICs, and the definition of the term ''interest'', Michael Chin, (202) 317–5846 (not toll-free numbers).

ADDRESSES: Submit electronic submissions to the Federal eRulemaking Portal at *http://www.regulations.gov* (indicate IRS and REG–106089–18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to CC:PA:LPD:PR (REG–106089–18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

SUPPLEMENTARY INFORMATION:

Background

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This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 163(j) of the Code. The final regulations reflect amendments to section 163(j) made by Public Law 115–97, 131 Stat. 2054 (December 22, 2017), commonly referred to as the Tax Cuts and Jobs Act (the TCJA) and the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116–136 (2020) (the CARES Act). 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) and significantly changed the limitation for deducting interest on certain indebtedness. The provisions of section 163(j) as amended by section 13301 of the TCJA are effective for tax years beginning after December 31, 2017. The CARES Act further amended section 163(j) by redesignating section 163(j)(10), as amended by the TCJA, as new section 163(j)(11), and adding a new section 163(j)(10) providing special rules for applying section 163(j) to taxable years beginning in 2019 or 2020. All references to ''old section 163(j)'' in this document are references to section 163(j) prior to amendment by the TCJA and the CARES Act, and all references to ''section 163(j)'' are references to section 163(j) as amended by the TCJA and the CARES Act.

Old section 163(j) generally disallowed a deduction for ''disqualified interest'' paid or accrued by a corporation in a taxable year if the payor's debt-to-equity ratio exceeded 1.5 to 1.0, and if the payor's net interest expense exceeded 50 percent of its adjusted taxable income. Disqualified interest 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) certain real estate investment trusts (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, the excess of the taxpayer's net interest expense over 50 percent of its adjusted taxable income, could be carried forward three years. The interest limitation under old section 163(j) was designed to prevent a taxpayer from deducting interest from its U.S. taxable income without a corresponding inclusion in U.S. taxable income by the recipient, or to prevent the stripping of earnings from the U.S. tax system.

In contrast, section 163(j) now applies broadly to all business interest expense regardless of whether the related indebtedness is between related parties or incurred by a corporation, and regardless of the taxpayer's debt-to-equity ratio. Section 163(j) provides an entirely new limitation on the deduction for ''business interest expense'' of all taxpayers, including, for example, individuals, corporations, partnerships, S corporations, unless a specific exclusion applies under section 163(j). Although certain terms are used in both old section 163(j) and section 163(j), such as ''adjusted taxable income,'' such terms have been updated in the final regulations to reflect the new limitation under section 163(j).

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 preamble 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 (30 percent

ATI limitation); and (3) the taxpayer's floor plan financing interest expense for the taxable year. As further described later in this Background section, section 163(j)(10), as amended by the CARES Act, provides special rules relating to the 30 percent ATI limitation for taxable years beginning in 2019 or 2020. The section 163(j) limitation 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 section 163(j) limitation 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 allow the carryforward of any excess limitation.

Section 163(j)(3) provides that the section 163(j) limitation does not apply to a taxpayer, other than a tax shelter as described 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 the partnership's excess taxable income, as defined in section 163(j)(4)(C), but not by the partner's distributive share of the partnership's income, gain, deduction, or loss. Section 163(j)(4)(B)(i) 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, and to the extent, the partnership allocates excess taxable income to the partner. As further described later in this Background section, section 163(j)(10)(A)(ii)(II), as amended by the CARES Act, provides a special rule for excess business interest expense allocated to a partner in a taxable year beginning in 2019. Section 163(j)(4)(B)(iii) provides basis adjustment rules for 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)) and do not include investment income or investment expense within the meaning of section 163(d). 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 (excepted 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 (NOL) 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 it 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 section 163(j) limitation.

Under section 163(j)(10)(A)(i), the amount of business interest that is deductible under section 163(j)(1) for taxable years beginning in 2019 or 2020 is computed using 50 percent, rather than 30 percent, of the taxpayer's ATI for the taxable year (50 percent ATI limitation). A taxpayer may elect not to apply the 50 percent ATI limitation to any taxable year beginning in 2019 or 2020, and instead apply the 30 percent ATI limitation. The election must be made separately for each taxable year. Once the taxpayer makes the election, the election may not be revoked without the consent of the Secretary of the Treasury or his delegate. See section 163(j)(10)(A)(iii).

Sections 163(j)(10)(A)(ii)(I) and 163(j)(10)(A)(iii) provide that, in the case of a partnership, the 50 percent ATI limitation does not apply to partnerships for taxable years beginning in 2019, and the election to not apply the 50 percent ATI limitation may be made only for taxable years beginning in 2020. This election may be made only by the partnership and may not be revoked without the consent of the Secretary of the Treasury or his delegate. Under section 163(j)(10)(A)(ii)(II), however, a partner treats 50 percent of its allocable share of a partnership's excess business interest expense for 2019 as a business interest expense in the partner's first taxable year beginning in 2020 that is not subject to the section 163(j) limitation (50 percent EBIE rule). The remaining 50 percent of the partner's allocable share of the partnership's excess business interest expense remains subject to the section 163(j) limitation applicable to excess business interest expense carried forward at the partner level. A partner may elect out of the 50 percent EBIE rule.

Section 163(j)(10)(B)(i) allows a taxpayer to elect to use its ATI for the last taxable year beginning in 2019 for the taxpayer's ATI in determining the taxpayer's section 163(j) limitation for any taxable year beginning in 2020.

Section 163(j)(11) provides cross-references to provisions requiring that electing farming businesses and electing real property businesses excepted from the section 163(j) limitation 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.

On December 28, 2018, the Treasury Department and the IRS (1) published proposed regulations under section 163(j) in a notice of proposed rulemaking (REG–106089–18) (proposed regulations) in the **Federal Register** (83 FR 67490), and (2) withdrew the notice of proposed rulemaking (1991–2 C.B. 1040) published in the **Federal Register** on June 18, 1991 (56 FR 27907) (as corrected by 56 FR 40285 (August 14, 1991)) to implement rules under old section 163(j) (1991 Proposed Regulations). The proposed regulations were issued following guidance announcing and describing regulations intended to be issued under section 163(j). See Notice 2018–28, 2018–16 I.R.B. 492.

A public hearing was held on February 27, 2019. The Treasury Department and the IRS received written comments responding to the notice of proposed rulemaking. Comments received before the final regulations were substantially developed, including all comments received on or before the deadline for comments on February 26, 2019, were carefully considered in developing the final regulations.

Copies of the comments received are available for public inspection at *http://www.regulations.gov* or upon request. After consideration of the comments received and the testimony at the public hearing, this Treasury decision adopts the proposed regulations as revised in response to such comments and testimony as described in the Summary of Comments and Explanation of Revisions section. The revisions are discussed in this preamble. Concurrently with the publication of the final regulations, the Treasury Department and the IRS are publishing in the Proposed Rule section of this edition of the **Federal Register** (RIN 1545–BO76) a notice of proposed rulemaking providing additional proposed regulations under section 163(j) (REG–107911–18) (Concurrent NPRM). The Concurrent NPRM includes proposed regulations relating to changes made to section 163(j) under the CARES Act.

On September 10, 2019, the Treasury Department and the IRS published proposed regulations under section 382(h) (REG–125710–18) in the **Federal Register** (84 FR 47455) (the September 2019 section 382 proposed regulations). The September 2019 section 382 proposed regulations included a rule to clarify that section 382 disallowed business interest carryforwards are not treated as recognized built-in losses (RBILs). No formal comments were received on this rule during the comment period for the September 2019 section 382 proposed regulations.

On April 10, 2020, the Treasury Department and the IRS released Revenue Procedure 2020–22, 2020–18 I.R.B. 745, to provide the time and manner of making a late election, or withdrawing an election under section 163(j)(7)(B) to be an electing real property trade or business, or under section 163(j)(7)(C) to be an electing farming business, for taxable years beginning in 2018, 2019, or 2020. Revenue Procedure 2020–22 also provides the time and manner of making or revoking elections provided by the CARES Act under section 163(j)(10) for taxable years beginning in 2019 or 2020. As described earlier in this Background section, these elections are: (1) To not apply the 50 percent ATI limitation under section 163(j)(10)(A)(iii); (2) to use the taxpayer's ATI for the last taxable year beginning in 2019 to calculate the taxpayer's section 163(j) limitation in 2020 under section 163(j)(10)(B); and (3) for a partner to elect out of the 50 percent EBIE rule under section 163(j)(10)(A)(ii)(II).

Summary of Comments and Explanation of Revisions

I. Overview

The Treasury Department and the IRS received approximately 120 written comments in response to the notice of proposed rulemaking. Most of the comments addressing the proposed regulations are summarized in this Summary of Comments and Explanation of Revisions section. However, comments merely summarizing or interpreting the proposed regulations or recommending statutory revisions generally are not discussed in this preamble. Additionally, comments outside the scope of this rulemaking are generally not addressed in this Summary of Comments and Explanation of Revisions section.

The Treasury Department and the IRS continue to study comments on certain issues related to section 163(j), including issues that are beyond the scope of the final regulations (or the Concurrent NPRM in the Proposed Rules section of this issue of the **Federal Register**), and may discuss those comments if future guidance on those issues is published.

The final regulations retain the same basic structure as the proposed regulations, with certain revisions.

II. Comments on and Changes to Proposed § 1.163(j)–1: Definitions

Section 1.163(j)–1 provides definitions of the terms used in the final regulations. The following discussion addresses comments relating to proposed § 1.163(j)–1.

A. Definition and Calculation of Adjusted Taxable Income (ATI)—Proposed § 1.163(j)–1(b)(1)

1. Taxable Income and Tentative Taxable Income

Consistent with section 163(j)(8), proposed § 1.163(j)–1(b)(1) defines ATI as the ''taxable income'' of the taxpayer for the taxable year, with certain specified adjustments. Thus, in calculating ATI, the proposed regulations begin with taxable income as the amount to which adjustments are made when calculating ATI. Proposed § 1.163(j)–1(b)(37)(i) generally provides that the term ''taxable income'' has the meaning provided in section 63, but for purposes of section 163(j), is computed without regard to the application of section 163(j) and the section 163(j) regulations. However, in some instances in the section 163(j) regulations the term ''taxable income'' is used to indicate the amount calculated under section 63 for purposes other than calculating ATI.

To prevent confusion from using the term ''taxable income'' in different contexts (in determining ATI, and for purposes other than determining ATI), the final regulations use a new term, ''tentative taxable income,'' to refer to the amount to which adjustments are made in calculating ATI. See § 1.163(j)–1(b)(43). Tentative taxable income is generally determined in the same manner as taxable income under section 63, but is computed without regard to the application of the section 163(j) limitation, and without regard to any disallowed business interest expense carryforwards. This definitional change avoids confusion with section 63 taxable income, avoids creating an iterative loop that takes into account the section 163(j) limitation, and ensures that disallowed business interest expense carryforwards are taken into account only once in testing business interest expense against the limitation.

Therefore, ''tentative taxable income'' is used in the final regulations and, where appropriate, in this Summary of Comments and Explanation of Provisions section, to describe the starting point for the calculation of ATI in the final regulations. See part II(G)(1) of this Summary of Comments and Explanation of Revisions section.

2. Adjustments to ATI for Amounts Incurred as Depreciation, Amortization, and Depletion

Section 163(j)(8)(A)(v) defines ATI as the taxable income of the taxpayer computed without regard to certain items, including any deduction allowable for depreciation, amortization, or depletion for taxable years beginning before January 1, 2022. Consistent with section 163(j)(8)(A)(v), proposed § 1.163(j)–1(b)(1)(i) requires an addback to taxable income of deductions for depreciation, amortization, and depletion for taxable years beginning before January 1, 2022. In general, section 263A requires certain taxpayers that manufacture or produce inventory to capitalize all direct costs and certain indirect costs into the basis of the property produced or acquired for resale. Depreciation, amortization or depletion that is capitalized into inventory under section 263A is recovered through cost of goods sold as an offset to gross receipts in computing gross income; cost of goods sold reduces the amount realized upon the sale of goods that is used to calculate gross income and is technically not a deduction that is applied against gross income in determining taxable income. See §§ 1.61–3(a) and 1.263A–1(e)(3)(ii)(I) and (J). Thus, proposed § 1.163(j)–1(b)(1)(iii) provides that depreciation, amortization, or depletion expense capitalized into inventory under section 263A is not a depreciation, amortization, or depletion deduction, that may be added back to taxable income in computing ATI. The preamble to the proposed regulations further noted that an amount that is incurred as depreciation, amortization, or depletion, but that is capitalized to inventory under section 263A and included in costs of goods sold, is not a deduction for depreciation, amortization, or depletion for purposes of section 163(j).

Many commenters raised questions and concerns regarding proposed § 1.163(j)–1(b)(1)(iii) and requested that the addback of deductions for depreciation, amortization, and depletion include any amount that is required to be capitalized into inventory under section 263A. First, commenters stated that the provision does not reflect congressional intent, which was to determine ATI using earnings before interest, tax, depreciation, and amortization (EBITDA) through taxable year 2021 and using earnings before interest and tax (EBIT) thereafter. Commenters noted that the proposed rule would eliminate this distinction for certain manufacturers or producers of property for sale. Commenters pointed out that capital-intensive businesses that manufacture or produce inventory are at a disadvantage in comparison to other types of businesses because the manufacturers or producers would have to compute ATI without an addback for a substantial amount of their depreciation, and that neither section 163(j) nor its legislative history indicates an intent by Congress to treat manufacturers or producers of inventory differently from other trades or businesses. Commenters also contrasted the language in section 163(j)(8)(A)(iv), which allows an addback of ''the amount of any deduction *allowed* under section 199A,'' with section 163(j)(8)(A)(v), which allows an addback of ''any deduction *allowable* for depreciation, amortization, or depletion'' (emphasis added).

The phrase ''allowed or allowable'' is used in other Code provisions. Section 1016(a)(2) provides that, in calculating tax basis, adjustments are required for depreciation to the extent such amounts are allowed as deductions in computing taxable income but not less than the amounts allowable. Some commenters noted that depreciation allowable as a deduction for purposes of section 1016(a)(2) should be read consistently with depreciation allowable as a deduction for purposes of section 163(j), and that section 1016(a)(2) treats depreciation capitalized into inventory under section 263A as deductions allowable. As provided in section 263A(a)(2) and § 1.263A–1(c)(2), an amount is not subject to capitalization under section 263A unless such cost may be taken into account in computing taxable income.

The Treasury Department and the IRS have reconsidered proposed § 1.163(j)–1(b)(1)(iii). Accordingly, under the final regulations, the amount of any depreciation, amortization, or depletion that is capitalized into inventory under section 263A during taxable years beginning before January 1, 2022, is added back to tentative taxable income as a deduction for depreciation, amortization, or depletion when calculating ATI for that taxable year, regardless of the period in which the capitalized amount is recovered through cost of goods sold. For example, if a taxpayer capitalized an amount of depreciation to inventory under section 263A in the 2020 taxable year, but the inventory is not sold until the 2021 taxable year, the entire capitalized amount of depreciation is added back to tentative taxable income in the 2020 taxable year, and such capitalized amount of depreciation is not added back to tentative taxable income when the inventory is sold and recovered through cost of goods sold in the 2021 taxable year. Under such facts, the entire capitalized amount is deemed to be included in the calculation of the taxpayer's tentative taxable income for the 2020 taxable year, regardless of the period in which the capitalized amount is actually recovered. See §§ 1.163(j)–1(b)(1)(iii) and 1.163(j)–2(h)(3).

Further, in order to treat similarly situated taxpayers similarly, the final regulations allow taxpayers, and their related parties within the meaning of sections 267(b) and 707(b)(1), otherwise relying on the proposed regulations in their entirety under § 1.163(j)–1(c) to alternatively choose to follow § 1.163(j)–1(b)(1)(iii) rather than proposed § 1.163(j)–1(b)(1)(iii). See § 1.163(j)–1(c).

The Treasury Department and the IRS note that neither proposed § 1.163(j)–1(b)(1) nor § 1.163(j)–1(b)(1) determines the amount of allowed or allowable depreciation, amortization, or depletion for purposes of any other Code section (for example, sections 167(c), 1016(a)(2), 1245, and 1250). Accordingly, no inference should be drawn regarding the determination of the amount of allowed or allowable depreciation, amortization, or depletion under any other Code section based on proposed § 1.163(j)–1(b)(1) or § 1.163(j)–1(b)(1).

In addition to comments about whether depreciation, amortization, and depletion include amounts recovered through cost of goods sold, a commenter requested clarification that section 179 deductions are depreciation deductions for purposes of section 163(j)(8)(A)(v) and proposed § 1.163(j)–1(b)(1)(i)(D). Section 179 deductions are allowed to be added back as amortization under proposed § 1.163(j)–1(b)(1)(i)(E), which allows an addback of 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)), for taxable years beginning before January 1, 2022. Section 1245(a)(2)(C) provides ''any deduction allowable under sections 179, 179B, 179C, 179D, 179E, 181, 190, 193, or 194 shall be treated as if it were a deduction allowable for amortization.'' Because section 179 deductions are included as amortization under proposed § 1.163(j)–1(b)(1)(i)(E), rather than as depreciation under proposed § 1.163(j)–1(b)(1)(i)(D), no clarification is necessary in the final regulations. See § 1.163(j)–1(b)(1)(i)(E).

3. ATI and Floor Plan Financing Interest

Consistent with section 163(j)(8)(A)(ii), the proposed regulations provide that any business interest expense or business interest income is added back to (in the case of business interest expense) or subtracted from (in the case of business interest income) taxable income in computing ATI. Because business interest expense includes floor plan financing interest expense, ATI is further adjusted by subtracting from it any floor plan financing interest expense under proposed § 1.163(j)–1(b)(1)(ii)(B). Floor plan financing interest expense is also separately included in the section 163(j) limitation as provided in section 163(j)(1)(C).

One commenter suggested that floor plan financing interest expense should not be subtracted from ATI because such adjustment is inconsistent with the statute and the ordering implied by section 168(k)(9)(B). The addition of floor plan financing interest expense as business interest in the calculation of ATI is consistent with section 163(j)(8)(A)(ii). The purpose of subtracting floor plan financing interest expense from tentative taxable income to compute ATI is to avoid the double benefit that would result upon separately including floor plan financing interest expense in the computation of the section 163(j) limitation. If floor plan financing interest expense were included in ATI without a corresponding subtraction, thus resulting in an increased ATI, taxpayers with such expense would be able to increase their section 163(j) limitation not only by the separately stated floor plan financing interest under section 163(j)(1)(C), but also by the inclusion of such amount in ATI, which would permit a deduction of $1.30 (or $1.50, if the 50 percent ATI limitation is applicable) of business interest expense for each $1 of floor plan financing interest expense. Although it is clear that Congress did not intend to limit the deduction for floor plan financing interest expense under section 163(j), there is no indication that Congress also intended to provide the additional benefit of an increased ATI related to floor plan financing interest expense. Therefore, under the authority granted in section 163(j)(8)(B), the final regulations adopt the proposed rule without change to include a subtraction of floor plan financing interest expense from tentative taxable income in computing ATI.

Several commenters also requested clarification and submitted recommendations on the interaction between section 168(k)(9) and section 163(j). Section 168(k)(9)(B) provides that the additional first-year depreciation deduction is not allowed for any property used in a trade or business that has had floor plan financing indebtedness (as defined in section 163(j)(9)), if the floor plan financing interest related to such indebtedness was taken into account under section 163(j)(1)(C).

First, commenters requested that floor plan financing indebtedness not be treated as taken into account if the sum of business interest income and 30 percent of ATI (the sum of section 163(j)(1)(A) and section 163(j)(1)(B)) is greater than the business interest expense paid or accrued in the taxable year. Second, if the sum of business interest income and 30 percent of ATI is less than the business interest expense paid or accrued in the taxable year, commenters requested that taxpayers be given the option to either include floor plan financing interest to increase the section 163(j) limitation, or to forgo the use of floor plan financing interest to increase the section 163(j) limitation (any forgone floor plan financing interest would be included in the disallowed business interest expense carryforward under proposed § 1.163(j)–2(c)) in order to utilize the additional first-year depreciation deduction under section 168(k).

Section 163(j) does not provide any guidance on the availability of section 168(k) for taxpayers that have had floor plan financing interest expense. As these comments relate to the operation of section 168(k)(9), taxpayers should look to Treasury Department or IRS guidance provided under section 168(k) for clarification. On September 24, 2019, the Treasury Department and the IRS published in the **Federal Register** final regulations (TD 9874, 84 FR 50108) and proposed regulations (REG–106808–19, 84 FR 50152) under section 168(k). The rules regarding when floor plan financing interest expense is ''taken into account'' for purposes of 168(k) are in the proposed regulations under § 1.168(k)–2(b)(2)(ii)(G). Accordingly, these final regulations do not address the interaction between section 163(j) and section 168(k)(9) regarding floor plan financing interest expense.

4. Adjustments to Taxable Income in Computing ATI Under Section 163(j)(8)(A)

Section 163(j)(8)(A) provides that ATI means taxable income ''computed without regard to'' the specified adjustments. The purpose of the adjustments listed in section 163(j)(8)(A) is to keep certain items, such as deductions for depreciation, amortization, depletion, or NOL carryforward amounts, from directly increasing or decreasing the amount of the deduction for business interest expense. Therefore, the Treasury Department and the IRS have determined that the adjustments listed in section 163(j)(8)(A) should adjust tentative taxable income for purposes of calculating ATI under § 1.163(j)–1(b)(1) only to the extent that they have been reflected (or deemed reflected, as in the case of certain amounts capitalized into inventory under section 263A as discussed in part II(A)(2) of this Summary of Comments and Explanation of Revisions section) in tentative taxable income under § 1.163(j)–1(b)(43).

A commenter requested that the definition of ATI not include some of the adjustments listed in section 163(j)(8)(A), such as the adjustments for NOL deductions and deductions under section 199A. The Treasury Department and the IRS do not have authority to ignore these clear and unambiguous statutory adjustments. Thus, the final regulations do not incorporate the commenter's suggestion.

5. Certain Adjustments to Tentative Taxable Income in Computing ATI Under Section 163(j)(8)(B)

Under the authority granted in section 163(j)(8)(B), the proposed regulations include several adjustments to taxable income in computing ATI to address certain sales or other dispositions of depreciable property, stock of a consolidated group member, or interests in a partnership. Proposed § 1.163(j)–1(b)(1)(ii)(C) provides that, if property is sold or otherwise disposed of, the lesser of the amount of gain on the disposition or the amount of depreciation, amortization, or depletion deductions (collectively, depreciation deductions) with respect to the property for the taxable years beginning after December 31, 2017 and before January 1, 2022 (such years, the EBITDA period) is subtracted from taxable income to determine ATI. Proposed § 1.163(j)–1(b)(1)(ii)(D) provides that, 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 (see § 1.1502–32) with respect to such stock that are attributable to deductions described in proposed § 1.163(j)–1(b)(1)(ii)(C) are subtracted from taxable income. In turn, proposed § 1.163(j)–1(b)(1)(ii)(E) provides that, with respect to the sale or other disposition of an interest in a partnership, the taxpayer's distributive share of deductions described in proposed § 1.163(j)–1(b)(1)(ii)(C) with respect to property held by the partnership at the time of such disposition is subtracted from taxable income to the extent such deductions were allowable under section 704(d).

In general, when a taxpayer takes depreciation deductions with respect to an asset, the taxpayer must reduce its adjusted basis in the asset accordingly. As a result, the taxpayer will realize additional gain (or less loss) upon the subsequent disposition of the asset than the taxpayer would have realized absent depreciation deductions. Thus, except with regard to timing (and, in some cases, character), depreciation deductions should have no net effect on a taxpayer's taxable income.

In order to mitigate the effects of the section 163(j) limitation during the EBITDA period, Congress provided an adjustment to taxable income for depreciation deductions. More specifically, as discussed in part II(A)(2) of this Summary of Comments and Explanation of Revisions section, depreciation deductions are added back to taxable income during the EBITDA period, thereby increasing a taxpayer's ATI and its section 163(j) limitation. Congress intended this adjustment to be a timing provision that delays the inclusion of depreciation deductions in calculating a taxpayer's section 163(j) limitation. Stated differently, Congress intended to allow taxpayers to accelerate the recognition of gain attributable to depreciation deductions when computing ATI.

However, if a taxpayer were to sell its depreciable property after making the foregoing adjustment to ATI, the taxpayer would realize additional gain (or less loss) on the disposition as a result of its depreciation deductions, and the taxpayer's ATI would be increased yet again. Similarly, if the depreciable property were held by a member of a consolidated group (S), and if another member of the group were to sell S's stock after making negative adjustments to its basis in S's stock under § 1.1502–32 to reflect S's depreciation deductions, the consolidated group's ATI would be increased yet again. A similar double benefit would arise with respect to interests in a partnership if, after the partner's basis in its partnership interest is reduced by depreciation deductions associated with the depreciable property, ATI were to reflect that reduced basis upon a subsequent sale of the partnership interest.

Proposed § 1.163(j)–1(b)(1)(ii)(C), (D), and (E) were intended to address these situations and ensure that the positive adjustment for depreciation deductions during the EBITDA period merely defers (rather than permanently excludes) depreciation deductions from a taxpayer's calculation of the section 163(j) limitation.

Commenters submitted various questions and comments about these provisions. First, a commenter questioned whether these proposed subtractions from taxable income are an advisable exercise of the authority granted in section 163(j)(8)(B) in light of congressional silence on the issue. However, the 1991 Proposed Regulations contained similar subtractions from taxable income in computing ATI. The 1991 Proposed Regulations had been outstanding for more than 25 years when Congress enacted the TCJA. Thus, Congress likely was well aware of these adjustments when it granted the Secretary of the Treasury the authority to make adjustments in new section 163(j)(8)(B). Moreover, there is no indication that Congress intended to preclude the Secretary from making adjustments similar to those in the 1991 Proposed Regulations.

Second, commenters asked why the subtraction from taxable income in proposed § 1.163(j)–1(b)(1)(ii)(D) does not include a ''lesser of'' calculation similar to proposed § 1.163(j)–1(b)(1)(ii)(C), and they questioned whether the ''lesser of'' calculation in proposed § 1.163(j)–1(b)(1)(ii)(C) captures the correct amount. For example, if a taxpayer purchased property for $100x, fully depreciated the property, and then sold the property for $60x, should the amount that is backed out under proposed § 1.163(j)–1(b)(1)(ii)(C) be $60x or $100x? Commenters also stated that the presence of a ''lesser of'' limitation in proposed § 1.163(j)–1(b)(1)(ii)(C) and the absence of such a limitation in proposed § 1.163(j)–1(b)(1)(ii)(D) can yield discontinuities. For example, if S (a member of P's consolidated group) uses $50x to purchase an asset that it fully depreciates under section 168(k) (resulting in a $50x reduction in P's basis in its S stock under § 1.1502–32), and if S sells the depreciated asset for $25x the following year, the P group would have to subtract $25x from taxable income under proposed § 1.163(j)–1(b)(1)(ii)(C), whereas the group would have had to reduce its taxable income by $50x under proposed § 1.163(j)–1(b)(1)(ii)(D) if P had sold its S stock instead. Commenters recommended several solutions to address this discontinuity, including eliminating the ''lesser of'' test.

Proposed § 1.163(j)–1(b)(1)(ii)(D) does not include a ''lesser of'' calculation because such a calculation would require consolidated groups to value their assets each time there is a sale of member stock. However, the Treasury Department and the IRS recognize the discrepancy in taxable income adjustments between asset dispositions and member stock dispositions under the proposed regulations. To eliminate this discrepancy, the final regulations revise proposed § 1.163(j)–1(b)(1)(ii)(C) by eliminating the ''lesser of'' standard and requiring taxpayers to back out depreciation deductions that were allowed or allowable during the EBITDA period with respect to sales or dispositions of property. This revised approach is consistent with the adjustment for asset sales in the 1991 Proposed Regulations, is simpler for taxpayers to administer than the ''lesser of'' approach in the proposed regulations, and renders moot questions as to whether that ''lesser of'' calculation captures the correct amount. However, the Treasury Department and the IRS also recognize that, in certain cases, a ''lesser of'' computation would not be difficult to administer. Thus, the Concurrent NPRM provides taxpayers the option to apply the ''lesser of'' standard, so long as they do so consistently. See proposed § 1.163(j)–1(b)(1)(iv)(E) of the Concurrent NPRM.

Third, commenters asked whether the application of proposed § 1.163(j)–1(b)(1)(ii)(C) and (D) to the same consolidated group member would result in an inappropriate double inclusion if the asset sale precedes the stock sale, and whether proposed § 1.163(j)–1(b)(1)(ii)(C) should continue to apply to a group member if the sale of member stock precedes the asset sale. For example, S (a member of P's consolidated group) takes a $50x depreciation deduction in 2020 with respect to asset X, P's basis in its S stock is reduced accordingly under § 1.1502–32, and $50x is added back to the P group's tentative taxable income in computing its 2020 ATI. In 2021, S realizes a $50x gain upon the sale of asset X, P's basis in its S stock is increased accordingly by $50x under § 1.1502–32, and the P group subtracts $50x from its tentative taxable income under proposed § 1.163(j)–1(b)(1)(ii)(C) in computing its 2021 ATI. Then, in 2022, P sells the S stock to an unrelated buyer. Must P subtract another $50x from its tentative taxable income under proposed § 1.163(j)–1(b)(1)(ii)(D)? What if the order of sales were reversed (with P selling its S stock to a member of another consolidated group in 2021 and S selling asset X in 2022)—would both consolidated groups be required to subtract $50x from tentative taxable income in computing ATI? To prevent duplicative adjustments under proposed § 1.163(j)–1(b)(1)(ii)(C) and (D), commenters recommended that these rules ''turn off'' further subtractions once a subtraction already has been made under either provision, and that the application of proposed § 1.163(j)–1(b)(1)(ii)(C) be limited to the group in which the depreciation deductions accrued.

The Treasury Department and the IRS agree that the application of § 1.163(j)–1(b)(1)(ii)(C) and (D) to the same consolidated group member would result in an inappropriate double inclusion, and that proposed § 1.163(j)–1(b)(1)(ii)(C) should not apply to a former group member with respect to depreciation deductions claimed by the member in a former group. Thus, § 1.163(j)–1(b)(1)(iv)(D) provides anti-duplication rules to ensure that neither § 1.163(j)–1(b)(1)(ii)(C) nor § 1.163(j)–1(b)(1)(ii)(D) applies if a subtraction for the same economic amount already has been required under either provision.

For example, assume that P wholly owns S1, which wholly owns S2, which owns depreciable asset Q, and that S1 and S2 are members of P's consolidated group. Further assume that S2's depreciation deductions with respect to asset Q have resulted in investment adjustments in S1's stock in S2 and in P's stock in S1. If S1 were to sell its S2 stock to a third party, adjustments to the P group's tentative taxable income would be required under proposed § 1.163(j)–1(b)(1)(ii)(D). If P later were to sell its S1 stock to a third party, an additional adjustment under proposed § 1.163(j)–1(b)(1)(ii)(D) would not be required with respect to investment adjustments attributable to asset Q.

Fourth, commenters observed that these proposed subtractions from taxable income in computing ATI are required even if the disposition of the depreciable property, member stock, or partnership interest occurs many years after the EBITDA period. Commenters expressed concern that tracking depreciation deductions for purposes of these adjustments could become burdensome, and a commenter questioned the appropriateness in proposed § 1.163(j)–1(b)(1)(ii)(C) of treating all gain upon the disposition of property after the EBITDA period as attributable to depreciation deductions during the EBITDA period.

Commenters are correct in observing that these proposed adjustments to taxable income in computing ATI must be made even if the relevant depreciable asset, member stock, or partnership interest is disposed of after the EBITDA period. However, the Treasury Department and the IRS note that members of consolidated groups already must track depreciation deductions to calculate separate taxable income (see § 1.1502–12) and to preserve the location of tax items (see § 1.1502–13). Additionally, all taxpayers must track depreciation deductions on an asset-by-asset basis for purposes of section 1245. Thus, the Treasury Department and the IRS have determined that the adjustments proposed in § 1.163(j)–1(b)(1)(ii)(C), (D), and (E) should not impose a significant administrative burden in many situations. The Treasury Department and the IRS further note that eliminating the ''lesser of'' standard in proposed § 1.163(j)–1(b)(1)(ii)(C) (see the response to the second comment in this part of the Summary of Comments and Explanation of Revisions section) will render moot the commenter's concern about the calculation of gain.

Fifth, a commenter asked whether the term ''sale or other disposition'' in proposed § 1.163(j)–1(b)(1)(ii)(C), (D), and (E) is intended to apply to the transfer of stock of a consolidated group member in an intercompany transaction (within the meaning of § 1.1502–13(b)(1)(i)) or to the transfer of assets in a nonrecognition transaction to which section 381 applies (a section 381 transaction).

As provided in proposed § 1.163(j)–4(d)(2), a consolidated group has a single section 163(j) limitation, and intercompany items and corresponding items are disregarded for purposes of calculating the group's ATI to the extent they offset in amount. The Treasury Department and the IRS have determined that regarding intercompany items and corresponding items for purposes of § 1.163(j)–1(b)(1)(ii)(C) and (D) would be inconsistent with this general approach. Thus, § 1.163(j)–1(b)(1)(iv)(A)(*2*) provides that an intercompany transaction should not be treated as a ''sale or other disposition'' for purposes of § 1.163(j)–1(b)(1)(ii)(C) and (D).

In turn, the transfer of depreciable assets in a section 381 transaction generally should not be treated as a ''sale or other disposition'' because the transfer does not affect ATI and because the transferee corporation is the successor to the transferor corporation. Thus, the final regulations generally provide that a transfer of an asset to an acquiring corporation in a transaction to which section 381(a) applies is not treated as a ''sale or other disposition'' for purposes of § 1.163(j)–1(b)(1)(ii)(C), (D), and (E). However, if a member leaves a consolidated group, that transaction generally is treated as a sale or other disposition under the final regulations for purposes of § 1.163(j)–1(b)(1)(ii)(C) and (D), regardless of whether the transaction is a section 381 transaction, because the adjustment to ATI under these provisions should be reflected on the tax return of the group that received the benefit of the earlier increase in ATI.

Sixth, a commenter asked for clarification as to when the adjustment in proposed § 1.163(j)–1(b)(1)(ii)(D) is required and which investment adjustments under § 1.1502–32 are treated as ''attributable to'' depreciation deductions for purposes of this provision. For example, P wholly and directly owns both S and S1 (members of P's consolidated group). In 2021, S purchases asset X for \$100x and fully depreciates asset X under section 168(k), and P reduces its basis in its S stock by \$100x under § 1.1502–32. In 2022, P contributes the stock of S to S1 in an intercompany transaction (which, as noted previously, is not treated as a ''sale or other disposition'' for purposes of proposed § 1.163(j)–1(b)(1)(ii)(C) and (D)). If P later sells the S1 stock, is the adjustment in proposed § 1.163(j)–1(b)(1)(ii)(D) required even though no adjustment to P's basis in the S1 stock under § 1.1502–32 is ''attributable to'' the \$100x of depreciation deductions taken with respect to asset X?

The Treasury Department and the IRS have determined that the adjustment to tentative taxable income in proposed § 1.163(j)–1(b)(1)(ii)(D) should apply in the foregoing situation. The final regulations have been revised to provide that, for these purposes, P's stock in S1 would be treated as a successor asset (within the meaning of § 1.1502–13(j)(1)) to P's stock in S.

Seventh, commenters stated that there should be no adjustments to taxable income under proposed § 1.163(j)–1(b)(1)(ii)(C), (D), and (E) if and to the extent that adding back depreciation deductions pursuant to section 163(j)(8)(A)(v) and proposed § 1.163(j)–1(b)(1)(i) did not increase the amount of business interest expense the taxpayer could have deducted in the year the deductions were incurred. For example, in 2021, corporation C has \$500x of ATI (computed by adding back \$50x of depreciation deductions with respect to asset X) and \$100x of business interest expense. Without adding back the depreciation deductions, C's ATI would have been \$450x, C's section 163(j) limitation would have been \$135x (\$450x × 30 percent), and C still could have deducted all \$100x of its business interest expense in that year. In 2022, C has \$90x of business interest expense and \$300x of ATI. C sells asset X for a \$50x gain in that year. If C were required to reduce its ATI by \$50x (from \$300x to \$250x) in 2022 under proposed § 1.163(j)–1(b)(1)(ii)(C), its section 163(j) limitation would be reduced to \$75x (\$250x × 30 percent), and C would not be able to deduct all \$90x of its business interest expense in 2022 even though C derived no benefit from adding back its depreciation deductions to taxable income in 2021.

The Treasury Department and the IRS have determined that predicating the application of proposed § 1.163(j)–1(b)(1)(ii)(C), (D), and (E) upon whether a taxpayer derived a benefit under section 163(j) from adding back its depreciation deductions to taxable income would involve significant additional complexity. In addition, this approach would have an effect similar to allowing a carryforward of these amounts to the taxable year in which gain on the related items is recognized on a sale or other disposition. Such a carryforward is inconsistent with the general approach of section 163(j), which does not permit a carryforward of excess ATI to later taxable years. As noted earlier in this part II(A)(5) of this Summary of Comments and Explanation of Revisions section, depreciation deductions should have no net effect on the amount of a taxpayer's taxable income (except with respect to timing and, perhaps, character). Thus, if a taxpayer sells an asset with respect to which the taxpayer has taken depreciation deductions, the increase in gain (or decrease in loss) upon the sale should be reversed under proposed § 1.163(j)–1(b)(1)(ii)(C).

6. Adjustments to Adjusted Taxable Income in Respect of United States Shareholders of CFCs

Some commenters argued that United States shareholders, as defined in section 951(b) (U.S. shareholders), of controlled foreign corporations, as defined in section 957(a) (CFCs), should be allowed to include in their ATI the amounts included in gross income under section 951(a) (subpart F inclusions), section 951A(a) global intangible low-taxed income (GILTI) inclusions, and section 78 ''gross-up'' inclusions (collectively, CFC income inclusions) attributable to non-excepted trades or businesses. Because section 163(j) applies to CFCs, the Treasury Department and the IRS have determined that allowing a U.S. shareholder to include its CFC income inclusions in its ATI would not be appropriate. The income of the CFC that gives rise to such income is taken into account in computing the ATI of the CFC for purposes of determining its section 163(j) limitation, and allowing the same income to also be taken into account in computing the ATI of a U.S. shareholder would result in an inappropriate double-counting of income.

Furthermore, the Treasury Department and the IRS question the premise of several comments that, if the business interest expense of a CFC were excluded from the application of section 163(j), including the income of a CFC in a U.S. shareholder's ATI would be appropriate. Even if section 163(j) did not apply to CFCs, CFCs are entities that also may be leveraged. Thus, permitting the income of the CFC that gives rise to CFC income inclusions attributable to non-excepted trades or businesses of CFCs to be included in the ATI of U.S. shareholders would be inconsistent with the principles of section 163(j).

In particular, consider a case in which a CFC has interest expense of $100x, trade or business gross income of $300x treated as subpart F income, and no foreign tax liability. In such a case, a U.S. shareholder that wholly owns the CFC would have a subpart F inclusion of $200x (if section 163(j) did not apply to CFCs). If the $200x subpart F inclusion were included in the ATI of the U.S. shareholder, the U.S. shareholder could deduct an additional $60x of business interest expense ($200x × 30 percent). As a result, $300x of gross income could support $160x of interest expense deductions rather than the $90x permitted under section 163(j)(1).

Finally, under the final regulations (and consistent with proposed § 1.163(j)–7(d)(1)(ii)), if a domestic partnership includes amounts in gross income under sections 951(a) and 951A(a) with respect to an applicable CFC and such amounts are investment income to the partnership, then, a domestic C corporation partner's distributive share of such amounts that are properly allocable to a non-excepted trade or business of the domestic C corporation by reason of §§ 1.163(j)–4(b)(3) and 1.163(j)–10(c) are excluded from the domestic C corporation partner's ATI.

B. Definition of Business Interest Expense—Proposed § 1.163(j)–1(b)(2)

The proposed regulations provide that business interest expense includes interest expense allocable to a non-excepted trade or business, floor plan financing interest expense, and disallowed business interest expense carryforwards. The Treasury Department and the IRS received informal questions about the interaction between section 163(j) and sections 465 and 469, which may operate to disallow a deduction for business interest expense even if such expense was allowable after the application of section 163(j). More specifically, questions have arisen regarding how to treat amounts of business interest expense that are disallowed under section 465 or 469, including which amounts carry forward to subsequent taxable years but keep their character as interest expense, and which amounts, if any, are business interest expense in such subsequent taxable years.

If amounts of business interest expense that are disallowed under section 465 or 469 are treated as business interest expense in subsequent taxable years, the section 163(j) limitation could operate to disallow a deduction even though such amounts were allowable in the prior taxable year after application of the section 163(j) limitation. The Treasury Department and the IRS do not intend such a result. Therefore, the final regulations clarify that amounts allowable as a deduction after application of the section 163(j) limitation but disallowed by section 465 or 469 are not business interest expense subject to the section 163(j) limitation in subsequent taxable years.

C. Definition of Excepted Regulated Utility Trade or Business—Proposed § 1.163(j)–1(b)(13)

Numerous comments were submitted concerning the definition of an ''excepted regulated utility trade or business'' under proposed § 1.163(j)–1(b)(13). Proposed § 1.163(j)–1(b)(13), which implements the exception in section 163(j)(7)(A)(iv) to the definition of a ''trade or business,'' generally provides that an excepted regulated utility trade or business is a trade or business that sells or furnishes the items listed in section 163(j)(7)(A)(iv) at rates that are established or approved by certain regulatory bodies described in proposed § 1.163(j)–1(b)(13)(i)(B)(*1*) and (*2*).

The proposed regulations provide that utilities that sell or furnish the regulated items at rates that are established or approved by a regulatory body described in proposed § 1.163(j)–1(b)(13)(i)(B)(*1*), other than an electric cooperative, are considered to be excepted only to the extent that such rates are determined on a ''cost of service and rate of return'' basis. The ''cost of service and rate of return'' requirement was intended to provide certainty to taxpayers because many utilities are familiar with the definition of ''cost of service and rate of return,'' which is used to determine whether a public utility company must use a normalization method of accounting under section 168 for certain properties.

However, several commenters questioned whether a ''cost of service and rate of return'' requirement would be satisfied in specific fact patterns. Commenters questioned whether certain negotiated rates are established or approved on a ''cost of service and rate of return'' basis if (1) the applicable regulatory body has the authority to impose a cost-based rate instead of the negotiated rate, (2) the rates are computed with reference to cost but discounted from the recourse (or maximum) rate allowed by the regulatory body, or (3) the rates are computed with reference to cost and a set rate of return but are subject to a market-based cap. Commenters also asked whether the inclusion of certain amounts in determining ''cost of service,'' specifically the costs of affiliates and some revenues attributable to market-rate sales, would affect the determination of whether rates are established or approved on a ''cost of service and rate of return'' basis.

One commenter noted that the normalization rules operate logically only in the ''cost of service and rate of return'' context. The commenter stated that, because section 163(j)(7)(A)(iv) does not reference the normalization rules, there is no need to include the ''cost of service and rate of return'' requirement in the section 163(j) regulations.

The Treasury Department and the IRS note that, in private letter rulings and informal guidance related to section 168(i)(9) and (10), the IRS has stated that, for purposes of applying the normalization rules, the definition of ''public utility property'' must contain the requirement that the regulated rates be established or approved on a ''rate of return'' basis. In this guidance, the IRS explained that the normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under section 168, is defined in terms of the method the taxpayer uses in computing its tax expense in establishing its ''cost of service'' for ratemaking purposes and reflecting operating results in its regulated books of account. Furthermore, the IRS has issued numerous private letter rulings regarding whether under the specific facts of the taxpayer, the cost of service and rate of return requirement has been met for purposes of section 168(i). Thus, it is clear that, in the context of section 168, the ''cost of service and rate of return'' requirement is necessary.

Neither the text of section 163(j) nor the legislative history specifically references the normalization rules or the ''cost of service and rate of return'' requirement under section 168(i)(10). With the omission of such references, the exception in section 163(j) for regulated utility trade or business could be applied broadly without reference to specific requirements applicable in the normalization rules. However, the Treasury Department and the IRS note that under section 168(k)(9), the additional first-year depreciation deduction is not available to any property that is primarily used in an excepted regulated utility trade or business. Therefore, to ease the administrative burden of determining whether businesses qualify as excepted regulated utility trades or businesses, and to allow taxpayers the option of claiming the additional first-year depreciation deduction under section 168(k) in lieu of being treated as an excepted regulated utility trade or business, the final regulations retain the ''cost of service and rate of return'' requirement from the proposed regulations, and also allow taxpayers to make an election to be an excepted regulated utility trade or business to the extent that the rates for the furnishing or sale of the items described in § 1.163(j)–1(b)(15)(i)(A)(*1*) have been established or approved by a regulatory body described in § 1.163(j)–1(b)(15)(i)(A)(*2*), if the rates are not determined on a ''cost of service and rate of return'' basis. See § 1.163(j)–1(b)(15)(i) and (iii).

For purposes of the election, the focus of section 163(j)(7)(A)(iv) is the phrase ''established or approved'' in section 163(j)(7)(A)(iv), which describes the authority of the regulatory body described in § 1.163(j)–1(b)(15)(i)(A)(*2*). Ratemaking programs similar to those described by commenters and discussed previously in this part II(C) of this Summary of Comments and Explanation of Revisions section, including discounted rates, negotiated rates, and regulatory rate caps, are established or approved by a regulatory body if the taxpayer files a schedule of such rates with a regulatory body that has the power to approve, disapprove, alter the rates, or substitute a rate determined in an alternate manner.

Similar to elections for electing real property trades or businesses and electing farming businesses, the election to be an excepted regulated utility trade or business is irrevocable. Taxpayers making the election to be an excepted regulated utility trade or business are not required to allocate items between regulated utility trades or businesses that are described in § 1.163(j)–1(b)(15)(i) and trades or businesses that are described in § 1.163(j)–1(b)(15)(iii)(A) as to which the taxpayer makes an election because they are treated as operating an entirely excepted regulated utility trade or business. Electing taxpayers cannot claim the additional first-year depreciation deduction under section 168(k).

The rules set forth in the final regulations are limited solely to the determination of an ''excepted regulated utility trade or business'' for purposes of section 163(j)(7)(A)(iv). As a result of this limited application, the rules in the final regulations are not applicable to the determination of ''public utility property'' or the application of the normalization rules within the meaning of section 46(f), as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990, section 168(i)(9) and (10) and the regulations thereunder, or to the determination of any depreciation allowance available under sections 167 and 168.

Comments also were received on the application of the rules for excepted regulated utility trades or businesses to electric cooperatives. The definition of an ''excepted regulated utility trade or business'' under proposed § 1.163(j)–1(b)(13) includes trades or businesses that sell or furnish the items listed in section 163(j)(7)(A)(iv) at rates established or approved by an electric cooperative. Unlike utility businesses regulated by public authorities, utilities that sell items at rates regulated by a cooperative are not described in section 168(i)(10). However, there is a long-standing body of law regulating the taxation of electric cooperatives. Electric cooperatives described in section 501(c)(12) are generally exempt from income tax but are subject to taxation under section 511. The application of section 163(j) and the section 163(j) regulations with respect to exempt electric cooperatives is governed by proposed § 1.163(j)–4(b)(5). Other electric cooperatives are subject to taxation under sections 1381 through 1388 in subchapter T of chapter 1 of subtitle A of the Code (subchapter T), except for certain rural electric cooperatives specifically excluded from subchapter T by section 1381(a)(2)(C).

Generally, the exception in section 163(j)(7)(A)(iv) for the trade or business of selling or furnishing items at rates established or approved by the governing or ratemaking body of an electric cooperative applies both to sales and furnishing by an electric cooperative and to sales and furnishing to an electric cooperative by another utility provider, as long as the rates for the sale or furnishing have been established or approved in the manner required by section 163(j). Thus, an electric cooperative exempt from Federal income tax under section 501(c)(12) may not be subject to section 163(j) for the sale or furnishing of electricity due to the operation of proposed § 1.163(j)–4(b)(5), and another utility provider may be in an excepted regulated utility trade or business to the extent that it sells electricity to the section 501(c)(12) cooperative at rates established or approved by the governing or ratemaking body of the cooperative.

A commenter asked whether proposed § 1.163(j)–1(b)(13) requires that, for sales involving electric cooperatives to qualify as an excepted regulated utility trade or business, the rates for the sales be established or approved by the governing or ratemaking body of an electric cooperative on a ''cost of service and rate of return'' basis, or if all sales made subject to a contract or tariff approved by an electric cooperative's governing or ratemaking body would qualify. Under the proposed regulations, the specific requirement that rates for the sale or furnishing of items listed in proposed § 1.163(j)–1(b)(13)(i)(A) be established or approved on a ''cost of service and rate of return'' basis did not extend to rates established or approved by the governing or ratemaking body of an electric cooperative. These regulations adopt the proposed rule, and do not impose a requirement that rates for the sale or furnishing of items listed in § 1.163(j)–1(b)(15)(i)(A) by an electric cooperative be established or approved on a ''cost of service and rate of return'' basis.

Comments also were submitted regarding the allocation of tax items between excepted regulated utility trades or businesses and non-excepted trades or businesses. These comments are discussed with other comments on proposed § 1.163(j)–10 in part XI of this Summary of Comments and Explanation of Revisions section.

D. Definition of Floor Plan Financing Interest Expense—Proposed § 1.163(j)–1(b)(17)

Commenters recommended that interest paid on commercial financing liabilities or trade financing (in which a taxpayer borrows to fund the purchase or transport of commodities and then sells the inventory to pay off the debt) should not be subject to section 163(j). Commenters noted that trade financing is different from normal financing because it is short-term and backed by inventory that is monetizable (rather than plant and equipment). Thus, commenters suggested that section 163(j) should not apply to trade financing because there is no depreciation trade-off for inventory purchased with trade financing. Commenters compared trade financing to floor plan financing (because both are used to finance the purchase of inventory), and they noted that the 1991 Proposed Regulations under old section 163(j) excluded commercial financing liabilities from debt taken into account for purposes of applying the debt-equity ratio under old section 163(j). See 1991 Proposed Regulations § 1.163(j)–3(b)(2)(ii).

The Treasury Department and the IRS decline to exclude commercial financing liabilities from the section 163(j) limitation. Section 163(j) does not contain a provision analogous to the debt-equity ratio safe harbor that was present in old section 163(j) and for which rules were proposed in the 1991 Proposed Regulations. In addition, because Congress specifically excluded interest paid on floor plan financing from the section 163(j) limitation, but not all commercial financing liabilities and trade financing, Congress does not appear to have intended to exclude all commercial financing liabilities from the section 163(j) limitation.

E. Definition of Interest—Proposed § 1.163(j)–1(b)(20)

1. In General

Commenters submitted numerous comments on the definition of ''interest'' in the proposed regulations. Proposed § 1.163(j)–1(b)(20) contains a relatively broad definition of the term ''interest'' for purposes of section 163(j). This definition was proposed to provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that otherwise may have been entered into to avoid the application of section 163(j).

Under the proposed regulations, the term ''interest'' means any amount described in one of four categories. First, proposed § 1.163(j)–1(b)(20)(i) generally provides that 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, or an amount that is treated as interest under other provisions of the Code or the Income Tax Regulations. For example, this category includes qualified stated interest, original issue discount (OID), and accrued market discount. Commenters agree that this definition of interest has long been accepted, is consistent with longstanding precedent, and reduces the risk of inconsistency within the Code and regulations. No commenters requested any changes to this category, and the final regulations adopt this category in the definition of the term ''interest'' without any substantive changes.

Second, proposed § 1.163(j)–1(b)(20)(ii) treats a swap (other than a cleared swap) with significant nonperiodic payments as two separate transactions consisting of an on-market, level payment swap and a loan. Under the proposed regulations, the time value component of the loan is recognized as interest expense to the payor and as interest income to the recipient. Several comments were received on this category in the definition and are described in part II(E)(2) of this Summary of Comments and Explanation of Revisions section.

Third, proposed § 1.163(j)–1(b)(20)(iii) treats 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. For example, this category includes substitute interest payments, debt issuance costs, commitment fees, and hedging gains and losses that affect the yield of a debt instrument. Numerous comments were received on this category and are described in part II(E)(3) of this Summary of Comments and Explanation of Revisions section.

Fourth, proposed § 1.163(j)–1(b)(20)(iv) provides an anti-avoidance rule. Under this rule, 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 is treated as interest expense for purposes of section 163(j). Numerous comments were received on this category and are described in part II(E)(4) of this Summary of Comments and Explanation of Revisions section.

2. Swaps With Significant Nonperiodic Payments

The proposed regulations treat a non-cleared swap with significant nonperiodic payments as two separate transactions consisting of an on-market, level payment swap and a loan (the embedded loan rule). The embedded loan rule did not apply to a collateralized swap that was cleared by a derivatives clearing organization or by a clearing agency (a cleared swap) because the treatment of cleared swaps was reserved. In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on the proper treatment of collateralized swaps under the embedded loan rule.

One commenter recommended that the final regulations provide an exception to the embedded loan rule for cleared swaps and for non-cleared swaps that are substantially collateralized. This commenter further suggested that the final regulations not include any specific rules regarding the type of collateral that is required to be posted to qualify for the exception. The commenter also recommended that the final regulations provide objective rules for determining if a nonperiodic payment is ''significant'' and if a financial instrument is treated as a ''swap'' for purposes of these rules.

Another commenter agreed with the embedded loan rule, including use of the ''significant'' standard, and also recommended exceptions to the embedded loan rule for both cleared swaps and non-cleared swaps that are required to be fully collateralized by the terms of the swap contract or by a federal regulator. However, this commenter interpreted the embedded loan rule in the proposed regulations to apply solely for purposes of section 163(j) and recommended that the embedded loan rule, as well as timing and character rules for nonperiodic payments on swaps, be issued under section 446. Until that guidance is issued, the commenter requested that the application of the embedded loan rule for purposes of section 163(j) be delayed. The proposed regulations provide that the time value component of the embedded loan is determined in accordance with § 1.446–3(f)(2)(iii)(A). This commenter questioned the reference to § 1.446–3(f)(2)(iii)(A) because, under that rule, the time value component is not treated as interest; rather, the time value component is only used to compute the amortization of the nonperiodic payment.

As a result of the cross-reference in proposed § 1.446–3(g)(4) to proposed § 1.163(j)–1(b)(20)(ii), the embedded loan rule set forth in the proposed regulations applies for purposes of both sections 163(j) and 446. In addition, and as noted in the preamble to the proposed regulations, the embedded loan rule set forth in the proposed regulations applies in the same manner that former § 1.446–3(g)(4) applied before it was amended by the now expired temporary regulations in T.D. 9719 (80 FR 26437) (May 8, 2015) (as corrected by 80 FR 61308 (October 13, 2015)). The Treasury Department and the IRS do not adopt commenters' suggestions to delay finalizing the embedded loan rule or to provide guidance on determining if a nonperiodic payment is ''significant'' because the same embedded loan rule applied in the context of section 446 for over 20 years from 1993 to 2015. See T.D. 8491 (58 FR 53125) (October 14, 1993). Instead, subject to the exceptions discussed in this part II(E)(2) of this Summary of Comments and Explanation of Revisions section, the final regulations adopt the embedded loan rule without change. The final regulations retain the reference to § 1.446–3(f)(2)(iii)(A), which provides a known method for computing the time value component associated with the loan component that is treated as interest under §§ 1.163(j)–1(b)(22)(ii) and 1.446–3(g)(4).

Further, to eliminate the possibility of confusion regarding the application of the embedded loan rule for purposes of sections 163(j) and 446, the final regulations add the substantive text of the embedded loan rule and the exceptions to that rule to both §§ 1.446–3(g)(4) and 1.163(j)–1(b)(22)(ii) instead of merely including a cross-reference in § 1.446–3(g)(4) to § 1.163(j)–1(b)(22)(ii).

In response to comments, the final regulations add two exceptions to the embedded loan rule. Specifically, the final regulations add exceptions for cleared swaps and for non-cleared swaps that require the parties to meet the margin or collateral requirements of a federal regulator or that provide for margin or collateral requirements that are substantially similar to a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a federal regulator. For purposes of this exception, the term ''federal regulator'' means the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a), as amended by section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law 111–203, 124 Stat. 1376, Title VII (the Dodd-Frank Act). Because federal regulators have adopted final requirements for non-cleared swaps that permit netting of swap exposures and specify the types of collateral required to be posted, the final regulations do not address netting or require that the margin or collateral be paid or received in cash.

In addition, § 1.163(j)–1(c)(3)(i) delays the applicability date of the embedded loan rule for purposes of section 163(j) to allow taxpayers additional time to develop systems to implement these rules (the delayed applicability date), though taxpayers may choose to apply the rules to swaps entered into before the delayed applicability date. See also § 1.446–3(j)(2), which provides applicability date rules similar to those in § 1.163(j)–1(c)(3)(i). However, the delayed applicability date does not apply for purposes of the anti-avoidance rules in § 1.163(j)–1(b)(22)(iv) (described in part II(E)(4) of this Summary of Comments and Explanation of Revisions section). Instead, the applicability date in § 1.163(j)–1(c)(3)(ii) applies. As a result, the anti-avoidance rules in § 1.163(j)–1(b)(22)(iv) apply to a notional principal contract entered into on or after September 14, 2020. However, for a notional principal contract entered into before September 14, 2021, the anti-avoidance rules in § 1.163(j)–1(b)(22)(iv) apply without regard to the references in those rules to § 1.163(j)–1(b)(22)(ii). For example, if a taxpayer enters into a swap with a significant nonperiodic payment that does not meet the exceptions in § 1.163(j)–1(b)(22)(ii)(B) or (C) before the delayed applicability date, and a principal purpose of the taxpayer is to reduce the amount that otherwise would be interest expense, the anti-avoidance rules apply and the taxpayer must treat the time value component associated with the loan component of the swap as interest expense.

3. Other Amounts Treated as Interest

i. Items Relating to Premium, Ordinary Income or Loss on Certain Debt Instruments, Section 1258 Gain, and Factoring Income

Proposed § 1.163(j)–1(b)(20)(iii)(A) treats any bond issuance premium treated as ordinary income under § 1.163–13(d)(4) as interest income of the issuer and any amount deductible as a bond premium deduction under § 1.171–2(a)(4)(i)(A) or (C) as interest expense of the holder. Proposed § 1.163(j)–1(b)(20)(iii)(B) treats any ordinary income recognized by an issuer of a debt instrument, and any ordinary loss recognized by a holder of a debt instrument, under the rules for a contingent payment debt instrument, a nonfunctional currency contingent payment debt instrument, or an inflation-indexed debt instrument, as interest income of the issuer and as interest expense of the holder, respectively. Proposed § 1.163(j)–1(b)(20)(iii)(D) treats any ordinary gain under section 1258 as interest income. Commenters supported treating the amounts in proposed § 1.163(j)–1(b)(20)(iii)(A), (B), and (D) as interest income or interest expense for purposes of section 163(j). Accordingly, the final regulations adopt the rules in the proposed regulations for these three items without any substantive changes.

Proposed § 1.163(j)–1(b)(20)(iii)(J) treats factoring income as interest income. Several commenters supported treating factoring income as interest income. However, one commenter questioned the differences between the provisions related to the inclusion of factoring income and § 1.954–2(h)(4). The inclusion of factoring income in the definition of interest is generally supported by the commenters, is a taxpayer-favorable rule, is generally consistent with the rules in § 1.954–2(h)(4), and is consistent with the treatment of other types of discount, such as acquisition discount and market discount. Accordingly, the final regulations adopt the rules in the proposed regulations for factoring income without any substantive changes. In the case of a factoring transaction with a principal purpose of artificially increasing a taxpayer's business interest income, the anti-avoidance rules in § 1.163(j)–1(b)(22)(iv) (described in part II(E)(4) of this Summary of Comments and Explanation of Revisions section) would not permit the taxpayer to treat factoring income as interest income for purposes of section 163(j).

ii. Substitute Interest Payments

Proposed § 1.163(j)–1(b)(20)(iii)(C) generally provides that a substitute interest payment described in § 1.861–2(a)(7) and made in connection with a sale-repurchase or securities lending transaction is treated as interest expense to the payor and interest income to the recipient. In general, substitute interest payments are economically equivalent to interest. A few commenters questioned the inclusion of substitute interest payments in the definition of interest in the proposed regulations. Commenters stated that treating these amounts as interest would be contrary to longstanding tax law, including the holding in *Deputy* v. *Du Pont,* 308 U.S. 488, 498 (1940). However, commenters recommended that, if the Treasury Department and the IRS decide to include substitute interest payments in the definition of interest in the final regulations, the inclusion be limited to the extent the substitute interest payments relate to transactions that are economically similar to a borrowing. Commenters recommended that the following factors be taken into consideration in making this determination: (a) Whether the taxpayer posted (or has received) collateral consisting of cash or liquid assets; (b) whether the borrowed security is due to mature shortly after the scheduled termination date of the securities borrowing; (c) the type of security being lent (for example, Treasury bonds as compared to riskier corporate bonds); and (d) whether the securities borrowing was entered into in the ordinary course of the taxpayer's trade or business.

The final regulations retain substitute interest payments in the definition of interest because the payments generally are economically equivalent to interest and should be treated as such for purposes of section 163(j). However, in response to comments, the final regulations provide that a substitute interest payment is treated as interest expense to the payor only if the payment relates to a sale-repurchase or securities lending transaction that is not entered into by the payor in the payor's ordinary course of business, and that a substitute interest payment is treated as interest income to the recipient only if the payment relates to a sale-repurchase or securities lending transaction that is not entered into by the recipient in the recipient's ordinary course of business. The final regulations do not adopt the other suggested factors because the Treasury Department and the IRS have determined that the ordinary course rule in the final regulations provides an appropriate and effective limit on the scope of the definition. Specifically, the Treasury Department and the IRS have determined that these transactions are rarely entered into outside the payor's ordinary course of business, and that any such non-ordinary course transactions likely would involve an intention to avoid section 163(j).

iii. Commitment Fees

Proposed § 1.163(j)–1(b)(20)(iii)(G)(*1*) treats any fees in respect of a lender commitment to provide financing as interest if any portion of such financing is actually provided. Commenters recommended that commitment fees and other debt-related fees not be included in the definition of interest until general substantive guidance is provided on the treatment of the fees in the separate fee-related project on the Office of Tax Policy and IRS 2019–2020 Priority Guidance Plan (REG–132517–17). According to the commenters, uncertainty exists as to whether to characterize these fees for Federal income tax purposes as fees for services or property or for compensation for the use or forbearance of money. In addition, under existing guidance, commitment fees are treated differently by the borrower (similar to an option premium) and the lender (service income). See Rev. Rul. 81–160, 1981–1 C.B. 312, and Rev. Rul. 70–540, 1970–2 C.B. 101, Situation (3). Some taxpayers, however, argue that a commitment fee should be treated as creating or increasing discount on a debt instrument and that the fee should be treated consistently by both the borrower and the lender. If commitment fees are included in the definition of interest in the final regulations, commenters recommended that only the portion of the commitment fee that is proportionate to the amount drawn be treated as interest.

In response to comments, the final regulations do not include commitment fees in the definition of interest. The treatment of commitment fees and other fees paid in connection with lending transactions will be addressed in future guidance that applies for all purposes of the Code.

iv. Debt Issuance Costs

Proposed § 1.163(j)–1(b)(20)(iii)(H) treats debt issuance costs as interest expense of the issuer. Commenters argued that debt issuance costs should not be treated as interest expense because these costs are paid to third parties in connection with the issuance of debt and are not paid or incurred for the use or forbearance of money under a debt instrument. For tax purposes, these costs are capitalized by the issuer and are treated as deductible under section 162 over the term of the debt instrument as if the costs adjust the instrument's yield by reducing the instrument's issue price by the amount of the costs. See § 1.446–5.

In response to comments, the final regulations exclude debt issuance costs from the definition of interest.

v. Guaranteed Payments

Proposed § 1.163(j)–1(b)(20)(iii)(I) provides that any guaranteed payments for the use of capital under section 707(c) are treated as interest. Some commenters stated that a guaranteed payment for the use of capital should not be treated as interest for purposes of section 163(j) unless the guaranteed payment was structured with a principal purpose of circumventing section 163(j). Other commenters stated that section 163(j) never should apply to guaranteed payments for the use of capital.

In response to comments, the final regulations do not explicitly include guaranteed payments for the use of capital under section 707(c) in the definition of interest. However, consistent with the recommendations of some commenters, the anti-avoidance rules in § 1.163(j)–1(b)(22)(iv) (described in part II(E)(4) of this Summary of Comments and Explanation of Revisions section) include an example of a situation in which a guaranteed payment for the use of capital is treated as interest expense and interest income for purposes of section 163(j). See § 1.163(j)–1(b)(22)(v)(E), *Example 5.*

vi. Hedging Transactions

Proposed § 1.163(j)–1(b)(20)(iii)(E) generally treats income, deduction, gain, or loss from a derivative that alters a taxpayer's effective cost of borrowing with respect to a liability of the taxpayer as an adjustment to the taxpayer's interest expense. Proposed § 1.163(j)–1(b)(20)(iii)(F) generally treats income, deduction, gain, or loss from a derivative that alters a taxpayer's effective yield with respect to a debt instrument held by the taxpayer as an adjustment to the taxpayer's interest income. The rules in the two provisions are referred to as the ''hedging rules'' in this preamble.

Numerous comments were received on the hedging rules. The commenters questioned the administrability of the broad hedging rules, especially if the taxpayer hedges on a macro (that is, on an aggregate) basis. Also, the commenters noted that it is not clear how to apply the rules in certain situations, including a situation in which the hedge relates to non-debt items (for example, if the taxpayer hedges the mismatch or ''gap'' between its assets and liabilities), the debt instrument is not subject to section 163(j), or the debt instrument is subject to other interest deferral provisions for Federal tax purposes. In addition, the commenters noted that the proposed regulations effectively would require integration, even if the hedge otherwise would not be integrated with the debt instrument for Federal tax purposes and the income, deduction, gain, and loss from the hedge ordinarily would be accounted for separately, which the commenters suggested would require taxpayers to maintain two sets of books. Moreover, the commenters stated that, under the proposed regulations, any gain or loss on the underlying debt instrument (for example, due to changes in interest rates) would not be treated as an adjustment to interest income or expense, whereas the corresponding loss or gain on the hedge would be treated as an adjustment to interest expense or income. Some commenters stated that the yield on third-party borrowings reflects the true cost of the borrowing, and that hedges are not relevant to the cost of the borrowing.

Commenters recommended that, if the hedging rules are retained in the final regulations as a separate item, the final regulations precisely define (a) what standard is used to include a derivative in section 163(j) (for example, a primary purpose or principal motivation standard), and (b) the standard for determining whether the effect of a derivative on the cost of borrowing or effective yield is sufficiently significant for the income, deduction, gain, or loss from the derivative to be included in the computation. Commenters noted that one approach would be to apply the hedging rules only to derivatives that qualify for integration under § 1.988–5 or § 1.1275–6. Another approach would be to apply the hedging rules to derivatives that have a sufficiently close connection with the liability to qualify as hedging transactions under §§ 1.446–4 and 1.1221–2. Some commenters indicated that the hedging rules could apply if the derivative is treated as a hedge of a borrowing or liability for financial reporting purposes, and that the hedging rules should not apply to broker-dealers, active traders in derivatives, and financial institutions acting in the ordinary course of business.

One commenter recommended that section 163(j) not alter the timing of taxable items from hedging transactions that are subject to § 1.446–4, regardless of whether interest expense on the hedged item is deferred under section 163(j). Other commenters noted that the proposed regulations do not provide guidance on the interaction between the hedging rules and the straddle rules.

With respect to foreign currency hedging transactions, a commenter noted that foreign currency gain or loss is due to the time value of money only to a limited extent; thus, the commenter recommended that section 163(j) not apply to a taxpayer's foreign currency hedging transactions (other than an integrable transaction under § 1.988–5).

In response to comments, the final regulations do not include the hedging rules in the definition of interest. However, in certain circumstances, the anti-avoidance rules in § 1.163(j)–1(b)(22)(iv) (described in part II(E)(4) of this Summary of Comments and Explanation of Revisions section) may apply to require income, deduction, gain, or loss from a hedging transaction to be taken into account for purposes of section 163(j).

vii. Other Items

Commenters recommended other items to be included in, or excluded from, the definition of interest as follows:

a. Dividends From Regulated Investment Company (RIC) Shares

Some commenters recommended that dividend income from a RIC be treated as interest income for a shareholder in a RIC, to the extent that the dividend is attributable to interest income earned by the RIC. To address this comment, in the Concurrent NPRM, the Treasury Department and the IRS have proposed rules under which a RIC that earns business interest income may pay section 163(j) interest dividends that certain shareholders may treat as interest income for purposes of section 163(j). See paragraphs (b)(22)(iii)(F) and (b)(35) in proposed § 1.163(j)–1 in the Concurrent NPRM.

b. MMF Income

A few commenters recommended that the final regulations allow look-through treatment for earnings from certain foreign entities, such as foreign money market funds (MMFs), so that dividends from foreign MMFs would be treated as interest income to the extent the underlying income derived by a foreign MMF was interest income. According to the commenters, this treatment would alleviate issues for a CFC that borrows money from related parties and invests in foreign MMFs. In general, the commenters stated that any interest limitation under section 163(j) could lead to unexpected results in this situation, such as section 952(c) recapture accounts solely generated by the section 163(j) interest expense limitation.

The final regulations do not adopt this recommendation because it is beyond the scope of the final regulations and because there are significant differences between the rules governing income inclusions in respect of passive foreign investment companies (PFICs), such as foreign MMFs, and RICs. These differences make it difficult to adopt a rule that would provide for look-through treatment in the context of dividends or inclusions from a PFIC. In particular, the regime for taxing income from a PFIC that shareholders have elected to treat as a qualified electing fund (QEF) under section 1295 generally focuses only on inclusions related to ordinary income or net capital gain income and does not separately report amounts of interest income for Federal income tax purposes. In the case of a PFIC for which a QEF election has not been made, there would be no information about the underlying taxable income of the PFIC and no reason or ability to treat an interest in the PFIC differently from the treatment of stock held in other C corporations.

c. Negative Interest

One commenter requested clarification on the treatment of negative interest (an amount that a depositor may owe a bank in a negative interest rate environment) and inquired whether such payments are more similar to payments for custodial or service fees rather than for interest. The final regulations do not address this issue because it is beyond the scope of the final regulations. However, in certain cases (for example, a Treasury bill acquired with a negative yield), a payment may be treated as bond premium subject to the rules in section 171, including the rules in § 1.171–2(a)(4)(i)(C).

d. Leases

A commenter recommended that the Treasury Department and the IRS adopt rules that clearly describe the circumstances in which fleet leases are treated as generating interest for purposes of section 163(j). The commenter noted that there is a time-value-of-money portion of a fleet lease payment similar to the time-value-of-money portion of other items treated as interest under the proposed regulations, such as guaranteed payments, commitment fees, debt issuance costs, and items of income or loss from a derivative instrument that alters a taxpayer's effective yield or effective cost of borrowing. In addition, to the extent that the anti-avoidance rule in the proposed regulations is retained, the commenter asked that the final regulations clearly define the circumstances (if any) in which the anti-avoidance rule would operate to recharacterize any portion of a fleet lease payment as interest expense, and modify the anti-avoidance rule to apply to both interest expense of the fleet lessee and interest income of the fleet lessor.

The Treasury Department and the IRS do not adopt the commenter's suggestions in the final regulations because the suggestions generally are no longer relevant after the revisions made to the definition of interest in the final regulations. For example, as explained in this part II(E)(3) of this Summary of Comments and Explanation of Revisions section, no portion of the items generally cited by the commenter is explicitly treated as interest in the final regulations. Moreover, there are explicit provisions in the Code that determine whether a portion of a lease payment is treated as interest for Federal income tax purposes depending on the terms of a lease, such as sections 467 and 483. In addition, as explained in part II(E)(4) of this Summary of Comments and Explanation of Revisions section, the anti-avoidance rule in the final regulations is revised to include a principal purpose test and to generally align the treatment of income and expense, which should address the commenter's concerns.

4. Anti-Avoidance Rule for Amounts Predominantly Associated With the Time Value of Money

Proposed § 1.163(j)–1(b)(20)(iv) provides that 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. Numerous comments were received on this anti-avoidance rule in the proposed regulations. Most commenters recommended that any anti-avoidance rule in the final regulations contain a requirement that the taxpayer have a principal purpose to avoid section 163(j). Several commenters asserted that the anti-avoidance rule should cover only transactions that are economically equivalent to interest and should set forth examples of transactions that are and are not covered. Most commenters recommended that the anti-avoidance rule be symmetrical and apply to income or gain, as well as to expense or loss. One commenter suggested that, based on section 1258 concepts, the anti-avoidance rule should apply only if, at the time of the relevant transaction or series of transactions that secure the use of funds for a period of time for the taxpayer, substantially all of the expense or loss was expected to be attributable to the time value of money. In addition, commenters noted that it should be clear when a taxpayer should test whether a transaction falls within the anti-avoidance rule. Other commenters requested specific rules coordinating this anti-avoidance rule with the general anti-avoidance rule in proposed § 1.163(j)–2(h).

Some commenters stated that an interest anti-avoidance rule should not be included in the final regulations because, for example, the rule would impose substantial compliance costs, the Treasury Department and the IRS have other tools to combat any abuse, and there already is a general anti-avoidance rule in proposed § 1.163(j)–2(h). Commenters also noted that the interest anti-avoidance rule in the proposed regulations has the potential to capture ordinary market transactions that possess a time value component but that are not generally treated as financings with disguised interest for tax purposes.

In response to comments, the Treasury Department and the IRS have modified the anti-avoidance rule in the final regulations. Under § 1.163(j)–1(b)(22)(iv)(A)(*1*), any expense or loss economically equivalent to interest is treated as interest expense for purposes of section 163(j) if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been interest expense or treated as interest expense under § 1.163(j)–1(b)(22)(i) through (iii). For this purpose, the fact that the taxpayer has a business purpose for obtaining the use of funds does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense. In addition, the fact that the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction(s) does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense.

For purposes of § 1.163(j)–1(b)(22)(iv)(A)(*1*), any expense or loss is economically equivalent to interest to the extent that the expense or loss is (1) deductible by the taxpayer; (2) incurred by the 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; (3) substantially incurred in consideration of the time value of money; and (4) not described in § 1.163(j)–1(b)(22)(i), (ii), or (iii).

Under § 1.163(j)–1(b)(22)(iv)(A)(*2*), if a taxpayer knows that an expense or loss is treated by the payor as interest expense under § 1.163(j)–1(b)(22)(iv)(A)(*1*), the taxpayer provides the use of funds for a period of time in the transaction(s) subject to § 1.163(j)–1(b)(22)(iv)(A)(*1*), the taxpayer earns income or gain with respect to the transaction(s), and such income or gain is substantially earned in consideration of the time value of money provided by the taxpayer, such income or gain is treated as interest income for purposes of section 163(j) to the extent of the expense or loss treated by the payor as interest expense under § 1.163(j)–1(b)(22)(iv)(A)(*1*).

Under § 1.163(j)–1(b)(22)(iv)(B), notwithstanding § 1.163(j)–1(b)(22)(i) through (iii), any income realized by a taxpayer in a transaction or series of integrated or related transactions is not treated as interest income of the taxpayer for purposes of section 163(j) if and to the extent that a principal purpose for structuring the transaction(s) is to artificially increase the taxpayer's business interest income. For this purpose, the fact that the taxpayer has a business purpose for holding interest-generating assets does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of artificially increasing the taxpayer's business interest income.

For purposes of the foregoing anti-avoidance rules, § 1.163(j)–1(b)(22)(iv)(C) provides that whether a transaction or a series of integrated or related transactions is entered into with a principal purpose depends on all the facts and circumstances related to the transaction(s), except that the fact that the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction(s) or the fact that the taxpayer has a business purpose related to the item is ignored for this purpose. A purpose may be a principal purpose even though it is outweighed by other purposes taken together or separately. Factors to be taken into account in determining whether one of the taxpayer's principal purposes for entering into the transaction(s) include the taxpayer's normal borrowing rate in the taxpayer's functional currency, whether the taxpayer would enter into the transaction(s) in the ordinary course of the taxpayer's trade or business, whether the parties to the transaction(s) are related persons (within the meaning of section 267(b) or section 707(b)), whether there is a significant and bona fide business purpose for the structure of the transaction(s), whether the transactions are transitory, for example, due to a circular flow of cash or other property, and the substance of the transaction(s).

In response to comments, § 1.163(j)–1(b)(22)(iv)(D) provides that the anti-avoidance rules in § 1.163(j)–1(b)(22)(iv), rather than the general anti-avoidance rules in § 1.163(j)–2(j), apply to determine whether an item is treated as interest expense or interest income.

Section 1.163(j)–1(b)(22)(v) contains examples illustrating the application of the interest anti-avoidance rules in a number of situations, including examples relating to a hedging transaction involving a foreign currency swap transaction, a forward contract involving gold, a loan guaranteed by a related party in which the related party receives guarantee fees, and guaranteed payments for the use of capital. However, these examples are not intended to represent the only situations in which the anti-avoidance rules might apply.

The anti-avoidance rules in § 1.163(j)–1(b)(22)(iv) apply to transactions entered into on or after September 14, 2020. See § 1.163(j)–1(c)(2).

5. Authority Comments

Most of the commenters on the definition of interest in the proposed regulations questioned whether the Treasury Department and the IRS have the authority to expand the definition of interest for purposes of section 163(j) to include ''interest equivalents'' (the items listed in proposed § 1.163(j)–1(b)(20)(iii) and the expenses or losses subject to the anti-avoidance rule in proposed § 1.163(j)–1(b)(20)(iv)). The commenters asserted that the term ''business interest'' in section 163(j)(5) means any interest paid or accrued on indebtedness properly allocable to a trade or business, and that expanding the definition to include interest equivalents would capture amounts that do not fall within the scope of the general rule in section 163(a) that ''[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.'' Even though section 163(j)(1) refers to an ''amount allowed as a deduction under this chapter for business interest'' when describing the amounts limited by section 163(j), the commenters argued that the deduction otherwise allowed must be with respect to ''business interest'' (which is defined in section 163(j)(5)) and that the phrase ''deduction under this chapter'' does not and should not modify the definition of ''business interest'' in section 163(j)(5).

The commenters noted that section 163(j), as amended by the TCJA, does not contain a specific delegation of regulatory authority to expand the definition of interest. The commenters further asserted that the Treasury Department and the IRS may issue only ''interpretive regulations'' under section 7805, and that any such regulations may not go beyond the stated meaning of the statutory language. The commenters noted that old section 163(j)(9) provided broad regulatory authority to prescribe regulations, including regulations appropriate to prevent the avoidance of old section 163(j). In addition, the commenters noted that the legislative history for old section 163(j) indicated that the Treasury Department could issue guidance treating ''items not denominated as interest but appropriately characterized as equivalent to interest'' as interest income or interest expense. The commenters stated that there is no similar regulatory authority or legislative history relating to section 163(j) as amended by the TCJA.

Commenters also noted that, when Congress has chosen to expand the definition of interest in other parts of the Code, Congress has done so explicitly. For example, section 263(g) provides that, ''[for purposes of section 263(g)(2)(A)], the term 'interest' includes any amount paid or incurred in connection with personal property used in a short sale.'' As noted in the preamble to the proposed regulations, most of the rules treating interest equivalent items as interest income or expense in proposed § 1.163(j)–1(b)(20)(iii) were developed in §§ 1.861–9T and 1.954–2. However, commenters argued that the use of the interest equivalent provisions in §§ 1.861–9T and 1.954–2 by analogy to define interest for purposes of section 163(j) is inappropriate because different policy considerations underlie those sections, there is statutory or regulatory authority to address interest equivalents under those sections (unlike section 163(j)), and those sections apply only for limited purposes (for example, for sourcing purposes).

In addition, because the broad definition of interest in the proposed regulations applies only for purposes of section 163(j), commenters asserted that there will be additional compliance burdens and costs for taxpayers to separately track amounts treated as interest for purposes of section 163(j) and for other purposes. Commenters asserted that the broad definition of interest for purposes of section 163(j) in the proposed regulations may create uncertainty and confusion for taxpayers with respect to other sections of the Code.

Contrary to the assertions made by many of the commenters, the Treasury Department and the IRS have the authority to prescribe rules relating to interest equivalents and an anti-avoidance rule. As noted in the preamble to the proposed regulations, there are no generally applicable regulations or statutory provisions addressing when financial instruments are treated as indebtedness for Federal income tax purposes or when a payment is ''interest.'' Therefore, a regulatory definition of interest is needed in order to implement the statutory language of section 163(j).

In addition, it would be inconsistent with the purpose of section 163(j) to allow transactions that are essentially financing transactions to avoid the application of section 163(j). Thus, an anti-avoidance rule is needed to address situations in which a taxpayer's principal purpose in structuring a transaction or series of transactions is to artificially reduce the taxpayer's business interest expense or to increase the taxpayer's business interest income. Moreover, at least one commenter suggested the inclusion of the type of anti-avoidance rule that is included in the final regulations and that the Treasury Department and the IRS have the authority to include such a rule.

Section 7805(a) provides the Treasury Department and the IRS with the authority to prescribe all rules and regulations needed for enforcement of the Code, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue. Providing a regulatory definition of interest for purposes of section 163(j) and the anti-avoidance rule falls within this authority. The statutory language of section 163(j)(1) (''The amount allowed as a deduction *under this chapter* for any taxable year for business interest . . .'') (emphasis added) also supports the application of section 163(j) to more items than merely items traditionally deducted under section 163(a).

Although the Treasury Department and the IRS have the authority to prescribe regulations addressing interest equivalents and anti-avoidance transactions, as noted earlier in parts II(E)(3) and (4) of this Summary of Comments and Explanation of Revisions section, in response to comments, the final regulations nevertheless limit the interest equivalent items to those items commenters agreed should be treated as interest expense or interest income, substitute interest payments made in connection with a sale-repurchase agreement or securities lending transaction that is not entered into by the taxpayer in the taxpayer's ordinary course of business, and certain amounts relating to transaction(s) entered into by a taxpayer with a principal purpose of artificially reducing interest expense or increasing interest income.

F. Definition of Motor Vehicle—Proposed § 1.163(j)–1(b)(25)

Proposed § 1.163(j)–1(b)(25) provides that the term ''motor vehicle'' means a motor vehicle as defined in section 163(j)(9)(C). Under section 163(j)(9)(C), a motor vehicle means any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road; a boat; and farm machinery or equipment. A few commenters questioned whether towed recreational vehicles and trailers are included in the definition of ''motor vehicle.'' One commenter requested that the final regulations define motor vehicle to include any trailer or camper that is designed to provide temporary living quarters for recreational, camping, travel, or seasonal use and is designed to be towed by, or affixed to, a motor vehicle. Another commenter recommended allowing motor vehicle dealers to deduct floor plan financing interest on both motor vehicles and trailers that are offered for sale in integrated or related businesses.

Because section 163(j)(9)(C) specifically defines motor vehicles as self-propelled vehicles, the Treasury Department and the IRS do not have the authority to expand the definition of motor vehicles in the final regulations to include vehicles that are not self-propelled, such as towed recreational vehicles and trailers. For this reason, the Treasury Department and the IRS decline to adopt these comments in the final regulations. Therefore, the definition of motor vehicles in the final regulations continues to incorporate the definition in section 163(j)(9)(C) by cross-reference.

G. Definition of Taxable Income—Proposed § 1.163(j)–1(b)(37)

1. Calculation of Taxable Income

Proposed § 1.163(j)–1(b)(1)(i)(A) provides that business interest expense is added to taxable income to determine ATI. Some commenters noted that this provision could be construed as distorting ATI if a taxpayer has a disallowed business interest expense carryforward from a prior taxable year. Under such facts, the proposed regulations would not have reduced taxable income by the amount of the carryforward, because proposed § 1.163(j)–1(b)(37) disregards the carryforward as part of section 163(j) and the section 163(j) regulations. However, in calculating ATI, taxpayers might argue that taxable income should be increased by the amount of the disallowed business interest expense carryforward because the term ''business interest expense'' in the proposed regulations includes disallowed business interest expense carryforwards.

The Treasury Department and the IRS did not intend to create a net positive adjustment to ATI for disallowed business interest expense carryforwards. To address this potential distortion, the final regulations clarify that tentative taxable income is computed without regard to the section 163(j) limitation, and that disallowed business interest expense carryforwards are not added to tentative taxable income in computing ATI under § 1.163(j)–1(b)(1).

2. Interaction With Section 250

Proposed § 1.163(j)–1(b)(37)(ii) provides a rule to coordinate the application of sections 163(j) and 250. Section 250(a)(1) generally provides a deduction based on the amount of a domestic corporation's foreign-derived intangible income and GILTI. Section 250(a)(2) limits the amount of this deduction based on the taxpayer's taxable income—the greater the amount of a taxpayer's taxable income for purposes of section 250(a)(2), the greater the amount of the taxpayer's allowable deduction under section 250(a)(1).

In particular, proposed § 1.163(j)–1(b)(37)(ii) provides that, if a taxpayer is allowed a deduction for a taxable year under section 250(a)(1) that is properly allocable to a non-excepted trade or business, then the taxpayer's taxable income for that year is determined without regard to the limitation in section 250(a)(2). Some commenters observed that this proposed rule results in a lower ATI and section 163(j) limitation for the taxpayer than if the limitation in section 250(a)(2) were taken into account. Commenters also stated that the rationale for this approach (which does not reflect the taxpayer's actual taxable income) is unclear, and they recommended that this provision be withdrawn or made elective for taxpayers.

The Treasury Department and the IRS have determined that further study is required to determine the appropriate rule for coordinating sections 250(a)(2), 163(j), and other Code provisions (such as sections 170(b)(2) and 172(a)(2)) that limit the availability of deductions based, directly or indirectly, upon a taxpayer's taxable income (taxable income-based provisions). Therefore, the final regulations do not contain the rule in proposed § 1.163(j)–1(b)(37)(ii). Until such additional guidance is effective, taxpayers may choose any reasonable approach (which could include an ordering rule or the use of simultaneous equations) for coordinating taxable income-based provisions as long as such approach is applied consistently for all relevant taxable years. For this purpose, the ordering rule contained in proposed §§ 1.163(j)–1(b)(37)(ii) (83 FR 67490 (Dec. 28, 2018)) and 1.250(a)–1(c)(4) (contained in 84 FR 8188 (March 6, 2019)) is treated as a reasonable approach for coordinating sections 163(j) and 250. Comments are welcome on what rules should be provided, and whether an option to use simultaneous equations in lieu of an ordering rule would be appropriate in order to coordinate taxable income-based provisions.

3. When Disallowed Business Interest Expense Is ''Paid or Accrued''

As noted in the Background section of this preamble, section 163(j)(2) provides that the amount of any business interest not allowed as a deduction for any taxable year under section 163(j)(1) is treated as business interest ''paid or accrued'' in the succeeding taxable year. Commenters asked for clarification as to whether disallowed business interest expense should be treated as ''paid or accrued'' in the taxable year in which such expense is taken into account for Federal income tax purposes (without regard to section 163(j)), or whether such expense instead should be treated as paid or accrued in the succeeding taxable year in which the expense can be deducted by the taxpayer under section 163(j).

For purposes of section 163(j) and the section 163(j) regulations, the term ''paid or accrued'' in section 163(j)(2) must be construed in such a way as to further congressional intent. Although the use of this term in section 163(j)(2) provides a mechanism for disallowed business interest expense to be carried forward to and deducted in a subsequent taxable year, it does not mean that a disallowed business interest expense carryforward is treated as paid or accrued in a subsequent year for all purposes. In certain contexts, a disallowed business interest expense must be treated as paid or accrued in the year the expense was paid or accrued without regard to section 163(j) to give effect to congressional intent. For example, if a disallowed business interest expense were treated as paid or accrued only in a future taxable year in which such expense could be deducted after the application of section 163(j), then section 382 never would apply to such expense (because disallowed business interest expense carryforwards never would be pre-change losses). This outcome is clearly contrary to congressional intent (see section 382(d)(3)). Similarly, if a disallowed business interest expense were treated as paid or accrued in a future taxable year for purposes of section 163(j)(8)(A)(ii), then such expense would be added back to tentative taxable income in determining ATI for that taxable year (and for all future taxable years to which such expense is carried forward under section 163(j)(2)), thereby artificially increasing the taxpayer's section 163(j) limitation. (See part II(A) of this Summary of Comments and Explanation of Revisions section.) This outcome also is inconsistent with congressional intent. However, in other contexts, a disallowed business interest expense must be treated as paid or accrued in a succeeding taxable year to allow for the deduction of the carryforward in that year.

The definition of ''disallowed business interest expense'' has been revised in the final regulations to reflect that, solely for purposes of section 163(j) and the section 163(j) regulations, disallowed business interest expense is treated as ''paid or accrued'' in the taxable year in which the expense is taken into account for Federal income tax purposes (without regard to section 163(j)), or in a succeeding taxable year in which the expense can be deducted by the taxpayer under section 163(j), as the context may require.

4. Interaction With Sections 461(l), 465, and 469—Proposed § 1.163(j)–1(b)(37)

The Treasury Department and the IRS received questions asking for clarification of the interaction between proposed § 1.163(j)–1(b)(37) and the limitations in sections 461(l), 465, and 469. The final regulations clarify that sections 461(l), 465, and 469 are taken into account when determining tentative taxable income. Then, as provided in proposed § 1.163(j)–3(b)(4), sections 461(l), 465, and 469 are applied after the application of the section 163(j) limitation. See part II(B) of this Summary of Comments and Explanation of Revisions section.

H. Definition of Trade or Business—Proposed § 1.163(j)–1(b)(38)

1. In General

The section 163(j) limitation applies to taxpayers with ''business interest,'' which is defined in section 163(j)(5) as any interest properly allocable to a trade or business. Neither section 163(j) nor the legislative history defines the term ''trade or business.'' However, section 163(j)(7) provides that the term ''trade or business'' does not include the trade or business of performing services as an employee, as well as electing real property, electing farming, and certain utility trades or businesses.

As described in the preamble to the proposed regulations, the proposed regulations define the term ''trade or business'' by reference to section 162. Section 162(a) permits a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. Commenters requested additional guidance in determining whether an activity constitutes a section 162 trade or business.

The rules under section 162 for determining the existence of a trade or business are well-established and illustrated through a large body of case law and administrative guidance. Additionally, whether an activity is a section 162 trade or business is inherently a factual question. *Higgins* v. *Commissioner,* 312 U.S. 212, 217 (1941) (determining ''whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case'').

The courts have developed two definitional requirements. One, in relation to profit motive, requires the taxpayer to enter into and carry on the activity with a good-faith intention to make a profit or with the belief that a profit can be made from the activity. The second, in relation to the scope of the activities, requires considerable, regular, and continuous activity. See generally *Commissioner* v. *Groetzinger,* 480 U.S. 23 (1987). In the seminal case of *Groetzinger,* the Supreme Court stated that, ''[w]e do not overrule or cut back on the Court's holding in *Higgins* when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned.'' Id. at 35.

2. Multiple Trades or Businesses Within an Entity

Commenters also suggested there should be factors to determine how to delineate separate section 162 trades or businesses within an entity and when an entity's combined activities should be considered a single section 162 trade or business for purposes of section 163(j). One commenter suggested adopting the rules for separate trades or businesses provided in section 446 and the regulations thereunder.

The Treasury Department and the IRS decline to adopt these recommendations because specific guidance under section 162 is beyond the scope of the final regulations. Further, § 1.446–1(d) does not provide guidance on when trades or businesses will be considered separate and distinct. Instead, it provides that a taxpayer may use different methods of accounting for separate and distinct trades or businesses, and it specifies two circumstances in which trades or businesses will not be considered separate and distinct. For example, § 1.446–1(d)(2) provides that no trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business.

The Treasury Department and the IRS recognize that an entity can conduct more than one trade or business under section 162. This position is inherent in the allocation rules detailed in proposed § 1.163(j)–10(c)(3), which require a taxpayer with an asset used in more than one trade or business to allocate its adjusted basis in the asset to each trade or business using the permissible methodology described therein. In this context, the final regulations provide, consistent with the proposed regulations, that maintaining separate books and records for all excepted and non-excepted trades or businesses is one indication that a particular asset is used in a particular trade or business.

Whether an entity has multiple trades or businesses is a factual determination, and numerous court decisions that define the meaning of ''trade or business'' also provide taxpayers guidance in determining whether more than one trade or business exists. See *Groetzinger,* 480 U.S. at 35. For example, some court decisions discuss whether the activities have separate books and records, facilities, locations, employees, management, and capital structures, and whether the activities are housed in separate legal entities.

Accordingly, the final regulations define ''trade or business'' as a trade or business within the meaning of section 162, which should aid taxpayers in the proper allocation of interest expense, interest income, and other tax items to a trade or business and to an excepted or non-excepted trade or business.

3. Rental Real Estate Activities as a Trade or Business

See the discussion of elections for real property trades or businesses that may not qualify as section 162 trades or businesses in part X of this Summary of Comments and Explanation of Revisions section.

4. Separate Entities

One commenter requested clarification that the determination of whether an entity generates interest attributable to a trade or business within the meaning of section 162 is made at the entity level without regard to the classification of the entity's owners. Except in the context of a consolidated group, or if § 1.163(j)–10 provides otherwise, the determination of whether an entity generates interest and whether such interest is properly allocable to a trade or business is determined at the entity level, without regard to the classification of the entity's owners. See also the discussion of trading partnerships and CFC groups in the Concurrent NPRM.

I. Applicability Dates

The proposed regulations provide generally that the final regulations would apply to taxable years ending after the date that this Treasury Decision is published in the **Federal Register**. The proposed applicability date has been changed in the final regulations to avoid the application of the changes reflected in the final regulations to a taxpayer at the end of the taxable year, which may result in unexpected effects on the taxpayer under section 163(j). Accordingly, the final regulations generally apply to taxable years beginning on or after the date that is 60 days after the date that this Treasury Decision is published in the **Federal Register**.

III. Comments on and Changes to Proposed § 1.163(j)–2: Deduction for Business Interest Expense Limited

Proposed § 1.163(j)–2 provides general rules regarding the section 163(j) limitation, including rules on how to calculate the limitation, how to treat disallowed business interest expense carryforwards, and how the small business exemption and the aggregation rules apply with the limitation. The following discussion addresses comments relating to proposed § 1.163(j)–2.

A. Whether the Section 163(j) Limitation Is a Method of Accounting

A few commenters requested clarification that the section 163(j) limitation is not a method of accounting under section 446 and the regulations thereunder. The commenters requested clarification on whether the application of the section 163(j) limitation is a method of accounting because the rules under section 163(j) appear to defer, rather than permanently disallow, a deduction for disallowed business interest expense and disallowed disqualified interest (as defined in proposed § 1.163(j)–1(b)(10)). Specifically, section 163(j)(2) and proposed § 1.163(j)–2(c) allow the carryforward of disallowed business interest expense, and proposed § 1.163(j)–2(c) allows the carryforward of disallowed disqualified interest, to succeeding taxable years.

Section 1.446–1(a)(1) defines the term ''method of accounting'' to include not only the overall method of accounting of a taxpayer, but also the accounting treatment of any item of gross income or deduction. Under § 1.446–1(e)(2)(ii)(*a*), an accounting method change includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan of accounting. Moreover, § 1.446–1(e)(2)(ii)(*a*) provides that a ''material item'' is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. The key characteristic of a material item ''is that it determines the timing of income or deductions.'' *Knight-Ridder Newspapers, Inc.* v. *United States,* 743 F.2d 781, 798 (11th Cir. 1984). Once a taxpayer has established a method of accounting for an item of income or expense, the taxpayer must obtain the consent of the Commissioner under section 446(e) before changing to a different method of accounting for that item.

For purposes of § 1.446–1(e)(2)(ii)(*a*), if there is a change in the application of the section 163(j) limitation, the item involved is the taxpayer's deduction for business interest expense. The taxpayer is not changing its treatment of this item; instead, the taxpayer is changing the limitation placed upon that specific item. The effect of removing the section 163(j) limitation is that the taxpayer would be able to recognize the full amount of the interest expense that is otherwise deductible under its accounting method in a given taxable year before it was limited by section 163(j).

The Treasury Department and the IRS do not view the section 163(j) limitation as a method of accounting under section 446(e) and the regulations thereunder. The determination of whether a taxpayer is subject to the section 163(j) limitation is determined for each taxable year. The carryover rules in section 163(j)(2) and proposed § 1.163(j)–2(c) provide that disallowed business interest expense and disallowed disqualified interest may be carried forward to a future taxable year. However, section 163(j) does not provide a mechanism to ensure that, in every situation, a taxpayer will be able to deduct the business interest expense that the taxpayer was not permitted to deduct in one taxable year and was required to carry forward to succeeding taxable years. Thus, the section 163(j) limitation is not a method of accounting under § 1.446–1(e)(2)(ii)(*a*) because the change in practice may result in a permanent change in the taxpayer's lifetime taxable income. Further, the section 163(j) limitation does not involve an ''item'' as it is not a recurring element of income or expense.

B. General Gross Receipts Test and Aggregation

As noted in the preamble to the proposed regulations, section 163(j)(3) exempts certain small businesses from the section 163(j) limitation. See proposed § 1.163(j)–2(d). Under section 163(j), a small business taxpayer is one that meets the gross receipts test in section 448(c) and is not a tax shelter under section 448(a)(3). The gross receipts test is met if a taxpayer has average annual gross receipts for the three taxable years prior to the current taxable year of $25 million or less. For taxable years beginning after December 31, 2018, the gross receipts threshold reflects an annual adjustment for inflation as provided for in section 448(c)(4); thus, the gross receipts threshold for taxable years beginning in 2020 is $26 million. See section 3.31 of Rev. Proc. 2019–44, 2019–47 I.R.B.1093. Section 448(c)(2) aggregates the gross receipts of multiple taxpayers that are treated as a single employer under sections 52(a) and (b) and 414(m) and (o). The gross receipts test under section 448(c) normally applies only to corporations and to partnerships with C corporation partners. However, section 163(j)(3) and proposed § 1.163(j)–2(d)(2)(i) provide that, for a taxpayer that is not a corporation or a partnership, the gross receipts test of section 448(c) applies as if the taxpayer were a corporation or a partnership.

Some commenters noted that the aggregation rules in sections 52(a) and (b) and sections 414(m) and (o) could be difficult to apply in certain instances due to their complexity. Other commenters asked that the final regulations clarify the application of the aggregation rules to the gross receipts test under section 448(c). Addressing the application of the aggregation rules to the gross receipts test is beyond the scope of the final regulations. The section 52(a) and (b) aggregation rules were enacted as part of the work opportunity tax credit, but have also been applied to numerous Code provisions, including sections 45A, 45S, 264, 280C and 448. The affiliated service group rules under section 414(m) were enacted to address certain abuses related to qualified retirement plans, but also have been applied to several other Code provisions, including sections 45R, 162(m), 414(t), 4980H, and 4980I.

However, the Treasury Department and the IRS are aware that the aggregation rules set forth in sections 52(a) and (b) and sections 414(m) and (o) are complex. Therefore, Frequently Asked Questions that explain the basic operation of these rules are provided on *http://irs.gov/newsroom.* See FAQs Regarding the Aggregation Rules Under Section 448(c)(2) that Apply to the Section 163(j) Small Business Exemption. The Treasury Department and the IRS continue to study the application of the aggregation rules to the gross receipts test, and request comments on issues relating to such application, taking into account the application of the aggregation rules beyond the gross receipts test.

The Treasury Department and the IRS continue to review and consider issues relating to the affiliated service group rules under section 414(m), and a guidance project regarding the aggregation rules under section 414(m) is listed on the 2019–2020 Priority Guidance Plan (RIN 1545–BO34). As guidance is published relating to the affiliated service group rules, the FAQs will be updated, taking into account the various Code provisions to which these aggregation rules apply.

In addition, the Treasury Department and the IRS recognize that proposed § 1.163(j)–2(d)(2)(i) may generate confusion with respect to the aggregation rules. Although section 448(c) applies only to corporations and to partnerships with a C corporation partner, sections 52(a), 52(b), 414(m), and 414(o) apply to a broader array of entities. These statutes contain different ownership thresholds for different types of entities that apply in determining whether multiple entities are treated as a single employer. To resolve potential confusion, the final regulations remove the reference to the aggregation rules from proposed § 1.163(j)–2(d)(2)(i). Taxpayers that are not a corporation or a partnership with a C corporation partner must apply section 448(c) as if they were a corporation or a partnership in accordance with section 163(j)(3) and proposed § 1.163(j)–2(d)(2)(i). However, taxpayers should treat themselves as the type of entity that they actually are in applying sections 52(a), 52(b), 414(m), and 414(o).

C. Small Business Exemption and Single Employer Aggregation Rules—Proposed §§ 1.163(j)–2(d) and 1.52–1(d)(1)(i)

Section 52(b) treats trades or businesses under common control as a single employer. Section 1.52–1(b) through (d) defines ''trades or businesses under common control'' to include parent-subsidiary groups and brother-sister groups. Commenters noted that the version of § 1.52–1(d)(1)(i) in effect at the time of the proposed regulations defined ''brother-sister groups'' to include entities a controlling interest in which is owned by the same 5 or fewer people who are individuals, estates, or trusts (directly and with the application of § 1.414(c)–4(b)(1)).

Section 1.414(c)–4(b)(1) provides that, if a person has an option to purchase an interest in an organization, the person is deemed to own an interest in that organization. Other provisions under § 1.414(c)–4 apply attribution on a broader scale, such as through familial relationships and for closely held partnerships and S corporations.

Commenters questioned whether the cross-reference in § 1.52–1(d)(1)(i) was correct, and whether the cross-reference should have been to § 1.414(c)–4 instead of § 1.414(c)–4(b)(1). The Treasury Department and the IRS agree that there is no discernible reason why § 1.52–1(d)(1)(i) aggregation should be limited solely to options holders. Taxpayers need to know how to aggregate gross receipts properly in order to know if they are subject to section 163(j).

On July 11, 2019, a correcting amendment to T.D. 8179 was published in the **Federal Register** to clarify that the cross-reference in § 1.52–1(d)(1)(i) should be to § 1.414(c)–4. See 84 FR 33002. This correcting amendment should eliminate uncertainty for taxpayers that need to determine how to aggregate gross receipts in the context of a brother-sister group under common control.

D. Small Business Exemption and Tax Shelters—Proposed § 1.163(j)–2(d)(1)

Consistent with section 163(j)(3), proposed § 1.163(j)–2(d)(1) provides that the exemption for certain small businesses that meet the gross receipts test of section 448(c) does not apply to a tax shelter as defined in section 448(d)(3). Several commenters requested clarification on the application of the small business exemption under section 163(j)(3) to a tax shelter.

Section 448(d)(3) defines a tax shelter by cross-reference to section 461(i)(3), which defines a tax shelter, in relevant part, as a syndicate within the meaning of section 1256(e)(3)(B). Section 1.448–1T(b)(3) provides, in part, that a syndicate is a partnership or other entity (other than a C corporation) if more than 35 percent of its losses during the taxable year are *allocated* to limited partners or limited entrepreneurs, whereas section 1256(e)(3)(B) refers to losses that are *allocable* to limited partners or limited entrepreneurs. As a result, the scope of the small business exemption in section 163(j)(3) is unclear. Commenters requested that an entity be a syndicate in a taxable year only if it has net losses in that year and more than 35 percent of those net losses are actually *allocated* to limited partners or limited entrepreneurs. To provide a consistent definition of the term ''syndicate'' for purposes of sections 163(j), 448, and 1256, the Treasury Department and the IRS propose to define the term ''syndicate'' using the actual allocation rule from the definition in § 1.448–1T(b)(3). This definition is also consistent with the definition used in a number of private letter rulings under section 1256. See proposed § 1.1256(e)–2(a) in the Concurrent NPRM.

Commenters also requested specific relief for small business taxpayers from the definition of a syndicate based on the ''active management'' exception under section 1256(e)(3)(C). Section 1256(e)(3)(C) lists several examples of interests in an entity that ''shall not be treated as held by a limited partner or a limited entrepreneur,'' thus excluding the entity from the definition of a syndicate. In particular, section 1256(e)(3)(C)(v) allows the Secretary to determine (by regulations or otherwise) ''that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.''

The commenters requested that the Treasury Department use its authority under section 1256(e)(3)(C)(v) to provide relief from the definition of a syndicate to small business entities that (1) qualify under the gross receipts test of section 448(c), (2) meet the definition of a syndicate, and (3) do not qualify to make an election as an electing real property business or electing farming business. If a small business satisfies these three conditions, the commenters requested that the Treasury Department and the IRS provide a rule that all interests in the entity are treated as held by partners or owners who actively participate in the management of such entity.

The Treasury Department and the IRS have determined that the request deeming limited partners in small partnerships to be active participants even if those owners would not be treated as active participants under section 1256(e)(3)(C) is contrary to the statutory language and legislative history in section 163(j)(3). Therefore, the Treasury Department and the IRS decline to adopt the comments.

Another commenter asked for clarification on how to compute the amount of loss to be tested under § 1.448–1T(b)(3) and section 1256(e)(3)(B). The commenter provided a particular fact pattern in which a small business would be caught in an iterative loop of (a) of having net losses due to a business interest deduction, (b) which would trigger disallowance of the exemption for small businesses in section 163(j)(3) if more than 35 percent of the losses were allocated to a limited partner, (c) which would trigger the application of the section 163(j)(1) limitation to reduce the amount of the interest deduction, (d) which would then lead to the taxpayer having no net losses and therefore being eligible for the application of the exemption for small businesses under section 163(j)(3). To address this fact pattern, in the Concurrent NPRM, the Treasury Department and the IRS have added an ordering rule providing that, for purposes of section 1256(e)(3)(B) and § 1.448–1T(b)(3), losses are determined without regard to section 163(j). See proposed § 1.1256(e)–2(b) and the example provided in proposed § 1.1256(e)–2(c) in the Concurrent NPRM.

E. Gross Receipts for Partners in Partnerships and Shareholders of S Corporation Stock—Proposed § 1.163(j)–2(d)(2)(iii)

Proposed § 1.163(j)–2(d)(iii) provides that, in determining whether a taxpayer meets the gross receipts test of section 448(c), 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. Similarly, shareholders of S corporations include a pro rata share of the S corporation's gross receipts. See Rev. Rul. 71–455, 1971–2 C.B. 318 (holding that a partner's distributive share of the partnership's gross receipts is used in applying the passive investment income test under section 1372(e)(5)).

This approach would be applicable only in situations in which the partner and the partnership (or a shareholder and the S corporation) are not treated as one person under the aggregation rules of sections 52(a) and (b) and 414(m) and (o). The Treasury Department and the IRS requested comments in the preamble to the proposed regulations on this approach and on whether other approaches to determining the gross receipts of partners and S corporation shareholders for purposes of section 163(j) would measure the gross receipts of such partners and shareholders more accurately.

In response, several commenters suggested different approaches for determining the gross receipts of partners and S corporation shareholders. One commenter recommended that a taxpayer should include gross receipts only from entities eligible for the small business exemption (exempt entities). In other words, the commenter recommended that a taxpayer's gross receipts should not include gross receipts from (1) any electing real property trade or business or electing farming business; (2) any entities utilizing the floor plan financing interest exception under section 163(j)(1)(C); and (3) any other entities subject to section 163(j). The commenter noted that this modification would simplify the computation of gross receipts and prevent the same gross receipts from being double-counted both at the entity level and the partner or S corporation shareholder level. However, the determination of gross receipts generally is not affected by whether any other entity is subject to section 163(j).

One commenter noted that passthrough entities generally do not provide information regarding gross receipts to their partners. As it is difficult for partners to determine the partnership's gross receipts, the commenter suggested various approaches, such as a de minimis rule whereby a less-than-10 percent owner of a passthrough entity may use the taxable income from such entity rather than gross receipts; use the current-year gross receipts as a reasonable estimate of the past three years; or not exclude the gross receipts of the exempt entity in certain situations.

Another commenter recommended that, in situations in which a partner and a partnership are not subject to the aggregation rules of section 448(c), a partner should not be required to include any share of partnership gross receipts when determining its partner-level eligibility for the small business exemption. The commenter noted that section 163(j) is applied at the partnership level. The commenter stated it is inconsistent to take an aggregate view of partnerships for purposes of the small business exemption without a specific rule under section 163(j) requiring such attribution or aggregation. The commenter also stated that requiring a partner to include a share of partnership gross receipts would discourage taxpayers who operate small businesses from investing in partnerships.

The Treasury Department and the IRS understand that passthrough entities might not have reported gross receipts to their partners or shareholders in the past. However, the statute is clear that a taxpayer must meet the gross receipts test of section 448(c), and that, if the taxpayer is not subject to section 448(c), the section 448(c) rules must be applied in the same manner as if such taxpayer were a corporation or partnership. The alternatives presented either do not have universal application or do not adequately reflect a passthrough entity's gross receipts.

Additionally, there is no authority under section 448 and the regulations thereunder to substitute taxable income for gross receipts or to estimate gross receipts. Accordingly, the Treasury Department and the IRS do not adopt the suggested approaches, and the proposed rules are finalized without any change.

IV. Comments on and Changes to Section Proposed § 1.163(j)–3: Relationship of Section 163(j) Limitation to Other Provisions Affecting Interest

Proposed § 1.163(j)–3 provides ordering and operating rules that control the interaction of the section 163(j) limitation with other provisions of the Code that defer, capitalize or disallow interest expense. The ordering and operating rules provide that section 163(j) applies before the operation of the loss limitation rules in section 465 and 469, and before the application of section 461(l), and after other provisions of the Code that defer, capitalize, or disallow interest expense. The ordering and operating rules in proposed § 1.163(j)–3 apply only in determining the amount of interest expense that could be deducted without regard to the section 163(j) limitation, and not for other purposes, such as the calculation of ATI. The following discussion addresses comments relating to proposed § 1.163(j)–3.

A. Capitalized Interest

Proposed § 1.163(j)–3(b)(5) provides that provisions that require interest to be capitalized, such as sections 263A and 263(g), apply before section 163(j). Commenters suggested that this section is too restrictive by referring solely to sections 263(A) and 263(g), and that other provisions could require interest to be capitalized. The Treasury Department and the IRS agree with this comment, and an appropriate revision has been made in the final regulations to account for any possible additional provisions that could require interest to be capitalized.

B. Provisions That Characterize Interest Expense as Something Other Than Business Interest Expense

Proposed § 1.163(j)–3(b)(9) generally provides that provisions requiring interest expense to be treated as something other than business interest expense, such as section 163(d) governing investment interest expense, govern the treatment of the interest expense. Commenters expressed confusion with the provision, suggesting that, by virtue of the statute and the proposed regulations, if interest expense is treated as something other than business interest expense, there is no need to consult proposed § 1.163(j)–3. The Treasury Department and the IRS generally agree with the comment and have removed this section from the final regulations.

C. Section 108

In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on the interaction between section 163(j) and the rules addressing income from the discharge of indebtedness under section 108. In response, commenters noted, for example, that it is unclear whether cancellation of indebtedness income under section 61(a)(11) arises when the taxpayer only receives a benefit in the form of a disallowed business interest expense carryforward, or whether any exclusions, such as sections 108(e)(2) or 111, or any tax benefit principles, should apply. In light of the complex and novel issues raised in these comments, the Treasury Department and the IRS have determined that the interaction between section 163(j) and section 108 requires further consideration and may be the subject of future guidance.

D. Sections 461(l), 465, and 469

The proposed regulations provide that sections 461(l), 465, and 469 apply after the application of section 163(j). The Treasury Department and the IRS received informal questions about the effect of these sections on the calculation of ATI. Therefore, the final regulations clarify whether and how sections 461(l), 465, and 469 are applied when determining tentative taxable income. The final regulations also include examples to demonstrate the calculation of ATI if a loss tentatively is suspended in the calculation of tentative taxable income, and if a loss is carried forward from a prior taxable year under section 469.

V. Comments on and Changes to Proposed § 1.163(j)–4: General Rules Applicable to C Corporations (Including Real Estate Investment Trusts (REITs), RICs, and Members of Consolidated Groups) and Tax-Exempt Corporations

Section 1.163(j)–4 provides 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. The following discussion addresses comments relating to proposed § 1.163(j)–4.

A. Aggregating Affiliated but Non-Consolidated Entities

Under the proposed regulations, members of a consolidated group are aggregated for purposes of section 163(j), and the consolidated group has a single section 163(j) limitation. In contrast, partnerships that are wholly owned by members of a consolidated group are not aggregated with the group for purposes of section 163(j), and members of an affiliated group that do not file a consolidated return are not aggregated with each other for purposes of section 163(j).

Several commenters recommended that aggregation rules be applied to related taxpayers other than consolidated group members. For example, one commenter recommended that aggregation rules similar to those provided under section 199A be applied for purposes of the section 163(j) limitation to obviate the need for related entities to shift debt or business assets around to avoid this limitation. Several other commenters noted that the 1991 Proposed Regulations applied section 163(j) to an affiliated group of corporations (including all domestic corporations controlled by the same parent, whether consolidated or not) and recommended that this ''super-affiliation rule'' be retained so that affiliated but non-consolidated groups are not disadvantaged under the section 163(j) regulations. In contrast, another commenter agreed with the approach taken in the proposed regulations with respect to affiliated but non-consolidated groups, in part because the allocation of the section 163(j) limitation among non-consolidated affiliates can become quite complex.

Commenters also recommended that a partnership owned by members of an affiliated group (controlled partnership) be treated as an aggregate rather than an entity so that the section 163(j) limitation would not apply separately at the partnership level. Instead, each partner would include its allocable share of the controlled partnership's tax items in determining its own section 163(j) limitation, and transactions between the controlled partnership and its controlling partners would be disregarded. Some commenters would apply this approach to partnerships wholly owned by members of a controlled group of corporations (as defined in section 1563). Others would apply this approach to partnerships wholly owned (or at least 80 percent-owned) by members of a consolidated group in order to reduce compliance complexity, to ensure that similarly situated taxpayers (namely, consolidated groups that conduct business activities directly and those that conduct such activities through a controlled partnership) are treated similarly, and to discourage consolidated groups from creating a controlled partnership to obtain a better result under section 163(j). Commenters observed that the proposed regulations apply an aggregate approach to certain controlled partnerships that own CFCs (see proposed § 1.163(j)–7(f)(6)(ii)(B)), and they recommended applying this principle more broadly.

As explained in the preamble to the proposed regulations, the Treasury Department and the IRS have determined that non-consolidated entities generally should not be aggregated for purposes of applying the section 163(j) limitation. 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). See the Concurrent NPRM for a discussion of a proposed exception to this general rule for CFCs. Moreover, the Treasury Department and the IRS have determined that controlled partnerships generally should not be treated as aggregates because section 163(j) clearly applies at the partnership level. See section 163(j)(4). In other words, Congress decided that partnerships should be treated as entities rather than aggregates for purposes of section 163(j). Additionally, revising the regulations to treat controlled partnerships as aggregates would not necessarily achieve the objectives sought by commenters because the controlling partners effectively could ''elect'' entity or aggregate treatment for the partnership simply by selling or acquiring interests therein (thereby causing the partnership to satisfy or fail the ownership requirement for aggregate treatment).

However, the Treasury Department and the IRS are concerned that the application of section 163(j) on an entity-by-entity basis outside the consolidated group context could create the potential for abuse in certain situations by facilitating the separation of excepted and non-excepted trades or businesses. For example, a consolidated group that is engaged in both excepted and non-excepted trades or businesses could transfer its excepted trades or businesses to a controlled partnership, which in turn could borrow funds from a third party and distribute those funds to the consolidated group tax-free under section 731 (unless the debt is recharacterized as debt of the consolidated group in substance; see *Plantation Patterns, Inc.* v. *Commissioner,* 462 F.2d 712 (5th Cir. 1972)). Similarly, an individual taxpayer that is engaged in both excepted and non-excepted trades or businesses could transfer its excepted trades or businesses to a controlled corporation, which in turn could borrow funds from a third party and distribute those funds to the individual tax-free under section 301(c)(2) (assuming the corporation has no earnings and profits). Additionally, a partnership with two trades or businesses—one that generates ATI, and another that generates losses—could separate the two trades or businesses into a tiered partnership structure solely for the purpose of borrowing through the partnership that generates ATI and avoiding a section 163(j) limitation.

The anti-avoidance rule in proposed § 1.163(j)–2(h) and the anti-abuse rule in proposed § 1.163(j)–10(c)(8) would preclude taxpayers from undertaking the foregoing transfers in certain circumstances. The final regulations add an example illustrating the application of the anti-avoidance rule in proposed § 1.163(j)–2(h) to the use of a controlled corporation to avoid the section 163(j) limitation, as well as an example illustrating the application of this anti-avoidance rule to the use of a lower-tier partnership to avoid the section 163(j) limitation in a similar manner.

Commenters further requested that the Treasury Department and the IRS simplify the rules applicable to controlled partnerships if the final regulations do not treat such partnerships as aggregates rather than entities. For example, commenters recommended (i) eliminating steps 3 through 10 in proposed § 1.163(j)–6(f)(2) for such partnerships, (ii) applying the principles of the § 1.469–7 self-charged interest rules to partnership interest expense and income owed to or from consolidated group members by treating all members of the group as a single taxpayer, or (iii) allowing excess taxable income (ETI) that is allocated by a partnership to one consolidated group member to offset excess business interest expense allocated by that partnership to another group member.

The final regulations do not adopt these recommendations. For a discussion of steps 3 through 10 in proposed § 1.163(j)–6(f)(2), see part VII(A)(3) of this Summary of Comments and Explanation of Revisions section. For a discussion of the self-charged interest rules, see the Concurrent NPRM. For a discussion of the proposal to allow ETI allocated by a partnership to one member of a consolidated group to offset excess business interest expense allocated by that partnership to another group member, see part V(D)(4) of this Summary of Comments and Explanation of Revisions section.

B. Intercompany Transactions and Intercompany Obligations

Proposed § 1.163(j)–4(d)(2) contains rules governing the calculation of the section 163(j) limitation for members of a consolidated group. These rules provide, in part, that: (i) A consolidated group has a single section 163(j) limitation; (ii) for purposes of calculating the group's ATI, the relevant taxable income is the consolidated group's consolidated taxable income, and intercompany items and corresponding items are disregarded to the extent they offset in amount; and (iii) for purposes of calculating the group's ATI and determining the business interest expense and business interest income of each member, all intercompany obligations (as defined in § 1.1502–13(g)(2)(ii)) are disregarded (thus, interest expense and interest income from intercompany obligations are not treated as business interest expense and business interest income for purposes of section 163(j)).

In turn, proposed § 1.163(j)–5(b)(3) contains rules governing the treatment of disallowed business interest expense carryforwards for consolidated groups. These rules provide, in part, that if the aggregate amount of members' business interest expense (including disallowed business interest expense carryforwards) exceeds the group's section 163(j) limitation, then: (i) Each member with current-year business interest expense and either current-year business interest income or floor plan financing interest expense deducts current-year business interest expense to the extent of its current-year business interest income and floor plan financing interest expense; (ii) if the group has any remaining section 163(j) limitation, each member with remaining current-year business interest expense deducts a pro rata portion of its expense; (iii) if the group has any remaining section 163(j) limitation, disallowed business interest expense carryforwards are deducted on a pro rata basis in the order of the taxable years in which they arose; and (iv) each member whose business interest expense is not fully absorbed by the group in the current taxable year carries the expense forward to the succeeding taxable year as a disallowed business interest expense carryforward.

Commenters posed several questions and comments with regard to these proposed rules. One commenter expressed concern that these provisions would create noneconomic and distortive allocations of disallowed business interest expense within consolidated groups. For example, assume P (the parent of a consolidated group) acts as a group's sole external borrower, and P on-lends the loan proceeds to S (a member of P's consolidated group) for use in S's business operations. Under the proposed regulations, any disallowed business interest expense would be allocated to P even though S is the economic user of the borrowed funds and may generate the income that supports the external debt. The commenter also expressed concern that, under the proposed regulations, consolidated groups effectively may decide which member will carry forward disallowed business interest expense by having that member borrow funds from third parties, regardless of whether that member actually uses the funds. The commenter raised similar concerns about business interest income, noting that a group may choose which member will loan funds outside the group and thereby affect which member's business interest expense is absorbed within the group.

To address the foregoing concerns, the commenter suggested that the final regulations (i) take intercompany interest income and expense into account for purposes of section 163(j), (ii) allocate current-year disallowed business interest expense to members without regard to whether the interest expense results from intercompany obligations or external borrowings, and (iii) de-link disallowed business interest expenses from intercompany interest income for purposes of the rules under § 1.1502–13. However, the commenter acknowledged that this approach could introduce unwarranted complexity. Alternatively, the commenter suggested that taxpayers be permitted to apply any reasonable approach (apart from tracing) consistent with the economics, subject to a narrowly tailored anti-avoidance rule.

In the proposed regulations, the Treasury Department and the IRS determined that intercompany obligations should be disregarded for purposes of section 163(j) for several reasons. First, section 163(j) is concerned with interest expense paid to external lenders, not internal borrowing between divisions of a single corporation (or between members of a consolidated group). In this regard, the Treasury Department and the IRS note that treating a member with intercompany debt but no external debt as having business interest expense could lead to strange results.

Second, the approach taken in the proposed regulations results in application of the section 163(j) limitation at the consolidated group level, consistent with the expressed intent of Congress (see H. Rept. 115–466, at 386 (2017)).

Third, such an approach is simpler for taxpayers to administer than an approach that would require consolidated groups to track disallowed business interest expense with regard to intercompany obligations across taxable years, as further discussed in the following paragraph. Allowing taxpayers to apply any reasonable approach (and to ignore or take into account interest expense on intercompany obligations as they determine to be appropriate) also would further complicate rather than simplify tax administration, particularly with regard to the application of section 163(j) to consolidated groups.

Fourth, as the commenter acknowledged, taking intercompany obligations into account for purposes of section 163(j) would complicate the application of § 1.1502–13. Section 1.1502–13 achieves single-entity treatment for a consolidated group by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income or liability. To this end, § 1.1502–13(c) ''matches'' the tax items of the members that are parties to an intercompany transaction. In the case of intercompany interest, income and deductions do not affect consolidated taxable income or liability because each side of the transaction ''nets out'' the other in each taxable year. If section 163(j) applied to intercompany payments of business interest expense, and if a consolidated group's section 163(j) limitation did not permit the deduction of all of the group's intercompany business interest expense, the interest income and expense would not net out each other. Thus, the group would need to separately track both the intercompany borrower's non-deductible expense and the intercompany lender's non-includible income through future taxable years.

The Treasury Department and the IRS acknowledge that disregarding intercompany obligations may lead to results in some circumstances that are less economically accurate than a regime that takes such obligations into account, but the Treasury Department and the IRS considered administrability as well as economic accuracy when promulgating the proposed regulations. Moreover, although disregarding intercompany obligations may grant consolidated groups the latitude to decide which member will incur business interest expense, consolidated groups also would have significant flexibility to allocate business interest expense within a group using intercompany obligations if such obligations were regarded for purposes of section 163(j).

Although the proposed rules in the Concurrent NPRM concerning CFC group elections do regard inter-CFC group net interest expense in allocating CFC group disallowed business interest expense, the CFC group setting is materially different from that of a consolidated group. First, in the context of a CFC group, neither § 1.1502–13 nor similar rules apply. Second, the location of disallowed business interest expense may have more effect on tax liability. In particular, disallowed business interest expense may affect the calculation of foreign tax credits and the amount of qualified business asset investment within the meaning of section 951A(d)(1) (QBAI) taken into account in determining a U.S. shareholder's tax liability under section 951A. This effect depends entirely on the particular CFC group member affected by disallowed business interest expense. Although the location of disallowed business interest expense has an effect on consolidated groups, this effect often will be less than in the CFC group context.

For the foregoing reasons, the final regulations do not apply section 163(j) to business interest expense or business interest income incurred on intercompany obligations, with one limited exception related to repurchase premium on obligations that are deemed satisfied and reissued, which is described in part V(C) of this Summary of Comments and Explanation of Revisions section.

Commenters also expressed concern that consolidated groups may have difficulty determining which member is the borrower on external debt if other group members are co-obligors or guarantors on the debt, and that, as a result, each member may have difficulty calculating its business interest expense for each taxable year. Commenters voiced similar concerns about the lack of parameters for determining the appropriate location of business interest income and floor plan financing interest expense within the group.

The Treasury Department and the IRS do not find this comment persuasive. Consolidated groups (and other related parties) are required to determine which member is entitled to a deduction for interest expense. Specifically, a consolidated group must use this information for purposes of computing consolidated taxable income under §§ 1.1502–11 and 1.1502–12 and making stock basis adjustments in members under § 1.1502–32. Moreover, consolidated groups must determine which member has incurred business interest expense for purposes of applying section 382 and the separate return limitation year (SRLY) rules. Consolidated groups must look to existing law to determine which member should be treated as incurring business interest expense or business interest income for purposes of section 163(j).

C. Repurchase Premium on Obligations That Are Deemed Satisfied and Reissued

As discussed in part V(B) of this Summary of Comments and Explanation of Revisions section, interest expense on intercompany obligations generally is disregarded for purposes of section 163(j). Thus, commenters asked whether repurchase premium that is treated as interest with respect to intercompany obligations should be subject to the section 163(j) limitation. In general, if debt that is not an intercompany obligation becomes an intercompany obligation (for example, if a member of a consolidated group acquires another member's debt from a non-member), the debt is treated for all Federal income tax purposes, immediately after it becomes an intercompany obligation, as having been satisfied by the issuer for cash in an amount equal to the holder's basis in the note and as having been reissued as a new intercompany obligation for the same amount of cash. See § 1.1502–13(g)(5)(ii)(A). Additionally, if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price (as defined in § 1.1275–1(b)), the excess (repurchase premium) generally is deductible as interest for the taxable year in which the repurchase occurs. See § 1.163–7(c).

For example, S is a member of P's consolidated group, and S has borrowed $100x from unrelated X. At a time when S's note has increased in value to $130x due to a decline in prevailing interest rates, P purchases the note from X for $130x. Under § 1.1502–13(g)(5)(ii), S's note is treated as satisfied for $130x immediately after it becomes an intercompany obligation. As a result of the deemed satisfaction of the note, P has no gain or loss, and S has $30x of repurchase premium that is deductible as interest. See § 1.1502–13(g)(7)(ii), *Example 10.* Similarly, if S were to repurchase its note from X for $130x, S would have $30x of repurchase premium that is deductible as interest.

If S were to repurchase its note from X at a premium, the interest (in the form of repurchase premium) paid on that note would be subject to the section 163(j) limitation. See § 1.163(j)–1(b)(22)(i)(H) (treating repurchase premium that is deductible under § 1.163–7(c) as interest for purposes of section 163(j)). If section 163(j) does not apply to repurchase premium paid by S to P after P purchases S's note from X, the P group would obtain a different (and better) result than if S were to repurchase its own note. The Treasury Department and the IRS have determined that achieving different results under section 163(j) depending on which member repurchases external debt would be inconsistent with treating a consolidated group as a single entity for purposes of section 163(j) and would undermine the purpose of § 1.1502–13. Thus, the final regulations provide that, for purposes of section 163(j), if any member of a consolidated group purchases a member's note from a third party at a premium, the repurchase premium that is deductible under § 1.163–7(c) is treated as interest expense for purposes of section 163(j), regardless of whether the repurchase premium is treated as paid on intercompany indebtedness.

D. Intercompany Transfers of Partnership Interests

1. Overview of Proposed § 1.163(j)–4(d)(4)

Proposed § 1.163(j)–4(d)(4) provides 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 section 163(j)(4)(B)(iii)(II), regardless of whether the transfer is one in which gain or loss is recognized. Thus, the transferor member's excess business interest expense is eliminated rather than transferred to the transferee member. Proposed § 1.163(j)–4(d)(4) further provides that neither the allocation of excess business interest expense to a member from a partnership (and the resulting decrease in basis in the partnership interest) nor the elimination of excess business interest expense of a member upon a disposition of the partnership interest (and the resulting increase in basis in the partnership interest) affects basis in the member's stock for purposes of § 1.1502–32(b)(3)(ii). Instead, 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).

2. Intercompany Transfers of Partnership Interests Treated as Dispositions; Single-Entity Treatment; Application of § 1.1502–13

Commenters posed various questions and comments about the treatment of intercompany transfers of partnership interests as dispositions for purposes of section 163(j). For example, commenters asked why, in applying section 163(j) to consolidated groups, the proposed regulations treat such transfers as dispositions, rather than simply disregard the transfers, given that the proposed regulations generally treat consolidated groups as a single entity and disregard intercompany transactions for purposes of section 163(j).

The proposed regulations provide that intercompany transfers of partnership interests are treated as dispositions for purposes of section 163(j) because each member's separate ownership of interests in a partnership generally is respected (otherwise, a partnership whose interests are wholly owned by members of a consolidated group would be treated as a disregarded entity), and because the term ''disposition'' in section 163(j)(4)(B)(iii)(II) has broad application (for example, it applies to nonrecognition transactions). Moreover, if an intercompany transfer of partnership interests were not treated as a disposition (and if, as a result, basis were not restored to the transferor member), the amount of the transferor member's gain or loss on the intercompany transfer would be incorrect. Special rules also would be needed to account for the transfer of excess business interest expense from one member to another in a manner consistent with the purposes of § 1.1502–13 and to comply with the directive of section 1502 to clearly reflect the income of each member of the group.

Several commenters also noted problems with the approach in proposed §§ 1.163(j)–4(d)(4) and 1.1502–13(c)(7)(ii)(R), *Example 18.* These commenters pointed out that the approach in the proposed regulations does not achieve single-entity treatment because one member's transfer of its partnership interest to another member causes the transferor's excess business interest expense to be eliminated; thus, an intercompany transaction may alter the amount of business interest expense that is absorbed by the group. One commenter suggested a different approach under which the transferee could claim deductions for excess business interest expense to the extent the transferee is allocated excess taxable income from the same partnership. However, the commenter acknowledged that this approach would require additional rules under § 1.1502–13.

Another commenter suggested that intercompany transfers in which the transferee is the successor to the transferor (for example, in transactions to which section 381(a) applies, or in which the transferee's basis in the partnership interest is determined by reference to the transferor's basis) should not be treated as dispositions for purposes of section 163(j)(4)(B)(iii)(II). However, this approach would not result in an increase in the transferor member's (S's) basis in its partnership interest immediately before the transfer; thus, this approach would be inconsistent with § 1.1502–13, which requires the clear reflection of income at the level of the consolidated group member. This approach also would be inconsistent with section 163(j)(4)(B)(iii)(II), which clearly treats ''a transaction in which gain is not recognized in whole or in part'' as a disposition for purposes of that section.

Still another commenter observed that the analysis in proposed § 1.1502–13(c)(7)(ii)(R), *Example 18,* does not work in certain other fact patterns. In proposed § 1.1502–13(c)(7)(ii)(R), *Example 18,* P wholly owns S and B, both of which are members of P's consolidated group. S and A (an unrelated third party) are equal partners in PS1, which allocates $50x of excess business interest expense to each partner in Year 2. At the end of Year 2, S sells its PS1 interest to B at a $50x loss (S's excess business interest expense is eliminated, and S's basis in its PS1 interest is increased by $50x immediately before the sale). In Year 3, PS1 allocates $25x of excess taxable income to B. At the end of Year 4, B sells its PS1 interest to Z (an unrelated third party) for a $10x gain. The example concludes that S takes into account $25x of its loss in Year 3 as an ordinary loss, which matches B's inclusion of $25x of ordinary income in Year 3. The remaining $25x of S's $50x capital loss is taken into account in Year 4. The commenter noted that, although the analysis in proposed § 1.1502–13(c)(7)(ii)(R), *Example 18,* works under the facts presented, it would not work if, for example, S were to sell the PS1 interest to B at a gain (because S's gain and B's income could not be offset).

The Treasury Department and the IRS acknowledge the concerns raised by these commenters. The Treasury Department and the IRS are continuing to study the proper treatment of intercompany transfers of partnership interests that do not result in the termination of the partnership (intercompany partnership interest transfers), including whether such transfers should be treated as dispositions for purposes of section 163(j)(4)(B)(iii)(II). The final regulations reserve on issues relating to intercompany partnership interest transfers, and the Treasury Department and the IRS welcome further comments on such issues.

3. Possible Approach to Intercompany Partnership Interest Transfers

The Treasury Department and the IRS are considering various possible approaches to intercompany partnership interest transfers. Under one possible approach, such a transfer would be treated as a disposition by S; thus, S's excess business interest expense would be eliminated (and its basis in its partnership interest would be increased accordingly immediately before the transfer), as would S's negative section 163(j) expense (within the meaning of § 1.163(j)–6(h)(1)). However, unlike the approach in proposed § 1.163(j)–4(d)(4), B would be treated as if B had been allocated excess business interest expense or negative section 163(j) interest expense from the partnership in an amount equal to the amount of S's excess business interest expense or negative section 163(j) expense, respectively, immediately before the transfer. B's basis in its partnership interest would be adjusted under section 163(j)(4)(B)(iii)(I) and § 1.163(j)–6(h) to reflect the deemed allocation of excess business interest expense from the partnership. Similar rules would apply to intercompany transfers of partnership interests in nonrecognition transactions.

The foregoing approach would attempt to approximate single-entity treatment while treating the intercompany transfer of a partnership interest as a disposition for purposes of section 163(j)(4)(B)(iii)(II). To ensure that B has the same amount of excess business interest expense, negative section 163(j) expense, and disallowed business interest expense carryforwards as if S and B were divisions of a single corporation, this approach also would include special basis rules. For example, if S transfers its partnership interest to B at a gain, the excess of B's basis in the partnership interest at any time after the transfer over S's basis in the partnership interest immediately before the transfer would not be available to convert negative section 163(j) expense into excess business interest expense in the hands of B or to prevent excess business interest expense from converting into negative section 163(j) expense in the hands of B. Additionally, if adjustments to B's basis in its partnership interest under section 163(j)(4)(B)(iii)(I) and § 1.163(j)–6(h) (upon the deemed allocation of excess business interest expense from the partnership) would exceed B's basis, B would be treated as having a suspended negative basis adjustment in the partnership interest (similar to an excess loss account within the meaning of § 1.1502–19(a)(2)(i)).

The Treasury Department and the IRS request comments on possible approaches to intercompany partnership interest transfers, including the approach outlined in this part V(D)(3) of this Summary of Comments and Explanation of Revisions section.

4. Offsetting Excess Business Interest Expense and Adjusted Taxable Income Within the Consolidated Group

A commenter also recommended that, if the section 163(j) regulations do not treat partnerships wholly owned by members of the same consolidated group as aggregates rather than as entities (see part V(A) of this Summary of Comments and Explanation of Revisions section), the rules applicable to such partnerships should be simplified. For example, the excess taxable income allocated to one member partner could be made available to offset excess business interest expense allocated to another member partner.

The commenter's recommendation presents several issues. For example, the commenter's recommendation would entail disregarding the location of excess business interest expense and excess taxable income within a consolidated group. Such an approach would not fully respect each member's separate interest in a partnership and would not clearly reflect the taxable income of the members of the group. See section 1502; see also part V(D)(2) of this Summary of Comments and Explanation of Revisions section. Further, to the extent the ownership structure of the group is altered by an intercompany transfer of the partnership interest, substantial additional rules under § 1.1502–13 would be required.

5. Intercompany Nonrecognition Transactions

In proposed §§ 1.163(j)–4(d)(4) and 1.1502–13(c)(7)(ii)(S), *Example 19,* the intercompany transfer of a partnership interest in a nonrecognition transaction is treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II). In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments as to whether such transfers should constitute dispositions for purposes of section 163(j)(4)(B)(iii)(II) and, if so, how § 1.1502–13(c) should apply if there is excess taxable income in a succeeding taxable year. In such a case, S would have no intercompany item from the intercompany transfer, and B would take a carryover basis in the partnership interest (this amount would include any basis increase to reflect S's unused excess business interest expense under section 163(j)(4)(B)(iii)(II)).

One commenter agreed that, based on the plain language of section 163(j)(4)(B)(iii)(II), intercompany transfers that are nonrecognition transactions should be treated as dispositions. Another commenter stated that such transfers generally should not be treated as dispositions (if the transferee is the successor to the transferor, as previously discussed), but that, if such transfers are treated as dispositions, no redeterminations should be made under § 1.1502–13(c) with respect to S unless S recognizes gain in the intercompany transfer.

The Treasury Department and the IRS continue to study the proper treatment of intercompany partnership interest transfers and welcome further comments on this issue.

6. Basis Adjustments Under § 1.1502–32

A commenter stated that the approach to basis adjustments under § 1.1502–32 in the proposed regulations may lead to temporary inside/outside basis disparities. Although the commenter generally described this approach as reasonable and consistent with the application of both section 163(j) and § 1.1502–32, the commenter suggested that it may lead to anomalous results in certain cases. The commenter requested an example to illustrate the application of the matching and acceleration rules in the case of an intercompany transfer of an interest in a partnership with disallowed business interest expense.

When S (a member of a consolidated group that is not the common parent) is allocated excess business interest expense from a partnership, S's basis in the partnership is reduced under section 163(j)(4)(B)(iii)(I). Although S's basis in the partnership is reduced, S has excess business interest expense in the same amount, and S's overall inside attribute amount is unchanged. Because there is no net change to S's inside attribute amount, § 1.1502–32 does not apply to reduce other members' basis in S's stock, and there is no inside/outside disparity. Moreover, nothing in the final regulations affects the operation of § 1.1502–32(a), which generally requires adjustments to a member's basis in its S stock to reflect S's distributions and S's items of income, gain, deduction, and loss that are taken into account by the group while S is a member. Thus, the final regulations make no changes in response to this comment.

7. Partnership Terminations

In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on the treatment of the transfer of a partnership interest in an intercompany transaction that results in the termination of the partnership. Some commenters recommended that the transfer be treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II) and proposed § 1.163(j)–6(h)(3). Other commenters recommended that, under Revenue Ruling 99–6, 1999–1 C.B. 432, if the transferee member (B) also were a partner in the partnership before the intercompany transfer, B should be viewed as (i) receiving a distribution of assets from the terminating partnership with respect to its partnership interest, and (ii) purchasing the partnership's assets deemed distributed to the transferor member (S).

The Treasury Department and the IRS are continuing to study the proper treatment of intercompany transfers of partnership interests that result in the termination of the partnership. But see § 1.163(j)–6(h)(3) with respect to partnership terminations generally.

E. Application of § 1.1502–36 to Excess Business Interest Expense

Under proposed § 1.163(j)–4(d)(4), a partner's change in status as a member of a consolidated group is not treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II) and proposed § 1.163(j)–6(h)(3). In other words, if a corporation becomes or ceases to be a member of a consolidated group, and if that corporation is a partner in a partnership, that corporation's entry into or departure from a consolidated group does not trigger basis adjustments under section 163(j)(4)(B)(iii)(II). However, in the preamble to the proposed regulations, the Treasury Department and the IRS requested comments as to whether additional rules are needed to prevent loss duplication upon the disposition of stock of a subsidiary member (S) holding partnership interests.

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 the transfer of S stock. The rule applies when a group member transfers a loss share of S stock. If § 1.1502–36(d) applies to the transfer of a loss share, the attributes of S and its lower-tier subsidiaries generally 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 in assets other than cash and general deposit accounts. See § 1.1502–36(d)(4).

As noted in the preamble to the proposed regulations, the Treasury Department and the IRS have determined that disallowed business interest expenses should be treated as deferred deductions for purposes of § 1.1502–36 (see proposed § 1.1502–36(f)(2)). A commenter recommended that excess business interest expense also be treated as a deferred deduction in determining the net inside attribute amount for purposes of § 1.1502–36(c) and (d). Additionally, the commenter recommended that a consolidated group be permitted to elect to reattribute excess business interest expense from S to the common parent under § 1.1502–36(d)(6) if the common parent also is a partner in the partnership that allocated excess business interest expense to S.

The Treasury Department and the IRS agree that excess business interest expense should be treated as an attribute that is taken into account in determining the net inside attribute amount for purposes of § 1.1502–36(c) and (d). However, the Treasury Department and the IRS have determined that excess business interest expense is more akin to basis (a Category D attribute) than to deferred deductions (a Category C attribute) (see § 1.1502–36(d)(4)(i)). Section 1.163(j)–4(e)(4) reflects this conclusion.

The Treasury Department and the IRS also have determined that excess business interest expense should not be eligible for reattribution under § 1.1502–36(d)(6) because the election is not available with respect to Category D attributes. Thus, the final regulations do not adopt this recommendation.

F. Calculating ATI for Cooperatives

Proposed § 1.163(j)–1(b)(1) defines ATI as the taxable income of the taxpayer for the taxable year, with certain adjustments. Proposed § 1.163(j)–4(b)(4) provides a special rule for calculating the ATI of a RIC or REIT, allowing the RIC or REIT not to reduce its taxable income by the amount of any deduction for dividends paid. The preamble to the proposed regulations also requested comments on whether additional special rules are needed for specific types of taxpayers, including cooperatives.

A commenter asked that the final regulations include a special rule for calculating the ATI of cooperatives subject to taxation under subchapter T of the Code. Under this special rule, taxable income would not be reduced by amounts deducted under section

1382(b)(1) (patronage dividends), section 1382(b)(2) (amounts paid in redemption of nonqualified written notices of allocation distributed as patronage dividends), or section 1382(c) (certain amounts incurred by farm cooperatives described in sections 521 and 1381(a)(1)). The commenter reasoned that such amounts are earnings passed on to members and are therefore analogous to dividends paid by a RIC or REIT to its investor.

The Treasury Department and the IRS agree that, for purposes of section 163(j), amounts deducted by cooperatives under sections 1382(b)(1), (b)(2), and (c) are similar to amounts deducted by RICs and REITs for dividends paid to their investors. The final regulations adopt a rule providing that, for purposes of calculating ATI, the tentative taxable income of a cooperative subject to taxation under sections 1381 through 1388 is not reduced by such amounts. In order to provide similar treatment to similarly situated taxpayers, the final regulations also provide that, for purposes of calculating ATI, the tentative taxable income of cooperatives not subject to taxation under subchapter T of the Code is not reduced by the amount of deductions equivalent to the amounts deducted by cooperatives under sections 1382(b)(1), (b)(2), and (c).

G. Calculating ATI for a Consolidated Group

Proposed § 1.163(j)–1(b)(1) defines ATI as the taxable income of the taxpayer for the taxable year, with certain adjustments. For example, ATI is computed without regard to the amount of any NOL deduction under section 172. See proposed § 1.163(j)–1(b)(1)(i)(B).

As noted in part V(B) of this Summary of Comments and Explanation of Revisions section, for purposes of calculating the ATI of a consolidated group, the relevant taxable income is the group's consolidated taxable income, determined under § 1.1502–11 without regard to any carryforwards or disallowances under section 163(j). See proposed § 1.163(j)–4(d)(2)(iv). Commenters asked for clarification that a consolidated group's ATI does not take into account any NOL deductions available under section 172 and § 1.1502–11(a)(2) that result from either the carryback or carryforward of NOLs.

Proposed § 1.163(j)–4(d)(2)(iv) does not expressly mention the adjustments made to ATI in proposed § 1.163(j)–1(b)(1) because those adjustments are generally applicable (for example, the adjustment for NOLs applies to all taxpayers to whom section 172 applies, regardless of whether such taxpayers file a consolidated return). Moreover, there is no exception in proposed § 1.163(j)–4(d)(2)(iv) to the adjustment for NOLs in proposed § 1.163(j)–1(b)(1)(i)(B). Thus, under these provisions, a consolidated group's ATI would not take into account any NOL deductions resulting from the carryback or carryforward of NOLs. The Treasury Department and the IRS have determined that no change to proposed § 1.163(j)–4(d)(2)(iv) is needed to effectuate this result.

H. Application of Section 163(j) to Life-Nonlife Groups

Proposed § 1.163(j)–4(d)(2) provides that a consolidated group has a single section 163(j) limitation and that, for purposes of calculating the group's ATI, the relevant taxable income is the group's consolidated taxable income. However, § 1.1502–47 requires consolidated groups whose members include life insurance companies and other companies (life-nonlife groups) to adopt a subgroup method to determine consolidated taxable income. (One subgroup is the group's nonlife companies; the other subgroup is the group's life insurance companies.) Under the subgroup method, each subgroup initially computes its own consolidated taxable income, and there are limitations on a life-nonlife group's ability to offset one subgroup's income with the other subgroup's loss.

In light of the apparent tension between proposed § 1.163(j)–4(d)(2) and the subgroup method in § 1.1502–47, one commenter asked for clarification that there are not separate section 163(j) limitations for each subgroup in a life-nonlife group.

The subject matter of this comment is beyond the scope of the final regulations. The Treasury Department and the IRS expect to issue future guidance regarding the interaction of section 163(j) and § 1.1502–47 and welcome further comments on this topic.

I. Application of Section 163(j) to Tax-Exempt Entities

Proposed § 1.163(j)–1(b)(36) defines a tax-exempt corporation but does not define other types of tax-exempt organizations. Thus, a commenter asked for clarification as to whether section 163(j) applies solely to tax-exempt corporations or whether it also applies to other entities subject to tax under section 511. The final regulations clarify that section 163(j) applies to all entities that are subject to tax under section 511.

The commenter also suggested that section 163(j) should not apply to state colleges and universities described in section 511(a)(2)(B). The Treasury Department and the IRS have found nothing in the statute or legislative history to suggest that Congress intended special treatment for state colleges and universities to the extent such organizations are subject to tax under section 511. Therefore, the final regulations do not adopt this recommendation.

J. Partnership Investment Income and Corporate Partners

Under the proposed regulations, a partnership's investment interest income and investment expense are allocated to each partner in accordance with section 704(b), and the effect of the allocation is determined at the partner level. In general, any investment interest, investment income, and investment expense allocated by a partnership to a C corporation partner is treated by the partner as allocable to a non-excepted trade or business of the partner for purposes of section 163(j). See proposed §§ 1.163(j)–4(b)(3)(i) and 1.163(j)–10(b)(6).

In light of the statutory restriction against including investment income in a partner's ATI (see section 163(j)(8)(A)(i)), a commenter requested confirmation that a partnership's investment income is treated as properly allocable to a trade or business of (and thus is included in the ATI of) a corporate partner, perhaps by adding an example to illustrate the application of this rule.

Proposed § 1.163(j)–10(b)(6) provides that 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 proposed § 1.163(j)–4(b)(3)(i) is treated as properly allocable to a non-excepted trade or business of the C corporation partner. Thus, if a partnership incurs investment interest expense, any portion of that expense that is allocable to a C corporation partner is treated as a business interest expense of that partner that is subject to the section 163(j) limitation. However, if the partnership also has investment interest income, any portion thereof that is allocable to a C corporation partner is treated as business interest income of the partner, and any other investment income of the partnership that is allocable to the C corporation partner increases the partner's ATI. See § 1.163(j)–4(b)(7)(ii), *Example 2.*

To the extent that an investment item or other item of a partnership is with respect to property for which an election has been made by the partnership to treat as an electing real property trade or business or electing farming business, such item is treated as properly allocable to an excepted trade or business. This rule is necessary because the final regulations permit elections for some assets and activities to be an excepted trade or business even when such assets and activities are not trades or businesses for section 162 purposes. See part X(A) of this Summary of Comments and Explanation of Revisions section.

The final regulations also expand proposed § 1.163(j)–4(b)(3)(i) to cover not only a partnership's items of investment interest, investment income, and investment expense, but also a partnership's other separately stated tax items that are subject to neither section 163(j) nor section 163(d). Such items might include tax items allocable to rental activities that do not rise to the level of a section 162 trade or business that otherwise give rise to allowable deductions (such as under section 212 as it existed under prior law) that are subject to section 469. Thus, such items are treated as properly allocable to a trade or business of a C corporation partner as well.

K. Earnings and Profits of a Corporate Partner

Proposed § 1.163(j)–4(c)(1) generally provides that the disallowance and carryforward of a deduction for a C corporation's business interest expense under proposed § 1.163(j)–2 does not affect whether or when the business interest expense reduces the corporation's earnings and profits. Some commenters suggested that, if the business interest expense in question is incurred by a partnership rather than by the C corporation partner, the partner should reduce its earnings and profits twice with respect to that expense—once when the expense is allocated from the partnership to the partner, and again when the partner claims a deduction with respect to that expense (after the excess business interest expense allocated to that partner is treated as business interest expense and deducted by that partner).

The Treasury Department and the IRS have determined that the proposed regulations do not permit a C corporation partner to reduce its earnings and profits twice with respect to business interest expense incurred by a partnership. The final regulations are modified to clarify this point.

Proposed § 1.163(j)–4(c)(3) also provides a special earnings and profits rule for C corporations (other than REITs or RICs) with respect to excess business interest expense allocated from a partnership. Under this rule, the C corporation partner must increase its earnings and profits 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. The Treasury Department and the IRS have determined that the same rule should apply with respect to negative section 163(j) expense, and the final regulations have been modified accordingly.

VI. Comments on and Changes to Proposed § 1.163(j)–5: General Rules Governing Disallowed Business Interest Expense Carryforwards for C Corporations

Section 1.163(j)–5 provides rules regarding disallowed business interest expense carryforwards for taxpayers that are C corporations, including members of a consolidated group. The following discussion addresses comments relating to proposed § 1.163(j)–5.

A. Absorption of Disallowed Business Interest Expense Carryforwards Before Use of NOLs in Life-Nonlife Groups

Proposed § 1.163(j)–5(b)(3) provides rules regarding the treatment of disallowed business interest expense carryforwards of a consolidated group. Commenters asked for confirmation that, in the context of a life-nonlife group, such carryforwards are factored into taxable income at the subgroup level before NOLs are carried forward and limited under section 1503(c)(1).

In general, a consolidated group must determine the amount of business interest expense (whether current-year or carryforwards) that can be absorbed in a particular taxable year before determining whether NOLs can be carried forward or back to that taxable year. However, the specific subject matter of this comment is beyond the scope of the final regulations. The Treasury Department and the IRS expect to issue future guidance regarding the interaction of section 163(j) and § 1.1502–47 and welcome further comments in this regard.

B. Carryforwards From Separate Return Limitation Years

Proposed § 1.163(j)–5(d) contains rules for consolidated groups regarding disallowed business interest expense carryforwards from a separate return limitation year (a SRLY; see § 1.1502–1(f)). Under these rules, the disallowed business interest expense carryforwards of a member arising in a SRLY that are included in a group's business interest expense deduction for any taxable year may not exceed the group's section 163(j) limitation for that year, determined by reference only to the member's tax items for that year (the section 163(j) SRLY limitation). See proposed § 1.163(j)–5(d)(1). Additionally, disallowed business interest expense carryforwards of a member arising in a SRLY would be available for deduction by the consolidated group in the current year only to the extent the group had remaining section 163(j) limitation after deducting current-year business interest expense and disallowed business interest expense carryforwards from earlier taxable years, and only to the extent the section 163(j) SRLY limitation for the current year exceeded the amount of the member's business interest expense already deducted by the group in that year. In addition, SRLY-limited disallowed business interest expense carryforwards must be deducted on a pro rata basis with non-SRLY limited disallowed business interest expense carryforwards from taxable years ending on the same date. See proposed § 1.163(j)–5(d)(2).

Commenters asked several questions about the SRLY rules in proposed § 1.163(j)–5(d). In particular, commenters asked why the section 163(j) SRLY limitation is calculated annually rather than on an aggregate or cumulative basis, as is the case for NOLs. (Section 1.1502–21(c)(1)(i) generally limits the amount of a member's NOL carryforwards and carrybacks from a SRLY that may be included in the group's consolidated net operating loss deduction to the member's aggregate contribution to the group's consolidated taxable income for the entire period the member has been a group member, not just for the taxable year in question). More specifically, a commenter noted that the SRLY rules in § 1.1502–21(c) were designed to produce a result that roughly approximates the absorption that would have occurred if the SRLY member had not joined a consolidated group. In contrast, the annual section 163(j) limitation in proposed § 1.163(j)–5(d) could put the SRLY member in a worse position than if such member had not joined a consolidated group.

For example, if S were a standalone corporation with $100x of disallowed business interest expense carryforwards at the start of Year 2, and if S's section 163(j) limitation were $30 in Year 2, S could deduct $30x of its carryforwards. In comparison, if S joined a consolidated group at the start of Year 2, and if the group's section 163(j) limitation were $0 in Year 2, S could not deduct any of its $100x of carryforwards in Year 2 even if S's standalone section 163(j) limitation were $30x in that year. This result is correct for the P group for Year 2 given Congress's intent that the section 163(j) limitation apply at the consolidated group level. However, under the annual measurement approach in the proposed regulations, S also could not deduct any of its carryforwards in Year 3 if S had a standalone section 163(j) limitation of $0 in that year, even if the group's section 163(j) limitation were positive in that year. Thus, S would be in a worse position (with respect to the deduction of its disallowed business interest expense carryforwards) than if S had not joined a consolidated group.

To put S in roughly the same position as if S were a standalone corporation, commenters recommended the creation of a cumulative section 163(j) register under which the amount of a member's SRLY carryforwards that may be absorbed by the consolidated group in a taxable year may not exceed (i) the member's contributions (positive and negative) to the group's section 163(j) limitation in all consolidated return years, less (ii) the member's business interest expense (including carryforwards) absorbed by the group in all consolidated return years. For these purposes, and unlike the general rule in section 163(j)(1) and proposed § 1.163(j)–2(b)(2), the adjustment to a member's cumulative section 163(j) SRLY register for any taxable year or its total register for any taxable year could be less than zero.

In the preamble to the proposed regulations, the Treasury Department and the IRS stated that applying an aggregate or cumulative approach to the section 163(j) SRLY limitation would be inconsistent with congressional intent because Congress did not retain the excess limitation carryforward provisions from old section 163(j). One commenter expressed agreement with this conclusion. However, other commenters noted that applying a cumulative section 163(j) SRLY register would not effectuate the carryforward of excess limitation at the level of the consolidated group. In other words, although the SRLY member would be able to deduct its SRLY disallowed business interest expense carryforwards in a taxable year to the extent of that member's cumulative (rather than annual) contribution to the group's section 163(j) limitation, the SRLY member's ability to deduct such carryforwards still would be subject to the group's annual section 163(j) limitation.

After considering the comments received, the Treasury Department and the IRS have determined that a cumulative section 163(j) SRLY register would better approximate the results under section 163(j) if the SRLY member had not joined a consolidated group, and that this approach is not inconsistent with congressional intent. Therefore, the final regulations adopt a cumulative section 163(j) SRLY register.

The cumulative section 163(j) SRLY register operates in a manner similar to, but is separate and distinct from, the cumulative register for NOLs described in § 1.1502–21(c). In computing a member's section 163(j) SRLY register, the intercompany transaction rules of § 1.1502–13 generally continue to apply; thus, for example, intercompany income items and intercompany deductions and losses (to the extent absorbed by the group) generally are taken into account in computing the section 163(j) SRLY register. However, interest income and expense from intercompany obligations are not taken into account in computing the section 163(j) SRLY register. This approach approximates the SRLY member's capacity to utilize carryforwards on a standalone basis while harmonizing with the single-entity application of section 163(j) to consolidated groups. Under this approach, intercompany interest income and expense items will neither increase nor decrease the SRLY register.

In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on another alternative to both an annual register and a cumulative register—removing the SRLY limitation from a member's SRLY-limited disallowed business interest expense carryforwards, to the extent of the member's standalone section 163(j) limitation, in taxable years in which the member's standalone section 163(j) limitation exceeds the consolidated group's section 163(j) limitation. A commenter endorsed this approach. However, other commenters expressed concern that this approach would be more distortive than a cumulative register approach. The Treasury Department and the IRS agree that a cumulative register more closely approximates the results on a standalone basis than this alternative approach. Thus, the final regulations adopt a cumulative register approach rather than this alternative approach.

Commenters also expressed concern that proposed § 1.163(j)–5(d)(2) would treat SRLY carryforwards as available for deduction only to the extent the amount of the SRLY member's business interest expense already deducted by the group in the current year does not exceed the member's annual section 163(j) SRLY limitation. The adoption of the cumulative section 163(j) SRLY limitation mechanism, with the associated reduction to reflect all business interest expense of that member that is absorbed by the group, obviates the issues highlighted in the comment. The final regulations retain the other SRLY limitations in proposed § 1.163(j)–5(d)(2).

C. Offsetting Business Interest Expense With Business Interest Income and Floor Plan Financing Interest Expense at the Member Level

As described in part V(B) of this Summary of Comments and Explanation of Revisions section, proposed § 1.163(j)–5(b)(3) provides, in part, that if the aggregate amount of members' business interest expense (including carryforwards) exceeds the consolidated group's section 163(j) limitation for the current year, then each member with current-year business interest expense and current-year business interest income or floor plan financing interest expense deducts current-year business interest expense to the extent of its current-year business interest income and floor plan financing interest expense. Thereafter, if the group has any remaining section 163(j) limitation, each member with remaining current-year business interest expense deducts a pro rata portion thereof.

A commenter stated that offsetting business interest expense with business interest income or floor plan financing interest expense at the member level seems inconsistent with the single-entity principles adopted by the proposed regulations. Moreover, the commenter expressed concern that a consolidated group could choose where to incur business interest income within a group and thereby affect which member has disallowed business interest expense carryforwards. In addition, the commenter asserted that a group may have difficulty determining which member has incurred business interest income and floor plan financing interest expense (see the discussion in part V(B) of this Summary of Comments and Explanation of Revisions section). Thus, the commenter recommended an alternative approach that does not require such offsetting at the member level.

The Treasury Department and the IRS acknowledge that netting business interest income and floor plan financing interest expense against business interest expense at the member level deviates from a ''pure'' single-entity approach. This approach was adopted in the proposed regulations to give effect to section 163(j)(1) (which allows taxpayers to deduct business interest expense to the full extent of business interest income and floor plan financing interest expense) and to ensure that income tax liability is clearly reflected at the member level in accordance with section 1502 and § 1.1502–13. Further, because consolidated groups are under common control by definition (see section 1504), a consolidated group largely has control over the location of interest expense, even before the application of section 163(j). With regard to the comment regarding the difficulty of determining which member actually has incurred an interest expense, section 61 provides that interest income is includible in gross income, and section 163 provides rules by which interest expense is deductible in computing the taxable income. Section 1.1502–12 also requires consolidated group members to report interest income and expense at the member level for purposes of computing separate taxable income. Thus, the final regulations do not adopt the commenter's recommendation.

VII. Comments on and Changes to Section 1.163(j)–6: Application of the Business Interest Expense Deduction Limitations to Partnerships and Subchapter S Corporations

As discussed in the preamble to the proposed regulations, § 1.163(j)–6 provides general rules regarding the application of section 163(j)(4) to partnerships, S corporations, and their owners, including rules on how to calculate the limitation and how to treat disallowed business interest expense carryforwards. The following discussion addresses comments relating to proposed § 1.163(j)–6.

A. Partnership-Level Calculation and Allocation of Section 163(j) Excess Items

1. 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 non-separately 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.

As highlighted in the proposed regulations, the phrase ''nonseparately stated taxable income or loss of the partnership'' is not defined in section 163(j), and it has not previously been defined by statute or regulations.[1] The phrase ''in the same manner as'' is also undefined. The proposed regulations interpreted the phrase ''nonseparately stated taxable income or loss,'' as it is used in sections 163(j)(4)(A)(ii)(II) and 163(j)(4)(B)(i)(II), as meaning the items comprising adjusted taxable income, business interest income, and business interest expense of the partnership. The legislative history and structure of the statute suggest the purpose of the phrase ''nonseparately stated taxable income or loss of the partnership'' is to help coordinate the section 163(j) limit imposed at the partnership and partner levels.

Section 163(j)(4)(A)(i) uses this phrase when describing business interest expense that already has been tested at the partnership level. In general, an item included in nonseparately stated taxable income or loss of a partnership under section 702(a)(8) loses its tax character in the hands of the partner to whom it is allocated. By providing that such business interest expense is treated as a nonseparately stated item, section 163(j)(4)(A)(i) causes such business interest expense to lose its character as business interest expense, thus preventing it from being subject to retesting at the partner level under section 163(j). Although it does not use the same phrase, section 163(j)(4)(A)(ii)(I), in conjunction with section 163(j)(4)(C), similarly provides that, to the extent the partnership's adjusted taxable income was used in its section 163(j) calculation, such adjusted taxable income is not included in a partner's section 163(j) calculation. Consistent with this principle, proposed § 1.163(j)–6(e)(4) provided similar rules to prevent the double counting of business interest income. Therefore, interpreting the phrase ''nonseparately stated taxable income or loss of the partnership,'' as it is used in section 163(j)(4) as meaning the items comprising adjusted taxable income, business interest income, and business interest expense of the partnership (hereinafter, ''section 163(j) items'') is supported by the statute, which requires each of these items to be taken into account at the partnership level and prohibits the double counting of such items in the partner's section 163(j) calculation.

To allocate excess taxable income, excess business interest income, and excess business interest expense (hereinafter, ''section 163(j) excess items'') ''in the same manner'' as the ''nonseparately stated taxable income or loss of the partnership'' (that is, the section 163(j) items), proposed § 1.163(j)–6(f)(2) provided an 11-step calculation that, when completed by the partnership, provides the partnership with an 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 three descriptive (1 through 3) and two normative (4 through 5) issues outlined in part 6(D)(1) of the Explanation of Provisions section in the proposed regulations: (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).

In general, the 11-step calculation preserves the entity-level calculation required in section 163(j)(4) while also preserving the economics of the partnership, including respecting any special allocations made in accordance with section 704 and the regulations under section 704 of the Code. Stated otherwise, the allocations of section 163(j) excess items prescribed by the 11-step calculation attempt to reflect the aggregate nature of partnerships under subchapter K of the Code while remaining consistent with the application of section 163(j) at the partnership level.

The Treasury Department and the IRS requested comments on the 11-step calculation in the preamble to the

[1] Sections 163(j)(4)(A)(i) and (B)(i)(II) use the word ''nonseparately'' (no hyphen), but section 163(j)(4)(A)(ii)(II) uses the word ''non-separately'' (hyphen). For purposes of consistency, these final regulations use ''nonseparately'' when discussing the phrase at issue.

proposed regulations. Specifically, the Treasury Department and the IRS requested comments regarding alternative methods for allocating deductible business interest expense and section 163(j) excess items 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.

2. Requested Clarifications and Modifications

Commenters requested several clarifications of and modifications to the 11-step calculation. First, commenters requested confirmation that a partnership's allocations of section 163(j) excess items pursuant to the 11-step calculation will be considered to meet the requirements of section 704(b). The final regulations confirm that allocations pursuant to the 11-step calculation meet the requirements of section 704(b). Nothing in the 11-step calculation 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 the 11-step calculation are solely for the purpose of determining each partner's section 163(j) excess items, and do not otherwise affect any other provision under the Code, such as section 704(b). Further, the statement in the proposed regulations that the 11-step calculation is solely for section 163(j) purposes and does not apply for any other purposes of the Code does not mean that section 163(j) excess items have no effect on either outside basis or capital accounts. To illustrate this point, § 1.163(j)–6(o)(17), *Example 17* has been revised to show the beginning and ending outside basis and capital accounts after applying the 11-step calculation.

To further clarify that the allocation of section 163(j) excess items pursuant to the 11-step calculation will be sustained under section 704, a special rule has been added to § 1.704–1(b)(4). The allocation of deductible and nondeductible business interest expense does not have economic effect because classifying a portion of the interest expense as nondeductible merely changes the tax character of the item. Accordingly, § 1.704–1(b)(4)(xi) is added to clarify that, if § 1.163(j)–6(f) is satisfied, the allocation of section 163(j) excess items will be deemed to be in accordance with the partners' interests in the partnership.

Second, commenters recommended the 11-step calculation take remedial allocations into account. Commenters noted that the exclusion of remedial allocations from the partnership-level computation could frustrate the ability of the 11-step calculation to reach the most equitable result given its purpose. The Treasury Department and the IRS acknowledge that taking remedial allocations into account in the 11-step calculation after 2021 might produce an equitable result. However, because remedial income would not always be offset by remedial losses prior to 2022 for purposes of computing ATI, the Treasury Department and that IRS have determined that taking remedial allocations into account in the 11-step calculation would not achieve appropriate results in all circumstances. Therefore, the Treasury Department and the IRS decline to accept the recommendation.

Third, a commenter recommended that the final regulations allow partnerships to make remedial allocations of excess taxable income. Under this recommended modification to the 11-step calculation, if a partner receives an allocation of taxable income in excess of such partner's allocation of excess taxable income, the partnership could elect to create positive remedial excess taxable income in the amount of the excess and allocate such positive remedial excess taxable income to the affected partner. The partnership also would create an offsetting negative remedial excess taxable income item in an equal amount that would be allocated to the other partners. The Treasury Department and the IRS do not adopt this recommendation in the final regulations in light of the fact that the definition of ''excess taxable income'' is statutory and the statute does not appear to contemplate negative excess taxable income.

3. Recommended Alternative Methods

Commenters recommended the final regulations retain the 11-step calculation. Additionally, commenters recommended that the final regulations provide alternative methods for allocating section 163(j) excess items in addition to the 11-step calculation. The commenters seeking an alternative method expressed concern about the complexity of the 11-step calculation—specifically, that the required computations and recordkeeping are excessive for many taxpayers. Commenters argued that the attempted precision of the 11-step calculation should be weighed against its complexity and compared to the reduced precision that could be achieved through simpler methods.

As an alternative to the 11-step calculation, commenters recommended the final regulations allow taxpayers to adopt any reasonable method for allocating section 163(j) excess items, provided the method does not produce results inconsistent with the Treasury Department and the IRS's resolution of the five issues articulated in the preamble to the proposed regulations. See part VII(A)(1) of this Summary of Comments and Explanation of Revisions section. Commenters provided multiple examples of reasonable methods, and they recommended that the final regulations treat section 163(j) excess item allocations as reasonable if the allocations are: (1) Reasonably consistent with the allocations of the corresponding items under section 704(b); (2) in proportion to the allocation of the underlying section 163(j) item; (3) in proportion to the manner in which the partners bear liability for the debt or, in the case of non-recourse debt, in proportion to the manner in which profits will be allocated in order to repay the debt; or (4) the result of arms-length bargaining among partners with adverse tax interests.

The Treasury Department and the IRS do not adopt any of these alternatives in the final regulations. Each of the alternatives recommended by commenters requires an application of section 163(j) at the partnership level, a determination of each partner's share of the partnership's section 163(j) items, and a final determination of each partner's section 163(j) excess items that takes into account each partner's share of the partnership's section 163(j) items. These three determinations mirror steps 1, 2, and 11 (respectively) of the 11-step calculation. The Treasury Department and the IRS recognize the complexity of the computations and recordkeeping imposed by the statute on partnerships, but the Treasury Department and the IRS have concluded that the computations and recordkeeping associated with steps 1, 2, and 11 of the 11-step calculation are unavoidable under any approach. As such, the commenters' recommendation is, in effect, that the final regulations allow alternatives to steps 3 through 10 of the 11-step calculation.

With respect to steps 3 through 10, the Treasury Department and the IRS agree that these computations add to the complexity already required by the statute; thus, a worksheet and multiple examples have been provided to aid in the completion of these computations. However, the Treasury Department and the IRS have concluded that these computations are not overly burdensome given that the partnerships required to perform these calculations already are experienced with handling the complexities associated with special allocations or section 704(c) allocations. In terms of recordkeeping, taxpayers are not required to keep records of steps 3 through 10 because compliance with the 11-step calculation can be determined solely based on the records associated with steps 1, 2, and 11. Moreover, in terms of accuracy, the alternatives fall short of achieving the purpose of steps 3 through 10, which is to align deductible business interest expense with the ATI and business interest income that supported such deduction at the partnership level.

For example, consider the recommended alternative of allocating section 163(j) excess items in proportion to the allocation of the underlying section 163(j) item. If partnership AB's sole items of income, gain, loss, and deduction were $30 of business interest income, which it allocated solely to A, and $40 of business interest expense, which it allocated $20 to each of A and B, then A and B each would have $15 of deductible business interest expense and $5 of excess business interest expense. In situations where, as in this case, the partnership does not allocate all of its section 163(j) items pro rata 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. See part VII(A)(1) of this Summary of Comments and Explanation of Revisions section.

Applying the 11-step calculation 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 resolution of the five issues described in part VII(A)(1) of this Summary of Comments and Explanation of Revisions section. Because the alternative of allocating section 163(j) excess items in proportion to the allocation of the underlying section 163(j) item could require a partnership to allocate section 163(j) excess items to its partners in a manner that does not attempt to align deductible business interest expense with the ATI and business interest income that supported it at the partnership level (which is inconsistent with the resolution of the five issues described in part VII(A)(1) of this Summary of Comments and Explanation of Revisions section), this alternative is not adopted in the final regulations. Other commenters' similar alternatives were considered and were rejected on the same grounds based on the foregoing analysis.

One commenter recommended another alternative method that, in a more general way than the 11-step calculation, attempts to align deductible business interest expense with the ATI and business interest income that supported such deduction at the partnership level. The commenter stated that this objective could be accomplished as follows. For each partner that is allocated business interest expense, determine the portion of the business interest expense allocated to such partner that would be considered deductible business interest expense, taking into account only the business interest income and ATI allocated to such partner. If the aggregate amount determined for all partners is equal to, or less than, the amount of the partnership's deductible business interest expense, then each partner would be allocated deductible business interest expense in the amount determined in the first step. If the first step produced deductible business interest expense in excess of the limitation determined at the partnership level, each partner's allocation of deductible business interest expense would equal the proportion of the partnership's total deductible business interest expense that the deductible amount determined in the first step for such partner constitutes of the deductible amount determined for all partners. Also, any deductible business interest expense as determined at the partnership level that is not allocated through the first step then would be allocated among the partners that have been allocated business interest deductions in proportion to the amount of business interest expense of each partner remaining after the first step.

The Treasury Department and the IRS do not adopt this alternative method in the final regulations. The commenter's approach provides a method for allocating excess business interest expense, but it does not provide any guidance on allocating excess taxable income or excess business interest income. Further, it is not possible to infer a manner for allocating excess taxable income and excess business interest income from this approach because it fails to distinguish each partner's ATI from its business interest income. By comingling ATI and business interest income in its first step, this method fails to account for the ordering of ATI and business interest income in the partnership context as required by the statute. Section 163(j)(4)(C) provides that partnership ATI does not begin offsetting partnership business interest expense until partnership business interest income has been fully utilized. Because this method is only capable of addressing fact patterns in which there is excess business interest expense, it is not adopted in the final regulations.

Moreover, the Treasury Department and the IRS have concluded that this method for allocating excess business interest expense does not sufficiently reduce taxpayer burden given the trade-off in precision and administrability. To illustrate, the commenter applied its recommended method to the facts of *Example 14* of § 1.163(j)–6(o) of the proposed regulations. In that example, partnership PRS has $140 of business interest expense, $200 of ATI, and no business interest income. Accordingly, PRS has $60 of deductible business interest expense. PRS allocates its items of ATI such that A, B, and C have income of $100, $100, and $400 respectively, while D has a loss of $400. PRS allocates its business interest expense $40 to B, $60 to C, and $40 to D.

Under the suggested method, PRS first would determine for each of B, C, and D the amount of the business interest expense allocated to each partner that would be deductible under section 163(j) taking into account solely the ATI and business interest income allocated to such partner. In this case, the entire $60 of business interest expense allocated to C would have been deductible, $30 of the business interest expense allocated to B would have been deductible, and no amount of business interest expense allocable to D would have been deductible. The total amount of business interest expense determined in the first step (or $90) exceeds the total amount deductible under section 163(j) applied at the partnership level (or $60). PRS then would determine the proportion of the business interest expense allocated to each partner that is determined to be deductible in the first step and allocate the total deduction in those proportions. Thus, C would be entitled to two-thirds ($60/$90) of the $60 deduction ($40 of deductible business interest expense) and B would be entitled to one-third ($30/$90) of the $60 deduction ($20 of deductible business interest expense). D would not be entitled to any business interest expense deduction. Accordingly, B would have $20 of excess business interest expense, C would have $20 of excess business interest expense, and D would have $40 of excess business interest expense.

In contrast, applying the 11-step calculation to the same example results in an allocation of more deductible business interest expense to C ($48) than to B ($12) because C was allocated more ATI ($400) from PRS than B ($100). Unlike the commenter's method, the 11-step calculation increases a partner's amount of deductible business interest expense in response to an increased allocation of ATI and business interest income. The commenter's method allocates deductible business interest expense based on a ratio that does not take into account the fact that C was allocated significantly more ATI from PRS than B. To illustrate this point, consider what would happen in the previous example if the facts were changed so that C was allocated $1,100 of ATI and D was allocated ($1,100) of ATI. Applying the 11-step calculation, C would have $55 of deductible business interest expense. Applying the commenter's method, C's increased allocation of ATI from PRS would have no effect on C's deductible business interest expense—C still would have $40 of deductible business interest expense and $20 of excess business interest expense.

The Treasury Department and the IRS have determined that the 11-step calculation produces the result that is most consistent with the normative principle in the statute that the amount of business interest expense a taxpayer is capable of deducting should increase as its ATI and business interest income increase. Further, the Treasury Department and the IRS view methods that do not increase a partner's amount of deductible business interest expense in response to an increased allocation of ATI from the partnership as less intuitive, and therefore more burdensome in application. Therefore, the final regulations do not adopt commenters' suggested alternative methods.

4. Publicly Traded Partnerships

The Treasury Department and the IRS received comments raising concerns about the continued fungibility of publicly traded partnership (PTP) units if PTPs are required to allocate section 163(j) excess items pursuant to the 11-step calculation. The effect of section 163(j) on the fungibility of PTP units is being addressed in the Concurrent NPRM. Therefore, these issues are not addressed in the final regulations.

5. Pro Rata Exception

Multiple commenters recommended that partnerships that allocate all items of income and expense on a pro rata basis (similar to S corporations) be exempt from the 11-step calculation. Commenters stated that these partnerships by nature do not make the kinds of allocations the 11-step calculation is designed to address. Commenters asserted that simplifying the 11-step calculation for these pro-rata partnerships would reduce complexity and reduce their administrative burden.

The Treasury Department and the IRS agree with these comments. Accordingly, the final regulations provide an exception (pro rata exception) from steps 3 through 11 of the 11-step calculation for partnerships that allocate all section 163(j) items in step 2 proportionately. This pro rata exception will not result in allocations of section 163(j) excess items that vary from the array of allocations of section 163(j) excess items that would have resulted had steps 3 through 11 been performed. See § 1.163(j)–6(f)(2)(ii) and *Example 1* through *Example 16* of § 1.163(j)–6(o).

B. Basis Adjustments

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

Pursuant to proposed § 1.163(j)–6(f)(2), the adjusted basis of a partner's interest in a partnership is reduced, but not below zero, by the amount of excess business interest expense allocated to the partner. If a partner is subject to a loss limitation under section 704(d) and the partner is allocated losses from a partnership in a taxable year, the limited losses are grouped based on the character of each loss (each grouping of losses based on character, a ''section 704(d) loss class''). If there are multiple section 704(d) loss classes in a given year, the partner apportions the limitation to each section 704(d) loss class proportionately. For purposes of applying this proportionate rule, any deductible business interest expense and business interest expense of an exempt entity (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) makes up the same section 704(d) loss class (section 163(j) loss class). Moreover, once the partner determines the amount of limitation on losses apportioned to the section 163(j) loss class, any deductible business interest expense is taken into account before any excess business interest expense or negative section 163(j) expense.

Proposed § 1.163(j)–6(h)(2) provides that 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, which prevents 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).

Commenters noted that the rule in proposed § 1.163(j)–6(h)(2) is helpful and should be retained in the final regulations. However, commenters further noted that partners with no business interest expense from other sources generally would prefer to treat their negative section 163(j) expense as deductible business interest expense suspended under section 704(d) and utilize excess taxable income in the current year for that purpose, even though the resulting deductible business interest expense would continue to be non-deductible because of a section 704(d) limit. Thus, commenters recommended allowing a partner to use excess taxable income to treat negative section 163(j) expense as deductible business interest expense suspended under section 704(d) instead of using it to increase partner ATI.

The final regulations do not adopt this recommendation. No precedent exists for allowing items suspended under section 704(d) to preemptively clear limitations that apply after section 704(d) while remaining suspended under section 704(d). For example, in the section 469 context, a non-materially participating partner allocated passive income cannot use such passive income to recharacterize passive losses allocated in a previous year as non-passive while those losses remain suspended under section 704(d).

One commenter also recommended adopting a silo approach under section 704(d). Under this approach, if a partner had a section 704(d) limitation, it could bifurcate its items between non-excepted and excepted partnership business items. If the non-excepted portion was net positive, none of the excess business interest expense allocated from the partnership would be negative section 163(j) expense.

However, this approach would be a significant departure from the current rule under section 704(d), which generally requires the limitation on losses under section 704(d) to be allocated to a partner's distributive share of each loss proportionately, regardless of whether such loss is from an excepted or non-excepted trade or business under section 163(j). Moreover, nothing in section 163(j) indicates Congress intended to give excess business interest expense suspended under section 704(d) a better result than any other partnership losses suspended under section 704(d). For that reason, the final regulations do not adopt this recommendation.

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

Under the proposed regulations, if a partner disposes of all or substantially all of its partnership interest, the adjusted basis of the partnership interest is increased immediately before the disposition by the entire amount of the remaining excess business interest expense. Following such a disposition, no deduction is permitted to either the transferor or the transferee with respect to the excess business interest expense resulting in the basis increase. If a partner disposes of less than substantially all of its interest in a partnership, the partner cannot increase its basis by any portion of the remaining excess business interest expense. The Treasury Department and the IRS requested comments on this approach in the preamble to the proposed regulations.

Commenters cited multiple concerns with the approach adopted in the proposed regulations. First, commenters claimed that the absence of an excess business interest expense basis addback for a partial disposition of a partnership interest could result in tax gain in excess of economic gain in connection with the sale of a partial interest, while the addition of the entire adjustment to outside basis in connection with a complete disposition could result in economic gain in excess of tax gain. Commenters suggested this timing difference between economic gain and tax gain inappropriately disconnects taxable income from economic income. Second, commenters expressed concern that, because a partial disposition would result in a partner holding a smaller interest in a partnership than it held prior to the partial disposition, the partner would receive smaller allocations of excess taxable income (and excess business interest income) in subsequent years. If none of the excess business interest expense of the partner is affected by the partial disposition, this could extend the amount of time needed for a partner to convert its excess business interest expense to business interest expense treated as paid or accrued. Third, commenters noted that, in the event of a partial disposition of a partnership interest, the proposed regulations may cause a discrepancy between the capital accounts of the transferor and the transferee and the excess business interest expense associated with each partner's interest.

Commenters stated that neither the statute nor its policy of limiting business interest expense deductions calls for the potentially harsh results that could be imposed by the approach provided in the proposed regulations. The main purpose of the excess business interest expense carryover rule is to limit the partner's ability to claim a business interest expense deduction that exceeds the statutory threshold under section 163(j)(1). Commenters stated that this statutory purpose can be accomplished by denying the business interest expense deduction and eliminating the carryforward upon a partial disposition of the partnership interest. In other words, to the extent that a partner foregoes its business interest expense deduction, the purpose of the statute is fulfilled. Thus, a proportionate approach would fulfill the purpose of the statute while not subjecting taxpayers to outcomes that are not plainly contemplated by the statue.

As a solution, commenters recommended that a partial disposition of a partnership interest trigger a proportionate excess business interest expense basis addback and corresponding decrease in such partner's excess business interest expense carryover (proportionate approach). Under the proportionate approach, the partner would be required to track its basis in its partnership interest in a manner similar to that set forth in Revenue Ruling 84–53, 1984–1 C.B. 159 (April 9, 1984). Commenters advocating for a proportionate addback rule varied in their recommendations regarding where the addback should occur. In general, commenters suggested three options: (1) Increase the basis of the partnership interest retained; (2) apportion the basis increase proportionally between the partnership interest retained and the partnership interest being disposed of; and (3) increase the basis of the partnership interest being disposed of.

As described in the preamble to the proposed regulations, the Treasury Department and the IRS originally considered and rejected the proportionate approach. One reason the Treasury Department and the IRS adopted the all or substantially all approach in the proposed regulations over the proportionate approach was because the former appeared more taxpayer-favorable in certain circumstances. Under the all or substantially all approach in the proposed regulations, the excess business interest expense basis addback is delayed for the maximum amount of time (until a partner disposes of all or substantially all of its interest), giving taxpayers more time to receive excess taxable income (and excess business interest income) and thus potentially take an ordinary deduction. However, as commenters pointed out, a smaller partnership interest likely will result in a correspondingly smaller allocation of excess taxable income (and excess business interest income) from the partnership. For this reason, commenters did not perceive the proposed approach as taxpayer-favorable for preserving the possibility of a future ordinary deduction, but rather as taxpayer-unfavorable for delaying what likely will be a capital loss.

Accordingly, the Treasury Department and the IRS adopt the recommended proportionate approach in the final regulations. In the preamble to the proposed regulations, the Treasury Department and the IRS indicated that, if final regulations were to adopt a proportionate approach, such approach would increase the basis of the partnership interest being retained by the amount of the excess business interest expense basis addback. However, upon further consideration, the Treasury Department and the IRS agree with commenters that the basis addback should instead increase the basis of the partnership interest being disposed of. Thus, the final regulations adopt a proportionate approach that increases the basis of the partnership interest being disposed of.

For purposes of § 1.163(j)–6(h)(3), a disposition includes a distribution of money or other property by the partnership to a partner in complete liquidation of its interest in the partnership. The Treasury Department and the IRS request comments on whether a current distribution of money or other property by the partnership to a continuing partner as consideration for an interest in the partnership should also trigger an addback and, if so, how to determine the appropriate amount of the addback. Additionally, the final regulations clarify that each partner is considered to have disposed of its partnership interest within the meaning of § 1.163(j)–6(h)(3) if the partnership terminates under section 708(b)(1).

The proportionate rule adopted in the final regulations applies the equitable apportionment principles of § 1.61–6 (referenced in Revenue Ruling 84–53) to determine the amount of excess business interest expense attributable to the partner's interest sold. In *Example 1* of § 1.61–6, basis is apportioned among properties based on the fair market value of the property and is treated as equitably apportioned. Similarly, in Situations 1 and 3 of Revenue Ruling 84–53, the IRS ruled that a selling partner's basis in the transferred portion of the interest generally equals an amount that bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest (the pro rata approach to equitable apportionment). However, if a partnership has liabilities, special adjustments must be made to take into account the effect of the liabilities on the basis of the partner's interest. Accordingly, the final regulations adopt the pro rata approach to equitable apportionment and generally provide that the adjusted basis of the partnership interest being disposed of is increased immediately before the disposition by the amount of the excess business interest expense that is proportionate to the interest disposed of in the transaction.

The Treasury Department and the IRS also received comments recommending the final regulations treat a sale of all or substantially all of a partnership's assets as a deemed disposition of each partner's interest in the partnership within the meaning of section 163(j)(4)(B)(iii)(II). Because the statute requires a disposition of a partnership interest to trigger the basis adjustment described in section 163(j)(4)(B)(iii)(II), the final regulations do not adopt this recommendation.

3. Intercompany Transfer of a Partnership Interest

For a discussion of comments received on intercompany transfers of partnership interests, see part V(D) of this Summary of Comments and Explanation of Revisions section.

C. Debt-Financed Distributions

The treatment of interest expense associated with debt incurred by a partnership or S corporation to finance distributions to owners (debt-financed distributions) is being addressed in the Concurrent NPRM. Therefore, these issues are not addressed in the final regulations.

D. Trading Partnerships

The preamble to the proposed regulations stated that the business interest expense of certain passthrough entities, including S corporations, that are engaged in trades or businesses that are per se non-passive activities and in which one or more owners of the entities do not materially participate within the meaning of section 469, as described in section 163(d)(5)(A)(ii) and as illustrated in Revenue Ruling 2008–12, 2008–1 C.B. 520 (March 10, 2008), will be subject to section 163(j) at the entity level (even if the interest expense is also subject to limitation under section 163(d) at the individual partner level). 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. This rule does not apply to corporate partners.

The Treasury Department and the IRS received multiple comments questioning this interpretation of section 163(j)(5) and its interaction with section 163(d)(5)(A)(ii). The interaction of section 163(j)(5) with section 163(d)(5)(A)(ii) is being addressed in the Concurrent NPRM. Therefore, this issue is not addressed in the final regulations.

E. Treatment of Excess Business Interest Expense in Tiered Partnerships

The preamble to the proposed regulations requested comments regarding the application of section 163(j) to tiered partnership structures, and the proposed regulations reserved on this topic. Specifically, the preamble requested comments on whether excess business interest expense should be allocated through upper-tier partnerships and how or when an upper-tier partner's basis should be adjusted when a lower-tier partnership is subject to a section 163(j) limitation. This issue is being addressed in the Concurrent NPRM. Therefore, this issue is not addressed in the final regulations.

F. Partnership Mergers and Divisions

The proposed regulations reserve on guidance regarding the application of section 163(j) to partnership mergers and divisions, and the Treasury Department and the IRS requested comments in the preamble to the proposed regulations 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).

In response to this request, one commenter recommended that: (i) The carryforward rule in proposed § 1.163(j)–6(g) apply to partners of a partnership treated as a continuing partnership in a partnership merger or division; (ii) the disposition rule of proposed § 1.163(j)–6(h)(3)(i) apply to partnership interests that are treated as liquidated in a partnership merger or division; and (iii) the final regulations confirm, perhaps through examples, the application of the excepted trade or business election and termination rules in proposed § 1.163(j)–9 in the context of a partnership merger or division.

The partnership merger and division rules under section 708 may treat a partnership as terminating or continuing, and the regulations under § 1.708–1(c) and (d) provide a construct for analyzing the tax effects of a partnership merger or division. The Treasury Department and the IRS have determined that, in most situations, a partnership merger or division can be analyzed appropriately under the rules of § 1.708–1(c) and (d). As a result, the Treasury Department and the IRS are not providing special rules in the final regulations to analyze the consequences of a partnership merger or division in the context of section 163(j) at this time. However, the Treasury Department and the IRS continue to study these issues.

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

The proposed regulations provide that sections 381(c)(20) and 382(d)(3) and (k)(1) apply to S corporations with respect to disallowed business expense carryforwards. Proposed § 1.163(j)–6(l)(5) provides that the amount of any business interest expense not allowed as a deduction for any taxable year by reason of the section 163(j) limitation is carried forward in the succeeding taxable year as a disallowed business interest expense carryforward. Proposed

§ 1.163(j)–6(l)(1) provides that any disallowed business interest expense is not allocated to the S corporation's shareholders until such business interest expense is allowed as a deduction under section 163(j). Similarly, under proposed § 1.163(j)–6(l)(6) and (7), an S corporation shareholder's stock basis is reduced, but not below zero, and an S corporation's accumulated adjustments account (AAA) balance is adjusted, when a disallowed business interest expense becomes deductible under section 163(j).

The preamble to the proposed regulations requested comments regarding the proper integration of section 163(j) and section 382 and subchapter S of the Code (subchapter S). In addition, the preamble to the proposed regulations requested comments regarding the treatment of disallowed business interest expense carryforwards as an attribute of the S corporation subject to the section 382 limitation, as opposed to an attribute of the shareholders, and regarding the timing for any adjustments to shareholder basis and the corporation's AAA.

In response, one commenter recommended that the final regulations retain the approach as set forth in the proposed regulations. In particular, the commenter recommended that section 382 (and the comparable provisions of section 383) be applied only to those attributes that are carried forward and taken into account at the corporate level. The commenter contended that it would be appropriate to treat disallowed business interest expense of an S corporation as a ''pre-change loss'' such that the corporation would be a loss corporation pursuant to section 382(k)(1).

The Treasury Department and the IRS agree with the commenter. Because disallowed business interest expense is treated as an attribute of the S corporation, the S corporation's disallowed business interest expense carryforwards will be treated as pre-change losses subject to a section 382 limitation under section 382(d)(3) following an S corporation's ownership change (within the meaning of section 382(g)).

Accordingly, consistent with the treatment of C corporations under section 382, the final regulations provide that a disallowed business interest expense carryforward of an S corporation is treated as pre-change loss and will be subject to a section 382 limitation only if an S corporation undergoes an ownership change within the meaning of section 382(g). For example, under the final regulations, a ''qualifying disposition'' by a shareholder that results in a 20-percent ownership change of the S corporation, on its own, will not cause section 382 to apply to an S corporation upon such qualifying disposition. See § 1.1368–1(g)(2)(i)(A). See also § 1.1368–1(g)(2) (defining the term ''qualifying disposition'').

A commenter also recommended that section 382 not be applied to any item of deduction, loss, or credit that is allocated to shareholders on a current basis and taken into account at the shareholder level. As expressed in the preamble to the proposed regulations, 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 continue to seek comments regarding the proper integration of these two Code sections and subchapter S.

H. Separate Application of Section 163(j) Limitation to Short Taxable Years of S Corporation

An S corporation's items of income and loss generally are allocated on a pro rata, per-day basis to all shareholders that hold the corporation's stock during the corporation's taxable year. See section 1377(a)(1). However, subchapter S provides limited exceptions to that general allocation rule. For example, in the event that a shareholder completely terminates its interest, the S corporation and affected shareholders can elect to treat its taxable year ''as if the taxable year consisted of 2 taxable years the first of which ends on the date of the termination'' (each, a hypothetical short taxable year). Section 1377(a)(2)(A). In addition, an S corporation may make such an election if a shareholder has made a qualifying disposition. See § 1.1368–1(g)(2). With regard to each of these instances, the S corporation may elect to ''close the books'' even though the corporation will file one Federal income tax return for the taxable year covering both separate taxable periods.

Subchapter S also specifies instances in which an S corporation may elect, or is required, to file a Federal income tax return for a short taxable year (actual short taxable year). For example, an S corporation may elect to determine taxable income or loss based on a closing-of-the-books method with respect to an S termination year. See section 1362(e)(3) (providing an election to have items assigned to each short taxable year under normal Federal income tax accounting rules). However, if a sale or exchange of at least 50 percent of the S corporation's stock occurs during that S termination year, the S corporation must utilize the closing-of-the-books method. See section 1362(e)(6)(D). See also section 1362(e)(6)(C) (requiring the use of the closing-of-the-books method with respect to any item resulting from the application of section 338).

Based on a request from a commenter, the Treasury Department and the IRS have considered whether the section 163(j) limitation should apply separately with respect to each hypothetical or actual short taxable year. Specifically, the commenter recommended that, if an S corporation (1) has an actual short taxable year, or (2) determines its taxable income or loss as if its taxable year consisted of separate taxable years (that is, hypothetical short taxable years), the final regulations should clarify that a separate section 163(j) limitation should be calculated for, and applied to, each actual or hypothetical short taxable year. To support that recommendation, the commenter emphasized ''sound policy reasons'' for ensuring that owners of the corporation during the first short taxable period are not affected by the fortunes of the corporation during the second short period, and vice versa.

The Treasury Department and the IRS agree that a separate section 163(j) limitation should be calculated for, and applied to, each actual or hypothetical short taxable year. Section 163(j)(1) limits the amount of business interest expense allowed as a deduction ''for any taxable year.'' Accordingly, the Treasury Department and the IRS have determined that a separate section 163(j) limitation should apply to each actual short taxable year. See § 1.1362–3(c)(3) (setting forth the general rule that ''the S and C short years are treated as two separate years for purposes of all provisions of the Internal Revenue Code''). In addition, subchapter S and the regulations in this part under subchapter S explicitly treat hypothetical short taxable years as separate taxable years. See section 1377(a)(2)(A) (providing that an S corporation can treat its taxable year ''as if the taxable year consisted of 2 taxable years'') and § 1.1368–1(g)(1) (providing that the ''section applies as if the taxable year consisted of separate taxable years''). As a result, the Treasury Department and the IRS also have determined that a separate section 163(j) limitation should apply to each hypothetical short taxable year and sections 1.1362–3(c), 1.1368–1(g)(2), and 1.1377–1(b)(3) have been amended accordingly.

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

Under proposed § 1.163(j)–6(m)(1), 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. Commenters recommended that proposed § 1.163(j)–6(m)(1) be modified so that business interest expense incurred by a partnership that is an exempt entity is not subject to section 163(j) at the partner level. Commenters argued that proposed § 1.163(j)–6(m)(1) was inconsistent with section 163(j)(4)(A), which requires the testing of partnership-level business interest expense at the partnership level, not the partner level. The Treasury Department and the IRS agree, and have determined that the same argument naturally should apply to S corporations and their shareholders. See section 163(j)(4)(D) (in relevant part, providing that rules similar to section 163(j)(4)(A) shall apply with respect to any S corporation and its shareholders). Accordingly, the final regulations provide that business interest expense of an exempt partnership, or exempt S corporation, pursuant to section 163(j)(3) does not retain its character as business interest expense and, as a result, is not subject to the section 163(j) limitation at the partner or S corporation shareholder level.

One commenter requested clarification as to whether proposed § 1.163(j)–6(m)(3) applies only to exempt entities or also could apply to trades or businesses that become not subject to the requirements of section 163(j) by reason of engaging in excepted trades or businesses. The final regulations clarify that § 1.163(j)–6(m)(3) does not apply when a partnership engages in excepted trades or businesses. Accordingly, if a partner is allocated excess business interest expense from a partnership and, in a succeeding taxable year, such partnership engages in excepted trades or businesses, then the partner shall not treat any of its excess business interest expense that was previously allocated from such partnership as business interest expense paid or accrued by the partner in such succeeding taxable year by reason of the partnership engaging in excepted trades or businesses. Rather, such excess business interest expense shall remain as excess business interest expense until such time as it is treated as business interest expense paid or accrued by the partner pursuant to § 1.163(j)–6(g)(2) or by reason of the partnership becoming an exempt entity. The final regulations provide a similar clarification for S corporations in § 1.163(j)–6(m)(4).

J. Trusts

For purposes of determining ATI for trusts, one commenter noted that the definition of ATI does not contain an addback for deductible trust distributions. Trusts and decedents' estates taxable under section 641 are permitted to deduct under sections 651 and 661 certain distributions made to beneficiaries. The commenter suggested that section 163(j) should apply before a trust takes a deduction for distributions to beneficiaries, and that, if a deductible trust or estate distribution is added back to the trust's ATI and thus is taken into account in determining the amount of interest expense allowable to the trust under section 163(j), such trust or estate distribution should be excluded from the recipient beneficiaries' calculation of ATI. Thus, under the commenter's approach, a beneficiary of a trust or a decedent's estate would not be able to utilize a trust distribution to deduct additional business interest expense at the beneficiary level.

The Treasury Department and the IRS agree with this comment. Proposed Regulation § 1.163(j)–2(f) is consistent with this result. However, in order to clarify that trusts and decedents' estates taxable under section 641 compute ATI without regard to deductions under sections 651 and 661, the final regulations explicitly provide for this positive ATI adjustment. Additionally, the Treasury Department and the IRS have determined that a similar rule should apply for charitable deductions of a trust or a decedent's estate under section 642(c).

K. Qualified Expenditures

The ATI of a partnership is generally determined in accordance with proposed § 1.163(j)–1(b)(1). Partnership ATI is therefore reduced by deductions claimed under sections 173 (relating to circulation expenditures), 174(a) (relating to research and experimental expenditures), 263(c) (relating to intangible drilling and development expenditures), 616(a) (relating to mine development expenditures), and 617(a) (relating to mining exploration expenditures) (collectively, ''qualified expenditures''). As a result, deductions for qualified expenditures will reduce a partnership's section 163(j) limitation pursuant to proposed § 1.163(j)–2(b). Deductions for those items also will reduce the amount of excess taxable income that may be allocated to the partners and thus reduce the amount by which partner-level ATI may be increased under proposed § 1.163(j)–6(e)(1).

A partner may elect to capitalize its distributive share of any qualified expenditures of a partnership under section 59(e)(4)(C) or may be required to capitalize a portion of its distributive share of certain qualified expenditures of a partnership under section 291(b). As a result, the taxable income reported by a partner in a taxable year attributable to the ownership of a partnership interest may exceed the amount of taxable income reported to the partner on a Schedule K–1.

Commenters recommended that a distributive share of partnership deductions capitalized by a partner under section 59(e) or section 291(b) increase the ATI of the partner because qualified expenditures reduce both partnership ATI and excess taxable income but may not reduce the taxable income of a partner. Commenters suggested two different approaches for achieving this result: (1) Adjust the excess taxable income of the partnership, resulting in an increase to partner ATI; and (2) increase the ATI of the partner directly, without making any adjustments to partnership excess taxable income. The interaction of qualified expenditures with section 163(j)(4) is being addressed in the Concurrent NPRM. Therefore, this issue is not addressed in the final regulations.

L. CARES Act Partnership Rules

As discussed in the Background section to this preamble, section 163(j)(10), as amended by the CARES Act, provides a special rule for excess business interest expense allocated to a partner in a taxable year beginning in 2019 (50 percent EBIE Rule). See section 163(j)(10)(a)(ii). The 50 percent EBIE rule is addressed in proposed § 1.163(j)–6(g)(4) of the Concurrent NPRM. The application of the 2019 ATI rule, as provided in section 163(j)(10)(B), in the partnership context is also addressed in proposed § 1.163(j)–6(g)(4) of the Concurrent NPRM. Therefore, the 50 percent EBIE rule and the application of the 2019 ATI rule to partnerships are not addressed in the final regulations.

VIII. Comments on and Changes to Proposed § 1.163(j)–7: Application of the Section 163(j) Limitation to Foreign Corporations and United States Shareholders

Section 1.163(j)–7 provides general rules regarding the application of the section 163(j) limitation to foreign corporations and U.S. shareholders. The following discussion addresses comments relating to proposed § 1.163(j)–7.

The proposed regulations generally apply section 163(j) and the section 163(j) regulations to determine the deductibility of an applicable CFC's business interest expense in the same manner as these provisions apply to determine the deductibility of a domestic C corporation's business interest expense. See proposed § 1.163(j)–7(b)(2). The proposed regulations define an applicable CFC as a CFC in which at least one U.S. shareholder owns stock, within the meaning of section 958(a). However, in certain cases, the proposed regulations limit the amount of an applicable CFC's business interest expense subject to the section 163(j) limitation and modify the computation of an applicable CFC's ATI, respectively. Thus, under the proposed regulations, an applicable CFC with business interest expense applies 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 that is effectively connected with the conduct of a U.S. trade or business (ECI), as applicable. The proposed regulations provide additional guidance for an applicable CFC (and other foreign persons) with ECI in proposed § 1.163(j)-8, as discussed in part IX of this Summary of Comments and Explanation of Revisions section.

The Treasury Department and the IRS requested comments in the preamble to the proposed regulations regarding whether it would be appropriate to provide additional modifications to the application of section 163(j) to applicable CFCs and whether there are particular circumstances in which it may be appropriate to exempt an applicable CFC from the application of section 163(j).

Some commenters recommended that section 163(j) generally should not apply to applicable CFCs. Other commenters suggested that section 163(j) should apply to applicable CFCs only to the extent that they have ECI or, if an income tax treaty applies, business profits attributable to a United States permanent establishment, or to the extent that debt was introduced to an applicable CFC with a principal purpose of avoiding U.S. income taxes. Some commenters argued that the Treasury Department and the IRS lack the authority to apply section 163(j) to applicable CFCs because section 163(j) applies to taxpayers and, they argue, applicable CFCs are not taxpayers. Furthermore, some commenters argued that old section 163(j) did not apply to applicable CFCs and that Congress expressed no intent to change that. Some commenters also argued that applying section 163(j) to applicable CFCs creates significant complexity and an administrative burden. Furthermore, some commenters suggested that applying section 163(j) to applicable CFCs may have a limited effect on tax revenue or that applying section 163(j) to applicable CFCs could, in some cases, result in a net tax benefit to U.S. shareholders.

The Treasury Department and the IRS have determined that, under current law, section 163(j) applies to applicable CFCs and other foreign corporations whose income is relevant for U.S. tax purposes. As a general matter, application of U.S. tax principles to a foreign corporation for purposes of determining its income for U.S. tax purposes is within the authority of the Treasury Department and the IRS. For example, a U.S. shareholder of an applicable CFC takes into account its pro rata share of the subpart F income and net tested income of an applicable CFC. Accordingly, in order to determine the U.S. shareholder's pro rata share, the income of the applicable CFC must be determined. Section 1.952–2(a)(1) provides that, ''[e]xcept as provided in subparagraph (2) of this paragraph [relating to insurance gross income], the gross income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 61 and the regulations thereunder.'' Neither § 1.952–2(a)(2) nor (c) implicates section 163(j). Accordingly, pursuant to § 1.952–2, a foreign corporation is treated as a domestic corporation for U.S. tax purposes when calculating its taxable income, including by application of section 163(j).

The exclusion of CFCs from the application of old section 163(j) under the 1991 Proposed Regulations is not determinative as to whether applicable CFCs and other foreign corporations should be excluded from the application of section 163(j). Although both old section 163(j) and section 163(j) limit deductions for business interest expense, the policies of each provision are significantly different. Old section 163(j) was a narrower provision that limited a corporation's ability to use interest expense deductions to move earnings out of the United States tax base. Section 163(j) focuses on limiting the potential tax benefit of overleveraged businesses. Because Congress wholly repealed and replaced old section 163(j), the provisions of old section 163(j) and the 1991 Proposed Regulations are not determinative as to the application of section 163(j).

Furthermore, nothing in the Code or legislative history indicates that Congress intended to exclude applicable CFCs or other foreign corporations from the application of section 163(j). Congress expressly provided that section 163(j) should not apply to certain small businesses or to certain excepted trades or businesses. Congress did not exempt applicable CFCs or other foreign corporations from the application of section 163(j).

Accordingly, the final regulations clarify that section 163(j) applies to foreign corporations whose income is relevant for U.S. tax purposes, other than by reason of section 881 or 882 (relevant foreign corporations). Section 1.163(j)–7(b). Furthermore, no comments were received on the application of § 1.952–2 or section 882 for purposes of determining the income, including ECI, of an applicable CFC or on the reduction of an applicable CFC's taxable income by the amount of any dividend received from a related person for purposes of determining ATI. In addition to clarifying that these rules apply to all relevant foreign corporations, the final regulations otherwise adopt these rules unchanged. § 1.163(j)–7(g)(1).

The Treasury Department and the IRS acknowledge that the application of section 163(j) to applicable CFCs and other relevant foreign corporations, like many other tax provisions, will increase the complexity of determining the taxable income of a relevant foreign corporation. Similarly, section 163(j) may have a significant effect on the amount of taxable income of some relevant foreign corporations and have limited or no effect on the amount of taxable income of others. The Treasury Department and the IRS do not view the complexity of a provision of the Code or its net effect on tax revenue as determinative as to whether the provision applies to CFCs. Nonetheless, the Treasury Department and the IRS have determined that it is appropriate to reduce the compliance and administrative burdens of applying section 163(j) to certain applicable CFCs.

Accordingly, the Treasury Department and the IRS have developed new rules, taking into account comments received, that substantially modify the rules contained in proposed § 1.163(j)–7. The Treasury Department and the IRS anticipate that, in many cases, these modifications will significantly reduce the compliance and administrative burdens of applying section 163(j) to applicable CFCs. However, because the operation of these new rules is sufficiently different from the operation of the rules in proposed § 1.163(j)–7, the Treasury Department and the IRS have determined that these rules should be proposed in order to provide taxpayers the opportunity to comment before their finalization. These rules and a discussion of their operation are contained in the Concurrent NPRM.

IX. Comments on and Changes to Section 1.163(j)–8: Application of the Section 163(j) Limitation to Foreign Persons With Effectively Connected Taxable Income.

Proposed § 1.163(j)–8 provides rules for applying section 163(j) to a nonresident alien individual or foreign corporation with ECI. Although no comments were received on proposed § 1.163(j)–8, the Treasury Department and the IRS continue to study methods of determining the amount of deductible business interest expense and disallowed business interest expense carryforwards that are allocable to ECI. Accordingly, the final regulations reserve on the application of the business interest expense deduction limitation to foreign persons with ECI.

In the Concurrent NPRM, the Treasury Department and the IRS are proposing rules for determining the amount of deductible business interest expense and disallowed business interest expense carryforward of a nonresident alien, foreign corporation, or partnership that is properly allocable to ECI. The Treasury Department and the IRS request comments on appropriate methods of making this determination. These comments should consider the appropriate method for determining the extent to which business interest expense determined under § 1.882–5 should be treated as attributable to a partnership and subject to the section 163(j) limitation at the partnership level.

X. Comments on and Changes to Proposed § 1.163(j)–9: Elections for Excepted Trades or Businesses; Safe Harbor for Certain REITs

Section 1.163(j)–9 provides general rules and procedures for making an election for a trade or business to be an electing real property trade or business under section 163(j)(7)(B) and an election for a trade or business to be an electing farming business under section 163(j)(7)(C). The following discussion addresses some of the provisions in § 1.163(j)–9 and the comments received.

A. Protective Elections

Section 163(j)(3) provides that the section 163(j) limitation does not apply to taxpayers that meet the gross receipts test of section 448(c). The small business exemption applies automatically if the requirements are met; thus, no election is necessary to ensure that the section 163(j) limitation does not apply. However, for real property trades or businesses under section 163(j)(7)(B), and for farming businesses under section 163(j)(7)(C), the section 163(j) limitation does not apply only if the taxpayer is eligible for and makes an election.

The preamble to the proposed regulations provides that a taxpayer that qualifies for the small business exemption is not eligible to make an election for a trade or business to be an electing real property trade or business or an electing farming business, in part because the taxpayer is already not subject to the section 163(j) limitation, and in part because an electing real property trade or business or an electing farming business is required to use ADS for certain types of property under section 163(j)(10) and cannot claim the additional first-year depreciation deduction under section 168(k) for those types of property. The Treasury Department and the IRS were concerned that certain small business taxpayers might make the election without realizing that the election could have adverse effects on their deduction for depreciation expense and their method of accounting for depreciation.

Commenters suggested that, in some situations, making an annual gross receipts determination, to determine whether a taxpayer should make an election or is already exempt from the limitation, could be burdensome. For example, a taxpayer that has to request the average annual gross receipts of numerous unrelated entities under section 448 aggregation principles in order to make the gross receipts determination may choose to forgo making that determination if the taxpayer knows that its trade or business qualifies to be an electing real property trade or business or an electing farming business. These commenters requested that taxpayers be allowed to make such an election without regard to whether the gross receipts test of section 448(c) has been tested or is met, notwithstanding the potentially adverse depreciation expense implications.

The Treasury Department and the IRS agree with the commenters. Accordingly, the final regulations provide that taxpayers may make an election for a trade or business to be an electing real property trade or business or an electing farming business, provided that they qualify to make such elections, even if the gross receipts test under section 448(c) may be satisfied by the electing trades or businesses in the taxable year in which the election is made. As is the case for all other electing real property trades or businesses and electing farming businesses, the elections are irrevocable and affect depreciation as provided in section 163(j)(11). However, this rule also benefits taxpayers subject to section 163(j) that are owners of small businesses because treating these small businesses as engaged in an excepted trade or business may result in the allocation of more owner interest expense to excepted trades or businesses under § 1.163(j)–10(c).

Commenters also requested a protective election for taxpayers engaged in rental real estate activities if it is unclear whether the activities rise to the level of a trade or business under section 162. The protective election is necessary, according to some commenters, because the definition of an ''electing real property trade or business'' in section 163(j)(7)(B) and proposed § 1.163(j)–1(b)(14) allows a trade or business described in section 469(c)(7)(C) to make the election, and a real property trade or business as defined in section 469(c)(7)(C) can include rental real estate that does not rise to the level of a section 162 trade or business.

Generally, interest expense associated with an activity that does not rise to the level of a section 162 trade or business is not subject to the section 163(j) limitation. The section 163(j) limitation applies to taxpayers with business interest, which is defined under section 163(j)(5) as any interest properly allocable to a trade or business. Proposed § 1.163(j)–1(b)(38) defines a ''trade or business'' as a trade or business under section 162. In contrast, an electing real property trade or business must be described in section 469(c)(7)(C). Section 1.469–9(b)(1) provides that, for purposes of section 469(c)(7), the term ''trade or business'' is defined as ''any trade or business determined by treating the types of activities in § 1.469–4(b)(1) as if they involved the conduct of a trade or business; and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under section 212.''

Thus, section 469(c)(7)(C) includes all rental real estate (as defined in § 1.469–9(b)(3)) and adopts a broader definition of a ''trade or business'' than section 162. Under this broader definition, taxpayers with rental real estate may be able to qualify as ''real estate professionals'' through work performed in their rental real estate, even if the rental real estate activities otherwise do not rise to the level of a section 162 trade or business.

For example, for purposes of section 469(c)(7)(C), a taxpayer who owns real property and rents to tenants under a triple net lease arrangement will be treated as engaged in a real property trade or business even though the renting under the terms of a triple net lease arrangement may not rise to the level of a section 162 trade or business. The triple net lease arrangement is included in the broader definition of a trade or business under § 1.469–9(b)(1) because the arrangement represents an interest in rental real estate. Accordingly, renting real property under a triple net lease arrangement generally will fall within the definition of a ''rental real property trade or business'' in section 469(c)(7)(C) and proposed § 1.469–9(b)(2). As a result, the taxpayer with such a rental arrangement should be able to make an election to treat this activity as an electing real property trade or business, if the taxpayer so chooses, even though the renting of real property under a triple net lease arrangement might not be a section 162 trade or business. This result is simply a consequence of Congress cross-referencing the broader section 469 definition of a ''real property trade or business'' for purposes of section 163(j).

Thus, the commenters stated that, although taxpayers who are certain they are not engaged in a section 162 trade or business do not need to make an election out of the section 163(j) limitation because they are not subject to this limitation, taxpayers engaged in rental real estate activities who are not certain whether their rental real estate activities rise to the level of a section 162 trade or business should be given the ability to obtain certainty by making a protective election to treat their rental real estate activities as an electing real property trade or business.

The Treasury Department and the IRS agree with the recommendation for a protective election under these circumstances. Thus, the final regulations provide that an election to treat rental real estate activities as an electing real property trade or business is available regardless of whether the taxpayer making the election is engaged in a trade or business within the meaning of section 162. Under the protective election, a taxpayer engaged in activities described in section 469(c)(7)(C) and § 1.469–9(b)(2), as required in proposed § 1.163(j)–1(b)(14)(i), but unsure whether its activities rise to the level of a section 162 trade or business, may make an election for a trade or business to be an electing real property trade or business.

As with all other electing real property trades or businesses, once the election is made, all other consequences of the election outlined in § 1.163(j)–9 apply, such as the irrevocability of the election and the required use of the alternative depreciation system for certain assets.

B. One-Time Late Election or Withdrawal of Election Procedures

Commenters requested a one-time automatic extension of time for certain taxpayers to file an election under section 163(j)(7)(B) or section 163(j)(7)(C) due to uncertainty about the effect of a decision to make or not make such an election and about which taxpayers are eligible to make such an election prior to the publication of the final regulations. Additionally, commenters requested a one-time opportunity to withdraw an election made under section 163(j)(7)(B) or section 163(j)(7)(C) prior to the publication of the final regulations. The Treasury Department and the IRS agree with the commenters' concerns. Thus, in order to address the commenters' concerns, and to provide immediate transition guidance under section 163(j) for taxpayers affected by the various amendments to the Code made by the CARES Act (including, for example, the technical corrections to section 168(e) of the Code relating to the classification of qualified improvement property), Revenue Procedure 2020–22 was issued to provide an automatic extension of time to make, or an opportunity to withdraw, an election for taxable years beginning in 2018, 2019, or 2020. The revenue procedure also provides the time and manner of making or revoking the three elections provided by the CARES Act under section 163(j)(10) for taxable years beginning in 2019 or 2020.

C. The Anti-Abuse Rule Under Proposed § 1.163(j)–9(h)

Numerous comments were received concerning the anti-abuse rule in proposed § 1.163(j)–9(h)(1) (proposed –9(h) anti-abuse rule). The proposed –9(h) anti-abuse rule prohibits an otherwise qualifying real property trade or business from making an election under section 163(j)(7)(B) 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 (that is, 50 percent of the direct and indirect ownership of both businesses is held by related parties within the meaning of sections 267(b) and 707(b)) with the real property trade or business. Proposed § 1.163(j)–9(h)(2) provides an exception to the proposed –9(h) anti-abuse rule for REITs that lease qualified lodging facilities (defined in section 856(d)(9)(D)) and qualified health care properties (defined in section 856(e)(6)(D)) (REIT exception).

The preamble to the proposed regulations explains that it would be inappropriate to allow an election under section 163(j)(7)(B) 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.'' The preamble further explains the reasoning for the REIT exception by stating that, because REITs that lease qualified lodging facilities and qualified healthcare properties are generally permitted (pursuant to section 856(d)(8)(B)) to lease these properties to a taxable REIT subsidiary (TRS), this anti-abuse rule does not apply to these types of REITs. The Treasury Department and the IRS requested comments in the preamble to the proposed regulations 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.

Commenters suggested eliminating or modifying the proposed –9(h) anti-abuse rule because of the concern that, as currently written, this rule applies to non-abusive lease arrangements between commonly controlled trades or businesses. Specifically, commenters raised concerns about the applicability of the proposed –9(h) anti-abuse rule to specific types of business structures where the real property is owned by one legal entity (referred to as property company, or PropCo) and leased to a separate but commonly controlled legal entity that operates and manages a business (referred to as operating company, or OpCo). According to commenters, this PropCo/OpCo structure has valid business protection, lending, and regulatory purposes in certain industries. Commenters also claimed that this structure was in existence for many years prior to the enactment of the section 163(j) limitation and was not created in an attempt to circumvent application of the section 163(j) limitation.

For example, the PropCo/OpCo structure is used by some hotels in the following manner: PropCo generally owns the real property subject to significant debt, services such debt, and leases the real property to OpCo, which operates a real property trade or business by licensing the property to unrelated third parties (guests). This structure is used to limit legal liability, manage state and local tax burdens, plan for family wealth transfers, and for other business objectives. One commenter recommended a ''look-through'' exception to the proposed –9(h) anti-abuse rule where the real property is ultimately leased (or licensed) to unrelated third parties in a PropCo/OpCo structure. This exception would allow a real property trade or business owning real property, or PropCo, to make an election to be an electing real property trade or business if it leases real property to a commonly controlled real property trade or business, or OpCo, if OpCo subleases (or licenses) the real property to unrelated third parties.

Similarly, commenters noted that the property ownership, mortgage, and resulting interest expense for trades or businesses described as nursing homes, continuing care retirement communities, independent living facilities, assisted living facilities, memory care facilities, and skilled nursing facilities (collectively, ''residential living facilities'') is often contained in one legal entity, or PropCo, and the operation and management of the residential living facility is contained in another, commonly controlled legal entity, or OpCo. Commenters explained that the Department of Housing and Urban Development, which is a major lender in the residential living industry, and many other lenders often require the use of single-asset or separate legal entities for lending purposes.

To prevent the application of the proposed –9(h) anti-abuse rule to a PropCo that leases real property to a residential living facility, some commenters suggested that the anti-abuse rule should not apply to a trade or business that leases real property to a residential living facility (1) regardless of whether the lessor and lessee are under common control, or (2) if both the lessor trade or business and the commonly controlled lessee independently qualify as electing real property trades or businesses. Commenters noted that the proposed –9(h) anti-abuse rule should not apply to situations where the entities, if combined or aggregated and without taking the lease into account, would each qualify as real property trades or businesses. Without modification to the proposed –9(h) anti-abuse rule, the PropCo in a PropCo/OpCo structure would be prohibited from making a real property trade or business election even though all of its lease income is derived from a real property trade or business. Commenters suggested that proposed § 1.163(j)–9(h)(2), which provides an exception for REITs, should apply to similarly situated taxpayers that are privately owned but use a commonly controlled entity in a PropCo/OpCo structure rather than a REIT.

Other suggestions made by commenters include (1) eliminating the proposed –9(h) anti-abuse rule and instead relying on the more general proposed § 1.163(j)–2(h) anti-avoidance rule to disregard or recharacterize the types of non-economic structures targeted by the proposed –9(h) anti-abuse rule, (2) clarifying that the proposed –9(h) anti-abuse rule would apply only if there is a ''principal purpose of tax avoidance,'' (3) providing exceptions to the proposed –9(h) anti-abuse rule if the taxpayer demonstrates a substantial economic purpose for the PropCo/OpCo structures unrelated to avoiding section 163(j), or if the PropCo/OpCo structure was in place prior to enactment of the TCJA, and (4) expanding the REIT exception to include all real property trades or businesses that lease to residential living facilities.

The operation of two separate, but commonly controlled, legal entities is also common in the cattle and beef industry—one entity owns all of the land and the buildings used by the operating entity, whereas the operating entity owns inventory (cattle or crops) and equipment and operates the farm, ranch, or feed yard. Commenters recommended providing an exception from the proposed –9(h) anti-abuse rule for farming businesses or, alternatively, clarifying that the allocation rules under proposed § 1.163(j)–10 do not apply to separate out the real property to real property businesses included under the proposed –9(h) anti-abuse rule.

The Treasury Department and the IRS agree with commenters that certain exceptions should be added to the proposed –9(h) anti-abuse rule. The final regulations provide two additional exceptions to the anti-abuse rule. Under the first exception, if at least 90 percent of a lessor's real property, determined by fair market rental value, is leased to a related party that operates an excepted trade or business and/or to unrelated parties, the lessor is eligible to make an election to be an electing real property trade or business for its entire trade or business (de minimis exception). The de minimis exception accommodates taxpayers that, by law or for valid business reasons, divide their real property holding and leasing activities from their operating trade or business that qualifies as an excepted trade or business, while still maintaining an anti-abuse rule to prevent non-economic business structures designed to circumvent the section 163(j) limitation. See § 1.163(j)–9(j).

The second exception is a look-through rule that modifies the proposed –9(h) anti-abuse rule by allowing taxpayers to make an election for a certain portion of their real property trade or business (look-through exception). Under the look-through exception, if a lessor trade or business leases to a trade or business under common control (lessee), the lessor is eligible to make an election to be an electing real property trade or business to the extent that the lessor leases to an unrelated party or to an electing trade or business under common control with the lessor or lessee, and to the extent that the lessee trade or business under common control subleases (or licenses) to unrelated third parties and/or related parties that operate an excepted trade or business. Accordingly, the lessor can make an election for the portion of its trade or business that is equivalent to the portion of the real property that is ultimately leased to unrelated parties and/or related parties that operate an excepted trade or business. A lessor that makes an election under the look-through exception must allocate the basis of assets used in its trades or businesses under the rules provided in § 1.163(j)–10(c)(3)(iii)(D).

D. Residential Living Facilities and Notice With Proposed Revenue Procedure

The PropCo/OpCo structure, discussed previously in part X(C) of this Summary of Comments and Explanation of Revisions section, is used extensively by certain residential living facilities that provide residential housing along with supplemental assistive, nursing, and other routine medical services. The commonly controlled lessees in the PropCo/OpCo structure expressed concern about whether the residential living facility trades or businesses qualify as real property trades or businesses under section 469 and § 1.469–9(b)(2), and are thus eligible to make an election under section 163(j)(7)(B), because of the supplemental services that they provide. Accordingly, Notice 2020—[INSERT NOTICE #], 2020—[INSERT CB/IRB GUIDANCE NUMBERS], released concurrently with these final regulations, provides notice of a proposed revenue procedure detailing a proposed safe harbor under which a taxpayer engaged in a trade or business that manages or operates a residential living facility and that also provides supplemental assistive, nursing, and other routine medical services may elect to treat such trade or business as a real property trade or business within the meaning of section 469(c)(7)(C), solely for purposes of qualifying as an electing real property trade or business under section 163(j)(7)(B). Thus, if a lessor leases real property to a commonly controlled lessee that operates a residential living facility, which qualifies as and makes an election to be an excepted trade or business under the proposed safe harbor in Notice 2020—[INSERT NOTICE #], the lessor may qualify to use the de minimis exception or the look-through exception.

The Treasury Department and the IRS request comments in Notice 2020—[INSERT NOTICE #] on the proposed revenue procedure. Interested parties are invited to submit comments on the proposed revenue procedure by [INSERT DATE 90 DAYS AFTER PUBLICATION of Notice 2020—[INSERT NOTICE #] IN the IRB].

The proposed revenue procedure is proposed to apply to taxpayers with taxable years ending after December 31, 2017. Until such time that the proposed revenue procedure is published in final form, taxpayers may use the safe harbor described in the proposed revenue procedure for purposes of determining whether a residential living facility, as defined in the proposed revenue procedure, may be treated as a real property trade or business solely for purposes of section 163(j).

Future guidance might be needed to determine whether a particular trade or business can make an election. Accordingly, the definitions of electing real property trade or business in § 1.163(j)–1(b)(14) and electing farming business in § 1.163(j)–1(b)(13) include a new provision noting that the Secretary may issue guidance on whether a trade or business can be an electing real property trade or business or electing farming business.

E. Safe Harbor for Certain REITs

Proposed § 1.163(j)–9(g) provides a special safe harbor for REITs. The safe harbor provides that, if a REIT holds real property, interests in partnerships holding real property, or shares in other REITs holding real property, the REIT is eligible to make an election to be an electing real property trade or business for all or part of its assets. If a REIT makes an election to be an electing real property trade or business, and if the value of the REIT's real property financing assets (as defined in proposed § 1.163(j)–9(g)(5) and (6)) 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, then, under the safe harbor in the proposed regulations, all of the REIT's assets are treated as assets of an excepted trade or business. If a REIT makes an election to be an electing real property trade or business, and if the value of the REIT's real property financing assets at the close of the taxable year is more than 10 percent of the value of the REIT's total assets, then, under the safe harbor in the proposed regulations, 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). The safe harbor also allows REITs to use § 1.856–10 for the definition of ''real property'' in determining which assets are assets of an excepted trade or business. The final regulations generally adopt the safe harbor for REITs in the proposed regulations, with modifications in response to comments discussed in this part X(E) of the Summary of Comments and Explanation of Revisions section.

One commenter recommended that the Treasury Department and the IRS revise proposed § 1.163(j)–9(g)(1) to clarify that a REIT may make the safe harbor election if the REIT owns an interest in one or more partnerships holding real property or stock in one or more REITs holding real property. The commenter indicated that the use of the plural ''interests in partnerships'' and ''shares in other REITs'' could imply that a REIT cannot make the safe harbor election if the REIT owns an interest in a single partnership or shares in a single REIT. The Treasury Department and the IRS agree that the regulations should not preclude a REIT that owns an interest in a single partnership or shares in a single REIT from applying the safe harbor.

This commenter also recommended that the final regulations clarify that the safe harbor election may be made if the electing REIT owns a direct interest in a partnership or lower-tier REIT that does not directly hold real property, but that holds an interest in another partnership or lower-tier REIT that directly holds real property.

The determination of whether a REIT is eligible to make the safe harbor election under the proposed regulations was intended to mirror the determination of whether the REIT holds real property (as defined under § 1.856–10) when testing the value of the REIT's real estate assets under section 856(c)(4)(A). If a REIT is a partner in a partnership that holds real property (as defined under § 1.856–10), the REIT is deemed to own its proportionate share of the partnership's real property for purposes of section 856(c)(4). The Treasury Department and the IRS also recognize that, for purposes of section 856(c)(4), a REIT is deemed to own a share of real property from any partnership interest held through an upper-tier partnership.

Moreover, under section 856(c)(5)(B), shares in other REITs qualify as real estate assets. Although a REIT (shareholder REIT) that holds shares in another REIT would not need to determine whether the other REIT holds real property for purposes of testing the value of the shareholder REIT's real estate assets under section 856(c)(4), the proposed regulations allowed the shareholder REIT to make the safe harbor election as long as it determines that the other REIT holds real property. The Treasury Department and the IRS recognize that the other REIT in this situation may not necessarily hold real property but instead may hold shares in a lower-tier REIT (which is a real estate asset in the hands of the other REIT).

Because the shareholder REIT can hold shares in another REIT that holds shares in a lower-tier REIT that holds real property, the Treasury Department and the IRS have concluded that a shareholder REIT may make the safe harbor election if it determines that it holds an indirect interest in a REIT that holds real property. Accordingly, the final regulations clarify that a REIT may elect to be an electing real property trade or business if the REIT holds real property, interests in one or more partnerships holding real property either directly or indirectly through interests in other partnerships or shares in other REITs, or shares in one or more other REITs holding real property either directly or indirectly through interests in partnerships or shares in other REITs.

Several commenters also requested that certain partnerships with a REIT as a partner be allowed to apply the REIT safe harbor election at the partnership level. Commenters noted that many REITs own interests in partnerships that directly or indirectly hold real property, and these partnerships incur the debt that is secured by the real property and claim the interest expense deductions. Commenters recommended that the REIT safe harbor election be made available to partnerships if: (1) At least one partner is a REIT that owns, directly or indirectly, at least 50 percent of the partnership's capital or profits; (2) the partnership meets the requirements of section 856(c)(2), (3), and (4) as if the partnership were a REIT; and (3) the partnership satisfies the requirements of proposed § 1.163(j)–9(g)(1) as if the partnership were a REIT.

The Treasury Department and the IRS agree that a partnership that is controlled by a REIT or REITs and that would meet the REIT gross income and asset tests in section 856(c)(2), (3), and (4) (as if the partnership were a REIT) is sufficiently similar to a REIT for this purpose. Accordingly, the final regulations provide that a partnership may apply the REIT safe harbor election at the partnership level if one or more REITs own, directly or indirectly, at least 50 percent of the partnership's capital and profits, the partnership meets the requirements of section 856(c)(2), (3), and (4) as if the partnership were a REIT, and the partnership satisfies the requirements described in § 1.163(j)–9(h)(1) as if the partnership were a REIT.

A commenter also recommended that the REIT exception to the proposed § 1.163(j)–9(h) anti-abuse rule be clarified to apply to any partnership in which a REIT owns a 50 percent or greater direct or indirect capital or profits interest, if the partnership leases a qualified lodging facility or qualified health care property to a TRS or a partnership in which a TRS is a 50 percent or greater direct or indirect partner. The REIT exception was intended to allow REITs that lease qualified lodging facilities and qualified healthcare properties pursuant to the related party rental exception in section 856(d)(8)(B) to make a real property trade or business election because these leases are explicitly authorized by the Code. In response to comments, the final regulations clarify that the REIT exception also applies to partnerships making the REIT safe harbor election that lease qualified lodging facilities and qualified healthcare properties. However, the final regulations do not specify the related party to which the REIT must lease the qualified lodging facility or qualified healthcare property in order to qualify for the REIT exception and, therefore, Treasury and the IRS did not include a provision for partnerships in which a TRS is a partner.

A commenter requested clarification regarding the application of the real property trade or business election to a rental real estate partnership and its REIT partners if the partnership holds real property and is not engaged in a trade or business within the meaning of section 162. Part XVI of this Summary of Comments and Explanation of Revision section clarifies that taxpayers engaged in rental real estate activities that do not necessarily rise to the level of a section 162 trade or business nevertheless are treated as engaged in real property trades or businesses within the meaning of section 469(c)(7)(C) (and for purposes of section 163(j) by reference). As such, a partnership engaged in a rental real estate activity (regardless of whether that activity rises to the level of a section 162 trade or business) will be permitted to make the election under section 163(j)(7)(B) with respect to the rental real estate activity to be an electing real property trade or business for purposes of section 163(j), and any interest expense that is allocable to that rental real estate activity and that is allocable to a REIT partner will not be investment interest (within the meaning of section 163(d)) that is treated as interest expense allocable to a trade or business of a C corporation partner under § 1.163(j)–4(b)(3).

For purposes of valuing a REIT's assets, the proposed regulations provide that REIT real property financing assets also include the portion of a shareholder REIT's interest in another REIT attributable to that other REIT's real property financing assets. The final regulations clarify that this rule also applies in the context of tiered-REIT structures.

The proposed regulations provide that no portion of the value of a shareholder REIT's shares in another REIT is included in the value of the 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 proposed § 1.163–9(g)(2). The proposed regulations provide that if a 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 the shareholder REIT's shares in the other REIT are treated as real property financing assets.

A commenter requested that the final regulations clarify how a shareholder REIT determines whether the value of the other REIT's real property financing assets is 10 percent or less of the other REIT's total asset value for purposes of determining whether the electing shareholder REIT must allocate interest expense between excepted and non-excepted businesses. The commenter recommended that the final regulations provide an example to clarify this point or specify that the shareholder REIT may make this determination based on all of the facts available to the shareholder REIT. The commenter proposed that a shareholder REIT that makes an incorrect determination in good faith that the other REIT qualifies under proposed § 1.163–9(g)(2) nevertheless be permitted to treat all of the value of the lower REIT's shares as assets other than real property financing assets.

In response to this comment, the final regulations allow a shareholder REIT to use an applicable financial statement (within the meaning of section 451(b)) of the other REIT to determine whether and the extent that the assets of the other REIT are investments in real property financing assets (rather than having to receive the information directly from the other REIT). However, the final regulations do not permit a shareholder REIT to treat the shares in the other REIT as assets other than real property financing assets when the shareholder REIT's determination is based on information other than an applicable financial statement or information received directly from the other REIT.

In the event that a REIT is required to allocate its interest expense between excepted and non-excepted trades or businesses under § 1.163(j)–10, a commenter requested clarification regarding the application of the look-through rules to tiered entities. Under the proposed regulations, if a REIT holds an interest in a partnership, in applying the partnership look-through rule in proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*), the REIT also applies the definition of real property under § 1.856–10 to determine whether the partnership's assets are allocable to an excepted trade or business. In addition, under the proposed regulations, if a shareholder REIT holds shares in another REIT and all of the other REIT's assets are not treated as assets of an excepted trade or business, the proposed regulations provide that the shareholder REIT applies the same partnership look-through rule (as if the other REIT were a partnership) in determining the extent to which the shareholder REIT's adjusted basis in the shares of the other REIT is properly allocable to an excepted trade or business of the shareholder REIT.

In response to comments, the final regulations provide that, when applying the partnership look-through rule in the case of tiered entities, a REIT applies the definition of real property in § 1.856–10 to each partnership in the chain to determine whether the partnership's assets are allocable to an excepted trade or business. Furthermore, because shares in other REITs qualify as real estate assets under section 856(c)(5)(B), the final regulations provide that, when applying the look-through rule to REITs within a tiered-entity structure, a shareholder REIT may apply the partnership look-through rule in § 1.163(j)–10(c)(5)(ii)(A)(*2*) to all REITs in the chain.

In response to an informal inquiry, the final regulations also clarify that a REIT or a partnership that is eligible but chooses not to apply the REIT safe harbor election may still elect, under § 1.163(j)–9(b)(1), for one or more of its trades or businesses to be an electing real property trade or business, provided that such trade or business is otherwise eligible to elect under § 1.163(j)–9(b)(1). A REIT or partnership that makes the election under § 1.163(j)–9(b)(1) without utilizing the REIT safe harbor provisions may not rely on any portion of § 1.163(j)–9(h)(1) through (7).

F. Real Property Trade or Business

Proposed § 1.163(j)–10(a)(1)(i) provides that the amount of a taxpayer's interest expense that is properly allocable to excepted trades or businesses is not subject to the section 163(j) limitation, and 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. Commenters suggested that, for purposes of allocating interest between a non-excepted trade or business and an excepted trade or business, a corporate partner in a partnership that conducts a real property trade or business should be allowed to treat its share of the partnership's real property trade or business as an electing real property trade or business even if the partnership does not make the election.

The Treasury Department and the IRS have rejected this comment because an election under section 163(j)(7)(B) has certain consequences—for example, the use of ADS rather than the general depreciation system for certain types of property, which results in the inability of electing real property trades or businesses to claim the additional first-year depreciation deduction under section 168(k) for those types of property. Therefore, the Treasury Department and the IRS have determined that a corporate partner in a partnership that conducts a real property trade or business should be allowed to treat its share of the partnership's real property trade or business as an electing real property trade or business only if the partnership makes the election. However, see part X(A) of this Summary of Comments and Explanation of Revisions section regarding taxpayers that are eligible to make an election to be an electing real property trade or business but are not certain whether they are engaged in a trade or business under section 162.

XI. Comments on and Changes To Proposed § 1.163(j)–10: Allocation of Interest Expense, Interest Income, and Other Items of Expense and Gross Income to an Excepted Trade or Business.

Section 1.163(j)–10 provides 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 following discussion addresses comments relating to proposed § 1.163(j)–10.

A. General Method of Allocation: Asset Basis

Proposed § 1.163(j)–10(c) sets 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 is 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 trades or businesses. As noted in the preamble to the proposed regulations, 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. Many commenters expressed support for this proposed allocation method.

However, some commenters argued that taxpayers should be permitted to allocate interest expense and income between excepted and non-excepted trades or businesses based on the earnings or gross income of each business, for various reasons. For example, some commenters posited that asset basis may bear little connection to a corporation's borrowing capacity, whereas earnings or revenue are useful indicators of a taxpayer's ability to meet its debt obligations, and earnings are a key factor in determining the amount of debt the taxpayer may borrow and the interest rate the taxpayer will be charged. These commenters also noted that an asset-basis allocation method could yield inconsistent results across industries (for example, industries whose asset mix is heavily skewed towards self-created intangibles will have low asset basis) or within similarly situated industries (if assets are purchased at different times). One commenter also suggested that an earnings-based approach would be easier for the IRS and taxpayers to administer because ATI already must be calculated by each taxpayer that is subject to a section 163(j) limitation.

Although the foregoing arguments have merit, adopting an earnings-based approach would raise many additional considerations, such as taxpayers' ability to time income recognition to affect allocation and create other distortions (as in the case of a trade or business that requires capital investment for a period of years before earning significant gross income). Thus, after further consideration, the Treasury Department and the IRS have decided to retain the asset-basis allocation approach contained in proposed § 1.163(j)–10(c). However, the Treasury Department and the IRS continue to study these comments and may provide future guidance on this issue.

B. Allocation Between Trades or Businesses and Non-Trades or Businesses

Proposed § 1.163(j)–10(a)(2)(i) coordinates the rules under proposed § 1.163(j)–10 with other Federal income tax rules. For example, proposed § 1.163(j)–10(a)(2)(i) provides that, before a taxpayer may determine the amount of interest expense, interest income, or other tax items that is properly allocable to excepted or non-excepted trades or businesses, the taxpayer first must apply § 1.163–8T to determine which tax items are allocable to non-trades or businesses rather than to trades or businesses. Some commenters recommended that non-corporate partners be permitted to allocate tax items between a trade or business and a non-trade or business based on an approach that looks to the earnings of the trade or business and non-trade or business. The commenters argued that an earnings-based approach to determining when debt is properly allocable between a trade or business and a non-trade or business is consistent with determining whether the earnings of a taxpayer can support the level of debt incurred.

After further consideration, the Treasury Department and the IRS have decided to retain the § 1.163–8T tracing approach contained in proposed § 1.163(j)–10(a)(2)(i). However, the Treasury Department and the IRS continue to study these comments and may provide future guidance on this issue. Additionally, the Treasury Department and the IRS are considering issuing additional guidance related to the allocation of interest expense by partnerships or S corporations. See proposed § 1.163–14 in the Concurrent NPRM.

Commenters also recommended that no allocation between business and nonbusiness interest expense be required when a partnership is wholly owned by corporate partners because a corporation can have only business interest income and expense and cannot have investment interest income and expense (see proposed § 1.163(j)–4(b)(3)(i)). The Treasury Department and the IRS have rejected this comment because the recommended approach is inconsistent with the entity approach taken with respect to partnerships in section 163(j)(4). Moreover, a separate rule for partnerships that are wholly owned by corporate partners is subject to manipulation because the partnership could alter the rules to which it is subject simply by admitting a non-corporate partner with a small economic interest in the partnership.

C. Consolidated Groups

1. Overview

As provided in proposed § 1.163(j)–10(a)(4)(i), the computations required by section 163(j) and the section 163(j) regulations generally are made for a consolidated group on a consolidated basis. Thus, for purposes of applying the allocation rules of proposed § 1.163(j)–10, all members of a consolidated group are treated as a single corporation. For example, the group (rather than a particular member) is treated as engaged in excepted or non-excepted trades or businesses. Moreover, intercompany transactions (as defined in § 1.1502–13(b)(1)(i)) are disregarded for purposes of these allocation rules, 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. Additionally, stock of a member that is owned by another member of the same consolidated group is not treated as an asset for purposes of § 1.163(j)–10, 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.

After a consolidated group has determined the percentage of the group's interest expense allocable to excepted trades or businesses for the taxable year, 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. Thus, except to the extent proposed § 1.163(j)–10(d) (providing rules for direct allocation in certain limited circumstances) applies, the same percentage of interest paid or accrued by each member to a lender that is not a member is treated as allocable to excepted trades or businesses, regardless of whether any particular member actually engaged in an excepted trade or business.

2. Intercompany Transactions

Commenters observed that ignoring all intercompany transactions and intercompany obligations for purposes of proposed § 1.163(j)–10 is theoretically simple and generally furthers the single-entity approach adopted elsewhere in the proposed regulations. However, a commenter recommended that taxpayers be permitted to take into account basis from certain intercompany transactions, so long as adequate safeguards are put in place against abuse (for example, to prevent taxpayers from using intercompany transactions to increase the consolidated group's ATI or to shift asset basis to excepted trades or businesses), in order to reduce the administrative burden of tracking asset basis separately for purposes of section 163(j). The commenter also recommended that the Treasury Department and the IRS reconsider whether, in certain circumstances, items from intercompany transactions (other than business interest expense and business interest income) should affect the amount of the consolidated group's ATI.

The Treasury Department and the IRS acknowledge that the approach in proposed § 1.163(j)–10(a)(4)(i) creates an administrative burden for members of consolidated groups. However, this approach is consistent with § 1.1502–13, the stated purpose of which is to prevent intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income or consolidated tax liability (see § 1.1502–13(a)(1)). Allowing tax items from intercompany transactions to affect the calculation of a consolidated group's tentative taxable income and ATI would be inconsistent with the single-entity principles of § 1.1502–13(a). Moreover, taxpayers already must track asset basis information for purposes of § 1.1502–13. Additionally, giving effect to intercompany transactions for purposes of section 163(j) would create other administrative burdens for consolidated group members. See the discussion in part V(B) of this Summary of Comments and Explanation of Revisions section. Thus, the final regulations continue to disregard intercompany transactions for purposes of the allocation rules in proposed § 1.163(j)–10.

3. Use of Property Derives From an Intercompany Transaction

A commenter observed that the meaning of the phrase ''property is not treated as used in a trade or business to the extent the use of such property derives from an intercompany transaction'' is unclear. For example, one member of a consolidated group (S) leases property to another member of the group (B), which uses the property in its trade or business. B's lease with S entitles B to use the property. Should B's use of the property in its trade or business be disregarded for purposes of proposed § 1.163(j)–10 because such use ''derives from an intercompany transaction''?

The Treasury Department and the IRS did not intend for B's use of the property in the foregoing scenario to be disregarded for purposes of the allocation rules in proposed § 1.163(j)–10. If S and B were treated as disregarded entities owned by the same corporation, the lease would be ignored, and the leased property would be treated as an asset used in B's trade or business. The final regulations clarify proposed § 1.163(j)–10(a)(4)(i) to better reflect this intended result.

The commenter also requested confirmation that the same allocation principle applies to third-party costs incurred by members of the group (in other words, that such costs are allocated based on the use of assets in excepted or non-excepted trades or businesses). However, proposed § 1.163(j)–10(b)(5) already provides special rules for the allocation of expenses other than interest expenses. Thus, the final regulations do not adopt this recommendation.

4. Purchase of Member Stock From a Nonmember

A commenter recommended that a purchase by one consolidated group member (S) of stock of another member (or of an entity that becomes a member as a result of the purchase) (in either case, T) from a non-member (X) be treated as a purchase of a proportionate amount of T's assets for purposes of proposed § 1.163(j)–10. Although the proposed regulations treat the transfer of the stock of a member to a non-member as a transfer of a proportionate amount of the member's assets, the proposed regulations do not expressly address the acquisition of the stock of a member (or of a corporation that becomes a member as a result of the acquisition). The commenter noted that, if such acquisitions are not treated as asset purchases, the amount of adjusted basis allocated to an excepted or non-excepted trade or business may differ significantly depending on whether S and T file a consolidated return.

For example, T (which is engaged solely in an excepted trade or business) has assets with a fair market value of $100x and $0 adjusted basis, and $0 liabilities. S (which is engaged solely in a non-excepted trade or business) has $100x adjusted basis in its assets. S purchases 100 percent of T's stock from X for $100x, and S and T do not file a consolidated tax return. As a result, S's stock in T is treated as an asset (under proposed § 1.163(j)–10(c)(5)(ii)(B)) with a basis of $100x. In contrast, if S and T were to file a consolidated return, S's stock in T would not be treated as an asset under proposed § 1.163(j)–10(a)(4). Moreover, it is unclear how much adjusted basis the group could take into account for purposes of the allocation rules. Would the group's adjusted basis in T's assets equal T's basis in its assets immediately before the acquisition (here, $0)? Or would all or some portion of the amount paid by S to acquire T's stock be taken into account? The commenter argued that S should have the same amount of adjusted basis in T's assets regardless of whether S and T file a consolidated return, and that there is no legislative history revealing congressional intent to treat members of a consolidated group and non-consolidated corporations differently in this regard. Thus, according to the commenter, S should be able to take into account the amount paid for its T stock for purposes of the allocation rules in proposed § 1.163(j)–10.

Although Congress did not expressly address this issue, Congress did make clear that the section 163(j) limitation applies at the consolidated group level (see H. Rept. 115–466, at 386 (2017)). Moreover, section 1502 provides broad authority for the Secretary of the Treasury to prescribe regulations to determine the tax liability of a consolidated group in a manner that clearly reflects the income tax liability of the group and that prevents the avoidance of tax liability. Consistent with legislative intent regarding section 163(j) and with the broad grant of authority under section 1502, the proposed regulations treat a consolidated group as a single corporation for purposes of the allocation rules of § 1.163(j)–10, and they disregard the stock of members for purposes of this section.

Additionally, the Treasury Department and the IRS have questions and concerns about treating the acquisition of stock of a member (or of an entity that becomes a member) as an asset sale. How would the purchase price be added to the group's basis in the member's assets, and how would the additional basis added to these assets be depreciated? Would this approach deem the transaction to be an asset acquisition for all Federal income tax purposes or just for purposes of section 163(j), and what complications would arise from treating the transaction as an asset purchase for purposes of section 163(j) but as a stock purchase for other purposes?

Due to concerns about these and other issues, the final regulations do not adopt the commenter's recommendation. However, the Treasury Department and the IRS continue to study the issue raised by the commenter and may address the issue in future guidance.

5. Inclusion of Income From Excepted Trades or Businesses in Consolidated ATI

A commenter noted that, because every member of a consolidated group is treated as engaged in every trade or business of the group for purposes of proposed § 1.163(j)–10, a member engaged solely in an excepted regulated utility trade or business that incurs interest expense related to its business activities will be subject to the section 163(j) limitation if other group members are engaged in non-excepted trades or businesses. The commenter suggested that this outcome is contrary to the policy rationale for the exception for regulated utility trades or businesses. The commenter further noted that the gross income of the excepted trade or business is not included in the group's ATI calculation, and that this outcome could produce anomalous results. The commenter thus recommended that a proportionate share of the gross income of the excepted trade or business be included as an adjustment to consolidated ATI.

The Treasury Department and the IRS do not agree that the results under proposed § 1.163(j)–10(a)(4) are inconsistent with congressional intent or lead to anomalous results. As noted in part XI(C)(4) of this Summary of Comments and Explanation of Revisions section, Congress expressly stated that the section 163(j) limitation applies at the consolidated group level. Thus, the treatment of a consolidated group as a single corporation, and the treatment of every member as engaged in every trade or business of the group, is consistent with congressional intent. Moreover, if the section 163(j) limitation were inapplicable to group members engaged in excepted trades or businesses, consolidated groups could readily avoid the section 163(j) limitation by concentrating their external borrowing in such members. Furthermore, although a portion of the interest expense of a member engaged solely in an excepted trade or business will be subject to the section 163(j) limitation if the group is otherwise engaged in non-excepted trades or businesses, a portion of the interest expense of a member engaged solely in a non-excepted trade or business will not be subject to the section 163(j) limitation if the group is otherwise engaged in excepted trades or businesses—and all of that member's income will factor into the group's ATI calculation. Finally, as the commenter acknowledged, section 163(j)(8)(A)(i) specifically excludes from the determination of ATI any item of income, gain, deduction, or loss that is allocable to an excepted trade or business.

For the foregoing reasons, the Treasury Department and the IRS have determined that no changes to the final regulations are needed with respect to this comment.

6. Engaging in Excepted or Non-Excepted Trades or Businesses as a ''Special Status''

One commenter suggested that the Treasury Department and the IRS consider whether engaging in an excepted trade or business should be treated as a ''special status'' under § 1.1502–13(c)(5) for purposes of applying the intercompany transaction rules of § 1.1502–13.

The intercompany transaction rules apply for purposes of redetermining and allocating attributes under § 1.1502–13(c)(1)(i) in order to reach a ''single entity'' answer under the matching rule of § 1.1502–13(c). For example, one member of a consolidated group is a dealer in securities under section 475 (dealer) and sells a security to a second member that is not a dealer; that second member then sells the security to a nonmember in a later year. The matching rule can apply to ensure that the taxable items of the two members harmonize with regard to timing and character in order to reach the same overall tax treatment that would be given to a single corporation whose two operating divisions engaged in those transactions. See § 1.1502–13(c)(7)(i), *Example 11.*

However, if one member has ''special status'' under § 1.1502–13(c)(5) but the other does not, then attributes of the item would not be redetermined under the matching rule. For example, if S (a bank to which section 582(c) applies) and B (a nonbank) are members of a consolidated group, and if S sells debt securities at a gain to B, the character of S's intercompany gain is ordinary (as required under section 582(c)), but the character of B's corresponding item is determined under § 1.1502–13(c)(1)(i) without the application of section 582(c). See § 1.1502–13(c)(5).

The ''special status'' rules of § 1.1502–13(c)(5) are applicable to entities, such as banks or insurance companies, that are subject to a separate set of Federal income tax rules. Although there are special tax rules for farming, real estate, and utilities, an entity engaged in such trades or businesses also may be engaged in other trades or businesses to which such special tax rules would not apply. Further, the entity's farming, real estate, or utility trade or business need not be its primary trade or business. Moreover, the treatment of excepted trades or businesses as a special status effectively would result in additional tracing of specific items for purposes of § 1.1502–13. As noted in the preamble to the proposed regulations, the Treasury Department and the IRS have decided not to apply a tracing regime to allocate interest expense and income between excepted and non-excepted trades or businesses. Thus, the final regulations do not treat engaging in an excepted trade or business as a special status.

D. Quarterly Asset Testing

Under proposed § 1.163(j)–10(c)(6), a taxpayer must determine the adjusted basis in its assets on a quarterly basis 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. In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on the frequency of asset basis determinations required under proposed § 1.163(j)–10(c).

In response, commenters stated that this quarterly determination requirement is administratively burdensome, and that such a burden is unwarranted because, in many circumstances, measuring asset basis less frequently would produce similar results. Thus, commenters recommended that taxpayers be permitted to allocate asset basis for a taxable year based on the average of adjusted asset basis at the beginning and end of the year. As a result, the ''determination date'' would be the last day of the taxpayer's taxable year, and the ''determination period'' would begin on the first day of the taxpayer's taxable year and end on the last day of the year.

Several commenters recommended that this approach be modeled on the interest valuation provisions in § 1.861–9T(g)(2)(i). Under these rules, taxpayers generally must compute the value of assets based on an average of asset values at the beginning and end of the year. However, if a ''substantial distortion'' of asset values would result from this approach (for example, if there is a major acquisition or disposition), the taxpayer must use a different method of asset valuation that more clearly reflects the average value of assets.

Other commenters suggested that their proposed approach could be limited to cases in which there is no more than a de minimis change in asset basis between the beginning and end of the taxable year. For example, this approach could be available for a taxable year only if the taxpayer demonstrates that its total adjusted basis (as measured in accordance with the rules in proposed § 1.163(j)–10(c)(5)) at the end of the year in its assets used in its excepted trades or businesses, as a percentage of the taxpayer's total adjusted basis at the end of such year in all of its assets used in a trade or business, does not differ by more than 10 percent from such percentage at the beginning of the year.

The Treasury Department and the IRS acknowledge that determining asset basis on a quarterly basis would impose an administrative burden. The Treasury Department and the IRS also agree with commenters that a safeguard is needed to account for episodic events, such as acquisitions, dispositions, or changes in business, that could affect average values. Thus, the final regulations permit a taxpayer to compute asset basis in its excepted and non-excepted trades or businesses by averaging asset basis at the beginning and end of the year, so long as the taxpayer falls under a 20 percent de minimis threshold.

E. De Minimis Rules

1. Overview

The proposed regulations provide a number of de minimis rules to simplify the application of § 1.163(j)–10. For example, proposed § 1.163(j)–10(c)(3)(iii)(C)(*3*) provides that a utility trade or business is treated entirely as an excepted regulated utility trade or business if more than 90 percent of the items described in proposed § 1.163(j)–1(b)(15) are furnished or sold at rates qualifying for the excepted regulated utility trade or business exception. Proposed § 1.163(j)–10(c)(3)(iii)(B)(*2*) provides that, if 90 percent or more of the basis in an asset would be allocated under proposed § 1.163(j)–10(c)(3) to either excepted or non-excepted trades or businesses, then the entire basis in the asset is allocated to either excepted or non-excepted trades or businesses, respectively. In turn, proposed § 1.163(j)–10(c)(1)(ii) provides that, if 90 percent or more of a taxpayer's basis in its assets is allocated under proposed § 1.163(j)–10(c) to either excepted or non-excepted trades or businesses, then all of the taxpayer's interest expense and interest income are allocated to either excepted or non-excepted trades or businesses, respectively.

2. Order in Which the De Minimis Rules Apply

A commenter recommended that these de minimis rules be applied in the order in which they are listed in the foregoing paragraph. In other words, a taxpayer first should determine the extent to which its utility businesses are excepted regulated utility trades or businesses. The taxpayer then should determine the extent to which the basis of any assets used in both excepted and non-excepted trades or businesses should be wholly allocated to either excepted or non-excepted trades or businesses. Only then should the taxpayer determine whether all of its interest expense and interest income should be wholly allocated to either excepted or non-excepted trades or businesses. The Treasury Department and the IRS agree that the order recommended by the commenter is the most reasonable application of these de minimis rules, and the final regulations adopt language confirming this ordering.

3. Mandatory Application of De Minimis Rules

Commenters also requested that the final regulations continue to mandate the application of the foregoing de minimis rules rather than make such de minimis rules elective. The commenters expressed concern that creating an election to use the de minimis rules in § 1.163(j)–10(c)(1) and (3) would create uncertainty for taxpayers, and they argued that mandatory application of the de minimis rules would simplify the rules for taxpayers. The Treasury Department and the IRS agree that mandatory application of the de minimis rules simplifies the application of § 1.163(j)–10 and eases the burdens of compliance and administration. Therefore, the final regulations continue to mandate the application of the de minimis rules in § 1.163(j)–10(c)(1) and (3).

4. De Minimis Threshold for Electric Cooperatives

A commenter requested that the de minimis threshold for utilities in proposed § 1.163(j)–10(c)(3)(iii)(C)(*3*) be lowered from 90 percent to 85 percent for electric cooperatives. The commenter argued that a different threshold is appropriate for electric cooperatives because, under section 501(c)(12), 85 percent or more of an electric cooperative's income (with adjustments) must consist of amounts collected from members for the sole purpose of meeting losses and expenses in order for the cooperative to be exempt from Federal income tax.

The Treasury Department and the IRS have determined that the final regulations should provide the same de minimis threshold for electric cooperatives as for other utility trades or businesses. The 85 percent threshold under section 501(c)(12) measures a cooperative's income, with adjustments that are specific to section 501. Moreover, an electric cooperative is not required to qualify for tax exemption under section 501(c)(12) to be engaged in an excepted regulated utility trade or business. Therefore, the Treasury Department and the IRS have determined that the nexus between section 501(c)(12) and proposed § 1.163(j)–10 is insufficient to justify lowering the utility de minimis threshold to 85 percent for electric cooperatives, and the final regulations do not incorporate the commenter's suggestion.

5. Standardization of 90 Percent De Minimis Tests

The terminology used in the 90 percent de minimis tests in proposed § 1.163(j)–10 is not consistent. For example, proposed § 1.163(j)–10(c)(3)(iii)(C)(*3*) uses a ''more than 90 percent'' standard, whereas proposed § 1.163(j)–10(c)(3)(iii)(B)(*2*) uses a ''90 percent or more'' standard. For the sake of consistency, and in order to minimize confusion, the final regulations standardize the language used in these tests.

6. Overlapping De Minimis Tests

In addition to the de minimis tests previously described in this part XI(E) of the Summary of Comments and Explanation of Revisions section, proposed § 1.163(j)–10(c)(3)(iii)(B)(*1*) also contains another de minimis rule. Under this rule, if at least 90 percent of gross income generated by an asset during a determination period is with respect to either excepted or non-excepted trades or businesses, then the entire basis in the asset is allocated to either excepted or non-excepted trades or businesses, respectively.

The Treasury Department and the IRS have determined that this rule not only overlaps with, but also may yield results inconsistent with, the de minimis rule in § 1.163(j)–10(c)(3)(iii)(B)(*2*). Thus, the final regulations eliminate the de minimis rule in proposed § 1.163(j)–10(c)(3)(iii)(B)(*1*).

F. Assets Used in More Than One Trade or Business

1. Overview

Proposed § 1.163(j)–10(c)(3) contains special rules for allocating basis in assets used in more than one trade or business. In general, if an asset is used in more than one trade or business during a determination period, the taxpayer's adjusted basis in the asset must be allocated to each trade or business using one of three permissible methodologies, depending on which methodology most reasonably reflects the use of the asset in each trade or business during that determination period. These three methodologies are: (i) 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; (ii) if the asset is land or an inherently permanent structure, the relative amounts of physical space used by the trades or businesses; and (iii) if the trades or businesses generate the same unit of output, the relative amounts of output of those trades or businesses. However, taxpayers must use the relative output methodology to allocate the basis of assets used in both excepted and non-excepted utility trades or businesses.

As described in part XI(E)(1) of this Summary of Comments and Explanation of Revisions section, a taxpayer's allocation of basis in assets used in more than one trade or business is subject to several de minimis rules (see proposed § 1.163(j)–10(c)(3)(iii)).

2. Consistency Requirement

A commenter requested clarification that the consistency requirement in proposed § 1.163(j)–10(c)(3)(iii)(A) does not require a taxpayer to use a single methodology for different categories of assets, because a methodology that is reasonable for one type of asset (for example, office buildings) may not be reasonable for another (for example, intangibles). The Treasury Department and the IRS agree with this comment, and the final regulations have been clarified accordingly.

3. Changing a Taxpayer's Allocation Methodology

The Treasury Department and the IRS have determined that requiring taxpayers to obtain consent from the Commissioner to change their allocation methodology would impose an undue burden. Thus, the final regulations permit a taxpayer to change its allocation methodology after a period of five taxable years without obtaining consent from the Commissioner. A taxpayer that seeks to change its allocation methodology more frequently must obtain consent from the Commissioner.

The Treasury Department and the IRS also have determined that an allocation methodology is not a method of accounting because there is no guarantee that a taxpayer will be able to deduct a disallowed business interest expense carryforward in future taxable years (as a result, there could be a permanent disallowance). See the discussion in part III(A) of this Summary of Comments and Explanation of Revisions section.

4. Mandatory Use of Relative Output for Utility Trades or Businesses

A commenter requested that the final regulations allow electric cooperatives to use methodologies other than relative output to allocate the basis of assets used in both excepted and non-excepted utility trades or businesses. The commenter noted that alternative methods, such as allocations based on dollars of sales (or sales less the cost of sales), have been allowed by the IRS in the context of allocating expenses between patronage and non-patronage sales. The commenter also stated that economic realities facing electric cooperatives operating on a not-for-profit basis would not be accurately reflected by a relative output methodology.

The Treasury Department and the IRS have concluded that relative output most reasonably reflects the use of assets in excepted and non-excepted utility trades or businesses because § 1.163(j)–1(b)(15)(i)(A) divides utility businesses into excepted regulated utility trades or businesses and non-excepted utility businesses on the same basis. To the extent that items described in § 1.163(j)–1(b)(15)(i)(A) are sold at rates described in § 1.163(j)–1(b)(15)(i)(B), and to the extent that the trade or business is an electing regulated utility trade or business under § 1.163(j)–1(b)(15)(iii), a utility trade or business is an excepted trade or business. The Treasury Department and the IRS do not agree that the final regulations should apply one methodology for differentiating excepted and non-excepted utility trades or businesses under § 1.163(j)–1 and a different methodology to determine the allocation of an asset's basis between such businesses. Therefore, the final regulations do not incorporate the commenter's suggestion.

Another commenter recommended that the rule mandating the use of relative output for the allocation of asset basis under proposed § 1.163(j)–10(c)(3)(iii)(C)(*2*) not be used either to allocate assets used exclusively in excepted or non-excepted utility trades or businesses or to apply the de minimis test of proposed § 1.163(j)–10(c)(1)(ii).

The special rule in proposed § 1.163(j)–10(c)(3)(iii)(C)(*2*) mandates the use of relative output only for the purpose of allocating the basis of assets used in both excepted and non-excepted utility trades or businesses. Therefore, the rule does not mandate the use of relative output to allocate the basis of an asset that is used solely in either an excepted regulated utility trade or business or a non-excepted utility trade or business, except to the extent the de minimis rule in proposed § 1.163(j)–10(c)(3)(iii)(C)(*3*) treats a taxpayer's entire trade or business as either an excepted trade or business or a non-excepted trade or business. The language proposed by the commenter still subjects assets to the de minimis rule in proposed § 1.163(j)–10(c)(3)(iii)(C)(*3*). Because the proposed regulations achieve the result requested by the commenter, the final regulations do not adopt the recommended change.

The de minimis rule in proposed § 1.163(j)–10(c)(1)(ii) applies only after the basis of assets has been allocated between excepted and non-excepted trades or businesses. This de minimis rule treats all of a taxpayer's trades or businesses as either excepted or non-excepted trades or businesses based on such allocation. Because the rule of proposed § 1.163(j)–10(c)(1)(ii) does not apply the methodologies listed in proposed § 1.163(j)–10(c)(3), including the relative output methodology, no change to the proposed regulations is necessary to achieve the result requested by the commenter with respect to proposed § 1.163(j)–10(c)(1)(ii).

G. Exclusions From Basis Calculations

For purposes of allocating interest expense and interest income under the asset-basis allocation method in proposed § 1.163(j)–10(c), a taxpayer's basis in certain types of assets generally is not taken into account. These assets include cash and cash equivalents (see proposed § 1.163(j)–10(c)(5)(iii)). As noted in the preamble to the proposed regulations, this rule is intended to discourage taxpayers from moving cash to excepted trades or businesses to increase the amount of asset basis therein. In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on this special rule, including whether any exceptions should apply (such as for working capital).

In response, commenters recommended that working capital be included in the basis allocation determination, along with collateral that secures derivatives that hedge business assets and liabilities within the meaning of § 1.1221–2.

The Treasury Department and the IRS have concluded that the inclusion of working capital in the basis allocation determination could lead to frequent disputes between taxpayers and the IRS over the amount of cash that comprises ''working capital'' and the allocation of such amount between and among a taxpayer's excepted and non-excepted trades or businesses. Thus, the final regulations do not adopt this recommendation.

The Treasury Department and the IRS also have concluded that the inclusion of collateral that secures derivatives that hedge business assets and liabilities within the meaning of § 1.1221–2 could lead to frequent disputes between taxpayers and the IRS for reasons similar to those for working capital. For example, it is not always clear which business asset or liability is being hedged, especially in the case of an aggregate hedging transaction. In addition, taxpayers could use this rule as a planning opportunity for purposes of allocating the collateral to excepted trades or businesses. Thus, the final regulations also do not adopt this recommendation.

H. Look-Through Rules

1. Ownership Thresholds; Direct and Indirect Ownership Interests

Proposed § 1.163(j)–10(c)(5)(ii) provides, in part, that if a taxpayer owns an interest in a partnership or stock in a corporation that is not a member of the taxpayer's consolidated group, the partnership interest or stock is treated as an asset of the taxpayer for purposes of the allocation rules of proposed § 1.163(j)–10.

For purposes of allocating a partner's basis in its partnership interest between excepted and non-excepted trades or businesses under proposed § 1.163(j)–10, the partner generally may look through to its share of the partnership's basis in the partnership's assets (with certain modifications and limitations) regardless of the extent of the partner's ownership interest in the partnership. However, the partner must apply this look-through rule if its direct and indirect interest in the partnership is greater than or equal to 80 percent. Similar rules apply to shareholders of S corporations. See proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*)(*i*) and (c)(5)(ii)(B)(*3*)(*ii*).

For purposes of allocating a shareholder's stock basis between excepted and non-excepted trades or businesses, a shareholder of a domestic non-consolidated C corporation or a CFC also must look through to the assets of the corporation if the shareholder's direct and indirect interest therein satisfies the ownership requirements of section 1504(a)(2). Shareholders of domestic non-consolidated C corporations and CFCs may not look through their stock in such corporations if they do not satisfy this ownership threshold. See proposed § 1.163(j)–10(c)(5)(ii)(B)(*2*)(*i*) and (c)(7)(i)(A).

If a shareholder receives a dividend that is not investment income, and if the shareholder looks through to the assets of the payor corporation under proposed § 1.163(j)–10(c)(5)(ii) for the taxable year, the shareholder also must look through to the activities of the payor corporation to allocate the dividend between the shareholder's excepted and non-excepted trades or businesses. See proposed § 1.163(j)–10(b)(3) and (c)(7)(i)(B).

Commenters recommended that taxpayers be afforded greater flexibility to look through their stock in domestic non-consolidated C corporations and CFCs. For example, one commenter suggested that the look-through threshold for CFCs be lowered to 50 percent (analogous to the look-through threshold for related CFCs in section 954(c)(6)). Another commenter recommended that a taxpayer be allowed to look through its stock in a domestic non-consolidated C corporation if the taxpayer owns at least 80 percent of such stock by value, regardless of whether the taxpayer also owns 80 percent of such stock by vote. Yet another commenter recommended that a taxpayer be allowed to look through its stock in a domestic non-consolidated C corporation (or be allowed to allocate its entire basis in such stock to an excepted trade or business) if (i) the taxpayer and the C corporation are engaged in the same excepted trade or business, and (ii) the taxpayer either (A) owns at least 50 percent of the stock of the C corporation, or (B) owns at least 20 percent of the stock of the C corporation and exercises a significant degree of control over the corporation's trade or business. Another commenter recommended that the ownership threshold for looking through domestic non-consolidated C corporations and CFCs be eliminated entirely so that interest expense paid or accrued on debt incurred to finance the acquisition of a real estate business is exempt from the section 163(j) limitation (if the business qualifies for and makes an election under proposed § 1.163(j)–9), regardless of whether that business is held directly or through a subsidiary.

The Treasury Department and the IRS have determined that a de minimis ownership threshold is appropriate for domestic non-consolidated C corporations and CFCs because, unlike a partnership, a corporation generally is respected as an entity separate from its owner(s) for tax purposes. See, for example, *Moline Properties* v. *Commissioner,* 319 U.S. 436 (1943). The look-through rule for non-consolidated C corporations provides a limited exception to this general rule. Moreover, unlike S corporations, domestic C corporations are not taxed as flow-through entities. Thus, the final regulations retain an 80 percent ownership threshold for looking through a domestic non-consolidated C corporation or a CFC.

However, the final regulations permit a taxpayer to look through its stock in a domestic non-consolidated C corporation or a CFC if the taxpayer owns at least 80 percent of such stock by value, regardless of whether the taxpayer also owns at least 80 percent of such stock by vote. Corresponding changes have been made to the look-through rule for dividends.

Additionally, the final regulations permit a shareholder that meets the ownership requirements for looking through the stock of a domestic non-consolidated C corporation (determined without applying the constructive ownership rules of section 318(a)) to look through to such shareholder's pro rata share of the C corporation's basis in its assets for purposes of § 1.163(j)–10(c) (asset basis look-through approach). If a shareholder applies the asset basis look-through approach, it must do so for all domestic non-consolidated C corporations for which the shareholder is eligible to use this approach, and it must continue to use the asset basis look-through approach in all future taxable years in which the shareholder is eligible to use this approach.

Commenters also asked for clarification as to the meaning of an ''indirect'' interest for purposes of these look-through rules. For example, commenters asked what the term ''indirect'' means in the context of the look-through rule for dividends. Commenters further noted that, because section 1504(a)(2) does not contain constructive ownership rules, there is uncertainty as to when a shareholder's indirect ownership in a corporation is counted for purposes of the ownership requirement in the look-through rule. Commenters also requested specific constructive ownership rules, as well as examples to illustrate the application of the ''direct or indirect'' ownership threshold.

The Treasury Department and the IRS have determined that, for purposes of applying the ownership thresholds in § 1.163(j)–10(c)(5)(ii)(B)(*2*)(*i*), (c)(5)(ii)(B)(*3*)(*ii*), and (c)(7)(i)(A) to shareholders of domestic non-consolidated C corporations, CFCs, and S corporations, as applicable, the constructive ownership rules of section 318(a) should apply. For example, assume A, B, and C are all non-consolidated C corporations; A wholly and directly owns B; A and B each directly own 50 percent of C; A and B both conduct a non-excepted trade or business; and C conducts an excepted trade or business. Under section 318(a)(2)(C), A is considered to own the stock owned by B. As a result, A is considered to own 100 percent of the stock of C, and the look-through rule of proposed § 1.163(j)–10(c)(5)(ii)(B)(*2*)(*i*) and (c)(7)(i)(A) applies to A's stock in C. Thus, although the Treasury Department and the IRS have determined that the ownership threshold for non-consolidated C corporations should remain at 80 percent, the constructive ownership rules of section 318 will broaden the availability of the look-through rules to shareholders of such corporations.

In contrast, the Treasury Department and the IRS have determined that the constructive ownership rules of section 318(a) should not apply for purposes of applying the ownership threshold in proposed § 1.163(j)–10(b)(3) and (c)(7)(i)(B) to the receipt of dividends from domestic C corporations and CFCs because dividends are not paid to indirect shareholders. To avoid confusion in this regard, the final regulations remove the word ''indirect'' from the ownership threshold for the dividend look-through rule.

2. Application of Look-Through Rules to Partnerships

i. In General

For purposes of proposed § 1.163(j)–10(c), a partnership interest is treated as an asset of the partner. Pursuant to proposed § 1.163(j)–10(c)(5)(ii)(A)(*1*), the partner's adjusted basis in its partnership interest is reduced, but not below zero, by the partner's share of partnership liabilities as determined under section 752 (section 752 basis reduction rule). Pursuant to proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*)(*iii*), a partner other than a C corporation or tax-exempt corporation must further reduce its adjusted basis in its partnership interest by its share of the tax basis of partnership assets that is not properly allocable to a trade or business (investment asset basis reduction rule).

As noted in part XI(H)(1) of this Summary of Comments and Explanation of Revisions section, a partner may determine what portion of its adjusted tax basis in a partnership interest is attributable to an excepted or non-excepted trade or business by reference to its share of the partnership's basis in the partnership's assets (look-through rule). Under proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*)(*i*), a partner generally may choose whether to apply the look-through rule without regard to its ownership percentage, with two exceptions. First, if a partner's direct or 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 look-through rule. Second, if the partnership is eligible for the small business exemption under section 163(j)(3) and proposed § 1.163(j)–2(d)(1), a partner may not apply the look-through rule.

Proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*)(*ii*) provides that if, after applying the investment asset basis reduction rule, 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 or non-excepted trades or businesses, the partner's entire basis in its partnership interest is treated as allocable to such excepted or non-excepted trades or businesses.

Pursuant to proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*)(*iv*), if a partner, other than a C corporation or a tax-exempt corporation, does not apply the 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).

ii. Coordination of Look-Through Rule and Basis Determination Rules

Outside of the partnership context, proposed § 1.163(j)–10(c)(5)(i) provides rules regarding the computation of adjusted basis for purposes of allocating business interest expense between excepted and non-excepted trades or businesses (collectively, the ''basis determination rules''). For example, proposed § 1.163(j)–10(c)(5)(i)(A) generally provides that the adjusted basis of non-depreciable property other than land is the adjusted basis of the asset used for determining gain or loss from the sale or other disposition of that asset as provided in § 1.1011–1, and proposed § 1.163(j)–10(c)(5)(i)(C) generally provides that the adjusted basis of land and inherently permanent structures is its unadjusted basis. For purposes of applying the look-through rule, the Treasury Department and the IRS intended the basis determination rules to require adjustments to the partnership's basis in its assets and the partner's basis in its partnership interest to the extent of the partner's share of any adjustments to the basis of the partnership's assets. Accordingly, the final regulations explicitly provide that such is the case.

Multiple commenters noted that the proposed regulations do not specify whether a partner that does not apply the look-through rule should use the adjusted tax basis in its partnership interest or should adjust its tax basis to reflect what its basis would be if the partnership applied the basis determination rules to its assets. Because all partnerships are not subject to section 163(j) and cannot provide all partners with the information necessary to adjust the tax basis of their partnership interests consistent with the basis determination rules, the Treasury Department and the IRS have determined that the basis determination rules should not apply to the basis of a partnership interest if a partner does not apply the look-through rule.

iii. Applying the Look-Through Rule and Determining Share of Partnership Basis

Proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*)(*i*) provides that, for purposes of the look-through rule, a partner's share of a partnership's assets is determined using a reasonable method, taking into account special allocations under section 704(b), adjustments under sections 734(b) and 743(b), and direct adjustments relating to assets subject to qualified nonrecourse indebtedness under proposed § 1.163(j)–10(d)(4). Commenters argued that this language does not provide adequate guidance regarding how a partner should determine its share of the tax basis of a specific partnership asset when applying the look-through rule. The commenters stated that, by indicating that sections 743(b) and 704(b) should be taken into account, the proposed regulations imply that a partner's share of the partnership's basis in an asset is determined by reference to the future depreciation deductions that a partner would be allocated with regard to such asset or the amount of basis to be taken into account by that partner in determining its allocable share of gain or loss on the partnership's disposition of the asset. The commenters also requested that final regulations address whether and how allocations under section 704(c) affect a partner's share of the partnership's basis in its assets. After further consideration, the Treasury Department and the IRS have decided to retain the rule in proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*)(*i*).

iv. Investment Asset Basis Reduction Rule

Under proposed § 1.163(j)–10(c)(5)(ii)(A)(*2*)(*iii*), for purposes of applying the investment asset basis reduction rule, a partner's share of a partnership's assets is determined under a reasonable method, taking into account special allocations under section 704(b). A commenter recommended clarifying whether the investment asset basis reduction should be made in accordance with a partner's share of the partnership's actual adjusted basis in an asset or in accordance with the partner's share of the partnership's basis in an asset as determined pursuant to the basis determination rules. The commenter further recommended that the approach adopted on this issue should be consistent with the approach adopted for purposes of determining a partner's adjusted basis in its partnership interest.

The Treasury Department and the IRS agree that these two rules should be applied consistently. After further consideration, the Treasury Department and the IRS have decided to retain the rule that allows a partner's share of a partnership's investment assets to be determined using a reasonable method, taking into account special allocations under section 704(b). However, if a partner elects to apply the look-through rule, then the partner also must apply the basis determination rules. If a partner elects not to apply, or is precluded from applying, the look-through rule, then the approach the partner uses for purposes of the investment asset basis reduction rule must be consistent with the approach the partner uses to determine the partner's adjusted basis in its partnership interest.

v. Coordination of Section 752 Basis Reduction Rule and Investment Asset Basis Reduction Rule

Multiple commenters noted that the combined effect of the section 752 basis reduction rule and the investment asset basis reduction rule could require a partner, other than a C corporation or a tax-exempt corporation, in a partnership that holds investment assets funded by partnership liabilities to reduce the adjusted tax basis of its partnership interest twice—once for the partnership's basis in its investment assets, and a second time for the liabilities that funded their purchase. The Treasury Department and the IRS have determined that this result would be inappropriate. Accordingly, the final regulations amend the investment asset basis reduction rule by providing that, with respect to a partner other than a C corporation or tax-exempt corporation, the partner's adjusted basis in its partnership interest is decreased by the partner's share of the excess of (a) the partnership's asset basis with respect to those assets over (b) the partnership's debt that is traced to such assets in accordance with § 1.163–8T. In order to neutralize the effect of any cost recovery deductions associated with a partnership's investment assets funded by partnership liabilities (for example, non-trade or business property held for the production of income), the final regulations also amend the investment asset basis reduction rule by providing that, with respect to a partner other than a C corporation or tax-exempt corporation, the partner's adjusted basis in its partnership interest is increased by the partner's share of the excess of (a) the partnership's debt that is traced to such assets in accordance with § 1.163–8T over (b) the partnership's asset basis with respect to those assets.

vi. Allocating Basis in a Partnership Interest Between Excepted and Non-Excepted Trades or Businesses

A commenter requested explicit confirmation that, under the look-through rule, a partner allocates the basis of its partnership interest between excepted and non-excepted trades or businesses in the same proportion as the partner's share of the partnership's adjusted tax basis in its trade or business assets is allocated between excepted and non-excepted trades or businesses. The final regulations explicitly state that this is the rule.

Commenters also stated that the proposed regulations do not address how a partner should allocate business interest expense and business interest income under proposed § 1.163(j)–10(c) to the extent the partner (i) has zero basis in all partnership interests for purposes of section 163(j), and (ii) owns no other trade or business assets. The Treasury Department and the IRS have determined that these facts would be rare, particularly given the adjustments to partnership basis provided for in § 1.163(j)–10. Therefore, the final regulations do not include a rule addressing this fact pattern. However, the Treasury Department and the IRS request comments on how frequently this fact pattern would occur and how best to address such a situation.

3. Additional Limitation on Application of Look-Through Rules to C Corporations

A commenter noted that the look-through rules may be distortive if an individual (A) that is directly engaged in a trade or business also owns stock in a C corporation (with its own trade or business) that satisfies the section 1504(a)(2) ownership requirements. A's interest expense that is attributable to A's investment in the C corporation under § 1.163–8T retains its character as investment interest expense. Moreover, if A also has business interest expense, the allocation of that expense between excepted and non-excepted trades or businesses would appear to take into account A's investment in the C corporation on a look-through basis as well. Thus, A's shares in the C corporation may be double-counted insofar as they affect the character of both the directly attributable investment interest expense and the unrelated business interest expense.

To address the possible distortive effects of the look-through rules when applied to stock of a non-consolidated C corporation that is held as an investment, the final regulations provide that the look-through rule in § 1.163(j)–10(c)(5)(ii)(B)(*2*)(*i*) is available only if dividends paid on the stock would not be included in the taxpayer's investment income under section 163(d)(4)(B). Because corporations cannot have investment income under section 163(d)(4)(B), this additional requirement does not otherwise affect their ability to look-through the stock of a non-consolidated C corporation.

4. Dispositions of Stock in Non-Consolidated C Corporations

Under proposed § 1.163(j)–10(b)(4)(i), if a shareholder recognizes gain or loss upon the disposition of its stock in a non-consolidated C corporation, if such stock is not property held for investment, and if the taxpayer looks through to the assets of the C corporation under proposed § 1.163(j)–10(c)(5)(ii)(B), then the taxpayer must allocate gain or loss from the stock disposition 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. This rule is analogous to the look-through rule for dividends in proposed § 1.163(j)–10(b)(3).

However, the dividend look-through rule also provides that, if at least 90 percent of the payor corporation's adjusted basis in its assets during the taxable year is allocable to either excepted or non-excepted trades or businesses, then all of the taxpayer's dividend income from the payor corporation for the taxable year is treated as allocable to excepted or non-excepted trades or businesses, respectively. Commenters asked why the rule regarding the disposition of non-consolidated C corporation stock is not subject to a 90 percent de minimis rule analogous to the rule for dividends.

The Treasury Department and the IRS have determined that the rule regarding the disposition of stock in a non-consolidated C corporation (including a CFC) should be subject to a 90 percent de minimis rule. The final regulations have modified proposed § 1.163(j)–10(b)(4)(i) accordingly.

5. Application of Look-Through Rules to Small Businesses

Under proposed § 1.163(j)–10(c)(5)(ii)(D), a taxpayer may not apply the look-through rules in proposed § 1.163(j)–10(b)(3) and (c)(5)(ii)(A), (B), and (C) to an entity that is eligible for the small business exemption. As described in the preamble to the proposed regulations, the Treasury Department and the IRS determined that these 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 preamble to the proposed regulations also provides that a taxpayer that is eligible for the small business exemption may not make an election under proposed § 1.163(j)–9.

Commenters requested that entities that qualify for the small business exemption be allowed to make an election under proposed § 1.163(j)–9, and that such an electing entity's shareholders or partners be permitted to apply the look-through rules. Absent such a rule, shareholders and partners of a small business entity that conducts an excepted trade or business could be worse off than shareholders and partners of a larger entity (ineligible for the small business exemption) that conducts an excepted trade or business.

As noted in part X(A) of this Summary of Comments and Explanation of Revisions section, the Treasury Department and the IRS have determined that entities eligible for the small business exemption should be permitted to make a protective election under proposed § 1.163(j)–9. Accordingly, the final regulations also allow taxpayers to apply the look-through rules to entities that qualify for the small business exemption and that make a protective election under proposed § 1.163(j)–9.

6. Application of the Look-Through Rules to Foreign Utilities

Section 163(j)(7)(A)(iv) does not treat utilities that are exclusively regulated by foreign regulators (and not by a State government, a political subdivision of a State government, an agency or instrumentality of the United States, or the governing or ratemaking body of a domestic electric cooperative) (foreign-regulated utility) as excepted trades or businesses. As a result, under the interest allocation rules of proposed § 1.163(j)–10(c), a U.S. corporation that looks through to the assets of a CFC that operates a foreign-regulated utility must allocate its entire basis in its CFC stock to a non-excepted trade or business, even if all of the CFC's operating assets are used in a foreign-regulated utility business. Moreover, if the U.S. corporation has significant basis in its CFC stock, a significant portion of the U.S. corporation's business interest expense will be subject to the section

163(j) limitation, even if the U.S. corporation is solely or primarily engaged in an excepted utility trade or business.

A commenter noted that, if the U.S. corporation does not have sufficient income from non-excepted trades or businesses, the corporation might never be able to deduct its disallowed business interest expense. The commenter thus recommended that stock in a CFC engaged in a foreign-regulated utility trade or business be treated as having zero basis for purposes of the interest allocation rules in proposed § 1.163(j)–10(c).

The final regulations do not adopt the commenter's recommendation. However, the Treasury Department and the IRS have determined that, if a taxpayer applies the look-through rule to a CFC, the taxpayer may allocate its basis in its CFC stock to an excepted trade or business to the extent the CFC is engaged in either (i) an excepted trade or business, or (ii) a foreign-regulated utility trade or business that would be treated as an excepted trade or business if the utility meets certain requirements related to regulation by a foreign government. The final regulations have been modified accordingly. See § 1.163(j)–10(c)(5)(ii)(C)(*2*).

I. Deemed Asset Sale

Proposed § 1.163(j)–10(c)(5)(iv) provides that, 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, 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 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. As explained in the preamble to the proposed regulations, this deemed asset sale rule is intended to place taxpayers that are actually or effectively precluded from making an election under section 336, section 338, or section 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.

Commenters pointed out that, as a practical matter, a basis step-up election generally cannot be made if the acquired entity has a regulatory liability for deferred taxes on its books because, in that case, the election may cause customer bills to increase. In other words, deferred tax liabilities typically lower a utility's rate base (which is used to compute the rates charged to customers). An election under section 336, section 338, or section 754 would eliminate this deferred tax liability, thereby increasing the rate base and potentially increasing the rates charged to customers. As a result, regulatory agencies frequently do not approve a basis step-up election made in connection with the sale or purchase of a regulated utility. Commenters argued that even broaching the possibility of such a basis step-up could create concerns for the regulatory agency regarding a proposed acquisition. Commenters also queried how taxpayers that do not raise this issue with the regulatory agency can ''demonstrate'' that they were ''effectively precluded'' by the agency from making the election. In short, commenters claimed that the ''demonstration'' requirement in proposed § 1.163(j)–10(c)(5)(iv) would be impractical, result in unnecessary requests to regulatory agencies, lead to controversy, create uncertainty, and limit the effectiveness of this provision.

To address the foregoing concerns, the final regulations provide that a taxpayer that acquired or acquires an interest in a regulated entity should be deemed to have made an election to step up the tax basis of the assets of the acquired entity if the taxpayer can demonstrate that (a) the acquisition qualified for an election under section 336, 338, or 754, and (b) immediately before the acquisition, the acquired entity had a regulatory liability for deferred taxes on its books with respect to property predominantly used in an excepted regulated utility trade or business.

J. Carryforwards of Disallowed Disqualified Interest

Proposed § 1.163(j)–1(b)(10) defines the term ''disallowed disqualified interest'' to mean interest expense, including carryforwards, for which a deduction was disallowed under old section 163(j) in the taxpayer's last taxable year beginning before January 1, 2018, and that was carried forward under old section 163(j). Under the proposed regulations, disallowed disqualified interest that is properly allocable to a non-excepted trade or business is subject to the section 163(j) limitation as a disallowed business interest expense carryforward. See proposed §§ 1.163(j)–2(c)(1) and 1.163(j)–11(b)(1). In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments as to how the allocation rules in proposed § 1.163(j)–10 should apply to disallowed disqualified interest.

Commenters recommended several possible approaches to allocating disallowed disqualified interest between excepted and non-excepted trades or businesses. Under one approach (historical approach), a taxpayer would apply the allocation rules of proposed § 1.163(j)–10 to disallowed disqualified interest in the taxable year in which such interest expense was incurred. Although this approach would be consistent with the allocation rules for other business interest expense, it likely would be administratively burdensome for many taxpayers because such interest expense may have been incurred years (if not decades) ago.

Under another approach (effective date approach), a taxpayer would apply the allocation rules of proposed § 1.163(j)–10 to disallowed disqualified interest in the taxpayer's first taxable year beginning after December 31, 2017, as if the disallowed disqualified interest expense were incurred in that year. Although this approach would be less administratively burdensome than the historical approach, it might not accurately represent the taxpayer's circumstances in the year(s) in which the disallowed disqualified interest actually was incurred.

Under a third approach, taxpayers would be permitted to use any reasonable method to allocate disallowed disqualified interest between excepted and non-excepted trades or businesses, provided the method is applied consistently to disallowed disqualified interest that arose in the same taxable year. This approach also might include the effective date approach as a safe harbor. However, this approach could prove to be administratively burdensome for the IRS.

To reduce the administrative burden for both taxpayers and the IRS, the final regulations permit taxpayers to use either the historical approach or the effective date approach.

A commenter also pointed out that proposed § 1.163(j)–11(b)(1) could be construed as permitting only disallowed disqualified interest that is properly allocable to a non-excepted trade or business to be carried forward to the taxpayer's first taxable year beginning after December 31, 2017. The commenter requested confirmation that disallowed disqualified interest that is properly allocable to an excepted trade or business also is carried forward. The final regulations confirm this point. See § 1.163(j)–11(c)(1).

K. Anti-Abuse Rule

Proposed § 1.163(j)–10(c)(8) provides an anti-abuse rule to discourage taxpayers from manipulating the allocation of business interest expense and business interest income between non-excepted and excepted trades or businesses. Pursuant to this provision, 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 is not taken into account for purposes of § 1.163(j)–10.

A commenter expressed support for this rule but suggested that the final regulations eliminate the ''principal purpose'' standard and rely instead on a rule based on asset acquisitions, dispositions, or changes in use that do not have ''a substantial business purpose.''

The Treasury Department and the IRS have determined that using ''a substantial business purpose'' as the threshold for applying the anti-abuse rule would limit the effectiveness of this rule because taxpayers generally would be able to provide an ostensible business purpose for the acquisition, disposition, or transfer of an asset. Thus, the anti-abuse rule in the final regulations retains the ''principal purpose'' standard.

L. Direct Allocation

1. Overview

As previously noted, proposed § 1.163(j)–10(c) generally requires interest expense and interest income to be allocated between excepted and non-excepted trades or businesses according to the relative amounts of basis in the assets used in such trades or businesses. However, proposed § 1.163(j)–10(d) contains several exceptions to this general rule.

First, a taxpayer with qualified nonrecourse indebtedness is required to directly allocate interest expense from such indebtedness to the taxpayer's assets in the manner and to the extent provided in § 1.861–10T(b) (see proposed § 1.163(j)–10(d)(1)). Section 1.861–10T(b) defines the term ''qualified nonrecourse indebtedness'' to mean any borrowing (other than borrowings excluded by § 1.861–10T(b)(4)) that satisfies certain requirements, including the requirements that (i) the creditor can look only to the identified property (or any lease or other interest therein) as security for payment of the principal and interest on the loan, and (ii) the cash flow from the property is reasonably expected to be sufficient to fulfill the terms and conditions of the loan agreement. For these purposes, the term ''cash flow from the property'' does not include revenue if a significant portion thereof is derived from activities such as sales or the use of other property. Thus, revenue derived from the sale or lease of inventory or similar property, including plant or equipment used in the manufacture and sale or lease, or purchase and sale or lease, of such inventory or similar property, does not constitute cash flow from the property. See § 1.861–10T(b)(3)(i).

Second, a taxpayer that is engaged in the trade or business of banking, insurance, financing, or a similar business is required to directly allocate interest expense and interest income from such business to the taxpayer's assets used in that business (see proposed § 1.163(j)–10(d)(2)).

Additionally, for purposes of the general allocation rule in proposed § 1.163(j)–10(c), taxpayers are required to reduce their asset basis by the entire amount of the basis in the assets to which interest expense is directly allocated pursuant to proposed § 1.163(j)–10(d)(1) or (2). See proposed § 1.163(j)–10(d)(4).

2. Expansion of the Direct Allocation Rule

Some commenters recommended that the direct allocation rule in proposed § 1.163(j)–10(d) be applied in circumstances other than those set forth in proposed § 1.163(j)–10(d)(1) and (2). For example, a commenter queried whether a borrowing could be considered qualified nonrecourse indebtedness for purposes of proposed § 1.163(j)–10(d) even if the loan document doesn't require the creditor to look exclusively to an asset as security for payment of principal and interest on a loan (as required by § 1.861–10T(b)(2)(iii)). Other commenters asked that direct allocation be applied to debt directly incurred by an excepted regulated utility trade or business. These commenters argued that, because such debt must be approved by a regulatory agency and relates directly to the underlying needs of that trade or business, such debt should be viewed as ''properly allocable'' to that trade or business. Moreover, they claimed that the definition of ''qualified nonrecourse indebtedness'' in § 1.861–10T(b) is too narrow to include either debt directly incurred by an excepted regulated utility trade or business or debt incurred to purchase stock of a corporation or interests in a partnership primarily engaged in an excepted regulated utility trade or business.

In contrast, other commenters supported the decision to limit the availability of tracing to the limited circumstances in proposed § 1.163(j)–10(d).

As noted in part XI(L)(1) of this Summary of Comments and Explanation of Revisions section, a borrowing is not considered qualified nonrecourse indebtedness under § 1.861–10T(b) unless the creditor can look only to the identified property (or any interest therein) as security for the loan. By definition, the creditor on a non-recourse loan may not seek to recover the borrower's other assets; in other words, the creditor has no further recourse. The Treasury Department and the IRS decline to expand the exception in proposed § 1.163(j)–10(d)(1) to include unsecured debt because, by definition, such debt is supported by all of the assets of the borrower.

The Treasury Department and the IRS also have determined that the definition of qualified nonrecourse indebtedness should not be expanded to encompass indebtedness incurred to acquire stock or partnership interests in an entity primarily engaged in an excepted trade or business because such an approach is akin to tracing. As noted in the preamble to the proposed regulations, money is fungible, and the Treasury Department and the IRS have determined that a tracing regime would be inappropriate, with limited exceptions. The Treasury Department and the IRS have determined that the definition of qualified nonrecourse indebtedness should not be expanded to encompass all indebtedness directly incurred by regulated utility trades or businesses, for similar reasons.

However, the Treasury Department and the IRS appreciate that it is difficult for utility trades or businesses to avail themselves of the direct allocation rule in proposed § 1.163(j)–10(d)(1) given the definition of qualified nonrecourse debt in § 1.861–10T(b). In particular, the Treasury Department and the IRS understand that the exclusion of inventory revenue from the calculation of ''cash flow from the property'' effectively precludes many utilities from using direct allocation under proposed § 1.163(j)–10(d)(1). Thus, solely for purposes of the allocation rules in proposed § 1.163(j)–10, the final regulations create an exception to the definition of qualified nonrecourse indebtedness in § 1.861–10T(b) to allow for the inclusion of revenue from the sale or lease of inventory for utility trades or businesses.

Another commenter recommended that, for taxpayers engaged in excepted regulated utility trades or businesses, the basis in certain grants and contributions in aid of construction should be directly allocated to non-excepted trades or businesses if the costs have not been taken into account by a regulatory body in determining the cost of the utility's service for ratemaking purposes. As discussed in part II of this Summary of Comments and Explanation of Revisions section, the final regulations do not require the rates for the sale or furnishing of utility items to be established or approved on a cost of service and rate of return basis in order for a utility trade or business to qualify as an excepted regulated utility trade or business. Without such a requirement, the Treasury Department and the IRS do not find a significant nexus between a regulatory body's determination of a utility trade or business's cost of service and the allocation of the basis in grants and contributions in aid of construction. Therefore, the final regulations do not adopt the commenter's recommendation.

3. Basis Reduction Requirement for Qualified Nonrecourse Indebtedness

Commenters noted that, as drafted, the basis reduction requirement in proposed § 1.163(j)–10(d)(4) would lead to inappropriate results for assets that are acquired using both equity financing and qualified nonrecourse indebtedness (or using both recourse and nonrecourse indebtedness) because this requirement would remove asset basis that was not financed by qualified nonrecourse indebtedness.

Commenters also observed that this requirement could lead to significant distortions because a small amount of qualified nonrecourse indebtedness would cause an entire property to be removed from a taxpayer's basis allocation computation. For example, assume a taxpayer has (i) $500,000 of unsecured debt, (ii) property used in an excepted trade or business with a basis of $10 million and $100,000 of qualified nonrecourse indebtedness (Asset A), and (iii) a non-excepted trade or business whose assets have a basis of $1 million. Under proposed § 1.163(j)–10(d)(4), Asset A would be entirely excluded from the basis allocation computation in proposed § 1.163(j)–10(c). As a result, all interest expense on the $500,000 of unsecured debt would be subject to the section 163(j) limitation.

Commenters further noted that taxpayers could take advantage of this basis adjustment rule to minimize the application of section 163(j). In other words, taxpayers could incur a relatively small amount of nonrecourse debt to acquire assets used in non-excepted trades or businesses, thereby reducing the amount of asset basis allocated to such trades or businesses for purposes of the general allocation rule in proposed § 1.163(j)–10(c).

To eliminate these distortions and inappropriate results, commenters recommended that basis in the assets securing qualified nonrecourse indebtedness be reduced (but not below zero) for purposes of the general allocation rule solely by the amount of such qualified nonrecourse indebtedness. The Treasury Department and the IRS agree with this recommendation, and the final regulations have been modified accordingly.

4. Direct Allocation Rule for Financial Services Businesses

Commenters asked for clarification of the direct allocation rule for financial services entities in proposed § 1.163(j)–10(d)(2). For example, commenters noted that, because the definition in § 1.904–4(e)(2) includes income from certain services (including investment advisory services), this rule may apply to taxpayers that are not doing much actual financing, and commenters queried whether the direct allocation rule should apply to such taxpayers. Commenters also asked whether proposed § 1.163(j)–10(d)(2) is intended to cover all of a bank's activities or only part of them and, if the answer is the latter, whether a bank must bifurcate its activities for purposes of proposed § 1.163(j)–10.

Commenters also questioned the basis reduction rule in proposed § 1.163(j)–10(d)(4) for financial services businesses. Commenters noted that, unlike the case of qualified nonrecourse indebtedness, it may not be possible to trace all interest expense related to a financial services business to specific assets. Moreover, requiring a taxpayer to fully eliminate its basis in the assets of a financial services business under proposed § 1.163(j)–10(d)(4) could be distortive because the taxpayer's general debt obligations likely support at least some portion of the taxpayer's financial services business assets.

Given the uncertainty surrounding the proper scope of the direct allocation rule for financial services businesses in proposed § 1.163(j)–10(d)(2) and the proper application of the basis reduction rule to such businesses in proposed § 1.163(j)–10(d)(4), the Treasury Department and the IRS have decided to remove proposed § 1.163(j)–10(d)(2). To ensure that financial services entities are not unduly affected by the rule (in proposed § 1.163(j)–10(c)(5)(iii)) that excludes cash and cash equivalents from the general asset basis allocation rule in proposed § 1.163(j)–10(c), the final regulations have retained the exception in proposed § 1.163(j)–10(c)(5)(iii) for financial services entities.

XII. Comments on Proposed Changes to § 1.382–2: General Rules for Ownership Change

As described in the preamble to the proposed regulations, section 382(k)(1) provides that, for purposes of section 382, the term ''loss corporation'' includes a corporation entitled to use a carryforward of disallowed interest described in section 381(c)(20), which refers to carryovers of disallowed business interest described in section 163(j)(2). Section 163(j)(2) permits business interest expense for which a deduction is disallowed under section 163(j)(1) to be carried forward to the succeeding taxable year.

In turn, section 382(d)(3) provides that the term ''pre-change loss'' includes disallowed business interest expense carryforwards ''under rules similar to the rules'' in section 382(d)(1). 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 changes to § 1.382–2 clarified 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, and that a ''loss corporation'' includes a corporation that is entitled to use a carryforward of such a disallowed business interest expense.

Commenters noted that, viewed in isolation, section 382(k)(1) would not appear to apply to a corporation that has only a current-year disallowed business interest expense. Some commenters also claimed that the inclusion of current-year disallowed business interest expense in the definition of a ''loss corporation'' is inconsistent with the statutory language of section 382(k)(1).

The Treasury Department and the IRS have determined that section 382 should apply to current-year disallowed business interest expense (to the extent such expense is allocable to the pre-change period) because this approach is consistent with the statutory treatment of NOLs. See section 382(k)(1) (providing, in part, that the term ''loss corporation'' means a corporation ''having a net operating loss for the taxable year in which the ownership change occurs''). Moreover, as a policy matter, current-year attributes that relate to the period before an ownership change should be subject to section 382. The exclusion of these items would permit trafficking in losses, which is contrary to the stated policy underlying section 382 of preventing ''exploit[ation] by persons other than those who incurred the loss.'' H. Rept. 83–1337, at 42 (1954). Thus, no changes to the final regulations have been made in response to these comments. However, the final regulations revise the definition of a ''section 382 disallowed business interest carryforward'' (which includes both disallowed business interest expense carryforwards and current-year disallowed business interest expense allocable to the pre-change period) in § 1.382–2(a)(7) to reflect changes to the allocation rules discussed in part XIII of this Summary of Comments and Explanation of Revisions section.

XIII. Comments on Proposed Changes to § 1.382–6: Allocation of Income and Loss to Periods Before and After the Change Date for Purposes of Section 382

Section 1.382–6 provides rules for the allocation of income and loss to periods before and after the change date for purposes of section 382. Section 1.382–6(a) generally provides that a loss corporation must allocate its net operating loss or taxable income, and its net capital loss or modified capital gain net income, for the change year between the pre-change and post-change periods by ratably allocating an equal portion to each day in the year. Section 1.382–6(b), which contains an exception to this general rule, permits a loss corporation to elect to allocate the foregoing items for the change year between the pre-change and post-change periods as if the loss corporation's books were closed on the change date. Such an election does not terminate the loss corporation's taxable year as of the change date (in other words, the change year is still treated as a single tax year for Federal income tax purposes).

The proposed regulations revise § 1.382–6 to address the treatment of business interest expense. More specifically, the proposed regulations provide that, regardless of whether a loss corporation has made a closing-of-the-books election under § 1.382–6(b), the amount of the corporation's deduction for current-year business interest expense is calculated based on ratable allocation for purposes of calculating the corporation's taxable income attributable to the pre-change period.

Commenters objected to the mandatory use of ratable allocation for business interest expense in § 1.382–6. For example, commenters argued that this approach is distortive (and taxpayer-unfavorable) in situations in which the loss corporation incurs minimal interest expense in the pre-change period but makes highly leveraged acquisitions in the post-change period. Another commenter noted that this approach is distortive (and taxpayer-favorable) in situations in which the loss corporation incurs significant business interest expense in the pre-change period and allocates a portion of that expense to the post-change period. To avoid these distortions and complications, commenters recommended that a closing-of-the-books election also be allowed for business interest expense.

The Treasury Department and the IRS acknowledge that a ratable allocation approach may lead to distortions and administrative burdens in certain situations. Thus, the final regulations permit a loss corporation to allocate current-year business interest expense between the pre-change and post-change periods using the closing-of-the-books method set forth in § 1.382–6(b)(4) if the loss corporation makes a closing-of-the-books election under § 1.382–6(b). Section 1.382–6(b)(4) also provides correlative rules for the allocation of disallowed business interest expense carryforwards to the pre-change and post-change periods when a closing-of-the-books election is made. In turn, section 1.382–6(a)(2) clarifies the amount of business interest expense, disallowed business interest expense, and disallowed business interest expense carryforwards that are allocable to the pre-change and post-change periods if no closing-of-the-books election is made.

XIV. Comments on and Changes to Proposed § 1.383–1: Special Limitations on Certain Capital Losses and Excess Credits

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. Under proposed changes to § 1.383–1(d), a taxpayer's section 382 limitation would be absorbed by disallowed business interest expense carryforwards before being absorbed by NOLs. As described in the preamble to the proposed regulations, the Treasury Department and the IRS prioritized the use of disallowed business interest expense carryforwards over 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.''

Although commenters described the foregoing ordering rule as understandable and fairly simple to administer, they noted that pre-2018 NOLs (unlike disallowed business interest expense carryforwards) have a limited carryforward period, and that such NOLs may expire without use as a result of this ordering rule. Commenters thus recommended allowing taxpayers to elect an alternative ordering rule with respect to pre-2018 NOLs.

The Treasury Department and the IRS have decided not to adopt this recommended approach, for several reasons. First, as commenters also noted, such an approach would add complexity. Second, as stated in the preamble to the proposed regulations, deductions for business interest expense (including disallowed business interest expense carryforwards) factor into the determination whether and to what extent a taxpayer can use an NOL in a taxable year. Thus, no changes have been made to proposed § 1.383–1(d) in the final regulations.

XV. Other Comments About Section 382

A. Application of Section 382(l)(5)

Section 382(l)(5) provides an exception to the general loss limitation rule under section 382(a) for an old loss corporation in Title 11 proceedings or in similar cases if the historic shareholders and creditors of such corporation own at least 50 percent of the stock of the new loss corporation as a result of being shareholders or creditors immediately before the ownership change. If this exception applies, the corporation's pre-change losses and excess credits that may be carried over to a post-change year must be ''computed as if no deduction was allowable under this chapter for the interest paid or accrued'' on debt converted into stock under Title 11 (or in a similar case) during the 3-year period preceding the year of the ownership change (change year) or during the pre-change period in the change year. Section 382(l)(5)(B). In other words, because the old loss corporation gets the benefit of treating certain creditors as shareholders for purposes of determining whether the corporation has undergone an ownership change within the meaning of section 382(g), the corporation must treat the debt held by such creditors as equity for Federal income tax purposes. As a result, the corporation must treat the interest payments as non-deductible distributions on equity.

As provided in proposed § 1.382–2, section 382 disallowed business interest carryforwards are pre-change losses. Because a deduction for such carryforwards is ''allowable'' in a future year, commenters asked whether such carryforwards must be recomputed under section 382(l)(5)(B).

The Treasury Department and the IRS have determined that no clarification of the rule is necessary. Because section 382 disallowed business interest carryforwards are pre-change losses, if a corporation has such a carryforward from any taxable year ending during the 3-year period preceding the change year (or during the pre-change period in the change year), and if section 382(l)(5) applies to an ownership change, the corporation must recompute the amount of such carryforwards as if the business interest expense that generated such carryforwards were not interest.

B. Application of Section 382(e)(3)

A commenter also recommended that the final regulations address the application of section 382(e)(3) to foreign corporations with section 382 disallowed business interest carryforwards. Section 382(e)(3) provides that, except as otherwise provided in regulations, only items treated as connected with the conduct of a U.S. trade or business are taken into account in determining the value of an old loss corporation that is a foreign corporation if an ownership change occurs. Thus, if a foreign corporation is not engaged in a U.S. trade or business, that corporation's section 382 limitation is zero. As a result, if a foreign corporation with no U.S. trade or business undergoes a section 382 ownership change, section 382(e)(3) appears to limit the corporation's section 382 disallowed business interest carryforwards to $0. The commenter described this result as onerous and unintended and recommended that, for purposes of applying section 382 to such carryforwards, a foreign corporation's value be treated as the total value of its stock.

The Treasury Department and the IRS are aware of this issue and other issues relating to the application of section 382 to CFCs. The Treasury Department and the IRS continue to study the application of section 382 to CFCs and may address this issue in future guidance. The Treasury Department and the IRS welcome further comments on the application of section 382 to CFCs.

C. Application of Section 382(h)(6)

As noted in the Background section, the September 2019 section 382 proposed regulations included a rule expressly providing that section 382 disallowed business interest carryforwards are not treated as RBILs, thus precluding a double detriment under section 382 with respect to such carryforwards. This conclusion might have been reached by application of the general anti-duplication principles reflected in the current regulations under section 382. See, for example, § 1.382–8(d) (regarding duplicative reductions in value of loss corporations). However, because of the complexity of this area, the Treasury Department and the IRS included the clarification to prevent possible confusion and to provide certainty to taxpayers that there is no double detriment with respect to section 382 disallowed business interest carryforwards. Although no formal comments were received on this rule during the comment period for the September 2019 section 382 proposed regulations, informal comments from practitioners active in the field have been uniformly positive and have confirmed that this rule is a welcome, taxpayer-beneficial addition to the regulations under section 382.

Due to the uncontroversial nature of this rule, the Treasury Department and the IRS have determined that finalization of this portion of the September 2019 section 382 proposed regulations is warranted at this time. The Treasury Department and the IRS continue to actively study the remainder of the rules in the September 2019 section 382 proposed regulations.

XVI. Definition of Real Property Trade or Business

Commenters suggested that the definition of a ''real property trade or business'' should be clarified to include all rental real estate, even if the rental real estate does not rise to the level of a section 162 trade or business. The Treasury Department and the IRS have determined that modifications to the rules in the proposed regulations are not necessary to make this point clear. Section 1.469–9(b)(1) provides that the definition of a ''trade or business'' (for purposes of section 469(c)(7)(C)) includes interests in rental real estate even if the rental real estate gives rise to deductions under section 212. The definition of real property trade or business in § 1.469–9(b)(2) (for purposes of section 469(c)(7)(C)) necessarily would encompass or include the definition of a trade or business as provided in § 1.469–9(b)(1). Accordingly, taxpayers engaged in rental real estate activities that do not necessarily rise to the level of a section 162 trade or business nevertheless will be treated as engaged in real property trades or businesses for purposes of section 469(c)(7)(C) (and section 163(j) by reference), and such taxpayers will be permitted to make the election for a trade or business to be an electing real property trade or business for purposes of section 163(j).

Commenters also requested clarification that a trade or business should not be required to have a direct nexus or relationship to rental real estate in order to qualify as a real property trade or business under section 469(c)(7)(C). The Treasury Department and the IRS agree that businesses involving real property construction, reconstruction, development, redevelopment, conversion, acquisition, or brokerage should not necessarily be required to have a direct nexus or relationship to rental real estate to be treated as a real property trade or business under section 469(c)(7)(C). The proposed regulations provide definitions for the terms ''real property management'' and ''real property operations'' while reserving the remaining nine terms in section 469(c)(7)(C) as undefined. The statement in the preamble to the proposed regulations regarding a nexus or relationship to rental real estate was intended as the rationale for the decision to limit the definition of the two terms to the management and operation of rental real estate. Without these limiting definitions, the Treasury Department and the IRS were concerned that these two terms could be read so broadly as to allow virtually any type of business to qualify as a real property trade or business. The other nine terms in section 469(c)(7)(C) currently remain undefined, although the Treasury Department and the IRS intend to issue additional guidance in the future to provide definitions for these terms.

The Treasury Department and the IRS generally agree with the observation that real property construction, reconstruction, development, redevelopment, conversion, acquisition, or brokerage businesses should not necessarily be required to have a direct nexus or relationship to rental real estate in order to be treated as real property trades or businesses. However, the expectation nevertheless remains that the end products or final objectives of such businesses should at least have the potential to be used as rental real estate or as integral components in rental real estate activities.

Several commenters requested clarification regarding whether timberlands will qualify as real property trades or businesses. The Treasury Department and the IRS have concluded that unharvested or unsevered timber clearly fall within the definition of ''real property'' as provided in the proposed regulations. The question is whether the activity of holding of timberlands falls within the definition of a ''real property trade or business.'' The Treasury Department and the IRS have concluded that the maintenance and management of timberlands generally does not meet the intended meaning of any of the eleven terms in section 469(c)(7)(C), and that the owners of timberlands were not intended recipients for relief from the per se passive rule for rental real estate when section 469(c)(7) originally was enacted. However, as set forth in the Concurrent NPRM, such activities might constitute the development of real estate within the meaning of section 469(c)(7)(C). See proposed § 1.469–9(b)(2)(ii)(A) and (B) contained in the Concurrent NPRM.

One commenter requested an example illustrating that the management or operation of a pipeline or transmission line will meet the definition of a real property trade or business. In addition, another commenter requested an example illustrating that the operation of a bridge, tunnel, toll road, or airport qualifies as a real property trade or business.

Although the Treasury Department and the IRS generally agree that the operation of a pipeline, bridge, tunnel, toll road, or airport may meet the definition of a real property trade or business under certain and specific facts and circumstances, the answers to these questions will remain dependent on the facts and circumstances of each case. The Treasury Department and the IRS expect that such examples generally will provide very limited guidance to most taxpayers because any such examples likely will be viewed as inapplicable for taxpayers with any differing facts and circumstances.

Additionally, one commenter recommended removing the reference to the term ''customers'' from the definitions of the terms ''real property management'' and ''real property operation'' because, in certain situations, the party paying for the use of the property or for other services may be a governmental agency providing services to the general public or for the public good. The Treasury Department and the IRS have determined that this modification is unnecessary because the term ''customer'' for this purpose is broad enough to include governmental entities.

One commenter also requested that the definition of a real property trade or business be revised to include broadband, street lighting, telephone poles, parking meters, and rolling stock. The Treasury Department and the IRS decline to revise the definition of real property trade or business in section 469(c)(7)(C) in this manner because the maintenance and management of these types of assets generally do not meet the intended meaning of any of the eleven terms in section 469(c)(7)(C), and the owners of such assets were not intended recipients for relief from the per se passive rule for rental real estate when section 469(c)(7) originally was enacted.

One commenter requested that the final regulations remove the last sentence in the definition of each of the terms ''real property management'' and ''real property operation.'' The commenter stated that these sentences create confusion regarding whether incidental services provided along with rental real estate will cause the business to fail to qualify as a real property trade or business. In response to this comment, the Treasury Department and the IRS have revised these sentences to clarify that incidental services, even if significant, do not disqualify a business as a real property trade or business.

Statement of Availability of IRS Documents

The IRS Notices, Revenue Rulings, 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 Publishing Office, Washington, DC 20402, or by visiting the IRS website at *http://www.irs.gov.*

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.

The final regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. OMB has designated this final regulation as economically significant under section 1(c) of the Memorandum of Agreement. Accordingly, the final regulations have been reviewed by OMB's Office of Information and Regulatory Affairs. For purposes of E.O. 13771 this rule is regulatory.

A. Need for the Final Regulations

The Tax Cuts and Jobs Act (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. As a result of those changes, a number of the relevant terms and necessary calculations that taxpayers are required to apply under the statute can benefit from greater specificity. The Treasury Department and the IRS issued proposed regulations related to section 163(j) on December 28, 2018 (proposed regulations). The comments to the proposed regulations demonstrate a variety of opinions on how to define terms and on how section 163(j) interacts with other sections of the Code and corresponding regulations.

Based on these considerations, the final regulations are needed to bring clarity to instances where the meaning of the statute was unclear and to respond to comments received on the proposed regulations. Among other benefits, the clarity provided by the final regulations generally helps ensure that all taxpayers calculate the business interest expense limitation in a similar manner.

B. 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 limited exceptions. As described in the preamble to the proposed regulations (83 FR 67490), 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. With the enactment of TCJA, 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 adjusted taxable income (ATI) for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year. As described in the Background section earlier, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) amended section 163(j) to provide special rules relating to the ATI limitation for taxable years beginning in 2019 or 2020. The section 163(j) limitation applies to all taxpayers, except for certain small businesses with average annual gross receipts of $25 million or less (adjusted for inflation) and 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. 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 the TCJA, in part, out of concern that prior law treated debt-financed investment more favorably than equity-financed investment. According to Congress, this debt bias generally encouraged taxpayers to utilize more leverage than they would 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.R. Rep. No. 115–409, at 247 (2017)).

C. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the economic effects of the final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these final regulations.

2. Summary of Economic Effects

The final regulations provide certainty and clarity to taxpayers regarding terms and calculations that are contained in section 163(j), which was substantially modified by TCJA. In the absence of this clarity, the likelihood that different taxpayers would interpret the rules regarding the deductibility of business interest expense differently would be exacerbated. In general, overall economic performance is enhanced when businesses face more uniform signals about tax treatment. Certainty and clarity over tax treatment also reduce compliance costs for taxpayers. For those situations where taxpayers would generally adopt similar interpretations of the statute even in the absence of guidance, the final regulations provide value by helping to ensure that those interpretations are consistent with the intent and purpose of the statute. For example, the final regulations may specify a tax treatment that few or no taxpayers would adopt in the absence of specific guidance but that nonetheless advances Congressional intent.

The Treasury Department and the IRS project that the final regulations will have an annual economic effect greater than $100 million ($2020). This determination is based on the substantial volume of business interest payments in the economy [2] and the general responsiveness of business investment to effective tax rates,[3] one component of which is the deductibility of interest expense. Based on these two magnitudes, even modest changes in the deductibility of interest payments (and in the certainty of that deductibility) provided by the final regulations, relative to the no-action baseline, can be expected to have annual effects greater than $100 million. This claim is particularly likely to hold for the first set of general 163(j) guidance that is promulgated following major legislation, such as TCJA.

The Treasury Department and the IRS have not undertaken more precise estimates of the economic effects of changes in business activity stemming from these final regulations. The Treasury Department and the IRS do not have readily available data or models that predict with reasonable precision the decisions that taxpayers would make under the final regulations versus alternative regulatory approaches, including the no-action baseline. Nor do they have readily available data or models that would measure with reasonable precision the loss or gain in economic surplus resulting from those business decisions relative to the decisions that would be made under an alternative regulatory approach. Such estimates would be necessary to quantify the economic effects of the final regulations versus alternative approaches.

In the absence of such quantitative estimates, the Treasury Department and the IRS have undertaken a qualitative analysis of the economic effects of the final regulations relative to the no-action baseline and relative to alternative regulatory approaches. This analysis is presented in the next two sections of this Special Analyses.

3. Economic Effects of Provisions Substantially Revised From the Proposed Regulations

a. Calculation of ATI

Similar to the proposed regulations, the final regulations prescribe various 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 all taxpayers are treated equitably when calculating ATI. One of these adjustments prevents the double counting of depreciation deductions when a depreciable asset is sold (only relevant for depreciation deductions in taxable years beginning after December 31, 2017, and before January 1, 2022). Other adjustments apply to particular types of taxpayers, such as regulated investment companies (RICs), real estate investment trusts (REITs), or consolidated groups.

As an alternative, the Treasury Department and the IRS considered not providing such adjustments. Without such adjustments, however, 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 entities would almost always have ATI of zero or close to zero. This outcome would limit the ability of such taxpayers to ever deduct business interest expense for Federal income tax purposes even when their financing profile was similar to other entities that could deduct similar net business interest expense.

Based on calculations using the IRS's Statistics of Income (SOI) sample of corporate taxpayers for 2017, the Treasury Department and the IRS estimate that approximately $13.5 billion of net business interest expense is potentially affected by the dividends paid deduction adjustment to ATI provided to RICs and REITs in the final regulations. This net business interest expense is the amount of interest expense that is greater than interest income for RICs and REITs with gross receipts greater than $25 million.

The final regulations make one notable change compared to the proposed regulations regarding the ATI calculation for taxpayers that manufacture or produce inventory. Under the proposed regulations, the

[2] Interest deductions in tax year 2013 for corporations, partnerships, and sole proprietorships were approximately $800 billion.

[3] See E. Zwick and J. Mahon, ''Tax Policy and Heterogeneous Investment Behavior,'' at *American Economic Review* 2017, 107(1): 217–48 and articles cited therein.

amount of any depreciation, amortization, or depletion that is capitalized into inventory under section 263A during a taxable year beginning before January 1, 2022 was not added back to taxable income when calculating ATI for that taxable year. Under the final regulations, such amounts are added back to tentative taxable income, regardless of the period in which the capitalized amount is recovered through cost of goods sold.

Without the final regulations, a taxpayer with depreciation, amortization, or depletion expense that is subject to capitalization would have lower ATI (and potentially a higher tax liability due to smaller net interest deductions) than a similarly situated taxpayer with depreciation, amortization, or depletion expense that is not subject to capitalization. Thus, the effect of the final regulations for the calculation of ATI is to prevent economic distortions by having the net interest limitation apply more stringently for certain types of taxpayers than others. The final regulations achieve this outcome more effectively that alternative regulatory approaches, including the proposed regulations and the no-action baseline.

Number of Affected Taxpayers. The Treasury Department and the IRS estimate that roughly 61,000 entities are both (i) subject to calculating their section 163(j) net interest limitation and (ii) required by the Code to capitalize any expenses, including depreciation, amortization, or depletion expenses. This estimate is an upper bound estimate of the number of taxpayers potentially affected by the definition of ATI prescribed under the regulations because capitalized depreciation, amortization, or depletion expenses are not separately reported and this tax return item includes other types of capitalized expenses.

b. Definition of Interest

The statute limits the amount of deductible interest expense for a taxpayer but, as described in the Explanation of Provisions section of the proposed regulations, 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 counted as interest. While 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), these rules only apply to particular taxpayers in particular situations.

The proposed regulations defined interest for the purpose of the section 163(j) limitation as (1) amounts associated with conventional debt instruments and amounts already treated as interest for all purposes under existing statutory provisions or regulations; (2) additional amounts that are functionally similar to interest but not currently labeled as interest under the Code, or amounts treated as interest for certain purposes, such as amounts described in §§ 1.861–9T and 1.954–2; and (3) any deductible expense or loss predominantly incurred in consideration of the time value of money as part of an anti-avoidance rule. Thus, the proposed regulations applied to interest associated with conventional debt instruments as well as generally to transactions that are indebtedness in substance even if not in form.

The Treasury Department and the IRS proposed this definition of interest, rather than leaving the term interest undefined for purposes of section 163(j). In the absence of this clarity, the likelihood that different taxpayers would reach different conclusions over whether a particular business expense was deductible business interest expense would be exacerbated. In general, overall economic performance is enhanced when businesses face more uniform signals about tax treatment. Another concern about not defining the term at all is that taxpayer uncertainty over whether certain transactions are considered interest 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.

A further concern, over providing a narrower definition of interest, is that it could encourage taxpayers to engage in transactions that provide financing while generating deductions economically similar to interest but that were not defined as interest for the purposes of section 163(j). There are several reasons why curbing such taxpayer behavior would be beneficial. First, the ability of taxpayers to engage in such transactions is correlated with the size of the trade or business, with large businesses more likely to benefit from such avoidance strategies than small businesses. Second, 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. Third, such avoidance strategies may 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. Fourth, 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 final regulations prescribe a definition of interest that is similar to the definition of interest in the proposed regulations although with changes made in response to comments.[4] There are three general types of changes: (1) Changes are made to the proposed regulations that modify, and generally limit, to what extent certain amounts are included under the definition of interest for the purposes of section 163(j). (2) Several items deemed to be interest for the purpose of section 163(j) under proposed § 1.163(j)–1(b)(20)(iii) are not included in the final regulations. (3) The anti-avoidance rule in proposed § 1.163–1(b)(20)(iv) is modified to include a principal purpose test and now also applies to situations where a taxpayer seeks to artificially increase the amount of interest income.

To the extent that these changes narrow the definition of interest that is subject to the section 163(j) limitation relative to the proposed regulations, they are expected to (i) reduce the cost of financing for taxpayers, an effect that is expected to increase investment by these taxpayers, and (ii) increase the proportion of that financing that might generally be considered debt-financed. The first effect occurs because taxpayers can deduct without limitation costs from a larger set of financial instruments under the final regulations, relative to the proposed regulations. They will choose these instruments only if the cost of obtaining funds through those instruments is lower than what would have been available under the proposed regulations. By extension, this change lowers the overall cost of financing for taxpayers. A lower cost of financing is associated with greater investment by taxpayers, all other things equal. The second effect occurs because the larger set of financial instruments for which taxpayers can deduct expense without limitation (under the final regulations,

[4] The proposed regulations represent the regulatory alternative to which the final regulations are compared in the following analysis.

relative to the proposed regulations) generally consists of instruments that have a greater share of debt characteristics, rather than equity characteristics. To the extent that taxpayers use these instruments to a greater degree under the final regulations relative to the proposed regulations, the share of debt-financing will increase. Congress has generally expressed the view that excessive debt-financing may be a less efficient capital structure for firms. See Senate Budget Explanation of the Bill at 165.

Because the final regulations define interest based on the intent and purpose of the statute and generally treat similar taxpayers similarly and similar economic activity similarly, the Treasury Department and the IRS have determined that the net result under these final regulations is a more efficient allocation of capital across taxpayers relative to regulatory alternatives, within the context of the intent and purpose of the statute.

The Treasury Department and the IRS have not undertaken quantitative estimates of the change in the level or nature of economic activity arising from the final regulations relative to the proposed regulations due to limitations on available data, but to the extent possible has provided further below an estimate of the quantity of potentially affected taxpayers and volume of transactions. Consider, for example, the treatment of guaranteed payments for the use of capital provided by a partner to a partnership, a financial arrangement that has both equity and debt characteristics. The proposed regulations included guaranteed payments to capital in the definition of interest while the final regulations do not, except to the extent that they are covered by other provisions of the final regulations. The Treasury Department and the IRS have not undertaken quantitative estimates of this regulatory decision because we do not have readily available data or models to measure with sufficient precision: (i) The volume and nature of guaranteed payments to capital and other financial instruments that taxpayers might use if the final regulations were in effect; (ii) the volume and nature of guaranteed payments and other financial instruments that taxpayers might have used if the proposed regulations were in effect; and (iii) the types of economic activities that partnerships might undertake under these two financial portfolios. Regarding item (iii), the Treasury Department and the IRS do not have readily available data or models to predict how economic activity might differ under debt-financed versus equity-financed investment for the sets of instruments affected by these final regulations.

Compliance costs are also expected to be lower for those transactions that are not subject to the section 163(j) limitation under the final regulations and that would be subject to the limitation under the proposed regulations. Generally, this is because taxpayers would be less likely to need to calculate the section 163(j) limitation and less likely to need to track unused interest deductions that are carried forward to future tax years. For most taxpayers, this impact on compliance costs is expected to be relatively small. However, for certain taxpayers using hedging transactions, calculating the amount of interest associated with the transactions would be burdensome and not including such transactions in the definition of interest lowers compliance costs to a greater degree. The Treasury Department and the IRS have not estimated the reduction in compliance costs for these taxpayers (under the final regulations, relative to the proposed regulations) because we do not have data or models that are suitable for this estimation.

The specific changes made with regard to items (1), (2), and (3) are discussed in further detail here.

(1) The final regulations change (relative to the proposed regulations) how amounts from certain transactions will be considered interest for the purposes of section 163(j). There are two main forms of transactions that are affected:

Treatment of swaps. The proposed regulations treated a non-cleared swap with significant non-periodic payments as two separate transactions consisting of an on-market, level payment swap and a loan (the embedded loan rule).[5] The time value component associated with the embedded loan is recognized as interest expense to the payor and interest income to the recipient. The treatment of cleared swaps was not specified in the proposed regulations. The final regulations add two exceptions to the embedded loan rule. Specifically, the final regulations add exceptions for cleared swaps and for those non-cleared swaps that require the parties to meet the margin or collateral requirements of a federal regulator (or requirements that are substantially similar to a federal regulator). Relative to the proposed regulations this treatment will discourage taxpayers from using swaps that are unregulated and dissimilar to regulated swaps, because under the final regulations only such swaps will require the time value component associated with the embedded loan to be treated as interest. One reason for excepting both regulated and non-regulated collateralized swaps from the definition of interest is that the repayment risk of using such transactions is small, while the non-collateralized swaps are more risky as individual transactions and would be likely to contribute to the overall riskiness of the financial system.

Substitute interest payments. The proposed regulations provided that certain substitute interest payments will be treated as interest for the purposes of section 163(j).[6] The final regulations modify the treatment of substitute interest payments by only including such transactions as interest when the transaction is not part of the ordinary course of business of the taxpayer. The Treasury Department and the IRS have determined that the ordinary course rule in the final regulations provides an appropriate and effective limit on the treatment of substitute interest as interest for section 163(j) purposes. This change has the effect of reducing the amount of substitute interest payments that will be deemed interest for the purpose of section 163(j) relative to the proposed regulations.

For taxpayers that use substitute interest payments in the ordinary course of business, the final regulations may lower the after-tax cost of such transactions and such taxpayers are more likely to use transactions with substitute interest payments relative to the proposed regulations. The Treasury Department and the IRS do not have readily available data or models to estimate either (i) the change in financing arrangements, including both substitute interest payments and other financial instruments, that will be used by taxpayers under this provision of the final regulations relative to the proposed regulations, or (ii) the change in the volume or nature of economic activity by these taxpayers given these financing arrangements.

(2) The items removed by the final regulations from the definition of interest in the proposed regulations include debt issuance costs, guaranteed payments for the use of capital provided

[5] A cleared swap is a collateralized swap that was cleared by a derivatives clearing organization or by a clearing agency. A non-cleared swap is a swap that has not been so cleared.

[6] A substitute interest payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to an interest payment which the owner of the transferred security is entitled to receive during the term of the transaction. This provision applies to substitute interest payments as described in § 1.861–2(a)(7).

by a partner to a partnership, and hedging transactions.[7] Under the final regulations, these items can still be considered interest under the anti-avoidance rule. These items share some characteristics with interest, but comments received on the proposed regulations indicate there is not a consensus that such items should always be defined as interest. Removing these items from the definition of interest lowers compliance costs for taxpayers in some cases relative to the proposed regulations. However, not including these items in the definition of interest increases uncertainty regarding whether amounts from certain transactions will be treated as interest under the anti-avoidance rule, and more disputes are likely to arise between taxpayers and the IRS.

The final regulations do not include debt issuance costs, such as legal fees for document preparation, in the definition of interest. Debt issuance costs are usually small relative to total interest payments in a lending transaction and often the payments are made to a third-party who is not the lender. Hence, there is limited ability for taxpayers to be able to disguise interest payments as debt issuance costs. The primary effect of not including debt issuance costs in the definition of interest is to decrease the after-tax cost of debt financing.

The final regulations do not include hedging transactions in the definition of interest. Taxpayers could have multiple reasons for engaging in hedging transactions other than just to lower the amount of interest expense, such as a reduction in risk. Not including hedging transactions in the definition of interest should decrease administration and compliance costs compared to the treatment in the proposed regulations since it can be difficult to separate the time value component from the insurance aspects of a hedging transaction. Under the final regulations, taxpayers are more likely to use hedging relative to the proposed regulations due to the decline in compliance costs and due to the reduced after-tax cost of using hedges.

The final regulations do not include guaranteed payments in the definition of interest. Guaranteed payments for the use of capital provided by a partner to a partnership have both equity and debt characteristics. The partner who provided the capital is an owner of the business, but also receives payments that are similar to interest. Removing guaranteed payments from the definition of interest lowers the after-tax cost of such financing for some taxpayers and may lead these taxpayers to increase the fraction of financing through capital with guaranteed payments relative to other financial instruments. The Treasury Department and the IRS do not have readily available data or models to project the change in the volume or nature of businesses' economic activities that would arise as a consequence of this change in the tax treatment of guaranteed payments to capital, relative to the proposed regulations.

(3) The final regulations also modify the anti-avoidance rule found in proposed § 1.163–1(b)(20)(iv) relative to the proposed rule. One change is that the anti-avoidance rule not only applies to financing transactions used to avoid the classification of financing expense as interest expense, but also excludes transactions that artificially increase the taxpayer's interest income from being included as interest income. The final regulations also add a principal purpose condition to the anti-avoidance rule. That is, the anti-avoidance rule in the final regulations only applies to amounts where a principal purpose of the taxpayer for engaging in a transaction is to artificially reduce the amount of net business interest expense, whether this stems from a decrease in the amounts reported as interest expense or an increase in the amounts reported as interest income. This symmetric anti-avoidance rule adopted under the final regulations, applying to both interest income and interest expense, increases the number of transactions to which the rule could potentially apply compared to the proposed regulations. However, including a principal purpose test in the anti-avoidance rule will decrease how often the rule would potentially apply to transactions relative to the proposed rule.

The anti-avoidance rule is an important component of the definition of interest because it is difficult for the Treasury Department and the IRS to specifically categorize every type of transaction already in practice or to anticipate future innovations in financial transactions. Relative to regulatory alternatives, the anti-avoidance rule will 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 the final 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 narrower definition of interest. The Treasury Department and the IRS further have determined that the definition of interest specified under the final regulations will encourage a more efficient allocation of capital and use of financing across taxpayers relative to the no-action baseline, within the context of the intent and purpose of the statute.

Number of Affected Taxpayers. The Treasury Department and the IRS estimate that the number of partnerships potentially affected by the change in treatment to guaranteed payments for the use of capital provided by a partner to a partnership is 6,000. This is the number of partnerships in tax year 2017 with more than $25 million in gross receipts that also report paying deductible guaranteed payments. The amount of total guaranteed payments reported by these partnerships is approximately $30 billion. However, it is not known to what extent these guaranteed payments are made to capital or labor, as the tax form for that tax year did not distinguish between the two types of guaranteed payments. Beginning in 2019, Form 1065 will separately report those two types of guaranteed payments.

It is not possible to provide a meaningful estimate of the number of taxpayers potentially affected by the final regulations that have deductible debt issuance costs, substitute interest payments, or amounts from swaps or hedging transactions, because those amounts are not reported separately on a tax return.

4. Economic Effects of Provisions Not Substantially Revised From the Proposed Regulations

a. Calculation of Excess Business Interest Expense, Excess Business Interest Income, and Excess Taxable Income for Partnerships and S Corporations

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

[7] Commitment fees are also not included in the definition of interest in the final regulations, but may be addressed as part of another guidance project on the treatment of fees relating to debt instruments and other securities in the future.

that the items should be allocated in the same manner as ''nonseparately stated taxable income or loss of the partnership''; however, this concept had not previously been defined by statute or regulations prior to the proposed regulations. In the absence of guidance, partnerships would have significant uncertainty in determining which partners receive excess items. This uncertainty could lead one partnership to undertake an activity that another partnership might decline to take based solely on different expectations about tax treatment of interest income rather than underlying productivity differences or economic signals.

The final regulations provide guidance on how to allocate partnership excess business interest expense, excess business interest income, and excess taxable income to partners. The allocation method detailed in the final regulations follows a number of principles. First, it ensures that the sum of the excess items at the partner level is equal to the total at the partnership level. Second, it ensures that the partnership does not allocate excess business interest expense to a partner that was allocated items that include 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 final regulations thus 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 across taxpayers and across financing options, relative to the no-action baseline.

b. Interest Income Inclusion for Owners of Partnerships and S Corporations

The final regulations 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. It thereby avoids exacerbating the incentive to seek out interest income relative to other forms of less economically productive income in order to avoid the section 163(j) limitation, relative to the no-action baseline.

c. Rules Related to Excepted Businesses

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. The final regulations clarify whether a trade or business could elect as a farming business or a real property trade or business and thus be excepted from section 163(j). Specifically, § 1.163(j)–9 provides guidance in applying the rules for farming and real property trade or business elections. For an 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 § 1.163(j)–9 provides taxpayers with the time and manner for electing real property trades or businesses and electing farming businesses. In addition, the final regulations define the conditions under which an election terminates.

In the absence of specific guidance, taxpayers may engage in behavior that counteracts the intent and purpose of the statute and would not otherwise be taken except to avoid the irrevocable nature of the election the statute specified. The final regulations increase the likelihood that taxpayers interpret the 'irrevocable' designation similarly and do not engage in tax-motivated behavior by appearing to cease operations in an effort to change an irrevocable designation.

In addition, § 1.163(j)–9(h) provides a safe harbor for certain REITs to elect to be electing real property trades or businesses. 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 compliance time and cost in applying new rules if the rules are consistent with other rules that they must comply with under the Code. An estimate of the compliance cost savings that would be due to this cross-code consistency, relative to regulatory alternatives, is beyond the capabilities of the IRS's compliance model.

In addition, the final regulations provide 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.

The Treasury Department and the IRS received no comments requesting that the percentage amounts be changed.

Number of Affected Taxpayers. The Treasury Department and the IRS project that nearly 3,500 REITs are potentially affected by the provision in the final regulations that allows REITs for which 10 percent or less of the value of the REIT's assets are real property financing assets to elect to treat all of its assets as allocable to an excepted real property trade or business. This estimate is based the number of REITs in the SOI sample of corporate taxpayers for 2017 that identify as an Equity REIT. An Equity REIT is identified by a check-box on form 1120–REIT where the choice is Equity REIT or Mortgage REIT. The Mortgage REIT category should be chosen by the taxpayer if the primary source of gross receipts is derived from mortgage interest and fees. These Equity REITs reported $1.7 trillion in total assets.

The Treasury Department and the IRS project that roughly 2.8 million filers are potentially affected by provisions of the final regulations that affect electing real property trades or businesses or electing farm businesses. This estimate is based on a count of all filers with NAICS codes starting with 111 or 112 (farming), and 531 (real property) with at least $10 million in gross receipts in taxable year 2017.

d. Allocation Rules Between Excepted and Non-Excepted Trades or Businesses

The statute is silent over how ATI, interest income, and expense should be allocated between excepted and non-excepted trades or businesses. Thus, the Treasury Department and the IRS decided to provide taxpayers with an allocation method. Because allocation, by whatever method, is costly for taxpayers, the final regulations further provide that allocation is only required when the share of the asset tax basis in both the excepted and the non-excepted trades or businesses exceeds 10 percent. In other words, if the share for either excepted or non-excepted trades or businesses is 10 percent or less, allocation is not required. The Treasury Department and the IRS received no comments that addressed the 10 percent threshold provided in this provision.

In terms of the allocation method, the Treasury Department and the IRS decided in the final regulations to require taxpayers to allocate interest expense and interest income between related excepted and non-excepted trades or businesses based on 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 of the proposed regulations, 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. This asset basis approach is consistent with the regulations under section 861. Because this approach is familiar to taxpayers and consistent with other parts of the Code, taxpayers benefit in reduced time and cost spent learning and applying the rules, relative to alternative regulatory approaches. An estimate of the compliance cost savings that would be due to this familiarity and cross-code consistency, relative to regulatory alternatives, is beyond the capabilities of the IRS's compliance model.

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 compliance burden on 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 impose substantial compliance costs 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, relative to the final regulations. 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. The final regulations provide for a limited tracing rule in those cases.

The Treasury Department and the IRS also considered allocating interest expense based on 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. 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) and claimed that the ability to elect to allocate interest expense under section 864 on the basis of fair market value of assets has led to inappropriate results and needless complexity. See Senate Budget Explanation of the Bill at 400. Thus, the Treasury Department and the IRS have determined that allocating interest expense based on relative amounts of asset basis is more appropriate than a regime based on the relative fair market value of assets.

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 taxpayers may exert control over the timing of income items, which may lead taxpayers to make tax-driven business decisions with no accompanying general economic benefit. 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, the Treasury Department and the IRS have determined that allocating interest expense based on relative amounts of asset basis is more appropriate than a regime based on the relative amounts of gross income.

Number of Affected Taxpayers. The Treasury Department and the IRS estimate that roughly 83,000 firms had allocated interest income and expenses among multiple trades or businesses in tax year 2015 and thus are potentially affected by provisions of the final regulations that affect the annual allocation statement. This estimate is based on a count of all Forms 1120, 1120S, and 1065 in tax year 2015 in real estate, farming, and public utilities industries that had over $25 million in gross receipts.

II. Paperwork Reduction Act

The collections of information contained in the final regulations have 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.

A. Collections of Information Imposed by the Regulations

The collections of information imposed directly by these regulations are contained in §§ 1.163(j)–1(b)(15)(iii), 1.163(j)–2(b)(2)(ii), 1.163(j)–2(b)(3), 1.163(j)–9 and 1.163(j)–10.

The collection of information in §§ 1.163(j)–1(b)(15)(iii) and 1.163(j)–9, the election statement, is required for taxpayers to make a one-time election to treat their regulated utility trade or business, real property trade or business or farming trade or business as an electing excepted regulated utility trade or business, electing real property trade or business under section 163(j)(7)(B) or an electing farming business under section 163(j)(7)(C). The election to be an excepted regulated utility trade or business was not in the proposed regulations. The scope of taxpayers eligible to make an election to be an excepted real property or farming trade or business has changed from the proposed regulations. As discussed in part X of the Summary of Comments and Explanation of Revisions section, under the proposed regulations, taxpayers that met the small business exemption test under section 448(c) were not able to make an election for their trade or business to be an electing real property trade or business or an electing farming business because they were already not subject to the limitation. Under the final regulations, those taxpayers are eligible to make a protective election. Additionally, under the proposed regulations, it was unclear whether taxpayers that were unsure of whether their activity constitutes a trade or business under section 162 could make an election. The final regulations clarify that a taxpayer that is unsure whether its activity constitutes a trade or business under section 162 is eligible to make an election.

The collections of information in §§ 1.163(j)–2(b)(2)(ii) and 1.163(j)–2(b)(3) are required to make two elections relating to changes made to section 163(j)(10) by the CARES Act. The election under § 1.163(j)–2(b)(2)(ii) is for a taxpayer to use the 30 percent ATI limitation instead of the 50 percent ATI limitation when calculating the taxpayer's section 163(j) limitation for a 2019 or 2020 taxable year, as provided in section 163(j)(10)(A)(i) and (iii). The election under § 1.163(j)–2(b)(2) is for a taxpayer to use the taxpayer's ATI for the last taxable beginning in 2019 as its ATI for any taxable year beginning in 2020, as provided in section 163(j)(10)(B). Revenue Procedure 2020–22 describes the time and manner for making these elections. See also § 1.163(j)–2(b)(4).

Taxpayers make the elections by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, amended Form 1065, or administrative adjustment request, as applicable. More specifically, taxpayers complete the Form 8990, Limitation on Business Interest Expense under Section 163(j), using the 30 percent ATI limitation and/or using the taxpayer's 2019 ATI, as applicable. No formal statements are required to make these elections. Accordingly, for Paperwork Reduction Act purposes, the reporting burden associated with the collections of information in §§ 1.163(j)–2(b)(2)(ii) and 1.163(j)–2(b)(3) will be reflected in the IRS Form 8990 Paperwork Reduction Act Submissions (OMB control number 1545–0123).

The collection of information in § 1.163(j)–10, the allocation statement, 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. The mechanics of the allocation statement, and the scope of taxpayers required to file the allocation statement, have not changed from the proposed regulations.

Section 1.163(j)–10 in the final regulations contains another collection of information, an allocation methodology change request, requiring taxpayers to request the Commissioner's permission to change a methodology for allocating the basis in an asset that is used in multiple trades or businesses if the request is being made within five years of any prior change. This requirement does not create a new burden because the allocation methodology change request is made by following the procedures for requesting a letter ruling in section 7.01 of Revenue Procedure 2020–1, 2020–1 IRB 1. Revenue Procedure 2020–1 was approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–0123.

In 2018, the Treasury Department and the IRS considered developing a form election and allocation statement under §§ 1.163(j)–9 and 1.163(j)–10 for taxpayers to make the one-time election and to demonstrate their interest allocation. To minimize taxpayer burden, the Treasury Department and the IRS decided that, for now, taxpayers should be allowed to use their own election form and allocation statement. In the future, if the Treasury Department and the IRS develop election or allocation form, the draft versions of the forms will be posted for comment at *https://apps.irs.gov/app/picklist/list/draftTaxForms.html.*

Certain forms have been modified with simple questions to signal whether the taxpayer is subject to section 163(j). The Treasury Department and the IRS are considering modifying certain forms with a checkbox to note that a taxpayer has made an election for a trade or business to be an electing real property trade or business or electing farming business.

For the allocation methodology change request in § 1.163(j)–10, the Treasury Department and the IRS initially determined that taxpayers should file a change request any time there is a change in methodology. However, a change in allocation methodology presents a burden for taxpayers. The disadvantages of changing an allocation methodology regularly, including the administrative and accounting costs associated with any such change, outweigh the advantages of changing an allocation methodology regularly. Accordingly, the Treasury Department and the IRS do not anticipate taxpayers using the allocation methodology change request regularly. The final regulations require the request to be made only if a change has not been made in the past 5 years. To minimize any compliance burden, the procedures in Revenue Procedure 2020–1, which are familiar to taxpayers, apply for the allocation methodology change request.

B. Burden Estimates

The following burden estimates are based on the information that is available to the IRS, and have been updated from the proposed regulations to take into account the new election for certain regulated utility trades or businesses, the increased scope of potential filers for the election statement and to use 2017 Statistics of Income (SOI) tax data where available.

The most recently available 2017 SOI tax data indicates that approximately 8,208 filers are possible for the one-time election to opt out of the section 163(j) limitation as an electing excepted regulated utility trade or business. This estimate was based on a count of Form 1065, 1065B, 1120 and 1120–S filers with NAICS codes starting with 2211 (electric power generation, transmission and distribution), 2212 (natural gas distribution), and 2213 (water, sewage and other systems).

The 2017 SOI tax data indicates that approximately 2,838,981 filers are possible for the 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. This estimate is based on a count of all filers with NAICS codes starting with 111 or 112 (farming), and 531 (real property) with at least $10 million in gross receipts in taxable year 2017. The increase in potential filers from the number provided in the proposed regulations is due exclusively to the fact that the final regulations provide that taxpayers that satisfy the small business exemption are eligible to file an election.

For the election to use the 30 percent ATI limitation for a 2019 or 2020 taxable year under § 1.163(j)–2(b)(ii), while any taxpayer subject to the section 163(j) limitation is eligible to make the election, the Treasury Department and the IRS estimate that only taxpayers that actively want to reduce their deductions will make this election. The application of the base erosion minimum tax under section 59A depends, in part, on the amount of a taxpayer's deductions. Accordingly, the Treasury Department and the IRS estimate that taxpayers that are subject to both the base erosion minimum tax under section 59A and section 163(j) are the potential filers of this election. Using the 2017 SOI tax data, the Treasury Department estimate that 3,376 firms will make the election. This estimate was determined by examining the number of C corporations with at least $500,000,000 in gross receipts, that do not have an NAICS code associated with a trade or business that is generally not subject to the section 163(j) limitation (2211 (electric power generation, transmission and distribution), 2212 (natural gas distribution), 2213 (water, sewage and other systems), 111 or 112 (farming), 531 (real property)).

For the election to use the taxpayer's 2019 ATI in 2020 under § 1.163(j)–2(b)(3), the Treasury Department and the IRS estimate that 72,608 firms will make the election. This figure was determined, using 2017 SOI tax data, by examining Form 1040, Form 1120, Form 1120S, and Form 1065 filers with more than $26M in gross receipts, that have reported interest expense, and do not have an NAICS code associated with any trade or business that is generally not subject to the section 163(j) limitation.

The Treasury Department and the IRS continue to estimate the same number of filers, 82,755, for the annual allocation statement as was projected in the proposed regulations. Using the 2015 SOI tax data, the Treasury Department and the IRS estimate that 82,755 firms will 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	Estimated average annual burden hours per respondent	Estimated total annual reporting burden (hours)	Estimated monetized burden @ $95/hour ($millions)	Estimated frequency of responses
Section 1.163(j)–1(b)(15)(iii) (one-time election statement (2017 Levels).	Corporations and partnerships with regulated utility trades or businesses.	8,028 business respondents (including Forms 1120, 1120–S, and 1065 filers).	0 to 30 minutes (estimated average: 15 minutes).	2,007	$190,665 ...	One-time.
Section 1.163(j)–2(b)(ii) (election to apply the 30 percent ATI percentage).	C corporations with more than $500 M in gross receipts.	3,376 business respondents (Form 1120 filers).	See Form 8990 ..	See Form 8990.	See Form 8990.	See Form 8990.
Section 1.163(j)–2(b)(3) (election to use 2019 ATI as 2020 ATI).	Individuals, corporations, and partnerships with more than $26 M in gross receipts and not part of an excepted trade or business.	72,608 business respondents (including Form 1120, Form 1120–S, and Form 1065 filers).	See Form 8990 ..	See Form 8990.	See Form 8990.	See Form 8990.

	Likely respondents	Estimated number of respondents	Estimated average annual burden hours per respondent	Estimated total annual reporting burden (hours)	Estimated monetized burden @ $95/hour ($millions)	Estimated frequency of responses
Section 1.163(j)–9 (one-time election statement) (2017 Levels).	Individuals, corporations, and partnerships with real property or farming trades or businesses with gross receipts exceeding $10 million.	2,838,981 business respondents (all filers).	0 to 30 minutes (estimated average:15 minutes).	70,746	67.4	One-time.
Section 1.163(j)–10 (annual allocation statement) (2015 Levels).	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.
Section 1.163(j)–10 (change in allocation methodology request).	Individuals, corporations, and partnerships that want to change their methodology for allocating basis among two or more trades or businesses, and (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.	See Rev. Proc. 2020–1.	See Rev. Proc. 2020–1.	See Rev. Proc. 2020–1.	See Rev. Proc. 2020–1.	On occasion.
Section 1.163(j)–10 (one-time start-up cost to develop procedures for filing an annual allocation statement) (2017 Levels).	Same as above	82,755	4 hours (start-up burden).	331,020	31.4	One-time.
Three year monetized burden estimate.					40.8	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 40.9 million ($2017) ([($190, 665) + ($67.4 million + $31.4 million) + ($7.9 million × 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.

C. Forms

The IRS has developed Form 8990, ''Limitation on Business Interest Expense Under Section 163(j),'' to facilitate reporting of the limitation. The form is posted at *https://www.irs.gov/pub/irs-access/f8990_accessible.pdf.* The Form 8990 instructions are posted at *https://www.irs.gov/pub/irs-pdf/i8990.pdf.* The Form 1120 series and the Form 1065 have been revised to include a question to alert taxpayers of the need to file a Form 8990. The instructions to those and other forms have been revised to include information about the Form 8990.

As described previously, the reporting burdens associated with the information collections in the proposed regulations are included in the aggregated burden estimates for OMB control number 1545–0123 (in the case of filers of Form 1120, Form 1065 and Form 8990), 1545–0074 (in the case of individual filers), and 1545–0123 (in the case of filers under Revenue Procedure 2020–1).

The Treasury Department and the IRS request comment on all aspects of information collection burdens related to these regulations, including estimates for how much time it would take to comply with the paperwork burdens described previously for each relevant form and ways for the IRS to minimize the paperwork burden. In addition, when available, drafts of IRS forms are posted for comment at *https://apps.irs.gov/app/picklist/list/draftTaxForms.htm.*

Form/revenue procedure	Type of filer	OMB No(s).	Status
	Business (NEW Model)	1545–0123	Published in the **Federal Register** on 10/8/18. Public comment period closed on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		

Form/revenue procedure	Type of filer	OMB No(s).	Status
	Individual (NEW Model)	1545–0074	Limited scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 2019.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031.*		
Revenue Procedure 20201	IRS Research estimates ...	1545–0123	Published in the Internal Revenue Bulletin on January 2, 2020.
	Link: *https://www.irs.gov/irb/2020-01_IRB.*		

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the final regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (small entities). This certification can be made because the Treasury Department and the IRS have determined that the regulations may affect a substantial number of small entities but have also concluded that the economic effect on small entities as a result of these regulations is not expected to be significant.

When enacted, the section 163(j) limitation generally applied to taxpayers with average annual gross receipts exceeding $25 million. The gross receipts threshold for general applicability of the section 163(j) limitation increased to $26 million in 2020. The threshold will be adjusted annually for inflation. However, under the final regulations, small taxpayers operating regulated utility trades or businesses, real property trades or businesses and farming trades or businesses are now eligible to protectively elect out of the election. Accordingly, the regulations in §§ 1.163(j)–1 and –9 may apply to small business filers that operate regulated utility trades or businesses, real property trades or businesses or farming trades or businesses. Those taxpayers may choose to make a protective election, such that they are not subject to the limitation if their average annual gross receipts for the three prior tax years eventually exceeds $26 million (for 2020). Although the exact number of small entities that will make an election is unknown, an upper bound on the number of potentially affected entities is 10.5 million. This number was determined by looking at, for the 2017 taxable year, the number of Form 1120, 1120–S, 1120–REIT, 1065, and individual business filers with more than $10M in gross receipts that have NAICS codes commonly associated with real property trades or businesses or farming businesses.

If a taxpayer chooses to make the election for its trades or businesses, the taxpayer must attach to its tax return a statement identifying and describing the trade or business for which the election is being made, and must provide other information as the Commissioner may require in forms, instructions, or other published guidance. The election is not required. The election is potentially beneficial to businesses with business interest, but is detrimental to businesses that have assets for which bonus depreciation is desired.

The reporting burden is estimated at 0–30 minutes, depending on individual circumstances, with an estimated average of 0.25 hours for all affected entities, regardless of size. The burden on small entities is expected to be the same as other entities because the requirements to make the election apply equally to all taxpayers. Using the IRS's taxpayer compliance cost estimates, the monetization rate is $95 per hour. Thus, the average annual burden is $23.75 per business.

For the section 163(j)(10) elections under §§ 1.163(j)–2(b)(ii) or 1.163(j)–2(b)(3), most small business taxpayers do not need the elections because, as discussed earlier, they are not subject to the section 163(j) limitation. For small taxpayers that are subject to the limitation, the cost to implement the elections is low. Pursuant to Revenue Procedure 2020–22, these taxpayers simply complete the Form 8990 as if the election has been made. Accordingly, the burden of complying with the elections, if needed, is no different than for taxpayers that do not make the elections.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its effect on small business, and no comments were received.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private section, of $100 million in 1995 dollars, update annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private section in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

VI. Congressional Review Act

The Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget has determined that this is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 *et seq.*) (CRA). Under section 801(3) of the CRA, a major rule takes effect 60 days after the rule is published in the **Federal Register**. Notwithstanding this requirement, section 808(2) of the CRA allows agencies to dispense with the requirements of 801 when the agency for good cause finds that such procedure would be impracticable, unnecessary, or contrary to the public interest and the rule shall take effect at such time as the agency promulgating the rule determines.

The Treasury Department and the IRS have determined that the rules in this Treasury decision shall take effect for taxable years beginning on or after November 13, 2020. Pursuant to section 808(2) of the CRA, however, the Treasury Department and the IRS find, for good cause, that a 60-day delay in the effective and the applicability date for the anti-avoidance rules in § 1.163(j)–1(b)(22)(iv) is unnecessary and contrary to the public interest. Section 1.163(j)–1(b)(22)(iv) serves an anti-abuse function and, because § 1.163(j)–1(b)(22)(iv) provides a clear scope of abusive transactions that could otherwise be executed prior to the effective date of the section, immediate application of § 1.163(j)–1(b)(22)(iv) is necessary as of the publication of this final regulation.

Drafting Information

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List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 entries 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 as follows:

Authority: 26 U.S.C. 7805, unless otherwise noted.

* * * * *

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.

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

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

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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.

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

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

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■ **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.

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

§ 1.163(j)–1 Definitions.

(a) *In general.* The definitions provided in this section apply for purposes of the section 163(j) regulations. For purposes of the rules set 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 tentative taxable income of the taxpayer for the taxable year, with the adjustments in this paragraph (b)(1).

(i) *Additions.* The amounts of the following items that were included in the computation of the taxpayer's tentative taxable income (if any) are added to tentative taxable income to determine ATI—

(A) Any business interest expense, other than disallowed business interest expense carryforwards;

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

(C) Any deduction under section 199A;

(D) Subject to paragraph (b)(1)(iii) of this section, for taxable years beginning before January 1, 2022, any depreciation under section 167, section 168, or section 168 of the Internal Revenue Code (Code) of 1954 (former section 168);

(E) Subject to paragraph (b)(1)(iii) of this section, for taxable years beginning before January 1, 2022, any amortization of intangibles (for example, under section 167 or 197) and other amortized expenditures (for example, under section 174(b), 195(b)(1)(B), 248, or 1245(a)(2)(C));

(F) Subject to paragraph (b)(1)(iii) of this section, for taxable years beginning before January 1, 2022, any 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)(44) and 1.163(j)–10).

(ii) *Subtractions.* The amounts of the following items (if any) are subtracted from the taxpayer's tentative taxable income to determine ATI —

(A) Any business interest income that was included in the computation of the taxpayer's tentative taxable income;

(B) Any floor plan financing interest expense for the taxable year that was included in the computation of the taxpayer's tentative taxable income;

(C) With respect to the sale or other disposition of property, the greater of the allowed or allowable depreciation, amortization, or depletion of the property, as provided under section 1016(a)(2), for the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group) 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 by another member, the investment adjustments 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);

(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)(44) and 1.163(j)–10)) and that was included in the computation of the taxpayer's tentative taxable income; and

(G) An amount equal to the sum of any specified deemed inclusions that were included in the computation of the taxpayer's tentative taxable income, reduced by the portion of the deduction allowed under section 250(a) by reason of the specified deemed inclusions. For this purpose, a *specified deemed inclusion* is the inclusion of an amount by a United States shareholder (as defined in section 951(b)) in gross income under section 78, 951(a), or 951A(a) with respect to an applicable CFC (as defined in § 1.163(j)–1(b)(2)) that is properly allocable to a non-excepted trade or business. Furthermore, a specified deemed inclusion includes any amounts included in a domestic partnership's gross income under section 951(a) or 951A(a) with respect to an applicable CFC to the extent such amounts are attributable to investment income of the partnership and are allocated to a domestic C corporation that is a direct (or indirect partner) and treated as properly allocable to a non-excepted trade or business of the domestic C corporation under §§ 1.163(j)–4(b)(3) and 1.163(j)–10. To determine the amount of a specified deemed inclusion described in this paragraph (b)(1)(ii)(G), the portion of a United States shareholder's inclusion under section 951A(a) treated as being with respect to an applicable CFC is determined under section 951A(f)(2) and § 1.951A–6(b)(2).

(iii) *Depreciation, amortization, or depletion capitalized under section 263A.* For purposes of paragraph (b)(1)(i) of this section, amounts of depreciation, amortization, or depletion that are capitalized under section 263A during the taxable year are deemed to be included in the computation of the taxpayer's tentative taxable income for such taxable year, regardless of the period in which the capitalized amount is recovered. See *Example 3* in § 1.163(j)–2(h)(3).

(iv) *Application of § 1.163(j)–1(b)(1)(ii)(C), (D), and (E)*—(A) *Sale or other disposition*—(*1*) *In general.* For purposes of paragraphs (b)(1)(ii)(C), (D), and (E) of this section, except as otherwise provided in this paragraph (b)(1)(iv)(A), the term *sale or other disposition* does not include a transfer of an asset to an acquiring corporation in a transaction to which section 381(a) applies.

(*2*) *Intercompany transactions.* For purposes of paragraphs (b)(1)(ii)(C) and (D) of this section, the term *sale or other disposition* excludes all intercompany transactions, within the meaning of § 1.1502–13(b)(1)(i).

(*3*) *Deconsolidations.* Notwithstanding any other rule in this paragraph (b)(1)(iv)(A), any transaction in which a member leaves a consolidated group is treated as a sale or other disposition for purposes of paragraphs (b)(1)(ii)(C) and (D) of this section unless the transaction is described in § 1.1502–13(j)(5)(i)(A).

(B) *Deductions by members of a consolidated group.* If paragraph (b)(1)(ii)(C), (D), or (E) of this section applies to adjust the tentative taxable income of a taxpayer, the amount of the adjustment under paragraph (b)(1)(ii)(C) of this section equals the greater of the allowed or allowable depreciation, amortization, or depletion of the property, as provided under section 1016(a)(2), for any member of the consolidated group for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property.

(C) *Successor assets.* This paragraph (b)(1)(iv)(C) applies if deductions described in paragraph (b)(1)(ii)(C) of this section are allowed or allowable to a consolidated group member (S) and either the depreciable property or S's stock is subsequently transferred to another member (S1) in an intercompany transaction in which the transferor receives S1 stock. If this paragraph (b)(1)(iv)(C) applies, and if the transferor's basis in the S1 stock received in the intercompany transaction is determined, in whole or in part, by reference to its basis in the S stock, the S1 stock received in the intercompany transaction is treated as a successor asset to S's stock for purposes of paragraph (b)(1)(ii)(D) of this section. Thus, except as otherwise provided in paragraph (b)(1)(iv)(D) of this section, the subsequent disposition of either the S1 stock or the S stock gives rise to an adjustment under paragraph (b)(1)(ii)(D) of this section.

(D) *Anti-duplication rule*—(*1*) *In general.* The aggregate of the subtractions from tentative taxable income of a consolidated group under paragraphs (b)(1)(ii)(C) and (D) of this section with respect to an item of property (including with regard to dispositions of successor assets described in paragraph (b)(1)(iv)(C) of this section) cannot exceed the aggregate amount of the consolidated group members' deductions described in paragraph (b)(1)(ii)(C) of this section with respect to such item of property. For example, if an adjustment to the tentative taxable income of a consolidated group is made under paragraph (b)(1)(ii)(C) of this section with respect to the sale or other disposition of property by a consolidated group member (S) to an unrelated person, and if a member of the group subsequently sells or otherwise disposes of S's stock, no further adjustment to the group's tentative taxable income is made under paragraph (b)(1)(ii)(D) of this section in relation to the same property with respect to that stock disposition.

(*2*) *Adjustments following deconsolidation.* Depreciation, amortization, or depletion deductions allowed or allowable for a corporation for a consolidated return year of a group are disregarded in applying this paragraph (b)(1)(iv)(D) to any year that constitutes a separate return year (as defined in § 1.1502–1(e)) of that corporation. For example, assume that S deconsolidates from a group (Group 1) after holding property for which depreciation, amortization, or depletion deductions were allowed or allowable in Group 1. On the deconsolidation, S and Group 1 would adjust tentative taxable income with regard to that property under paragraphs (b)(1)(ii)(D) and (b)(1)(iv)(A)(*3*) of this section. If, following the deconsolidation, S sells the property referred to in the previous sentence, no subtraction from tentative taxable income is made under paragraph (b)(1)(ii)(C) of this section during S's separate return year with regard to the amounts included in Group 1 under paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(A)(*3*) of this section.

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

(vi) *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) and 1.163(j)–6(m)(1) and (2).

(G) For rules governing partnership basis adjustments affecting 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 certain beneficiaries of trusts and estates, see § 1.163(j)–2(f).

(vii) *ATI cannot be less than zero.* If the ATI of a taxpayer would be less than zero, the ATI of the taxpayer is zero.

(viii) *Examples.* The examples in this paragraph (b)(1)(viii) illustrate the application of paragraphs (b)(1)(ii), (iii), and (iv) of this section. Unless otherwise indicated, A, B, P, S, and T are calendar-year domestic C corporations; P is the parent of a consolidated group of which S and T are members; the exemption for certain small businesses in § 1.163(j)–2(d) does not apply; no entity is engaged in an excepted trade or business; no entity has business interest income or floor plan financing interest expense; and all amounts of interest expense are deductible except for the potential application of section 163(j).

(A) *Example 1*—(*1*) *Facts.* In 2021, A purchases a depreciable asset (Asset X) for $100x and fully depreciates Asset X under section 168(k). For the 2021 taxable year, A's ATI (after adding back A's depreciation deductions with respect to Asset X under paragraph (b)(1)(i)(D) of this section) is $150x. A incurs $45x of business interest expense in 2021. In 2024, A sells Asset X to an unrelated third party.

(*2*) *Analysis.* A's section 163(j) limitation for 2021 is $45x ($150x × 30 percent). Thus, all $45x of A's business interest expense incurred in 2021 is deductible in that year. However, under paragraph (b)(1)(ii)(C) of this section, A must subtract $100x from its tentative taxable income in computing its ATI for its 2024 taxable year. A would be required to subtract $100x from its tentative taxable income in computing its ATI for its 2024 taxable year even if A's ATI in 2021 was $150x before adding back A's depreciation deductions with respect to Asset X.

(*3*) *Transfer of assets in a nonrecognition transaction to which section 381 applies.* The facts are the same as in paragraph (b)(1)(viii)(A)(*1*) of this section, except that, rather than sell Asset X to an unrelated third party in 2024, A merges with and into an unrelated third party in 2024 in a transaction described in section 368(a)(1)(A) in which no gain is recognized. As provided in paragraph (b)(1)(iv)(A) of this section, the merger transaction is not treated as a ''sale or other disposition'' for purposes of paragraph (b)(1)(ii)(C) of this section. Thus, no adjustment to tentative taxable income is required in 2024 under paragraph (b)(1)(ii)(C) of this section.

(*4*) *Transfer of assets in a nonrecognition transaction to which section 351 applies.* The facts are the same as in paragraph (b)(1)(viii)(A)(*1*) of this section, except that, rather than sell Asset X to an unrelated third party in 2024, A transfers Asset X to B (A's wholly owned subsidiary) in 2024 in a transaction to which section 351 applies. The section 351 transaction is treated as a ''sale or other disposition'' for purposes of paragraph (b)(1)(ii)(C) of this section. Thus, A must subtract $100x from its tentative taxable income in computing its ATI for its 2024 taxable year.

(B) *Example 2*—(*1*) *Facts.* In 2021, S purchases a depreciable asset (Asset Y) for $100x and fully depreciates Asset Y under section 168(k). P reduces its basis in its S stock by $100x under § 1.1502–32 to reflect S's depreciation deductions. For the 2021 taxable year, the P group's ATI (after adding back S's depreciation deductions with respect to Asset Y under paragraph (b)(1)(i)(D) of this section) is $150x. The P group incurs $45x of business interest expense in 2021. In 2024, P sells all of its S stock to an unrelated third party.

(*2*) *Analysis.* The P group's section 163(j) limitation for 2021 is $45x ($150x × 30 percent). Thus, all $45x of the P group's business interest expense incurred in 2021 is deductible in that year. However, under paragraph (b)(1)(ii)(D) of this section, the P group must subtract $100x from its tentative taxable income in computing its ATI for its 2024 taxable year. The answer would be the same if the P group's ATI in 2021 were $150x before adding back S's depreciation deductions with respect to Asset Y.

(*3*) *Disposition of less than all member stock.* The facts are the same as in paragraph (b)(1)(viii)(B)(*1*) of this section, except that, in 2024, P sells half of its S stock to an unrelated third party. Pursuant to paragraph (b)(1)(ii)(D) of this section, the P group must subtract $100x from its tentative taxable income in computing its ATI for its 2024 taxable year.

(*4*) *Transfer in an intercompany transaction.* The facts are the same as in paragraph (b)(1)(viii)(B)(*1*) of this section, except that, rather than sell S's stock to an unrelated third party in 2024, P transfers S's stock to another member of the P group in an intercompany transaction (as defined in § 1.1502–13(b)(1)(i)) in 2024. As provided in paragraph (b)(1)(iv)(A) of this section, the intercompany transaction is not treated as a ''sale or other disposition'' for purposes of paragraph (b)(1)(ii)(D) of this section. Thus, no adjustment to tentative taxable income is required in 2024 under paragraph (b)(1)(ii)(D) of this section.

(*5*) *Disposition of successor assets.* The facts are the same as in paragraph (b)(1)(viii)(B)(*1*) of this section, except that, rather than sell S's stock to an unrelated third party in 2024, P transfers S's stock to T in 2024 in a transaction to which section 351 applies and, in 2025, P sells all of its T stock to an unrelated third party. Pursuant to paragraph (b)(1)(iv)(A) of this section, P's intercompany transfer of S's stock to T is not a ''sale or other disposition'' for purposes of paragraph (b)(1)(ii)(D) of this section. However, pursuant to paragraph (b)(1)(iv)(C) of this section, P's stock in T is treated as a successor asset for purposes of paragraph (b)(1)(ii)(D) of this section. Thus, the P group must subtract $100x from its tentative taxable income in computing its ATI for its 2025 taxable year.

(C) *Example 3*—(*1*) *Facts.* In 2021, S purchases a depreciable asset (Asset Z) for $100x and fully depreciates Asset Z under section 168(k). P reduces its basis in its S stock by $100x under § 1.1502–32 to reflect S's depreciation deductions. For the 2021 taxable year, the P group's ATI (after adding back S's depreciation deductions with respect to Asset Z under paragraph (b)(1)(i)(D) of this section) is $150x. The P group incurs $45x of business interest expense in 2021. In 2024, S sells Asset Z to an unrelated third party. In 2025, P sells all of its S stock to a member of another consolidated group.

(*2*) *Analysis.* Under paragraph (b)(1)(ii)(C) of this section, the P group must subtract $100x from its tentative taxable income in computing its ATI for its 2024 taxable year. The answer would be the same if the P group's ATI in 2021 were $150x before adding back S's depreciation deductions with respect to Asset Z. P's sale of all of its S stock in 2025 is a ''sale or other disposition'' for purposes of paragraph (b)(1)(ii)(D) of this section. However, pursuant to paragraph (b)(1)(iv)(D)(*1*) of this section, no further adjustment to the P group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(D) of this section.

(*3*) *Disposition of S stock prior to S's asset disposition.* The facts are the same as in paragraph (b)(1)(viii)(C)(*1*) of this section, except that, in 2024, P sells all of its S stock to a member of another consolidated group and, in 2025, S sells Asset Z to an unrelated third party. Pursuant to paragraph (b)(1)(ii)(D) of this section, the P group must subtract $100x from its tentative taxable income in computing its ATI for its 2024 taxable year. Pursuant to paragraph (b)(1)(iv)(D)(*2*) of this section, no adjustment to the acquiring group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(C) of this section.

(*4*) *Transfer of S stock in nonrecognition transaction.* The facts are the same as in paragraph (b)(1)(vii)(C)(*3*) of this section, except that, rather than sell all of S's stock to a member of another consolidated group, P causes S to merge with and into a member of another consolidated group in a transaction described in section 368(a)(1)(A). As provided in paragraph (b)(1)(iv)(A) of this section, the merger transaction is treated as a ''sale or other disposition'' for purposes of paragraph (b)(1)(ii)(D) of this section because S leaves the P group. Thus, the results are the same as in paragraph (b)(1)(vii)(C)(*3*) of this section.

(D) *Example 4*—(*1*) *Facts.* P wholly owns T, which wholly owns S. In 2021, S purchases a depreciable asset (Asset AA) for $100x and fully depreciates Asset AA under section 168(k). T reduces its basis in its S stock, and P reduces its basis in its T stock, by $100x under § 1.1502–32 to reflect S's depreciation deductions. For the 2021 taxable year, the P group's ATI (after adding back S's depreciation deductions with respect to Asset AA under paragraph (b)(1)(i)(D) of this section) is $150x. The P group incurs $45x of business interest expense in 2021. In 2024, T sells all of its S stock to a member of another consolidated group. In 2025, P sells all of its T stock to a member of another consolidated group.

(*2*) *Analysis.* Pursuant to paragraph (b)(1)(ii)(D) of this section, the P group must subtract $100x from its tentative taxable income in computing its ATI for its 2024 taxable year. Pursuant to paragraph (b)(1)(iv)(D)(*1*) of this section, no adjustment to the P group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(D) of this section.

(2) *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.

(3) *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)(11) of this section). However, business interest expense does not include amounts of interest expense carried forward to the taxable year from a prior taxable year due to the application of section 465 or section 469, which apply after the application of section 163(j). 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 1.163(j)–4(d)(2)(iii) (regarding consolidated groups), 1.163(j)–1(b)(9) (regarding current-year business interest expense), and 1.163(j)–6(c) (regarding partnerships and S corporations).

(4) *Business interest income*—(i) *In general.* The term *business interest income* means interest income includible in the gross income of a taxpayer for the taxable year 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), 1.163(j)–4(d)(2)(iii) (regarding consolidated groups), and 1.163(j)–6(c) (regarding partnerships and S corporations).

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

(6) *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.

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

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

(9) *Current-year business interest expense.* 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.

(10) *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). For purposes of section 163(j) and the regulations in this part under section 163(j) of the Internal Revenue Code (Code) disallowed business interest expense is treated as ''paid or accrued'' in the taxable year in which the expense is deductible for Federal income tax purposes (without regard to section 163(j)) or in the taxable year in which a deduction for the business interest expense is permitted under section 163(j), as the context may require.

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

(12) *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)(27) 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).

(13) *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);

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

(iii) Specifically designated by the Secretary in guidance published in the **Federal Register** or the Internal Revenue Bulletin (see § 601.601(d) of this chapter) as a farming business for purposes of section 163(j).

(14) *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—

(i) A real property trade or business described in section 469(c)(7)(C) and § 1.469–9(b)(2); or

(ii) A REIT that qualifies for the safe harbor described in § 1.163(j)–9(h); or

(iii) A trade or business specifically designated by the Secretary in guidance published in the **Federal Register** or the

Internal Revenue Bulletin (see § 601.601(d) of this chapter) as a real property trade or business for purposes of section 163(j).

(15) *Excepted regulated utility trade or business*—(i) *In general.* The term *excepted regulated utility trade or business* means:

(A) *Automatically excepted regulated utility trades or businesses.* A trade or business—

(*1*) That furnishes or sells—

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

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

(*iii*) Transportation of gas or steam by pipeline; but only

(*2*) To the extent that the rates for the furnishing or sale of the items in paragraph (b)(15)(i)(A)(*1*) of this section—

(*i*) 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

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

(B) *Electing regulated utility trades or businesses.* A trade or business that makes a valid election under paragraph (b)(15)(iii) of this section; or

(C) *Designated excepted regulated utility trades or businesses.* A trade or business that is specifically designated by the Secretary in guidance published in the **Federal Register** or the Internal Revenue Bulletin as an excepted regulated utility trade or business (see § 601.601(d) of this chapter) for section 163(j) purposes.

(ii) *Depreciation and excepted and non-excepted utility trades or businesses.*

(A) *Depreciation.* Taxpayers engaged in an excepted trade or business described in paragraph (b)(15)(i) of this section cannot claim the additional first-year depreciation deduction under section 168(k) for any property that is primarily used in the excepted regulated utility trade or business.

(B) *Allocation of items.* If a taxpayer is engaged in one or more excepted trades or businesses, as described in paragraph (b)(15)(i) of this section, and one or more non-excepted trades or businesses, the taxpayer must allocate items between the excepted and non-excepted utility trades or businesses. See §§ 1.163(j)–1(b)(44) 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)(15)(i)(A)(*1*) of this section that are not sold pursuant to rates that are determined on a cost of service and rate of return basis or established or approved by the governing or ratemaking body of an electric cooperative, and are not subject to an election in paragraph (b)(15)(iii), are treated as excepted trades or businesses. See § 1.163(j)–10(c)(3)(iii)(C)(*3*). For look-through rules applicable to certain CFCs that furnish or sell items described in paragraph (b)(15)(i)(A)(*1*) of this section that are not sold pursuant to rates that are determined on a cost of service and rate of return basis or established or approved by the governing or ratemaking body of an electric cooperative as described in paragraph (b)(15)(i)(A)(*2*) of this section, see § 1.163(j)–10(c)(5)(ii)(C).

(iii) *Election to be an excepted regulated utility trade or business.* (A) *In general.* A trade or business that is not an excepted regulated utility trade or business described in paragraph (b)(15)(i)(A) or (C) of this section and that furnishes or sells items described in paragraph (b)(15)(i)(A)(*1*) of this section is eligible to make an election to be an excepted regulated utility trade or business to the extent that the rates for furnishing or selling the items described in paragraph (b)(15)(i)(A)(*1*) of this section have been established or approved by a regulatory body described in paragraph (b)(15)(i)(A)(*2*)(i) of this section.

(B) *Scope and effect of election*—(*1*) *In general.* An election under paragraph (b)(15)(iii) of this section is made with respect to each eligible trade or business of the taxpayer and applies only to the trade or business for which the election is made. An election under paragraph (b)(15)(iii) of this section applies to the taxable year in which the election is made and to all subsequent taxable years.

(*2*) *Irrevocability.* An election under paragraph (b)(15)(iii) of this section is irrevocable.

(C) *Time and manner of making election*—(*1*) *In general.* Subject to paragraph (b)(15)(iii)(C)(*5*) of this section, a taxpayer makes an election under paragraph (b)(15)(iii) 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)–1(b)(15)(iii) 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 sufficient to demonstrate qualification for an election under this section, including the principal business activity code; and

(*v*) A statement that the taxpayer is making an election under section 1.163(j)–1(b)(15)(iii).

(*3*) *Consolidated group's or partnership's trade or business.* The rules in § 1.163(j)–9(d)(3) and (4) apply with respect to an election under paragraph (b)(15)(iii) of this section for a consolidated group's or partnership's trade or business.

(*4*) *Termination of election.* The rules in § 1.163(j)–9(e) apply to determine when an election under paragraph (b)(15)(iii) of this section terminates.

(*5*) *Additional guidance.* The rules and procedures regarding the time and manner of making an election under paragraph (b)(15)(iii) of this section and the election statement contents in paragraph (b)(15)(iii)(C)(*2*) 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 (b)(15)(iii)(C)(*4*) 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).

(16) *Excess business interest expense.* For any partnership, the term *excess business interest expense* means the amount of disallowed business interest expense of the partnership for a taxable year under section § 1.163(j)–2(b). With respect to a partner, see § 1.163(j)–6(g) and (h).

(17) *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).

(18) *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 motor vehicles so acquired.

(19) *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)(3) of this section.

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

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

(22) *Interest.* The term *interest* means any amount described in paragraph (b)(22)(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 Code or the Income Tax Regulations. Thus, interest includes, but is not limited to, the following:

(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) (determined without regard to section 163(j));

(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; however, in the case of a sale-repurchase agreement relating to tax-exempt bonds, 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) *In general.* Except as provided in paragraphs (b)(22)(ii)(B) and (C) of this section, a 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) *Exception for cleared swaps.* Paragraph (b)(22)(ii)(A) of this section does not apply to a cleared swap (as defined in paragraph (b)(6) of this section).

(C) *Exception for non-cleared swaps subject to margin or collateral requirements.* Paragraph (b)(22)(ii)(A) of this section does not apply to a non-cleared swap that requires the parties to meet the margin or collateral requirements of a federal regulator or that provides for margin or collateral requirements that are substantially similar to a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a federal regulator. For purposes of this paragraph (b)(22)(ii)(C), the term *federal regulator* means the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a), as amended by section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law 111–203, 124 Stat. 1376, Title VII.

(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 deductible as a bond premium deduction under section 171(a)(1) and § 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 only if the payment relates to a sale-repurchase agreement or a securities lending transaction that is not entered into by the payor in the ordinary course of the payor's business. A substitute interest payment described in § 1.861–2(a)(7) is treated as interest income to the recipient only if the payment relates to a sale-repurchase agreement or a securities lending transaction that is not entered into by the recipient in the ordinary course of the recipient's business; however, in the case of a sale-repurchase agreement or a securities lending transaction relating to tax-exempt bonds, the recipient of a substitute payment does not receive tax-exempt interest income. This paragraph (b)(22)(iii)(C) does not apply to an amount described in paragraph (b)(22)(i)(N) of this section.

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

(E) *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)(22)(iii)(E), 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. This paragraph (b)(22)(iii)(E) does not apply to an amount described in paragraph (b)(22)(i)(C) or (E) of this section.

(F) [*Reserved]*

(iv) *Anti-avoidance rules*—(A) *Principal purpose to reduce interest expense*—(*1*) *Treatment as interest expense.* Any expense or loss economically equivalent to interest is treated as interest expense if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been described in paragraph (b)(22)(i), (ii), or (iii) of this section. For this purpose, the fact that the taxpayer has a business purpose for obtaining the use of funds does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense. In addition, the fact that the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction(s) does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense. For purposes of this paragraph (b)(22)(iv)(A)(*1*), any expense or loss is economically equivalent to interest to the extent that the expense or loss is—

(*i*) Deductible by the taxpayer;

(*ii*) Incurred by the 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;

(*iii*) Substantially incurred in consideration of the time value of money; and

(*iv*) Not described in paragraph (b)(22)(i), (ii), or (iii) of this section.

(*2*) *Corresponding treatment of amounts as interest income.* If a taxpayer knows that an expense or loss is treated by the payor as interest expense under paragraph (b)(22)(iv)(A)(*1*) of this section, the taxpayer provides the use of funds for a period of time in the transaction(s) subject to paragraph (b)(22)(iv)(A)(*1*) of this section, the taxpayer earns income or gain with respect to the transaction(s), and such income or gain is substantially earned in consideration of the time value of money provided by the taxpayer, such income or gain is treated as interest income to the extent of the expense or loss treated by the payor as interest expense under paragraph (b)(22)(iv)(A)(*1*) of this section.

(B) *Interest income artificially increased.* Notwithstanding paragraphs (b)(22)(i) through (iii) of this section, any income realized by a taxpayer in a transaction or series of integrated or related transactions is not treated as interest income of the taxpayer if and to the extent that a principal purpose for structuring the transaction(s) is to artificially increase the taxpayer's business interest income. For this purpose, the fact that the taxpayer has a business purpose for holding interest generating assets does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of artificially increasing the taxpayer's business interest income.

(C) *Principal purpose.* Whether a transaction or a series of integrated or related transactions is entered into with a principal purpose described in paragraph (b)(22)(iv)(A) or (B) of this section depends on all the facts and circumstances related to the transaction(s), except for those facts described in paragraph (b)(22)(iv)(A) or (B) of this section. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). Factors to be taken into account in determining whether one of the taxpayer's principal purposes for entering into the transaction(s) include the taxpayer's normal borrowing rate in the taxpayer's functional currency, whether the taxpayer would enter into the transaction(s) in the ordinary course of the taxpayer's trade or business, whether the parties to the transaction(s) are related persons (within the meaning of section 267(b) or section 707(b)), whether there is a significant and bona fide business purpose for the structure of the transaction(s), whether the transactions are transitory, for example, due to a circular flow of cash or other property, and the substance of the transaction(s).

(D) *Coordination with anti-avoidance rule in § 1.163(j)–2(j).* The anti-avoidance rules in paragraphs (b)(22)(iv)(A) through (C) of this section, rather than the anti-avoidance rules in § 1.163(j)–2(j), apply to determine whether an item is treated as interest expense or interest income.

(v) *Examples.* The examples in this paragraph (b)(22)(v) illustrate the application of paragraph (b)(22)(iv) of this section. Unless otherwise indicated, 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.* A is engaged in a manufacturing business and uses the calendar year as its annual accounting period. A's functional currency is the U.S. dollar and A conducts virtually all of its business in the U.S. dollar. A has no connection to Japan or the Japanese yen in the ordinary course of business. A projects that it will have business interest expense of $100x on an existing loan obligation with a stated principal amount of $2,000x (Loan 1) and no business interest income in its taxable year ending December 31, 2021. In early 2021, A enters into the following transactions, which A would not have entered into in the ordinary course of A's trade or business:

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

(*ii*) A enters into a foreign currency swap transaction (FX Swap) with Bank with a notional principal amount of $2,000x under which A receives Japanese yen at 1 percent multiplied by the amount of Japanese yen borrowed from Bank (which for 2021 equals $20x) and pays U.S. dollars at 5 percent multiplied by a notional amount of $2,000x ($100x per year);

(*iii*) The FX Swap is not integrated with Loan 2 under § 1.988–5; and

(*iv*) A enters into a spot transaction with Bank to convert the proceeds of Loan 2 into $2,000x U.S. dollars and A uses the U.S. dollars to repay Loan 1.

(*2*) *Analysis.* A principal purpose of A entering into the transactions with Bank was to try to reduce the amount incurred by A that otherwise would be interest expense; in effect, A sought to alter A's cost of borrowing by converting a substantial portion of its interest expense deductions on Loan 1 into section 165 deductions on the FX Swap ($100x interest expense related to Loan 1 compared to $20x interest expense related to Loan 2 and $80x section 165 deduction). A's functional currency is the U.S. dollar and A conducts virtually all of its business in the U.S. dollar. A has no connection to Japan or the Japanese yen and would not have entered into the transactions in the ordinary course of A's trade or business. The section 165 deductions related to the FX Swap were incurred by A in a series of transactions in which A secured the use of funds for a period of time and were substantially incurred in consideration of the time value of money. As a result, under paragraph (b)(22)(iv)(A)(*1*) of this section, for purposes of section 163(j), the $80x paid by A to Bank on the FX Swap is treated by A as interest expense.

(B) *Example 2*—(*1*) *Facts.* A is engaged in a manufacturing business and uses the calendar year as its annual accounting period. A does not use gold in its manufacturing business. In 2021, A expects to borrow $1,000x for six months. In January 2021, 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 for six months, A has sustained a loss of $13x in connection with these related transactions. A would not have entered into the gold transactions in the ordinary course of A's trade or business.

(*2*) *Analysis.* In a series of related transactions, A has obtained the use of $1,000x for six months and created a loss of $13x substantially incurred in consideration of the time value of money. A would not have entered into the gold transactions in the ordinary course of A's trade or business. A entered into the transactions with a principal purpose of structuring the transactions to reduce its interest expense (in effect, A sought to convert what otherwise would be interest expense into a loss through the transactions). As a result, under paragraph (b)(22)(iv)(A)(*1*) of this section, for purposes of section 163(j), the loss of $13x is treated by A as interest expense.

(C) *Example 3*—(*1*) *Facts.* A is engaged in a manufacturing business and uses the calendar year as its annual accounting period. A's functional currency is the U.S. dollar and A conducts virtually all of its business in the U.S. dollar. A has no connection to Argentina or the Argentine peso as part of its ordinary course of business. As of January 1, 2021, A expects to have adjusted taxable income (as defined in paragraph (b)(1) of this section) of $200x in the taxable year ending December 31, 2021. A also projects that it will have business interest expense of $70x on an existing loan in 2021. A has cash equivalents of $100x on which A expects to earn $5x of business interest income. In early 2021, A enters into the following transactions, which A would not have entered into in the ordinary course of A's trade or business:

(*i*) A enters into a spot transaction with Bank to convert the $100x of cash equivalents into an amount in Argentine pesos equivalent to $100x and A uses the Argentine pesos to purchase an Argentine peso note (Note) issued by a subsidiary of Bank for the Argentine peso equivalent of $100x; the Note pays interest at a 10 percent rate; and

(*ii*) A enters into a foreign currency swap transaction (FX Swap) with Bank with a notional principal amount of $100x under which A pays Argentine pesos at 10 percent multiplied by the amount of Argentine peso principal amount on the Note (which for 2021 equals $10x) and receives U.S. dollars at 5 percent multiplied by a notional amount of $100x ($5x per year).

(*2*) *Analysis.* A principal purpose of A entering into the transactions was to increase the amount of business interest income received by A; in effect, A increased its business interest income by separately accounting for its net deduction of $5x per year on the FX Swap. A's functional currency is the U.S. dollar and A conducts virtually all of its business in the U.S. dollar. A has no connection to Argentina or the Argentine peso and would not have entered into the transactions in the ordinary course of A's trade or business. The FX Swap was incurred by A as a part of a transaction that A entered into with a principal purpose of artificially increasing its business interest income. As a result, under paragraph (b)(22)(iv)(B) of this section, for purposes of section 163(j), the $10x business interest income earned on the Note by A is reduced by $5x (the net $5x paid by A on the FX Swap).

(D) *Example 4*—(*1*) *Facts.* A is wholly owned by FC, a foreign corporation organized in foreign country X. A uses the calendar year for its annual accounting period. FC has a better credit rating than A. A needs to borrow $2,000x in the taxable year ending December 31, 2021, to fund its business operations. A also projects that, if it borrows $2,000x on January 1, 2021, and pays a market rate of interest, it will have business interest expense of $100x in its taxable year ending December 31, 2021. In early 2021, A enters into the following transactions:

(*i*) A enters into a loan obligation in which A borrows $2,000x from Bank with an interest rate of 3 percent (Loan 1);

(*ii*) FC and Bank enter into a guarantee arrangement (Guarantee) under which FC agrees to guarantee Bank that Bank will be timely paid all of the amounts due on Loan 1; and

(*iii*) A enters into a guarantee fee agreement with FC (Guarantee Fee Agreement) under which A agrees to pay FC $40x in return for FC entering into the Guarantee, which was not an agreement that A would have entered into in the ordinary course of A's trade or business.

(*2*) *Analysis.* A principal purpose of A entering into the transactions was to reduce the amount incurred by A that otherwise would be interest expense; in effect, A sought to convert a substantial portion of its interest expense deductions on Loan 1 into section 162 deductions on the Guarantee Fee Agreement ($100x interest expense had A borrowed without the Guarantee compared to $60x interest expense related to Loan 1 and $40x section 162 deduction). A would not have entered into the Guarantee Fee Agreement in the ordinary course of A's trade or business. The $40x section 162 deductions related to the Guarantee Fee Agreement were incurred by A in a series of transactions in which A secured the use of funds for a period of time and were substantially incurred in consideration of the time value of money. As a result, under paragraph (b)(22)(iv)(A)(*1*) of this section, for purposes of section 163(j), the $40x paid by A to FC on the Guarantee Fee Agreement is treated by A as interest expense.

(E) *Example 5*—(*1*) *Facts.* A, B, and C are equal partners in ABC partnership. ABC is considering acquiring an additional loan from a third-party lender to expand its business operations. However, ABC already has significant debt and interest expense. For the purpose of reducing the amount of additional interest expense ABC would have otherwise incurred by borrowing, A agrees to make an additional contribution to ABC for use in its business operations in exchange for a guaranteed payment for the use of capital under section 707(c).

(*2*) *Analysis.* The guaranteed payment is deductible by ABC, incurred by ABC in a transaction in which ABC secures the use of funds for a period of time, substantially incurred in consideration of the time value of money, and not described in paragraph (b)(22)(i), (ii), or (iii) of this section. As a result, the guaranteed payment to A is economically equivalent to the interest that ABC would have incurred on an additional loan from a third-party lender. A principal purpose of A making a contribution in exchange for a guaranteed payment for the use of capital was to reduce the amount incurred by ABC that otherwise would be interest expense. As a result, under paragraph (b)(22)(iv)(A)(*1*) of this section, for purposes of section 163(j), such guaranteed payment is treated as interest expense of ABC for purposes of section 163(j). In addition, under paragraph (b)(22)(iv)(A)(*2*) of this section, if A knows that the guaranteed payment is treated as interest expense of ABC, because A provides the use of funds for a period of time in a transaction subject to paragraph (b)(22)(iv)(A)(*1*) of this section, A earns income or gain with respect to the transaction, and such income or gain is substantially earned in consideration of the time value of money provided by A, the guaranteed payment is treated as interest income of A for purposes of section 163(j).

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

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

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

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

(27) *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).

(28) *Ownership change.* The term *ownership change* has the meaning provided in section 382 and the regulations in this part under section 382 of the Code.

(29) *Ownership date.* The term *ownership date* has the meaning provided in section 382 and the regulations in this part under section 382 of the Code.

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

(31) *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.

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

(33) *Relevant foreign corporation.* The term *relevant foreign corporation* means any foreign corporation whose classification is relevant under § 301.7701–3(d)(1) for a taxable year, other than solely pursuant to section 881 or 882.

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

(35) [*Reserved*]

(36) *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).

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

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

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

(40) *Separate tentative taxable income.* The term *separate tentative taxable income* with respect to a taxpayer and a taxable year has the meaning provided in § 1.1502–12, but for this purpose computed without regard to the application of the section 163(j) limitation and with the addition of the adjustments made in paragraph (b)(43)(ii) of this section and § 1.163(j)–4(d)(2)(iv).

(41) *Tax-exempt corporation.* The term *tax-exempt corporation* means any tax-exempt organization that is organized as a corporation.

(42) *Tax-exempt organization.* The term *tax-exempt organization* means any entity subject to tax under section 511.

(43) *Tentative taxable income*—(i) *In general.* The term *tentative taxable income,* with respect to a taxpayer and a taxable year, generally is determined in the same manner as taxable income under section 63 but for this purpose computed without regard to the application of the section 163(j) limitation. Tentative taxable income is computed without regard to any disallowed business interest expense carryforwards.

(ii) [Reserved]

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

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

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

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

(E) For special rules clarifying that tentative taxable income takes sections 461(l), 465, and 469 into account, see § 1.163(j)–3(b)(4).

(F) For special rules clarifying that tentative taxable income takes sections 461(l), 465, and 469 into account, see § 1.163(j)–3(b)(4).

(G) For special rules clarifying that tentative taxable income takes sections 461(l), 465, and 469 into account, see § 1.163(j)–3(b)(4).

(44) *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 the trade or business of performing services as an employee, an electing real property trade or business, an electing farming business, or an excepted regulated utility trade or business. 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.

(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.

(45) *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), any adjustments for tax credits claimed by the taxpayer (for example, under section 50(c)), or any adjustments for any portion of the basis that the taxpayer has elected to treat as an expense (for example, under section 179, 179B, or 179C).

(46) *United States shareholder.* The term *United States shareholder* has the meaning provided in section 951(b).

(c) *Applicability date*—(1) *In general.* Except as provided in paragraphs (c)(2) and (3) of this section, this section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, and before November 13, 2020 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year. Additionally, taxpayers and their related parties within the meaning of sections 267(b) and 707(b)(1), otherwise relying on the notice of proposed rulemaking that was published on December 28, 2018, in the **Federal Register** (83 FR 67490) in its entirety under § 1.163(j)–1(c), may alternatively choose to follow § 1.163(j)–1(b)(1)(iii), rather than proposed § 1.163(j)–1(b)(1)(iii).

(2) *Anti-avoidance rules.* The anti-avoidance rules in paragraph (b)(22)(iv) of this section apply to transactions entered into on or after September 14, 2020.

(3) *Swaps with significant nonperiodic payments*—(i) *In general.* Except as provided in paragraph (c)(3)(ii) of this section, the rules provided in paragraph (b)(22)(ii) of this section apply to notional principal contracts entered into on or after September 14, 2021. However, taxpayers may choose to apply the rules provided in paragraph (b)(22)(ii) of this section to notional principal contracts entered into before September 14, 2021.

(ii) *Anti-avoidance rule.* The anti-avoidance rules in paragraph (b)(22)(iv) of this section (applied without regard to the references to paragraph (b)(22)(ii) of this section) apply to a notional principal contract entered into on or after September 14, 2020.

§ 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 that is part of provides rules regarding real estate mortgage investment conduits (REMICs). Paragraph (f) of this section provides rules regarding the calculation of ATI with respect to certain beneficiaries. Paragraph (g) of this section provides rules regarding tax-exempt organizations. Paragraph (h) of this section provides examples illustrating the application of this section. Paragraph (i) of this section is reserved. Paragraph (j) of this section provides an anti-avoidance rule.

(b) *General rule*—(1) *In general.* 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—

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

(ii) 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

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

(2) *50 percent ATI limitation for taxable years beginning in 2019 or 2020*—(i) *In general.* Except as otherwise provided in section 163(j)(10) and paragraph (b)(2) of this section, for any taxable year beginning in 2019 or 2020, paragraph (b)(1)(ii) of this section is applied by substituting 50 percent for 30 percent. The 50 percent ATI limitation does not apply to partnerships for taxable years beginning in 2019. Further, for a partnership taxable year beginning in 2020 for which an election out of section 163(j)(10)(A)(i) has not been made, § 1.163(j)–6(f)(2)(xi) is applied by substituting two for ten-thirds when grossing up each partner's final ATI capacity excess amount.

(ii) *Election out of the 50 percent ATI limitation.* A taxpayer may elect to not have paragraph (b)(2)(i) of this section apply for any taxable year beginning in 2019 or 2020. In the case of a partnership, the election must be made by the partnership and may be made only for taxable years beginning in 2020.

(3) *Election to use 2019 ATI in 2020*—(i) *In general.* Subject to paragraph (b)(3)(ii), a taxpayer may elect to use the taxpayer's ATI for the last taxable year beginning in 2019 (2019 ATI) as the ATI for any taxable year beginning in 2020.

(ii) *Short taxable years.* If an election is made under paragraph (b)(3)(i) of this section for a taxable year beginning in 2020 that is a short taxable year, the ATI for such taxable year is equal to the amount that bears the same ratio to 2019 ATI as the number of months in the short taxable year bears to 12.

(4) *Time and manner of making or revoking the elections.* The rules and procedures regarding the time and manner of making, or revoking, an election under paragraphs (b)(2) and (3) of this section are provided in Revenue Procedure 2020–22, 2020–18 I.R.B. 745, or in other guidance that may be issued (see §§ 601.601(d) and 601.602 of this chapter).

(c) *Disallowed business interest expense carryforward*—(1) *In general.* 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 a disallowed business interest expense carryforward, and is therefore business interest expense that is subject to paragraph (b) of this section in such succeeding taxable year. Disallowed business interest expense carryforwards 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. See § 1.163(j)–10(c)(4).

(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 of the taxpayer in that taxable year. See § 1.163(j)–6(m)(3) for rules applicable to the treatment of excess business interest expense from a partnership that is not subject to section 163(j) in a succeeding taxable year, and see § 1.163(j)–6(m)(4) for rules applicable to S corporations with disallowed business interest expense carryforwards that are not subject to section 163(j) in a succeeding 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)–(v) [Reserved]

(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 in which the taxpayer meets the gross receipts test of section 448(c) and the regulations in this part under section 448 of the Code for the taxable year. See § 1.163(j)–9(b) for elections available under section 163(j)(7)(B) and 163(j)(7)(C) for real property trades or businesses or farming businesses that also may be exempt small businesses. See § 1.163(j)–6(m) for rules applicable to partnerships and S corporations not subject to section 163(j).

(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 of section 448(c) and the regulations in this part under section 448 of the Code 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), 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 a tax-exempt organization include 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) *Trusts*—(i) *Calculation of ATI with respect to certain trusts and estates.* The ATI of a trust or a decedent's estate taxable under section 641 is computed without regard to deductions under sections 642(c), 651, and 661.

(ii) *Calculation of ATI with respect to certain beneficiaries.* The ATI of a beneficiary (including a tax-exempt beneficiary) of a trust or a decedent's estate is reduced by any income (including any distributable net income) received from the trust or estate by the beneficiary to the extent such income was necessary to permit a deduction under section 163(j)(1)(B) and § 1.163(j)–2(b) for any business interest expense of the trust or estate that was in excess of any business interest income of the trust or estate.

(g) *Tax-exempt organizations.* Except as provided in paragraph (d) of this section, the section 163(j) limitation applies to tax-exempt organizations for purposes of computing their unrelated business taxable income under section 512. For rules on determining the gross receipts of a tax-exempt organization for purposes of the small business exemption, see paragraph (d)(2)(iv) of this section. For special rules applicable to tax-exempt beneficiaries of a trust or a decedent's estate, see § 1.163(j)–2(f). For special rules applicable to tax-exempt corporations, see § 1.163(j)–4. For special allocation rules applicable to tax-exempt organizations, see § 1.163(j)–10(a)(5).

(h) *Examples.* The examples in this paragraph (h) illustrate the application of section 163(j) and the provisions of this section. Unless otherwise indicated, 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, 2021, 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.* For the 2021 taxable year, 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 × 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 2021 taxable year.

(2) *Example 2: Carryforward of business interest expense*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (h)(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 (h)(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 2021 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 2020 taxable year, Y has tentative taxable income of $30x, which is determined without regard to the application of the section 163(j) limitation on business interest expense. Y's tentative taxable income 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 under section 167, of which $10x is capitalized to inventory under section 263A. Of the $10x capitalized to inventory, only $7x is recovered through cost of goods sold during the 2020 taxable year and $3x remains in ending inventory at the end of the 2020 taxable year. The $3x of ending inventory is recovered through cost of goods sold during the 2021 taxable year. Y also has a disallowed business interest expense carryforward from the prior year of $8x.

(ii) *Analysis.* (A) For purposes of determining the section 163(j) limitation for 2020, Y's disallowed business interest expense carryforward is not taken into account in determining tentative taxable income or ATI. Y's ATI is $90x, calculated as follows:

TABLE 1 TO PARAGRAPH (h)(3)(ii)(A)

Tentative taxable income	$30x
Less:	
Floor plan financing interest	10x
Business interest income	20x
	0x

(B) Plus:

TABLE 2 TO PARAGRAPH (h)(3)(ii)(B)

Business interest expense	$50x
Net operating loss deduction	25x
Depreciation	15x
ATI	90x

(C) For Y's 2021 taxable year, the $3x of ending inventory that is recovered through cost of goods sold in 2021 is not added back to tentative taxable income (TTI) in determining ATI because it was already included as an addback in ATI in Y's 2020 taxable year. See § 1.163(j)–1(b)(1)(iii).

(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 2021 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 2021 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 (h)(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, 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 2021 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 does not conduct an electing real property trade or business or an electing farming 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 in this part under section 448, 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 2021 taxable year without regard to section 163(j).

(7) *Example 7: Partnership with excess business interest expense qualifies for the small business exemption in a succeeding taxable year*—(i) *Facts.* X and Y are equal partners in partnership PRS. In addition to being partners in PRS, X and Y each operate their own sole proprietorships. For the taxable year ending December 31, 2021, PRS is subject to section 163(j) and has excess business interest expense of $10x. For the taxable year ending December 31, 2022, PRS has $40x of business interest expense, and X and Y have $20x of business interest expense from their respective sole proprietorships. For the taxable year ending December 31, 2022, PRS and Y qualify for the small business exemption under § 1.163(j)–2(d), while X is subject to section 163(j) and has a section 163(j) limitation of $22x.

(ii) *Partnership-level analysis.* For the 2021 taxable year, PRS allocates the $10x of excess business interest expense equally to X and Y ($5x each). See § 1.163(j)–6(f)(2). For the 2022 taxable year, section 163(j) does not apply to PRS because PRS qualifies for the small business exemption. As a result, none of PRS's $40x of business interest expense for the 2022 taxable year is subject to the section 163(j) limitation at the partnership level.

(iii) *Partner-level analysis.* For the 2022 taxable year, each partner treats its $5x of excess business interest expense from PRS as paid or accrued in that year. See § 1.163(j)–6(m)(3). This amount becomes business interest expense that each partner must subject to its own section 163(j) limitation, if any. With this $5x, each partner has $25x of business interest expense for the 2022 taxable year ($20x from its sole proprietorship, plus $5x of excess business interest expense treated as paid or accrued in the 2020 taxable year). X deducts $22x of its business interest expense pursuant to its section 163(j) limitation and carries forward the remainder ($3x) as a disallowed business interest expense carryforward to the taxable year ending December 31, 2023. Y is not subject to section 163(j) because Y qualifies for the small business exemption. Y therefore deducts all $25x of its business interest expense for the 2022 taxable year.

(8) *Example 8: 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, 2020, 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 2020. 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 2020, X may elect for its farming business to be an excepted trade or business.

(i) [Reserved]

(j) *Anti-avoidance rule*—(1) *In general.* 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).

(2) *Examples.* The examples in this paragraph (j)(2) illustrate the application of this section.

(i) *Example 1*—(A) *Facts.* Individual A operates an excepted trade or business (Business X) and a non-excepted trade or business (Business Y). With a principal purpose of avoiding the rules of section 163(j) or the regulations in this part under section 163(j) of the Code, A contributes Business X to newly-formed C corporation B in exchange for stock; A then causes B to borrow funds from a third party and distributes a portion of the borrowed funds to A for use in Business Y. B takes the position that its interest payments on the debt are not subject to the section 163(j) limitation because B is engaged solely in an excepted trade or business.

(B) *Analysis.* A has entered into an arrangement with a principal purpose of avoiding the rules of section 163(j) or the regulations in this part under section 163(j). Thus, under paragraph (j)(1) of this section, the Commissioner of the IRS may disregard or recharacterize this transaction to the extent necessary to carry out the purposes of section 163(j). In this case, payments of interest on the debt may be recharacterized as payments of interest properly allocable to a non-excepted trade or business subject to the section 163(j) limitation.

(ii) *Example 2*—(A) *Facts.* Partnership UTP has two non-excepted trades or businesses. Business A has gross income of $1000x and gross deductions of $200x. Business B has gross income of $100x and gross deductions of $600x. With a principal purpose of avoiding the rules in section 163(j) or the regulations in this part under section 163(j), UTP and a partner of UTP form partnership LTP and UTP contributes Business B to LTP prior to borrowing funds. UTP takes the position that it does not take its share of LTP gross deductions into account when computing its ATI.

(B) *Analysis.* UTP has entered into an arrangement with a principal purpose of avoiding the rules of section 163(j) or the regulations in this part under section 163(j). Thus, under paragraph (j)(1) of this section, the Commissioner of the IRS may disregard or recharacterize this transaction to the extent necessary to carry out the purposes of section 163(j). In this case, UTP's share of gross deductions from LTP may be recharacterized as gross deductions incurred directly by UTP solely for purposes of computing UTP's ATI.

(k) *Applicability date.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

§ 1.163(j)–3 Relationship of the section 163(j) 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 regulations in this part under section 163(j) of the Code generally apply only to business interest expense that would be deductible in the current taxable year without regard to section 163(j). Thus, for example, a taxpayer must apply § 1.163–8T, if applicable, to determine which items of interest expense are investment interest under section 163(d) before applying the rules in this section to interest expense. 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).

(4) *At risk rules, passive activity loss provisions, and limitation on excess business losses of noncorporate taxpayers.* Section 163(j) generally applies to limit the deduction for business interest expense before the application of sections 461(l), 465, and 469. However, in determining tentative taxable income for purposes of computing ATI, sections 461(l), 465, and 469 are taken into account.

(5) *Capitalized interest expenses.* Section 163(j) applies after the application of provisions that require the capitalization of interest, such as sections 263A and 263(g). 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 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(c), the regulations in this part under sections 382 and 383 of the Code, and §§ 1.1502–91 through 1.1502–99.

(c) *Examples.* The examples in this paragraph (c) illustrate the application of section 163(j) and the provisions of this section. Unless otherwise indicated, X and Y are calendar-year domestic C corporations; 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 certain small businesses in § 1.163(j)–2(d) does not apply.

(1) *Example 1: Disallowed interest expense*—(i) *Facts.* In 2021, 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 2021 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 2019 ATI ($27x). Therefore, in the 2021 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 2021, 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). The $30x expense is allowed as a deduction under section 267(a)(2) in 2022.

(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 2021 because it is not currently deductible under section 267(a)(2). Accordingly, in 2021, 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 2021 ($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 2021 taxable year under section 267(a)(2) will be taken into account in determining the business interest expense deduction under section 163(j) in 2022, 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 2021 will be carried forward to 2022 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 the 2021 taxable year, 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, except that section 469 is taken into account in the determination of tentative taxable income for purposes of computing ATI. 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 2021, $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 2021 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 2021, 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 section 163(a) and (j), $270x (a proportionate amount of the $300x (0.90 × $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 × $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 2021, $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).

(5) *Example 5: ATI calculation with passive activity loss*—(i) *Facts.* D is an individual who engages in a trade or business, V, as a sole proprietorship. D relies on employees to perform most of the work and, as a result, D does not materially participate in V. Therefore, V is a passive activity of D. V is not an excepted trade or business. In Year 1, V generates $500x of passive income, $400x of business interest expense, and $600x of ordinary and necessary expenses deductible under section 162 (not including any interest described in § 1.163(j)–1(b)(22)). No disallowed business interest expense carryforward has been carried to Year 1 from a prior year, and no amounts have been carried over to Year 1 from a prior year under either section 465(a)(2) or section 469(b).

(ii) *Tentative taxable income.* Under § 1.163(j)–1(b)(43), tentative taxable income is determined as though all business interest expense was not subject to the section 163(j) limitation. Sections 461(l), 465, and 469 apply in the determination of tentative taxable income. For year 1, D has $500x of allowable deductions and a $500x tentative passive activity loss under section 469, because D's $1000x of passive expenses exceeds D's $500x of passive income from V. The tentative disallowance of $500x is generally allocated pro rata between D's passive expenses under § 1.469–1T(f)(2)(ii)(A). In this case, fifty percent ($500x of passive activity loss divided by $1000x of total passive expenses) of each category of passive expense is tentatively disallowed: $200x of business interest expense and $300x of section 162 expense. D's tentative taxable income is $0 (zero), which is determined by reducing $500x of gross income by the remaining $200x of business interest expense and $300x of section 162 expense ($500x − $200x − $300x).

(iii) *ATI.* Under section § 1.163(j)–1(b)(1), to determine ATI, D must add business interest expense to tentative taxable income, but only to the extent that the business interest expense reduced tentative taxable income, or $200x. The $200x of business interest expense that was tentatively disallowed under section 469 is not added to tentative taxable income to determine ATI. D's ATI is $200x, which is determined by adding the $200x of business interest expense that reduced tentative taxable income to D's tentative taxable income, or $0 (0 + $200x).

(iv) *Section 163(j) limitation.* D's section 163(j) limitation in Year 1 is D's business interest income, or $0, plus 30 percent of ATI, or $60x (30 percent × $200x ATI), plus D's floor plan financing, or $0, for a total of $60x ($0 + $60x + $0). Before the application of section 469, D has $60x of deductible business interest expense and $340x of disallowed business interest expense carryforward under § 1.163(j)–2(c).

(v) *Passive activity loss.* Because D's passive deductions exceed the passive income from V, and D does not have any passive income from other sources, section 469 applies to limit D's passive loss from V. Having first applied section 163(j), D has $660x of passive expenses, determined by adding D's $60x of business interest expense that is allowed by section 163(j) as a deduction and $600x of section 162 expense ($60x + $600x). D offsets $500x of the passive expenses against $500x of passive income; therefore, D has a passive activity loss of $160x in Year 1, determined as the excess of D's total passive expenses over D's passive income ($660x − $500x). The amount of D's loss from the passive activity that is disallowed under section 469 ($160x) is generally ratably allocated to each of D's passive activity deductions under § 1.469–1T(f)(2)(ii)(A). As a general rule, each deduction is multiplied by the ratio of the total passive loss to total passive expenses (160x/660x). Of D's $60x business interest expense, $14.55x (($160x/$660x) × $60x) is disallowed in Year 1. Additionally, of D's $600x section 162 expense, $145.45x (($160x/$660x) × $600x) is disallowed. The amounts disallowed under section 469(a)(1) and § 1.469–2T(f)(2) are carried over to the succeeding taxable year under section 469(b) and § 1.469–1(f)(4).

(6) *Example 6: Effect of passive activity loss carryforwards*—(i) *Facts.* The facts are the same as in *Example 5* in paragraph (c)(5)(i) of this section. In Year 2, V generates $500x of passive income, $100x of business interest expense, and $0 (zero) of other deductible expenses. D is not engaged in any other trade or business activities. A disallowed business interest expense carryforward of $340x has been carried to Year 2 from Year 1. Under section 469, D has a suspended loss from Year 1 that includes $14.55x of business interest expense and $145.45x of section 162 expense. These amounts are treated as passive activity deductions in Year 2.

(ii) *Tentative taxable income.* To determine D's tentative taxable income, D must first determine D's allowable deductions. In year 2, D has $260x of allowable deductions, which includes $100x of business interest expense generated Year 2, $14.55x of business interest expense disallowed in Year 1 by section 469, and $145.45x of section 162 expense disallowed in Year 1 by section 469 ($100x + $14.55x + $145.45x)). D's disallowed business interest expense carryforward from Year 1 is not taken into account in determining tentative taxable income. See § 1.163(j)–1(b)(43). Additionally, the $14.55x of business interest expense disallowed in Year 1 by section 469 is not business interest expense in Year 2 because it was deductible after the application of section 163(j) (but before the application of section 469) in Year 1. D does not have a tentative passive activity loss in Year 2, because D's $500x of passive income from V exceeds D's $260x of tentative passive expenses. Therefore, D's tentative taxable income in Year 2 is $240x, which is determined by subtracting D's allowable deductions other than disallowed business interest expense carryforwards, or $260x, from D's gross income, or $500x ($500x − $260x).

(iii) *ATI.* D's ATI in Year 2 is $340x, which is determined by adding D's business interest expense, or $100x, to D's tentative taxable income, or $240x ($240x + $100x). Because disallowed business interest expense carryforwards are not taken into account in determining tentative taxable income, there is no corresponding adjustment for disallowed business interest expense carryforwards in calculating ATI. Therefore, there is no adjustment for D's $340x of disallowed business interest expense carryforward in calculating D's ATI. D has no other adjustments to determine ATI.

(iv) *Section 163(j) limitation.* D's section 163(j) limitation in Year 2 is $102x, which is determined by adding D's business interest income, or $0, 30 percent of D's ATI for year 2, $102 ($340x × 30 percent), and D's floor plan financing for Year 2, or $0 ($0 + ($102x) + $0). Accordingly, before the application of section 469 in Year 2, $102x of D's $440x of total business interest expense (determined by adding $340x of disallowed business interest expense carryforward from Year 1 and $100x of business interest expense in Year 2) is deductible. D has $338x of disallowed business interest expense carryforward that will carry forward to subsequent taxable years under § 1.163(j)–2(c), determined by subtracting D's deductible business interest expense in Year 2, or $102x, from D's total business interest expense in Year 2, or $440x ($440x − $102x).

(v) *Section 469.* After applying the section 163(j) limitation, D applies section 469 to determine if any amount of D's expense is a disallowed passive activity loss. For Year 2, D has $262x of passive expenses, determined by adding D's business interest expense deduction allowed by section 163(j) ($102x), D's section 162 expense carried forward from Year 1 under section 469 ($145.45x), and D's interest expense carried forward from Year 1 under section 469 which is not business interest expense in Year 2, or $14.55x ($102x + $145.45x + $14.55x). Therefore, D has $238x of net passive income in Year 2, determined by reducing D's total passive income in Year 2 ($500x), by D's disallowed passive activity loss, or $262x ($500x − $262x). D does not have a passive activity loss in Year 2, and no part of D's $262x of passive expenses is disallowed in Year 2 under section 469.

(7) *Example 7: Capitalized interest expense*—(i) *Facts.* In 2020, X has $50x of interest expense. Of X's interest expense, $10x is required to be capitalized under section 263A. X capitalizes this interest expense to a depreciable asset. X's business interest income is $9x and X's ATI is $80x. X makes the election in § 1.163(j)–2(b)(2)(ii) to use 30 percent, rather than 50 percent, of ATI in determining X's section 163(j) limitation for the 2020 taxable year.

(ii) *Analysis.* Under paragraph (b)(5) of this section, section 263A is applied before section 163(j). Accordingly, $10x of X's interest expense cannot be taken into consideration for purposes of section 163(j) in 2020. Additionally, under paragraph (b)(5) of this section, X's $10 of capitalized interest expense is not business interest expense for purposes of section 163(j). As a result, when X recovers its capitalized interest expense through depreciation deductions, such capitalized interest expense will not be taken into account as business interest expense in determining X's section 163(j) limitation. X's section 163(j) limitation in 2020, or the amount of business interest expense that X may deduct, is limited to $33x under § 1.163(j)–2(b), determined by adding X's business interest income ($9x) and 30 percent of X's 2020 ATI ($24x). X therefore has $7x of disallowed business interest expense in 2020 that will be carried forward to 2021 as a disallowed business interest expense carryforward.

(d) *Applicability date.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

§ 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 rules regarding the computation of items of income and expense under section 163(j) for taxpayers that are C corporations, including, for example, members of a consolidated group, REITs, RICs, tax-exempt corporations, and cooperatives. 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 rules applicable to members of a consolidated group. Paragraph (e) of this section provides rules governing the ownership of partnership interests by members of a consolidated group. Paragraph (f) 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, investment expenses, and certain other tax items 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, investment income, or investment expense (within the meaning of section 163(d)) that a partnership pays, receives, or accrues and that is allocated to a C corporation partner as a separately stated item is treated by the C corporation partner as properly allocable to a trade or business of that partner. Similarly, for purposes of section 163(j), any other tax items of a partnership that are neither properly allocable to a trade or business of the partnership nor described in section 163(d) and that are allocated to a C corporation partner as separately stated items are treated as properly allocable to a trade or business of that partner.

(ii) *Effect of characterization on partnership.* The characterization of a partner's tax items pursuant to paragraph (b)(3)(i) of this section does not affect the characterization of these items at the partnership level.

(iii) *Separately stated interest expense and interest income of a partnership not treated as excess business interest expense or excess taxable income of a C corporation partner.* Investment interest expense and other interest expense of a partnership that is treated as business interest expense by a C corporation partner under paragraph (b)(3)(i) of this section is not treated as excess business interest expense of the partnership. Investment interest income and other interest income of a partnership that is treated as business interest income by a C corporation partner under paragraph (b)(3)(i) of this section is not treated as excess taxable income of the partnership. For rules governing excess business interest expense and excess taxable income, see § 1.163(j)–6.

(iv) *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 sections 951(a) or 951A(a) that are not properly allocable to a trade or business of the domestic partnership, then, notwithstanding paragraph (b)(3)(i) of this section, 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.

(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) *Tentative taxable income of RICs and REITs.* The tentative taxable income of a RIC or REIT for purposes of calculating ATI is the tentative 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 tentative 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). See paragraph (b)(4)(iii) of this section for an adjustment to ATI 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).

(5) *Application to tax-exempt corporations.* The rules in this paragraph (b) apply to a tax-exempt corporation 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) *Adjusted taxable income of cooperatives.* Solely for purposes of computing the ATI of a cooperative under § 1.163(j)–1(b)(1), tentative taxable income is not reduced by the amount of any patronage dividend under section 1382(b)(1) or by any amount paid in redemption of nonqualified written notices of allocation distributed as patronage dividends under section 1382(b)(2) (for cooperatives subject to taxation under sections 1381 through 1388), any amount described in section 1382(c) (for

cooperatives described in section 1381(a)(1) and section 521), or any equivalent amount deducted by an organization that operates on a cooperative basis but is not subject to taxation under sections 1381 through 1388.

(7) *Examples.* The principles of this paragraph (b) are illustrated by the following examples. For purposes of the examples in this paragraph (b)(7) of this section, 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 2021, T's tentative 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 2021 taxable year is $520x ($320x of tentative taxable income + $200x business interest expense − $50x business interest income + $50x depreciation deductions = $520x), and its section 163(j) limitation for the 2021 taxable year is $206x ($50x of business interest income + 30 percent of its ATI (30 percent × $520x) = $206x). As a result, all $200x of T's interest expense is deductible in the 2021 taxable year under section 163(j).

(C) *Taxable year beginning in 2022.* The facts are the same as in *Example 1* in paragraph (b)(7)(i)(A) of this section, except that the taxable year begins in 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 tentative 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 × $470x) = $191x). As a result, T may only deduct $191x of its business interest expense for the taxable year, and the remaining $9x is 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 2021 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 equally to its two partners pursuant to § 1.163(j)–6(k). 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)(7)(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 2021, Business 1 earns $150x of net income (excluding interest expense and depreciation), and PS1 pays $100x of interest on Loan 2. For purposes of section 163(d) and (j), PS1 treats the interest paid on Loan 2 as properly allocable to a trade or business. 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 × $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 domestic C corporation, except as otherwise provided in paragraph (c)(2) of this section, the disallowance and carryforward under § 1.163(j)–2 (and § 1.163(j)–5, in the case of a taxpayer that is a consolidated group member) of a deduction for business interest expense of the taxpayer or of a partnership in which the taxpayer is a partner does not affect whether or when the business interest expense reduces the taxpayer's 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 does 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 does not affect whether or when such business interest expense reduces the PFIC'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, and if all or a portion 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 a portion of its interest in the partnership, the taxpayer must increase its earnings and profits immediately prior to the disposition by an amount equal to the amount of the basis adjustment required under section 163(j)(4)(B)(iii)(II) and § 1.163(j)–6(h)(3).

(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 2021 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 2021 taxable year. In that year, X has tentative 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 2021 taxable year is $100x ($0 of tentative 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 2021 taxable year under § 1.163(j)–2(b) (30 percent × $100x), and X may carry forward the remainder ($70x) to X's 2022 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 2021 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 2021 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 2021 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 2021 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 tentative 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 2021 taxable year is $60x ($10x tentative 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 2021 taxable year under section 163(j)(1) ($100x business interest income + (30 percent × $60x of ATI) = $118x), and X may carry forward the remainder ($7x) to X's 2022 taxable year. 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 2021 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 2021 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 2021 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 2021 taxable year. In addition, X has $50x of interest income and $20x of interest expense for the 2022 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 2022 taxable year and the $7x of disallowed business interest expense carryforward from the 2021 taxable year, X may deduct $27x of business interest expense in the 2022 taxable year. Under paragraph (c)(2) of this section, X must reduce its current earnings and profits for the 2022 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 2021 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), $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 2021 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 tentative 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 2021 taxable year is $40x ($0 tentative 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 2021 taxable year under section 163(j)(1) ($100x business interest income + (30 percent × $40x of ATI) = $112x), and X may carry forward the remainder of its business interest expense ($13x) to X's 2022 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 2021 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 2021 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 2021 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 2021 taxable year. In addition, X has $50x of mortgage interest income and $20x of interest expense for the 2022 taxable year. X has no other tax items for the 2022 taxable year.

(B) *Analysis.* Because X's $50x of business interest income exceeds the $20x of business interest expense from the 2022 taxable year and the $13x of disallowed business interest expense carryforwards from the 2021 taxable year, X may deduct $33x of business interest expense in 2022. Under paragraph (c)(2) of this section, X must reduce its current earnings and profits for 2022 by the full amount of the deductible interest expense ($33x).

(d) *Special rules for consolidated groups*—(1) *Scope.* This paragraph (d) provides 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 regulations in this part under section 163(j) 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 ownership of partnership interests by members of a consolidated group, see paragraph (e) of this section.

(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)(22), 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 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 tentative taxable income is the consolidated group's consolidated taxable income, determined under § 1.1502–11 but without regard to any carryforwards or disallowances under section 163(j). 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*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(v)(B) of this section, 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, except as otherwise provided in paragraph (d)(2)(v)(B) of this section, interest expense and interest income from intercompany obligations are not treated as business interest expense and business interest income.

(B) *Repurchase premium.* This paragraph (d)(2)(v)(B) applies if a member of a consolidated group purchases an obligation of another member of the same consolidated group in a transaction to which § 1.1502–13(g)(5) applies. Notwithstanding the general rule of paragraph (d)(2)(v)(A) of this section, if, as a result of the deemed satisfaction of the obligation under § 1.1502–13(g)(5)(ii), the debtor member has repurchase premium that is deductible under § 1.163–7(c), such repurchase premium is treated as interest that is subject to the section 163(j) limitation. See § 1.163(j)–1(b)(22)(i)(H).

(3) *Investment adjustments.* For rules governing investment adjustments within a consolidated group, see § 1.1502–32(b).

(4) *Examples.* The principles in this paragraph (d) are illustrated by the following examples. For purposes of the examples in this paragraph (d)(4), 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 2021 taxable year, P has $50x of separate tentative 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 tentative taxable income in the 2021 taxable year after taking into account $10x of depreciation deductions under section 168. S has no interest expense in the 2021 taxable year. The P group's tentative taxable income the 2021 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 × $150x = $45x), and a deduction for $20x of its $65x of business interest expense would be disallowed in the 2021 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 tentative 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 2021 taxable year is $60x (30 percent × $200x = $60x). As a result, all but $5x of the P group's business interest expense is deductible in the 2021 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, 2021, 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 2021, 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 × $10x = $3x). The P group may deduct $3x of its business interest expense in the 2021 taxable year. A deduction for P's remaining $7x of business interest expense is disallowed in the 2021 taxable year, and this amount is carried forward to the 2022 taxable year.

(e) *Ownership of partnership interests by members of a consolidated group.*

(1) [Reserved]

(2) *Change in status of a member.* A change in status of a member (that is, becoming or ceasing to be a member of the group) is not treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II) and § 1.163(j)–6(h)(3).

(3) *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)(iii)(I) 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 converted into business interest expense, deducted, and absorbed by the consolidated group. See § 1.1502–32(b).

(4) *Excess business interest expense and § 1.1502–36.* Excess business interest expense is a Category D asset within the meaning of § 1.1502–36(d)(4)(i).

(f) *Cross-references.* For rules governing the treatment of disallowed business interest expense carryforwards for C corporations, including rules governing the treatment of disallowed business interest expense carryforwards when members enter or leave a consolidated group, 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.

(g) *Applicability date*—(1) *In general.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

(2) [Reserved]

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

(a) *Scope and definitions*—(1) *Scope.* This section provides 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 a cross-reference 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 a cross-reference to other rules regarding the overlap of the SRLY limitation with section 382. Paragraph (g) of this section references additional rules that may limit the deductibility of interest or the use of disallowed business interest expense carryforwards.

(2) *Definitions*—(i) *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.

(ii) *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.

(iii) *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 section 163(j) limitation 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 equals 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 equals 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 is 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 Income Tax Regulations (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 is 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 expense 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 (including under paragraph (d)(1)(A) of this section) in the current year are to 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 tentative taxable income for the current year generally are to 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 \times (\$140x/(\$60x + \$140x)) = \$70x$), and S would be allowed to deduct $30x of its carryforwards from Year 1 ($\$100x \times (\$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, carries 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 tentative 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.

(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 × ($150x/$200x) = $75x), and A's allocable share is $25x ($100x × ($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 × ($60x/$150x)) = $48x), and A's allocable share is $72x (($120x × ($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 2 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

TABLE 2 TO PARAGRAPH (b)(3)(iv)(B)(*2*)—Continued

	Year 1 disallowed business interest expense carryforwards	Year 2 disallowed business interest expense carryforwards	Total disallowed business interest expense carryforwards
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 is 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 × ($12x/$30x)) = $4x), and A's allocable share is $6x (($10x × ($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*—(A) *Cumulative section 163(j) SRLY limitation.* This paragraph (d) applies to disallowed business interest expense carryforwards of a member arising in a SRLY (see § 1.1502–1(f))) or treated as arising in a SRLY under the principles of § 1.1502–21(c) and (g). The amount of the carryforwards described in the preceding sentence 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 aggregate section 163(j) limitation for all consolidated return years of the group, determined by reference only to the member's items of income, gain, deduction, and loss, and reduced (including below zero) by the member's business interest expense (including disallowed business interest expense carryforwards) absorbed by the group in all consolidated return years (cumulative section 163(j) SRLY limitation). For purposes of computing the member's cumulative section 163(j) SRLY limitation, intercompany items referred to in § 1.163(j)–4(d)(2)(iv) are included, with the exception of interest items with regard to intercompany obligations. See § 1.163(j)–4(d)(2)(v). Thus, for purposes of this paragraph (d), income and expense items arising from intercompany transactions (other than interest income and expense with regard to intercompany obligations) are included in the calculation of the cumulative section 163(j) SRLY limitation. In addition, items of interest expense with regard to intercompany obligations are not characterized as business interest expense for purposes of the reduction described in the second sentence of this paragraph (d)(1)(A).

(B) *Subgrouping.* For purposes of this paragraph (d), the SRLY subgroup principles of § 1.1502–21(c)(2)(i) (with regard to carryovers of SRLY losses) 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 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). 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. See also § 1.1502–21(b)(1).

(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 RICs or 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 2021, 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 2022. P does not pay or accrue business interest expense in 2021, and P has no disallowed business interest expense carryforwards from prior taxable years. At the close of 2021, P acquires all of the stock of T, which joins with P in filing a consolidated return beginning in 2022. Neither P nor T pays or accrues business interest expense in 2022, 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 all consolidated return years of the P group.

(B) *Analysis.* T's $100x of disallowed business interest expense carryforwards from 2021 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. T's cumulative section 163(j) SRLY limitation for 2022 is the P group's section 163(j) limitation, determined by reference solely to T's items for all consolidated return years of the P group ($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 2022, and the remaining $30x of T's disallowed business interest expense carryforwards are carried forward to 2023. After the P group deducts $70x of T's disallowed business interest expense carryforwards, T's cumulative section 163(j) SRLY limitation is reduced by $70x to $0.

(C) *Cumulative section 163(j) SRLY limitation of $0.* The facts are the same as in *Example 1* in paragraph (d)(3)(i)(A) of this section, except that T's cumulative section 163(j) SRLY limitation for 2022 is $0. Because the amount of T's disallowed business interest expense carryforwards that may be deducted by the P group in 2022 may not exceed T's cumulative section 163(j) SRLY limitation, none of T's carryforwards from 2021 may be deducted by the P group in 2022. Because none of T's disallowed business interest expense carryforwards are absorbed by the P group in 2022, T's cumulative section 163(j) SRLY limitation remains at $0 entering 2023.

(ii) *Example 2: Cumulative section 163(j) SRLY limitation less than zero*—(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. For the current year, the P group has a section 163(j) limitation of $150x, $25x of which is attributable to P, and $125x of which is attributable to S. S has $100x of disallowed business interest expense carryforwards that arose in a SRLY and $150x of current-year business interest expense. S's cumulative section 163(j) SRLY limitation entering the current year (computed by reference solely to S's items for all consolidated return years of the P group) is $0.

(B) *Analysis.* Under paragraph (d)(1) of this section, S's cumulative section 163(j) SRLY limitation is increased by $125x to reflect S's tax items for the current year. The P group's section 163(j) limitation permits the P group to deduct all $150x of S's current-year business interest expense. S's cumulative section 163(j) SRLY limitation is reduced by the $150x of S's business interest expense absorbed by the P group in the current year, which results in a −$25x balance. Thus, none of S's SRLY'd disallowed business interest expense carryforwards may be deducted by the P group in the current year. Entering the subsequent year, S's cumulative section 163(j) SRLY limitation remains −$25x.

(iii) *Example 3: Pro rata absorption of SRLY-limited disallowed business interest expense carryforwards*—(A) *Facts.* P, R, and S are the only members of a consolidated group, and no member has floor plan financing or business interest income. P has $60x of current-year business interest expense and $40x of disallowed business interest expense carryforwards from the previous year, which was not a separate return year. R has $120x of current-year business interest expense and $80x of disallowed business interest expense carryforwards from the previous year, which was not a separate return year. S has $70x of current-year business interest expense and $30x of disallowed business interest expense carryforwards from the previous year, which was a separate return year. The P group has a section 163(j) limitation of $300x, $50x of which is attributable to P, $90x to R, and $160x to S. S's cumulative section 163(j) SRLY limitation entering the current year (computed by reference solely to S's items for all consolidated return years of the P group) is $0.

TABLE 3 TO PARAGRAPH (d)(3)(iii)(A)

	Current-year business interest expense	Disallowed business interest expense carryforwards from prior taxable year	Section 163(j) limitation
P	$60x	$40x	$50x
R	120x	80x	90x
S	70x	(SRLY) 30x	160x
Total	250x	150x	300x

(B) *Analysis.* Under paragraph (d)(1) of this section, S's cumulative section 163(j) SRLY limitation is increased in the current year by $160x. The P group's section 163(j) limitation permits the P group to deduct all $70x of S's current-year business interest expense (and all $180x of P and R's current-year business interest expense). S's cumulative section 163(j) SRLY limitation is reduced by the $70x of S's business interest expense absorbed by the P group in the current year, resulting in a $90x balance. Because the P group has $50x of section 163(j) limitation remaining after the absorption of current-year business interest expense, the P group can absorb $50x of its members' disallowed business interest expense carryforwards. Under paragraph (d)(2) of this section, SRLY-limited disallowed business interest expense carryforwards are deducted on a pro rata basis with other disallowed business interest expense carryforwards from the same taxable year. Accordingly, the P group can deduct $10x ($50x × ($30x/$150x)) of S's SRLY-limited disallowed business interest expense carryforwards. S's cumulative section 163(j) SRLY limitation is reduced (to $80x) by the $10x of SRLY-limited disallowed business interest carryforwards absorbed by the P group in the current year.

(C) *Cumulative section 163(j) SRLY limitation of −$75x.* The facts are the same as in *Example 3* in paragraph (d)(3)(iii)(A) of this section, except that S's cumulative section 163(j) SRLY limitation entering the current year is −$75x. After adjusting for S's tax items for the current year ($160x) and the P group's absorption of S's current-year business interest expense ($70x), S's cumulative section 163(j) SRLY limitation is $15x (−$75x + $160x − $70x). Because S's cumulative section 163(j) SRLY limitation ($15x) is less than the amount of S's SRLY-limited disallowed business interest expense carryforwards ($30x), the pro rata calculation under paragraph (d)(2) of this section is applied to $15x (rather than $30x) of S's carryforwards. Accordingly, the P group can deduct $5.56x ($50x × ($15x/$135x)) of S's SRLY-limited disallowed business interest expense carryforwards. S's cumulative section 163(j) SRLY limitation is reduced (to $9.44x) by the $5.56x of SRLY-limited disallowed business interest carryforwards absorbed 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(c)(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(c)(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.

(5) *Recognized built-in loss.* For a rule providing that a section 382 disallowed business interest carryforward (as defined in § 1.382–2(a)(7)) is not treated as a recognized built-in loss for purposes of section 382, see § 1.382–7(d)(5).

(f) *Overlap of SRLY limitation with section 382.* For rules governing the overlap of the application of section 382 and the application of the SRLY rules, see § 1.1502–21(g).

(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 beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

§ 1.163(j)–6 Application of the section 163(j) limitation to partnerships and subchapter S corporations.

(a) *Overview.* If a deduction for business interest expense of a partnership or an S corporation is subject to the section 163(j) limitation, 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 is taken into account in determining the nonseparately stated taxable income or loss of the partnership or S corporation. Once a partnership or an 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. Paragraph (h) of this section provides basis adjustment rules, and paragraph (k) 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.

(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.

(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 non-excepted trade or business.

(8) *Excepted assets.* The term *excepted assets* means assets from an excepted trade or business.

(c) *Business interest income and business interest expense of a partnership*—

(1)–(2) [Reserved]

(3) *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. However, for all other purposes of the Code, 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 a partnership*—(1) *Tentative taxable income of a partnership.* For purposes of computing a partnership's ATI under § 1.163(j)–1(b)(1), the tentative taxable income of a partnership is the partnership's taxable income determined under section 703(a), but computed without regard to the application of the section 163(j) limitation.

(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 6* in paragraph (o)(6) 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, except as provided for in paragraph (m) of this section, 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 items. See *Example 6* in paragraph (o)(6) 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. See § 1.163(j)–10(b)(4)(ii) for dispositions of interests in partnerships that own—

(i) Non-excepted assets and excepted assets; or

(ii) Investment assets; or

(iii) Both.

(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 the partner 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 already has 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 paragraph 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 under section 704 of the Code. 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 under section 704 of the Code, including any allocations under section 704(c), other than remedial items. 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 § 1.163–8T 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 (that is, 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. If the partnership determines that each partner has a pro rata share of allocable ATI, allocable business interest income, and allocable business interest expense, then the partnership may bypass paragraphs (f)(2)(iii) through (xi) of this section and allocate its section 163(j) excess items in the same proportion. See *Example 1* through *Example 16* in paragraphs (o)(1) through (16), respectively. This pro-rata exception does not result in allocations of section 163(j) excess items that vary from the array of allocations of section 163(j) excess items that would have resulted had paragraphs (f)(2)(iii) through (xi) been applied.

(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 determined 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 30 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 30 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 30 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 30 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 or 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 *Example 17* through *Example 21* in paragraphs (o)(17) through (21) of this section, respectively.

(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 and the excess business interest expense is treated as such under paragraph (h)(2) of this section—

(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 taxable years, unless paragraph (m)(3) of this section applies. See *Example 1* through *Example 16* in paragraphs (o)(1) through (16) of this section, respectively.

(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 *Example 2* through *Example 16* in paragraphs (o)(2) through (16) of this section, respectively.

(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 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 and business interest expense of an exempt entity (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 *Example 7* in paragraph (o)(7) 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 *Example 8* in paragraph (o)(8) of this section.

(3) *Partner basis adjustment upon disposition of partnership interest.* If a partner (transferor) disposes of an interest in a partnership, the adjusted basis of the partnership interest being disposed of (transferred 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 transferor under paragraph (f)(2) of this section which has previously been treated under paragraph (g) of this

section as business interest expense paid or accrued by the transferor, multiplied by the ratio of the fair market value of the transferred interest to the total fair market value of the transferor's partnership interest immediately prior to the disposition. Therefore, the adjusted basis of the transferred interest is not increased immediately before the disposition by any allocation of excess business interest expense from the partnership that did not reduce the transferor's adjusted basis in its partnership interest pursuant to paragraph (h) of this section prior to the disposition, or by any excess business interest expense that was treated under paragraph (g) of this section as business interest expense paid or accrued by the transferor prior to the disposition. If the transferor disposes of all of its 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 or negative section 163(j) expense. If the transferor disposes of a portion of its 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 the amount of excess business interest expense proportionate to the transferred interest. The amount of excess business interest expense proportionate to the partnership interest retained by the transferor shall remain as excess business interest expense of the transferor until such time as such excess business interest expense is treated as business interest expense paid or accrued by the transferor pursuant to paragraph (g) of this section. Further, if the transferor disposes of a portion of its partnership interest, 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). For purposes of this paragraph, a disposition includes a distribution of money or other property by the partnership to a partner in complete liquidation of its interest in the partnership. Further, solely for purposes of this section, each partner is considered to have disposed of its partnership interest if the partnership terminates under section 708(b)(1). See *Example 9* and *Example 10* in paragraphs (o)(9) and (o)(10) of this section, respectively.

(i)–(j) [Reserved]

(k) *Investment items and certain other items.* Any item of a partnership's income, gain, deduction, or loss that is investment interest income or expense pursuant to § 1.163–8T, and any other tax item of a partnership that is neither properly allocable to a trade or business of the partnership nor described in section 163(d), is allocated to each partner in accordance with section 704(b) and the regulations under section 704 of the Code, 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.

(l) *S corporations*—(1) *In general—(i) Corporate level limitation.* 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' 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). See *Example 22* and *Example 23* in paragraphs (o)(22) and (23) of this section, respectively.

(ii) *Short taxable periods.* For rules on applying the section 163(j) limitation where an S corporation has a two short taxable periods or where its taxable year consists of two separate taxable years see §§ 1.1362–3(c), 1.1368–1(g), and 1.1377–1(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. However, for all other purposes of the Code, 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 tentative 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, except as provided in paragraph (m), and is increased by such shareholder's distributive share of such S corporation's excess taxable income.

(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 the stock of which is being disposed of 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. See § 1.163(j)–10(b)(4)(ii) for dispositions of stock of S corporations that own—

(A) Non-excepted assets and excepted assets; or

(B) Investment assets; or

(C) Both.

(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 the shareholder 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 already has 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 taxable year or a C corporation taxable year). For purposes of applying section 163(j), S corporations are subject to the same ordering rules as a C corporation that is not a member of a consolidated group. See § 1.163(j)–5(b)(2).

(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) and § 1.163–8T.

(10) *Application of section 382.* In the event of an ownership change, within the meaning of section 382(g), the S corporation's business interest expense is subject to section 382. Therefore, the allocation of the S corporation's business interest expense between the pre-change period (as defined in § 1.382–6(g)(2)) and the post-change period (as defined in § 1.382–6(g)(3)), and the determination of the amount that is deducted and carried forward, is determined pursuant to § 1.382–6. If the date of the ownership change is also the date of a qualifying disposition (as defined in § 1.1368–1(g)(2)) or the date for a termination of shareholder interest (as defined in § 1.1377–1(b)(4)), then—

(i) The rules of this paragraph govern the S corporation's business interest expense;

(ii) The S corporation must make an election under § 1.382–6(b) with respect to such date if it also makes an election under § 1.1368–1(g)(2) or a shareholder termination election to apply normal tax accounting rules, as applicable, with respect to such date; and

(iii) The S corporation may not make an election under § 1.382–6(b) with respect to such date if it does not make an election under § 1.1368–1(g)(2) or a termination election under § 1.1377–1(b)(1), as applicable, with respect to such date.

(m) *Partnerships and S corporations not subject to section 163(j)*—(1) *Exempt partnerships and S corporations.* If the small business exemption in § 1.163(j)–2(d) applies to a partnership or an S corporation in a taxable year (exempt entity), the general rule in § 1.163(j)–2 and this section does not apply to limit the deduction for business interest expense of the exempt entity in that taxable year. Additionally, if a partner or S corporation shareholder is allocated business interest expense from an exempt entity, such business interest expense is not subject to the section 163(j) limitation at the partner's or S corporation shareholder's level. However, see paragraph (h)(1) of this section. Further, a partner or S corporation shareholder of an exempt entity includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of such exempt entity when calculating its ATI. However, if a partner's or S corporation shareholder's allocations of non-excepted trade or business items of loss and deduction from an exempt entity exceed its allocations of non-excepted trade or business items of income and gain from such exempt entity (net loss allocation), then such net loss allocation will not reduce a partner's or S corporation shareholder's ATI. See *Example 11* and *Example 12* in paragraphs (o)(11) and (12) of this section, respectively.

(2) *Partnerships and S corporations engaged in excepted trades or businesses.* To the extent a partnership or an S corporation is engaged in an excepted trade or business, the general rule in § 1.163(j)–2 and this section does not apply to limit the deduction for 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 an excepted trade or business of the partnership or S corporation (excepted 163(j) items), such excepted 163(j) items are excluded from the partner's 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). See also *Example 13* in paragraph (o)(13) of this section.

(3) *Treatment of excess business interest expense from partnerships that are exempt entities in a succeeding taxable year.* If a partner is allocated excess business interest expense from a partnership and, in a succeeding taxable year, such partnership is an exempt entity, then the partner shall treat any of its excess business interest expense that was previously allocated from such partnership as business interest expense paid or accrued by the partner in such succeeding taxable year, which is potentially subject to limitation at the partner level under section 163(j). However, if a partner is allocated excess business interest expense from a partnership and, in a succeeding taxable year, such partnership engages in excepted trades or businesses, then the partner shall not treat any of its excess business interest expense that was previously allocated from such partnership as business interest expense paid or accrued by the partner in such succeeding taxable year by reason of the partnership engaging in excepted trades or businesses. See *Example 14* through *Example 16* in paragraphs (o)(14) through (o)(16) of this section, respectively. For rules regarding the treatment of excess business interest expense from a partnership that terminates under section 708(b)(1), see paragraph (h)(3) of this section.

(4) *S corporations with disallowed business interest expense carryforwards prior to becoming exempt entities.* If an S corporation has a disallowed business interest expense carryforward for a taxable year and, in a succeeding taxable year, such S corporation is an exempt entity, 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, unless stated otherwise, each partnership and S corporation is subject to the provisions of section 163(j), is only engaged in non-excepted trades or businesses, was created or organized in the United States, and uses the calendar year for its annual accounting period. Unless stated otherwise, all partners and shareholders 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 use the calendar year for their annual accounting period. 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 in this part under section 704 of the Code.

(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 × 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 nonseparately 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 × 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 × 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 × 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 nonseparately 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 × 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 × 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 × 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 nonseparately 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 × 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 × 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 × 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 nonseparately 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 × 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 × 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 × 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 nonseparately 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 × 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 × 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.* 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 × 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 nonseparately 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 × 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.

(7) *Example 7*—(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 × 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 nonseparately 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 partner's 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 × 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 × 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.

(8) *Example 8*—(i) *Facts.* The facts are the same as in *Example 7* in paragraph (o)(7)(i) of this section. In Year 2, PRS has $20 of gross income that is taken into account in determining PRS's ATI (in other words, 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 × 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 × ($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 × ($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 × 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 × 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.

(9) *Example 9*—(i) *Facts.* X and Y are equal partners in partnership PRS, and are not members of a consolidated group. At the beginning of Year 1, X and Y each have $120 of outside basis in PRS. Neither X nor Y's share of partnership liabilities exceeds the adjusted basis of its entire interest. In Year 1, X is allocated $20 of excess business interest expense, which reduces its outside basis from $120 to $100. In Year 2, X sells 80 percent of its interest in PRS to Z for $160. Immediately prior to the sale, X's entire PRS interest had a fair market value of $200 and the transferred portion of the interest had a fair market value of $160.

(ii) *Basis adjustment.* Immediately before the sale to Z, X increases its basis in the portion of the interest sold by 80 percent of the amount of the excess of the amount of the basis reduction under paragraph (h)(2) of this section ($20) over the portion of any excess business interest expense allocated the partner under paragraph (f)(2) of this section that has previously been treated under paragraph (g) of this section as business interest expense paid or accrued by X ($0). Therefore, X's basis in the portion of its interest sold is $96 (($100 × 80%) + ($20 × 80%)), and X's gain is $64 ($160 − $96). Following the sale, X has $20 of outside basis in its remaining partnership interest and $4 of excess business interest expense.

(10) *Example 10*—(i) *Facts.* X and Y are equal partners in partnership PRS, and are not members of a consolidated group. At the beginning of Year 1, X and Y each have an outside basis in PRS of $10. Neither X nor Y's share of partnership liabilities exceeds the adjusted basis of its entire interest. In Year 1, X is allocated $8 of excess business interest expense and $12 of loss from PRS. As a result, X has $4 of excess business interest expense, $4 of negative section 163(j) expense, $6 of allowable loss, $6 of loss suspended under section 704(d), and $0 of outside basis in PRS at the end of Year 1. In Year 2, X sells 50 percent of its interest in PRS to Z for $20. Immediately prior to the sale, X's entire partnership interest had a fair market value of $40 and the transferred portion of the interest had a fair market value of $20.

(ii) *Basis adjustment.* Immediately before the sale to Z, X increases its basis in the portion of the interest sold by 50 percent of the amount of the excess of the amount of the basis reduction under paragraph (h)(2) of this section ($4) over the portion of any excess business interest expense allocated the partner under paragraph (f)(2) of this section that has previously been treated under paragraph (g) of this section as business interest expense paid or accrued by X ($0). Therefore, X's basis in the portion of its interest sold is $2 (($0 × 50%) + $2), and X's gain is $18 ($20 − $2). Following the sale, X has $0 of outside basis in its remaining partnership interest, $2 of excess business interest expense, $4 of negative section 163(j) expense, and $6 of loss suspended under section 704(d).

(11) *Example 11*—(i) *Facts.* X (a corporation), Y (an individual), and Z (an individual) are equal partners in partnership PRS. X, Y, and Z are subject to section 163(j). PRS is not subject to section 163(j) under section 163(j)(3). In 2021, PRS has $150 of trade or business income (not taking into account business interest income or business interest expense), $30 of business interest income, and $45 of business interest expense. PRS also has $75 of investment income and $60 of investment interest expense. PRS allocates its items of income, gain, loss, and deduction equally among its partners. X, Y, and Z each have $10 of business interest expense from their respective businesses.

(ii) *Partnership-level.* PRS is not subject to section 163(j) by reason of section 163(j)(3). As a result, none of PRS's $45 of business interest expense is subject to the section 163(j) limitation.

(iii) *Partner-level allocations.* Because PRS is not subject to section 163(j) by reason of section 163(j)(3), PRS's $45 of business interest expense does not retain its character as business interest expense for purposes of section 163(j). As a result, such business interest expense is not subject to the section 163(j) limitation at the level of either the partnership or partner. Additionally, pursuant to § 1.163(j)–6(m)(1), each partner includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of PRS when calculating its ATI. As a result, each partner increases its ATI by $45 (one third of $150 + $30 − $45). Also, X increases its ATI by an additional $25 because its items of investment income and loss from PRS are recharacterized as non-excepted trade or business income and loss at its level pursuant to §§ 1.163(j)–4(b)(3)(i) and 1.163(j)–10(b)(6). Further, X increases its business interest expense by its $20 allocation of investment interest expense from PRS pursuant to §§ 1.163(j)–4(b)(3)(i) and 1.163(j)–10(b)(6).

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $70 of ATI and $30 of business interest expense. X's section 163(j) limit is $21 ($70 × 30 percent). Thus, X has $21 of deductible business interest expense. X's $9 of business interest expense not allowed as a deduction is treated as business interest expense paid or accrued by X in 2020. Y and Z, in computing their respective limits under section 163(j), each have $45 of ATI and $10 of business interest expense. Y and Z each have a section 163(j) limit of $13.50 ($45 − 30 percent). Thus, Y and Z each have $10 of deductible business interest expense.

(12) *Example 12*—(i) *Facts.* The facts are the same as in *Example 11* in paragraph (o)(11)(i) of this section, except PRS has $200 of depreciation deductions in addition to its other items of income, gain, loss, and deduction.

(ii) *Partnership-level.* Same analysis as *Example 11* in paragraph (o)(11)(ii) of this section.

(iii) *Partner-level allocations.* Because PRS is not subject to section 163(j) by reason of section 163(j)(3), PRS's $45 of business interest expense does not retain its character as business interest expense for purposes of section 163(j). As a result, such business interest expense is not subject to the section 163(j) limitation at the level of either the partnership or partner. Additionally, pursuant to § 1.163(j)–6(m)(1), each partner includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of PRS when calculating its ATI; however, a net loss allocation of trade or business items from an exempt entity does not reduce a partner's ATI. Because each of the partners has a net loss allocation of trade or business items from PRS, none of the partners adjust their ATI for the trade or business items of PRS. X, the corporate partner, increases its ATI by $25 because its items of investment income and loss from PRS are recharacterized as trade or business income and loss at its level pursuant to §§ 1.163(j)–4(b)(3)(i) and 1.163(j)–10(b)(6). Further, X increases its business interest expense by its $20 allocation of investment interest expense from PRS pursuant to §§ 1.163(j)–4(b)(3)(i) and 1.163(j)–10(b)(6).

(iv) *Partner-level computations.* In computing its limit under section 163(j), each partner has $0 of ATI and $10 of business interest expense. Each partner's section 163(j) limit is $0 ($0 × 30 percent). Thus, each partner's $10 of business interest expense is not allowed as a deduction and is treated as business interest expense paid or accrued by the partner in 2020. X, in computing its limit under section 163(j), has $25 of ATI and $30 of business interest expense. X's section 163(j) limit is $7.50 ($25 × 30 percent). Thus, X has $7.50 of deductible business interest expense. X's $22.50 of business interest expense not allowed as a deduction is treated as business interest expense paid or accrued by X in 2020. Y and Z, in computing their respective limits under section 163(j), each have $0 of ATI and $10 of business interest expense. Thus, Y and Z each have $10 of business interest expense not allowed as a deduction that is treated as business interest expense paid or accrued in 2020.

(13) *Example 13*—(i) *Facts.* X, Y, and Z are equal partners in partnership PRS. X, Y, and Z are each individuals subject to section 163(j). PRS is not subject to section 163(j) under section 163(j)(3). PRS has one excepted and one non-excepted trade or business. In Year 1, PRS has $200 of income and $10 of business interest expense from its excepted trade or business, and $60 of business interest income and $30 of business interest expense from its non-excepted trade or business. PRS allocates its items of income, gain, loss, and deduction equally among its partners. X, Y, and Z each have $10 of business interest expense from their respective businesses.

(ii) *Partnership-level.* PRS is not subject to section 163(j) by reason of section 163(j)(3). As a result, none of PRS's business interest expense is subject to the section 163(j) limitation.

(iii) *Partner-level allocations.* Because PRS's business interest expense is not subject to the section 163(j) limitation, such business interest expense is not subject to the section 163(j) limitation at the level of either the partnership or partner. Additionally, pursuant to § 1.163(j)–6(m)(1), each partner includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of PRS when calculating its ATI. Therefore, each partner increases its ATI by $10 (each partner's share of $20 of non-excepted income less each partner's share of $10 of non-excepted loss).

(iv) *Partner-level computations.* In computing its limit under section 163(j), each partner has $10 of ATI and $10 of business interest expense. Each partner's section 163(j) limit is $3 ($10 × 30 percent). Thus, each partner has $3 of deductible business interest expense. Each partner has $7 of business interest expense not allowed as a deduction that is treated as business interest expense paid or accrued by the partner in Year 2.

(14) *Example 14*—(i) *Facts.* The facts are the same as in *Example 5* in paragraph (o)(5)(i) of this section, except in Year 2 Y is 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).

(15) *Example 15*—(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) by reason of section 163(j)(3).

(ii) *Partnership-level.* In Year 2, PRS is not subject to section 163(j) by reason of section 163(j)(3). As a result, none of PRS's $40 of business interest expense is subject to the section 163(j) limitation at the level of either the partnership or partner.

(iii) *Partner-level allocations.* Because PRS is not subject to section 163(j) by reason of section 163(j)(3), PRS's $40 of business interest expense does not retain its character as business interest expense for purposes of section 163(j).

As a result, such business interest expense is not subject to the section 163(j) limitation at the level of either the partnership or partner. Additionally, pursuant to § 1.163(j)–6(m)(1), each partner includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of PRS when calculating its ATI. As a result, X and Y each increase their ATI by $35.60. Further, because PRS is not subject to section 163(j) 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 $135.60 of ATI ($100 from its sole proprietorship, plus $35.60 ATI from PRS) and $25 of business interest expense ($20 from its sole proprietorship, plus $5 of excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $40.68 ($135.60 × 30 percent). Thus, $25 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 the section 163(j) limitation. Thus, all $45 of Y's business interest expense ($20 from its sole proprietorship, plus $20 disallowed from year 1, plus $5 of excess business interest expense treated as paid or accrued in Year 2) is not subject to the section 163(j) limitation.

(16) *Example 16*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section, except that PRS's only trade or business is a real property trade or business for which PRS does not make the election provided for in section 163(j)(7)(B). In Year 2, when PRS's only trade or business is still its real property trade or business, PRS makes the election provided for in section 163(j)(7)(B). Further, in Year 2, PRS has $100 of income and $40 of business interest expense. PRS allocates its items of income, gain, deduction, and loss equally between X and 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 is not subject to section 163(j) because its only trade or business is an excepted trade or business. As a result, none of PRS's $40 of business interest expense is subject to the section 163(j) limitation at the level of either the partnership or partner.

(iii) *Partner-level allocations.* Because PRS is not subject to section 163(j), PRS's $40 of business interest expense does not retain its character as business interest expense for purposes of section 163(j). As a result, such business interest expense is not subject to the section 163(j) limitation at the partners' level. Pursuant to § 1.163(j)–6(m)(1), the partners do not include their respective $50 shares of income from PRS when calculating their own ATI because such $50 is excepted trade or business income.

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $100 of ATI ($100 from its sole proprietorship) and $20 of business interest expense ($20 from its sole proprietorship). X's section 163(j) limit is $30 ($100 × 30 percent). Thus, $20 of X's business interest expense is deductible business interest expense. At the end of Year 2, X has $5 of excess business interest expense from PRS ($5 from Year 1). Y, in computing its limit under section 163(j), has $0 of ATI and $40 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1). Y's section 163(j) limit is $0. Thus, Y's $40 of business interest expense not allowed as a deduction is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $5 of excess business interest expense from PRS ($5 from Year 1).

(17) *Example 17: Facts.* A (an individual) and B (a corporation) own all of the interests in partnership PRS. At the beginning of Year 1, A and B each have $100 section 704(b) capital account and $100 of basis in 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 × 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)(17)(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 2 TO PARAGRAPH (o)(17)(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 × 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 × 50 percent). As a result, B's remaining business interest expense is $20.

TABLE 3 TO PARAGRAPH (o)(17)(v)

	A	B	Total
Allocable BII deficit	$20	$20	$40
Less: (Total allocable BII excess) × (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 × 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 4 TO PARAGRAPH (o)(17)(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 5 TO PARAGRAPH (o)(17)(vi)

	A	B	Total
Positive allocable ATI	$100	$0	$100
Less: (Total negative allocable ATI) × (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 × 30 percent) and B's ATIC amount is $0 ($0 × 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 6 TO PARAGRAPH (o)(17)(vii)

	A	B	Total
ATIC (Final allocable ATI × 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)(17)(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)(17)(ix) and (x) of this section are as follows.

TABLE 7 TO PARAGRAPH (o)(17)(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 × 100 percent)).

TABLE 8 TO PARAGRAPH (o)(17)(ix)

	A	B	Total
ATIC excess	$10	$0	N/A
Less: (Total ATIC deficit) × (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 × 100 percent)).

TABLE 9 TO PARAGRAPH (o)(17)(x)

	A	B	Total
ATIC deficit	$0	$20	N/A
Less: (Total ATIC excess) × (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). As a result of its allocations from PRS, A increases its section 704(b) capital account and basis in PRS by $80 to $180. As a result of its allocations from PRS, B decreases its capital account and basis in PRS by $20 to $80.

TABLE 10 TO PARAGRAPH (o)(17)(xi)

	A	B	Total
Deductible BIE	$30	$20	$50

TABLE 10 TO PARAGRAPH (o)(17)(xi)—Continued

	A	B	Total
EBIE allocated	0	10	10
ETI allocated	0	0	0
EBII allocated	0	0	0

(18) *Example 18: 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 × 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 11 TO PARAGRAPH (o)(18)(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 12 TO PARAGRAPH (o)(18)(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 × 100 percent). As a result, C's allocable business interest income excess is $0.

TABLE 13 TO PARAGRAPH (o)(18)(iv)

	A	B	C	Total
Allocable BII excess	$0	$0	$10	N/A
Less: (Total allocable BII deficit) × (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 × 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 × 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 14 TO PARAGRAPH (o)(18)(v)

	A	B	C	Total
Allocable BII deficit	$30	$10	$0	$40
Less: (Total allocable BII excess) × (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 × 100 percent). As a result, B's final allocable ATI is $150.

TABLE 15 TO PARAGRAPH (o)(18)(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
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 16 TO PARAGRAPH (o)(18)(vi)

	A	B	C	Total
Positive allocable ATI	$0	$200	$0	$200
Less: (Total negative allocable ATI) × (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 × 30 percent), B's ATIC amount is $45 ($150 × 30 percent), and C's ATIC amount is $0 ($0 × 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 17 TO PARAGRAPH (o)(18)(vii)

	A	B	C	Total
ATIC (Final allocable ATI × 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)(18)(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)(18)(ix) and (x) of this section are as follows.

TABLE 18 TO PARAGRAPH (o)(18)(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 × 100 percent)).

TABLE 19 TO PARAGRAPH (o)(18)(ix)

	A	B	C	Total
ATIC excess	$0	$37.50	$0	N/A
Less: (Total ATIC deficit) × (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 × 100 percent)).

TABLE 20 TO PARAGRAPH (o)(18)(x)

	A	B	C	Total
ATIC deficit	$22.50	$0	$0	N/A
Less: (Total ATIC excess) × (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 $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. 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 21 TO PARAGRAPH (o)(18)(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

(19) *Example 19: 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 × 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 22 TO PARAGRAPH (o)(19)(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 23 TO PARAGRAPH (o)(19)(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 24 TO PARAGRAPH (o)(19)(v)

	A	B	C	Total
Allocable BII deficit	$0	$25	$25	$50
Less: (Total allocable BII excess) × (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 × 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 × 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 25 TO PARAGRAPH (o)(19)(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 26 TO PARAGRAPH (o)(19)(vi)

	A	B	C	Total
Positive allocable ATI	$100	$100	$0	$200
Less: (Total negative allocable ATI) × (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 × 30 percent), B's ATIC amount is $15 ($50 × 30 percent), and C's ATIC amount is $0 ($0 × 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 27 TO PARAGRAPH (o)(19)(vii)

	A	B	C	Total
ATIC (Final allocable ATI × 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 paragraphs (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 30 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) × 30 percent), and C's priority amount is $0 (($0 − $0) × 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 28 TO PARAGRAPH (o)(19)(viii)(B)

	A	B	C	Total
(Positive allocable ATI—Final allocable ATI)	$0	$50	$0	N/A
Multiplied by 30 percent	30%	30%	30%	N/A
= Priority amount	$0	$15	$0	$15

TABLE 29 TO PARAGRAPH (o)(19)(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 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 30 TO PARAGRAPH (o)(19)(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)(1) 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.

(2) In sum, the correct amounts to be used in paragraphs (o)(19)(ix) and (x) of this section are as follows.

TABLE 31 TO PARAGRAPH (o)(19)(viii)(D)(2)

	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 × 100 percent)).

TABLE 32 TO PARAGRAPH (o)(19)(x)

	A	B	C	Total
ATIC deficit	$0	$0	$25	N/A
Less: (Total ATIC excess) × (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 33 TO PARAGRAPH (o)(19)(xi)

	A	B	C	Total
Deductible BIE	$0	$25	$5	$30
EBIE allocated	0	0	20	20
ETI allocated	0	0	0	0

TABLE 33 TO PARAGRAPH (o)(19)(xi)—Continued

	A	B	C	Total
EBII allocated	0	0	0	0

(20) *Example 20: 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 × 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 34 TO PARAGRAPH (o)(20)(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 35 TO PARAGRAPH (o)(20)(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 36 TO PARAGRAPH (o)(20)(v)

	A	B	C	D	Total
Allocable BII deficit	$0	$40	$60	$40	$140
Less: (Total allocable BII excess) × (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 × 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 × 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 × 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 37 TO PARAGRAPH (o)(20)(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 38 TO PARAGRAPH (o)(20)(vi)

	A	B	C	D	Total
Positive allocable ATI	$100	$100	$400	$0	$600
Less: (Total negative allocable ATI) × (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 × 30 percent), B's ATIC amount is $10 ($33.33 × 30 percent), C's ATIC amount is $40 ($133.33 × 30 percent), and D's ATIC amount is $0 ($0 × 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 39 TO PARAGRAPH (o)(20)(vii)

—	A	B	C	D	Total
ATIC (Final allocable ATI × 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 30 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) × 30 percent), C's priority amount is $80 (($400 − $133.33) × 30 percent), and D's priority amount is $0 (($0 − $0) × 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) of this section ($10), PRS must perform the adjustments described in paragraph (f)(2)(viii)(D) of this section.

TABLE 40 TO PARAGRAPH (o)(20)(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%	30%	30%	30%	N/A
= Priority amount	0	20	80	0	$100

TABLE 41 TO PARAGRAPH (o)(20)(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 × ($20/$100)) and C's step eight excess share is $8 ($10 × ($80/$100)). To the extent a priority partner's step eight excess share exceeds its ATIC deficit, the excess will 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 will 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 42 TO PARAGRAPH (o)(20)(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 43 TO PARAGRAPH (o)(20)(viii)(D)(*1*)

	A	B	C	D	Total
Priority partners step eight excess share = (Total ATIC excess) × (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 paragraphs (o)(20)(ix) and (x) of this section are as follows.

TABLE 44 TO PARAGRAPH (o)(20)(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	0	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 × 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 × 30 percent)). Pursuant to paragraph (f)(2)(viii)(D) of this section, D's final ATIC deficit amount is $40.

TABLE 45 TO PARAGRAPH (o)(20)(x)

	A	B	C	D	Total
ATIC deficit	N/A	$28	$12	N/A	N/A
Less: (Total ATIC excess) × (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 46 TO PARAGRAPH (o)(20)(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

(21) *Example 21: 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 × 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 47 TO PARAGRAPH (o)(21)(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 48 TO PARAGRAPH (o)(21)(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 49 TO PARAGRAPH (o)(21)(v)

	A	B	C	D	Total
Allocable BII deficit	$0	$50	$50	$50	$150
Less: (Total allocable BII excess) × (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 × 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 × 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 × 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 50 TO PARAGRAPH (o)(21)(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 51 TO PARAGRAPH (o)(21)(vi)

	A	B	C	D	Total
Positive allocable ATI	$50	$50	$400	$0	$500

TABLE 51 TO PARAGRAPH (o)(21)(vi)—Continued

	A	B	C	D	Total
Less: (Total negative allocable ATI) × (Positive allocable ATI/Total positive allocable ATI)	30	30	240	0	N/A
= 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 × 30 percent), B's ATIC amount is $6 ($20 × 30 percent), C's ATIC amount is $48 ($160 × 30 percent), and D's ATIC amount is $0 ($0 × 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 52 TO PARAGRAPH (o)(21)(vii)

	A	B	C	D	Total
ATIC (Final allocable ATI × 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 30 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) × 30 percent), C's priority amount is $72 (($400 − $160) × 30 percent), and D's priority amount is $0 (($0 − $0) × 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 53 TO PARAGRAPH (o)(21)(viii)(B)

	A	B	C	D	Total
(Positive allocable ATI − Final allocable ATI)	$0	$30	$240	$0	N/A
Multiplied by 30 percent	30%	30%	30%	30%	N/A
= Priority amount	$0	$9	$72	$0	$81

TABLE 54 TO PARAGRAPH (o)(21)(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 × ($9/$81)) and C's step eight excess share is $5.33 ($6 × ($72/$81)). To the extent a priority partner's step eight excess share exceeds its ATIC deficit, the excess will 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 will 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 55 TO PARAGRAPH (o)(21)(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 56 TO PARAGRAPH (o)(21)(viii)(D)(1)

	A	B	C	D	Total
Priority partners step eight excess share = (Total ATIC excess) × (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 paragraphs (o)(21)(ix) and (x) of this section are as follows.

TABLE 57 TO PARAGRAPH (o)(21)(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 × 100 percent)). Pursuant to paragraph (f)(2)(viii)(D) of this section, D's final ATIC deficit amount is $40.

TABLE 58 TO PARAGRAPH (o)(21)(x)

	A	B	C	D	Total
ATIC deficit	$0	$43.33	$0	N/A	N/A

TABLE 58 TO PARAGRAPH (o)(21)(x)—Continued

	A	B	C	D	Total
Less: (Total ATIC excess) × (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 59 TO PARAGRAPH (o)(21)(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

(22) *Example 22*—(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 × 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 nonseparately 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 × 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 × 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.

(23) *Example 23*—(i) *Facts.* The facts are the same as in *Example 22* in paragraph (o)(22)(i) 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 × 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 nonseparately 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)(17).

(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 × 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 × 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 beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

§ 1.163(j)–7 Application of the section 163(j) limitation to foreign corporations and United States shareholders.

(a) *Overview.* This section provides rules for the application of section 163(j) to relevant foreign corporations with shareholders that are United States persons. Paragraph (b) of this section describes the general rule regarding the application of section 163(j) to relevant foreign corporations. Paragraphs (c) through (f) of this section are reserved. Paragraph (g) of this section provides rules concerning the computation of ATI of a relevant foreign corporation. Paragraphs (h) through (k) of this section are reserved.

(b) *General rule regarding the application of section 163(j) to relevant foreign corporations.* Except as otherwise provided in this section, section 163(j) and the section 163(j) regulations apply to determine the deductibility of a relevant foreign corporation's business interest expense for purposes of computing its taxable income for U.S. income tax purposes (if any) 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. See also § 1.952–2. If a relevant foreign corporation is a direct or indirect partner in a partnership, see § 1.163(j)–6 (concerning the application of section 163(j) to partnerships).

(c)–(f) [Reserved]

(g) *Rules concerning the computation of adjusted taxable income of a relevant foreign corporation*—(1) *Tentative taxable income.* For purposes of computing the tentative taxable income of a relevant foreign corporation for a taxable year, the relevant foreign corporation's gross income and allowable deductions are determined under the principles of § 1.952–2 or under the rules of section 882 for determining income that is, or deductions that are allocable to, effectively connected income, as applicable.

(2) *Treatment of certain dividends.* For purposes of computing the ATI of a relevant foreign corporation 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 tentative taxable income.

(h)–(l) [Reserved]

(m) *Applicability date.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

§ 1.163(j)–8. [Reserved]

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

(a) *Overview.* The limitation in section 163(j) applies to business interest, which is defined under section 163(j)(5) as interest properly allocable to a trade or business. The term trade or business does not include any electing real property trade or business or any electing farming business. See section 163(j)(7). This section provides the rules and procedures for taxpayers to follow in making an election under section 163(j)(7)(B) for a trade or business to be an electing real property trade or business and an election under section 163(j)(7)(C) for a trade or business to be an electing farming business.

(b) *Availability of election*—(1) *In general.* An election under section 163(j)(7)(B) for a real property trade or business to be an electing real property trade or business is available to any trade or business that is described in § 1.163(j)–1(b)(14)(i), (ii), or (iii), and an election under section 163(j)(7)(C) for a farming business to be an electing farming business is available to any trade or business that is described in § 1.163(j)–1(b)(13)(i), (ii), or (iii).

(2) *Special rules*—(i) *Exempt small businesses.* An election described in paragraph (b)(1) of this section is available regardless of whether the real property trade or business or farming business making the election also meets the requirements of the small business exemption in section 163(j)(3) and § 1.163(j)–2(d). See paragraph (c)(2) of this section for the effect of the election relating to depreciation.

(ii) *Section 162 trade or business not required for electing real property trade or business.* An election described in paragraph (b)(1) of this section to be an electing real property trade or business is available regardless of whether the trade or business with respect to which the election is made is a trade or business under section 162. For example, a taxpayer engaged in activities described in section 469(c)(7)(C) and § 1.469–9(b)(2), as required in § 1.163(j)–1(b)(14)(i), may make an election for a trade or business to be an electing real property trade or business, regardless of whether its activities rise to the level of a section 162 trade or business.

(c) *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. See paragraph (e) of this section for terminations of elections.

(2) *Irrevocability.* An election under this section is irrevocable.

(3) *Depreciation.* Taxpayers making an election under this section are required to use the alternative depreciation system for certain types of property under section 163(j)(11) and cannot claim the additional first-year depreciation deduction under section 168(k) for those types of property.

(d) *Time and manner of making election*—(1) *In general.* Subject to paragraph (f) 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 sufficient to demonstrate qualification for an election under this section, 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 for a 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.

(e) *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 (e), 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 (e), the term *related party* means any person who bears a relationship to the taxpayer which is described in 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 (e)(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.

(f) *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 (d) 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 (e) 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).

(g) *Examples.* The examples in this paragraph (g) illustrate the application of this section. Unless otherwise indicated, 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.* For the taxable year ending December 31, 2021, D, a sole proprietor, owned and operated a dairy farm and an orchard as separate farming businesses described in section 263A(e)(4). D filed an original Federal income tax return for the 2021 taxable year on August 1, 2022, and included with the return an election statement meeting the requirements of paragraph (d)(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, 2023, D sold some but not all or substantially all of the assets from D's dairy farm business to D's 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 2021 taxable year and subsequent years. D's dairy farm business is an excepted trade or business because D made the election with D's timely filed Federal income tax return. D's orchard business is a non-excepted trade or business, because D did not make an election for the orchard business to be an excepted trade or business. The sale of some but not all or substantially all of the assets from D's dairy farm business does not affect D's election under this section.

(2) *Example 2: Availability of election*—(i) *Facts.* E, an individual, operates a dairy business that is a farming business under section 263A and also owns real property that is not part of E's dairy business that E leases to an unrelated party through a triple net lease. E's average gross receipts, excluding inherently personal amounts, for the three years prior to 2021 are approximately $25 million, but E is unsure of the exact amount.

(ii) *Analysis.* Under paragraph (b)(2)(i) of this section, E may make an election under this section for the dairy business to be an electing farming business, even though E is unsure whether the small business exemption of § 1.163(j)–2(d) applies. Additionally, under paragraph (b)(2)(ii) of this section, assuming the requirements of section 163(j)(7)(C) and this section are otherwise satisfied, E may make an election under this section for its triple net lease property to be an electing real property trade or business, even though E may not be engaged in a trade or business under section 162 with respect to the real property.

(3) *Example 3: 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 2021 Federal income tax return. On March 1, 2022, 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, 2022, under paragraph (e)(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.

(4) *Example 4: Anti-abuse rule*—(i) *Facts.* The facts are the same as in *Example 3* in paragraph (g)(3)(i) of this section, except that X re-started its previous real property trade or business on February 1, 2023, when X reacquired substantially all of the assets that X had sold on March 1, 2022.

(ii) *Analysis.* X's election under this section terminated on March, 1, 2022, under paragraph (e)(1) of this section. On February 1, 2023, X's election was reinstated under paragraph (e)(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.

(5) *Example 5: 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 2021 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, 2022, X transferred all of its assets to Y in a transaction described in section 368(a)(1)(D). After the transfer, Y continues to operate the farming trade or business acquired from X.

(ii) *Analysis.* Under paragraph (e)(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.

(6) *Example 6: Trade or business merged after acquisition*—(i) *Facts.* The facts are the same as in *Example 5* in paragraph (g)(5)(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.

(h) *Safe harbor for REITs*—(1) *In general.* If a REIT holds real property, as defined in § 1.856–10, interests in one or more partnerships directly or indirectly holding real property (through interests in other partnerships or shares in other REITs), as defined in § 1.856–10, or shares in one or more other REITs directly or indirectly holding real property (through interests in partnerships or shares in other REITs), 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 (h)(2) or (3) of this section.

(2) *REITs that do not significantly invest in real property financing assets.* If a REIT makes the election under paragraph (h)(1) of this section and the value of the REIT's real property financing assets, as defined in paragraphs (h)(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 the election under paragraph (h)(1) of this section and the value of the REIT's real property financing assets, as defined in paragraphs (h)(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 the allocation of interest expense, interest income, and other items of expense and gross income to excepted and non-excepted trades or businesses, the REIT must apply the rules set forth in § 1.163(j)–10 as modified by paragraph (h)(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 (h)(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 (h)(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. However, no portion of the adjusted basis of the REIT's interest in the partnership is allocated to a non-excepted trade or business if the partnership makes an election under paragraph (h)(7) of this section and if all of the partnership's assets are treated as assets of an excepted trade or business under paragraph (h)(2) of this section.

(iii) *Shares in other REITs*—(A) *In general.* If a REIT (shareholder REIT) described in paragraph (h)(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*), as modified by paragraph (h)(4)(ii) of this section, applies to the assets of the other REIT (as if the other REIT were a partnership) in determining the portion of shareholder REIT's adjusted basis in the shares of the other REIT that 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 (h)(2) of this section.

(B) *Information necessary.* If shareholder REIT does not receive, either directly from the other REIT or indirectly through the analysis of an applicable financial statement (within the meaning of section 451(b)(3)) of the other REIT, the information necessary to determine whether and to what extent 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).

(iv) *Tiered entities.* In applying § 1.163(j)–10(c)(5)(ii)(E), the rules in paragraphs (h)(4)(ii) and (h)(4)(iii)(A) and (B) of this section apply to any partnerships and other REITs within the tier.

(5) *Value of shares in other REITs*—(i) *In general.* If a REIT (shareholder REIT) holds shares in another REIT, then solely for purposes of applying the value tests under paragraphs (h)(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 (h)(2) of this section.

(ii) *Information necessary.* If shareholder REIT does not receive, either directly from the other REIT or indirectly through the analysis of an applicable financial statement (within the meaning of section 451(b)(3)) of the other REIT, the information necessary to determine whether and to what extent 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 (h)(2) and (3) of this section.

(iii) *Tiered REITs.* The rules in paragraphs (h)(5)(i) and (ii) of this section apply successively to the extent that the other REIT, and any other REIT in the tier, holds shares in another REIT.

(6) *Real property financing assets.* For purposes of this paragraph (h), *real property financing assets* include interests, including participation interests, in the following: Mortgages, deeds of trust, and installment land contracts; mortgage pass-through 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.

(7) *Application of safe harbor for partnerships controlled by REITs.* A partnership is eligible to make the election under paragraph (h)(1) of this section if one or more REITs own directly or indirectly at least 50 percent of the partnership's capital and profits, the partnership meets the requirements of section 856(c)(2), (3), and (4) as if the partnership were a REIT, and the partnership satisfies the requirements described in paragraph (h)(1) of this section as if the partnership were a REIT. The portion of the partnership's assets eligible for this election is determined under paragraph (h)(2) or (3) of this section, treating the partnership as if it were a REIT.

(8) *REITs or partnerships controlled by REITs that do not apply the safe harbor.* A REIT or a partnership that is eligible but chooses not to apply the safe harbor provisions of paragraph (h)(1) or (7) of this section, respectively, may still elect, under paragraph (b)(1) of this section, for one or more of its trades or businesses to be an electing real property trade or business, provided that such trade or business is otherwise eligible to elect under paragraph (b)(1) of this section. A REIT or partnership that makes the election under paragraph (b)(1) of this section without utilizing the safe harbor provisions of paragraph (h) of this section may not rely on any portion of paragraphs (h)(1) through (7) of this section.

(i) [Reserved]

(j) *Special anti-abuse rule for certain real property trades or businesses*—(1) *In general.* Except as provided in paragraph (j)(2) of this section, a trade or business (lessor) 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 rental value, of the real property used in the business is leased to a trade or business (lessee) under common control with the lessor, regardless of whether the arrangement is pursuant to a written lease or pursuant to a service contract or another agreement that is not denominated as a lease. For purposes of this paragraph (j), fair market rental value is the amount of rent that a prospective lessee that is unrelated to the lessor would be willing to pay for a rental interest in real property, taking into account the geographic location, size, and type of the real property. For purposes of this paragraph (j), 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) *Exceptions*—(i) *De minimis exception.* The limitation in paragraph (j)(1) of this section does not apply, and the lessor is eligible to make an election under paragraph (b)(1) of this section, if the lessor leases, regardless of whether the arrangement is pursuant to a written lease or pursuant to a service contract or another agreement that is not denominated as a lease, at least 90 percent of the lessor's real property, determined by fair market rental value, to one or more of the following:

(A) A party not under common control with the lessor or lessee;

(B) A party under common control with the lessor or lessee that has made an election described in paragraph (b)(1) of this section for a trade or business to be an electing real property trade or business or electing farming business, but only to the extent that the real property is used as part of its electing real property trade or business or electing farming business; or

(C) A party under common control with the lessor or lessee that is an excepted regulated utility trade or business, but only to the extent that the real property is used as part of its excepted regulated utility trade or business.

(ii) *Look-through exception.* If the de minimis exception in paragraph (j)(2)(i) of this section does not apply because less than 90 percent of the lessor's real property is leased to parties described in paragraphs (j)(2)(i)(A), (B), and (C), the lessor is eligible to make the election under paragraph (b)(1) of this section to the extent that the lessor leases the real property to parties described in paragraph (j)(2)(A), (B), or (C), and to the extent that the lessee subleases (or lessees ultimately sublease) the real property to:

(A) A party not under common control with the lessor or lessee;

(B) A party under common control with the lessor or lessee that has made an election described in paragraph (b)(1) of this section for a trade or business to be an electing real property trade or business or electing farming business to the extent that the real property is used as part of its electing real property trade or business or electing farming business; or

(C) A party under common control with the lessor or lessee that is an excepted regulated utility trade or business to the extent that the real property is used as part of its excepted regulated utility trade or business.

(iii) *Inapplicability of exceptions to consolidated groups.* The exceptions in paragraphs (j)(2)(i) and (ii) of this section do not apply when the lessor and lessee are members of the same consolidated group.

(iv) *Exception for certain REITs.* The special anti-abuse rule in paragraph (j)(1) of this section does not apply to REITs or to partnerships making an election under paragraph (h)(7) of this section 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).

(3) *Allocations.* See § 1.163(j)–10(c)(3)(iii)(D) for rules related to the allocation of the basis of assets used in lessor trades or businesses described in paragraphs (j)(1) and (j)(2)(i) of this section.

(4) *Examples.* The examples in this paragraph (j)(4) illustrate the application of paragraphs (j)(1), (2), and (3) of this section. Unless otherwise indicated, the parties are all domestic entities and are not members of a single consolidated group within the meaning of § 1.1502–1(h).

(i) *Example 1: Related party lease of hotel*—(A) *Facts.* X and Y are under common control, as defined in paragraph (j)(1) of this section. X owns one piece of real property, a hotel, that X leases to Y. Y operates the hotel and provides hotel rooms and associated amenities to third party guests of the hotel. The form of the arrangement with third party hotel guests is a license to use rooms in the hotel and associated amenities. Y is a real property trade or business that has made an election under paragraph (b)(1) of this section.

(B) *Analysis.* Because X leases at least 80 percent of X's real property to a party under common control, X is subject to the anti-abuse rule in paragraph (j)(1) of this section. However, under the de minimis exception under paragraph (j)(2)(i) of this section, 100 percent of the fair market rental value of the building is leased to a party under common control that has made an election to be an electing real property trade or business. Accordingly, X is eligible to make the election described in paragraph (b)(1) of this section for its entire trade or business.

(ii) *Example 2*—(A) *Facts.* The facts are the same as in *Example 1* in paragraph (j)(4)(i)(A) of this section, except that Y has not made an election under paragraph (b)(1) of this section, and is not otherwise using the real property in an excepted trade or business.

(B) *Analysis.* Because X leases at least 80 percent of X's real property, determined by fair market rental value, to Y, a party under common control, X is subject to the anti-abuse rule in paragraph (j)(1) of this section. X is not eligible for the de minimis exception under paragraph (j)(2)(i) of this section because X does not lease at least 90 percent of its real property to a party under common control, as defined in paragraph (j)(1) of this section, such as Y, and Y is not using the property in an otherwise excepted trade or business. However, X is eligible for the look-through exception under paragraph (j)(2)(ii) of this section because X leases 100 percent of its real property to Y, a party that is under common control, and Y subleases 100 percent of the real property to parties that are not under common control with X or Y. The fact that the license provided to hotel guests is not denominated as a lease does not prevent these licenses from being treated as a lease for purposes of paragraph (j) of this section. Accordingly, under the look-through exception under paragraph (j)(2)(ii) of this section, X is eligible to make the election described in paragraph (b)(1) of this section with regard to its entire trade or business.

(iii) *Example 3: Sublease to related party and unrelated third party*—(A) *Facts.* X owns one piece of real property that X leases to Y, a party under common control, as defined in paragraph (j)(1) of this section. Y does not operate an excepted trade or business. Y subleases 80 percent of the real property, determined by the fair market rental value, to a party under common control with Y that does not operate an excepted trade or business and 20 percent of the real property, determined by the fair market rental value, to an unrelated third party.

(B) *Analysis.* Because X leases at least 80 percent of X's real property, determined by fair market rental value, to a party under common control, X is subject to the anti-abuse rule in paragraph (j)(1) of this section. X is not eligible for the de minimis exception in paragraph (j)(2)(i) of this section because X is not leasing at least 90 percent of the real property, determined by fair market rental value, to a party under common control that operates an excepted trade or business and/or unrelated parties. Under the look-through exception under paragraph (j)(2)(ii) of this section, X is eligible to make the election described in paragraph (b)(1) of this section with respect to the 20 percent of the fair market rental value of the real property subleased to an unrelated party because X is treated as directly leasing this portion to an unrelated party. X is not eligible to make the election described in paragraph (b)(1) of this section with respect to the 80 percent of the building subleased to a party under common control because X is still treated as directly leasing this portion to a related party. Under § 1.163(j)–10(c)(3)(iii)(D), X must allocate 80 percent of the basis in the real property as a non-excepted trade or business and 20 percent of the basis in the real property as an excepted trade or business.

(iv) *Example 4: Multiple subleases*—(A) *Facts.* X owns a building that X leases to Y, a party under common control as defined in paragraph (j)(1) of this section. Y does not operate an excepted trade or business. Y subleases 80 percent of the building, determined by fair market rental value, to Z, a party under common control with both X and Y. Y subleases the remaining 20 percent of the building, determined by fair market rental value, to unrelated parties. Z subleases 50 percent of its leasehold interest, determined by fair market rental value, to parties unrelated to X, Y and Z, and uses the remaining leasehold interest in its retail business. Z does not operate an excepted trade or business.

(B) *Analysis.* Because X leases at least 80 percent of X's real property, determined by fair market rental value, to a party under common control, X is subject to the anti-abuse rule in paragraph (j)(1) of this section. X is not eligible for the de minimis exception in paragraph (j)(2)(i) because X is not leasing at least 90 percent of the building, determined by fair market rental value, to a party under common control that operates an excepted trade or business and/or unrelated parties. Under the look-through exception under paragraph (j)(2)(ii) of this section, X is eligible to make the election described in paragraph (b)(1) of this section with respect to the 60 percent of the building that is subleased to unrelated parties, determined by adding 40 percent (50 percent of the 80 percent leasehold interest) from Z's sublease to an unrelated party and 20 percent from Y's sublease to unrelated parties (40 + 20). X is not eligible to make the election described in paragraph (b)(1) of this section with respect to the 40 percent of the building subleased to Z, because Z is a related party that does not operate an excepted trade or business.

(v) *Example 5: Lessee's Trade or Business*—(A) *Facts.* X owns a building that X leases to W, a party under common control as defined in paragraph (j)(1) of this section. W operates the building as a widget manufacturing plant and does not sublease any portion of the building.

(B) *Analysis.* X is not eligible to make the election described in paragraph (b)(1) of this section because X leases the entire building to a party under common control. X is not eligible for the de minimis exception in paragraph (j)(2)(i) of this section because X is not leasing at least 90 percent of the real property to a party under common control that operates an excepted trade or business and/or unrelated parties. W's trade or business cannot be an electing real property trade or business. X is not eligible for the look-through exception under paragraph (j)(2)(ii) of this section because W is not subleasing any part of the building.

(k) *Applicability date.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

§ 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.* Except as provided in § 1.163(j)–6(m) or § 1.163(j)–9(h), 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 the section 163(j) limitation. 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 separate trade or business to the extent those activities involve the provision of real property, goods, or services to a trade or business of the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group). For example, if a taxpayer engaged in a manufacturing trade or business has in-house legal personnel that provide legal services solely with respect to the taxpayer's manufacturing business, the taxpayer is not treated as also engaged in the trade or business of providing legal services. Similarly, if the taxpayer described in the previous sentence constructs or acquires real property solely for use by the taxpayer's manufacturing business, the taxpayer is not treated as also engaged in a real property trade or business.

(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, if applicable, 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 the section 163(j) limitation and to determine which items are included or excluded in computing its section 163(j) limitation.

(ii) *Treatment of investment interest, investment income, investment expenses, and certain other tax items of a partnership with a C corporation or tax-exempt corporation as a partner.* For rules governing the treatment of investment interest, investment income, investment expenses, and certain other separately stated tax items 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(k).

(3) *Application of allocation rules to foreign corporations and foreign partnerships.* The rules of this section apply to foreign corporations and foreign partnerships.

(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 regulations in this part under section 163(j) of the Code 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 allocated to a trade or business based on the activities of the group as if the members of the group were divisions of a single corporation. 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 the section 163(j) limitation), 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 is 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 tax-exempt organizations, section 512 and the regulations in this part under section 512 of the Code determine the rules for allocating all income and expenses among multiple trades or businesses.

(6) *Application of allocation rules to disallowed disqualified interest.* A taxpayer may apply the allocation rules of this section to disallowed disqualified interest by either:

(i) Applying the allocation rules of this section to all of the taxpayer's disallowed disqualified interest in the taxable year(s) in which the disallowed disqualified interest was paid or accrued (the historical approach); or

(ii) Treating all of the taxpayer's disallowed disqualified interest as if it were paid or accrued in the taxpayer's first taxable year beginning after December 31, 2017 (the effective date approach).

(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.

(iii) *Example 3: Intercompany sale of natural gas*—(A) *Facts.* S is a member of a consolidated group of which P is the common parent. S drills for natural gas and is not an excepted regulated utility trade or business. S sells most of its natural gas production to P, which produces electricity at its natural gas-fired power plants, and S sells the rest of its natural gas production to third parties at market rates. P is an excepted regulated utility trade or business to the extent that it is engaged in a trade or business described in § 1.163(j)–1(b)(15)(i).

(B) *Analysis.* Intercompany transactions are disregarded for purposes of this section. As a result, the intercompany sales of natural gas by S to P are disregarded. Moreover, the assets of S and P are allocated between the excepted and non-excepted trades or businesses of the P group based on the assets used in each trade or business. Assets of S may be allocated to the P group's excepted trade or business to the extent those assets are used in the trade or business of the furnishing or sale of electrical energy. Likewise, assets of P may be allocated to the P group's non-excepted trade or business to the extent those assets are used in the trade or business of natural gas production.

(iv) *Example 4: Disallowed disqualified interest*—(A) *Facts.* S is a member of a consolidated group of which P is the common parent. P and S are the only members of an affiliated group under old section 163(j)(6)(C). S operates a farm equipment leasing business (Business X) that is not an excepted trade or business. P is engaged in an electing farming business (Business Y). Entering its first taxable year beginning after December 31, 2017, the P group has disallowed disqualified interest of $120x, all of which the P group paid or accrued in earlier taxable years in which it only operated Business X. The P group also incurs $100x of interest expense during its 2018 taxable year, of which $25x (25 percent of $100x) is business interest expense properly allocable to Business X and $75x (75 percent of $100x) is properly allocable to Business Y under paragraph (c) of this section.

(B) *Analysis.* Under paragraph (a)(6) of this section, the P group may allocate disallowed disqualified interest to Business X and Business Y by either applying the allocation rules of this section in the taxable years in which the disallowed disqualified interest was paid or accrued (the historical approach) or by treating such interest as though it were paid or accrued in the P group's first taxable year beginning after December 31, 2017 (the effective date approach). Accordingly, if the P group chooses to rely on the historical approach, it allocates all $120x of disallowed disqualified interest to Business X (a non-excepted trade or business), and all $120x of disallowed disqualified interest is subject to the section 163(j) limitation. If, instead, the P group chooses to rely on the effective date approach, it allocates its $120x of disallowed disqualified interest in the same proportion as its $100x of business interest expense that was paid or accrued in its 2018 taxable year. Of the $120x of disallowed disqualified interest, $30x (25 percent of $120x) is allocated to Business X and $90x (75 percent of $120x) is allocated to Business Y. The $90x of disallowed disqualified interest that is properly allocable to Business Y (an excepted trade or business) is not subject to the section 163(j) limitation.

(b) *Allocation of tax items other than interest expense and interest income*—(1) *In general.* Except as otherwise provided in § 1.163(j)–6(m) or § 1.163(j)–9(h), 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 satisfies the minimum ownership threshold in paragraph (c)(7) of this section, 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 satisfy the minimum ownership threshold in paragraph (c)(7) of this section, 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.* (A) 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 C 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 C 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 gain or loss from the disposition is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(B) 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.

(C) 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. However, if at least 90 percent of the partnership's or S 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 gain or loss from the disposition is treated as allocable to either excepted or non-excepted trades or businesses, respectively. This rule also applies to tiered passthrough entities 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. For purposes of this paragraph, a 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.

(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 based on the gross income of each trade or business.

(6) *Treatment of investment items and certain other items of a partnership with a C corporation partner.* Any investment income, investment expense, or other item 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, except that any item with respect to property or activities for which an election has been made by the partnership under § 1.163(j)–9(b) is treated as properly allocable to an excepted trade or business. See, for example, an election for activities described in § 1.163(j)–9(b)(2)(ii) or an election under § 1.163(j)–9(h).

(7) *Examples: Allocation of income and expense.* The following examples illustrate the principles of this paragraph (b):

(i) *Example 1: Allocation of income and expense between excepted and non-excepted trades or businesses*—(A) *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.

(B) *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.

(ii) *Example 2: Allocation of partnership items from investment activity*—(A) *Facts.* U, a domestic C corporation, directly conducts an electing real property trade or business. U also has an interest in PRS, a partnership that holds real property for investment. PRS's investment in real property is not a trade or business under section 162 or a real property trade or business under section 469. During the taxable year, PRS sells some of its real property to third parties and allocates $80x of income to U from these sales. In addition, PRS incurs deductible expenses related to its investment in real property and allocates $9x of these deductible expenses to U.

(B) *Analysis.* Under paragraph (b)(6) of this section, any investment income or investment expense that a partnership receives, pays, or accrues and that is treated as properly allocable to a trade or business of a C corporation partner is treated as properly allocable to a non-excepted trade or business of the C corporation partner. Because PRS generates its income and expense from investment activity that is not a trade or business under section 162 or a real property trade or business under section 469, U's allocation of $80x of income and $9x of deductible expense from PRS is treated as properly allocable to a non-excepted trade or business.

(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, § 1.163(j)–6(m), or § 1.163(j)–9(h), 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 at least 90 percent 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:

(i) *Facts.* 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 in Year 1, 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 (which are non-excepted trades or businesses) in Year 1 is $200x.

(ii) *Analysis.* $80x (($800x/($800x + $200x)) × $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 the section 163(j) limitation. The remaining $20x of T's interest expense is business interest expense for Year 1 that is subject to the section 163(j) limitation.

(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. A taxpayer is not required to use the same allocation methodology for each type of asset used in a trade a business. Instead, a taxpayer may use different allocation methodologies for different types of assets used in a 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 must maintain the same allocation methodology for a period of at least five taxable years.

(*2*) *Consent to change allocation methodology.* If a taxpayer has used the same allocation methodology for at least five taxable years, the taxpayers may change its method of allocation under paragraphs (c)(3)(i) and (ii) of this section without the consent of the Commissioner. If a taxpayer has used the same allocation methodology for less than five taxable years, and if the 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 only 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 will be granted only in extraordinary circumstances.

(B) *De minimis exception.* If at least 90 percent 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. This rule applies before the application of paragraph (c)(1)(ii) of this section.

(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, a taxpayer is engaged in an excepted regulated utility trade or business only to the extent that the taxpayer is engaged in an excepted regulated utility trade or business described in § 1.163(j)–1(b)(15)(i)(A), (B), or (C), and any remaining utility trade or business is a non-excepted trade or business. Thus, for example, electricity sold by a utility trade or business at rates not established or approved by an entity described in § 1.163(j)–1(b)(15)(i)(A)(*2*) and not subject to an election under § 1.163(j)–1(b)(15)(iii) 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 under this paragraph (c)(3) for allocating the taxpayer's basis in assets used in both the excepted and non-excepted trades or businesses of selling or furnishing the items described in § 1.163(j)–1(b)(15)(i)(A)(*1*).

(*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 at least 90 percent of the items described in § 1.163(j)–1(b)(15)(i)(A)(*1*) are furnished or sold by trades or businesses described in § 1.163(j)–1(b)(15)(i)(A), (B) or (C), 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. This rule applies before the application of paragraph (c)(3)(iii)(B) of this section.

(*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 megawatt-hours generated in the electricity generation trade or business is sold at rates negotiated with the purchaser, and with respect to which X filed a schedule of rates with a public utility commission. The public utility commission has the authority to take action on the filed schedule of rates, but if no action is taken, the rules governing the public utility commission explicitly state that the public utility commission is deemed to have approved the rates. The public utility has taken no action with respect to the negotiated rate. The remaining 20 percent of the megawatt-hours is sold on the wholesale market at rates not established or subject to approval by a regulator described in § 1.163(j)–1(b)(15)(i)(A)(*2*). X has not made an election under § 1.163(j)–1(b)(15)(iii). 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, because the rate for the sale of the electricity was subject to approval by a regulator described in § 1.163(j)–1(b)(15)(i)(A)(*2*). 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 the assets to non-excepted trades or businesses.

(D) *Special allocation rule for real property trades or businesses subject to special anti-abuse rule*—(*1*) *In general.* In the case of a trade or business that leases real property subject to an arrangement described in § 1.163(j)–9(j)(1), including trades or businesses to which the look-through exception in § 1.163(j)–9(j)(2)(ii) applies, the taxpayer must allocate under this paragraph (c)(3) the basis of property used in both the excepted and non-excepted portions of its trade or business, as determined under § 1.163(j)–9(j)(3).

(*2*) *Allocation methodology for real property.* For purposes of this paragraph (c)(3)(iii)(D), a taxpayer must allocate the basis of real property leased under an arrangement described in § 1.163(j)–9(j)(1) or (j)(2)(i) between the excepted and non-excepted portions of the real property trade or business based on the relative fair market rental value of the real property that is attributable to the excepted and non-excepted portions of the trade or business, respectively.

(*3*) *Example.* The following example illustrates the principles of this paragraph (c)(3)(iii)(D):

(*i*) *Facts.* X and Y are domestic C corporations under common control within the meaning of section 267(b), but neither X nor Y are members of a consolidated group. The small business exemption in § 1.163(j)–2(d) does not apply to X or Y. X owns an office building and leases the entire building to Y. Y subleases 80 percent of the office building, measured by fair market rental value, to a related party. Y subleases the remaining 20 percent of the building to unrelated third parties. X also owns depreciable scaffolding equipment, which it uses to clean all of the building's windows as part of its leasing arrangement with Y.

(*ii*) *Analysis.* Under § 1.163(j)–9(j)(2)(ii), X is eligible to make an election for 20 percent of its business of leasing the office building to be an electing real property trade or business. Assuming X makes such an election, X must allocate the basis of assets used in both the excepted and non-excepted portions of its leasing trade or business under this paragraph (c). Under paragraph (c)(3)(iii)(D)(*2*) of this section, X must allocate the basis of the office building based on the relative fair market value attributable to the excepted and non-excepted portions of its leasing business. Therefore, X must allocate 20 percent of the basis of the building to the excepted portion of its leasing business, and it must allocate the remaining 80 percent of the building to the non-excepted portion of its leasing business. Under paragraph (c)(3)(iii)(D)(*2*) of this section, X may use one of the allocation methods described in paragraph (c)(3)(ii) of this section to allocate the basis of its scaffolding equipment between the excepted and non-excepted portions of its leasing trade or business.

(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)(19)) 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, 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. A change to the alternative depreciation system should be determined in a manner similar to that in § 1.168(i)–4(d)(4) or (d)(5)(ii)(B), as applicable.

(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 a deduction is allowable under section 167 is determined in accordance with section 167(g). The adjusted basis of any intangible asset under this paragraph (c)(5)(i)(D) is determined before any application of the additional first-year depreciation deduction. 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 under 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 to fund specific liabilities (for example, pension trusts, and nuclear decommissioning funds (including, but not limited to, those funds for which an election is made under section 468A)) 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 non-consolidated C 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. If a partner elects or is required to apply the rules in this paragraph (c)(5)(ii)(A) to look through to a partnership's basis in the partnership's assets, the partner's basis in the partnership interest is adjusted to the extent of the partner's share of any adjustments to the basis of the partnership's assets required pursuant to the rules in paragraph (c)(5)(i) 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)(*2*) to look through to the partnership's basis in the partnership's assets. If a partner elects or is required to apply the rules in this paragraph (c)(5)(ii)(A)(*2*) to look through to a partnership's basis in the partnership's assets, the partner allocates the basis of its partnership interest between excepted and non-excepted trades or businesses based on the ratio in which the partner's share of the partnership's adjusted tax basis in its trade or business assets is allocated between excepted and non-excepted trade or business 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 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 a non-excepted trade or business of such partner. However, if the partnership made an election under § 1.163(j)–9(b) or § 1.163(j)–9(h) with respect to an asset or activity, the assets (or assets related to such activities) are treated as properly allocable to an excepted trade or business of such partner. See, for example, an election under § 1.163(j)–9(h) for an asset or an election under § 1.163(j)–9(b) with respect to activities described in § 1.163(j)–9(b)(2)(ii). For 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; instead, such partner's adjusted basis in its partnership interest is decreased by that partner's share of the excess of the partnership's basis in those assets over the partnership's debt that is traced to such assets in accordance with § 1.163–8T, and it is increased by that partner's share of the excess of the partnership's debt that is traced to such assets in accordance with § 1.163–8T over the partnership's basis in those assets. For purposes of the preceding sentence, the partnership's asset basis in property not allocable to a trade or business is adjusted pursuant to the rules in paragraph (c)(5)(i) of this section. 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 domestic non-consolidated 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 for stock in a domestic non-consolidated C corporation, and if dividends paid on such stock would not be included in the shareholder's investment income under section 163(d)(4)(B), then, for purposes of determining the extent to which the shareholder's basis in the stock 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. If a shareholder does not satisfy the minimum ownership threshold in paragraph (c)(7) of this section for stock in a domestic non-consolidated C corporation, but the shareholder's direct and indirect interest in such corporation is greater than or equal to 80 percent by value, and if dividends paid on such stock would not be included in the shareholder's investment income under section 163(d)(4)(B), then, for purposes of determining the extent to which the shareholder's basis in the stock is allocable to an excepted or non-excepted trade or business, the shareholder may 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. For purposes of the preceding sentence, indirect stock ownership is determined by applying the constructive ownership rules of section 318(a).

(*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 is ineligible to look through or chooses not to look through to a corporation's basis in its assets under 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 is ineligible to look through or chooses not to look through to a corporation's basis in its assets under 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.

(*iv*) *Use of inside basis for purposes of C corporation look-through rule.* This paragraph (c)(5)(ii)(B)(*2*)(*iv*) applies if a shareholder meets the requirements to look through the stock of a domestic non-consolidated C corporation under paragraph (c)(5)(ii)(B)(*2*)(*i*) of this section, determined without applying the constructive ownership rules of section 318(a). If this paragraph (c)(5)(ii)(B)(*2*)(*iv*) applies, then solely for purposes of allocating asset basis under paragraph (c)(5)(ii)(B)(*2*)(*i*) of this section, and except as otherwise provided in paragraph (c)(5)(ii)(D) of this section, the shareholder may look through to such shareholder's pro rata share of the C corporation's basis in its assets, taking into account the modifications in paragraph (c)(5)(i) of this section with respect to the C corporation's assets, and adjusted to the extent required under paragraph (d)(4) of this section (asset basis look-through approach). If a shareholder applies the asset basis look-through approach, it must do so for all domestic non-consolidated C corporations for which the shareholder is eligible to use this approach, and it must report its use of this approach on the information statement described in paragraph (c)(6)(iii) of this section. The shareholder also must continue to use the asset basis look-through approach in all future taxable years in which the shareholder is eligible to use this approach.

(*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) 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. For these purposes, indirect stock ownership is determined by applying the constructive ownership rules of section 318(a).

(*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 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 relevant foreign corporations*—(*1*) *In general.* The rules applicable to domestic non-consolidated C corporations in paragraph (c)(5)(ii)(B) of this section also apply to relevant foreign corporations (as defined in § 1.163(j)–1(b)(33)).

(*2*) *Special rule for CFC utilities.* Solely for purposes of applying the rules in paragraph (c)(5)(ii)(B) of this section, a utility trade or business conducted by an applicable CFC is treated as an excepted regulated utility trade or business, but only to the extent that the applicable CFC sells or furnishes the items described in § 1.163(j)–1(b)(15)(i)(A)(*1*) pursuant to rates established or approved by an entity described in § 1.163(j)–1(b)(15)(i)(A)(*2*), a foreign government, a public service or public utility commission or other similar body of any foreign government, or the governing or ratemaking body of a foreign electric cooperative. For purposes of this paragraph (c)(5)(ii)(C)(*2*), the term *foreign government* means 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).

(D) *Inapplicability of look-through rule to partnerships or non-consolidated C 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 C corporation that is eligible for the small business exemption under section 163(j)(3) and § 1.163(j)–2(d)(1), unless the partnership, S corporation, or non-consolidated C corporation elects under § 1.163(j)–9 for a trade or business to be an electing real property trade or business or an electing farming business.

(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 the last sentence of this paragraph (c)(5)(iii), 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, a territory, a possession of the United States, the District of Columbia, or any political subdivision thereof 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). This paragraph (c)(5)(iii) does not apply to an entity that qualifies as a financial services entity as described in § 1.904–4(e)(3).

(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, in the information statement required by paragraph (c)(6)(iii)(B) of this section, that the acquisition qualified for such an election and that, immediately before the acquisition, the acquired entity had a regulatory liability for deferred taxes recorded on its books with respect to property predominantly used in 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) *Determination dates and determination periods*—(A) *Quarterly determination periods.* For purposes of this section, and except as otherwise provided in paragraph (c)(6)(i)(B) 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.

(B) *Annual determination periods.* If a taxpayer satisfies the requirements of the last sentence of this paragraph (c)(6)(i)(B), the taxpayer may allocate asset basis for a taxable year based on the average of adjusted asset basis at the beginning of the year and the end of the year (annual determination method). For these purposes, the term *determination date* means the last day of the taxpayer's taxable year, and the term *determination period* has the same meaning as provided in paragraph (c)(6)(i)(A) of this section. A taxpayer may use the annual determination method for a taxable year only if the taxpayer demonstrates that its total adjusted basis (as determined under paragraph (c)(5) of this section) at the end of the year in its assets used in its excepted trades or businesses, as a percentage of the taxpayer's total adjusted basis at the end of such year in all of its assets used in a trade or business, does not differ by more than 20 percent from such percentage at the beginning of the year.

(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 C corporation to which the taxpayer is applying those rules, then, for purposes of this paragraph (c)(6), the taxpayer must use the most recent asset basis figures from the partnership or non-consolidated C corporation. For example, assume that PS1 is a partnership with a May 31 taxable year, and that C (a calendar-year C corporation that is ineligible to use the annual determination method for the taxable year) is a partner in PS1. 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 any adjustments to asset basis for purposes of applying this paragraph (c). One indication 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), including any taxpayer that satisfies the de minimis rule in paragraph (c)(1)(ii) of this section, must prepare a statement titled ''Section 163(j) Asset Basis Calculations'' containing the information described in paragraphs (c)(6)(iii)(B)(*1*) through (*7*) of this section and must attach the statement to its timely filed Federal income tax return for the taxable year:

(*1*) The taxpayer's adjusted basis in the assets used in its excepted and non-excepted businesses, determined as set forth in this section, including detailed information for the different groups of assets identified in paragraphs (c)(5)(i) and (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;

(*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;

(*6*) Whether the taxpayer used the historical approach or the effective date approach for all of its disallowed disqualified interest; and

(*7*) If the taxpayer changed its methodology for allocating asset basis between or among two or more trades or businesses under paragraph (c)(3)(ii) of this section, a statement that the taxpayer has changed the allocation methodology and a description of the new methodology or, if the taxpayer is required to request consent for the allocation methodology change under paragraph (c)(3)(iii)(A)(*2*) of this section, a statement that the request has been or will be filed and a description of the methodology change.

(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.* For purposes of this section, a shareholder must look through to the assets of a domestic non-consolidated C corporation or a relevant foreign corporation under paragraph (c)(5)(ii) of this section if the shareholder's direct and indirect interest in the corporation satisfies the ownership requirements of section 1504(a)(2). For purposes of this paragraph (c)(7)(i)(A), indirect stock ownership is determined by applying the constructive ownership rules of section 318(a). 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 domestic non-consolidated C corporation or a relevant foreign corporation under paragraph (b)(3) of this section if the shareholder's direct interest in the corporation satisfies the ownership requirements of section 1504(a)(2). A shareholder may look through to the activities of a domestic non-consolidated C corporation or an applicable CFC under paragraph (b)(3) of this section if the shareholder's direct interest in the corporation is greater than or equal to 80 percent by value. 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 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.* It is not necessary to allocate interest expense under this paragraph (d) if all of the taxpayer's interest expense is allocable to excepted trades or businesses or if all of the taxpayer's interest expense is allocable to non-excepted trades or businesses.

(2) *Qualified nonrecourse indebtedness.* For purposes of this section, a taxpayer with qualified nonrecourse indebtedness 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). For purposes of this paragraph (d)(2), the term *qualified nonrecourse indebtedness* has the meaning provided in § 1.861–10T(b), except that the term *cash flow from the property* (within the meaning of § 1.861–10T(b)(3)(i)) includes revenue derived from the sale or lease of inventory or similar property with respect to an excepted regulated utility trade or business or a non-excepted regulated utility trade or business.

(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 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). The amount of the taxpayer's basis in these assets must be reduced, but not below zero, by the amount of qualified nonrecourse indebtedness secured by these assets. 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)(2) 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 $1,000x of T's basis in Building B to reflect the amount of Note A (see paragraph (d)(4) of this section), and without regard to T's $200x of cash and cash equivalents (see paragraph (c)(5)(iii) of this section), T's basis in its assets used in Businesses X and Y is $2,600x and $800x (76.5 percent and 23.5 percent), respectively. Thus, $306x of the remaining $400x of interest expense would be allocated to Business X, and $94x 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, 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 × 20 percent) of P's interest expense and $2x ($10x × 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 the section 163(j) limitation, 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 × 20 percent) of S's interest expense and $1x ($5x × 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 the section 163(j) limitation, 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 × $200x), and $80x is allocated to non-excepted trades or businesses (40 percent × $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/$1,000x) of the P group's Year 1 interest expense is properly allocable to an excepted trade or business. Thus, $15x ($50x × 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 the section 163(j) limitation. In turn, $30x ($100x × 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 the section 163(j) limitation.

(3) *Example 3: Application of look-through rules*—(i) *Facts.* (A) Each of Corp A, Corp B, Corp C, and Corp D is a domestic calendar-year corporation that is not a member of a consolidated group. Corp A owns 100 percent of the stock of Corp C; the basis of Corp A's stock in Corp C is $500x. Corp C owns 10 percent of the interests in PS1 (a domestic partnership), and Corp B owns the remaining 90 percent. Corp C's basis in its PS1 interests is $25x; Corp B's basis in its PS1 interests is $225x. PS1 owns 100 percent of the stock of Corp D; the basis of PS1's stock in Corp D is $1,000x. Corp A and Corp B are owned by unrelated, non-overlapping shareholders.

(B) In 2021, Corp C was engaged solely in a non-excepted trade or business. That same year, PS1's only activity was holding Corp D stock. In turn, Corp D 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 D's asset basis in 2021 was allocable to the electing farming business, and the remaining 50 percent was allocable to the non-excepted trade or business.

(C) Corp A and Corp B each paid or accrued (without regard to section 163(j)) $150x of interest expense allocable to a trade or business. Corp A's trade or business was an excepted trade or business, and Corp B's trade or business was a non-excepted trade or business. Corp A's basis in the assets used in its trade or business was $100x, and Corp 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. Corp A directly owns 100 percent of the stock of Corp C; thus, Corp A satisfies the 80 percent minimum ownership threshold with respect to Corp C. Corp A also owns 10 percent of the interests in PS1. There is no minimum ownership threshold for partnerships; thus, Corp A may apply the look-through rules to PS1. However, Corp A does not directly or indirectly own at least 80 percent of the stock of Corp D; thus, Corp A cannot look through its indirect interest in Corp D. In turn, Corp B directly owns 90 percent of the interests in PS1, and Corp B indirectly owns at least 80 percent of the stock of Corp D. Thus, Corp B must apply the look-through rules to PS1 and Corp D.

(B) From Corp 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 D 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 Corp A's application of the look-through rules, Corp C's entire basis in its PS1 interest ($25x) is allocable to a non-excepted trade or business. Corp C's basis in its other assets also is allocable to a non-excepted trade or business (the only trade or business in which Corp C is engaged). Thus, under paragraph (c) of this section, Corp A's $500x basis in its Corp C stock is allocable entirely to a non-excepted trade or business. Corp A's $100x basis in its other business assets is allocable to an excepted trade or business. Thus, 5/6 (or $125x) of Corp A's $150x of interest expense is properly allocable to a non-excepted trade or business and is business interest expense subject to the section 163(j) limitation, and the remaining $25x of Corp A's $150x of interest expense is allocable to an excepted trade or business and is not subject to the section 163(j) limitation.

(C) From Corp B's perspective, PS1 must look through its stock in Corp D 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 D'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 Corp B's perspective, $500x of PS1's basis in its Corp D 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. Corp B's basis in its PS1 interests is $225x. Applying the look-through rules to Corp B's PS1 interests, $112.5x of Corp B's basis in its PS1 interests is allocable to an excepted trade or business, and $112.5x of Corp B's basis in its PS1 interests is allocable to a non-excepted trade or business. Since Corp B's basis in the assets used in its non-excepted trade or business also was $112.5x, two-thirds of Corp B's interest expense ($100x) is properly allocable to a non-excepted trade or business and is business interest expense subject to the section 163(j) limitation, and one-third of Corp B's interest expense ($50x) is allocable to an excepted trade or business and is not subject to the section 163(j) limitation.

(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 × $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.

(6) *Example 6: Constructive ownership*—(i) *Facts.* P, S, T, and U are domestic C corporations that are not members of a consolidated group. P directly owns 80 percent of the stock of each of S and T as measured by total voting power and value; an unrelated third party, X, owns the remaining 20 percent. In turn, S and T directly own 15 percent and 80 percent, respectively, of the stock of U as measured by total voting power and value; P directly owns the remaining 5 percent. P conducts both excepted and non-excepted trades or businesses. S and T conduct only non-excepted trades or businesses, and U conducts both excepted and non-excepted trades or businesses.

(ii) *Analysis.* Under paragraph (c)(7)(i)(A) of this section, a shareholder must look through to the assets of a domestic non-consolidated C corporation 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). For purposes of paragraph (c)(7)(i)(A) of this section, a shareholder's stock ownership is determined by applying the constructive ownership rules of section 318(a). P directly owns 80 percent of each of S and T as measured by total voting power and value; thus, P must look through to the assets of S and T when allocating the basis in its stock of S and T. P directly owns 5 percent of the stock of U as measured by total voting power and value, and P constructively owns the other 95 percent; thus, P also must look through to U's assets when allocating the basis in its U stock. S directly owns 15 percent of the stock of U, and S constructively owns only 5 percent through P; thus, S cannot look through to U's assets when allocating the basis in its U stock. T directly owns 80 percent of the stock of U, and T constructively owns an additional 5 percent; thus, T must look through to U's assets when allocating the basis in its U stock.

(iii) *Dividend.* The facts are the same as in paragraph (e)(6)(i) of this section, except that U distributes a $160x dividend pro rata to its shareholders. Thus, P receives $8x (5 percent of $160x) of the U dividend, S receives $24x (15 percent of $160x), and T receives $128x (80 percent of $160x). Under paragraph (c)(7)(i)(B) of this section, if a shareholder's direct interest in a corporation satisfies the ownership requirements of section 1504(a)(2), the shareholder must look through to the activities of a domestic non-consolidated C corporation in determining whether dividend income is from an excepted or non-excepted trade or business. The constructive ownership rules do not apply in allocating dividends under paragraph (c)(7)(i)(B) of this section. P directly owns 5 percent of the stock of U as measured by vote and value, and S directly owns 15 percent of the stock of U as measured by vote and value; thus, neither P nor S is required to apply the look-through rules in allocating its dividend income from U, and all such income is allocable to non-excepted trades or businesses. T directly owns 80 percent of the stock of U as measured by vote and value; thus, T must allocate its U dividend in accordance with the activities of U's excepted and non-excepted trades or businesses.

(7) *Example 7: Dispositions with a principal purpose of shifting basis*—(i) *Facts.* U and V are members of a consolidated group of which P is the common parent. U conducts an electing farming business (Business F), and V conducts a farm equipment leasing business (Business L) that is a non-excepted trade or business. After the end of a farming season, the P group, with a principal purpose of shifting basis from Business L to Business F, has V sell to U all off-lease farming equipment that previously was leased out as part of Business L. Immediately before the start of the next season, U sells the farming equipment back to V for use in Business L.

(ii) *Analysis.* Under paragraph (c)(8) of this section, in the case of a disposition of assets undertaken with a principal purpose of artificially shifting 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. Because V's sale of farming equipment to U for storage in Business F's facilities is undertaken with a principal purpose of shifting basis from Business L to Business F, the additional basis Business F receives from these transactions will not be taken into account for purposes of this section. Instead, the basis of the farming equipment will be allocated as though the farming equipment continued to be used in Business L.

(f) *Applicability date.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year. Accordingly, for purposes of § 1.163(j)–10(c)(5), taxpayers make any change to the alternative depreciation system as of November 13, 2020, or if relying on the provisions of § 1.163(j)–10 in regulation project REG–106089–18 (83 FR 67490), as of December 28, 2018.

§ 1.163(j)–11 Transition rules.

(a) *Overview.* This section provides transition rules regarding the section 163(j) limitation. Paragraph (b) of this section provides rules regarding the application of the section 163(j) limitation to a corporation that joins a consolidated group during a taxable year of the group beginning before January 1, 2018 and is subject to the section 163(j) limitation at the time of its change in status. Paragraph (c) of this section provides rules regarding the treatment of carryforwards of disallowed disqualified interest.

(b) *Application of section 163(j) limitation if a corporation joins a consolidated group during a taxable year of the group beginning before January 1, 2018*—(1) *In general.* If a corporation (S) joins a consolidated group during a taxable year of the group beginning 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).

(c) *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. Disallowed disqualified interest is subject to disallowance as a disallowed business interest expense carryforward under section 163(j) and § 1.163(j)–2 to the extent the interest is properly allocable to a non-excepted trade or business under § 1.163(j)–10. Disallowed disqualified interest that is properly allocable to an excepted trade or business is not subject to the section 163(j) limitation. See § 1.163(j)–10(a)(6) for rules governing the allocation of disallowed disqualified interest between excepted and non-excepted trades or businesses.

(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 (c)(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 (c)(3)(ii)(B) of this section.

(B) *Definitions.* The following definitions apply for purposes of paragraph (c)(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 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 Code;

(*ii*) A person that is not related to the taxpayer, within the meaning of section 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 (c)(3)(ii)(B)(*3*)(*ii*), a *gross basis U.S. tax* means any tax imposed by this subtitle A of the 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 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 section 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 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 (c)(3)(ii) of this section is treated in the same manner as described in paragraph (c)(1) of this section.

(4) *Application of section 382*—(i) *Ownership change occurring before* November 13, 2020—(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 November 13, 2020. 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 November 13, 2020. But see section 382(h)(6) (regarding built-in deductions).

(ii) *Ownership change occurring on or after* November 13, 2020—(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 November 13, 2020, 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 November 13, 2020, see § 1.382–2(a)(1)(i)(A).

(5) *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.

(6) *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 in this part under old section 163(j) (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) × $200x), and disallowed disqualified interest of $40x is allocated to C (($150x/$750x) × $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 a 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 (c)(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)–1(b)(9)) of $80x, and no excepted trade or business. Under paragraph (c)(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 (c)(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 (c)(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) × $60x) of B's disallowed disqualified interest carryforwards, and $12x (($40x/$200x) × $60x) of C's disallowed disqualified interest carryforwards, are deducted by the consolidated group in the 2018 taxable year.

(d) *Applicability date.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

■ **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 1.263A–15 is amended by adding paragraph (a)(4) to read as follows:

§ 1.263A–15 Effective dates, transitional rules, and anti-abuse rules.

(a) * * *

(4) Section 1.263A–9(g)(1)(i) applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of that 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 (as defined in § 1.163(j)–1(b)(37)), and, if applicable, §§ 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

* * * * *

■ **Par. 6.** 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 (as defined in § 1.163(j)–1(b)(11)), including any disallowed disqualified interest (as defined in § 1.163(j)–1(b)(12)), 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 in this part under section 382 of the Code, 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, 2021 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, 2022, X transferred all of its assets to Y in a statutory merger to which section 361 applies. For the 2021 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, 2022, X had an additional $350x of disallowed business interest expense (X did not deduct any of its 2021 carryforwards in its 2022 taxable year). For the taxable year ending December 31, 2022, 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 2022 taxable year was $500x ($200x + (30 percent × $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)–1(b)(9)) 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, 2022, 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 × (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, 2022. For the taxable year ending December 31, 2022, X had an additional $350x of disallowed business interest expense (X did not deduct any of its 2021 carryforwards in its 2022 taxable year). For the taxable year ending December 31, 2023, 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 2023 taxable year was $500x ($200x + (30 percent × $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, 2023, 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 2023 taxable year. Since the amount of Y's section 163(j) limit for the 2023 taxable year was $500x, Y may deduct the full amount ($100x) of its own business interest expense for the 2023 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, 2022, X and Y transferred all of their assets to Z in statutory mergers to which section 361 applies. For the 2021 taxable year, X had $300x of disallowed business interest expense, Y had $200x, and Z had $0. For the taxable year ending October 31, 2022, each of X and Y had an additional $125x of disallowed business interest expense (neither X nor Y deducted any of its 2021 carryforwards in 2022). For the taxable year ending December 31, 2022, 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 2022 taxable year was $500x ($200x + (30 percent × $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, 2022, is $750x. However, pursuant to paragraph (c)(2) of this section, only $84x of the aggregate amount ($500x × (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 $100x of current-year business interest expense (as defined in § 1.163(j)–1(b)(9)).

(d) *Applicability date.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to ta axable 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 (as defined in § 1.163(j)–1(b)(37)), and, if applicable, §§ 1.263A–9, 1.263A–15, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

■ **Par. 7.** Section 1.382–1 is amended by:

■ 1. Adding an entry for § 1.382–2(a)(1)(vi) and (a)(7) and (8);

■ 2. Revising the entry for § 1.382–2(b)(3);

■ 3. Adding entries for § 1.382–6(a)(1) and (2) and (b)(4);

■ 4. Revising the entry for § 1.382–6(h); and

■ 5. Adding an entry for § 1.382–7(c), (d), (d)(1) through (5), (e) through (g), and (g)(1) through (4).

The additions and revisions read as follows:

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* * * * *

■ **Par. 8.** 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 the period and adding ''; and'' in its place at the end of 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 will 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)(11)), including disallowed disqualified interest (as defined in § 1.163(j)–1(b)(12)), as of the date of the ownership change.

(ii) The loss corporation's current-year business interest expense (as defined in § 1.163(j)–1(b)(9)) in the change year (as defined in § 1.382–6(g)(1)) that is allocable to the pre-change period (as defined in § 1.382–6(g)(2)) under § 1.382–6(a) or (b) and that becomes disallowed business interest expense (as defined in § 1.163(j)–1(b)(10)).

(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 November 13, 2020. For loss corporations that have testing dates occurring before November 13, 2020, see § 1.382–2 as contained in 26 CFR part 1, revised April 1, 2019. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to testing dates occurring during a taxable year beginning after December 31, 2017, and before November 13, 2020, so long as the taxpayers and their related parties consistently apply the rules of this section, the section 163(j) regulations (as defined in § 1.163(j)–1(b)(37)), §§ 1.382–1, 1.382–5, 1.382–6, 1.382–7, 1.383–0, and 1.383–1, and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

■ **Par. 9.** 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 November 13, 2020. For loss corporations that have undergone an ownership change before or after November 13, 2020, see § 1.382–5 as contained in 26 CFR part 1, revised April 1, 2019. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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 (as defined in § 1.163(j)–1(b)(37)), §§ 1.382–1, 1.382–2, 1.382–6, 1.382–7, 1.383–0, and 1.383–1, and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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 that taxable year.

■ **Par. 10.** Section 1.382–6 is amended by:

■ 1. Redesignating the text of paragraph (a) as paragraph (a)(1);

■ 2. Adding a subject heading to newly redesignated paragraph (a)(1);

■ 3. Adding paragraph (a)(2);

■ 4. Removing the language ''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;

■ 5. Adding paragraph (b)(4); and

■ 6. Revising paragraph (h).

The additions 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.

(a) * * *

(1) *In general.* * * *

(2) *Allocation of business interest expense*—(i) *Scope.* Except as provided in paragraph (b)(4) of this section, this paragraph (a)(2) applies if a loss corporation has business interest expense (as defined in § 1.163(j)–1(b)(3)) in the change year. The rules of this paragraph (a)(2) apply to determine the amount of current-year business interest expense (as defined in § 1.163(j)–1(b)(9)) that is deducted in the change year. These rules also apply to determine the amount of any current-year business interest expense that is characterized as disallowed business interest expense (as defined in § 1.163(j)–1(b)(10)) allocable to the pre-change period and the post-change period, and to allocate disallowed business interest expense carryforwards (as defined in § 1.163(j)–1(b)(11)) to the change year for deduction in the pre-change period and the post-change period.

(ii) *Deductibility of business interest expense.* The rules of this paragraph (a)(2)(ii) apply in the following order.

(A) First, the loss corporation calculates its section 163(j) limitation (as defined in § 1.163(j)–1(b)(36)) for the change year.

(B) Second, the loss corporation calculates its deductible current-year BIE and deducts this amount in determining its taxable income or net operating loss for the change year. For purposes of this paragraph (a)(2)(ii), the term *deductible current-year BIE* means the loss corporation's current-year business interest expense (including its floor plan financing interest expense, as defined in § 1.163(j)–1(b)(19)), to the extent of its section 163(j) limitation.

(C) Third, if the loss corporation has disallowed business interest expense paid or accrued (without regard to section 163(j)) in the change year that is carried forward to post-change years, it allocates an equal portion of that disallowed business interest expense to each day in the change year. Any amount of disallowed business interest expense that is allocated to the pre-change period pursuant to this paragraph (a)(2)(ii)(C) is carried forward subject to section 382(d)(3). Any amount of disallowed business interest expense that is allocated to the post-change period pursuant to this paragraph (a)(2)(ii)(C) is carried forward and is not subject to section 382(d)(3).

(D) Fourth, if the loss corporation has excess section 163(j) limitation, then the loss corporation calculates its deductible disallowed business interest expense carryforward and allocates an equal portion to each day in the change year. For purposes of this paragraph (a)(2)(ii), the term *excess section 163(j) limitation* means the excess, if any, of the loss corporation's section 163(j) limitation over its deductible current-year BIE, and the term *deductible disallowed business interest expense carryforward* means the loss corporation's disallowed business interest expense carryforward to the extent of its excess section 163(j) limitation.

(E) Fifth, the loss corporation deducts its deductible disallowed business interest expense carryforward that was allocated to the pre-change period under paragraph (a)(2)(ii)(D) of this section. Subject to the application of sections 382(b)(3)(B) and 382(d)(3), the loss corporation deducts its deductible disallowed business interest expense carryforward that was allocated to the post-change period under paragraph (a)(2)(ii)(D) of this section. Any amount of disallowed business interest expense carryforward that is not deducted pursuant to this paragraph (a)(2)(ii)(E) is carried forward subject to section 382(d)(3).

* * * * *

(b) * * *

(4) *Allocation of business interest expense*—(i) *Scope.* This paragraph (b)(4) applies if a loss corporation makes a closing-of-the-books election pursuant to paragraph (b) of this section and has business interest expense in the change year. The rules of this paragraph (b)(4)

apply to determine the amount of deductible current-year business interest expense that is allocable to the pre-change period and the post-change period for purposes of the allocations referred to in paragraph (b)(1) of this section. These rules also apply to determine the amount of any current-year business interest expense that is characterized as disallowed business interest expense allocable to the pre-change period and the post-change period, and to allocate disallowed business interest expense carryforwards to the change year between the pre-change period and the post-change period for deduction.

(ii) *Deductibility of business interest expense.* The rules of this paragraph (b)(4)(ii) apply in the order provided.

(A) The loss corporation calculates its ATI limit, which is the product of its ATI (as defined in § 1.163(j)–1(b)(1)) for the change year and 30 percent. For purposes of this paragraph (b)(4)(ii), the terms *pre-change ATI limit* and *post-change ATI limit* mean the amount of ATI limit allocated to the pre-change period or the post-change period, respectively, computed by allocating an equal portion of the ATI limit to each day in the change year.

(B) Pursuant to paragraph (b)(1) of this section, the loss corporation allocates its current-year business interest expense (including its floor plan financing interest expense) and its business interest income (as defined in § 1.163(j)–1(b)(4)) to the pre-change and post-change periods as if the loss corporation's books were closed on the change date. For purposes of this paragraph (b)(4)(ii), the terms *pre-change BIE* and *post-change BIE* mean the amount of the loss corporation's current-year business interest expense that is allocated to the pre-change period or the post-change period, respectively, under this paragraph (b)(4)(ii)(B).

(C) The loss corporation deducts its pre-change BIE to the extent of its pre-change section 163(j) limit, and the loss corporation deducts its post-change BIE to the extent of its post-change section 163(j) limit. For purposes of this paragraph (b)(4)(ii), the term *pre-change section 163(j) limit* means the sum of the pre-change ATI and the amount of business interest income and floor plan financing interest expense allocated to the pre-change period; the term *post-change section 163(j) limit* means the sum of the post-change ATI limit and the amount of business interest income and floor plan financing interest expense allocated to the post-change period.

(D) If any pre-change BIE or post-change BIE has not been deducted under paragraph (b)(4)(ii)(C) of this section, the loss corporation deducts either any pre-change BIE that has not been deducted to the extent of its surplus post-change section 163(j) limit or any post-change BIE that has not been deducted to the extent of its surplus pre-change section 163(j) limit. For purposes of this paragraph (b)(4)(ii), the term *surplus pre-change section 163(j) limit* means the amount by which the pre-change section 163(j) limit exceeds the amount of pre-change BIE deducted pursuant to paragraph (b)(4)(ii)(C) of this section; the term *surplus post-change section 163(j) limit* means the amount by which the post-change section 163(j) limit exceeds the amount of post-change BIE deducted pursuant to paragraph (b)(4)(ii)(C) of this section.

(E) If the loss corporation has any excess pre-change section 163(j) limit or excess post-change section 163(j) limit, the loss corporation allocates its disallowed business interest expense carryforward, if any, ratably between the pre-change and post-change periods based upon the relative amounts of excess pre-change section 163(j) limit and excess post-change section 163(j) limit. For purposes of this paragraph (b)(4)(ii), the term *excess pre-change section 163(j) limit* means the amount by which the surplus pre-change section 163(j) limit exceeds the amount of post-change BIE deducted pursuant to paragraph (b)(4)(ii)(D) of this section; the term *excess post-change section 163(j) limit* means the amount by which the surplus post-change section 163(j) limit exceeds the amount of pre-change BIE deducted pursuant to paragraph (b)(4)(ii)(D) of this section.

(F) The loss corporation deducts its disallowed business interest expense carryforward that was allocated to the pre-change period under paragraph (b)(4)(ii)(E) of this section to the extent of its excess pre-change section 163(j) limit. Subject to the application of sections 382(b)(3)(B) and 382(d)(3), the loss corporation deducts its disallowed business interest expense carryforward that was allocated to the post-change period under paragraph (b)(4)(ii)(E) of this section to the extent of its excess post-change section 163(j) limit. Any amount of disallowed business interest expense carryforward that is not deducted pursuant to this paragraph (b)(4)(ii)(F) is subject to section 382(d)(3) irrespective of the period to which it was allocated pursuant to paragraph (b)(4)(ii)(E) of this section.

(iii) *Example 1*—(A) *Facts.* X is a calendar-year domestic C corporation that is not a member of a consolidated group. As of January 1, 2021, X has no disallowed business interest expense carryforwards. On October 19, 2021, X experiences an ownership change under section 382(g). For calendar year 2021, X's ATI is $500. For the period beginning on January 1, 2021 and ending on October 19, 2021, X pays or accrues $250 of current-year business interest expense that is deductible but for the potential application of section 163(j), including $50 of floor plan financing interest expense, and X has $60 of business interest income. For the period beginning on October 20, 2021 and ending on December 31, 2021, X pays or accrues $100 of current-year business interest expense that is deductible but for the potential application of section 163(j), including $40 of floor plan financing interest expense, and X has $70 of business interest income. X makes a closing-of-the-books election pursuant to paragraph (b) of this section.

(B) *Analysis*—(*1*) *Calculation and allocation of ATI limit.* For purposes of allocating its net operating loss or taxable income for the change year between the pre-change period and the post-change period under § 1.382–6, X applies paragraph (b)(4) of this section to allocate items related to section 163(j). X's ATI for calendar year 2021 is $500x. Therefore, pursuant to paragraph (b)(4)(ii)(A) of this section, X's ATI limit is $150 ($500 × 30 percent). Additionally, pursuant to paragraph (b)(4)(ii)(A) of this section, X's pre-change ATI limit is $120 ($150 × (292 days/365 days)), and X's post-change ATI limit is $30 ($150 × (73 days/365 days)).

(*2*) *Determination of pre-change BIE and post-change BIE.* Pursuant to paragraph (b)(4)(ii)(B) of this section, X's pre-change BIE and post-change BIE are $250 and $100, respectively.

(*3*) *Determination of pre-change section 163(j) limit and post-change section 163(j) limit.* Pursuant to paragraph (b)(4)(ii)(C) of this section, X's pre-change section 163(j) limit is $230 ($120 (X's pre-change ATI limit) + $60 (X's business interest income allocated to the pre-change period) + $50 (X's floor plan financing interest expense allocated to the pre-change period)). Additionally, pursuant to paragraph (b)(4)(ii)(C) of this section, X's post-change section 163(j) limit is $140 ($30 (X's post-change ATI limit) + $70 (X's business interest income allocated to the post-change period) + $40 (X's floor plan financing interest expense allocated to the post-change period)).

(*4*) *Initial deduction of BIE.* Pursuant to paragraph (b)(4)(ii)(C) of this section, X deducts $230 (its pre-change section 163(j) limit) of its $250 pre-change BIE and all $100 (less than its $140 post-change section 163(j) limit) of its post-change BIE.

(*5*) *Deduction of BIE due to surplus post-change section 163(j) limit.* After applying paragraph (b)(4)(ii)(C) of this section, X has $20 of pre-change BIE that has not been deducted ($250 − $230) and a surplus post-change section 163(j) limit of $40 ($140 − $100). As a result, pursuant to paragraph (b)(4)(ii)(D) of this section, X deducts its remaining $20 of pre-change BIE. (If, after applying paragraph (b)(4)(ii)(C) of this section, X instead had $20 of post-change BIE that had not yet been deducted and a $40 surplus pre-change section 163(j) limit, then X would deduct its remaining $20 of post-change BIE pursuant to paragraph (b)(4)(ii)(D) of this section.)

(iv) *Example 2—Potential deduction of disallowed business interest expense carryforwards.* The facts are the same as in paragraph (b)(4)(iii)(A) of this section, except that, as of January 1, 2021, X has $90 of disallowed business interest expense carryforwards and $150 (rather than $250) of pre-change BIE. X's pre-change section 163(j) limit and post-change section 163(j) limit are the same as in paragraph (b)(4)(iii)(B)(*3*) of this section. Pursuant to paragraph (b)(4)(ii)(C) of this section, X deducts all $150 of its pre-change BIE and all $100 of its post-change BIE. X has no remaining pre-change BIE or post-change BIE to deduct under paragraph (b)(4)(ii)(D) of this section. Paragraph (b)(4)(ii)(E) of this section applies because X has $80 of excess pre-change section 163(j) limit ($230 − $150) and $40 of excess post-change section 163(j) limit ($140 − $100). Under paragraph (b)(4)(ii)(E) of this section, X allocates $60 of its disallowed business interest expense carryforwards to the pre-change period ($90 × ($80/($80 + $40))) and $30 of its disallowed business interest expense carryforwards to the post-change period ($90 × ($40/($80 + $40))). As provided in paragraph (b)(4)(ii)(F) of this section, X deducts all $60 of its disallowed business interest expense carryforwards that are allocated to the pre-change period; subject to the application of section 382, X deducts all $30 of its disallowed business interest expense carryforwards that are allocated to the post-change period.

* * * * *

(h) *Applicability date*—(1) *In general.* This section applies to ownership changes occurring on or after June 22, 1994.

(2) *Ownership changes.* Paragraphs (a) and (b)(1) and (4) of this section apply with respect to an ownership change occurring during a taxable year beginning on or after November 13, 2020. For ownership changes occurring during a taxable year beginning before November 13, 2020, see § 1.382–6 as contained in 26 CFR part 1, revised April 1, 2019. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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 (as defined in § 1.163(j)–1(b)(37)), §§ 1.382–1, 1.382–2, 1.382–5, 1.383–0, and 1.383–1, and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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, 1.382–7, and 1.383–1), and 1.1504–4, to taxable years beginning after December 31, 2017.

■ **Par. 11.** Section 1.382–7 is amended by adding paragraphs (c), (d), (e), (f), and (g) to read as follows:

§ 1.382–7 Built-in gains and losses.

* * * * *

(c) [Reserved]

(d) *Special rules.* This paragraph (d) contains special rules regarding the identification of recognized built-in losses.

(1)–(4) [Reserved]

(5) *Section 382 disallowed business interest carryforwards.* Section 382 disallowed business interest carryforwards are not treated as recognized built-in losses.

(e)–(f) [Reserved]

(g) *Applicability dates.*

(1)–(3) [Reserved]

(4) Paragraph (d)(5) of this section. Paragraph (d)(5) of this section applies with respect to an ownership change occurring on or after November 13, 2020. For loss corporations that have undergone an ownership change before or after November 13, 2020, see § 1.382–7 as contained in 26 CFR part 1, revised April 1, 2019. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of paragraph (d)(5) of this section to testing dates occurring during a taxable year beginning after December 31, 2017.

■ **Par. 12.** Section 1.383–0 is amended by revising paragraph (a) to read as follows:

§ 1.383–0 Effective date.

(a) The regulations in this part under section 383 of the Code (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 Public Law 115–97 (2017). See § 1.383–1(j) for effective date rules.

* * * * *

■ **Par. 13.** 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), (ii), and (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 subject 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, 2021. For 2022, 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 2022 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) *General rule.* 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 as defined in § 1.163(j)–1(b)(10), 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, as defined in § 1.163(j)–1(b)(36), 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 November 13, 2020, but during the taxable year which includes November 13, 2020, the pre-change loss described in section 382(d)(3);

(B) With respect to an ownership change date occurring on or after November 13, 2020, 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, 2021. For 2022, 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 2020 of $25,000. L has a section 382 limitation for 2022 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) × 25 percent) of its business credit carryforward in 2022. The unabsorbed portion of L's section 382 limitation, $1,000 (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, $14,500, 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, 2021. For 2022, 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-2021 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 2022.

(ii) *Analysis.* The following computation illustrates the application of this section for 2022:

TABLE 1 TO PARAGRAPH (f)(2)(ii)

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 × section 11 rates)	52,500
9. Modified tax liability (line 5 minus line 6 (but not less than zero) × 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 2022 (lesser of line 7 or line 10)	52,500
12. Amount of pre-change credits to be carried over to 2023 under section 904(c) (line 7 minus line 11)	147,500

TABLE 1 TO PARAGRAPH (f)(2)(ii)—Continued

13. Section 383 credit reduction amount: $52,500/0.21	250,000
14. Section 382 limitation to be carried to 2023 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, 2021. L has $80,000 of ordinary taxable income (before the application of carryovers) and a section 382 limitation of $25,000 for 2022, a post-change year. L's only carryover is from a pre-2021 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 2022.

(ii) *Analysis.* The following computation illustrates the application of this section:

TABLE 2 TO PARAGRAPH (f)(3)(ii)

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 × section 11 rates)	16,800
5. Modified tax liability ((line 1 minus line 2) × 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 2023 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 2023 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 beginning on or after November 13, 2020. For loss corporations that have undergone an ownership change during a taxable year beginning before November 13, 2020, see § 1.383–1 as contained in 26 CFR part 1, revised April 1, 2019. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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 (as defined in § 1.163(j)–1(b)(37)), §§ 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, and 1.383–0, and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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; or the rules of this section (except paragraph (d)(2)(iv)(A) of this section), the section 163(j) regulations (as defined in § 1.163(j)–1(b)(37)) and §§ 1.382–1, 1.382–2, 1.382–5, 1.382–6, and 1.383–0, and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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, 1.382–7, and 1.383–1), and 1.1504–4, to those ownership changes.

■ **Par. 14.** 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*—(i) *General rule.* Except as provided in paragraph (g)(4)(ii) of this section, a 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 paragraph (f)(2)(iii)(A) of this section, is recognized as interest expense to the payor and interest income to the recipient.

(ii) *Exception for cleared swaps and non-cleared swaps subject to margin or collateral requirements.* Paragraph (g)(4)(i) of this section does not apply to a swap if the contract is described in paragraph (g)(4)(ii)(A) or (B) of this section.

(A) The swap 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, and the derivatives clearing organization or clearing agency requires the parties to the swap to post and collect margin or collateral.

(B) The swap is a non-cleared swap that requires the parties to meet the margin or collateral requirements of a federal regulator or that provides for margin or collateral requirements that are substantially similar to a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a federal regulator. For purposes of this paragraph (g)(4)(ii)(B), the term *federal regulator* means the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a), as amended by section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law 111–203, 124 Stat. 1376, Title VII.

(iii) *Coordination with section 163(j).* For the treatment of swaps with significant nonperiodic payments under section 163(j), see § 1.163(j)–1(b)(22)(ii).

* * * * *

(j) * * *

(2) The rules provided in paragraph (g)(4) of this section apply to notional principal contracts entered into on or after September 14, 2021. Taxpayers may choose to apply the rules provided in paragraph (g)(4) of this section to notional principal contracts entered into before September 14, 2021.

■ **Par. 15.** 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 under this section are real property for purposes of section 469(c)(7)(C). However, property manufactured or produced for sale that is not real property in the hands of the manufacturer or producer, but that may be incorporated into real property through installation or any similar process or technique by any person after the manufacture or production of such property (for example, bricks, nails, paint, and windowpanes), is not treated as real property in the hands of any person (including any person involved in the manufacture, production, sale, incorporation or installation of such property) prior to the completed incorporation or installation of such property into the real property for purposes of section 469(c)(7)(C) and this section.

(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 certain types of trees in a farming operation as defined in section 464(e), 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, under 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, under § 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, for purposes of and with respect to the preceding sentence, 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.

(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, under 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, under § 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, for purposes of and with respect to the preceding sentence, 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. 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.

(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 (under 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 (under § 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 under § 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 is treated as owning an interest in a real property trade or business conducted by or through P and P is 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 under 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 under section 469(c)(7)(C) and this section.

* * * * *

■ **Par. 16.** Section 1.469–11 is amended by:

■ 1. Revising the section heading;

■ 2. Removing the period at the end of paragraph (a)(1) and adding a semicolon in its place;

■ 3. Revising paragraph (a)(3);

■ 4. Redesignating paragraphs (a)(4) and (5) as paragraphs (a)(5) and (6), respectively; and

■ 5. Adding a new paragraph (a)(4).

The revision and addition read as follows:

§ 1.469–11 Applicability date and transition rules.

(a) * * *

(3) The rules contained in § 1.469–9, other than paragraph (b)(2), 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;

(4) The rules contained in § 1.469–9(b)(2) apply to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, under sections 267(b) and 707(b)(1), may choose to apply the rules of § 1.469–9(b)(2) for a taxable year beginning after December 31, 2017, so long as they consistently apply the rules of § 1.469–9(b)(2), the section 163(j) regulations (as defined in § 1.163(j)–1(b)(37)), and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, 1.382–7, and 1.383–1), and 1.1504–4 to that taxable year;

* * * * *

■ **Par. 17.** Section 1.704–1 is amended by adding paragraph (b)(4)(xi) to read as follows:

§ 1.704–1 Partner's distributive share.

* * * * *

(b) * * *

(4) * * *

(xi) *Section 163(j) excess items.* Allocations of section 163(j) excess items as defined in § 1.163(j)–6(b)(6) do not have substantial economic effect under paragraph (b)(2) of this section and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership. See paragraph (b)(3)(iv) of this section. Allocations of section 163(j) excess items will be deemed to be in accordance with the partners' interests in the partnership if such allocations are made in accordance with § 1.163(j)–6(f).

* * * * *

■ **Par. 18.** 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. 19.** Section 1.1362–3 is amended by:

■ 1. Redesignating the text in paragraph (c)(3) as paragraph (c)(3)(i), adding a subject heading to newly redesignated paragraph (c)(3)(i), and adding paragraph (c)(3)(ii); and

■ 2. Designating *Examples 1* through *4* of paragraph (d) as paragraphs (d)(1) through (d)(4), respectively.

The additions read as follows:

§ 1.1362–3 Treatment of S termination year.

* * * * *

(c) * * *

(3) * * *

(i) *In general.* * * *

(ii) *Application of section 163(j).* For purposes of section 163(j), a separate limitation (as defined in § 1.163(j)–1(b)(36)) applies to each S short year and each C short year. Any items necessary to determine the amount of business interest expense (as defined in § 1.163(j)–1(b)(3)) that are deducted in each S short year or C short year must be allocated between the S short year and C short year in accordance with an allocation methodology provided in section 1362(e).

* * * * *

■ **Par. 20.** Section 1.1368–1 is amended by adding a sentence to the end of paragraph (g)(2)(ii) to read as follows:

§ 1.1368–1 Distributions by S corporations.

* * * * *

(g) * * *

(2) * * *

(ii) * * * In the case of a taxable year for which an election is made under paragraph (g)(2)(i), for purposes of section 163(j), a separate section 163(j) limitation (as defined in § 1.163(j)–1(b)(36)) applies to each separate taxable year. Any items necessary to determine the amount of business interest expense (as defined in § 1.163(j)–1(b)(3)) that are deducted in each separate taxable year must be allocated between the two separate taxable years in accordance with an allocation methodology provided in this paragraph (g).

* * * * *

■ **Par. 21.** Section 1.1377–1 is amended by:

■ 1. Redesignating paragraphs (b)(3)(ii) through (iv) as paragraphs (b)(3)(iii) through (v), respectively; and

■ 2. Adding a new paragraph (b)(3)(ii).

The addition reads as follows:

§ 1.1377–1 Pro rata share.

* * * * *

(b) * * *

(3) * * *

(ii) *Section 163(j).* If a terminating election is made to treat the S corporation's taxable year as consisting of separate taxable years, for purposes of section 163(j), a separate limitation (as defined in § 1.163(j)–1(b)(36)) will apply to each separate taxable year. Any items necessary to determine the amount of business interest expense (as defined in § 1.163(j)–1(b)(3)) that are deducted in each separate taxable year must be allocated between the separate taxable years in accordance with an allocation methodology provided in this section.

* * * * *

■ **Par. 22.** Section 1.1502–13 is amended:

■ 1. In paragraph (a)(6)(ii), under the heading ''Anti-avoidance rules. (§ 1.1502–13(h)(2))'', by:

■ i. Designating *Examples 1* through *5* as entries (i) through (v); and

■ ii. Adding an entry (vi);

■ 2. In paragraph (h)(2) by:

■ 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. Redesignating paragraphs (h)(2)(v)(a) and (b) as paragraphs (h)(2)(iv)(A) and (B); and

■ c. Adding paragraph (h)(2)(vi).

The additions read as follows:

§ 1.1502–13 Intercompany transactions.

(a) * * *

(6) * * *

(ii) * * *

Anti-avoidance rules. (§ 1.1502–13(h)(2))

* * * * *

(vi) *Example 6.* Section 163(j) interest limitation.

* * * * *

(h) * * *

(2) * * *

(vi) *Example 6: Section 163(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. 23.** Section 1.1502–21 is amended by adding new paragraph (c)(3) to read as follows:

§ 1.1502–21 Net operating losses.

* * * * *

(c) * * *

(3) *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. 24.** 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 beginning on or after November 13, 2020. For taxable years beginning before November 13, 2020, see § 1.1502–36 as contained in 26 CFR part 1, revised April 1, 2019. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, and before November 13, 2020, so long as the taxpayers and their related parties consistently apply the rules of this section, the section 163(j) regulations (as defined in § 1.163(j)–1(b)(37)), and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, 1.382–7, and 1.383–1), and 1.1504–4, to that taxable year.

■ **Par. 25.** 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 (as defined in § 1.163(j)–1(b)(11)) of a member arising in a separate return limitation year, see § 1.163(j)–5(d) and (f).

■ **Par. 26.** 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.

* * * * *

§ 1.1502–99 Effective dates.

* * * * *

(d) Application to section 163(j).

■ **Par. 27.** 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. 28.** 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. 29.** Section 1.1502–98 is amended by:

■ 1. Revising the section heading;

■ 2. Designating the undesignated text as paragraph (a) and adding a subject 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 in this part under sections 163(j), 382, and 383 of the Code contain rules governing the application of section 382 to interest expense governed by section 163(j) and the regulations in this part under section 163(j) of the Code. See, for example, §§ 1.163(j)–11(c), 1.382–2, 1.382–6, 1.382–7, 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, as defined in § 1.163(j)–1(b)(11), 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 (as defined in § 1.163(j)–1(b)(9)), disallowed business interest expense carryforwards, and section 382 disallowed business interest carryforwards, appropriate adjustments are required.

■ **Par. 30.** 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 November 13, 2020. For loss corporations that have ownership changes occurring before November 13, 2020, see §§ 1.1502–91 through 1.1502–99 as contained in 26 CFR part 1, revised April 1, 2019. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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 §§ 1.382–6 and 1.383–1), the section 163(j) regulations (as defined in § 1.163(j)–1(b)(37)), and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–7, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–79, and 1.1504–4, to that taxable year.

(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 beginning on or after November 13, 2020. For the application of these rules to an ownership change with respect to an ownership change

occurring during a taxable year beginning before November 13, 2020, see §§ 1.1502–91 through 1.1502–99 as contained in 26 CFR part 1, revised April 1, 2019. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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 1.1502–91 through 1.1502–99 (to the extent that those rules effectuate the rules of §§ 1.382–2 and 1.382–5), the section 163(j) regulations (as defined in § 1.163(j)–1(b)(37)), and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–7, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, and 1.1504–4, to a taxable year beginning after December 31, 2017.

■ **Par. 31.** Section 1.1504–4 is amended by:

■ 1. Removing ''163(j), 864(e),'' from 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 additions read 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 beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to 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 (as defined in § 1.163(j)–1(b)(37)), and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 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, 1.382–7, and 1.383–1), to that taxable year.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: July 14, 2020.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

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