DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–107911–18]

RIN 1545–BP73

Limitation on Deduction for Business Interest Expense; Allocation of Interest Expense by Passthrough Entities; Dividends Paid by Regulated Investment Companies; Application of Limitation on Deduction for Business Interest Expense to United States Shareholders of Controlled Foreign Corporations and to Foreign Persons With Effectively Connected Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This notice of proposed rulemaking provides rules concerning 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. Specifically, these proposed regulations address application of the limitation in contexts involving passthrough entities, regulated investment companies (RICs), United States shareholders of controlled foreign corporations, and foreign persons with effectively connected income in the United States. These proposed regulations also provide guidance regarding the definitions of real property development, real property redevelopment, and a syndicate. These proposed regulations affect taxpayers that have business interest expense, particularly passthrough entities, their partners and shareholders, as well as foreign corporations and their United States shareholders and foreign persons with effectively connected income. These proposed regulations also affect RICs that have business interest income, RIC shareholders that have business interest expense, and members of a consolidated group.

DATES: Written or electronic comments and requests for a public hearing must be received by November 2, 2020, which is 60 days after the date of filing for public inspection with the Office of the Federal Register.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–107911–18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and when practicable on paper, to its public docket.

Send paper submissions to: CC:PA:LPD:PR (REG–107911–18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning § 1.163(j)–1, Steven Harrison, (202) 317–6842, Michael Chin, (202) 317–6842 or John Lovelace, (202) 317–5363; concerning § 1.163(j)–2, Sophia Wang, (202) 317–4890 or John Lovelace, (202) 317–5363, concerning § 1.163–14, § 1.163(j)–6, or § 1.469–9, William Kostak, (202) 317–5279 or Anthony McQuillen, (202) 317–5027; concerning § 1.163–15, Sophia Wang, (202) 317–4890; concerning § 1.163(j)–7 or § 1.163(j)–8, Azeka J. Abramoff, (202) 317–3800 or Raphael J. Cohen, (202) 317–6938, concerning § 1.1256(e)–2, Sophia Wang, (202) 317–4890 or Pamela Lew, (202) 317–7053; concerning submissions of comments and/or requests for a public hearing, Regina L. Johnson, (202) 317–5177 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 163 (in particular section 163(j)), 469 and 1256(e) of the Code. Section 163(j) was amended as part of Public Law 115–97, 131 Stat. 2054 (December 22, 2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA), and the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116–136 (2020) (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). 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.

Section 163(j) generally limits the amount of business interest expense (BIE) 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 BIE is limited to the sum of (1) the taxpayer's business interest income (BII) 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 (in sum, the section 163(j) limitation). As further described later in this Background section, section 163(j)(10), as amended by the CARES Act, provides special rules relating to the ATI limitation for taxable years beginning in 2019 or 2020. Under section 163(j)(2), the amount of any BIE that is not allowed as a deduction in a taxable year due to the section 163(j) limitation is treated as business interest paid in the succeeding taxable year.

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)(3) provides that the section 163(j) limitation does not apply to any taxpayer that meets the gross receipts test under section 448(c), other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3).

Section 163(j)(4) provides special rules for applying section 163(j) in the case of passthrough entities. Section 163(j)(4)(A) requires that the section 163(j) limitation be applied at the partnership level, and that a partner's ATI be increased by the partner's share of excess taxable income, as defined in section 163(j)(4)(C), but not by the partner's distributive share of income, gain, deduction, or loss. Section 163(j)(4)(B) provides that the amount of partnership BIE limited by section 163(j)(1) (EBIE) is carried forward at the partner level. Section 163(j)(4)(B)(ii) provides that EBIE allocated to a partner and carried forward is available to be deducted in a subsequent year only to the extent that the partnership allocates excess taxable income to the partner. As further described later in this Background section, 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.

Section 163(j)(4)(B)(iii) provides rules for the adjusted basis in a partnership of a partner that is allocated EBIE. 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) define ''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. This 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, and may be made only by the partnership. 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 substitute its ATI for the last taxable year beginning in 2019 (2019 ATI) for the taxpayer's ATI for a taxable year beginning in 2020 (2020 ATI) in determining the taxpayer's section 163(j) limitation for the 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 Department of the Treasury (Treasury Department) and the IRS (1) published proposed regulations under section 163(j), as amended by the TCJA, in a notice of proposed rulemaking (REG–106089–18) (2018 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 section 163(j) before amendment by the TCJA. The 2018 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 (April 16, 2018).

A public hearing on the 2018 Proposed Regulations was held on February 27, 2019. The Treasury Department and the IRS also received written comments responding to the 2018 Proposed Regulations (available at *http://www.regulations.gov*). In response to certain comments, the Treasury Department and the IRS are publishing this notice of proposed rulemaking to provide additional proposed regulations (these Proposed Regulations) under section 163(j).

Concurrently with the publication of these Proposed Regulations, the Treasury Department and the IRS are publishing in the Rules and Regulations section of this edition of the **Federal Register** (RIN 1545–BO73) final regulations under section 163(j) (the Final 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 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 2019 ATI to calculate the taxpayer's section 163(j) limitation for any taxable year beginning 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).

Explanation of Provisions

These Proposed Regulations would provide guidance in addition to the Final Regulations regarding the section 163(j) limitation. These Proposed Regulations would also add or amend regulations under certain other provisions of the Code where necessary to provide conformity across the Income Tax Regulations. A significant number of the terms used throughout these Proposed Regulations are defined in § 1.163(j)–1 of the Final Regulations and discussed in the Explanation of Provisions section of the 2018 Proposed Regulations and the Summary of Comments and Explanation of Revisions section of the Final Regulations. Some of these terms are further discussed in this Explanation of Provisions section as they relate to specific provisions of these Proposed Regulations.

Part I of this Explanation of Provisions describes proposed rules that would allocate interest expense for purposes of sections 469, 163(d), 163(h), and 163(j) in connection with certain transactions involving passthrough entities. Part II provides proposed rules relating to distributions of debt proceeds from any taxpayer account or from cash so that interest expense may be allocated for purposes of sections 469, 163(d), 163(h), and 163(j). Part III describes proposed modifications to the definitions and general guidance in § 1.163(j)–1, including proposed rules permitting taxpayers to apply a different computational method in determining adjustments to tentative taxable income to address sales or other dispositions of depreciable property, stock of a consolidated group member, or interests in a partnership, and proposed rules allowing RIC shareholders to treat certain RIC dividends as interest income for purposes of section 163(j). Part IV describes proposed modifications to § 1.163(j)–6, relating to the applicability of the section 163(j) limitation to passthrough entities, including proposed rules on the applicability of the section 163(j) limitation to trading partnerships and publicly traded partnerships, the application of the section 163(j) limitation in partnership self-charged lending transactions, proposed rules relating to the treatment of excess business interest expense in tiered partnerships, proposed rules relating to partnership basis adjustments upon partner dispositions, proposed rules regarding the election to substitute 2019 ATI for the partnership's 2020 ATI in determining the partnership's section 163(j) limitation for a taxable year beginning in 2020, and proposed rules regarding excess business interest expense allocated to a partner in a taxable year beginning in 2019.

Part V discusses re-proposed rules regarding the application of the section 163(j) limitation to foreign corporations and United States shareholders (as defined in section 951(b) (U.S. shareholders) of controlled foreign corporations (as defined in section 957(a)) (CFCs). Part VI discusses re-proposed rules regarding the application of the section 163(j) limitation to nonresident alien individuals and foreign corporations with effectively connected income in the United States. Part VII describes proposed modifications to the definition of a real property trade or business under § 1.469–9 for purposes of the passive activity loss rules and the definition of an electing real property trade or business under section 163(j)(7)(B). Part VIII describes proposed rules regarding the definition of a ''tax shelter'' for purposes of § 1.163(j)–2 and section 1256(e), as well as proposed rules regarding the election to use 2019 ATI in determining the taxpayer's section 163(j) limitation for a taxable year beginning in 2020. Part IX describes proposed modifications regarding the application of the corporate look-through rules to tiered structures.

I. Proposed § 1.163–14: Allocation of Interest Expense With Respect to Passthrough Entities

Section 1.163–8T provides rules regarding the allocation of interest expense for purposes of applying the passive activity loss limitation in section 469, the investment interest limitation in section 163(d), and the personal interest limitation in section 163(h) (such purposes, collectively, § 1.163–8T purposes). Under § 1.163–8T, debt generally is allocated by tracing disbursements of the debt proceeds to specific expenditures and interest expense associated with debt is allocated for § 1.163–8T purposes in the same manner as the debt to which such interest expense relates. When debt proceeds are deposited to the borrower's account, and the account also contains unborrowed funds, § 1.163–8T(c) provides that the debt generally is allocated to expenditures by treating subsequent expenditures from the account as made first from the debt proceeds to the extent thereof. The rules further provide that if the proceeds of two or more debts are deposited in the account, the proceeds are treated as expended in the order in which they were deposited. In addition to these rules, § 1.163–8T also provides specific rules to address reallocation of debt, repayments and refinancing.

The preamble to § 1.163–8T (52 FR 24996) stated that ''interest expense of partnerships and S corporations, and of partners and S corporation shareholders, is generally allocated in the same manner as the interest expense of other taxpayers.'' The preamble acknowledged the need for special rules for debt financed distributions to owners of partnerships and S corporations, and for cases in which taxpayers incur debt to acquire or increase their capital interest in the passthrough entity, but reserved on these issues and requested comments.

In a series of notices, the Treasury Department and the IRS provided further guidance with respect to the allocation of interest expense in connection with certain transactions involving passthrough entities and owners of passthrough entities. See Notice 88–20, 1988–1 C.B. 487, Notice 88–37, 1988–1 C.B. 522, and Notice 89–35, 1989–1 C.B. 675. Specifically, Notice 89–35 provides, in part, rules addressing the treatment of (1) a passthrough entity owner's debt allocated to contributions to, or purchases of, interests in a passthrough entity (debt-financed contributions or acquisitions), and (2) passthrough entity debt allocated to distributions by the entity to its owners (debt-financed distributions).

In the case of a debt-financed acquisition of an interest in a passthrough entity by purchase (rather than by way of a contribution to the capital of the entity), Notice 89–35 provides that the interest expense of the owner of the passthrough entity, for § 1.163–8T purposes, is allocated among the assets of the entity using any reasonable method. A reasonable method for this purpose includes, for example, allocating the debt among all of the assets of the passthrough entity based on the fair market value, the book value, or the adjusted basis of the assets, reduced by the amount of any debt of the entity or the amount of any debt that the owner of the entity allocates to such assets. Notice 89–35 also provides that interest expense on debt proceeds allocated to a contribution to the capital of a passthrough entity shall be allocated using any reasonable method for § 1.163–8T purposes. For this purpose, any reasonable method includes allocating the debt among the assets of the passthrough entity or tracing the debt proceeds to the expenditures of the passthrough entity.

In the case of debt-financed distributions, Notice 89–35 provides a general allocation rule and an optional allocation rule. The general allocation rule applies the principles of § 1.163–8T to interest expense associated with debt-financed distributions by applying a tracing approach to determine the character of the interest expense for § 1.163–8T purposes. Under this approach, the debt proceeds and the associated interest expense related to a debt-financed distribution are allocated under § 1.163–8T in accordance with the use of the distributed debt proceeds by the distributee owner of the passthrough entity. To the extent an owner's share of a passthrough entity's interest expense related to the debt-financed distribution exceeds the entity's interest expense on the portion of the debt proceeds distributed to that particular owner, Notice 89–35 provides that the passthrough entity may allocate such excess interest expense using any reasonable method.

The optional allocation rule applicable to debt-financed distributions allows a passthrough entity to allocate distributed debt proceeds and the associated interest expense to one or more expenditures, other than distributions, of the entity that are made during the same taxable year of the entity as the distribution, to the extent that debt proceeds, including other distributed debt proceeds, are not otherwise allocated to such expenditures. Under the optional allocation rule, distributed debt proceeds are traced to the owner's use of the borrowed funds to the extent that such distributed debt proceeds exceed the entity's expenditures, not including distributions, for the taxable year to which debt proceeds are not otherwise allocated.

While the 2018 Proposed Regulations did not include rules to further address the application of § 1.163–8T to passthrough entities, the Treasury Department and the IRS received comments indicating that, for purposes of section 163(j), a tracing rule based on how a passthrough entity owner uses the proceeds of a debt-financed distribution does not align well with the statutory mandate in section 163(j)(4) to apply section 163(j) at the passthrough entity level. Based on these comments and a review of the rules under § 1.163–8T, the Treasury Department and the IRS have determined that additional rules, specific to passthrough entities and their owners, are needed to clarify how the rules under § 1.163–8T work when applied to a passthrough entity and to account for the entity-level limitation under section 163(j)(4).

A. In General

The rules of § 1.163–8T generally apply to partnerships, S corporations, and their owners and the rules in proposed § 1.163–14 would provide additional rules for purposes of applying the § 1.163–8T rules to passthrough entities. As with the rules under § 1.163–8T, proposed § 1.163–14 would provide that interest expense on a debt incurred by a passthrough entity is allocated in the same manner as the debt to which such interest relates is allocated, and that debt is generally allocated by tracing disbursements of the debt proceeds to specific expenditures.

The Treasury Department and the IRS have determined that the scope of § 1.163–8T(a)(4) and (b) is not appropriate in the passthrough entity context. Section 1.163–8T(a)(4) generally provides rules regarding the treatment of interest expense allocated to specific expenditures, which are described in § 1.163–8T(b). However, the list of expenditures described in § 1.163–8T(b) is based on an allocation of interest for purposes of applying sections 163(d), 163(h), and 469, and does not adequately account for the uses of debt proceeds by a passthrough entity (for example, distributions to owners).

To more accurately account for the types of expenditures made by passthrough entities, proposed § 1.163–14(b) would provide rules tailored to passthrough entities. In addition, the framework that proposed § 1.163–14(b) would provide is needed for a passthrough entity to determine how much of its interest expense is allocable to a trade or business for purposes of applying section 163(j). These proposed regulations would apply before a passthrough entity applies any of the rules in section 163(j) (including § 1.163(j)–10).

In application, a passthrough entity would continue to apply the operative rules in § 1.163–8T to allocate debt and the interest expense associated with such debt. However, instead of generally tracing debt proceeds to the types of expenditures described under § 1.163–8T(b) and treating any interest expense associated with such debt proceeds in the manner described under § 1.163–8T(a)(4), a passthrough entity would generally trace debt proceeds to the types of expenditures described under proposed § 1.163–14(b)(2) and treat any interest expense associated with such debt proceeds in the manner provided under proposed § 1.163–14(b)(1).

B. Debt Financed Distributions

Proposed § 1.163–14 would provide that when debt proceeds of a passthrough entity are allocated under § 1.163–8T to distributions to owners of the entity, the debt proceeds distributed to any owner and the associated interest expense shall be allocated under proposed § 1.163–14(d). In general, proposed § 1.163–14(d) would adopt a rule similar to Notice 89–35, but with the following modifications. First, instead of providing that passthrough entities may use the optional allocation rule, proposed § 1.163–14(d) would generally provide that passthrough entities are required to apply a rule that is similar to the optional allocation rule. Second, instead of providing that the passthrough entity may allocate excess interest expense using any reasonable method, proposed § 1.163–14(d) would generally provide that the passthrough entity must allocate excess interest expense based on the adjusted tax basis of the passthrough entity's assets.

Specifically, proposed § 1.163–14(d)(1) would provide a rule based in principle on the optional allocation rule in Notice 89–35. Under this proposed rule, distributed debt proceeds (debt proceeds of a passthrough entity allocated under § 1.163–8T to distributions to owners of the entity) would first be allocated under proposed § 1.163–14(d)(1)(i) to the passthrough entity's available expenditures. Available expenditures are those expenditures of a passthrough entity made in the same taxable year as the distribution, but only to the extent that debt proceeds (including other distributed debt proceeds) are not otherwise allocated to such expenditure. This approach is consistent with the concept that money is fungible (a passthrough entity may be fairly treated as distributing non-debt proceeds rather than debt proceeds and using debt proceeds rather than non-debt proceeds to finance its non-distribution expenditures) and seeks to coordinate the interest allocation rules with the entity-level approach to passthroughs adopted in section 163(j). Where the distributed debt proceeds exceed the passthrough entity's available expenditures, this excess amount of distributed debt proceeds would be allocated to distributions to owners of the passthrough entity (debt financed distributions) under proposed § 1.163–14(d)(1)(ii).

After determining the amount of its distributed debt proceeds allocated to available expenditures and debt financed distributions, a passthrough entity would use this information to determine the tax treatment of each owner's allocable interest expense (that is, an owner's share of interest expense associated with the distributed debt proceeds allocated under section 704(b) or 1366(a)). To aid the passthrough entity and owner in determining the tax treatment of each owner's allocable interest expense, proposed § 1.163–14(d)(2) would provide rules for determining the portion of each owner's allocable interest expense that is (1) debt financed distribution interest expense, (2) expenditure interest expense, and (3) excess interest expense. These three categories of allocable interest expense are mutually exclusive—*e.g.,* a given dollar of allocable interest expense cannot simultaneously be both debt financed distribution interest expense and expenditure interest expense. The computations in proposed § 1.163–14(d)(2) would ensure this outcome.

Once a passthrough entity categorizes each owner's allocable interest expense as described earlier, it would apply proposed § 1.163–14(d)(3) to determine the tax treatment of such interest expense. The manner in which the tax treatment of allocable interest expense is determined depends on how such allocable interest expense was categorized under proposed § 1.163–14(d)(2).

Conceptually, each of the three categories described earlier, as well as the prescribed tax treatment of interest expense in each category, is discussed in Notice 89–35. Debt financed distribution interest expense is referred to in Notice 89–35 as an owner's share of a passthrough entity's interest expense on debt proceeds allocated to such owner. Similar to Notice 89–35, proposed § 1.163–14(d)(3)(i) would generally provide that such interest expense is allocated under § 1.163–8T in accordance with the owner's use of the debt proceeds. Further, expenditure interest expense is referred to in Notice 89–35 as interest expense allocated under the optional allocation rule. Similar to Notice 89–35, proposed § 1.163–14(d)(3)(ii) would generally provide that the tax treatment of such interest expense is determined based on how the distributed debt proceeds were allocated among available expenditures. Finally, both Notice 89–35 and proposed § 1.163–14(d) would use the term excess interest expense to refer to an owner's share of allocable interest expense in excess of the entity's interest expense on the portion of the debt proceeds distributed to that particular owner. Unlike Notice 89–35, which generally allows any reasonable method for determining the tax treatment of excess interest expense, proposed § 1.163–14(d)(3)(iii) would generally provide that the tax treatment of excess interest expense is determined by allocating the distributed debt proceeds among all the assets of the passthrough entity, pro-rata, based on the adjusted basis of such assets.

Proposed § 1.163–14(d)(4) also would provide rules addressing the tax treatment of the interest expense of a transferee owner where the transferor had previously been allocated debt financed distribution interest expense. In the case of a transfer of an interest in a passthrough entity, any debt financed distribution interest expense of the transferor generally shall be treated as excess interest expense by the transferee. However, in the case of a transfer of an interest in a passthrough entity to a person who is related to the transferor, any debt financed distribution interest expense of the transferor shall continue to be treated as debt financed distribution interest expense by the related party transferee, and the tax treatment of such debt financed distribution expense shall be the same to the related party transferee as it was to the transferor. 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).

The proposed regulations also would include an anti-avoidance rule to recharacterize arrangements entered into with a principal purpose of avoiding the rules of proposed § 1.163–14(d), including the transfer of an interest in a passthrough entity by an owner who treated a portion of its allocable interest expense as debt financed distribution interest expense to an unrelated party pursuant to a plan to transfer the interest back to the owner who received the debt financed distribution interest expense or to a party who is related to the owner who received the debt financed distribution interest expense.

C. Operational Rules

Proposed § 1.163–14 also would include several operational rules that clarify the application of certain rules under § 1.163–8T as they apply to passthrough entities. Proposed § 1.163–14(e) would provide an ordering rule applicable to repayment of debt by passthrough entities similar to the rules in § 1.163–8T(d)(1). Proposed § 1.163–14(g) would provide that any transfer of an ownership interest in a passthrough entity is not a reallocation event for purposes of § 1.163–8T(j), except as provided for in § 1.163–14(d)(4).

D. Debt-Financed Acquisitions

Proposed § 1.163–14(f) would adopt a rule providing that the tax treatment of an owner's interest expense associated with a debt financed acquisition (either by purchase or contribution) will be determined by allocating the debt proceeds among the assets of the entity. The owner would allocate the debt proceeds (1) in proportion to the relative adjusted tax basis of the entity's assets reduced by any debt allocated to such assets, or (2) based on the adjusted basis of the entity's assets in accordance with the rules in § 1.163(j)–10(c)(5)(i) reduced by any debt allocated to such assets. The Treasury Department and the IRS request comments regarding whether asset basis (either adjusted tax basis or adjusted tax basis based on the rules in § 1.163(j)–10(c)(5)(i)) less the amount of debt allocated to assets under §§ 1.163–14 and 1.163–8T is appropriate as the sole method for allocating interest expense in this context.

II. Proposed § 1.163–15: Debt Proceeds Distributed From Any Taxpayer Account or From Cash

Proposed § 1.163–15 supplements the rules in § 1.163–8T regarding debt proceeds distributed from any taxpayer account or from cash proceeds. Section 1.163–8T(c)(4)(iii)(B) provides that a taxpayer may treat any expenditure made from an account within 15 days after the debt proceeds are deposited in such account as being made from such proceeds, regardless of any other rules in § 1.163–8T(c)(4). Under § 1.163–8T(c)(5)(i), if a taxpayer receives debt proceeds in cash, the taxpayer may treat any cash expenditure made within 15 days after receiving the cash as being made from such debt proceeds, and may treat such expenditure as being made on the date the taxpayer received the cash. Commenters have suggested that the 15-day limit in § 1.163–8T could encourage taxpayers to keep separate accounts, rather than commingled accounts for tracing purposes.

In Notice 88–20, 1988–1 C.B. 487, the IRS announced the intention to issue regulations providing that, for debt proceeds deposited in an account on or before December 31, 1987, taxpayers could treat any expenditure made from any account of the taxpayer or from cash within 30 days before or after debt proceeds are deposited in such account or any other account of the taxpayer as made from such proceeds. The Notice states that the regulations also would provide that for debt proceeds received in cash on or before December 31, 1987, taxpayers may treat any expenditure made from any account of the taxpayer or from cash within 30 days before or after debt proceeds are received in cash as made from such proceeds. Section VI of Notice 89–35 adopts the standard described in Notice 88–20 without the date limitation, although no regulations have been issued.

Consistent with Notice 89–35, proposed § 1.163–15 provides that taxpayers may treat any expenditure made from an account of the taxpayer or from cash within 30 days before or after debt proceeds are deposited in any account of the taxpayer or received in cash as made from such proceeds.

III. Proposed Modifications to § 1.163(j)–1(b): Definitions

A. Adjustments to Tentative Taxable Income

Section 1.163(j)–1(b)(1) requires taxpayers to make certain adjustments to tentative taxable income in computing ATI, including adjustments to address certain sales or other dispositions of depreciable property, stock of a consolidated group member (member stock), or interests in a partnership. More specifically, § 1.163(j)–1(b)(1)(ii)(C) provides that, if property is sold or otherwise disposed of, the greater of the allowed or allowable depreciation, amortization, or depletion of the property for the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group) for taxable years beginning after December 31, 2017, and before January 1, 2022 (such years, the EBITDA period), with respect to such property is subtracted from tentative taxable income. Section 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 by another member, the investment adjustments under § 1.1502–32 with respect to such stock that are attributable to deductions described in § 1.163(j)–1(b)(1)(ii)(C) are subtracted from tentative taxable income. Section 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 § 1.163(j)–1(b)(1)(ii)(C) with respect to property held by the partnership at the time of such sale or other disposition is subtracted from tentative taxable income to the extent such deductions were allowable under section 704(d). See the preamble to the Final Regulations for a discussion of the rationale for these adjustments.

The preamble to the Final Regulations noted that, in the 2018 Proposed Regulations, § 1.163(j)–1(b)(1)(ii)(C) incorporated a ''lesser of'' standard. In other words, the lesser of (i) the amount of gain on the sale or other disposition of property, or (ii) the amount of depreciation deductions with respect to such property for the EBITDA period, was required to be subtracted from tentative taxable income to determine ATI. As explained in the preamble to the Final Regulations, commenters raised several questions regarding this ''lesser of'' standard. The Final Regulations removed the ''lesser of'' approach due in part to concerns that this approach would be more difficult to administer than the approach reflected in the Final Regulations.

However, the Treasury Department and the IRS recognize that, in certain cases, the ''lesser of'' approach might not create administrative difficulties for taxpayers. Thus, these Proposed Regulations permit taxpayers to choose whether to compute the amount of their adjustment using a ''lesser of'' standard. While the 2018 Proposed Regulations applied this standard solely to dispositions of property, these Proposed Regulations extend this standard to dispositions of partnership interests and member stock to eliminate the discontinuity between the amount of the adjustment for these different types of dispositions. Taxpayers opting to use this alternative computation method must do so for all sales or other dispositions that otherwise would be subject to § 1.163(j)–1(b)(1)(ii)(C), (D), or (E) when the taxpayer computes tentative taxable income.

The Treasury Department and the IRS request comments on the ''lesser of'' approach, including how such an approach should apply to dispositions of member stock and partnership interests.

B. Dividends From Regulated Investment Company (RIC) Shares

Some commenters on the 2018 Proposed Regulations recommended that dividend income from a RIC be treated as interest income for a shareholder in a RIC, to the extent that the income earned by the RIC is interest income. Because a RIC is a subchapter C corporation, section 163(j) applies at the RIC level, and any BIE that is disallowed at the RIC level is carried forward to subsequent years at the RIC level. Furthermore, because a RIC is a subchapter C corporation, a shareholder in a RIC generally does not take into account a share of the RIC's items of income, deduction, gain, or loss. Thus, if a RIC's BII exceeds its BIE in a taxable year, the RIC may not directly allocate the excess amount to its shareholders (unlike a partnership, which may allocate excess BII to its partners).

Under part 1 of subchapter M and other Code provisions, however, a RIC that has certain items of income or gain may pay dividends that a shareholder in the RIC may treat in the same manner (or a similar manner) as the shareholder would treat the underlying items of income or gain if the shareholder realized the items directly. Although this treatment differs fundamentally from the passthrough treatment of partners or trust beneficiaries, this Explanation of Provisions refers to this treatment as ''conduit treatment.'' For example, under sections 871(k)(1) and 881(e)(1), a RIC that has qualified interest income within the meaning of section 871(k)(1)(E) may pay interest-related dividends, and no tax generally would be imposed under sections 871(a)(1)(A) or 881(a)(1) on an interest-related dividend paid to a nonresident alien individual or foreign corporation. Section 871(k)(1) provides necessary limits and procedures that apply to interest-related dividends. The Code provides similar conduit treatment for capital gain dividends in section 852(b)(3), exempt-interest dividends in section 852(b)(5), short-term capital gain dividends in section 871(k)(2), dividends eligible for the dividends received deduction in section 854(b)(1)(A), and qualified dividend income in section 854(b)(1)(B).

In response to comments, these Proposed Regulations provide rules under which a RIC that earns BII may pay section 163(j) interest dividends. A shareholder that receives a section 163(j) interest dividend may treat the dividend as interest income for purposes of section 163(j), subject to holding period requirements and other limitations. A section 163(j) interest dividend that meets these requirements is treated as BII if it is properly allocable to a non-excepted trade or business of the shareholder. A section 163(j) interest dividend is treated as interest income solely for purposes of section 163(j).

The rules under which a RIC may report section 163(j) interest dividends are based on the rules for reporting exempt-interest dividends in section 852(b)(5) and interest-related dividends in section 871(k)(1). The total amount of a RIC's section 163(j) interest dividends for a taxable year is limited to the excess of the RIC's BII for the taxable year over the sum of the RIC's BIE for the taxable year and the RIC's other deductions for the taxable year that are properly allocable to the RIC's BII. For some types of income and gain to which conduit treatment applies, the gross amount of the RIC's income or gain of that type serves as the limit on the RIC's corresponding dividends. It would be inconsistent with the purposes of section 163(j) to permit a RIC to pay section 163(j) interest dividends in an amount based on the RIC's gross BII, unreduced by the RIC's BIE. Further reducing the limit on a RIC's section 163(j) interest dividends by the amount of the RIC's other deductions that are properly allocable to the RIC's BII is consistent with the provisions of the Code that provide conduit treatment for types of interest earned by a RIC. For example, the limit on interest-related dividends in section 871(k)(1)(D) is reduced by the deductions properly allocable to the RIC's qualified interest income. Similarly, the limit on exempt-interest dividends in section 852(b)(5)(A)(iv)(V) is reduced by the amounts disallowed as deductions under sections 265 and 171(a)(2). Taking into account the appropriate share of deductions also reduces the likelihood that the sum of a RIC's items that are eligible for conduit treatment and that are relevant to a particular shareholder will exceed the amount of the dividend distribution paid to the particular shareholder.

These Proposed Regulations contain an additional limit to prevent inconsistent treatment of RIC dividends by RIC shareholders. Revenue Ruling 2005–31, 2005–1 C.B. 1084, allows a RIC to report the maximum amount of capital gain dividends, exempt-interest dividends, interest-related dividends, short-term capital gain dividends, dividends eligible for the dividends received deduction, and qualified dividend income for a taxable year, even if the sum of the reported amounts exceeds the amount of the RIC's dividends for the taxable year. The ruling allows different categories of shareholders (United States persons and nonresident aliens) to report the dividends they receive by giving effect to the conduit treatment of the items relevant to them. A single shareholder, however, generally does not benefit from the conduit treatment of amounts in excess of the dividend paid to that shareholder, because to do so would require the shareholder to include in its taxable income amounts exceeding the dividend it received. Conduit treatment of BII, however, differs from the conduit treatment of other items, because a section 163(j) interest dividend is treated as interest income only for purposes of section 163(j). Thus, absent a limit, a RIC shareholder could obtain an inappropriate benefit by treating a portion of a RIC dividend as interest income for purposes of section 163(j) while treating the same portion of the dividend as another non-interest type of income, such as a dividend eligible for the dividends received deduction under sections 243 and 854(b). Therefore, these Proposed Regulations limit the amount of a section 163(j) interest dividend that a shareholder may treat as interest income for purposes of section 163(j) to the excess of the amount of the RIC dividend that includes the section 163(j) interest dividend over the sum of the portions of that dividend affected by conduit treatment in the hands of that shareholder, other than interest-related dividends under section 871(k)(1)(C) and section 163(j) interest dividends.

Under these Proposed Regulations, a shareholder generally may not treat a section 163(j) interest dividend as interest income unless it meets certain holding period and similar requirements. The holding period requirements do not apply to (i) dividends paid by a RIC regulated as a money market fund under 17 CFR 270.2a–7 or (ii) certain regular dividends paid by a RIC that declares section 163(j) interest dividends on a daily basis and distributes such dividends on a monthly or more frequent basis. The Treasury Department and the IRS request comments on whether there are other categories of section 163(j) interest dividends for which the holding period requirements should not apply or should be modified. The Treasury Department and the IRS also request comments on whether any payments that are substitutes for section 163(j) interest dividends (for example, in a securities lending or sale-repurchase transaction with respect to RIC shares) should be treated for purposes of section 163(j) as interest expense of taxpayers making the payments or interest income to taxpayers receiving the payments. Cf. § 1.163(j)–1(b)(22)(iii)(C) (addressing certain payments that are substitutes for interest).

These Proposed Regulations, to the extent they concern the payment of section 163(j) interest dividends by a RIC and the treatment of such dividends as interest by a RIC shareholder, are proposed to apply to taxable years beginning on or after the date that is 60 days after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**. Solely in the case of section 163(j) interest dividends that would be exempt from the holding period rules under these Proposed Regulations, the RIC paying such dividends and the shareholders receiving such dividends may rely on the provisions of these Proposed Regulations pertaining to section 163(j) interest dividends for taxable years ending on or after September 14, 2020, and beginning before the date that is 60 days after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

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

A. Trading Partnerships

The preamble to the 2018 Proposed Regulations states that the business interest expense of certain passthrough entities, including S corporations, allocable to trade or business activities that are described in section 163(d)(5)(A)(ii) (*i.e.,* activities that are per se non-passive under section 469 in which the taxpayer does not materially participate) and illustrated in Revenue Ruling 2008–12, 2008–1 C.B. 520 (March 10, 2008) (trading activities), will be subject to section 163(j) at the entity level, even if the interest expense is later subject to limitation under section 163(d) at the individual partner or shareholder level. Accordingly, at least with respect to partnerships, to the extent that interest expense from a trading activity is limited under section 163(j) and becomes a carryover item of partners who do not materially participate in the trading activity, the interest expense will be treated as investment interest in the hands of those partners for purposes of section 163(d) once the interest expense is no longer limited under section 163(j). As a result, the interest expense would be subject to two section 163 limitations.

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). Specifically, commenters stated that the interpretation improperly results in the application of section 163(j) to partnerships engaged in a trade or business activity of trading personal property (including marketable securities) for the account of owners of interests in the activity, as described in § 1.469–1T(e)(6) (trading partnerships). At issue is the extent to which BIE of trading partnerships should be subject to limitation under section 163(j). This issue involves the definition of BIE under section 163(j)(5) and, more specifically, the second sentence of section 163(j)(5), which generally provides that BIE shall not include investment interest within the meaning of section 163(d).

The approach described in the preamble to the 2018 Proposed Regulations interprets section 163(j)(5) as simply providing that interest expense cannot be both BIE and investment interest expense in the hands of the same taxpayer. Under this interpretation, section 163(j)(5) will treat interest as investment interest where conflicting provisions may otherwise subject an amount of interest expense to limitation under both section 163(j) and section 163(d) with respect to the same taxpayer (for example, interest expense allocable to business assets comprising ''working capital'' as that term is used in section 469(e)(1)(B)). In addition, this approach views the partnership as an entity separate from its partners for purposes of section 163(j) to the partnership and section 163(d) at the individual partner level. Several commenters disagreed with this interpretation of section 163(j)(5), asserting that the second sentence of section 163(j)(5) unequivocally provides that interest expense can never be subject to limitation under both section 163(j) and section 163(d) under any circumstances. Based on these comments, the Treasury Department and the IRS considered three alternative approaches for interpreting section 163(j)(5).

One approach would require a partnership engaged in a trading activity to apply section 163(j) at the partnership level to all of the partnership's interest expense from the trading activity. Under this approach, any deductible interest expense from the partnership's trading activity would not be subject to any further limitation under section 163(d) at the individual partner level. This interpretation would respect the partnership as an entity separate from its partners for purposes of section 163(j), but would treat section 163(j)(4) and (5) as superseding section 163(d)(5)(A)(ii).

A second approach would require a partnership engaged in a trading activity to bifurcate its interest expense from a trading activity between partners that materially participate in the trading activity and partners that are passive investors in the activity, and subject only the portion that is allocable to the materially participating partners to limitation under section 163(j). Under this approach, to the extent any interest expense is allocable to passive investors in the trading activity, the interest expense would be subject only to section 163(d) at the partner level and would never be subject to section 163(j) at the partnership level.

A third approach would require a partnership to treat all of the interest expense from a trading activity as investment interest under section 163(d), regardless of whether any individual partners materially participate in the trading activity. Under this approach, the interest expense properly allocable to materially participating partners would never be subject to limitation under section 163(j), even though interest expense allocable to materially participating partners would also not be subject to limitation under section 163(d) at the individual partner level.

After considering the comments, Treasury Department and the IRS have concluded that the approach described in the preamble to the 2018 Proposed Regulations is inconsistent with the statutory language and intent of section 163(j)(5) because the second sentence of section 163(j)(5) specifically states that BIE shall not include investment interest expense. In addition, the Treasury Department and the IRS have determined that the second alternative approach, as described earlier, appears to be the most consistent with the intent of sections 163(d) and 163(j). Accordingly, these Proposed Regulations would interpret section 163(j)(5) as requiring a trading partnership to bifurcate its interest expense from a trading activity between partners that materially participate in the trading activity and partners that are passive investors, and as subjecting only the portion of the interest expense that is allocable to the materially participating partners to limitation under section 163(j) at the partnership level. The portion of interest expense from a trading activity allocable to passive investors will be subject to limitation under section 163(d) at the partner level, as provided in section 163(d)(5)(A)(ii).

In addition, these Proposed Regulations require that a trading partnership bifurcate all of its other items of income, gain, loss and deduction from its trading activity between partners that materially participate in the partnership's trading activity and partners that are passive investors. The portion of the partnership's other items of income, gain, loss or deduction from its trading activity properly allocable to the passive investors in the partnership will not be taken into account at the partnership level as items from a trade or business for purposes of applying section 163(j) at the partnership level. Instead, all such partnership items properly allocable to passive investors will be treated as items from an investment activity of the partnership, for purposes of sections 163(j) and 163(d).

This approach, in order to be effective, adopts the presumption that a trading partnership generally will possess knowledge regarding whether its individual partners are material participants in its trading activity. No rules currently exist requiring a partner to inform the partnership whether the partner has grouped activities of the partnership with other activities of the partner outside of the partnership. Therefore, the partnership might possess little or no knowledge regarding whether an individual partner has made such a grouping. Without this information, a trading partnership may presume that an individual partner is a passive investor in the partnership's trading activity based solely on the partnership's understanding as to the lack of work performed by the partner in that activity, whereas the partner may in fact be treated as a material participant in the partnership's trading activity by grouping that activity with one or more activities of the partner in which the partner materially participates. In order to avoid this result and the potential for abuse, a new rule is proposed for the section 469 activity grouping rules to provide that any activity described in section 163(d)(5)(A)(ii) may not be grouped with any other activity of the taxpayer, including any other activity described in section 163(d)(5)(A)(ii). The Treasury Department and the IRS invite comments regarding whether other approaches may be feasible and preferable to a special rule that prohibits the grouping of trading activities with other activities of a partner, such as adoption of a rule or reporting regime requiring all partners in the partnership to annually certify or report to the partnership whether they are material participants in a grouped activity that includes the partnership's trading activity.

The Treasury Department and the IRS further invite comments regarding whether similar rules should be adopted with respect to S corporations that may also be involved in trading activities, and whether such rules would be compatible with Subchapter S (for example, whether the bifurcation of items from the S corporation's trading activity between material participants and passive investors would run afoul of the second class of stock prohibition).

B. Fungibility of Publicly Traded Partnerships

In order to be freely marketable, each unit of a publicly traded partnership (PTP), as defined in § 1.7704–1, must have identical economic and tax characteristics so that such PTP units are fungible. For PTP units to be fungible, the section 704(b) capital account associated with each unit must be economically equivalent to the section 704(b) capital account of all other units of the same class, and a PTP unit buyer must receive equivalent tax allocations regardless of the specific unit purchased. In other words, from the perspective of a buyer, a PTP unit cannot have variable tax attributes depending on the identity of the PTP unit seller. In general, to achieve fungibility, a PTP (1) makes a section 754 election, pursuant to which a purchaser can insulate itself from its predecessor's allocable section 704(c) gain or loss through a section 743(b) basis adjustment, and (2) adopts the remedial allocation method under section 704(c) for all of its assets.

Pursuant to § 1.704–3(d)(1), a partnership adopts the section 704(c) remedial allocation method to eliminate distortions caused by the application of the ceiling rule, as defined in § 1.704–3(b)(1), under the section 704(c) traditional method. A partnership adopting the remedial allocation method eliminates ceiling rule distortions by creating remedial items and allocating those items to its partners. Under the remedial allocation method, a partnership first determines the amount of section 704(b) book items under § 1.704–3(d)(2) and the partners' section 704(b) distributive shares of such items. The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method described in § 1.704–3(b)(1). If the ceiling rule causes the section 704(b) book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner. In sum, by coupling the remedial allocation method with a section 754 election, PTP units remain fungible from a net tax perspective, regardless of the PTP unit seller's section 704(c) position.

However, even when the remedial allocation method is coupled with a section 754 election, the application of section 163(j) in the partnership context results in variable tax attributes for a buyer depending upon the tax characteristics of the interest held by the seller. The Treasury Department and the IRS have determined this is an inappropriate result for PTPs because PTPs, unlike other partnerships, always require that tax attributes be proportionate to economic attributes to retain the fungibility of their units. The Treasury Department and the IRS have determined that the manner in which section 163(j) applies in the partnership context should not result in the non-fungibility of PTP units. Accordingly, these Proposed Regulations provide a method, solely for PTPs, for applying section 163(j) in a manner that does not result in PTP units lacking fungibility.

Specifically, commenters identified three ways in which the 2018 Proposed Regulations may cause PTP units to be non-fungible. First, the method for allocating excess items may cause PTP units to be non-fungible. In general, under § 1.163(j)–6(f)(2), the allocation of the components of ATI dictate the allocation of a partnership's deductible BIE and section 163(j) excess items. Consequently, the unequal sharing of inside basis, including cost-recovery deductions, amortization, gain, and loss affects the ratio in which a partnership's section 163(j) excess items, as defined in § 1.163(j)–6(b)(6), are shared. A partner's share of section 163(j) excess items affects the tax treatment and economic consequences of the partner. For example, a greater share of excess taxable income enables a partner subject to section 163(j) to deduct more interest.

The Treasury Department and the IRS recognize that a non-pro rata sharing of inside basis could result in a non-pro rata allocation of excess items, which may result in PTP units lacking fungibility. Therefore, these Proposed Regulations would amend § 1.163(j)–6(f)(1)(iii) to provide that, solely for purposes of section 163(j), a PTP allocates section 163(j) excess items in accordance with the partners' shares of corresponding section 704(b) items that comprise ATI.

Second, the required adjustments to partner ATI for partner basis items (*e.g.,* section 743(b) income and loss) may cause PTP units to lack fungibility. A non-pro rata sharing of inside basis may result in a different allocation of partner basis items, as defined in § 1.163(j)–6(b)(2), and section 704(c) remedial items, as defined in § 1.163(j)–6(b)(3), among partners. Pursuant to § 1.163(j)–6(d)(2), 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 section 704(c) remedial items affect the tax treatment and economic consequences of the partner. Similar to the disproportionate sharing of excess items discussed earlier, the disproportionate sharing of partner basis items and section 704(c) remedial items among partners may cause PTP units to lack fungibility.

The Treasury Department and the IRS recognize that a non-pro rata sharing of inside basis could result in different partner basis items and remedial items being allocated to different partners. Therefore, these Proposed Regulations would amend § 1.163(j)–6(e)(2)(ii) to provide that, solely for the purpose of determining remedial items under section 163(j), a PTP either allocates gain or loss that would otherwise be allocated under section 704(c) to a specific partner to all partners based on each partner's section 704(b) sharing ratio, or, for purposes of allocating cost recovery deductions under section 704(c), determines each partner's remedial items based on an allocation of the partnership's inside basis items among its partners in proportion to their share of corresponding section 704(b) items, rather than applying the traditional method as described in § 1.704–3(b).

Third, the treatment of section 704(c) remedial income allocations for taxable years beginning before 2022 may cause PTP units to lack fungibility. For taxable years beginning before January 1, 2022, when tentative taxable income is not reduced by depreciation and amortization deductions for purposes of determining ATI, a buyer acquiring PTP units with section 704(c) remedial income allocations (and an offsetting section 743(b) adjustment) will have an increase to its ATI that exceeds that of a buyer of the same number of otherwise fungible units that is not stepping into section 704(c) remedial income (with no corresponding section 743(b) deduction). While the net amount of the section 743(b) and section 704(c) remedial items is the same to both buyers, for taxable years beginning before January 1, 2022, different units would affect a buyer's ATI differently. The section 704(c) remedial income of a buyer of units with section 704(c) remedial income would be included in its ATI, while the section 743(b) deductions would not. Thus, a buyer of units with section 704(c) remedial income would increase its ATI each year (before 2022). A buyer of units with no section 704(c) remedial income, however, would add back any remedial depreciation and amortization deductions before 2022, and its ATI would be unaffected by the remedial deductions for such years.

The Treasury Department and the IRS recognize that, before 2022, a buyer of PTP units with inherent section 704(c) gain would include any remedial income and would not include section 743(b) deductions in its ATI. Therefore, these Proposed Regulations would amend § 1.163(j)–6(d)(2)(ii) to provide that, solely for purposes of section 163(j), a PTP treats the amount of any section 743(b) adjustment of a purchaser of a partnership unit that relates to a remedial item that the purchaser inherits from the seller as an offset to the related section 704(c) remedial item. The Treasury Department and the IRS request comments as to whether the approaches outlined adequately resolves the fungibility issues created by section 163(j).

C. Treatment of Business Interest Income and Business Interest Expense With Respect to Lending Transactions Between a Partnership and a Partner (Self-Charged Lending Transactions)

The 2018 Proposed Regulations reserved on the treatment of BII and BIE with respect to lending transactions between a partnership and a partner (self-charged lending transactions). The preamble to the 2018 Proposed Regulations requested comments regarding self-charged lending transactions. One commenter recommended the final regulations include rules under § 1.163(j)–6(n) akin to those contained in § 1.469–7 to identify self-charged interest income and expense and further allow such self-charged interest income and expense to be excluded from the definition of BIE and BII under section 163(j)(5) and (6), respectively. The same commenter recommended that the final regulations retain the rule in § 1.163(j)–3(b)(4), as set forth in the 2018 Proposed Regulations, which applies the section 163(j) limitation prior to the application of the passive activity loss rules of section 469. Other commenters recommended the Final Regulations exclude BIE and BII from the section 163(j) calculation where a partner or S-corporation shareholder lends to, or borrows from, a passthrough entity. These commenters recommended that the amount excluded be based on the amount of income or expense recognized by partners or shareholders that are lenders or borrowers, as well as partners or shareholders that are related to a lender or borrower partner within the meaning of section 267(b) because it would be appropriate to exclude the BII and BIE realized by the related parties for purposes of the section 163(j) calculation.

In response to these comments, the Treasury Department and the IRS propose adding a rule in proposed § 1.163(j)–6(n) to provide that, in the case of a lending transaction between a partner (lending partner) and partnership (borrowing partnership) in which the lending partner owns a direct interest (self-charged lending transaction), any BIE of the borrowing partnership attributable to the self-charged lending transaction is BIE of the borrowing partnership for purposes of § 1.163(j)–6. If in a given taxable year the lending partner is allocated EBIE from the borrowing partnership and has interest income attributable to the self-charged lending transaction (interest income), the lending partner shall treat such interest income as an allocation of excess business interest income (EBII) from the borrowing partnership in such taxable year, but only to the extent of the lending partner's allocation of EBIE from the borrowing partnership in such taxable year. To prevent the double counting of BII, the lending partner includes interest income that was re-characterized as EBII pursuant to proposed § 1.163(j)–6(n) only once when calculating the lending partner's own section 163(j) limitation. In cases where the lending partner is not a C corporation, to the extent that any interest income exceeds the lending partner's allocation of EBIE from the borrowing partnership for the taxable year, and such interest income otherwise would be properly treated as investment income of the lending partner for purposes of section 163(d) for that year, such excess amount of interest income will continue to be treated as investment income of the lending partner for that year for purposes of section 163(d).

The Treasury Department and the IRS generally agree that lending partners should not be adversely affected by the fact that, without special rules, the interest income received at the partner level from such lending transactions generally will be treated as investment income if the partner is not engaged in the trade or business of lending money, while the BIE of the partnership will be subject to section 163(j) and potentially limited at the partner level as EBIE. This situation would create a mismatch between the character of the interest income and of the interest expense at the partner level from the same lending transaction. These proposed rules would apply only to items of interest income attributable to the lending transaction and EBIE from the same partnership that arise in the same taxable year of the lending partner. By applying these proposed rules only to correct a mismatch in character that may occur at the partner level during a single taxable year, these proposed rules otherwise ensure that a partnership engaged in a self-charged lending transaction will be subject to the rules of section 163(j) to the same extent regardless of the sources of its loans.

These proposed rules will not apply in the case of an S corporation because BIE of an S corporation is carried over by the S corporation as a corporate-level attribute rather than immediately passed through to its shareholders. In the year such disallowed BIE is deductible at the corporate level, it is not separately stated, and it is not subject to further limitation under section 163(j) at either the S corporation or shareholder level. Therefore, a limited self-charged rule to ensure proper matching of the character of interest income and BIE at the shareholder level is not necessary. This approach is consistent with the treatment of S corporations as separate entities from their owners, both generally and specifically with respect to section 163(j).

However, the Treasury Department and the IRS recognize that issues analogous to the issues faced by partnerships in self-charged lending transactions exist with respect to lending transactions between S corporations and their shareholders. The Treasury Department and the IRS request comments on whether a similar rule is appropriate for S corporations in light of section 163(j)(4)(B) not applying and, if so, how such rule should be structured.

D. Partnership Basis Adjustments Upon Partner Dispositions

In general, a partnership's disallowed BIE is allocated to its partners as EBIE rather than carried forward at the partnership level in order to prevent the trafficking of deductions for BIE carryforwards in the partnership context. To achieve this, section 163(j)(4)(B)(iii)(I) provides that the adjusted basis of a partner in a partnership interest is reduced (but not below zero) by the amount of EBIE allocated to the partner. If a partner disposes of a partnership interest, section 163(j)(4)(B)(iii)(II) provides that the adjusted basis of the partner in the partnership interest is increased immediately before the disposition by the amount of any EBIE that was not treated as BIE paid or accrued by the partner prior to the disposition. Further, under section 163(j)(4)(B)(iii)(II), no deduction shall be allowed to the transferor or transferee for any EBIE resulting in a basis increase.

The Treasury Department and the IRS have determined that the basis increase required by section 163(j)(4)(B)(iii)(II) is not fully descriptive of what is occurring when a partner with EBIE disposes of its partnership interest. If EBIE is not treated as BIE paid or accrued by the partner pursuant to § 1.163(j)–6(g) prior to the partner disposing of its partnership interest (nondeductible EBIE), section 163(j)(4)(B)(iii)(II) treats such nondeductible EBIE as though it were a nondeductible expense of the partnership.

This nondeductible expense is not a nondeductible, non-capitalizable expense under section 705(a)(2)(B). If it were, the partner's basis in its partnership interest at the time of the disposition would already reflect such an expense. Instead, section 163(j)(4)(B)(iii)(II) requires the partner to increase its basis immediately before the disposition—in effect, treating the partner as though the partnership made a payment that decreased the value of the partnership interest but did not affect the partner's basis in its partnership interest. Thus, upon a disposition, section 163(j)(4) treats nondeductible EBIE as though it were a nondeductible, capitalizable expense of the partnership.

While the statute is clear that a partner increases the basis in its partnership interest immediately prior to a disposition by any nondeductible EBIE, it does not specifically state that there must also be a corresponding increase to the basis of partnership assets to account for the nondeductible, capitalized expense (*i.e.,* the nondeductible EBIE). The absence of a corresponding increase to the partnership's basis immediately before the partner's disposition would create distortions that are inconsistent with the intent of both section 163(j) and subchapter K of the Code.

For example, the basis increase attributable to nondeductible EBIE immediately before a liquidating distribution results in less gain recognized under section 731(a)(1) (or more loss recognized under section 731(a)(2)) for the partner disposing of its partnership interest. Consequently, following a liquidating distribution to a partner with EBIE, section 163(j)(4)(B)(iii)(II) causes a reduced section 734(b) adjustment if the partnership has a section 754 election in effect (versus the partner basis increase not occurring), resulting in basis disparity between the partnership's basis in its assets and the aggregate outside basis of the remaining partners.

To illustrate, consider the following example. In Year 1, A, B, and C formed partnership PRS by each contributing $1,000 cash. PRS borrowed $900, causing each partner's basis in PRS to increase by $300. Also in Year 1, PRS purchased Capital Asset X for $200. In Year 2, PRS pays $300 of BIE, all of which is disallowed and treated as EBIE. PRS allocated the $300 of EBIE to its partners, $100 each. Pursuant to § 1.163(j)–6(h)(2), each partner reduced its outside basis by its $100 allocation of EBIE to $1,200. In Year 3, when the fair market value of Capital Asset X is $3,200 and no partner's basis in PRS has changed, PRS distributed $1,900 to C in complete liquidation of C's partnership interest. PRS has a section 754 election in effect in Year 3.

Pursuant to § 1.163(j)–6(h)(3), C increases the adjusted basis of its partnership interest by $100 immediately before the disposition. Thus, C's section 731(a)(1) gain recognized on the disposition of its partnership interest is $900 (($1,900 cash + $300 relief of liabilities) − ($1,200 outside basis + $100 EBIE add-back)). Because the election under section 754 is in effect, PRS has a section 734(b) increase to the basis of its assets of $900 (the amount of section 731(a)(1) gain recognized by C). Under section 755, the entire adjustment is allocated to Capital Asset X. As a result, PRS's basis for Capital Asset X is $1,100 ($200 + $900 section 734(b) adjustment). Following the liquidation of C, PRS's basis in its assets ($1,500 of cash + $1,100 of Capital Asset X) does not equal the aggregate outside basis of partners A and B ($2,700).

The Treasury Department and the IRS have determined that basis disparity resulting from the absence of a corresponding inside basis increase, as described earlier, is an inappropriate result. Accordingly, these Proposed Regulations would provide for a corresponding inside basis increase that would serve as the partnership analog of section 163(j)(4)(B)(iii)(II). Specifically, proposed § 1.163(j)–6(h)(5) would provide that if a partner (transferor) disposes of its partnership interest, the partnership shall increase the adjusted basis of partnership property by an amount equal to the amount of the increase required under § 1.163(j)–6(h)(3), if any, to the adjusted basis of the partnership interest being disposed of by the transferor. Such increase in the adjusted basis of partnership property (§ 1.163(j)–6(h)(5) basis adjustment) shall be allocated among partnership properties in the same manner as a positive section 734(b) adjustment. Because a § 1.163(j)–6(h)(5) basis adjustment is taken into account when determining the gain or loss upon a sale of the asset, a § 1.163(j)–6(h)(5) basis adjustment prevents the shifting of built-in gain to the remaining partners.

These Proposed Regulations would adopt an approach that treats the increase in the adjusted basis of any partnership property resulting from a § 1.163(j)–6(h)(5) basis adjustment as not depreciable or amortizable under any section of the Code, regardless of whether the partnership property allocated such § 1.163(j)–6(h)(5) basis adjustment is otherwise generally depreciable or amortizable. This approach perceives EBIE as a deduction that was disallowed to the partnership (consistent with section 163(j)(4)(B)(iii)(II)), and thus should not result in a depreciable section 734(b) basis adjustment.

The Treasury Department and the IRS request comments on this approach. An alternative approach considered by the Treasury Department and the IRS would treat a § 1.163(j)–6(h)(5) basis adjustment as depreciable or amortizable if it is allocated to depreciable or amortizable property. However, section 163(j)(4)(B)(iii)(II) provides that no deduction shall be allowed to the transferor or transferee for any EBIE resulting in a basis increase to the partner that disposed of its interest. If a § 1.163(j)–6(h)(5) basis adjustment were depreciable or amortizable, a partnership—which can arguably be viewed as a transferee in a transaction in which a partner receives a distribution in complete liquidation of its partnership interest—could effectively deduct an expense that section 163(j)(4)(B)(iii)(II) states is permanently disallowed. The Treasury Department and the IRS request comments on whether treating a § 1.163(j)–6(h)(5) basis adjustment as potentially depreciable or amortizable is consistent with section 163(j)(4)(B)(iii)(II).

E. Treatment of Excess Business Interest Expense in Tiered Partnerships

1. Entity Approach

The preamble to the 2018 Proposed Regulations reserved and requested comments on the application of section 163(j)(4) to tiered partnership structures. Specifically, the preamble to the 2018 Proposed Regulations requested comments regarding whether, in a tiered partnership structure, EBIE should be allocated through an upper-tier partnership to the partners of upper-tier partnership. Additionally, comments were requested regarding how and when the basis of an upper-tier partnership partner should be adjusted when a lower-tier partnership has BIE that is limited under section 163(j).

In response, commenters recommended approaches that, in general, either (1) allocated EBIE through upper-tier partnership to the partners of upper-tier partnership (Aggregate Approach), or (2) did not allocate EBIE through upper-tier partnership to the partners of upper-tier partnership (Entity Approach). Commenters stated that both approaches reasonably implement Congressional intent of applying section 163(j) at the partnership level; however, the Entity

Approach reflects a stronger allegiance to entity treatment of partnerships for purposes of section 163(j). Commenters noted that the ultimate determination of which approach is more appropriate should rest, in large part, on whether partnerships or partners are more able to comply with the provision. The Entity Approach places more of that burden on partnerships, and the Aggregate Approach places more of the burden on partners. Commenters recommended that partnerships are better able to comply with an Entity Approach than partners are able to comply with an Aggregate Approach. Further, because the Entity Approach centers a significant portion of the compliance effort with partnerships, the Entity Approach may increase compliance and simplify Service review.

The Treasury Department and the IRS have concluded that an Entity Approach is the most consistent with the approach taken to partnerships under section 163(j)(4). Further, the Treasury Department and the IRS agree with commenters that partnerships are better able to comply with section 163(j) tiered partnership rules than partners. Accordingly, proposed § 1.163(j)–6(j)(3) would provide that if lower-tier partnership allocates excess business interest expense to upper-tier partnership, then upper-tier partnership reduces its basis in lower-tier partnership pursuant to § 1.163(j)–6(h)(2). Upper-tier partnership partners do not, however, reduce the bases of their upper-tier partnership interests pursuant to § 1.163(j)–6(h)(2) until upper-tier partnership treats such excess business interest expense as business interest expense paid or accrued pursuant to § 1.163(j)–6(g).

Although proposed § 1.163(j)–6(j)(3) would provide that EBIE allocated from a lower-tier partnership to an upper-tier partnership is not subject to further allocation by the upper-tier partnership, such EBIE necessarily reflects a reduction in the value of lower-tier partnership by the amount of the economic outlay that resulted in such EBIE. Accordingly, proposed § 1.163(j)–6(j)(2) would provide that if lower-tier partnership pays or accrues business interest expense and allocates such business interest expense to upper-tier partnership, then both upper-tier partnership and any direct or indirect partners of upper-tier partnership shall, solely for purposes of section 704(b) and the regulations thereunder, treat such business interest expense as a section 705(a)(2)(B) expenditure. Any section 704(b) capital account reduction resulting from such treatment occurs regardless of whether such business interest expense is characterized under this section as excess business interest expense or deductible business interest expense by lower-tier partnership. If upper-tier partnership subsequently treats any excess business interest expense allocated from lower-tier partnership as business interest expense paid or accrued pursuant to § 1.163(j)–6(g), the section 704(b) capital accounts of any direct or indirect partners of upper-tier partnership are not further reduced.

2. Basis and Carryforward Component of EBIE

Some commenters stated that an Entity Approach—that is, the approach these Proposed Regulations would adopt—would result in basis disparity between upper-tier partnership's basis in its assets and the aggregate basis of the upper-tier partners' interests in upper-tier partnership. The Treasury Department and the IRS do not agree. EBIE is neither an item of deduction nor a section 705(a)(2)(B) expense. If an allocation of EBIE from lower-tier partnership results in a reduction of the upper-tier partnership's basis in its lower-tier partnership interest, there is not a net reduction in the tax attributes of the upper-tier partnership. Rather, in such an event, upper-tier partnership merely exchanges one tax attribute (tax basis in its lower-tier partnership interest) for a different tax attribute (EBIE, which, in a subsequent year, could result in either a deduction or a basis adjustment). Thus, basis is preserved in this exchange.

Accordingly, proposed § 1.163(j)–6(j)(4) would provide that if lower-tier partnership allocates excess business interest expense to upper-tier partnership and such excess business interest expense is not suspended under section 704(d), then upper-tier partnership shall treat such excess business interest expense (UTP EBIE) as a nondepreciable capital asset, with a fair market value of zero and basis equal to the amount by which upper-tier partnership reduced its basis in lower-tier partnership pursuant to § 1.163(j)–6(h)(2) due to the allocation of such excess business interest expense. The fair market value of UTP EBIE, described in the preceding sentence, is not adjusted by any revaluations occurring under § 1.704–1(b)(2)(iv)(f).

In addition to generally treating UTP EBIE as having a basis component in excess of fair market value and, thus, built-in loss property, proposed § 1.163(j)–6(j)(4) would also provide that upper-tier partnership shall also treat UTP EBIE as having a carryforward component associated with it. The carryforward component of UTP EBIE shall equal the amount of excess business interest expense allocated from lower-tier partnership to upper-tier partnership under § 1.163(j)–6(f)(2) that is treated as such under § 1.163(j)–6(h)(2) by upper-tier partnership.

The carryforward component of UTP EBIE and the basis component of such UTP EBIE will always be equal immediately following the allocation of such EBIE from lower-tier partnership to upper-tier partnership if, at the time of such allocation, upper-tier partnership was required to reduce its section 704(b) capital account pursuant to proposed § 1.163(j)–6(j)(2) due to such allocation. However, subsequent to such initial allocation of EBIE from lower-tier partnership to upper-tier partnership, disparities between the carryforward component of UTP EBIE and the basis component of such UTP EBIE may arise as a result of proposed § 1.163(j)–6(j)(7).

Similar to the treatment of partner basis items (which do not affect the ATI of a partnership), proposed § 1.163(j)–6(j)(7)(i) would provide that negative basis adjustments under sections 734(b) and 743(b) allocated to UTP EBIE do not affect the carryforward component of such UTP EBIE; rather, negative basis adjustments under sections 734(b) and 743(b) affect only the basis component of such UTP EBIE. Although section 734(b) adjustments do affect a partnership's computation of ATI, the Treasury Department and the IRS have determined that negative section 734(b) adjustments, if allocated to UTP EBIE, should not reduce the carryforward component of such UTP EBIE. The purpose of proposed § 1.163(j)–6(j)(7)—in addition to preventing the duplication of loss—is to make partners indifferent for section 163(j) purposes as to whether a partner exiting upper-tier partnership sells its interest or receives a liquidating distribution from upper-tier partnership. Excluding negative section 734(b) adjustments from proposed § 1.163(j)–6(j)(7) would frustrate this purpose.

3. UTP EBIE Conversion Events

Proposed § 1.163(j)–6(j)(4) would further provide that if an allocation of excess business interest expense from lower-tier partnership is treated as UTP EBIE of upper-tier partnership, upper-tier partnership shall treat such allocation of excess business interest expense from lower-tier partnership as UTP EBIE until the occurrence of an UTP EBIE conversion event described in proposed § 1.163(j)–6(j)(5). In the non-tiered context, EBIE generally has two types of conversion events. The first EBIE conversion event is when EBIE is treated as BIE paid or accrued pursuant to § 1.163(j)–6(g). The second EBIE conversion event is the basis addback that occurs pursuant to proposed § 1.163(j)–6(h)(3) when a partner disposes of its interest in a partnership. Proposed § 1.163(j)–6(j)(5)(i) and (ii), respectively, would provide guidance regarding these two types of conversion events in the tiered partnership context.

a. First Type of Conversion Event—UTP EBIE Treated as Paid or Accrued

Regarding the first type of conversion event, proposed § 1.163(j)–6(j)(5)(i) would provide that to the extent upper-tier partnership is allocated excess taxable income (or excess business interest income) from lower-tier partnership, or § 1.163(j)–6 (m)(3) applies, upper-tier partnership shall apply proposed § 1.163(j)–6(j)(5)(i)(A) through (C).

First, proposed § 1.163(j)–6(j)(5)(i)(A) requires upper-tier partnership to apply the rules in § 1.163(j)–6(g) to its UTP EBIE, using any reasonable method (including, for example, FIFO and LIFO) to determine which UTP EBIE is treated as business interest expense paid or accrued pursuant § 1.163(j)–6(g). If § 1.163(j)–6(m)(3) applies, upper-tier partnership shall treat all of its UTP EBIE from lower-tier partnership as paid or accrued.

Proposed § 1.163(j)–6(j)(5)(i)(A) would provide that upper-tier partnership must determine which of its UTP EBIE is treated as paid or accrued, as opposed to just providing that upper-tier partnership reduces its UTP EBIE, because UTP EBIE is not necessarily a unified tax attribute of upper-tier partnership. UTP EBIE of upper-tier partnership could have been allocated in different years, have different bases, and have different specified partners (defined in the next paragraph). For example, assume $30 of UTP EBIE was allocated a negative $10 section 734(b) adjustment, resulting in the aggregate of upper-tier partnership's UTP EBIE having a carryforward component of $30 and basis component of $20. Thus, such UTP EBIE could, at most, result in $20 of deduction (the basis of such UTP EBIE). However, upper-tier partnership does not necessarily need $100 of ETI (or $30 of EBII) to deduct such $20. Rather, if upper-tier partnership was allocated $20 of EBII, upper-tier partnership could deduct $20 of business interest expense if, using a reasonable method, it determined the $20 of UTP EBIE with full basis was the UTP EBIE treated as business interest expense paid or accrued pursuant to § 1.163(j)–6(j)(5)(i)(A). Following such treatment, upper-tier partnership would still have $10 of UTP EBIE with $0 basis remaining (that is, $10 of carryforward component and $0 of basis component).

Second, with respect to any UTP EBIE treated as business interest expense paid or accrued in proposed § 1.163(j)–6(j)(5)(i)(A), proposed § 1.163(j)–6(j)(5)(i)(B) would require upper-tier partnership to allocate any business interest expense that was formerly such UTP EBIE to its specified partner. For purposes of proposed § 1.163(j)–6(j), the term specified partner refers to the partner of upper-tier partnership that, due to the initial allocation of excess business interest expense from lower-tier partnership to upper-tier partnership, was required to reduce its section 704(b) capital account pursuant to proposed § 1.163(j)–6(j)(2). Similar principles apply if the specified partner of such business interest expense is itself a partnership.

Proposed § 1.163(j)–6(j)(6) would provide rules if a specified partner disposes of its interest. Specifically, proposed § 1.163(j)–6(j)(6)(i) would provide that if a specified partner (transferor) disposes of an upper-tier partnership interest (or an interest in a partnership that itself is a specified partner), the portion of any UTP EBIE to which the transferor's status as specified partner relates is not reduced pursuant to proposed § 1.163(j)–6(j)(5)(ii). Stated otherwise, if a partner of an upper-tier partnership disposes of its interest in the upper-tier partnership, an interest in the lower-tier partnership held by upper-tier partnership is not deemed to have been similarly disposed of for purposes of proposed § 1.163(j)–6(j)(5)(ii). See Rev. Rul. 87–115. Rather, such UTP EBIE attributable to the interest disposed of is retained by upper-tier partnership and the transferee is treated as the specified partner for purposes of proposed § 1.163(j)–6(j) with respect to such UTP EBIE. Thus, upper-tier partnership must allocate any business interest expense that was formerly such UTP EBIE to the transferee.

Additionally, proposed § 1.163(j)–6(j)(6)(ii) would provide special rules regarding the specified partner of UTP EBIE following certain nonrecognition transactions. Proposed § 1.163(j)–6(j)(6)(ii)(A) would provide that if a specified partner receives a distribution of property in complete liquidation of an upper-tier partnership interest, the portion of UTP EBIE of upper-tier partnership attributable to the liquidated interest shall not have a specified partner. If a specified partner (transferee) receives a distribution of an interest in upper-tier partnership in complete liquidation of a partnership interest, the transferee is the specified partner with respect to UTP EBIE of upper-tier partnership only to the same extent it was prior to the distribution. Similar principles apply where an interest in a partnership that is a specified partner is distributed in complete liquidation of a transferee's partnership interest.

Proposed § 1.163(j)–6(j)(6)(ii)(B) would further provide that if a specified partner (transferor) contributes an upper-tier partnership interest to a partnership (transferee), the transferee is treated as the specified partner for purposes of proposed § 1.163(j)–6(j) with respect to the portion of the UTP EBIE attributable to the contributed interest. Following the transaction, the transferor continues to be the specified partner with respect to the UTP EBIE attributable to the contributed interest. Similar principles apply where an interest in a partnership that is a specified partner is contributed to a partnership.

Finally, after determining the specified partner of the UTP EBIE treated as business interest expense paid or accrued in proposed § 1.163(j)–6(j)(5)(i)(A) and allocating such business interest expense to its specified partner pursuant to proposed § 1.163(j)–6(j)(5)(i)(B), proposed § 1.163(j)–6(j)(5)(i)(C) would require upper-tier partnership to, in the manner provided in proposed § 1.163(j)–6(j)(7)(ii) (or (iii), as the case may be), take into account any negative basis adjustments under section 734(b) previously made to the UTP EBIE treated as business interest expense paid or accrued in (A) earlier. Additionally, persons treated as specified partners with respect to the UTP EBIE treated as business interest expense paid or accrued in (A) earlier shall take any negative basis adjustments under section 743(b) into account in the manner provided in proposed § 1.163(j)–6(j)(7)(ii) (or (iii), as the case may be).

Proposed § 1.163(j)–6(j)(7)(ii) would provide that if UTP EBIE that was allocated a negative section 734(b) adjustment is subsequently treated as deductible business interest expense, then such deductible business interest expense does not result in a deduction to the upper-tier partnership or the specified partner of such deductible business interest expense. If UTP EBIE that was allocated a negative section 743(b) adjustment is subsequently treated as deductible business interest expense, the specified partner of such deductible business interest expense recovers any negative section 743(b) adjustment attributable to such deductible business interest expense (effectively eliminating any deduction for such deductible business interest expense).

Proposed § 1.163(j)–6(j)(7)(iii) would provide that if UTP EBIE that was allocated a negative section 734(b) or 743(b) adjustment is subsequently treated as excess business interest expense, the specified partner's basis decrease in its upper-tier partnership interest required under proposed § 1.163(j)–6(h)(2) is reduced by the amount of the negative section 734(b) or 743(b) adjustment previously made to such excess business interest expense. If such excess business interest expense is subsequently treated as business interest expense paid or accrued by the specified partner, no deduction shall be allowed for any of such business interest expense. If the specified partner of such excess business interest expense is a partnership, such excess business interest expense is considered UTP EBIE that was previously allocated a negative section 734(b) adjustment for purposes of proposed § 1.163(j)–6(j).

b. Second Type of Conversion Event—UTP EBIE Reduction

Regarding the second type of conversion event, proposed § 1.163(j)–6(j)(5)(ii) would provide that if upper-tier partnership disposes of a lower-tier partnership interest (transferred interest), upper-tier partnership shall apply proposed § 1.163(j)–6(j)(5)(ii)(A) through (C).

First, proposed § 1.163(j)–6(j)(5)(ii)(A) would require upper-tier partnership to apply the rules in § 1.163(j)–6(h)(3) (except as provided in (B) and (C) later), using any reasonable method (including, for example, FIFO and LIFO) to determine which UTP EBIE is reduced pursuant to § 1.163(j)–6(h)(3). Stated otherwise, proposed § 1.163(j)–6(j)(5)(ii)(A) would require upper-tier partnership to apply all of the rules in § 1.163(j)–6(h)(3), except for the rule that determines the amount of the basis increase immediately before the disposition to the disposed of interest (the first sentence of § 1.163(j)–6(h)(3)). In lieu of applying the first sentence of § 1.163(j)–6(h)(3), upper-tier partnership would apply proposed § 1.163(j)–6(j)(5)(ii)(B) and (C) to determine the amount of such basis increase.

Second, proposed § 1.163(j)–6(j)(5)(ii)(B) would require upper-tier partnership to increase the adjusted basis of the transferred interest immediately before the disposition by the total amount of the UTP EBIE that was reduced in (A) earlier (the amount of UTP EBIE proportionate to the transferred interest). For example, if upper-tier partnership disposed of half of its lower-tier partnership interest while it held $40 of UTP EBIE allocated from lower tier partnership, upper-tier partnership would increase the adjusted basis of the disposed of lower-tier partnership interest by $20. However, immediately before the disposition, such $20 increase may be reduced pursuant to proposed § 1.163(j)–6(j)(5)(ii)(C).

Third, proposed § 1.163(j)–6(j)(5)(ii)(C) would require upper-tier partnership to, in the manner provided in proposed § 1.163(j)–6(j)(7)(iv), take into account any negative basis adjustments under sections 734(b) and 743(b) previously made to the UTP EBIE that was reduced in (A) earlier. Proposed § 1.163(j)–6(j)(7)(iv) would provide that if UTP EBIE that was allocated a negative section 734(b) or 743(b) adjustment is reduced pursuant to proposed § 1.163(j)–6(j)(5)(ii)(A), the amount of upper-tier partnership's basis increase under proposed § 1.163(j)–6(j)(5)(ii)(B) to the disposed of lower-tier partnership interest is reduced by the amount of the negative section 734(b) or 743(b) adjustment previously made to such UTP EBIE.

Continuing with the previous example, assume that $5 of the $20 of UTP EBIE reduced pursuant to proposed § 1.163(j)–6(j)(5)(ii)(A) was previously allocated a $5 negative section 743(b) adjustment. Pursuant to proposed § 1.163(j)–6(j)(5)(ii)(C), upper-tier partnership would reduce the $20 increase it determined under proposed § 1.163(j)–6(j)(5)(ii)(B) by $5. Thus, the adjusted basis of the lower-tier partnership interest being disposed of would be increased by $15 immediately before the disposition. Consequently, lower-tier partnership would have a corresponding § 1.163(j)–6(h)(5) basis adjustment to its property of $15.

4. Anti-Loss Trafficking Rules

Proposed § 1.163(j)–6(j) generally relies on negative sections 734(b) and 743(b) adjustments to prevent a partner from deducting business interest expense that was formerly UTP EBIE if such partner did not bear the economic cost of such business interest expense payment. To the extent a negative section 734(b) or 743(b) adjustment fails to prohibit such a deduction (or basis increase under proposed § 1.163(j)–6(j)(5)(ii)), the anti-loss trafficking rules in proposed § 1.163(j)–6(j)(8) would prohibit such a deduction (or basis addback under proposed § 1.163(j)–6(j)(5)(ii)).

The anti-loss trafficking rule under proposed § 1.163(j)–6(j)(8)(i) would prohibit the trafficking of business interest expense by providing that no deduction shall be allowed to any transferee specified partner for any business interest expense derived from a transferor's share of UTP EBIE. For purposes of proposed § 1.163(j)–6(j), the term transferee specified partner refers to any specified partner that did not reduce its section 704(b) capital account upon the initial allocation of excess business interest expense from lower-tier partnership to upper-tier partnership pursuant to proposed § 1.163(j)–6(j)(2). However, the transferee described in proposed § 1.163(j)–6(j)(ii)(B) is not a transferee specified partner for purposes of proposed § 1.163(j)–6(j).

Proposed § 1.163(j)–6(j)(8)(i) would also provide the mechanism for disallowing such BIE. Proposed § 1.163(j)–6(j)(8)(i) would provide that if, pursuant to proposed § 1.163(j)–6(j)(5)(i)(B), a transferee specified partner is allocated business interest expense derived from a transferor's share of UTP EBIE (business interest expense to which the partner's status as transferee specified partner relates), the transferee specified partner is deemed to recover a negative section 743(b) adjustment with respect to, and in the amount of, such business interest expense and takes such negative section 743(b) adjustment into account in the manner provided in proposed § 1.163(j)–6(j)(7)(ii) (or (iii), as the case may be), regardless of whether a section 754 election was in effect or a substantial built-in loss existed at the time of the transfer by which the transferee specified partner acquired the transferred interest. However, to the extent a negative section 734(b) or 743(b) adjustment was previously made to such business interest expense, the transferee specified partner does not recover an additional negative section 743(b) adjustment pursuant to this paragraph.

Additionally, the anti-loss trafficking rule under proposed § 1.163(j)–6(j)(8)(ii) would prohibit the trafficking of BIE that was formerly the UTP EBIE of a specified partner that received a distribution in complete liquidation of its upper-tier partnership interest. Specifically, proposed § 1.163(j)–6(j)(8)(ii) would provide that if UTP EBIE does not have a specified partner (as the result of a transaction described in proposed § 1.163(j)–6(j)(6)(ii)(A)), upper-tier partnership shall not allocate any business interest expense that was formerly such UTP EBIE to its partners. Rather, for purposes of applying § 1.163(j)–6(f)(2), upper-tier partnership shall treat such business interest expense as the allocable business interest expense (as defined in

§ 1.163(j)–6(f)(2)(ii)) of a § 1.163(j)–6(j)(8)(ii) account.

Any deductible business interest expense and excess business interest expense allocated to a § 1.163(j)–6(j)(8)(ii) account at the conclusion of the eleven-step computation set forth in § 1.163(j)–6(f)(2) is not tracked in future years. Treating such business interest expense as the allocable business interest expense of a separate account for purposes of applying § 1.163(j)–6(f)(2)(ii) ensures that partners of upper-tier partnership do not support a deduction for such business interest expense (for which no deduction will be allowed) using their shares of allocable ATI and allocable business interest income before supporting a deduction for their own shares of allocable business interest expense (for which a deduction may be allowed).

Additionally, if UTP EBIE that does not have a specified partner (as the result of a transaction described in proposed § 1.163(j)–6(j)(6)(ii)(A)) is treated as paid or accrued pursuant to § 1.163(j)–6(g), upper-tier partnership shall make a § 1.163(j)–6(h)(5) basis adjustment to its property in the amount of the adjusted basis (if any) of such UTP EBIE at the time such UTP EBIE is treated as business interest expense paid or accrued pursuant to § 1.163(j)–6(g). The purpose of this § 1.163(j)–6(h)(5) basis adjustment is to preserve basis in the system.

Thus, any time upper-tier partnership treats UTP EBIE as business interest expense paid or accrued pursuant to proposed § 1.163(j)–6(j)(5)(i)(A) it must apply proposed § 1.163(j)–6(j)(8)(i) and (ii). In application, upper-tier partnership would generally undertake the following analysis when applying proposed § 1.163(j)–6(j)(8)(i) and (ii). With respect to any UTP EBIE treated as business interest expense paid or accrued pursuant to proposed § 1.163(j)–6(j)(5)(i)(A) (UTP BIE), upper-tier partnership must first determine whether such UTP BIE has a specified partner. If it does not have a specified partner, upper-tier partnership must apply proposed § 1.163(j)–6(j)(8)(ii), which, in general, requires upper-tier partnership to capitalize the basis (if any) of such UTP BIE into the basis of upper-tier partnership property via a § 1.163(j)–6(h)(5) basis adjustment.

If UTP BIE does have a specified partner, upper-tier partnership must next determine whether the specified partner of such UTP BIE reduced its section 704(b) capital account upon the initial allocation of such excess business interest expense from lower-tier partnership to upper-tier partnership pursuant to proposed § 1.163(j)–6(j)(2). If the specified partner did reduce its section 704(b) capital account upon such initial allocation, then any deduction for such UTP BIE is not disallowed under proposed § 1.163(j)–6(j)(8)(i). However, if the specified partner did not reduce its section 704(b) capital account upon such initial allocation, upper-tier partnership must next determine whether such specified partner is a transferee described in proposed § 1.163(j)–6(j)(6)(ii)(B). If it is, then any deduction for such UTP BIE is not disallowed under proposed § 1.163(j)–6(j)(8)(i). However, if the specified partner is not a transferee described in proposed § 1.163(j)–6(j)(6)(ii)(B), then it is a transferee specified partner, as defined in proposed § 1.163(j)–6(j)(8)(i). As a result, any deduction for such UTP BIE is disallowed under proposed § 1.163(j)–6(j)(8)(i). If there are multiple tiers of partnerships, each tier must apply these rules.

Finally, proposed § 1.163(j)–6(j)(8)(iii) would provide a similar mechanism to proposed § 1.163(j)–6(j)(8)(i) for disallowing basis addbacks under § 1.163(j)–6(h)(3) for certain UTP EBIE. Specifically, proposed § 1.163(j)–6(j)(8)(iii) would provide that no basis increase under proposed § 1.163(j)–6(j)(5)(ii) shall be allowed to upper-tier partnership for any disallowed UTP EBIE. For purposes of § 1.163(j)–6, the term disallowed UTP EBIE refers to any UTP EBIE that has a specified partner that is a transferee specified partner (as defined in proposed § 1.163(j)–6(j)(8)(i)) and any UTP EBIE that does not have a specified partner (as the result of a transaction described in proposed § 1.163(j)–6(j)(6)(ii)(A)). For purposes of applying proposed § 1.163(j)–6(j)(5)(ii), upper-tier partnership shall treat any disallowed UTP EBIE in the same manner as UTP EBIE that has previously been allocated a negative section 734(b) adjustment. However, upper-tier partnership does not treat disallowed UTP EBIE as though it were allocated a negative section 734(b) adjustment pursuant to this paragraph to the extent a negative section 734(b) or 743(b) adjustment was previously made to such disallowed UTP EBIE.

5. Foundational Determinations

In general, the rules under proposed § 1.163(j)–6(j) are derived from the following three foundational determinations made by the Treasury Department and the IRS. First, basis is preserved when upper-tier partnership exchanges basis in its lower-tier partnership for EBIE allocated from lower-tier partnership (UTP EBIE). Thus, upper-tier partnership generally must treat UTP EBIE in the same manner as built-in loss property. Second, UTP EBIE has two components—a basis component and a carryforward component. In general, negative basis adjustments under section 734(b) and 743(b) reduce the basis component of UTP EBIE (and thus, any possible deduction for UTP EBIE), but do not reduce the carryforward component of UTP EBIE; only the two conversion events in proposed § 1.163(j)–6(j)(5) are capable of reducing the carryforward component of UTP EBIE. Third, upper-tier partnership must allocate any business interest expense that was formerly UTP EBIE to its specified partner—that is, the partner that reduced its section 704(b) capital account at the time of the initial allocation of the UTP EBIE from lower-tier partnership to upper-tier partnership. If there is a transfer of a partnership interest, the transferor generally steps into the shoes of the transferee's status as specified partner, but may not deduct any business interest expense derived from the transferor's share of UTP EBIE.

The Treasury Department and the IRS request comments on this approach. Specifically, the Treasury Department and the IRS request comments on whether further guidance on the treatment of UTP EBIE under the rules of subchapter K of the Code is necessary.

F. Partner Basis Adjustments Upon a Distribution

Under the 2018 Proposed Regulations, if a partner disposed of all or substantially all of its partnership interest, the adjusted basis of the partnership interest was increased immediately before the disposition by the entire amount of the EBIE not previously treated as paid or accrued by the partner. If a partner disposed of less than substantially all of its interest in a partnership, the partner could not increase its basis by any portion of the EBIE not previously treated as paid or accrued by the partner. The Treasury Department and the IRS requested comments on this approach in the preamble to the 2018 Proposed Regulations.

As discussed in the preamble to Final Regulations, commenters cited multiple concerns with the approach adopted in the 2018 Proposed Regulations and recommended that the Final Regulations adopt a proportionate approach. Under such an approach, a partial disposition of a partnership interest would trigger a proportionate EBIE basis addback and corresponding decrease in such partner's EBIE carryover. The Treasury

Department and the IRS agreed with commenters. Accordingly, § 1.163(j)–6(h)(3) provides for a proportionate approach.

In general, a distribution from a partnership is either a current distribution or a liquidating distribution; the concept of a redemptive distribution does not exist in the partnership context. Accordingly, proposed § 1.163(j)–6(h)(4) would provide that, 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 the partner's interest in the partnership. Proposed § 1.163(j)–6(h)(4) would further provide that, for purposes of § 1.163(j)–6(h)(3), a current distribution of money or other property by the partnership to a continuing partner is not a disposition for purposes of § 1.163(j)–6(h)(3). 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.

G. Allocable ATI and Allocable Business Interest Income of Upper-Tier Partnership Partners

Section 1.163(j)–6(f)(2) provides an eleven-step computation necessary for properly allocating a partnership's deductible BIE and section 163(j) excess items among its partners. Pursuant to § 1.163(j)–6(f)(2)(ii), a partnership must determine each of its 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. Further, § 1.163(j)–6(f)(2)(ii) provides that 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), and the term allocable business interest income means a partner's distributive share of the partnership's business interest income.

In general, if a partnership is not a partner in a partnership, each dollar of taxable income that is properly allocable to a trade or business will have a corresponding dollar of ATI associated with it. Accordingly, in the non-tiered partnership context, if a partner's share of gross income and gain items comprising ATI less such partner's share of gross loss and deduction items comprising ATI equals $1, such partner will have $1 of allocable ATI for purposes of § 1.163(j)–6(f)(2)(ii).

However, if a partnership is a partner in a partnership, each dollar of taxable income that is properly allocable to a trade or business may not have a full dollar of ATI associated with it. Section 163(j)(4)(A)(ii)(I) provides that the ATI of a partner in a partnership is determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership. Further, section 163(j)(4)(A)(ii)(II) provides that a partner only increases its ATI by its distributive share of a partnership's ETI.

To illustrate, consider the following example. LTP has $100 of income and $100 of loss properly allocable to a trade or business. Thus, LTP has $0 of ATI. LTP specially allocates the $100 of income to partner UTP. Under section 163(j)(4)(A)(ii)(I), UTP does not treat such $100 of income as ATI. Additionally, UTP has $300 of income properly allocable to a trade or business, which UTP properly treats as ATI. Here, UTP's taxable income that is properly allocable to a trade or business ($400) does not equal the amount of its ATI ($300).

The Treasury Department and the IRS recognize that a special rule is necessary to coordinate situations like the one illustrated earlier with the general requirement under § 1.163(j)–6(f)(2)(ii) for partnerships to determine a partner's allocable ATI based on such partner's allocation of items comprising the ATI of the partnership. Accordingly, proposed § 1.163(j)–6(j)(9) would provide that, when applying § 1.163(j)–6(f)(2)(ii), an upper-tier partnership determines the allocable ATI and allocable business interest income of each of its partners in the manner provided in proposed § 1.163(j)–6(j)(9). Specifically, if an upper-tier partnership's net amount of tax items that comprise (or have ever comprised) ATI is greater than or equal to its ATI, upper-tier partnership applies the rules in paragraph (j)(9)(ii)(A) to determine each partner's allocable ATI. However, if an upper-tier partnership's net amount of tax items that comprise (or have ever comprised) ATI is less than its ATI, upper-tier partnership applies the rules in proposed § 1.163(j)–6(j)(9)(ii)(B) to determine each partner's allocable ATI. To determine each partner's allocable business interest income, an upper-tier partnership applies the rules in proposed § 1.163(j)–6(j)(9)(iii).

H. Qualified Expenditures

The 2018 Proposed Regulations provided that partnership ATI is 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 reduced the amount of business interest expense a partnership could potentially deduct.

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 on the 2018 Proposed Regulations 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. Two different approaches for achieving this result were suggested: (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 Treasury Department and IRS agree that a distributive share of partnership deductions capitalized by a partner under section 59(e) should increase the ATI of the partner and adopt the recommended approach of increasing the ATI of the partner directly, without making any adjustments to partnership excess taxable income. The approach of increasing partner ATI by adjusting partnership excess taxable income is rejected, as it would result in partnerships with more excess taxable income than ATI—a result not possible under the current statutory conceptual framework. The Treasury Department and IRS have the authority to adjust ATI, but do not have a similar grant of authority to make adjustments to partnership excess taxable income, which is explicitly defined by statute.

Accordingly, proposed § 1.163(j)–6(e)(6) would provide that the ATI of a partner is increased by the portion of such partner's allocable share of qualified expenditures (as defined in section 59(e)(2)) to which an election under section 59(e) applies. Any deduction allowed under section 59(e)(1) would be taken into account in determining a partner's ATI pursuant to § 1.163(j)–1(b). Proposed § 1.163(j)–6(l)(4)(iv) would provide a similar rule in the S corporation context.

The Treasury Department and IRS are aware that a similar issue exists in the context of depletion and request comments as to whether a similar partner level add-back is appropriate. The Treasury Department and IRS are also aware that a partner may be required to capitalize certain qualified expenditures of a partnership under section 291(b) and request comments as to whether a similar partner level add-back is appropriate.

I. CARES Act Partnership Rules

As stated in the Background section of this preamble, section 163(j)(10), as enacted by the CARES Act, provides special rules for partners and partnerships for taxable years beginning in 2019 or 2020. Under sections 163(j)(10)(A)(i) and 163(j)(10)(A)(ii)(I), for partnerships, the amount of business interest that may be deductible under section 163(j)(1) for taxable years beginning in 2020 is computed using the 50 percent ATI limitation. The 50 percent ATI limitation does not apply to partnerships for taxable years beginning in 2019. See section 163(j)(10)(A)(ii)(I). Under section 163(j)(10)(A)(iii), a partnership may elect to not apply the 50 percent ATI limitation and, instead, to apply the 30 percent ATI limitation. This election is made by the partnership.

Under section 163(j)(10)(A)(ii)(II), 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 2019 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. Proposed § 1.163(j)–6(g)(4) provides further guidance on the 50 percent EBIE rule.

Additionally, section 163(j)(10)(B)(i) allows a taxpayer to elect to substitute its 2019 ATI for the taxpayer's 2020 ATI in determining the taxpayer's section 163(j) limitation for any taxable year beginning in 2020. Section 1.163(j)–2(b)(3) and (4) of the Final Regulations provide general rules regarding this election. Proposed § 1.163(j)–6(d)(5) provides further guidance on this election in the partnership context. The Treasury Department and the IRS request comments on these proposed rules and on whether further guidance is necessary.

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

Proposed § 1.163(j)–7 in these Proposed Regulations (Proposed § 1.163(j)–7) provides general rules regarding the application of the section 163(j) limitation to foreign corporations and U.S. shareholders of CFCs. This section V describes proposed § 1.163(j)–7 contained in the 2018 Proposed Regulations, the comments received on proposed § 1.163(j)–7 contained in the 2018 Proposed Regulations, and Proposed § 1.163(j)–7.

A. Overview of Proposed § 1.163(j)–7 Contained in the 2018 Proposed Regulations

1. General Application of Section 163(j) Limitation to Applicable CFCs

The 2018 Proposed Regulations clarify that, consistent with § 1.952–2, section 163(j) and the section 163(j) regulations apply to determine the deductibility of an applicable CFC's BIE in the same manner as these provisions apply to determine the deductibility of a domestic C corporation's BIE. The 2018 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 2018 Proposed Regulations allow certain applicable CFCs to make a CFC group election and be treated as part of a CFC group for purposes of computing the applicable CFC's section 163(j) limitation.

2. Limitation on Amount of Business Interest Expense of a CFC Group Member Subject to the Section 163(j) Limitation

Under the 2018 Proposed Regulations, if a CFC group election is in effect, the amount of BIE of a CFC group member that is subject to the section 163(j) limitation is limited to the amount of the CFC group member's allocable share of the CFC group's applicable net BIE (which is equal to the sum of the BIE of all CFC group members, reduced by the BII of all CFC group members). Thus, for example, if a CFC group has no debt other than loans between CFC group members, no portion of the BIE of a CFC group member would be subject to the section 163(j) limitation. A CFC group member's allocable share is computed by multiplying the applicable net BIE of the CFC group by a fraction, the numerator of which is the CFC group member's net BIE (computed on a separate company basis), and the denominator of which is the sum of the amounts of the net BIE of each CFC group member with net BIE (computed on a separate company basis).

After applying the CFC group rules to determine each CFC group member's allocable share of the CFC group's applicable net BIE, each CFC group member that has BIE is required to perform a stand-alone section 163(j) calculation to determine whether any BIE is disallowed under the section 163(j) limitation.

3. Membership in a CFC Group

Under the 2018 Proposed Regulations, in general, a CFC group means two or more applicable CFCs if at least 80 percent of the value of the stock of each applicable CFC is owned, within the meaning of section 958(a), by a single U.S. shareholder or, in the aggregate, by related U.S. shareholders that own stock of each member in the same proportion. The 2018 Proposed Regulations also generally treat a controlled partnership (in general, a partnership in which CFC group members own, in the aggregate, at least 80 percent of the interests) as a CFC group member. For purposes of identifying a CFC group, members of a consolidated group are treated as a single person, as are individuals filing a joint return, and stock owned by certain passthrough entities is treated as owned proportionately by the owners or beneficiaries of the passthrough entity.

The 2018 Proposed Regulations exclude from the definition of a CFC group member an applicable CFC that has any income that is effectively connected with the conduct of a trade or business in the United States. In addition, if one or more CFC group members conduct a financial services business, those entities are treated as comprising a separate subgroup.

Under the 2018 Proposed Regulations, a CFC group election is made by applying the rules applicable to CFC groups for purposes of computing each CFC group member's deduction for BIE. Once made, the CFC group election is irrevocable.

4. Roll-Up of CFC Excess Taxable Income to Other CFC Group Members and U.S. Shareholders

Under the 2018 Proposed Regulations, if a CFC group election is in effect with respect to a CFC group, then an upper-tier CFC group member takes into account a proportionate share of any ''CFC excess taxable income'' of a lower-tier CFC group member in which it directly owns stock for purposes of computing the upper-tier member's ATI. The meaning of the term ''CFC excess taxable income'' is analogous to the meaning of the term ''excess taxable income'' in the context of a partnership and S corporation, and, in general, means the amount of a CFC group member's ATI in excess of the amount needed to prevent any BIE of the CFC group member from being disallowed under section 163(j).

Under the 2018 Proposed Regulations, a U.S. shareholder is not permitted to include in its ATI amounts included in gross income under section 951(a) (subpart F inclusions), section 951A(a) (GILTI inclusions), or section 78 (section 78 inclusions) that are properly allocable to a non-excepted trade or business (collectively, deemed income inclusions). However, the 2018 Proposed Regulations provide that a portion of CFC excess taxable income of the highest-tier applicable CFC is permitted to be used to increase the ATI of its U.S. shareholders. That portion is equal to the U.S. shareholder's interest in the highest-tier applicable CFC multiplied by its specified ETI ratio. The numerator of the specified ETI ratio is the sum of the U.S. shareholder's income inclusions under sections 951(a) and 951A(a) with respect to the specified highest-tier member and specified lower-tier members, and the denominator is the sum of the taxable income of the specified highest-tier member and specified lower-tier members.

B. Summary of Comments on Proposed § 1.163(j)–7 Contained in the 2018 Proposed Regulations

The Treasury Department and the IRS requested comments in the preamble to the 2018 Proposed Regulations regarding whether it would be appropriate to further modify 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) not apply to applicable CFCs. Those comments are addressed in part VIII of the Summary of Comments and Explanation of Revisions section in the Final Regulations.

A number of commenters broadly requested changes to the roll-up of CFC excess taxable income. Many of these commenters expressed concern about the administrability of rolling up CFC excess taxable income. Some commenters suggested that the CFC group election be available to a stand-alone applicable CFC in order to allow its CFC excess taxable income to be used to increase the ATI of a U.S. shareholder, or that an applicable CFC be permitted to use any CFC excess taxable income to increase the ATI of a shareholder without regard to whether it is a CFC group member. Furthermore, some commenters asserted that the nature of the roll-up compels multinationals to restructure their operations in order to move CFCs with relatively high amounts of ATI and low amounts of interest expense to the bottom of the ownership chain and CFCs with relatively low amounts of ATI and high amounts of interest expense to the top of the ownership chain, in order to maximize the benefits of the roll-up of CFC excess taxable income.

Some commenters asserted that because multinational organizations may own hundreds of CFCs, applying the section 163(j) limitation on a CFC-by-CFC basis, without regard to whether a CFC group election has been made under the 2018 Proposed Regulations, represents a significant administrative burden. Many comments suggested that CFC groups should be permitted to apply section 163(j) on a group basis, with a single group-level section 163(j) calculation similar to the rules applicable to a consolidated group. A few commenters suggested that this rule should be applied in addition to the roll-up of CFC excess taxable income, but most commenters recommended that the group rule be applied instead of the roll-up.

A number of commenters asserted that the requirements to be a member of a CFC group under the 2018 Proposed Regulations are overly restrictive. Some of these commenters recommended that the 80-percent ownership threshold be replaced with the ownership requirements of affiliated groups under section 1504(a), the rules of which are well-known and understood. Others recommended that the 80-percent ownership requirement be reduced to 50 percent, consistent with the standard for treatment of a foreign corporation as a CFC. Still others asserted that U.S. shareholders owning stock in applicable CFCs should not each be required to own the same proportion of stock in each applicable CFC in order for their ownership interests to count towards the 80-percent ownership requirement, or that the attribution rules of section 958(b), rather than section 958(a), should apply for purposes of determining whether the ownership requirements are met. Finally, some of these commenters requested that a CFC group election be permitted when one applicable CFC meets the ownership requirements for other applicable CFCs, even if no U.S. shareholder meets the ownership requirements for a highest-tier applicable CFC.

Some commenters requested the CFC financial services subgroups not be segregated from the CFC group and their BIE and BII be included in the general CFC group.

Some commenters requested that an applicable CFC with effectively connected income be permitted to be a member of a CFC group and that only its effectively connected income items should be excluded. Alternatively, commenters requested a de minimis rule that would permit an applicable CFC to be a member of a CFC group if the applicable CFC's effectively connected income is below a certain threshold of total income, such as 10 percent.

Some commenters requested that the CFC group election be revocable. The commenters proposed either making the CFC group election an annual election or providing that the election applies for a certain period, for example, three or five years, before it can be revoked.

Finally, commenters requested a safe harbor or exclusion providing that if a CFC group would not be limited under section 163(j) either because the CFC group has no net BIE or because its BIE does not exceed 30 percent of the CFC group's ATI, a U.S. shareholder would not have to apply section 163(j) for the applicable CFC or be subject to applicable CFC section 163(j) reporting requirements.

C. Proposed § 1.163(j)–7

1. Overview

As noted in the preamble to the Final Regulations, the Treasury Department and the IRS have determined, based on a plain reading of section 163(j) and § 1.952–2, that section 163(j) applies to foreign corporations where relevant under current law and has applied to such corporations since the effective date of the new provision.[1] Congress

[1] Section 1.952–2(b) generally provides that the taxable income for a foreign corporation is determined by treating the foreign corporation as a

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expressly provided that section 163(j) should not apply to certain small businesses or to certain excepted trades or businesses. Nothing in the Code or legislative history indicates that Congress intended to except other persons with trades or businesses, as defined in section 163(j)(7), from the application of section 163(j). Accordingly, the Treasury Department and the IRS have determined that, consistent with a plain reading of section 163(j) and § 1.952–2, it is appropriate for section 163(j) to apply to applicable CFCs and other foreign corporations whose taxable income is relevant for Federal tax purposes (other than by reason of having ECI or income described in section 881 (FDAP)) (relevant foreign corporations).[2] In the case of CFCs with ECI, see proposed § 1.163(j)–8. For further discussion of the Treasury Department and the IRS's determination that there is not a statutory basis for exempting applicable CFCs from the application of section 163(j), see part VIII of the Summary of Comments and Explanation of Revisions section of the Final Regulations.

A number of comments were received asserting that there are other mechanisms that eliminate the policy need for section 163(j) to apply to limit leverage in CFCs. For example, some commenters have cited tax rules in foreign jurisdictions limiting interest deductions, including thin capitalization rules (or similar rules intended to implement the Organisation for Economic Co-operation and Development (OECD) recommendations under Action 4 of the Base Erosion and Profits Shifting Project). The Treasury Department and the IRS disagree with these assertions. The Treasury Department and the IRS note that these rules are not universally applied in other jurisdictions, that many jurisdictions do not have any meaningful interest expense limitation rules, and that some jurisdictions have no interest expense limitation rules of any kind.

Even if some CFCs owned by a U.S. shareholder are in foreign jurisdictions with meaningful thin capitalization rules, in the absence of section 163(j), it would still be possible to use leverage to reduce or eliminate a U.S. shareholder's global intangible low-taxed income (GILTI) under section 951A for these CFCs. This is because for purposes of computing a U.S. shareholder's GILTI under section 951A, tested income of CFCs may be offset by tested losses of CFCs owned by the U.S. shareholder. See section 951A(c). The ability to deduct interest without limitation under section 163(j) would result in tested losses in CFCs with significant leverage. Because of this aggregation, one overleveraged CFC in a single jurisdiction that does not have rules limiting interest expense can, without the application of section 163(j), reduce or eliminate tested income from all CFCs owned by a U.S. shareholder regardless of jurisdiction.

Other comments suggested that, to the extent that debt of a CFC is held by a related party, transfer pricing principles would discipline the amount of interest expense. Comments also note that to the extent that debt of a CFC is held by a third party, market forces would discipline the leverage present in the CFC. While both of these concepts may discipline the amount of leverage present in a CFC, they would also discipline the amount of leverage in any entity. If Congress believed that market forces and transfer pricing principles were sufficient disciplines to prevent overleverage, section 163(j) would not have been amended as part of TCJA to clearly apply to interest expense paid or accrued to both third parties and related parties. In addition, if transfer pricing were sufficient to police interest expense in the related party context, old section 163(j) (as enacted in 1989 and subsequently revised prior to TCJA) would not have been necessary.

However, the Treasury Department and the IRS also have determined that it is appropriate, while still carrying out the provisions of the statute and the policies of section 163(j), to reduce the administrative and compliance burdens of applying section 163(j) to applicable CFCs. Accordingly, Proposed § 1.163(j)–7 allows for an election to be made to apply section 163(j) on a group basis with respect to applicable CFCs that are ''specified group members'' of a ''specified group.'' If the election is made, the specified group members are referred to as ''CFC group members'' and all of the CFC group members collectively are referred to as a ''CFC group.'' The rules for determining a specified group and specified group members are discussed in part V.C.3. of this Explanation of Provisions section. The rules and procedures for treating specified group members as CFC group members and for determining a CFC group are discussed in part V.C.4. of this Explanation of Provisions section.

In addition, Proposed § 1.163(j)–7 provides a safe harbor election that exempts certain applicable CFCs from application of section 163(j). The safe-harbor election is available for stand-alone applicable CFCs (which is an applicable CFC that is not a specified group member of a specified group) and CFC group members. The election is not available for an applicable CFC that is a specified group member but not a CFC group member because a CFC group election is not in effect. See part V.C.7. of this Explanation of Provisions section.

Proposed § 1.163(j)–7 also provides an anti-abuse rule that increases ATI in certain circumstances.

Finally, Proposed § 1.163(j)–7 allows a U.S. shareholder of a stand-alone applicable CFC or a CFC group member of a CFC group to include a portion of its deemed income inclusions attributable to the applicable CFC in the U.S. shareholder's ATI. This rule does not apply with respect to an applicable CFC that is a specified group member but not a CFC group member because a CFC group election is not in effect. See part V.C.9. of this Explanation of Provisions section.

The Treasury Department and the IRS anticipate that, in many instances, Proposed § 1.163(j)–7 will significantly reduce the administrative and compliance burdens of applying section 163(j) to applicable CFCs relative to the 2018 Proposed Regulations.

Unlike Proposed § 1.163(j)–8, which provides rules for allocating disallowed BIE to ECI and non-ECI, Proposed § 1.163(j)–7 does not allocate disallowed BIE among classes of income. The Treasury Department and the IRS request comments on appropriate methods of allocating disallowed BIE among classes of income, such as subpart F income, as defined in section 952, and tested income, as defined in section 951A(c)(2)(A) and § 1.951A–2(b)(1), as well as comments on whether and the extent to which rules implementing such methods may be necessary.

In addition, the Treasury Department and the IRS request comments on appropriate methods of allocating disallowed BIE for other purposes, including between items described in § 1.163(j)–1(b)(22)(i) and other items described in § 1.163(j)–1(b)(22) (defining interest), as well as comments on whether and the extent to which rules implementing such methods may be necessary.

The Treasury Department and the IRS do not anticipate that section 163(j) will affect the tax liability of a passive foreign investment company, within the

domestic corporation but with certain enumerated exceptions. Section 1.952–2(c) provides for a number of exceptions, but none of the exceptions affects the application of section 163(j).

[2] For purposes of Proposed § 1.163(j)–7, the term effectively connected income (or ECI) means income or gain that is ECI, as defined in § 1.884–1(d)(1)(iii), and deduction or loss that is allocable to, ECI, as defined in § 1.884–1(d)(1)(iii).

meaning of section 1297(a) (PFIC), or its shareholders, solely because the PFIC is a relevant foreign corporation. See § 1.163(j)–4(c)(1) (providing that section 163(j) does not affect earnings and profits). The Treasury Department and the IRS request comments on whether any additional guidance is needed to reduce the compliance burden of section 163(j) on PFICs and their shareholders.

2. Application of Section 163(j) to CFC Group Members

a. Single Section 163(j) Limitation for a CFC Group

Proposed § 1.163(j)–7(c) provides rules for applying section 163(j) to CFC group members of a CFC group. Under the Proposed Regulations, a single section 163(j) limitation is computed for a CFC group. See proposed § 1.163(j)–7(c)(2). For this purpose, the current-year BIE, disallowed BIE carryforwards, BII, floor plan financing interest expense, and ATI of a CFC group are equal to the sums of the current-year amounts of such items for each CFC group member for its specified taxable year with respect to the specified period. (The terms ''specified taxable year'' and ''specified period'' are discussed in part V.C.3. of this Explanation of Provisions section.) A CFC group member's current-year BIE, BII, floor plan financing interest expense, and ATI for a specified taxable year are generally determined on a separate-company basis before being included in the CFC group calculation.

b. Allocation of CFC Group's Section 163(j) Limitation to Business Interest Expense of CFC Group Members

The extent to which a CFC group's section 163(j) limitation is allocated to a particular CFC group member's current-year BIE and disallowed BIE carryforwards is determined using the rules that apply to consolidated groups under § 1.163(j)–5(a)(2) and (b)(3)(ii) (consolidated BIE rules), subject to certain modifications. See proposed § 1.163(j)–7(c)(3)(i). Because many CFC groups will be owned by consolidated groups, many taxpayers will be familiar with the consolidated BIE rules.

If the sum of the CFC group's current-year BIE and disallowed BIE carryforwards exceeds the CFC group's section 163(j) limitation, then current-year BIE is deducted first. If the CFC group's current-year BIE exceeds the CFC group's section 163(j) limitation, then each CFC group member deducts the amount of its current-year BIE not in excess of the sum of its BII and floor plan financing interest expense, if any. Then, if the CFC group has any section 163(j) limitation remaining for the current year, each applicable CFC with remaining current-year BIE deducts a pro rata portion thereof.

If the CFC group's section 163(j) limitation exceeds its current-year BIE, then CFC group members may deduct all of their current-year BIE and may deduct disallowed BIE carryforwards not in excess of the CFC group's remaining section 163(j) limitation. The disallowed BIE carryforwards are deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, and disallowed BIE carryforwards that arose in the same taxable year are deducted on a pro rata basis. This taxable year ordering rule is consistent with the consolidated BIE rules. However, Proposed § 1.163(j)–7 provides special rules for disallowed BIE carryforwards when CFC group members have different taxable years, or a CFC group member has multiple taxable years with respect to the specified period of the CFC group. Unlike members of a consolidated group, not all CFC group members will have the same taxable years, and not all CFC group members will have the same taxable year as the parent of the CFC group. As discussed in part V.C.3 of this Explanation of Provisions section, a CFC group member is included in a CFC group for its entire taxable year that ends with or within a specified period.[3]

c. Limitation on Pre-Group Disallowed Business Interest Expense Carryforwards

The disallowed BIE carryforwards of a CFC group member when it joins a CFC group (pre-group disallowed BIE carryforwards) are subject to the same CFC group section 163(j) limitation and are deducted pro rata with other CFC group disallowed BIE carryforwards. However, pre-group disallowed BIE carryforwards are subject to additional limitations, similar to the limitations on deducting the disallowed BIE carryforwards of a consolidated group arising in a SRLY, as defined in § 1.1502–1(f), or treated as arising in a SRLY under the principles of § 1.1502–21(c) and (g). The policy of the limitation imposed on pre-group BIE carryforwards is analogous to the policy of the SRLY limitation for consolidated groups.

The rules and principles of § 1.163(j)–5(d)(1)(B), which applies SRLY subgroup principles to disallowed BIE carryforwards of a consolidated group, apply to pre-group subgroups. If a CFC group member with pre-group disallowed BIE carryforwards (loss member) leaves one CFC group (former group) and joins another CFC group (current group), the loss member and each other CFC group member that left the former group and joined the current group for a specified taxable year with respect to the same specified period consists of a ''pre-group subgroup.'' Unlike SRLY subgroups, it is not required that all members of a pre-group subgroup join the CFC group at the same time, since each applicable CFC that joins a CFC group is treated as joining on the first day of its taxable year. As a result, even if multiple applicable CFCs are acquired on the same day in a single transaction, they would join the CFC group on different days if they have different taxable years.

d. Special Rules for Specified Periods Beginning in 2019 or 2020

Proposed § 1.163(j)–7(c)(5) provides special rules for applying section 163(j)(10) to CFC groups. The proposed regulations provide that elections under section 163(j)(10) are made for a CFC group (rather than for each CFC group member). For a specified period of a CFC group beginning in 2019 or 2020, unless the election described in § 1.163(j)–2(b)(2)(ii)(A) is made, the CFC group section 163(j) limitation is determined by using 50 percent (rather than 30 percent) of the CFC group's ATI for the specified period, without regard to whether the taxable years of CFC group members begin in 2019 or 2020. If the election described in § 1.163(j)–2(b)(2)(ii)(A) is made for a specified period of a CFC group, the CFC group section 163(j) limitation is determined by using 30 percent (rather than 50 percent) of the CFC group's ATI for the specified period, without regard to whether the taxable years of CFC group members begin in 2019 or 2020. The election is made for the CFC group by each designated U.S. person.

[3] For example, assume a U.S. multinational group parented by a consolidated group with a taxable year that is the calendar year includes applicable CFCs with November 30 taxable years and other applicable CFCs with calendar year taxable years. In this case, as discussed in more detail in part V.C.3.b. of the Explanation of Provisions section, the specified period of the CFC group for 2020 would begin on January 1, 2020, and end on December 31, 2020. Furthermore, the specified taxable year of a CFC group member with a taxable year that is the calendar year is its taxable year ending December 31, 2020, and the specified taxable year of a CFC group member with a November 30 taxable year is its taxable year ending November 30, 2020 (the taxable years that end with or within the specified period). A CFC group member can also have multiple taxable years with respect to a specified period. For example, a CFC group member may have a short taxable year due to an election under § 1.245A–5T(e)(3)(i) (elective exception to close a CFC's taxable year in the case of an extraordinary reduction).

The election under § 1.163(j)–2(b)(3)(i) to use 2019 ATI (that is, ATI for the last taxable year beginning in 2019) rather than 2020 ATI (that is, ATI for a taxable year beginning in 2020) is made for a specified period of a CFC group beginning in 2020 (2020 specified period) and applies to the specified taxable years of CFC group members with respect to the 2020 specified period. Accordingly, if a specified taxable year of a CFC group member with respect to a CFC group's 2020 specified period begins in 2020, then the election is applied to such taxable year using the CFC group member's ATI for its last taxable year beginning in 2019. In some cases, the specified taxable year of a CFC group member with respect to a CFC group's 2020 specified period will begin in 2019 or 2021. If the specified taxable year of the CFC group member begins in 2019, then the election is applied to such taxable year using the CFC group member's ATI for its last taxable year beginning in 2018; if the specified taxable year of the CFC group member begins in 2021, then the election is applied to such taxable year using the CFC group member's ATI for its last taxable year beginning in 2020.

For example, assume a CFC group has two CFC group members, CFC1 and CFC2, and has a specified period that is the calendar year. CFC1 has a taxable year that is the calendar year, and CFC2 has a taxable year that ends November 30. The election under § 1.163(j)–2(b)(3)(i) is in effect for the specified period beginning January 1, 2020, and ending December 31, 2020 (which is the 2020 specified period). As a result, the ATI of the CFC group for the 2020 specified period is determined by reference to the specified taxable year of CFC1 beginning January 1, 2019, and ending December 31, 2019 (the last taxable year beginning in 2019), and the specified taxable year of CFC2 beginning December 1, 2018, and ending November 30, 2019 (the last taxable year beginning in 2018).

Alternatively, assume (i) the same CFC group instead has a 2020 specified period that begins on December 1, 2020, and ends on November 30, 2021; (ii) in 2019 and 2020, CFC1 has a taxable year that is the calendar year, but in 2021, CFC1 has a short taxable year that begins on January 1, 2021, and ends on June 30, 2021; and (iii) CFC2 has a taxable year ending November 30 (for all years). Further assume that the election under § 1.163(j)–2(b)(3)(i) is in effect for the 2020 specified period. In this case, the election applies to the specified taxable year of CFC1 that begins on January 1, 2020, and ends on December 31, 2020; the specified taxable year of CFC1 that begins on January 1, 2021, and ends on June 30, 2021; and the specified taxable year of CFC2 that begins on December 1, 2020, and ends on November 30, 2021. As a result of the election, the ATI of the CFC group for the 2020 specified period is determined by reference to the specified taxable year of CFC1 beginning January 1, 2019, and ending December 31, 2019, the specified taxable year of CFC1 beginning January 1, 2020, and ending December 31, 2020, and the specified taxable year of CFC2 beginning December 1, 2019, and ending November 30, 2020.

If the election under § 1.163(j)–2(b)(3)(i) to use 2019 ATI rather than 2020 ATI is made for a CFC group, the CFC group's ATI for the 2020 specified period is determined by reference to the 2019 ATI of all CFC group members (except to the extent that 2018 or 2020 ATI is used, as described earlier), including any CFC group member that joins the CFC group during the 2020 specified period. Therefore, a CFC group's ATI for the 2020 specified period may be determined by reference to a prior taxable year of a new CFC group member even though the CFC group member was not a CFC group member in the prior taxable year. If a CFC group member leaves the CFC group during the 2020 specified period, the ATI of the CFC group for the 2020 specified period is determined without regard to the ATI of the departing CFC group member.

As stated in the Background section of this preamble, Revenue Procedure 2020–22 generally provides the time and manner of making or revoking elections under section 163(j)(10), including elections with respect to applicable CFCs. References in Revenue Procedure 2020–22 to CFC groups and CFC group members are to CFC groups and applicable CFCs for which a CFC group election is made under the 2018 Proposed Regulations. The rules described in this part V.C.2.d of this Explanation of Provisions section and proposed § 1.163(j)–7(c)(5) modify the application of Revenue Procedure 2020–22 and the elections under section 163(j)(10) for CFC groups and applicable CFCs for which a CFC group election is made under Proposed § 1.163(j)–7.

Thus, for example, if a CFC group has two designated U.S. persons that are U.S. corporations, pursuant to proposed § 1.163(j)–7(c)(5), the election to not apply the 50 percent ATI limitation to the CFC group for a specified period beginning in 2020 is made for the specified period of the CFC group by each designated U.S. person, and pursuant to Revenue Procedure 2020–22, section 6.01(2), the election to not apply the 50 percent ATI limitation is made by the each designated U.S. person timely filing a Federal income tax return, including extensions, using the 30 percent ATI limitation for purposes of determining the taxable income of the CFC group.

For purposes of applying § 1.964–1(c), the elections described in proposed § 1.163(j)–7(c)(5) are treated as if made for each CFC group member. Thus, the requirements to provide a statement and written notice as provided under § 1.964–1(c)(3)(i)(B) and (C) apply.

3. Specified Groups and Specified Group Members

a. In General

Proposed § 1.163(j)–7(d) provides rules for determining a specified group and specified group members. The determination of a specified group and specified group members is the basis for determining a CFC group and CFC group members. This is because a CFC group member is a specified group member of a specified group for which a CFC group election is in effect, and a CFC group consists of all the CFC group members. See proposed § 1.163(j)–7(e)(2).

b. Specified Group

Under proposed § 1.163(j)–7(d)(2), a specified group includes one or more chains of applicable CFCs connected through stock ownership with a specified group parent, but only if the specified group parent owns stock meeting the requirements of section 1504(a)(2)(B) (pertaining to value) in at least one applicable CFC, and stock meeting the requirements of section 1504(a)(2)(B) in each of the applicable CFCs (except the specified group parent) is owned by one or more of the other applicable CFCs or the specified group parent.

Unlike the general rules in section 1504, in order to avoid breaking affiliation with a partnership or foreign trust or foreign estate, for purposes of determining whether stock in an applicable CFC meeting the requirements of section 1504(a)(2)(B) is owned by the specified group parent or other applicable CFCs, proposed § 1.163(j)–7(d)(2) takes into account both stock owned directly and stock owned indirectly under section 318(a)(2)(A) through a domestic or foreign partnership or under section 318(a)(2)(A) or (a)(2)(B) through a foreign estate or trust (the look-through rule). For example, assume CFC1 and CFC2 is each an applicable CFC and a specified group member of a specified group. If CFC1 and CFC2 each own 50 percent of the capital and profits interests in a partnership, and the partnership wholly owns CFC3, an applicable CFC, then, by reason of the look-through rule, CFC3 is also included in the specified group, although the partnership is not.

The specified group rules also differ from the affiliated group rules in section 1504 in that they require only that 80 percent of the total value (pursuant to section 1504(a)(2)(B)), not 80 percent of both vote and value (pursuant to section 1504(a)(2)(A) and (a)(2)(B)), of an applicable CFC be owned by the specified group parent or other applicable CFCs in the specified group in order for the applicable CFC to be included in the specified group. The Treasury Department and the IRS determined that limiting the 80-percent threshold to value is appropriate to prevent taxpayers from breaking affiliation by diluting voting power below 80 percent.

The specified group has a single specified group parent, which may be either a qualified U.S. person or an applicable CFC. However, the specified group parent is included in the specified group only if it is an applicable CFC. For this purpose, a *qualified U.S. person* means a U.S. person that is a citizen or resident of the United States or a domestic corporation. For purposes of determining the specified group parent, members of a consolidated group are treated as a single corporation and individuals whose filing status is ''married filing jointly'' are treated as a single individual (aggregation rule). The Treasury Department and the IRS have determined that the aggregation rule is appropriate because all deemed inclusions with respect to applicable CFCs included in gross income of members of a consolidated group or of individuals filing a joint return, as applicable, are reported on a single U.S. tax return. The Treasury Department and the IRS determined that it is appropriate for an S corporation to be a qualified U.S. person because an S corporation can have only a single class of stock and therefore the economic rights of its shareholders in all applicable CFCs owned by the S corporation are proportionate to share ownership. On the other hand, the Treasury Department and the IRS have determined that it is not appropriate for a domestic partnership to be a qualified U.S. person because of the ability of partnerships to make disproportionate or special allocations and therefore the economic rights of partners in the partnership with respect to all applicable CFCs owned by a partnership will not necessarily be proportionate to ownership. However, if, for example, a domestic partnership wholly owns an applicable CFC, which wholly owns multiple other applicable CFCs, and no qualified U.S. person owns stock in the top-tier CFC meeting the requirements of section 1504(a)(2)(B), taking into account the look-through rule, then the applicable CFCs are included in a specified group of which the top-tier CFC is the specified group parent.

The Treasury Department and the IRS request comments regarding whether, and to what extent, the definition of a ''qualified U.S. person'' should be expanded to include domestic estates and trusts or whether and to what extent the look-through rule should apply if stock of applicable CFCs is owned by domestic estates and trusts.

Each specified group has a specified period. A specified period is similar to a taxable year but determined with respect to a specified group. A specified group does not have a taxable year because the specified group members may not have the same taxable year. If the specified group parent is a qualified U.S. person, the specified period generally ends on the last day of the taxable year of the specified group parent and begins on the first day after the last day of the prior specified period. Thus, for example, if the specified group parent is a domestic corporation with a calendar year taxable year, the specified period generally begins on January 1 and ends on December 31. If the specified group parent is an applicable CFC, the specified period generally ends on the last day of the required year of the specified group parent, determined under section 898(c)(1), without regard to section 898(c)(2), and begins on the first day after the last day of the prior specified period. However, a specified period never begins before the first day on which the specified group exists or ends after the last day on which the specified group exists. Like a taxable year, a specified period can never be longer than 12 months.

The principles of § 1.1502–75(d)(1), (d)(2)(i) through (d)(2)(ii), and (d)(3)(i) through (d)(3)(iv) (regarding when a consolidated group remains in existence) (§ 1.1502–75(d) principles) apply for purposes of determining when a specified group ceases to exist. Solely for purposes of applying the § 1.1502–75(d) principles, each applicable CFC that is treated as a specified group member for a taxable year of the applicable CFC with respect to a specified period is treated as affiliated with the specified group parent from the beginning to the end of the specified period, without regard to the beginning or end of its taxable year. This rule does not affect the general rule that, for purposes other than § 1.1502–75(d) (such as the application of section 163(j) to a CFC group), an applicable CFC is a specified group member with respect to a specified period for its taxable year ending with or within the specified period.[4]

The Treasury Department and the IRS request comments as to whether any modifications to the § 1.1502–75(d) principles should be made for specified groups.

c. Specified Group Members

Proposed § 1.163(j)–7(d)(3) provides rules for determining specified group members with respect to a specified group. The determination as to whether an applicable CFC is a specified group member is made with respect to a taxable year of the applicable CFC and specified period of a specified group. Specifically, if the applicable CFC is included in a specified group on the last day of its taxable year that ends with or within the specified period, the applicable CFC is a specified group member with respect to the specified period for the entire taxable year.[5]

[4] For example, assume a specified group parent with a specified period that is the calendar year acquires all of the stock of CFC1, an applicable CFC, on June 30, Year 1, and sells all of the stock of CFC1 on June 30, Year 3. CFC1 has a November 30 taxable year, and the specified period is the calendar year. CFC1 is included in the specified group on November 30, Year 1, and November 30, Year 2 (but not November 30, Year 3). As a result, CFC1 is a specified group member for its taxable year ending November 30, Year 1, with respect to the specified period ending December 31, Year 1, and for its taxable year ending November 30, Year 2, with respect to the specified period ending December 31, Year 2. Solely for purposes of applying the § 1.1502–75(d) principles, CFC1 is treated as affiliated with the specified group parent from the beginning to the end of the specified period ending December 31, Year 1, and from the beginning to the end of the specified period ending December 31, Year 2. In other words, CFC1 is treated as affiliated with the specified group parent from January 1, Year 1, to December 31, Year 2.

[5] For example, assume CFC1, an applicable CFC, has a taxable year beginning December 1, Year 1, and ending November 30, Year 2, and a specified group has a specified period beginning January 1, Year 2, and ending December 31, Year 2. If CFC1 is included in the specified group on November 30, Year 2, then CFC1 is a specified group member with respect to the specified period for its entire taxable year ending November 30, Year 2. This is the case even if CFC1 is not included in the specified group during part of its taxable year ending November 30, Year 2 (for example, because all of the stock of CFC2 is purchased by the specified group on June 1, Year 2, and its taxable year does not close as a result of joining the specified group), or if CFC1 ceases to be included in the specified group after November 30, Year 2, but before December 31, Year 2 (for example, because all of the stock of CFC1 is

Continued

The Treasury Department and the IRS are concerned about the potential for abuse that may arise if taxpayers cause an applicable CFC that otherwise would be treated as a specified group member and a CFC group member to avoid being treated as a CFC group member. For example, the Treasury Department and the IRS have determined that it is not appropriate for taxpayers to prevent an applicable CFC with high ATI and low BIE from being part of a CFC group with a goal of increasing its CFC excess taxable income and its U.S. shareholders' ATI inclusions, rather than allowing the applicable CFC's ATI to be used by the CFC group. The Treasury Department and the IRS request comments on appropriate methods of preventing an applicable CFC from avoiding being a CFC group member for purposes of increasing the ATI of its U.S. shareholders. The Treasury Department and the IRS also request comments on whether a rule similar to the rule in section 1504(a)(3), which prevents domestic corporations from rejoining a consolidated group for 60 months, should apply to prevent applicable CFCs from rejoining a CFC group.

4. CFC Groups and CFC Group Members

a. In General

Proposed § 1.163(j)–7(e) provides rules and procedures for treating specified group members as CFC group members and for determining a CFC group. A CFC group member means a specified group member of a specified group for which a CFC group election is in effect. The specified group member is a CFC group member for a specified taxable year with respect to a specified period. A CFC group means all CFC group members for their specified taxable years with respect to a specified period. See proposed § 1.163(j)–7(e)(2) (defining CFC group and CFC group member). Thus, if a CFC group election is in place, the terms ''specified group members,'' ''CFC group members,'' and a ''CFC group'' refer to the same applicable CFCs. The term ''specified group,'' which is determined at any moment in time, may not necessarily refer to the exact same applicable CFCs.

Once a CFC group election is made, the CFC group continues until the CFC group election is revoked or until the end of the last specified period with respect to the specified group. See proposed § 1.163(j)–7(e)(3). When a CFC group election is in effect, if an applicable CFC becomes a specified group member with respect to a specified period of the specified group, the CFC group election applies to the applicable CFC and it becomes a CFC group member. When an applicable CFC ceases to be a specified group member with respect to a specified period of a specified group, the CFC group election terminates solely with respect to the applicable CFC. See proposed § 1.163(j)–7(e)(4) (joining or leaving a CFC group).

b. Making or Revoking a CFC Group Election

Proposed § 1.163(j)–7(e)(5) provides rules for making and revoking a CFC group election. Proposed § 1.163(j)–7(e)(5)(i) provides that a CFC group election applies with respect to a specified period of a specified group. Accordingly, the CFC group election applies to each specified group member for its entire specified taxable year that ends with or within the specified period. In response to comments to the 2018 Proposed Regulations, the CFC group election is not irrevocable. Instead, once made, a CFC group election cannot be revoked with respect to any specified period of the specified group that begins during the 60-month period following the last day of the first specified period for which the election was made. Similarly, once revoked, a CFC group election cannot be made again with respect to any specified period of the specified group that begins during the 60-month period following the last day of the first specified period for which the election was revoked.

The Treasury Department and the IRS request comments regarding whether a specified group that does not make a CFC group election when it first comes into existence (or for the first specified period following 60 days after the date of publication of the Treasury decision adopting these regulations as final in the **Federal Register**) should be prohibited from making the CFC group election for any specified period beginning during the 60-month period following that specified period.

Thus, under the Proposed Regulations, in the case of a specified group, taxpayers choose to apply section 163(j) to specified group members on a CFC group basis or on a stand-alone basis for no less than a 60-month period. The Treasury Department and the IRS have determined that a 60-month period is an appropriate balance between making the choice irrevocable and providing an annual election, the latter of which may facilitate inappropriate tax planning (in this regard, see, for example, the discussion in part C.7 of this part V of the Explanation of Provisions section).

c. Specified Financial Services Subgroup Rules

In response to comments, Proposed § 1.163(j)–7 does not provide for CFC financial services subgroups. Instead, applicable CFCs that otherwise qualify as CFC group members are treated as part of the same CFC group.

d. Interaction of the CFC Group Election in Proposed § 1.163(j)–7 With the CFC Group Election in the 2018 Proposed Regulations

The CFC group election can be made only in accordance with the method prescribed in proposed § 1.163(j)–7(e)(5). The 2018 Proposed Regulations also contained an election called a ''CFC group election'' (old CFC group election). The old CFC group election is a different election than the CFC group election contained in Proposed § 1.163(j)–7. Accordingly, the old CFC group election may be relied on only for taxable years in which the taxpayer relies on the 2018 Proposed Regulations. Whether an old CFC group election was made under the 2018 Proposed Regulations has no effect on whether a CFC group election under proposed § 1.163(j)–7(e)(5) is in effect for any taxable year in which the taxpayer relies on Proposed § 1.163(j)–7.

5. Exclusion of ECI From Application of Section 163(j) to a CFC Group

In response to comments, proposed § 1.163(j)–7 provides that an applicable CFC with ECI is not precluded from being a CFC group member. However, under proposed § 1.163(j)–7(f), only the ATI, BII, BIE, and floor plan financing of the applicable CFC that are not attributable to ECI are included in the CFC group's section 163(j) calculations. The ECI items of the applicable CFC are not included in the CFC group calculations. Instead, the ECI of the applicable CFC is treated as income of a separate CFC, an ''ECI deemed corporation,'' that has the same taxable year and shareholders as the applicable CFC, but that is not a CFC group member. The ECI deemed corporation must do a separate section 163(j) calculation for its ECI in accordance with Proposed § 1.163(j)–8. See Proposed § 1.163(j)–8 and part VI of this Explanation of Provisions section for rules applicable to foreign corporations with ECI.

6. Treatment of Foreign Taxes for Purposes of Computing ATI

Proposed § 1.163(j)–7(g)(3) provides that, for purposes of computing its ATI, tentative taxable income of a relevant foreign corporation is determined by taking into account a deduction for

sold by the specified group on December 15, Year 2).

foreign taxes. This rule is consistent with § 1.952–2, which provides that the taxable income of a foreign corporation for any taxable year is determined by treating the foreign corporation as a domestic corporation, and section 164(a), which allows a deduction for foreign taxes. The Treasury Department and the IRS request comments regarding whether, and the extent to which, the ATI of a relevant foreign corporation should be determined by adding to tentative taxable income any deductions for foreign income taxes.

7. Anti-Abuse Rule

The Treasury Department and the IRS are concerned that, in certain situations, U.S. shareholders may inappropriately affirmatively plan to limit BIE deductions as part of a tax-planning transaction, including by not making a CFC group election for purposes of increasing the disallowed BIE of a specified group member or of a partnership substantially owned by specified group members of the same specified group. For example, in a taxable year in which a U.S. shareholder would otherwise have foreign tax credits in the section 951A category in excess of the section 904 limitation, a U.S. shareholder might inappropriately cause one specified group member to pay interest to another specified group member in an amount in excess of the borrowing specified group member's section 163(j) limitation. As a result, the U.S. shareholder's pro rata share of tested income of the borrowing specified group member for the taxable year would be increased without increasing the U.S. shareholder's Federal income tax because excess foreign tax credits in the section 951A category in the taxable year that cannot be carried forward to a future taxable year would offset the Federal income tax on the incremental increase in the U.S. shareholder's pro rata share of tested income, while also enabling the borrowing specified group member to generate a disallowed BIE carryforward that may be used in a subsequent taxable year.

Accordingly, under proposed § 1.163(j)–7(g)(4), if certain conditions are met, when one specified group member or applicable partnership (specified borrower) pays interest to another specified group member or applicable partnership (specified lender), and the payment is BIE to the specified borrower and income to the specified lender, then the ATI of the specified borrower is increased by the amount necessary such that the BIE of the specified borrower is not limited under section 163(j). This amount is determined by multiplying the lesser of the payment amount or the disallowed BIE (computed without regard to this ATI adjustment) by 3⅓ (or by 2, in the case of taxable years or specified taxable years with respect to a specified period for which the section 163(j) limitation is determined by reference to 50 percent of ATI). A partnership is an applicable partnership if at least 80 percent of the capital or profits interests is owned, in aggregate, by direct or direct partners that are specified group members of the same specified group. The conditions for this rule to apply are as follows: (i) The BIE is incurred with a principal purpose of reducing the Federal income tax liability of a U.S. shareholder (including over multiple taxable years); (ii) the effect of the specified borrower treating the payment amount as disallowed BIE would be to reduce the Federal income tax of a U.S. shareholder; and (iii) either no CFC group election is in effect or the specified borrower is an applicable partnership.

8. The Safe-Harbor Election

Proposed § 1.163(j)–7(h) provides a safe-harbor election for stand-alone applicable CFCs and CFC groups. If the safe-harbor election is in effect for a taxable year, no portion of the BIE of the stand-alone applicable CFC or of each CFC group member, as applicable, is disallowed under the section 163(j) limitation. The safe-harbor election is an annual election. If the election is made, then no portion of any CFC excess taxable income is included in a U.S. shareholder's ATI. See proposed § 1.163(j)–7(j)(2)(iv).

The safe-harbor election cannot be made with respect to any foreign corporation that is not a stand-alone applicable CFC or a CFC group member. As a result, if a CFC group election is not in effect for a specified period, a specified group member of the specified group is not eligible for the safe-harbor election.

In the case of a stand-alone applicable CFC, the safe-harbor election may be made for a taxable year of the stand-alone applicable CFC if its BIE does not exceed 30 percent of the lesser of (i) its tentative taxable income attributable to non-excepted trades or businesses (referred to as ''qualified tentative taxable income''), and (ii) its ''eligible amount'' for the taxable year. In the case of a CFC group, the safe-harbor election may be made for the specified taxable years of each CFC group member with respect to a specified period if the CFC group's BIE does not exceed 30 percent of the lesser of (i) the sum of the qualified tentative taxable income of each CFC group member, and (ii) the sum of the eligible amounts of each CFC group member. For taxable years of a stand-alone applicable CFC or specified periods of a CFC group beginning in 2019 or 2020, the 30 percent limitation is replaced with a 50 percent limitation, consistent with the change in the section 163(j) limitation to take into account 50 percent, rather than 30 percent, of ATI for such taxable years or specified periods.

The ''eligible amount'' is a CFC-level determination. In general, the eligible amount is the sum of the applicable CFC's subpart F income plus the approximate amount of GILTI inclusions its U.S. shareholders would have were the applicable CFC wholly owned by domestic corporations that had no tested losses and that were not subject to the section 250(a)(2) limitation on the section 250(a)(1) deduction. Amounts used in the determination of the eligible amount are computed without regard to the application of section 163(j) and the section 163(j) regulations. While the eligible amount of an applicable CFC cannot be negative, qualified tentative taxable income can be negative. Thus, limiting the safe-harbor to 30 percent of qualified tentative taxable income ensures that losses of a stand-alone applicable CFC or a CFC group are taken into account in determining whether the stand-alone applicable CFC or the CFC group qualifies for the safe-harbor.[6]

The safe-harbor election does not apply to EBIE, as described in § 1.163(j)–6(f)(2), and EBIE is not taken into account for purposes of determining whether the safe-harbor election is available for a stand-alone applicable CFC or a CFC group, until such business interest expense is treated as paid or accrued by an applicable CFC in a succeeding year (that is, until the applicable CFC is allocated excess taxable income or excess business interest income from such partnership in accordance with § 1.163(j)–6(g)(2)(i)).

The safe-harbor election is intended to reduce the compliance burden on applicable CFCs that would not have disallowed BIE if they applied the

[6] For example, assume that, before taking into account BIE, a stand-alone applicable CFC has net income of $0x, consisting of $100x of subpart F income, a $100x loss attributable to foreign oil and gas extraction income, as defined in section 907(c)(1). It also has $20x of BIE, no BII, and no floor plan financing interest expense. The ATI of the CFC is zero and the section 163(j) limitation would be zero. However, the eligible amount of the CFC is $100x. Thus, absent a rule limiting the safe harbor to 30 percent of qualified tentative taxable income, the CFC would be permitted to deduct its $20x of business interest expense under the safe harbor, even though none of the BIE would be deductible under the section 163(j) limitation.

section 163(j) calculation. However, the Treasury Department and the IRS are concerned that the safe-harbor election might be used to deduct pre-group disallowed BIE carryforwards that would be limited under proposed § 1.163(j)–7(c)(3)(iv) (rules similar to the consolidated SRLY rules). Accordingly, the proposed regulations provide that a safe-harbor election cannot be made for a CFC group that has pre-group disallowed BIE carryforward. The Treasury Department and the IRS request comments on whether the safe-harbor election should be available for CFC groups with pre-group disallowed BIE carryforwards and, if so, appropriate methods of preventing pre-group disallowed BIE carryforwards that would be limited under proposed § 1.163(j)–7(c)(3)(iv) from being deductible by CFC group members of CFC groups that apply the safe-harbor election.

The Treasury Department and the IRS also request comments on appropriate modifications, if any, to the safe-harbor election that would further the goal of reducing the compliance burden on stand-alone applicable CFCs and CFC groups that would not have disallowed BIE if they applied the section 163(j) limitation.

9. Increase in Adjusted Taxable Income of U.S. Shareholders

As a general matter, a U.S. shareholder does not include in its ATI any portion of its specified deemed inclusions. Specified deemed inclusions include the U.S. shareholder's deemed income inclusions attributable to an applicable CFC and a non-excepted trade or business of the U.S. shareholder. See § 1.163(j)–1(b)(2)(ii)(G). Specified deemed inclusions also include amounts included in a domestic C corporation's allocable share of a domestic partnership's gross income inclusions under sections 951(a) and 951A(a) with respect to an applicable CFC that are investment income to the partnership, to the extent that such amounts are 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.[7] However, consistent with comments received, proposed § 1.163(j)–7(j) allows a U.S. shareholder to include in its ATI a portion of its specified deemed inclusions that are attributable to either a stand-alone applicable CFC or a CFC group member, except to the extent attributable to section 78 "gross-up" inclusions. That portion is equal to the ratio of the applicable CFC's CFC excess taxable income over its ATI.

In the case of a stand-alone applicable CFC, CFC excess taxable income is equal to an amount that bears the same ratio to the applicable CFC's ATI as (i) the excess of 30 percent of the applicable CFC's ATI over the amount, if any, by which its BIE exceeds its BII and floor plan financing interest expense, bears to (ii) 30 percent of its ATI. In the case of a CFC group, each applicable CFC's CFC excess taxable income is determined by calculating the excess taxable income of the CFC group and allocating it to each CFC group member pro rata on the basis of the CFC group member's ATI. For any taxable year or specified period to which the 50 percent (rather than 30 percent) limitation applies under section 163(j)(10), the formula for calculating CFC excess taxable income is adjusted accordingly.

The Treasury Department and the IRS are concerned that taxpayers may inappropriately attempt to aggregate debt in certain specified group members for which a CFC group election is not in effect, thereby overleveraging some specified group members and artificially creating CFC excess taxable income in other specified group members for purposes of increasing the ATI of a U.S. shareholder.[8] Accordingly, the Treasury Department and the IRS have determined that any excess taxable income of a specified group member should not become available to increase the ATI of a U.S. shareholder unless a CFC group election is in effect and the CFC group has not exceeded its section 163(j) limitation. Accordingly, under proposed § 1.163(j)–7(j)(4)(ii), only U.S. shareholders of stand-alone applicable CFCs and CFC group members can increase their ATI for a portion of their specified deemed inclusion. To the extent that a CFC group election is not in effect, a U.S. shareholder may not increase its ATI for any portion of its specified deemed inclusion attributable to a specified group member of the specified group.

In addition, if a safe-harbor election is in effect with respect to the taxable year of a stand-alone applicable CFC or the specified period of a CFC group, CFC excess taxable income is not calculated for the stand-alone applicable CFC or the CFC group members. As a result, proposed § 1.163(j)–7(j)(4)(i) provides that a U.S. shareholder of a stand-alone applicable CFC or of a CFC group member for which the safe-harbor election is in effect does not increase its ATI for any portion of its specified deemed inclusion attributable to the stand-alone applicable CFC or CFC group member.

VI. Section 1.163(j)–8: Application of the Business Interest Deduction Limitation to Foreign Persons With Effectively Connected Income

A. Proposed § 1.163(j)–8 Contained in the 2018 Proposed Regulations

The 2018 Proposed Regulations under § 1.163(j)–8 provide rules for how section 163(j) applies to a nonresident alien individual or foreign corporation that is not an applicable CFC (specified foreign person) with ECI. Although the regulations under section 163(j) generally apply to specified foreign persons, a number of the general rules under section 163(j) need to be adjusted to take into account the fact that a specified foreign person is taxed only on its ECI rather than all of its income. Accordingly, the definitions for ATI, BIE, BII, and floor plan financing interest expense are modified to limit such amounts to items that are, or are allocable to, ECI. The 2018 Proposed Regulations also modify § 1.163(j)–10(c) to provide that a specified foreign person's interest expense and interest income are only allocable to excepted or non-excepted trades or businesses that have ECI.

Under the 2018 Proposed Regulations, a specified foreign person that is a partner in a partnership that has ECI (specified foreign partner) is required to modify the application of the general allocation rules in § 1.163(j)–6 with respect to ETI, EBIE, and EBII of the

[7] The Treasury Department and the IRS anticipate that a domestic partnership's gross income inclusions under sections 951(a) and 951A(a) will virtually always be investment income to the partnership. See section 163(j)(5), excluding "investment interest" subject to section 163(d) from the definition of business interest, and sections 163(d)(3)(A) and (d)(5), treating as investment interest any interest properly allocable to "property which produces income of a type described in section 469(e)(1)." See also § 1.469–2T(c)(3).

[8] For example, assume a U.S. shareholder wholly owns CFC1, which wholly owns CFC2. CFC1 and CFC2 each have $100x of ATI and no business interest income or floor plan financing interest expense. CFC1 and CFC2 have not made a CFC group election. If CFC1 and CFC2 each have $35x of business interest expense, under section 163(j), CFC1 and CFC2 could each deduct $30x of business interest expense and have a $5x disallowed business interest expense carryforward. Neither CFC1 nor CFC2 would have CFC excess taxable income. As a result, the U.S. shareholder would have no ATI inclusion from CFC1 or CFC2. However, if the CFCs move all of CFC2's debt to CFC1, CFC1 would deduct $30x of business interest expense and have a $40x disallowed business interest expense carryforward. Absent rules providing otherwise, CFC2 would have $100x of CFC excess taxable income and $100x of ATI, allowing the U.S. shareholder to include in its ATI its CFC income inclusion attributable to CFC2 (to the extent attributable to a non-excepted trade or business and not attributable to section 78 "gross-up" inclusions).

partnership to take into account only the partnership's items that are, or are allocable to, ECI. Although the section 163(j) limitation is determined on an entity basis by a partnership, the Treasury Department and the IRS determined that excess items of a partnership should only be used by the specified foreign partner to the extent that the excess items arise from partnership items that are ECI with respect to the specified foreign partner. The amount of ETI and EBIE to be used by a specified foreign partner was determined by multiplying the amount of the ETI or the EBIE allocated under § 1.163(j)–6 to the specified foreign partner by a fraction, the numerator of which is the ATI of the partnership, with the adjustments described previously to limit such amount to only items that are ECI, and the denominator of which is the ATI of the partnership determined under § 1.163(j)–6(d). The amount of EBII that could be used by a specified foreign partner was limited to the amount of allocable BII that is ECI from the partnership that exceeds allocable BIE that is allocable to income that is ECI from the partnership.

Lastly, the 2018 Proposed Regulations provide that an applicable CFC that has ECI must first apply the general rules of section 163(j) and the section 163(j) regulations to determine how section 163(j) applies to the applicable CFC. If the applicable CFC has disallowed BIE, the applicable CFC then must apportion a part of its disallowed BIE to BIE allocable to income that is ECI. The amount of disallowed BIE allocable to income that is ECI is equal to the disallowed BIE multiplied by a fraction, the numerator of which is the applicable CFC's ECI ATI, and the denominator of which is the CFC's ATI.

No comments were received on the 2018 Proposed Regulations under § 1.163(j)–8. Nonetheless, the Treasury Department and the IRS have become aware of certain distortions that can result under the 2018 Proposed Regulations. Accordingly, proposed § 1.163(j)–8 has been revised, and re-proposed, to alleviate these distortions and to provide additional guidance and clarity on the manner in which these rules apply to specified foreign partners and CFCs with ECI.

B. Proposed § 1.163(j)–8 in the Proposed Regulations

Proposed § 1.163(j)–8 in the Proposed Regulations (Proposed § 1.163(j)–8) provides rules concerning the application of section 163(j) to foreign persons with ECI.[9] Similar to proposed § 1.163(j)–8(b) in the 2018 Proposed Regulations, proposed § 1.163(j)–8(b)(1)–(5) provides that, for purposes of applying section 163(j) and the section 163(j) regulations to a specified foreign person, certain definitions (ATI, BIE, BII, and floor plan financing interest expense) are modified to take into account only ECI items. Additionally, proposed § 1.163(j)–8(b)(6) provides that, for purposes of applying § 1.163(j)–10(c) to a specified foreign person, only ECI items and assets that are U.S. assets are taken into account in determining the amount of interest income and interest expense allocable to a trade or business.

Proposed § 1.163(j)–8(c) determines the portion of a specified foreign partner's allocable share of ETI, EBIE, and EBII (as determined under § 1.163(j)–6) that is treated as ECI and the portion that is not treated as ECI. The portion of the specified foreign partner's allocable share of ETI that is ECI is equal to its allocable share of ETI multiplied by a fraction, the specified ATI ratio (which compares the specified foreign partner's distributive share of the partnership's ECI to its distributive share of the partnership's total income). The remainder of the specified foreign partner's allocable share of ETI is not ECI. See proposed § 1.163(j)–8(c)(1). Similar to ETI, the portion of the specified foreign partner's allocable share of EBII that is ECI is equal to its allocable share of EBII multiplied by a fraction, the specified BII ratio (which compares the specified foreign partner's allocable share of BII that is ECI to its allocable share of total BII). See proposed § 1.163(j)–8(c)(4).

The portion of the specified foreign partner's allocable share of EBIE that is ECI is determined by subtracting the portion of the specified foreign partner's allocable share of deductible BIE that is characterized as ECI from the amount of the specified foreign partner's allocable share of BIE that is characterized as ECI. See proposed § 1.163(j)–8(c)(2). A similar rule applies for purposes of determining the portion of EBIE that is not ECI. A specified foreign partner's allocable share of deductible BIE that is characterized as ECI or not ECI is determined by allocating the deductible BIE pro rata between the respective amounts of deductible BIE that the specified foreign partner would have if the specified foreign partner's allocable share of the ECI items of the partnership and the non-ECI items of the partnership were treated as separate partnerships and a 163(j) limitation was applied to each hypothetical partnership. However, no more deductible BIE can be characterized as ECI or not ECI than the specified foreign partner's allocable share of BIE that is ECI or the specified foreign partner's allocable share of BIE that is not ECI, respectively. Any deductible BIE in excess of the hypothetical partnership limitations is characterized as ECI or not ECI pro rata in proportion to the remaining amounts of the specified foreign partner's allocable share of BIE that is ECI and not ECI.

Proposed § 1.163(j)–8(d) determines the portion of deductible and disallowed BIE of a relevant foreign corporation (as defined in § 1.163(j)–1(b)(33)) that is characterized as ECI or not ECI. These rules are similar to the rules in proposed § 1.163(j)–8(c) for characterizing a specified foreign partner's allocable share of excess items of a partnership as ECI or not ECI in that they calculate the hypothetical section 163(j) limitation for two hypothetical foreign corporations—a foreign corporation with ECI and a foreign corporation with non-ECI—and allocate the deductible BIE between the two hypothetical limitations. The portion of the relevant foreign corporation's disallowed BIE that is ECI is determined by subtracting the portion of the relevant foreign corporation's deductible BIE that is characterized as ECI from the relevant foreign corporation's BIE that is ECI. A similar rule applies for purposes of determining the portion of disallowed BIE that is characterized as not ECI.

Proposed § 1.163(j)–8(e) provides rules regarding disallowed BIE. These rules provide that disallowed BIE is characterized as ECI or not ECI in the year in which it arises and retains its characterization in subsequent years. Additionally, an ordering rule determines the EBIE that is treated as paid or accrued by a specified foreign partner in a subsequent year. Specifically, the specified foreign partner's allocable share of EBIE is treated as paid or accrued by the specified foreign partner in a subsequent year pursuant to § 1.163(j)–6(g)(2)(i) in the order of the taxable years in which the allocable EBIE arose and pro rata between the specified foreign partner's allocable share of EBIE that is ECI and not ECI that arose in the same taxable year.

Proposed § 1.163(j)–8(e)(2) provides that, for purposes of characterizing deductible BIE and EBIE as ECI or not ECI, a specified foreign partner's BIE is

[9] For purposes of Proposed § 1.163(j)–8, the term *effectively connected income* (or *ECI*) means income or gain that is ECI, as defined in § 1.884–1(d)(1)(iii), and deduction or loss that is allocable to, ECI, as defined in § 1.884–1(d)(1)(iii).

deemed to include its allocable share of EBIE of partnerships in which it is a direct or indirect partner. As a result, EBIE of both top-tier partnerships and lower-tier partnerships is characterized as ECI or not ECI in the year in which it arises, even if it is not included in the specified foreign partner's allocable share of EBIE.

Proposed § 1.163(j)–8(f) provides rules coordinating the application of section 163(j) with § 1.882–5 and similar rules and with the branch profits tax. Proposed § 1.163(j)–8(f)(1)(i) provides that a foreign corporation first determines its interest expense on liabilities that are allocable to ECI under § 1.882–5 before applying section 163(j). Similarly, interest expense, as defined in § 1.163(j)–1(b)(23), that is not allocable to ECI under § 1.882–5 must be allocable to income that is ECI under the regulations under section 861 before section 163(j) is applied.

Proposed § 1.163(j)–8(f)(1)(ii) provides rules for determining the portion of a specified foreign partner's BIE that is ECI, as determined under § 1.882–5(b) through (d) or § 1.882–5(e) (§ 1.882–5 interest expense), that is treated as attributable to a partner's allocable share of interest expense of a partnership. As a general matter, the determination as to whether a partnership's items of income and expense are allocable to ECI is made by the partnership. However, the determination as to the amount of interest expense that is allocable to ECI is made by a partner, not the partnership. Because section 163(j) applies separately to partnerships and their partners, a determination must be made as to the source of § 1.882–5 interest expense. If the BIE is attributable to BIE of the partnership, it is subject to the rules of §§ 1.163(j)–6 and 1.163(j)–8(c).

The § 1.882–5 interest expense is first treated as attributable to interest expense on U.S. booked liabilities, determined under § 1.882–5(d)(2)(vii), of the partner or a partnership. Any remaining § 1.882–5 interest expense (excess § 1.882–5 interest expense) is treated as attributable to interest expense on liabilities of the partner in proportion to its U.S. assets (other than partnership interests) over all of its U.S. assets, and as attributable to interest expense on liabilities of the partner's direct or indirect partnership interests in proportion to the portion of the partnership interest that is a U.S. asset over all of the partner's U.S. assets. The total amount of § 1.882–5 interest expense attributed to the partner or a partnership (taking into account both interest expense on U.S. booked liabilities and excess § 1.882–5 interest expense) and interest expense on a liability described in § 1.882–5(a)(1)(ii)(A) or (B) (direct allocations) may never exceed the amount of the partner's interest expense on liabilities or the partner's allocable share of the partnership's interest expense on liabilities (the interest expense limitation). The interest expense limitation prevents more § 1.882–5 interest expense from being attributed to the partner or the partner's allocable share of interest expense of a partnership than the actual amount of such interest expense. Any excess § 1.882–5 interest expense that would have been attributed to the partner or a partnership, but for the interest expense limitation, is re-attributed in accordance with these attribution rules.

When excess § 1.882–5 interest expense has been attributed to all of the interest expense on liabilities of the foreign corporation and its allocable share of partnership interests that have U.S. assets, the remaining excess § 1.882–5 interest expense, if any, is first attributed to interest expense on liabilities of the foreign corporation (but not in excess of the interest expense limitation), and then, pro rata, to its allocable share of interest expense on liabilities of its partnership interests that do not have U.S. assets, subject to the interest expense limitation. See proposed § 1.163(j)–8(f)(1)(iii). These rules merely characterize interest expense of the foreign corporation and its partnership interests as ECI or not ECI. These rules do not change the amount of interest expense of the foreign corporation or its partnership interests.

The rule in proposed § 1.163(j)–8(f)(1) of 2018 Proposed Regulations providing that the disallowance and carryforwards of BIE does not affect effectively connected earnings and profits of a foreign corporation is not retained in Proposed § 1.163(j)–8. This rule is not necessary in Proposed § 1.163(j)–8 because the general rule regarding the effect of section 163(j) on earnings and profits in § 1.163(j)–4(c)(1) applies to effectively connected earnings and profits.

VII. Proposed § 1.469–9: Definition of Real Property Trade or Business

Section 469(c)(7)(C) defines real property trade or business by reference to eleven undefined terms. The Final Regulations amended § 1.469–9 to define two of the eleven terms—management and operations. In response to questions received about the application of section 469(c)(7)(C) to timberlands, these proposed regulations would provide definitions for two additional terms—development and redevelopment—to further clarify what constitutes a real property trade or business.

The Treasury Department and IRS have determined that real property development and redevelopment trades or businesses should be defined to include business activities that involve the preservation, maintenance, and improvement of forest-covered areas (timberland). Congress most likely intended and expected that such business activities would be excepted from section 163(j), through election, similar to other real property and farming businesses. However, because timber is specifically excluded from the definition of farming under other Code provisions (such as section 464(e)), the Treasury Department and IRS have determined that such business activities are more properly described by and should be included in the definition of real property trade or business for this purpose. These proposed regulations would clarify that ''real property development'' is the maintenance and improvement of raw land to make the land suitable for subdivision, further development, or construction of residential or commercial buildings, or to establish, cultivate, maintain or improve timberlands (generally defined as parcels of land covered by forest). Similarly, these proposed regulations would clarify that ''real property redevelopment'' is the demolition, deconstruction, separation, and removal of existing buildings, landscaping, and infrastructure on a parcel of land to return the land to a raw condition or otherwise prepare the land for new development or construction, or for the establishment and cultivation of new timberlands.

VIII. Proposed § 1.163(j)–2 and § 1.1256(e)–2: Section 1256 and Determination of Tax Shelter Status; Election To Use 2019 ATI To Determine 2020 Section 163(j) Limitation

A. Section 1256 and Determination of Tax Shelter Status

Several commenters raised questions regarding the exclusion of ''a tax shelter that is not permitted to use a cash method of accounting'' from the small business exemption provided in section 163(j)(3). Section 448 and § 1.448–1T describe limitations on the use of the cash method of accounting, including an explicit prohibition on the use of the cash method of accounting by 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 part, as a syndicate within the meaning of section 1256(e)(3)(B). Under § 1.448–1T(b)(3), a syndicate is defined as an entity that is not a C corporation if more than 35 percent of the losses of such entity during the taxable year are *allocated* to limited partners or limited entrepreneurs. Section 1256(e)(3)(B) refers instead 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. To provide clarity, and to make these rules consistent, the Treasury Department and the IRS would define the term syndicate for purposes of section 1256 using the actual allocation rule from the definition in § 1.448–1T(b)(3). This proposed definition is also consistent with the definition of a syndicate used in a number of private letter rulings that were issued under section 1256. See proposed § 1.1256(e)–2(a).

One commenter asked for clarification on how to compute the amount of losses to be allocated for purposes of determining syndicate status under section 1256(e)(3)(A). The commenter provided a particular fact pattern in which a small business would be caught in an iterative loop of (a) having net losses due to an interest deduction, (b) which would trigger disallowance of the exemption in section 163(j)(3), (c) which would trigger the application of section 163(j)(1) 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 section 163(j)(3). To address this fact pattern, the Treasury Department and the IRS have added rules providing that, for purposes of section 1256(e)(3)(B), losses are determined without regard to section 163(j). See proposed §§ 1.163(j)–2(d)(3) and 1.1256(e)–2(b).

Several commenters requested that the exemption in section 163(j)(3) be broadened to apply to all small businesses without regard to the parenthetical that denies the section 163(j)(3) exemption for a small business that is ''a tax shelter that is not permitted to use a cash method of accounting.'' See section 163(j)(3). One commenter specifically requested that, for a small business meeting the gross receipts test in section 448(c), all interests held by limited partners or limited entrepreneurs be treated as held by owners actively managing the business even if those interests would not qualify for the active management exception under section 1256(e)(3)(C). After considering the comments, the Treasury Department and the IRS have determined that the requests are contrary to both the statutory language in section 163(j)(3) and the accompanying legislative history and therefore decline to adopt the comments.

B. Election To Use 2019 ATI To Determine 2020 Section 163(j) Limitation

As stated in the Background section of this preamble, section 163(j)(10)(B)(i) allows a taxpayer to elect to use its 2019 ATI in determining the taxpayer's section 163(j) limitation for its taxable year beginning in 2020. Section 1.163(j)–2(b)(3) and (4) of the Final Regulations provide general rules regarding this election.

These proposed regulations clarify that, if the acquiring corporation in a transaction to which section 381 applies makes an election under section 163(j)(10)(B)(i), the acquiring corporation's 2019 ATI for purposes of section 163(j)(10)(B)(i) is its ATI for its last taxable year beginning in 2019 (subject to the limitation for short taxable years in section 163(j)(10)(B)(ii)). For example, assume that T's 2019 ATI is $100 and A's 2019 ATI is $200. If T merges into A during A's 2020 taxable year in a transaction described in section 368(a)(1)(A), and if A makes an election under section 163(j)(10)(B)(i), A's 2019 ATI for purposes of this election is $200. Similarly, these proposed regulations clarify that a consolidated group's 2019 ATI for purposes of section 163(j)(10)(B)(i) is the consolidated group's ATI for its last taxable year beginning in 2019 (subject to the limitation in section 163(j)(10)(B)(ii)). The Treasury Department and the IRS request comments on these proposed rules. The Treasury Department and the IRS also request comments on (1) whether the 2019 ATI of an acquired corporation in a transaction to which section 381 applies should be included in the acquiring corporation's 2019 ATI for purposes of section 163(j)(10)(B)(i) and (2) how such a rule would address more complex fact patterns, such as situations where the acquiring corporation is acquired in a subsequent transaction described in section 381, or where the acquired corporation and the acquiring corporation have different tax years.

IX. Proposed § 1.163(j)–10: Application of Corporate Look-Through Rules to Tiered Structures

For purposes of determining the extent to which a shareholder's basis in the stock of a domestic non-consolidated C corporation or CFC is allocable to an excepted or non-excepted trade or business, § 1.163(j)–10(c)(5)(ii)(B) provides several look-through rules whereby the shareholder ''looks through'' to the corporation's basis in its assets.

A commenter pointed out that the application of these look-through rules may produce distortive results in certain situations. For example, assume Corporation X's basis in its assets is split equally between X's excepted and non-excepted trades or businesses, and that (as a result) X has a 50 percent exempt percentage applied to its interest expense. However, rather than operate its excepted trade or business directly, X operates its excepted trade or business through a wholly owned, non-consolidated subsidiary (Corporation Y), and each of X and Y borrows funds from external lenders. Assuming for purposes of this example that neither the anti-avoidance rule in § 1.163(j)–2(h) nor the anti-abuse rule in § 1.163(j)–10(c)(8) applies, Y's interest expense would not be subject to the section 163(j) limitation because Y is engaged solely in an excepted trade or business. Moreover, a portion of X's interest expense also would be allocable to an excepted trade or business by virtue of the application of the look-through rule in proposed § 1.163(j)–10(c)(5)(ii)(B)(2) to X's basis in Y's stock.

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 the foregoing result in certain circumstances. However, these proposed regulations would modify the look-through rule for domestic non-consolidated C corporations and CFCs to limit the potentially distortive effect of this look-through rule on tiered structures in situations to which the anti-avoidance and anti-abuse rules do not apply. More specifically, these proposed regulations would modify the look-through rule for non-consolidated C corporations to provide that, for purposes of determining a taxpayer's basis in its assets used in excepted and non-excepted trades or businesses, any such corporation whose stock is being looked through may not itself apply the look-through rule.

For example, P wholly and directly owns S1, which wholly and directly owns S2. Each of these entities is a non-consolidated C corporation to which the small business exemption does not apply. In determining the extent to which its interest expense is subject to the section 163(j) limitation, S1 may look through the stock of S2 for purposes of allocating S1's basis in its S2 stock between excepted and non-excepted trades or businesses. However, in determining the extent to which P's interest expense is subject to the section 163(j) limitation, S1 may not look through the stock of S2 for purposes of allocating P's basis in its S1 stock between excepted and non-excepted trades or businesses.

However, the Treasury Department and the IRS are aware that taxpayers are organized into multi-tiered structures for legitimate, non-tax reasons. The Treasury Department and the IRS request comments on the proposed limitation on the application of the corporate look-through rules. The Treasury Department and the IRS also request comments on whether there are other situations in which the look-through rules for domestic non-consolidated C corporations or CFCs should apply and whether there are other approaches for addressing the distortions that these proposed rules are intended to minimize.

Proposed Applicability Dates

These Proposed Regulations are proposed to apply to taxable years beginning on or after 60 days after the date the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**.

Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may rely on § 1.163–14, § 1.163–15, § 1.163(j)–2(d)(3), or § 1.1256(e)–2 of these Proposed Regulations for a taxable year beginning after December 31, 2017, and before 60 days after the date the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**, provided taxpayers and their related parties consistently follow all of the rules of the relevant section of the Proposed Regulations for that taxable year and for each subsequent taxable year. Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply § 1.163–14, 1.163–15, 1.163(j)–2(d)(3), or 1.1256(e)–2 of the final version of these Proposed Regulations for a taxable year beginning after December 31, 2017, and before 60 days after the date the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**, provided that taxpayers and their related parties consistently apply all of the rules of the relevant section, as applicable, to that taxable year and each subsequent taxable year. See also §§ 1.163–14(i), 1.163–15(b), 1.163(j)–2(k)(2), and 1.1256(e)–2(d) of these Proposed Regulations.

Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), who apply the Final Regulations (as defined in the Explanation of Provisions) published elsewhere in this issue of the **Federal Register** to a taxable year beginning after December 31, 2017, and before 60 days after the Treasury Decision adopting these rules as final regulations is published in the **Federal Register** may rely on §§ 1.163(j)–1(b)(1)(iv)(B) and 1.163(j)–1(b)(1)(iv)(E) of these Proposed Regulations for a taxable year beginning after December 31, 2017, and before 60 days after the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**, provided that taxpayers and their related parties consistently apply the rules of both §§ 1.163(j)–1(b)(1)(iv)(B) and 1.163(j)–1(b)(1)(iv)(E) of these Proposed 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 and each subsequent taxable year See also § 1.163(j)–1(c)(4)(i) of these Proposed Regulations.

Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), who apply the Final Regulations published elsewhere in this issue of the **Federal Register** to a taxable year beginning after December 31, 2017, and before 60 days after the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**, may rely on the rules in § 1.163(j)–2(b)(3)(iii) and (iv) of these Proposed Regulations for such taxable year, provided that taxpayers and their related parties consistently follow the rules of both § 1.163(j)–2(b)(3)(iii) and (iv) for that taxable year and for each subsequent taxable year beginning before 60 days after the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**. Taxpayers not applying the Final Regulations to taxable years beginning before November 13, 2020 may not rely on the rules in § 1.163(j)–2(b)(3)(iii) and (iv) of these Proposed Regulations for those taxable years. See also § 1.163(j)–2(k)(2) of these Proposed Regulations.

Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), who apply the Final Regulations published elsewhere in this issue of the **Federal Register** to a taxable year beginning after December 31, 2017, and before 60 days after the Treasury Decision adopting these rules as final regulations is published in the **Federal Register** may rely on the rules in § 1.163(j)–10(c)(5)(ii)(D)(2), 1.469–4(d)(6), or 1.469–9(b)(2) of these Proposed Regulations for a taxable year beginning after December 31, 2017, and before 60 days after the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**, provided that taxpayers and their related parties consistently follow the rules of § 1.163(j)–10(c)(5)(ii)(D)(2), 1.469–4(d)(6), or 1.469–9(b)(2) of these Proposed Regulations, as applicable, 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, 1.469–4, 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, for that taxable year and for each subsequent taxable year. See also §§ 1.163(j)–10(f)(2) and 1.469–11(a)(1) and (4) of these Proposed Regulations.

Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may rely on the rules in § 1.163(j)–6 of these Proposed Regulations for a taxable year beginning after December 31, 2017, and before 60 days after the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**, provided that taxpayers and their related parties also apply the rules of § 1.163(j)–6 in the Final Regulations and consistently follow all of those rules for that taxable year and for each subsequent taxable year. See also § 1.163(j)–6(p)(2) of these Proposed Regulations.

Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), who apply the Final Regulations published elsewhere in this issue of the **Federal Register** to a taxable year beginning after December 31, 2017, and before 60 days after the date the Final Regulations are published in the **Federal Register**, may rely on §§ 1.163(j)–7 and 1.163(j)–8 of these Proposed Regulations for that taxable year, provided the taxpayers and their related parties also rely on §§ 1.163(j)–7 and 1.163(j)–8 of these Proposed Regulations and apply the Final Regulations for each subsequent taxable year. Taxpayers who choose not to apply the Final Regulations to a taxable year beginning after December 31, 2017, and before 60 days after the date the Final Regulations are published in the **Federal Register** may not rely on either § 1.163(j)–7 or 1.163(j)–8 of these Proposed Regulations for that taxable year. For any taxable year beginning on or after 60 days after the date the Final Regulations are published in the

Federal Register and before 60 days after the date the Treasury Decision adopting these Proposed Regulations as final regulations is published in the **Federal Register**, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may rely on §§ 1.163(j)–7 and 1.163(j)–8 of these Proposed Regulations provided they consistently follow all of the rules of §§ 1.163(j)–7 and 1.163(j)–8 for such taxable year and for each subsequent taxable year beginning before 60 days after the Treasury Decision adopting these Proposed Regulations as final regulations is published in the **Federal Register**. See also §§ 1.163(j)–7(m) and 1.163(j)–8(j) of these Proposed Regulations. Taxpayers and their related parties who rely on § 1.163(j)–7 of these Proposed Regulations for any taxable year ending before November 13, 2020 can make a CFC group election or a safe-harbor election even if the deadline provided in § 1.163(j)–7(e)(5)(iii) or (h)(5)(i) of these Proposed Regulations has passed. Such taxpayers and their related parties are permitted to make the election on an amended Federal income tax return filed on or before the due date (taking into account extensions, if any) of the original Federal income tax return for the first taxable year ending after November 13, 2020.

See part III.B of the Explanation of Provisions for rules concerning reliance on these Proposed Regulations with respect to section 163(j) interest dividends.

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, reducing costs, harmonizing rules, and promoting flexibility. The Executive Order 13771 designation for any final rule resulting from these proposed regulations will be informed by comments received. The preliminary Executive Order 13771 designation for this proposed rule is regulatory.

These proposed regulations have been designated by the Office of Information and Regulatory Affairs as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. OMB has designated the proposed regulations as economically significant under section 1(c) of the MOA. Accordingly, the proposed regulations have been reviewed by OMB's Office of Information and Regulatory Affairs.

A. Background and Need for These Proposed Regulations

Section 163(j), substantially revised by the Tax Cuts and Jobs Act (TCJA), provides a set of relatively complex statutory rules that impose a limitation on the amount of business interest expense that a taxpayer may deduct for Federal tax purposes. This limitation does not apply to businesses with gross receipts of $25 million or less (inflation adjusted). This provision has the general effect of putting debt-financed investment by businesses on a more equal footing with equity-financed investment, a treatment that Congress believed will lead to a more efficient capital structure for firms. See Senate Budget Explanation of the Bill as Passed by SFC (2017–11–20) at pp. 163–4.

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 adjusted taxable income (ATI) limitation for taxable years beginning in 2019 or 2020.

Because this limitation on deduction for business interest expense is new, taxpayers would benefit from regulations that explain key terms and calculations. The Treasury Department and the IRS published proposed regulations in December 2018 (2018 Proposed Regulations) and are issuing final regulations simultaneously with the current proposed regulations. This current set of proposed regulations covers topics that were reserved in the 2018 Proposed Regulations, were raised by commenters to the proposed regulations, or need to be re-proposed.

B. Overview of the Proposed Regulations

The proposed regulations provide guidance on the definition of interest as it relates to income flowing through regulated investment companies (RICs); debt-financed distributions from pass-through entities; the treatment of business interest expense for publicly traded partnerships and trading partnerships [10]; the application of the section 163(j) limitation in the context of self-charged interest; and the treatment of excess business interest expense in tiered-partnership structures. The proposed regulations also modify the definition of real property development and real property redevelopment in section 1.469–9 of the regulations and the definition of syndicate for purposes of applying the small business exception in section 163(j)(3). The proposed regulations also re-propose rules regarding the application of the interest limitation to foreign corporations (including controlled foreign corporations as defined in section 957(a)) and United States shareholders of controlled foreign corporations, and the applicability of the section 163(j) limitation to foreign persons with U.S. effectively connected income.

C. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of these proposed regulations relative to a no-action baseline that reflects anticipated Federal income tax-related behavior in the absence of these regulations.

2. Summary of Economic Effects

The proposed 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 proposed regulations provide value by helping to ensure that those interpretations are consistent with the intent and purpose of the statute. For example, the proposed regulations may specify a tax treatment that few or no taxpayers would adopt in the absence of specific guidance.

The Treasury Department and the IRS project that the proposed regulations

[10] A trading partnership is a partnership engaged in the per se non-passive activity of trading personal property (including market securities) for the account of owners of interests in the activity, as described in section 1.469–1T(e)(6) (trading partnerships).

will have an annual economic effect greater than $100 million ($2019). This determination is based on the substantial volume of business interest payments in the economy [11] and the general responsiveness of business investment to effective tax rates,[12] 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 proposed 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 section 163(j) guidance that is promulgated following major legislation, such as TCJA, and for other major guidance, which we have determined includes these proposed regulations.

Regarding the nature of the economic effects, the Treasury Department and the IRS project that the proposed regulations will increase investment in the United States and increase the proportion that is debt-financed, relative to the no-action baseline. We have further determined that these effects are consistent with the intent and purpose of the statute. Because taxpayer favorable provisions will lead to a decrease in Federal tax revenue relative to the no-action baseline, there may be an increase in the Federal deficit relative to the no-action baseline. This may lead to a decrease in investment by taxpayers not directly affected by these proposed regulations, relative to the no-action baseline. This effect should be weighed against the enhanced efficiency arising from the clarity and enhanced consistency with the intent and purpose of the statute provided by these regulations. The Treasury Department and the IRS have determined that the proposed regulations provide a net benefit to the U.S. economy.

The Treasury Department and the IRS have not undertaken more precise quantitative estimates of these effects because many of the definitions and calculations under 163(j) are new and many of the economic decisions that are implicated by these proposed regulations involve highly specific taxpayer circumstances. We do not have readily available data or models to estimate with reasonable precision the types and volume of different financing arrangements that taxpayers might undertake under the proposed regulations versus the no-action baseline.

In the absence of such quantitative estimates, the Treasury Department and the IRS have undertaken a qualitative analysis of the economic effects of the proposed regulations relative to the no-action baseline and relative to alternative regulatory approaches. This analysis is presented in Part I.C.3 of this Special Analyses.

The Treasury Department and the IRS solicit comments on these findings and more generally on the economic effects of these proposed regulations. The Treasury Department and the IRS particularly solicit data, other evidence, or models that could be used to enhance the rigor of the process by which the final regulations might be developed.

3. Economic Effects of Specific Provisions

a. Definition of Interest

The final regulations set forth several categories of amounts and transactions that generate interest for purposes of section 163(j). The proposed regulations provide further guidance on the definition of interest relevant to the calculation of interest expense and interest income. In particular, the proposed regulations provide rules under which the dividends paid by a RIC that earns net business interest income (referred to as section 163(j) interest dividends) are to be treated as interest income by the RIC's shareholders. That is, under the proposed regulations, certain interest income earned by the RIC and paid to a shareholder as a dividend is treated as if the shareholder earned the interest income directly for purposes of section 163(j).

To the extent that taxpayers believed, in the absence of the proposed regulations, that dividends paid by RICs are not treated as business interest income for the purposes of the section 163(j) limitation, then taxpayers will likely respond to the proposed regulations by reducing their holding of other debt instruments and increasing investment in RICs. The Treasury Department and the IRS have determined that this treatment is consistent with the intent and purpose of the statute.

Number of Affected Taxpayers. The Treasury Department and the IRS have determined that the rules regarding section 163(j) interest dividends will potentially affect approximately 10,000 RICs. The Treasury Department and the IRS do not have readily available data on the number of RIC shareholders that would receive section 163(j) interest dividends that the shareholder could treat as business interest income for purposes of the shareholder's section 163(j) limitation.

b. Provisions Related to Partnerships

i. Trading Partnerships

Section 163(j) limits the deductibility of interest expense at the partnership level. These proposed regulations address commenter concerns about the interaction between this section 163(j) limitation and the section 163(d) partner level limitation on interest expense that existed prior to TJCA. Under logic described in the preamble to the 2018 Proposed Regulations, section 163(j) limitations would apply at the partnership level while section 163(d) limitations would apply at the partner level and these tests would be applied independently. Commenters suggested and Treasury has agreed that the correct interpretation of the statute is to exempt interest expense that is limited at the partner level by section 163(d) from the partnership level section 163(j) limitation in accordance with the language of section 163(j)(5).

These proposed regulations provide that interest expense at the partnership level that is allocated to non-materially participating partners subject to section 163(d) is not included in the section 163(j) limitation calculation of the partnership. Generally, the section 163(d) limitation is more generous than the section 163(j) limitation. Relative to the 2018 Proposed Regulations, this change may encourage these partners to incur additional interest expense because they will be less likely to be limited in their ability to use it to offset other income. Commenters argued that exempting from section 163(j) any interest expense allocated to non-materially participating partners subject to section 163(d) will treat this interest expense in the same way as the interest expense generated through separately managed accounts, which are not subject to section 163(j) limitations.

The Treasury Department and the IRS project that these proposed regulations will result in additional investment in trading partnerships and generally higher levels of debt in any given trading partnership relative to the 2018 Proposed Regulations. Because investments in trading partnerships may be viewed as economically similar to investments in separately managed accounts arrangements, we further project that the proposed regulations, by making the tax treatments of these two arrangements generally similar, will

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

[12] 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.

improve U.S. economic performance relative to the no-action baseline.

Number of Affected Taxpayers. The Treasury Department and the IRS have determined that the rules regarding trading partnerships will potentially affect approximately 275,000 taxpayers. This number was reached by determining, using data for the 2017 taxable year, the number of Form 1065 and Form 1065–B filers that (1) completed Schedule B to Form 1065 and marked box b, c, or d in question 1 to denote limited partnership, limited liability company, or limited liability partnership status; and (2) have a North American Industry Classification System (NAICS) code starting with 5231 (securities and commodity contracts intermediation and brokerage), 5232 (securities and commodity exchanges), 5239 (other financial investment activities), or 5259 (other investment pools and funds).

Additionally, the Treasury Department and the IRS have determined that the rules regarding publicly traded partnerships will potentially affect approximately 80 taxpayers. This number was reached by determining, using data for the 2017 taxable year, the number of Form 1065 and 1065–B filers with gross receipts exceeding $25 million that answered ''yes'' to question 5 on Schedule B to Form 1065 denoting that the entity is a publicly traded partnership. The Treasury Department and the IRS do not have readily available data on the number of filers that are tax shelters that are potentially affected by these provisions.

ii. Debt-Financed Distributions

Prior to TCJA, partners were responsible for determining the applicability of any limitations on the use of proceeds from debt because limitations on interest expense deductibility were determined at the partner level. Under section 163(j) as amended by TCJA, the partnership is required to complete a calculation to determine its limitation on trade or business interest expense. These proposed regulations provide guidance on the method that partnerships and partners should use to allocate interest expense in cases where a partner receives a distribution financed from debt. The Treasury Department and the IRS project that this guidance will reduce taxpayer uncertainty regarding the application of section 163(j) in this situation relative to the no-action baseline.

The proposed regulations require that partnerships allocate the interest expense of the partners not receiving a debt-financed distribution first. This interest expense is allocated to trade or business expense to the extent of the partnership's expenses. The character of any remaining interest expense is determined based on the partnership's asset basis. Next, the proposed regulations allocate the interest expense of the partner receiving the debt-financed distribution. If there is any remaining business expense that was not used by the other partners it is used first to allocate the interest expense. Then the partner receiving the debt financed distribution looks to the use of the proceeds of the distribution to determine the character of any additional interest expense.

This procedure provides lower compliance costs relative to alternative regulatory approaches. Any alternative method that required information on the partner's use of the proceeds to determine the partnership level section 163(j) limitation would have increased compliance costs for partnerships and partners because it would require a new reporting from partners to partnerships. In cases of tiered partnerships, this reporting could become extremely complex. The method outlined in these proposed regulations avoids the need for partnerships and other partners to have information about the use the debt-financed distribution proceeds. However, it maintains that interest expense allocated to the partner receiving the debt-financed distribution could still be subject to other limitations besides section 163(j) based on the use of the proceeds. For example, proceeds used for personal expenditures would still be subject to section 163(h) limitations on interest expense, which may be seen as an important existing anti-abuse provision.

The proposed procedure bases the allocation rules on optional and general allocation rules outlined in a previously issued notice, Notice 89–35, which will minimize compliance costs to partnerships (relative to the no-action baseline) to the extent that they are already familiar with allocating interest expense first to the partnership's business expenses and subsequently based on assets. Relative to the no-action baseline, the Treasury Department and the IRS expect these proposed regulations will reduce taxpayer uncertainty regarding the application of section 163(j). Treasury and IRS expect that this resolution of uncertainty itself will reduce taxpayer compliance costs and encourage similarly situated taxpayers to interpret section 163(j) similarly.

Number of Affected Taxpayers. The Treasury Department and the IRS are not currently able to determine the number of taxpayers affected by rules regarding debt financed distributions because debt financed distributions are not separately identified on tax forms, and therefore using the numbers of entities reporting interest on a Form K–1, Schedule C or Schedule E would produce overly broad results.

iii. Tiered Partnerships

Section 163(j) does not explicitly address how the interest deduction limitation should be applied to tiered partnerships. The 2018 Proposed Regulations requested comments on the treatment of tiered partnership structures. Suppose that an upper-tier partnership (UTP) is a partner of a lower-tier partnership (LTP), and that the LTP has business interest expense that is limited under section 163(j). Under the 2018 Proposed Regulations, the UTP would receive an excess business interest expense (EBIE) carryforward from the LTP. In response to comments received, these proposed regulations adopt the Entity Approach and specify that this EBIE carryforward should not be allocated to the partners of the UTP for purposes of section 163(j).

While some commenters favored the Entity Approach that these proposed regulations adopt, others favored an alternative under which the EBIE carryforward would be allocated to the UTP's partners (Aggregate Approach). Additionally, if the UTP's partner were itself a partnership, the EBIE would again be allocated to that partnership's partners. This would continue until the EBIE is eventually allocated to a non-partnership partner. Relative to the Entity Approach, the Aggregate Approach generally places greater compliance burden on partners. Under the Aggregate Approach, partners would be required to keep records linking separate amounts of EBIE to the partnerships that generated them. In simple partnership structures, this is not onerous; however, in a partnership structure with many tiers and many partners, this would prove cumbersome. In contrast, under the Entity Approach, only the UTP keeps a record of the EBIE carryforward.

In summary, the Treasury Department and the IRS project lower record-keeping requirements, higher compliance rates, and easier compliance monitoring of tiered partnerships under the Entity Approach relative to the Aggregate Approach, with no meaningful difference in the economic decisions that taxpayers would make under the two approaches.

Moreover, relative to the no-action baseline, the Treasury Department and the IRS expect these proposed regulations for tiered partnerships will reduce taxpayer uncertainty regarding the application of section 163(j). Treasury and IRS expect that this resolution of uncertainty itself will reduce taxpayer compliance costs and encourage similarly situated taxpayers to interpret section 163(j) similarly.

iv. Self-Charged Lending

The 2018 Proposed Regulations requested comments on the treatment of lending transactions between a partnership and a partner (self-charged lending transactions). Suppose that a partnership receives a loan from a partner and allocates the resulting interest expense to that partner. Prior to the TCJA, the interest income and interest expense from this loan would net precisely to zero on the lending partner's tax return. Under section 163(j) as revised by TCJA, however, the partnership's interest expense deduction may now be limited. Therefore, in absence of specific regulatory guidance, the lending partner may receive interest income from the partnership accompanied by less-than-fully-offsetting interest expense. Instead, the lending partner would receive EBIE, which would not be available to offset his personal interest income. This outcome has the effect of increasing the cost of lending transactions between partners and their partnerships relative to otherwise similar financing arrangements.

To avoid this outcome, these proposed regulations treat the lending partner's interest income from the loan as excess business interest income (EBII) from the partnership, but only to the extent of the partner's share of any EBIE from the partnership for the taxable year. This allows the interest income from the loan to be offset by the EBIE. The business interest expense (BIE) of the partnership attributable to the lending transaction will thus be treated as BIE of the partnership for purposes of applying section 163(j) to the partnership.

The Treasury Department and the IRS expect that these proposed regulations will lead a higher proportion of self-charged lending transactions in partnership financing, relative to the no-action baseline. We further project that these proposed regulations will increase the proportion of partnership financing that is debt-financed relative to the no-action baseline. We have determined that these effects are consistent with the intent and purpose of the statute.

Number of Affected Taxpayers. The Treasury Department and the IRS do not have readily available data to determine the number of taxpayers affected by rules regarding self-charged interest because no reporting modules currently connect these payments by and from partnerships.

c. Provisions Related to Controlled Foreign Corporations (CFCs)

i. How To Apply Section 163(j) When CFCs Have Shared Ownership

The Final Regulations clarify that section 163(j) and the section 163(j) regulations apply to determine the deductibility of a CFC's business interest expense for tax purposes in the same manner as these provisions apply to a domestic corporation. These proposed regulations provide further rules and guidance on how section 163(j) applies to CFCs when CFCs have shared ownership and are eligible to be members of CFC groups.

The Treasury Department and the IRS considered three options with respect to the application of section 163(j) to CFC groups. The first option was to apply the 163(j) limitation to CFCs on an individual basis, regardless of whether CFCs have shared ownership. However, if section 163(j) is applied on an individual basis, business interest deductions of individual CFCs may be limited by section 163(j) even when, if calculated on a group basis, business interest deductions would not be limited. Taxpayers could restructure or ''self-help'' to mitigate the effects of the section 163(j) limitation, but that option involves economically restructuring costs for the taxpayer (relative to the third option, described subsequently) with no corresponding economically productive activity.

The second option, which was proposed in the 2018 Proposed Regulations, was to allow an election to treat related CFCs and their U.S. shareholders as a group. Under this option, while the section 163(j) rules would still be computed at the individual CFC level, the ''excess taxable income'' of a CFC could be passed up from lower-tier CFCs to upper-tier CFCs and U.S. shareholders in the same group. Excess taxable income is the amount of income by which a CFC's adjusted taxable income (ATI) exceeds the threshold amount of ATI below which there would be disallowed business expense.

Many comments suggested that computing a section 163(j) limitation for each CFC and rolling up CFC excess taxable income would be burdensome for taxpayers, especially since some multinational organizations have hundreds of CFCs. In addition, comments noted that the ability to pass up excess taxable income would encourage multinational organizations to restructure such that CFCs with low interest payments and high ATI are lower down the ownership chain and CFCs with high interest payments and low ATI are higher up in the chain of ownership. Similar to the first option, this restructuring would be expensive to taxpayers without any corresponding productive economic activity.

The third option was to allow taxpayers to elect to apply the section 163(j) rules to CFC groups on an aggregate basis, similar to the rules applicable to U.S. consolidated groups. This option was suggested by many comments and is the approach taken in the proposed regulations. Under this option, a single 163(j) limitation is computed for a CFC group by summing the items necessary for this computation (*e.g.,* current-year business interest expense and ATI) across all CFC group members. The CFC group's limitation is then allocated to each CFC member using allocation rules similar to those that apply to U.S. consolidated groups.

This option reduces the compliance burden on taxpayers in comparison to applying the section 163(j) rules on an individual CFC basis and calculating the excess taxable income to be passed up from lower tier CFCs to higher tier CFCs. In comparison to the first and second options, this option also removes the incentive for taxpayers to undertake costly restructuring, since the location of interest payments and ATI among CFC group members will not affect the interest disallowance for the group.

The proposed regulations also set out a number of rules to govern membership in a CFC group. These rules specify which CFCs can be members of the same CFC group, how CFCs with U.S. effectively connected income (ECI) should be treated, and the timing for making or revoking a CFC group election. These rules provide clarity and certainty to taxpayers regarding the CFC group election for section 163(j). In the absence of these regulations, taxpayers would face uncertainty regarding CFC group membership, and may make financing decisions or undertake restructuring that would be inefficient relative to the proposed regulations.

Number of Affected Taxpayers. The population affected by this proposed rule includes any taxpayer with ownership in a CFC group, consisting of two or more CFCs that has average gross receipts over a three year period in excess of $25 million. The Treasury

Department and the IRS estimate that there are approximately 7,500 taxpayers with two or more CFCs based on counts of e-filed tax returns for tax years 2015–2017. This estimate includes C corporations, S corporations, partnerships, and individuals with CFC ownership.

ii. CFC Excess Taxable Income and ATI of U.S. Shareholders

Generally, for the purposes of computing interest expense disallowed under section 163(j), deemed income inclusions, such as subpart F and GILTI inclusions, are excluded from a U.S. shareholder's ATI under the Final Regulations. The proposed regulations allow a U.S. shareholder to add back to its ATI a percentage of its deemed income inclusions attributable to an applicable CFC. That percentage is equal to the ratio of the CFC's excess taxable income to its ATI.

The Treasury Department and the IRS considered three options with respect to the addition of deemed income inclusions to a U.S. shareholder's ATI. The first option is to allow such inclusions to be added to ATI with respect to any of a taxpayer's applicable CFCs regardless of whether a CFC group election is made. However, under this option, taxpayers with a number of highly leveraged CFCs would have the incentive to not make a CFC group election and concentrate debt in certain CFCs. The taxpayer could thereby reduce the leverage of other CFCs in order to create excess taxable income in those CFCs. This excess taxable income could be then passed up to increase the U.S. shareholder's ATI. This incentive could lead to costly debt shifting among CFCs with no corresponding productive economic activity.

The second option considered was to allow such income inclusions to be added to ATI with respect to CFC group members only. Deemed income attributable to CFCs that are not members of groups would not be allowed to be added to a U.S. shareholder's ATI. This would remove the incentive for taxpayers to aggregate debt in certain CFCs, since if CFCs are treated as members of a group, then the distribution of interest payments across members will not affect the total excess taxable income of the group. However, comments noted that this option would not allow deemed income from stand-alone CFCs, which do not meet the requirements to join a CFC group, to increase shareholders' ATI.

The third option, which is proposed by the Treasury Department and the IRS, is to allow such income inclusions to be added to ATI with respect to both CFC group members and stand-alone CFCs. Under this option, if CFCs are eligible to be members of a CFC group, then the group election must be made in order for deemed inclusions attributable to these CFCs to increase shareholder ATI. The ATI of a U.S. shareholder can also be increased with respect to CFCs that are not eligible to be members of CFC groups. In this way, the rule does not penalize, relative to shareholders of CFC groups, shareholders which own only one CFC or own CFCs which for other reasons are not eligible for group membership.

Number of Affected Taxpayers. The population of affected taxpayers includes any taxpayer with a CFC since the proposed rule affects both stand-alone CFCs as well as CFC groups. The Treasury Department and the IRS estimate that there are approximately 10,000 to 11,000 affected taxpayers based on a count of e-filed tax returns for tax years 2015–2017. These counts include C corporations, S corporations, partnerships, and individuals with CFC ownership that meet a $25 million three-year average gross receipts threshold. The Treasury Department and the IRS do not have readily available data on the number of filers that are tax shelters that are potentially affected by these provisions.

d. Election To Use 2019 ATI To Determine 2020 Section 163(j) Limitation for Consolidated Groups

The proposed regulations provide that if a taxpayer filing as a consolidated group elects to substitute its 2019 ATI for its 2020 ATI, that group can use the consolidated group ATI for the 2019 taxable year, even if membership of the consolidated group changed in the 2020 taxable year. For example, suppose consolidated group C has three members in the 2019 taxable year, P, the common parent of the consolidated group, and S1 and S2, which are both wholly owned by P. In the 2019 taxable year, each member of consolidated group C had $100 of ATI on a stand-alone basis, for a total of $300 of ATI for the consolidated group C. In the 2020 taxable year, consolidated group C sells all of the stock of S2 and acquires all of the stock of a new member, S3. In the 2019 taxable year, S3 had $50 in ATI on a stand-alone basis. Under the proposed regulations, consolidated group C may elect to use $300 in ATI from 2019 as a substitute for its ATI in the 2020 taxable year.

The Treasury Department and the IRS considered as an alternative basing the 2019 ATI on the membership of the consolidated group in the 2020 taxable year. In the example in the previous paragraph, this approach would subtract out the $100 in ATI from S2 and add the $50 in ATI from S3, for a total of $250 in 2019 ATI that could potentially be substituted for 2020 ATI for consolidated group C. This approach would add burden to taxpayers relative to the proposed regulations by requiring additional calculations and tracking of ATI on a member-by-member basis to determine the amount of 2019 ATI that can be used in the 2020 taxable year without providing any general economic benefit.

In addition, the 2019 tax year will have closed for many taxpayers by the time these proposed regulations will be published. This implies that proposed rule of basing the consolidated group composition on the 2019 taxable year to calculate the amount of 2019 ATI that can be used in the 2020 taxable year will, relative to the alternative approach of using the composition in the 2020 taxable year, reduce the incentive for taxpayers to engage in costly mergers, acquisitions, or divestures to achieve a favorable tax result.

Number of Affected Taxpayers. The Treasury Department and the IRS estimate that approximately 34,000 corporate taxpayers filed a consolidated group tax return for tax year 2017. This represents an upper-bound of the number of taxpayers affected by the proposed rule as not all consolidated groups would need to calculate the amount of section 163(j) interest limitation in tax years 2019 and 2020.

D. Paperwork Reduction Act

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

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

1. Collections of Information

The collections of information subject to the Paperwork Reduction Act in these

Proposed Regulations are in proposed §§ 1.163(j)–6(d)(5), 1.163(j)–6(g)(4), and 1.163(j)–7.

The collections of information in proposed §§ 1.163(j)–6(d)(5) and 1.163(j)–6(g)(4) are required to make two elections relating to changes made to section 163(j) by the CARES Act. The election under proposed § 1.163(j)–6(d)(5) is for a passthrough taxpayer to use the taxpayer's ATI for the last taxable year beginning in 2019 as its ATI for any taxable year beginning in 2020, in accordance with section 163(j)(10)(B). The election under proposed § 1.163(j)–6(g)(4) relates to excess business interest expense of a partnership for any taxable year beginning in 2019 that is allocated to a partner. Section 163(j)(10)(A)(ii)(II) provides that, unless the partner elects out, in 2020, the partner treats 50 percent of the excess business interest expense as not subject to the section 163(j) limitation. If the partner elects out, the partner treats all excess business interest expense as subject to the same limitations as other excess business interest expense allocated to the partner.

Revenue Procedure 2020–22 describes the time and manner for making these elections. For both elections, taxpayers make the election 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 taxpayer's 2019 ATI and/or not applying the rule in section 163(j)(10)(ii)(II), as applicable. No formal statements are required to make these elections. Accordingly, the reporting burden associated with the collections of information in proposed § 1.163(j)–6(d)(5) and –6(g)(4) will be reflected in the IRS Form 8990 Paperwork Reduction Act Submissions (OMB control number 1545–0123).

The collections of information in proposed § 1.163(j)–7 are required for taxpayers to make an election to apply section 163(j) to a CFC group (CFC group election) or an annual election to exempt a CFC or CFC group from the section 163(j) limitation (safe-harbor election). The elections are made by attaching a statement to the US shareholder's annual return. The CFC group election remains in place until revoked and may not be revoked for any period beginning prior to 60 months following the period for which it is made. The safe-harbor election is made on an annual basis.

Under § 1.964–1(c)(3)(i), no election of a foreign corporation is effectuated unless the controlling domestic shareholder provides a statement with their return and notice of the election to the minority shareholders under § 1.964–1(c)(3)(ii) and (iii). See also, § 1.952–2(b)–(c). These collections are necessary to ensure that the election is properly effectuated, and that taxpayers properly report the amount of interest that is potentially subject to the limitation.

2. Future Modifications to Forms To Collect Information

At this time, no modifications to any forms, including the Form 8990, ''Limitation on Business Interest Expense IRC 163(j),'' are proposed with regard to the elections under section 163(j)(10), or the CFC group or safe-harbor elections. The Treasury Department and the IRS are considering revisions to the Instructions for Form 8990 to reflect changes made to section 163(j)(10) regarding the elections under proposed §§ 1.163(j)–6(d)(5) and 1.163(j)–6(g)(4). For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)), the reporting burden of Form 8990 is associated with OMB control number 1545–0123. In the 2018 Proposed Regulations, Form 8990 was estimated to be required by fewer than 92,500 taxpayers.

If an additional information collection requirement is imposed through these regulations in the future, for purposes of the Paperwork Reduction Act, any reporting burden associated with these regulations will be reflected in the aggregated burden estimates and the OMB control numbers for general income tax forms or the Form 8990, ''Limitation on Business Interest Expense Under Section 163(j)''.

The forms are available on the IRS website at:

Form	OMB No.	IRS website link
Form 1040	1545–0074	*https://www.irs.gov/pub/irs-pdf/f1040.pdf* (Instructions: *https://www.irs.gov/pub/irs-pdf/i1040gi.pdf).*
Form 1120	1545–0123	*https://www.irs.gov/pub/irs-pdf/f1120.pdf* (Instructions: *https://www.irs.gov/pub/irs-pdf/i1120.pdf).*
Form 1120S		*https://www.irs.gov/pub/irs-pdf/f1120s.pdf* (Instructions: *https://www.irs.gov/pub/irs-pdf/i1120s.pdf).*
Form 1065		*https://www.irs.gov/pub/irs-pdf/f1065.pdf* (Instructions: *https://www.irs.gov/pub/irs-pdf/i1065.pdf).*
Form 1120–REIT		*https://www.irs.gov/pub/irs-prior/f1120rei--2018.pdf* (Instructions: *https://www.irs.gov/pub/irs-pdf/i1120rei.pdf).*
Form 8990		*https://www.irs.gov/pub/irs-access/f8990_accessible.pdf* (Instructions: *https://www.irs.gov/pub/irs-pdf/i8990.pdf).*

In addition, when available, drafts of IRS forms are posted for comment at *https://apps.irs.gov/app/picklist/list/draftTaxForms.htm.* IRS forms are available at *https://www.irs.gov/forms-instructions.* Forms will not be finalized until after they have been approved by OMB under the PRA.

3. Burden Estimates

The following estimates for the collections of information in these proposed regulations are based on the most recently available Statistics of Income (SOI) tax data.

For the collection of income in proposed § 1.163(j)–6(d)(5), where a passthrough taxpayer elects to use the taxpayer's ATI for the last taxable beginning in 2019 as the taxpayer's ATI for any taxable year beginning in 2020, the most recently available 2017 SOI tax data indicates that, on the high end, the estimated number of respondents is 49,202. This number was determined by examining, for the 2017 tax year, Form 1065 and Form 1120–S filers with greater than $26 million in gross receipts that have reported interest expense, and do not have an NAICS code that is associated with a trade or business that normally would be excepted from the section 163(j) limitation.

For the collection of information under § 1.163(j)–6(g)(4), in which a partner elects out of treating 50 percent of any excess business interest expense allocated to the partner in 2019 as not subject to a limitation in 2020, 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 1,182 firms will make the election. This estimate was determined by examining three criteria: First, the number of taxpayers subject to section 59A, namely, C corporations with at least $500,000,000 in gross receipts, second, the portion of those taxpayers 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)), and, third, the portion of taxpayers satisfying the first two criteria that received a Form K–1, ''Partner's Share of Income, Deductions, Credits, etc.''

For the collections of information in proposed § 1.163(j)–7, namely the CFC and safe-harbor elections, and the corresponding notice under § 1.964–1(c)(3)(iii), the most recently available 2017 SOI tax data indicates that, on the high end, the estimated number of respondents is 4,980 firms. This number was determined by examining, for the 2017 tax year, Form 1040, Form 1120, Form 1120–S, and Form 1065 filers with greater than $26 million in gross receipts that filed a Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, where an interest expense amount was reported on Schedule C of the Form 5471.

The estimated number of respondents that could be subject to the collection of information for the CFC group or safe-harbor election is 4,980. The estimated annual burden per respondent/recordkeeper varies from 0 to 30 minutes, depending on individual circumstances, with an estimated average of 15 minutes. The estimated total annual reporting and/or recordkeeping burden is 1,245 hours (4,980 respondents × 15 minutes). The estimated annual cost burden to respondents is $95 per hour. Accordingly, we expect the total annual cost burden for the CFC group election and safe-harbor election statements to be $118,275 (4,980 * .25 * $95).

The Treasury Department and the IRS request comment on the assumptions, methodology, and burden estimates related to this information collection. Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by November 2, 2020, which is 60 days after the date of filing for public inspection with the Office of the Federal Register.

Comments are specifically requested concerning—

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

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

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

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

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

II. Regulatory Flexibility Act

It is hereby certified that these Proposed Regulations, if adopted as final, will not have a significant economic impact on a substantial number of small entities.

This certification can be made because the Treasury Department and the IRS have determined that the number of small entities that are affected as a result of the regulations is not substantial. These rules do not disincentivize taxpayers from their operations, and any burden imposed is not significant because the cost of implementing the rules, if any, is low.

As discussed in the 2018 Proposed Regulations, section 163(j) provides exceptions for which many small entities will qualify. First, under section 163(j)(3), the limitation does not apply to any taxpayer, other than a tax shelter under section 448(a)(3), which meets the gross receipts test under section 448(c) for any taxable year. A taxpayer meets the gross receipts test under section 448(c) if the taxpayer has average annual gross receipts for the 3-taxable year period ending with the taxable year that precedes the current taxable year that do not exceed $26,000,000. The gross receipts threshold is indexed annually for inflation. Because of this threshold, the Treasury Department and the IRS project that entities with 3-year average gross receipts below $26 million will not be affected by these regulations except in rare cases.

Section 163(j) provides that certain trades or businesses are not subject to the limitation, including the trade or business of performing services as an employee, electing real property trades or businesses, electing farming businesses, and certain utilities as defined in section 163(j)(7)(A)(iv). Under the 2018 Proposed Regulations, taxpayers that otherwise qualified as real property trades or businesses or farming businesses that satisfied the small business exemption in section 448(c) were not eligible to make an election to be an electing real property trade or business or electing farming business. Under the Final Regulations, however, those taxpayers are eligible to make an election to be an electing real property trade or business or electing farming business. Additionally, the Final Regulations provide that certain utilities not otherwise excepted from the limitation can elect for a portion of their non-excepted utility trade or business to be excepted from the limitation. Any economic impact on any small entities as a result of the requirements in these Proposed Regulations, not just the requirements that impose a Paperwork Reduction Act burden, is not expected to be significant because the cost of implementing the rules, if any, is low.

The Treasury Department and the IRS do not have readily available data on the number of filers that are tax shelters, as defined in section 448(a)(3), that are potentially affected by these provisions. As described in more detail earlier in this Preamble, these Proposed Regulations cover several topics, including, but not limited to, debt financed distributions from passthrough entities, self-charged interest, the treatment of section 163(j) in relation to trader funds, the impact of section 163(j) on publicly traded partnerships, and the application of section 163(j) to United States shareholders of controlled foreign corporations and to foreign persons with effectively connected income in the United States.

The Treasury Department and the IRS do not have readily available data to determine the number of taxpayers affected by rules regarding self-charged interest because no reporting modules currently connect these payments by and from partnerships.

The Treasury Department and the IRS likewise do not have precise data on the number of taxpayers affected by rules regarding debt financed distributions. The Treasury Department and the IRS estimate that the number of taxpayers affected by the rules regarding debt-financed distributions is 50,036. This number was reached first by adding the number of Form 1065 filers that reported code W on line 13b of schedule K of the Form 1065, or approximately 410,996 using 2018 taxable year data, and the number of Form 1120–S filers that reported code S on line 12d of schedule K of the Form 1120–S, or approximately 89,367 using 2018 taxable year data. Those codes are used to report interest expense allocated to debt financed distributions. Using the result of the two numbers, 500,363 (410,996 + 89,367), produces overly broad results because the codes referenced above are used to report more than just interest expense allocated to debt financed distributions. Code W on line 13b of schedule K of the Form 1065 also is used to report at least nine other items, including, but not limited to, itemized deductions that Form 1040 or 1040–SR filers report on Schedule A, soil and water conservation expenditures, and the domestic productions activities deductions. Code S on line 12d of schedule K of the Form 1120–S also is used to report at least eleven other items, including, but not limited to, itemized deductions that Form 1040 or 1040–SR filers report on Schedule A, expenditures for the removal of architectural and transportation barriers for the elderly and disabled that the corporation elected to treat as a current expense, and film, television, and live theatrical production expenses. Considering the number of other items reported under those codes, the Treasury Department and the IRS estimate that approximately 10% of the filers using those codes report interest expense allocated to debt financed distributions (500,363 * 0.10 = 50,036).

Despite not having precise data, these rules do not impose a significant paperwork or implementation cost burden on taxpayers. Under Notice 89–35, taxpayers have been required to maintain books and records to properly report the tax treatment of interest associated with debt financed acquisitions and contributions by partners, and debt financed distributions to partners. Additional reporting requirements are needed to allow passthrough entities and their owners to comply with the interest tracing rules under § 1.163–8T. Without additional reporting, the mechanism for determining the tax treatment of interest under § 1.163–8T is burdensome and unclear. For example, in some cases, partners would need to report back to the partnership how they used debt financed distribution to allow the partnership to properly report its interest expense. This notice of proposed rules would provide consistent reporting and compliance by passthrough entities and their owners, which would reduce their overall burden. The estimated time to determine whether a distribution is a debt financed distribution and to comply with these rules would be 0 minutes to 30 minutes per taxpayer, depending on individual circumstances, for an average of 15 minutes. The 2018 monetization rates for this group of filers is $57.53. According, the Treasury Department and the IRS estimate the burden to be $719,642.77 (50,036 respondents * 0.25 hours * $57.53).

The Treasury Department and the IRS have determined that, on the high end, the rules regarding trading partnerships might affect approximately 309 small entities. This number was reached by determining, using data for the 2017 taxable year, the number of Form 1065 and Form 1065–B filers, with more than $26 million in gross receipts, that (1) completed Schedule B to Form 1065 and marked box b, c, or d in question 1 to denote limited partnership, limited liability company or limited liability partnership status; (2) have a North American Industry Classification System (NAICS) code starting with 5231, 5232, 5239 or 5259, and (3) do not have gross receipts exceeding the small business thresholds for the various NAICS codes. The following table provides a breakdown of the potentially affected taxpayers by NAICS code.

NAICS code	Titles	Gross receipts threshold	Number of respondents
5231	Securities and Commodity Contracts Intermediation and Brokerage, including Investment Bank and Securities Dealing; Securities Brokerage; Commodity Contract Dealing; Commodity Contracts Brokerage.	$41.5M	42
5232	Securities and Commodities Exchanges	41.5M	0
5239	Other Financial Investment Activities, including Miscellaneous Intermediation; Portfolio Management; Investment Advice; Trust, Fiduciary, and Custody Activities; Miscellaneous Financial Investment Activities.	41.5M	267
5259	Other Investment Pools and Funds, including Open-End Investment Funds; Trusts, Estates, and Agency Accounts; Other Financial Vehicles.	35M	[d]
Total Respondents.			309

Source: SOI Partnership Study, 2017.
[d] Data is suppressed based on disclosure rules detailed in Publication 1075.

Additionally, the Treasury Department and the IRS have determined that the rules regarding publicly traded partnerships might affect approximately 83 taxpayers. This number was reached by determining, using data for the 2017 taxable year, the number of Form 1065 and 1065–B filers with gross receipts exceeding $25 million that answered ''yes'' to question 5 on Schedule B to Form 1065 denoting that the entity is a publicly traded partnership.

As noted earlier, these Proposed Regulations do not impose any new collection of information on these entities. These Proposed Regulations actually assist small entities in meeting their filing obligations by providing definitive advice on which they can rely.

For the section 163(j)(10) elections for passthrough taxpayers under proposed §§ 1.163(j)–6(d)(5) and 1.163(j)–6(g)(4), most small taxpayers do not need to make 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 election is low. Pursuant to Revenue Procedure 2020–22, these passthrough 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 who do not make the elections.

The persons potentially subject to proposed § 1.163(j)–7 are U.S. shareholders in one or more CFCs for which BIE is reported, and that (1) have average annual gross receipts for the 3-taxable year period ending with the taxable year that precedes the current taxable year exceeding $26,000,000, and (2) want to make the CFC group election or safe-harbor election. Proposed § 1.163(j)–7 requires such taxpayers to attach a statement to their return providing basic information regarding the CFC group or standalone CFC.

As discussed in the Paperwork Reduction Act section of this Preamble, the reporting burden for both statements is estimated at 0 to 30 minutes, depending on individual circumstances, with an estimated average of 15 minutes for all affected entities, regardless of size. The estimated monetized burden for compliance is $95 per hour.

For these reasons, the Treasury Department and the IRS have determined that these Proposed Regulations will not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite comments from interested members of the public on both the number of small entities affected and the economic impact on those small entities.

E. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other 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 sector, of $100 million in 1995 dollars, updated annually for inflation. In 2019, that threshold was approximately $154 million. These Proposed Regulations do not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

F. 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. These Proposed Regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Before these proposed amendments to the regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the **ADDRESSES** section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at *www.regulations.gov* or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020–4, 2020–17 I.R.B. 667 (April 20, 2020), provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal authors of these regulations are Susie Bird, Charles Gorham, Jaime Park, Joanna Trebat and Sophia Wang (Income Tax & Accounting), Anthony McQuillen, Adrienne M. Mikolashek, and William Kostak (Passthroughs and Special Industries), Azeka J. Abramoff (International), Russell Jones, and John Lovelace (Corporate), and Pamela Lew, Steven Harrison, and Michael Chin (Financial Institutions & Products). Other personnel from the Treasury Department and the IRS participated in their development.

Effect on Other Documents

Notice 89–35, 1989–1 C.B. 675, is proposed to be obsoleted.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings notices, and other guidance 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.*

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

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

■ **Par. 2.** Section 1.163–14 is added to read as follows:

§ 1.163–14 Allocation of interest expense among expenditures—Passthrough Entities.

(a) *In general*—(1) *Application.* This section prescribes rules for allocating interest expense associated with debt proceeds of a partnership or S corporation (a *passthrough entity*). In general, interest expense on a debt of a passthrough entity is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. This section prescribes rules for tracing debt proceeds to specific expenditures of a passthrough entity.

(2) *Cross-references.* This paragraph provides the general manner in which interest expense of a passthrough entity is allocated. See paragraph (b) of this section for the treatment of interest expense allocated under the rules of this section, paragraph (c) for the manner in which debt proceeds of a passthrough entity are allocated and the manner in which interest expense allocated under this section is treated, paragraph (d) for rules relating to debt allocated under the rules of § 1.163–8T to distributions to owners of a passthrough entity, paragraph (e) for rules relating to debt repayments, paragraph (f) for rules relating to debt allocated under the rules of § 1.163–8T to expenditures for interests in passthrough entities, paragraph (g) for change of ownership rules for interest expense allocation

purposes, and paragraph (h) for examples.

(b) *Treatment of interest expense*—(1) *General rule.* Except as otherwise provided in section § 1.163(j)-8T(m), interest expense allocated under the rules of this section is treated in the following manner:

(i) Interest expense allocated to trade or business expenditures (as defined in paragraph (b)(2)(v) of this section) is taken into account under section 163(j) by the passthrough entity;

(ii) Interest expense allocated to other trade or business expenditures (as defined in paragraph (b)(2)(ii) of this section) is taken into account under the rules of § 1.163–8T, as applicable, by the passthrough entity owner allocated such interest expense;

(iii) Interest expense allocated to rental expenditures (as defined in paragraph (b)(2)(iv) of this section) is taken into account under the rules of § 1.163–8T, as applicable, by the passthrough entity owner allocated such interest expense;

(iv) Interest expense allocated to investment expenditures (as defined in paragraph (b)(2)(i) of this section) is taken into account under the rules of § 1.163–8T, as applicable, by the passthrough entity owner allocated such interest expense;

(v) Interest expense allocated to personal expenditures (as defined in paragraph (b)(2)(iii) of this section) is taken into account under the rules of § 1.163–8T, as applicable, by the passthrough entity owner allocated such interest expense;

(vi) Interest expense allocated to distributions to owners of a passthrough entity is taken into account in the manner provided under paragraph (d) of this section.

(2) *Definitions.* For purposes of this section—

(i) *Investment expenditure* means an expenditure defined in § 1.163–8T(b)(3), including any expenditure made with respect to a trade or business described in section 163(d)(5)(A)(ii) to the extent such expenditure is properly allocable under section 704(b) to partners that do not materially participate (within the meaning and for purposes of section 469) in the trade or business.

(ii) *Other trade or business expenditure* means an expenditure made with respect to any activity described in § 1.469–4(b)(1)(ii) and (iii).

(iii) *Personal expenditure* means an expenditure (other than a distribution) not described in paragraphs (b)(2)(i), (ii), (iv) and (v) of this section.

(iv) *Rental expenditure* means an expenditure made with respect to any activity described in § 1.469–4(b)(2) that is not a trade or business, as defined in § 1.163(j)–1(b)(44).

(v) *Trade or business expenditure* means an expenditure made with respect to a trade or business, as defined in § 1.163(j)–1(b)(44), except for an expenditure made with respect to a trade or business described in section 163(d)(5)(A)(ii) to the extent such expenditure is properly allocable under section 704(b) to partners that do not materially participate (within the meaning and for purposes of section 469) in the trade or business.

(c) *Allocation of debt and interest expense.* Except as otherwise provided in this section, the rules of § 1.163–8T apply to partnerships, S Corporations, and their owners.

(d) *Debt allocated to distributions by passthrough entities*—(1) *Allocation of distributed debt proceeds*—(i) *Available expenditures.* To the extent a passthrough entity has available expenditures (as defined in paragraph (d)(5)(ii) of this section), the passthrough entity shall first allocate distributed debt proceeds (as defined in paragraph (d)(5)(iii) of this section) to such available expenditures. If a passthrough entity has multiple available expenditures, the passthrough entity shall allocate distributed debt proceeds to such available expenditures in proportion to the amount of each expenditure.

(ii) *Debt financed distributions.* If a passthrough entity's distributed debt proceeds exceeds its available expenditures, the passthrough entity shall allocate such excess amount of distributed debt proceeds to distributions to owners of the passthrough entity (debt financed distributions).

(2) *Allocation of interest expense*—(i) *Interest expense allocated to debt financed distributions.* If distributed debt proceeds are allocated to distributions to owners of the passthrough entity (pursuant to paragraph (d)(1)(ii) of this section), the passthrough entity shall determine the portion of each passthrough entity owner's allocable interest expense that is debt financed distribution interest expense. The amount of a passthrough entity owner's *debt financed distribution interest expense* equals the lesser of such passthrough entity owner's allocable interest expense (as defined in paragraph (d)(5)(i) of this section) or the product of—

(A) The portion of the debt proceeds distributed to that particular passthrough entity owner; multiplied by

(B) A fraction, the numerator of which is the portion of the passthrough entity's distributed debt proceeds allocated to debt financed distributions (determined under paragraph (d)(1)(ii) of this section), and the denominator of which is the passthrough entity's total amount of distributed debt proceeds; multiplied by

(C) The distributed debt proceeds interest rate (as defined in paragraph (d)(5)(iv of this section).

(ii) *Interest expense allocated to available expenditures.* If distributed debt proceeds are allocated to available expenditures (pursuant to paragraph (d)(1)(i) of this section), the passthrough entity shall determine the portion of each passthrough entity owner's allocable interest expense that is expenditure interest expense. The amount of a passthrough entity owner's *expenditure interest expense* equals the product of—

(A) The portion of the passthrough entity's distributed debt proceeds allocated to available expenditures (determined under paragraph (d)(1)(i) of this section); multiplied by

(B) The distributed debt proceeds interest rate; multiplied by

(C) A fraction, the numerator of which is the excess of that particular passthrough entity owner's allocable interest expense over its debt financed distribution interest expense (determined under paragraph (d)(2)(i) of this section) (remaining interest expense), and the denominator of which is aggregate of all the passthrough owners' remaining interest expense amounts.

(iii) *Excess interest expense.* To the extent a passthrough entity owner's allocable interest expense is not treated as either debt financed distribution interest expense (determined under paragraph (d)(2)(i) of this section) or expenditure interest expense (determined under paragraph (d)(2)(ii) of this section), such allocable interest expense is *excess interest expense.*

(3) *Tax treatment of interest expense*—(i) *Debt financed distribution interest expense.* The tax treatment of a passthrough entity owner's debt financed distribution interest expense (determined under paragraph (d)(2)(i) of this section), if any, shall be determined by the passthrough entity owner under the rules of § 1.163–8T, as applicable, in accordance with such passthrough entity owner's use of its portion of the passthrough entity's distributed debt proceeds. The passthrough entity shall separately state the amount of each owner's debt financed distribution interest expense. Debt financed distribution interest expense is not treated as interest expense of the entity for purposes of this section.

(ii) *Expenditure interest expense.* The tax treatment of a passthrough entity owner's expenditure interest expense (determined under paragraph (d)(2)(ii) of this section), if any, shall be determined based on how the distributed debt proceeds were allocated among available expenditures (pursuant to paragraph (d)(1)(i) of this section). For example, if distributed debt proceeds are allocated to a rental activity under paragraph (d)(1)(i) of this section, the interest expense associated with such debt should be taken into account by the passthrough entity in computing income or loss from the rental activity that is reported to the owner.

(iii) *Excess interest expense.* The tax treatment of a passthrough entity owner's excess interest expense (determined under paragraph (d)(2)(iii) of this section), if any, shall be determined by allocating the distributed debt proceeds among all the assets of the passthrough entity, pro-rata, based on the adjusted basis of such assets. For purposes of the preceding sentence, the passthrough entity shall use either the adjusted tax bases of its assets reduced by any debt of the passthrough entity allocated to such assets, or determine its adjusted basis in its assets in accordance with the rules in § 1.163(j)–10(c)(5)(i), reduced by any debt of the passthrough entity allocated to such assets. Once a passthrough entity chooses a method for determining its adjusted basis in its assets for this purpose, the passthrough entity must consistently apply the same method in all subsequent tax years. Any assets purchased in the same taxable year as the distribution (such that the expenditure for those assets was taken into account in § 1.163–14(b)(1)) are not included in this allocation.

(4) *Treatment of transfers of interests in a passthrough entity by an owner that received a debt financed distribution*—(i) *In general.* In the case of a transfer of an interest in a passthrough entity, any debt financed distribution interest expense of the transferor shall be treated as excess interest expense by the transferee. However, in the case of a transfer of an interest in a passthrough entity to a person who is related to the transferor, any debt financed distribution interest expense of the transferor shall continue to be treated as debt financed distribution interest expense by the related party transferee, and the tax treatment of such debt financed distribution expense under paragraph (d)(3) of this section shall be the same to the related party transferee as it was to the transferor. 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).

(ii) *Anti-avoidance rule.* Arrangements entered into with a principal purpose of avoiding the rules of this paragraph, including the transfer of an interest in a passthrough entity by an owner who treated a portion of its allocable interest expense as debt financed distribution interest expense to an unrelated party pursuant to a plan to transfer the interest back to the owner who received the debt financed distribution interest expense or to a party who is related to the owner who received the debt financed distribution interest expense, may be disregarded or recharacterized by the Commissioner of the IRS to the extent necessary to carry out the purposes of this paragraph.

(5) *Definitions.* For purposes of this paragraph—

(i) *Allocable interest expense* means a passthrough entity owner's share of interest expense associated with the distributed debt proceeds allocated under section 704 or section 1366(a).

(ii) *Available expenditure* means an expenditure of a passthrough entity described in paragraph (b)(2) of this section made in the same taxable year of the entity as the distribution, to the extent that debt proceeds (including other distributed debt proceeds) are not otherwise allocated to such expenditure.

(iii) *Distributed debt proceeds* means debt proceeds of a passthrough entity that are allocated under § 1.163–8T and this section to distributions to owners of the passthrough entity in a taxable year. If debt proceeds from multiple borrowings are allocated under § 1.163–8T to distributions to owners of the passthrough entity in a taxable year, then all such borrowings are treated as a single borrowing for purposes of this section.

(iv) *Distributed debt proceeds interest rate* means a fraction, the numerator of which is the amount of interest expense associated with distributed debt proceeds, and the denominator of which is the amount of distributed debt proceeds.

(e) *Repayment of passthrough entity debt*—(1) *In general.* If any portion of passthrough entity debt is repaid at a time when such debt is allocated to more than one expenditure, the debt is treated for purposes of this section as repaid in the following order:

(i) Amounts allocated to one or more expenditures described in paragraph (b)(2)(iii);

(ii) Amounts allocated to one or more expenditures described in paragraph (b)(2)(i) (relating to investment expenditures as defined in § 1.163–8T(b)(3));

(iii) Amounts allocated to one or more expenditures described in paragraphs (b)(2)(ii) and (iv) (relating to expenditures with respect to any activities described in § 1.469–4(b)(1)(ii) and (iii), and § 1.469–4(b)(2)); and

(iv) Amounts allocated to one or more expenditures described in paragraph (b)(2)(v) (generally relating to expenditures made with respect to a trade or business as defined in § 1.163(j)–1(b)(44)).

(2) *Repayment of debt used to finance a distribution.* Any repayment of debt of a passthrough entity that has been allocated to debt financed distributions under paragraph (d)(1)(ii) of this section and to one or more available expenditures under paragraph (d)(1)(i) of this section may, at the option of the passthrough entity, be treated first as a repayment of the portion of the debt that had been allocated to such debt financed distributions.

(f) *Debt allocated to expenditures for interests in passthrough entities.* In the case of debt proceeds allocated under the rules of § 1.163–8T and this section to contributions to the capital of or to the purchase of an interest in a passthrough entity, the character of the debt proceeds and any associated interest expense shall be determined by allocating the debt proceeds among the adjusted tax bases of the entity's assets. For purposes of this paragraph, the owner must allocate the debt proceeds either in proportion to the relative adjusted tax basis of the entity's assets reduced by any debt allocated to such assets, or based on the adjusted basis of the entity's assets in accordance with the rules in § 1.163(j)–10(c)(5)(i) reduced by any debt allocated to such assets. Once the owner chooses a method for allocating the debt proceeds for this purpose, the owner must consistently apply the same method in all subsequent tax years. Individuals shall report interest expense paid or incurred in connection with debt-financed acquisitions on their individual income tax return in accordance with the asset to which the interest expense is allocated under this paragraph.

(g) *Change in ownership.* Any transfer of an ownership interest in a passthrough entity is not a reallocation event for purposes of § 1.163–8T(j), except as provided for in paragraph (d)(4) of this section.

(h) *Examples*—(1) *Example 1*—(i) *Facts.* A (an individual) and B (an individual) are partners in partnership PRS. PRS conducts two businesses; a manufacturing business, which is a trade or business as defined in § 1.163(j)–1(b)(44) (manufacturing), and a separate commercial real estate leasing business, which is an activity described in § 1.469–4(b)(2) (leasing). In Year 1, PRS borrowed $100,000 from an unrelated third-party lender (the loan). Other than the loan, PRS does not have any outstanding debt. During Year 1, PRS paid $80,000 in manufacturing expenses, $120,000 in leasing expenses, and made a $100,000 distribution to A, the proceeds of which A used to make a personal expenditure. Under § 1.163–8T, PRS treated the $100,000 of loan proceeds as having been distributed to A. As a result, in Year 1 PRS had $200,000 of available expenditures (as defined in paragraph (d)(5)(ii) of this section) and $100,000 of distributed debt proceeds (as defined in paragraph (d)(5)(iii) of this section). PRS paid $10,000 in interest expense that accrued during Year 1 on the loan, and allocated such interest expense under section 704(b) equally to A and B ($5,000 each). Thus, A and B each had $5,000 of allocable interest expense (as defined in paragraph (d)(5)(i) of this section).

(ii) *Applicability.* Because PRS treated all $100,000 of the loan proceeds as having been distributed under § 1.163–8T, PRS allocated all $10,000 of the interest expense associated with the loan to the distribution. Thus, pursuant to paragraph (b)(1)(vi) of this section, PRS must determine the tax treatment of such $10,000 of interest expense in the manner provided in paragraph (d) of this section.

(iii) *Debt allocated to distributions.* Under paragraph (d)(1)(i) of this section, to the extent PRS has available expenditures (as defined under paragraph (d)(5)(ii) of this section), it must allocate any distributed debt proceeds (as defined under paragraph (d)(5)(iii) of this section) to such available expenditures. Here, PRS has distributed debt proceeds of $100,000 and available expenditures of $200,000 (manufacturing expenditures of $80,000, plus leasing expenditures of $120,000). Thus, PRS allocates all $100,000 of the distributed debt proceeds to available expenditures as follows: $40,000 to manufacturing expenditures ($100,000 × ($80,000/$200,000)) and $60,000 to leasing expenditures ($100,000 × ($120,000/$200,000)). Because the amount of PRS's distributed debt proceeds is less than its available expenditures, none of the distributed debt proceeds are allocated to debt financed distributions pursuant to paragraph (d)(1)(ii) of this section.

(iv) *Allocation of interest expense.* Because all of PRS's distributed debt proceeds are allocated to available expenditures (pursuant to paragraph (d)(1)(i) of this section), A and B each treat all $5,000 of their allocable interest expense as expenditure interest expense.

(v) *Tax treatment of interest expense.* Pursuant to paragraph (d)(3)(ii) of this section, each partner treats its expenditure interest expense (determined under paragraph (d)(2)(ii) of this section) in the same manner as the distributed debt proceeds that were allocated to available expenditures under paragraph (d)(1)(i) of this section. Thus, A's $5,000 of expenditure interest expense comprises of $2,000 of business interest expense ($5,000 × ($40,000/$100,000)) and $3,000 of interest expense allocated to rental expenditures ($5,000 × ($60,000/$100,000)). B's $5,000 of expenditure interest expense similarly comprises of $2,000 of business interest expense and $3,000 of interest expense allocated to rental expenditures. As a result, $4,000 of interest expense associated with the distributed debt proceeds (A's $2,000 plus B's $2,000 of expenditure interest expense treated as business interest expense) is business interest expense of PRS, subject to section 163(j) at the PRS level.

TABLE 1 TO PARAGRAPH (h)(2)(vii)

	Partner A	Partner B
Allocable interest expense:		
Debt financed distribution interest expense:		
N/A	$0	$0
Expenditure interest expense:		
Business interest (to PRS)	2,000	2,000
Rental activity interest expense	3,000	3,000
Excess interest expense:		
N/A	0	0
Total	5,000	5,000

(2) *Example 2*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (h)(1)(i) of this section, except PRS did not have any rental expenditures in Year 1. As a result, in Year 1 PRS had $80,000 of available expenditures (as defined in paragraph (d)(5)(ii) of this section) and $100,000 of distributed debt proceeds (as defined in paragraph (d)(5)(iii) of this section).

(ii) *Applicability.* Because PRS treated all $100,000 of the loan proceeds as having been distributed to A under § 1.163–8T, PRS allocated all $10,000 of the interest expense associated with the loan to the distribution. Thus, pursuant to paragraph (b)(1)(vi) of this section, PRS must determine the tax treatment of such $10,000 of interest expense in the manner provided in paragraph (d) of this section.

(iii) *Debt allocated to distributions.* Under paragraph (d)(1)(i) of this section, to the extent PRS has available expenditures (as defined under paragraph (d)(5)(ii) of this section), it must allocate any distributed debt proceeds (as defined under paragraph (d)(5)(i) of this section) to such available expenditures. Here, PRS has distributed debt proceeds of $100,000 and available expenditures of $80,000. Thus, $80,000 of the distributed debt proceeds are allocated to such available expenditures. Pursuant to paragraph (d)(1)(ii) of this section, PRS allocates the remaining $20,000 of the distributed debt proceeds to debt financed distributions.

(iv) *Allocation of interest expense—debt financed distribution interest expense.* Pursuant to paragraph (d)(2)(i) of this section, A treats $2,000 of its allocable interest expense as debt financed distribution interest expense, which is the lesser of $5,000 or $2,000 ((A) the portion of debt proceeds distributed to A ($100,000), multiplied by (B) a fraction, the numerator of which is the portion of PRS's distributed debt proceeds allocated to debt financed distributions pursuant to paragraph (d)(1)(ii) of this section ($20,000), and the denominator of which is PRS's total amount of distributed debt proceeds ($100,000), multiplied by (C) the distributed debt proceeds interest rate, as defined in paragraph (d)(5)(iii) of this section, of 10% (the amount of interest expense associated with distributed debt proceeds ($10,000), divided by the amount of distributed debt proceeds ($100,000))) and B treats $0 of its allocable interest expense as debt financed distribution interest expense, which is the lesser of $5,000 or $0 ((A) $0 × (B) 20% × (C) 10%).

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Table 2 to paragraph (h)(2)(iv)

The portion of partner A's allocable interest expense that is debt financed distribution interest expense equals the lesser of:					
Partner A's allocable interest expense; or				=	$5,000
(d)(2)(i)(A)	Portion of debt proceeds allocated to partner A	=	$100,000		
(d)(2)(i)(B)	Debt financed distributions / Distributed debt proceeds	=	$20,000 / $100,000		
(d)(2)(i)(C)	Distributed debt proceeds interest rate	=	$10,000 / $100,000		
The product of (d)(2)(i)(A), (B), and (C).				=	$2,000

Table 3 to paragraph (h)(2)(iv)

The portion of partner B's allocable interest expense that is debt financed distribution interest expense equals the lesser of:					
Partner B's allocable interest expense; or				=	$5,000
(d)(2)(i)(A)	Portion of debt proceeds allocated to partner B	=	$0		
(d)(2)(i)(B)	Debt financed distributions / Distributed debt proceeds	=	$20,000 / $100,000		
(d)(2)(i)(C)	Distributed debt proceeds interest rate	=	$10,000 / $100,000		
The product of (d)(2)(i)(A), (B), and (C).				=	$0

(v) *Allocation of interest expense—expenditure interest expense.* Pursuant to paragraph (d)(2)(ii) of this section, A treats $3,000 of its allocable interest expense as expenditure interest expense ((A) the portion of PRS's distributed debt proceeds allocated to available expenditures pursuant to paragraph (d)(1)(i) of this section ($80,000), multiplied by (B) the distributed debt proceeds interest rate (10%), multiplied by (C) a fraction, the numerator of which is A's remaining interest expense (that is, the excess of A's allocable interest expense ($5,000) over its debt financed distribution interest expense as determined under paragraph (d)(2)(i) of this section ($2,000)), and the denominator of which is the aggregate of A's and B's remaining interest expense amounts ($3,000 + $5,000)) and B treats $5,000 of its allocable interest expense as expenditure interest expense ((A) $80 × (B) 10% × (C) 62.5%).

Table 4 to paragraph (h)(2)(v)

The portion of partner A's allocable interest expense that is expenditure interest expense equals the product of:			
(d)(2)(ii)(A)	Distributed debt proceeds allocated to available expenditures	=	$80,000
(d)(2)(ii)(B)	Distributed debt proceeds interest rate	=	$\frac{\$10,000}{\$100,000}$
(d)(2)(ii)(C)	$\frac{\text{Partner A's remaining interest expense}}{\text{Aggregate remaining interest expense}}$	=	$\frac{\$3,000}{\$8,000}$
The product of (d)(2)(ii)(A), (B), and (C).		=	$3,000

Table 5 to paragraph (h)(2)(v)

The portion of partner B's allocable interest expense that is expenditure interest expense equals the product of:			
(d)(2)(ii)(A)	Distributed debt proceeds allocated to available expenditures	=	$80,000
(d)(2)(ii)(B)	Distributed debt proceeds interest rate	=	$\frac{\$10,000}{\$100,000}$
(d)(2)(ii)(C)	$\frac{\text{Partner B's remaining interest expense}}{\text{Aggregate remaining interest expense}}$	=	$\frac{\$5,000}{\$8,000}$
The product of (d)(2)(ii)(A), (B), and (C).		=	$5,000

(vi) *Allocation of interest expense—excess interest expense.* Neither partner treats any of its allocable interest expense as excess interest expense under paragraph (d)(2)(iii) of this section.

(vii) *Tax treatment of interest expense.* Pursuant to paragraph (d)(3)(i) of this section, each partner determines the tax treatment of its debt financed distribution interest expense (determined under paragraph (d)(2)(i) of this section) based on its use of the distributed debt proceeds. Because A used its $100,000 of distributed debt proceeds on a personal expenditure, A's $2,000 of debt financed distribution interest expense is personal interest subject to section 163(h) at A's level. Pursuant to paragraph (d)(3)(ii) of this section, each partner treats its expenditure interest expense (determined under paragraph (d)(2)(ii) of this section) in the same manner as the distributed debt proceeds that were allocated to available expenditures under paragraph (d)(1)(i) of this section. Thus, all $3,000 of A's expenditure interest expense and all $5,000 of B's expenditure interest expense is business interest expense. As a result, $8,000 interest expense associated with the distributed debt proceeds (A's $3,000 plus B's $5,000 of expenditure interest expense treated as business interest expense) is business interest expense of PRS, subject to section 163(j) at the PRS level.

TABLE 6 TO PARAGRAPH (h)(2)(vii)

	Partner A	Partner B
Allocable interest expense;		
Debt financed distribution interest expense:		
Personal interest	$2,000	$0
Expenditure interest expense:		
Business interest (to PRS)	3,000	5,000
Excess interest expense:		
N/A	0	0
Total	5,000	5,000

(3) *Example 3*—(i) *Facts.* The facts are the same as in *Example 2* in paragraph (h)(2)(i) of this section, except PRS paid $20,000 in manufacturing expenses, made a distribution of $75,000 to A (the proceeds of which A used on a personal expenditure), and made a distribution of $25,000 to B (the proceeds of which B used on a trade or business expenditure). As a result, in Year 1 PRS had $20,000 of available expenditures (as defined in paragraph (d)(5)(ii) of this section) and $100,000 of distributed debt proceeds (as defined in paragraph (d)(5)(iii) of this section). The $20,000 manufacturing expenditure was to acquire assets used in PRS's manufacturing business. At the end of Year 1, the adjusted tax basis of PRS's assets used in manufacturing was $720,000 and the adjusted tax basis of PRS's assets used in leasing was $200,000. In addition, at the end of Year 1, the adjusted basis of PRS's assets held for investment (within the meaning of section 163(d)(5)) was $100,000.

(ii) *Applicability.* Because PRS treated all $100,000 of the loan proceeds as having been distributed under § 1.163–8T, PRS allocated all $10,000 of the interest expense associated with the loan to the distribution. Thus, pursuant to paragraph (b)(1)(vi) of this section, PRS must determine the tax treatment of such $10,000 of interest expense in the manner provided in paragraph (d) of this section.

(iii) *Debt allocated to distributions.* Under paragraph (d)(1)(i) of this section, to the extent PRS has available expenditures (as defined under paragraph (d)(5)(ii) of this section), it must allocate any distributed debt proceeds (as defined under paragraph (d)(5)(i) of this section) to such available expenditures. Here, PRS has distributed debt proceeds of $100,000 and available expenditures of $20,000. Thus, PRS allocates $20,000 of the distributed debt proceeds to available expenditures. Pursuant to paragraph (d)(1)(ii) of this section, PRS allocates the remaining $80,000 of distributed debt proceeds to debt financed distributions.

(iv) *Allocation of interest expense—debt financed distribution interest expense.* Pursuant to paragraph (d)(2)(i) of this section, A treats $5,000 of its allocable interest expense as debt financed distribution interest expense, which is the lesser of $5,000 or $6,000 ((A) $75,000 × (B) 80% × (C) 10%) and B treats $2,000 of its allocable interest expense as debt financed distribution interest expense, which is the lesser of $5,000 or $2,000 ((A) $25,000 × (B) 80% × (C) 10%).

Table 7 to paragraph (h)(3)(iv)

The portion of partner A's allocable interest expense that is debt financed distribution interest expense equals the lesser of:					
Partner A's allocable interest expense; or				=	$5,000
(d)(2)(i)(A)	Portion of debt proceeds allocated to partner A	=	$75,000		
(d)(2)(i)(B)	Debt financed distributions / Distributed debt proceeds	=	$80,000 / $100,000		
(d)(2)(i)(C)	Distributed debt proceeds interest rate	=	$10,000 / $100,000		
The product of (d)(2)(i)(A), (B), and (C).				=	$6,000

Table 8 to paragraph (h)(3)(iv)

The portion of partner B's allocable interest expense that is debt financed distribution interest expense equals the lesser of:					
Partner B's allocable interest expense; or				=	$5,000
(d)(2)(i)(A)	Portion of debt proceeds allocated to partner B	=	$25,000		
(d)(2)(i)(B)	Debt financed distributions / Distributed debt proceeds	=	$80,000 / $100,000		
(d)(2)(i)(C)	Distributed debt proceeds interest rate	=	$10,000 / $100,000		
The product of (d)(2)(i)(A), (B), and (C).				=	$2,000

(v) *Allocation of interest expense—expenditure interest expense.* Pursuant to paragraph (d)(2)(ii) of this section, A does not treat any of its allocable interest expense as expenditure interest expense ((A) $20,000 × (B) 10% × (C) 0%) and B treats $2,000 of its allocable interest expense as expenditure interest expense ((A) $20,000 × (B) 10% × (C) 100%).

Table 9 to paragraph (h)(3)(v)			
The portion of partner A's allocable interest expense that is expenditure interest expense equals the product of:			
(d)(2)(ii)(A)	Distributed debt proceeds allocated to available expenditures	=	$20,000
(d)(2)(ii)(B)	Distributed debt proceeds interest rate	=	$10,000 / $100,000
(d)(2)(ii)(C)	Partner A's remaining interest expense / Aggregate remaining interest expense	=	$0 / $3,000
The product of (d)(2)(ii)(A), (B), and (C).		=	$0

Table 10 to paragraph (h)(3)(v)			
The portion of partner B's allocable interest expense that is expenditure interest expense equals the product of:			
(d)(2)(ii)(A)	Distributed debt proceeds allocated to available expenditures	=	$20,000
(d)(2)(ii)(B)	Distributed debt proceeds interest rate	=	$10,000 / $100,000
(d)(2)(ii)(C)	Partner B's remaining interest expense / Aggregate remaining interest expense	=	$3,000 / $3,000
The product of (d)(2)(ii)(A), (B), and (C).		=	$2,000

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(vi) *Allocation of interest expense—excess interest expense.* Pursuant to paragraph (d)(2)(iii) of this section, A does not treat any of its allocable interest expense as excess interest expense ($5,000 of allocable interest expense, less $5,000 of debt financed distribution interest expense, less $0 of expenditure interest expense) and B treats $1,000 of its allocable interest expense as excess interest expense ($5,000 of allocable interest expense, less $2,000 of debt financed distribution interest expense, less $2,000 of expenditure interest expense).

(vii) *Tax treatment of interest expense.* Pursuant to paragraph (d)(3)(i) of this section, each partner determines the tax treatment of its debt financed distribution interest expense based on its use of the distributed debt proceeds. A used its share of the distributed debt proceeds to make personal expenditures. Thus, A's $5,000 of debt financed distribution interest expense is subject to section 163(h) at A's level. B used its share of the distributed debt proceeds to make trade or business expenditures. Thus, B's $2,000 of debt financed distribution interest expense is subject to section 163(j) at B's level. Pursuant to paragraph (d)(3)(ii) of this section, B treats its $2,000 of expenditure interest expense in the same manner as the distributed debt proceeds were allocated to available expenditures under paragraph (d)(1)(i) of this section. Thus, B's $2,000 of expenditure interest expense is business interest expense, subject to section 163(j) at the level of PRS. Pursuant to paragraph (d)(3)(iii) of this section, B determines the tax treatment of its $1,000 of excess interest expense by allocating distributed debt proceeds among the adjusted basis of PRS's assets, reduced by any debt allocated to such assets. For purposes of paragraph (d)(3)(iii) of this section, PRS's has $700,000 ($720,000 − $20,000 debt proceeds allocated to such assets) of basis in its manufacturing assets, $200,000 of basis in its leasing assets, and $100,000 of basis in its assets held for investment. Thus, B's $1,000 of excess interest expense is treated as $700 of business interest expense subject to 163(j) at the PRS level, $200 of interest expense related to a rental activity, and $100 of investment interest expense.

TABLE 11 TO PARAGRAPH (h)(3)(vii)

	Partner A	Partner B
Allocable interest expense:		
Debt financed distribution interest expense:		
Personal interest:	$5,000	$0
Business interest (but not to PRS)	0	2,000

TABLE 11 TO PARAGRAPH (h)(3)(vii)—Continued

	Partner A	Partner B
Expenditure interest expense:		
Business interest (to PRS)	0	2,000
Excess interest expense:		
Business interest (to PRS):	0	700
Rental activity interest expense	0	200
Investment interest expense	0	100
Total	5,000	5,000

(4) *Example 4.* The facts are the same as in *Example 2* in paragraph (h)(2)(i) of this section. In Year 2, A sells its interest in PRS to C. C is not related to either A or B under the rules of either section 267(b) or section 707(b)(1). No facts have changed with respect to PRS's loan. Under these facts, and only for purposes of this section, C's share of the debt financed distribution interest expense will be treated as excess interest expense pursuant to paragraph (d)(4)(i) of this section. Accordingly, C will determine the character of its share of this interest expense by allocating the debt proceeds associated with this interest expense among the assets of PRS under paragraph (d)(3)(iii) of this section.

(5) *Example 5.* The facts are the same as in *Example 4* in paragraph (h)(4) of this section, except that C is a party that is related to A under the rules of either section 267(b) or section 707(b)(1). Under these facts, and only for purposes of this section, A's $2,000 of debt financed distribution interest expense shall, pursuant to paragraph (d)(4)(i) of this section, continue to be treated as debt financed distribution interest expense of C, subject to the same tax treatment as it was to the transferor (personal interest expense).

(6) *Example 6.* The facts are the same as in *Example 2* in paragraph (h)(2)(i) of this section, except that in Year 2 B sells its interest in PRS to D. D is not related to either A or B under the rules of either section 267(b) or section 707(b)(1). No other facts have changed with respect to PRS's loan. Under these facts, the tax treatment of the expenditure interest expense does not change with respect to PRS or any of the partners as a result of the ownership change pursuant to paragraph (g) of this section. Accordingly, the tax treatment of the expenditure interest expense allocable to D under section 704(b) is identical to the expenditure interest expense that had been allocable to B prior to the sale.

(7) *Example 7*—(i) *Facts.* A (an individual) and B (an individual) are equal shareholders in S corporation X. X conducts a manufacturing business, which is a trade or business as defined in § 1.163(j)–1(b)(44) (manufacturing). In Year 1, X borrowed $100,000 from an unrelated third-party lender (the loan). Other than the loan, X does not have any outstanding debt. During Year 1, X paid $100,000 in manufacturing expenses and made a $50,000 distribution to each of its shareholders, A and B, which each shareholder used to make a personal expenditure. Under § 1.163–8T, X treated all $100,000 of the loan proceeds as having been distributed to A and B. As a result, in Year 1 X had $100,000 of available expenditures (as defined in paragraph (d)(5)(ii) of this section) and $100,000 of distributed debt proceeds (as defined in paragraph (d)(5)(iii) of this section). X paid $10,000 in interest expense that accrued during Year 1 on the loan, and allocated such interest expense under section 1366(a) equally to A and B ($5,000 each). Thus, A and B each had $5,000 of allocable interest expense (as defined in paragraph (d)(5)(i) of this section).

(ii) *Applicability.* Because X treated all $100,000 of the loan proceeds as having been distributed to A and B under § 1.163–8T, PRS allocated all $10,000 of the interest expense associated with the loan to the distributions. Thus, pursuant to paragraph (b)(1)(vi) of this section, PRS must determine the tax treatment of such $10,000 of interest expense in the manner provided in paragraph (d) of this section.

(iii) *Debt allocated to distributions.* Under paragraph (d)(1)(i) of this section, to the extent X has available expenditures (as defined under paragraph (d)(5)(ii) of this section), it must allocate any distributed debt proceeds (as defined under paragraph (d)(5)(iii) of this section) to such available expenditures. Here, X has distributed debt proceeds of $100,000 and available expenditures of $100,000. Thus, PRS allocates all $100,000 of the distributed debt proceeds to available expenditures

(iv) *Allocation of interest expense.* Because all of X's distributed debt proceeds are allocated to available expenditures (pursuant to paragraph (d)(1)(i) of this section), A and B each treat all $5,000 of their allocable interest expense as expenditure interest expense.

(v) *Tax treatment of interest expense.* Pursuant to paragraph (d)(3)(ii) of this section, each partner treats its expenditure interest expense (determined under paragraph (d)(2)(ii) of this section) in the same manner as the distributed debt proceeds that were allocated to available expenditures under paragraph (d)(1)(i) of this section. Thus, A's $5,000 of expenditure interest expense and B's $5,000 of expenditure interest expense is treated as business interest expense of X, subject to section 163(j) at X's level.

TABLE 12 TO PARAGRAPH (h)(7)(v)

	Partner A	Partner B
Allocable interest expense:		
Debt financed distribution interest expense:		
N/A	$0	$0
Expenditure interest expense:		
Business interest (to X)	5,000	5,000
Excess interest expense:		
N/A	0	0
Total	5,000	5,000

(h) *Applicability date.* This section applies to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. 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 [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**], provided that they consistently apply the rules of this section to that taxable year and each subsequent taxable year.

■ **Par. 3.** Section 1.163–15 is added to read as follows:

§ 1.163–15 Debt Proceeds Distributed from Any Taxpayer Account or from Cash.

(a) *In general.* Regardless of paragraphs (c)(4) and (5) of § 1.163–8T, in the case of debt proceeds deposited in an account, a taxpayer that is applying § 1.163–8T or § 1.163–14 may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are deposited in any account of the taxpayer as made from such proceeds to the extent thereof. Similarly, in the case of debt proceeds received in cash, a taxpayer that is applying § 1.163–8T or § 1.163–14 may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are received in cash as made from such proceeds to the extent thereof. For purposes of this section, terms used have the same meaning as in § 1.163–8T(c)(4) and (5).

(b) *Applicability date.* This section applies to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. 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 [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**], provided that they consistently apply the rules of this section to that taxable year and each subsequent taxable year.

■ **Par. 4.** As added in a final rule published elsewhere in this issue of the **Federal Register**, effective November 13, 2020, § 1.163(j)–0 is amended by:

■ 1. Revising the entries for § 1.163(j)–1(b)(1)(iv)(B), (b)(22)(iii)(F), and (b)(35);

■ 2. Adding entries for §§ 1.163(j)–1(b)(1)(iv)(E), (c)(4), and (c)(4)(i) and (ii);

■ 3. Adding an entry for § 1.163(j)–2(d)(3);

■ 4. Revising the entries for §§ 1.163(j)–2(k) and 1.163(j)–6(c)(1) and (2);

■ 5. Adding an entry for § 1.163(j)–6(d)(3), (4), and (5) and (e)(5);

■ 6. Revising the entries for §§ 1.163(j)–6(f)(1)(iii), (g)(4), (h)(4) and (5), (j), and (n) and 1.163(j)–7;

■ 7. Adding an entry for § 1.163(j)–8;

■ 8. Revising the entries for § 1.163(j)–10(c)(5)(ii)(D) and (f).

The revisions and additions read as follows:

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■ **Par. 5.** As added in a final rule published elsewhere in this issue of the **Federal Register**, effective November 13, 2020, § 1.163(j)–1 is amended by:

■ 1. Revising paragraph (b)(1)(iv)(B).
■ 2. Adding paragraphs (b)(1)(iv)(E), (b)(22)(iii)(F), and (b)(35)
■ 3. In paragraph (c)(1), removing ''paragraphs (c)(2) and (3)'' from the first sentence and adding ''paragraphs (c)(2), (3), and (4)'' in its place.
■ 4. Adding paragraph (c)(4).

The revisions and additions read as follows:

§ 1.163(j)–1 Definitions.

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(b) * * *
(1) * * *
(iv) * * *

(B) *Deductions by members of a consolidated group*—(*1*) *In general.* If paragraph (b)(1)(ii)(C), (D), or (E) of this section applies to adjust the tentative taxable income of a taxpayer, and if the taxpayer does not use the computation method in paragraph (b)(1)(iv)(E) of this section, 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.

(*2*) *Application of the alternative computation method.* If paragraph (b)(1)(ii)(C), (D), or (E) of this section applies to adjust the tentative taxable income of a taxpayer, and if the taxpayer uses the computation method in paragraph (b)(1)(iv)(E) of this section, the amount of the adjustment under paragraph (b)(1)(ii)(C) of this section equals the lesser of:

(i) Any gain recognized on the sale or other disposition of such property by the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group); and

(ii) 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.

* * * * *

(E) *Alternative computation method.* If paragraph (b)(1)(ii)(C), (D), or (E) of this section applies to adjust the tentative taxable income of a taxpayer, the taxpayer may compute the amount of the adjustments required by such paragraph using the formulas in paragraph (b)(1)(iv)(E)(*1*), (*2*), and (*3*) of this section, respectively, provided that the taxpayer applies such formulas to all dispositions for which an adjustment is required under paragraph (b)(1)(ii)(C), (D), or (E) of this section.

(*1*) *Alternative computation method for property dispositions.* With respect to the sale or other disposition of property, the lesser of:

(*i*) Any gain recognized on the sale or other disposition of such property by the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group); and

(*ii*) 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.

(*2*) *Alternative computation method for dispositions of member stock.* With respect to the sale or other disposition of stock of a member of a consolidated group by another member, the lesser of:

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

(*ii*) 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.

(*3*) *Alternative computation method for dispositions of partnership interests.* With respect to the sale or other disposition of an interest in a partnership, the lesser of (*i*) any gain recognized on the sale or other disposition of such interest, and (*ii*) the taxpayer's (or, if the taxpayer is a consolidated group, the consolidated group'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).

* * * * *

(22) * * *

(iii) * * *

(F) *Section 163(j) interest dividends*—(*1*) *In general.* Except as otherwise provided in this paragraph (b)(22)(iii)(F), a section 163(j) interest dividend is treated as interest income.

(*2*) *Limitation on amount treated as interest income.* A shareholder may not treat any part of a section 163(j) interest dividend as interest income to the extent the amount of the section 163(j) interest dividend exceeds the excess of the amount of the entire dividend that includes the section 163(j) interest dividend over the sum of the conduit amounts other than interest-related dividends under section 871(k)(1)(C) and section 163(j) interest dividends that affect the shareholder's treatment of that dividend.

(*3*) *Conduit amounts.* For purposes of paragraph (b)(22)(iii)(F)(*2*) of this section, the term *conduit amounts* means, with respect to any category of income (including tax-exempt interest) earned by a RIC for a taxable year, the amounts identified by the RIC (generally in a designation or written report) in connection with dividends paid by the RIC for that taxable year that are subject to a limit determined by reference to that category of income. For example, a RIC's conduit amount with respect to its net capital gain is the amount of capital gain dividends that the RIC pays under section 852(b)(3)(C).

(*4*) *Holding period.* Except as provided in paragraph (b)(22)(iii)(F)(*5*) of this section, no dividend is treated as interest income under paragraph (b)(22)(iii)(F)(*1*) of this section if the dividend is received with respect to a share of RIC stock—

(*i*) That is held by the shareholder for 180 days or less (taking into account the principles of section 246(c)(3) and (4)) during the 361-day period beginning on the date which is 180 days before the date on which the share becomes ex-dividend with respect to such dividend; or

(*ii*) To the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(*5*) *Exception to holding period requirement for money market funds and certain regularly declared dividends.* Paragraph (b)(22)(iii)(F)(*4*)(*i*) of this section does not apply to dividends distributed by any RIC regulated as a money market fund under 17 CFR 270.2a–7 (Rule 2a–7 under the 1940 Act) or to regular dividends paid by a RIC that declares section 163(j) interest dividends on a daily basis in an amount equal to at least 90 percent of its excess section 163(j) interest income, as defined in paragraph (b)(35)(iv)(E) of this section, and distributes such dividends on a monthly or more frequent basis.

* * * * *

(35) *Section 163(j) interest dividend.* The term *section 163(j) interest dividend* means a dividend paid by a RIC for a taxable year for which section 852(b) applies to the RIC, to the extent described in paragraph (b)(35)(i) or (ii) of this section, as applicable.

(i) *In general.* Except as provided in paragraph (b)(35)(ii) of this section, a section 163(j) interest dividend is any dividend, or part of a dividend, that is reported by the RIC as a section 163(j) interest dividend in written statements furnished to its shareholders.

(ii) *Reduction in the case of excess reported amounts.* If the aggregate reported amount with respect to the RIC for the taxable year exceeds the excess section 163(j) interest income of the RIC for such taxable year, the section 163(j) interest dividend is—

(A) The reported section 163(j) interest dividend amount; reduced by

(B) The excess reported amount that is allocable to that reported section 163(j) interest dividend amount.

(iii) *Allocation of excess reported amount*—(A) *In general.* Except as provided in paragraph (b)(35)(iii)(B) of this section, the excess reported amount, if any, that is allocable to the reported section 163(j) interest dividend amount is that portion of the excess reported amount that bears the same ratio to the excess reported amount as the reported section 163(j) interest dividend amount bears to the aggregate reported amount.

(B) *Special rule for noncalendar year RICs.* In the case of any taxable year that does not begin and end in the same calendar year, if the post-December reported amount equals or exceeds the excess reported amount for that taxable year, paragraph (b)(35)(iii)(A) of this section is applied by substituting "post-December reported amount" for "aggregate reported amount," and no excess reported amount is allocated to any dividend paid on or before December 31 of such taxable year.

(iv) *Definitions.* The following definitions apply for purposes of this paragraph (b)(35):

(A) *Reported section 163(j) interest dividend amount.* The term *reported section 163(j) interest dividend amount* means the amount of a dividend distribution reported to the RIC's shareholders under paragraph (b)(35)(i) of this section as a section 163(j) interest dividend.

(B) *Excess reported amount.* The term *excess reported amount* means the excess of the aggregate reported amount over the RIC's excess section 163(j) interest income for the taxable year.

(C) *Aggregate reported amount.* The term *aggregate reported amount* means the aggregate amount of dividends reported by the RIC under paragraph (b)(35)(i) of this section as section 163(j) interest dividends for the taxable year (including section 163(j) interest dividends paid after the close of the taxable year described in section 855).

(D) *Post-December reported amount.* The term *post-December reported* *amount* means the aggregate reported amount determined by taking into account only dividends paid after December 31 of the taxable year.

(E) *Excess section 163(j) interest income.* The term *excess section 163(j) interest income* means, with respect to a taxable year of a RIC, the excess of the RIC's business interest income for the taxable year over the sum of the RIC's business interest expense for the taxable year and the RIC's other deductions for the taxable year that are properly allocable to the RIC's business interest income.

(v) *Example*—(A) *Facts.* X is a domestic C corporation that has elected to be a RIC. For its taxable year ending December 31, 2021, X has $100x of business interest income (all of which is qualified interest income for purposes of section 871(k)(1)(E)) and $10x of dividend income (all of which is qualified dividend income within the meaning of section 1(h)(11) and would be eligible for the dividends received deduction under section 243, determined as described in section 854(b)(3)). X has $10x of business interest expense and $20x of other deductions. X has no other items for the taxable year. On December 31, 2021, X pays a dividend of $80x to its shareholders, and reports, in written statements to its shareholders, $71.82x as a section 163(j) interest dividend; $10x as dividends that may be treated as qualified dividend income or as dividends eligible for the dividends received deduction; and $72.73x as interest-related dividends under section 871(k)(1)(C). Shareholder A, a domestic C corporation, meets the holding period requirements in paragraph (b)(22)(iii)(F)(*4*) of this section with respect to the stock of X, and receives a dividend of $8x from X on December 31, 2021.

(B) *Analysis.* X determines that $18.18x of other deductions are properly allocable to X's business interest income. X's excess section 163(j) interest income under paragraph (b)(35)(iv)(E) of this section is $71.82x ($100x business interest income − ($10x business interest expense + $18.18x other deductions allocated) = $71.82x). Thus, X may report up to $71.82x of its dividends paid on December 31, 2021, as section 163(j) interest dividends to its shareholders. X may also report up to $10x of its dividends paid on December 31, 2021, as dividends that may be treated as qualified dividend income or as dividends that are eligible for the dividends received deduction. X determines that $9.09x of interest expense and $18.18x of other deductions are properly allocable to X's qualified interest income. Therefore, X may report up to $72.73x of its dividends paid on December 31, 2021, as interest-related dividends under section 871(k)(1)(C) ($100x qualified interest income − $27.27x deductions allocated = $72.73x). A treats $1x of its $8x dividend as a dividend eligible for the dividends received deduction and no part of the dividend as an interest-related dividend under section 871(k)(1)(C). Therefore, under paragraph (b)(22)(iii)(F)(*2*) of this section, A may treat $7x of the section 163(j) interest dividend as interest income for purposes of section 163(j) ($8x dividend − $1x conduit amount = $7x limitation).

* * * * *

(c) * * *

(4) *Alternative computation for certain adjustments to tentative taxable income, and section 163(j) interest dividends*—(i) *Alternative computation for certain adjustments to tentative taxable income.* Paragraphs (b)(1)(iv)(B) and (E) of this section apply to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **Federal Register**]. Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules in paragraphs (b)(1)(iv)(B) and (E) of this section to a taxable year beginning after December 31, 2017, and before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **Federal Register**], 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 and each subsequent taxable year.

(ii) *Section 163(j) interest dividends.* Paragraphs (b)(22)(iii)(*F*) and (b)(35) of this section apply to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **Federal Register**]. Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules in paragraphs (b)(22)(iii)(F) and (b)(35) of this section for a taxable year beginning after December 31, 2017, and before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **Federal Register**], so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations.

■ **Par. 6.** As added in a final rule published elsewhere in this issue of the **Federal Register**, effective November 13, 2020, § 1.163(j)–2 is amended by:

■ 1. Adding paragraphs (b)(3)(iii) and (iv) and (d)(3).

■ 2. Redesignating paragraph (k) as paragraph (k)(1).

■ 3. Adding a new subject heading for paragraph (k).

■ 4. Revising the subject heading of redesignated paragraph (k)(1).

■ 5. Adding paragraph (k)(2).

The additions and revision read as follows:

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

* * * * *

(b) * * *

(3) * * *

(iii) *Transactions to which section 381 applies.* For purposes of the election described in paragraph (b)(3)(i) of this section, and subject to the limitation in paragraph (b)(3)(ii) of this section, the 2019 ATI of the acquiring corporation in a transaction to which section 381 applies equals the amount of the acquiring corporation's ATI for its last taxable year beginning in 2019.

(iv) *Consolidated groups.* For purposes of the election described in paragraph (b)(3)(i) of this section, and subject to the limitation in paragraph (b)(3)(ii) of this section, the 2019 ATI of a consolidated group equals the amount of the consolidated group's ATI for its last taxable year beginning in 2019.

* * * * *

(d) * * *

(3) *Determining a syndicate's loss amount.* For purposes of section 163(j), losses allocated under section 1256(e)(3)(B) and § 1.448–1T(b)(3) are determined without regard to section 163(j). See also § 1.1256(e)–2(b).

* * * * *

(k) *Applicability dates.*

(1) *In general.* * * *

(2) *Paragraphs (b)(3)(iii), (b)(3)(iv), and (d)(3).* Paragraphs (b)(3)(iii) and (iv) and (d)(3) of this section apply to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of paragraphs (b)(3)(iii) and (iv) of this section to a taxable year beginning after December 31, 2017, and before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**], provided that they consistently apply the rules of paragraphs (b)(3)(iii) and (iv) of this section and the rules in the section 163(j) regulations for that taxable year and for each subsequent taxable year. Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may choose to apply the rules of paragraph (d)(3) of this section to a taxable year beginning after December 31, 2017, and before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE

IN THE **FEDERAL REGISTER**], provided that they consistently apply the rules of paragraph (d)(3) of this section for that taxable year and for each subsequent taxable year.

■ **Par. 7.**As added in a final rule published elsewhere in this issue of the **Federal Register**, effective November 13, 2020, § 1.163(j)–6 is amended by:

■ 1. Adding paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5) and (6), (f)(1)(iii), (g)(4), (h)(4) and (5), (j), (l)(4)(iv), (n), and (o)(24) through (29).

■ 2. Redesignating paragraph (p) as paragraph (p)(1).

■ 3. Adding a new subject heading for paragraph (p).

■ 4. Revising the subject heading of newly redesignated paragraph (p)(1).

■ 5. Adding paragraph (p)(2).

The additions and revision read as follows:

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

* * * * *

(c) * * *

(1) *Modification of business interest income for partnerships.* The business interest income of a partnership generally is determined in accordance with § 1.163(j)–1(b)(3). To the extent that interest income of a partnership that is properly allocable to trades or businesses that are per se non-passive activities and is allocated to partners that do not materially participate (within the meaning of section 469), as described in section 163(d)(5)(A)(ii), such interest income shall not be considered business interest income for purposes of determining the section 163(j) limitation of a partnership pursuant to § 1.163(j)–2(b). A per se non-passive activity is an activity that is not treated as a passive activity for purposes of section 469 regardless of whether the owners of the activity materially participate in the activity.

(2) *Modification of business interest expense for partnerships.* The business interest expense of a partnership generally is determined in accordance with § 1.163(j)–1(b)(2). To the extent that interest expense of a partnership that is properly allocable to trades or businesses that are per se non-passive activities is allocated to partners that do not materially participate within the meaning of section 469, as described in section 163(d)(5)(A)(ii), such interest expense shall not be considered business interest expense for purposes of determining the section 163(j) limitation of a partnership pursuant to § 1.163(j)–2(b).

* * * * *

(d) * * *

(3) *Section 743(b) adjustments and publicly traded partnerships.* Solely for purposes of § 1.163(j)–6, a publicly traded partnership, as defined in § 1.7704–1, shall treat the amount of any section 743(b) adjustment of a purchaser of a partnership unit that relates to a remedial item that the purchaser inherits from the seller as an offset to the related section 704(c) remedial item. For this purpose, § 1.163(j)–6(e)(2)(ii) applies. See *Example 25* in paragraph (o)(25) of this section.

(4) *Modification of adjusted taxable income for partnerships.* The adjusted taxable income of a partnership generally is determined in accordance with § 1.163(j)–1(b)(1). To the extent that the items comprising the adjusted taxable income of a partnership are properly allocable to trades or businesses that are per se non-passive activities and are allocated to partners that do not materially participate (within the meaning of section 469), as described in section 163(d)(5)(A)(ii), such partnership items shall not be considered adjusted taxable income for purposes of determining the section 163(j) limitation of a partnership pursuant to § 1.163(j)–2(b).

(5) *Election to use 2019 adjusted taxable income for taxable years beginning in 2020.* In the case of any taxable year beginning in 2020, a partnership may elect to apply this section by substituting its adjusted taxable income for the last taxable year beginning in 2019 for the adjusted taxable income for such taxable year. See § 1.163(j)–2(b)(4) for the time and manner of making or revoking this election. An electing partnership determines each partner's allocable ATI (as defined in paragraph (f)(2)(ii) of this section) pursuant to paragraph (j)(9) of this section in the same manner as an upper-tier partnership. See *Example 34* in paragraph (o)(34) of this section.

* * * * *

(e) * * *

(5) *Partner basis items, remedial items, and publicly traded partnerships.* Solely for purposes of § 1.163(j)–6, a publicly traded partnership, as defined in § 1.7704–1, shall either allocate gain that would otherwise be allocated under section 704(c) based on a partner's section 704(b) sharing ratios, or, for purposes of allocating cost recovery deductions under section 704(c), determine a partner's remedial items, as defined in § 1.163(j)–6(b)(3), based on an allocation of the partnership's asset basis (inside basis) items among its partners in proportion to their share of corresponding section 704(b) items (rather than applying the traditional method, described in § 1.704–3(b)). See *Example 24* in paragraph (o)(24) of this section.

(6) *Partnership deductions capitalized by a partner.* The ATI of a partner is increased by the portion of such partner's allocable share of qualified expenditures (as defined in section 59(e)(2)) to which an election under section 59(e) applies.

* * * * *

(f) * * *

(1) * * *

(iii) *Exception applicable to publicly traded partnerships.* Publicly traded partnerships, as defined in § 1.7704–1, do not apply the rules in paragraph (f)(2) of this section to determine a partner's share of section 163(j) excess items. Rather, publicly traded partnerships determine a partner's share of section 163(j) excess items by applying the same percentage used to determine the partner's share of the corresponding section 704(b) items that comprise ATI.

* * * * *

(g) * * *

(4) *Special rule for taxable years beginning in 2019 and 2020.* In the case of any excess business interest expense of a partnership for any taxable year beginning in 2019 that is allocated to a partner under paragraph (f)(2) of this section, 50 percent of such excess business interest expense (§ 1.163(j)–6(g)(4) business interest expense) is treated as business interest expense that, notwithstanding paragraph (g)(2) of this section, is paid or accrued by the partner in the partner's first taxable year beginning in 2020. Additionally, § 1.163(j)–6(g)(4) business interest expense is not subject to the section 163(j) limitation at the level of the partner. For purposes of paragraph (h)(1) of this section, any § 1.163(j)–6(g)(4) business interest expense is, similar to deductible business interest expense, taken into account before any excess business interest expense. This paragraph applies after paragraph (n) of this section. If a partner disposes of a partnership interest in the partnership's 2019 or 2020 taxable year, § 1.163(j)–6(g)(4) business interest expense is deductible by the partner and thus does not result in a basis increase under paragraph (h)(3) of this section. See *Example 35* and *Example 36* in paragraphs (o)(35) and (o)(36), respectively, of this section. A taxpayer may elect to not have this provision apply. The rules and procedures regarding the time and manner of making, or revoking, such an election are provided in Revenue Procedure 2020–22, 2020–18 I.R.B. 745, and may

be further modified through other guidance (see §§ 601.601(d) and 601.602 of this chapter).

* * * * *

(h) * * *

(4) *Partner basis adjustments upon liquidating distribution.* For purposes of paragraph (h)(3) of this section, a disposition includes a distribution of money or other property by the partnership to a partner in complete liquidation of the partner's interest in the partnership. However, a current distribution of money or other property by the partnership to a continuing partner is not a disposition for purposes of paragraph (h)(3) of this section.

(5) *Partnership basis adjustments upon partner dispositions.* If a partner (transferor) disposes of its partnership interest, the partnership shall increase the adjusted basis of partnership property by an amount equal to the amount of the increase required under paragraph (h)(3) (or, if the transferor is a partnership, (j)(5)(ii)) of this section (if any) to the adjusted basis of the partnership interest being disposed of by the transferor. Such increase in the adjusted basis of partnership property (§ 1.163(j)–6(h)(5) basis adjustment) shall be allocated among capital gain property of the partnership in the same manner as a positive section 734(b) adjustment. However, the increase in the adjusted basis of any partnership property resulting from a § 1.163(j)–6(h)(5) basis adjustment is not depreciable or amortizable under any section of the Code, regardless of whether the partnership property allocated such § 1.163(j)–6(h)(5) basis adjustment is otherwise generally depreciable or amortizable. In general, a partnership allocates its § 1.163(j)–6(h)(5) basis adjustment immediately before the disposition (simultaneous with the transferor's basis increase required under paragraph (h)(3) or (j)(5)(ii) of this section). However, if the disposition was the result of a distribution by the partnership of money or other property to the transferor in complete liquidation of the transferor's interest in the partnership, the partnership allocates its § 1.163(j)–6(h)(5) basis adjustment among its properties only after it has allocated its section 734(b) adjustment (if any) among its properties. See *Example 31* in paragraph (o)(31) of this section.

* * * * *

(j) *Tiered partnerships*—(1) *Purpose.* The purpose of this section is to provide guidance regarding the treatment of business interest expense of a partnership (lower-tier partnership) that is allocated to a partner that is a partnership (upper-tier partnership). Specifically, this section clarifies that disparities are not created between an upper-tier partner's basis in its upper-tier partnership interest and such partner's share of the adjusted basis of upper-tier partnership's property following the allocation of excess business interest expense from lower-tier partnership to upper-tier partnership. Further, these rules disallow any deduction for business interest expense that was formerly excess business interest expense to any person that is not the specified partner of such business interest expense. See *Example 27* through *Example 30* in paragraphs (o)(27) through (30), respectively.

(2) *Section 704(b) capital account adjustments.* If lower-tier partnership pays or accrues business interest expense and allocates such business interest expense to upper-tier partnership, then both upper-tier partnership and any direct or indirect partners of upper-tier partnership shall, solely for purposes of section 704(b) and the regulations thereunder, treat such business interest expense as a section 705(a)(2)(B) expenditure. Any section 704(b) capital account reduction resulting from such treatment occurs regardless of whether such business interest expense is characterized under this section as excess business interest expense or deductible business interest expense by lower-tier partnership. If upper-tier partnership subsequently treats any excess business interest expense allocated from lower-tier partnership as business interest expense paid or accrued pursuant to paragraph (g) of this section, the section 704(b) capital accounts of any direct or indirect partners of upper-tier partnership are not further reduced.

(3) *Basis adjustments of upper-tier partnership.* If lower-tier partnership allocates excess business interest expense to upper-tier partnership, then upper-tier partnership reduces its basis in lower-tier partnership pursuant to paragraph (h)(2) of this section. Upper-tier partnership partners do not, however, reduce the bases of their upper-tier partnership interests pursuant to paragraph (h)(2) of this section until upper-tier partnership treats such excess business interest expense as business interest expense paid or accrued pursuant to paragraph (g) of this section.

(4) *Treatment of excess business interest expense allocated by lower-tier partnership to upper-tier partnership.* Except as provided in paragraph (j)(7) of this section, if lower-tier partnership allocates excess business interest expense to upper-tier partnership and such excess business interest expense is not suspended under section 704(d), then upper-tier partnership shall treat such excess business interest expense (UTP EBIE) as a nondepreciable capital asset, with a fair market value of zero and basis equal to the amount by which upper-tier partnership reduced its basis in lower-tier partnership pursuant to paragraph (h)(2) of this section due to the allocation of such excess business interest expense. The fair market value of UTP EBIE, described in the preceding sentence, is not adjusted by any revaluations occurring under § 1.704–1(b)(2)(iv)(f). In addition to generally treating UTP EBIE as having a basis component in excess of fair market value and, thus, built-in loss property, upper-tier partnership shall also treat UTP EBIE as having a carryforward component associated with it. The carryforward component of UTP EBIE shall equal the amount of excess business interest expense allocated from lower-tier partnership to upper-tier partnership under paragraph (f)(2) of this section that is treated as such under paragraph (h)(2) of this section by upper-tier partnership. If an allocation of excess business interest expense from lower-tier partnership is treated as UTP EBIE of upper-tier partnership, upper-tier partnership shall treat such allocation of excess business interest expense from lower-tier partnership as UTP EBIE until the occurrence of an event described in paragraph (j)(5) of this section.

(5) *UTP EBIE conversion events*—(i) *Allocation to upper-tier partnership by lower-tier partnership of excess taxable income (or excess business interest income).* To the extent upper-tier partnership is allocated excess taxable income (or excess business interest income) from lower-tier partnership, or paragraph (m)(3) of this section applies, upper-tier partnership shall—

(A) First, apply the rules in paragraph (g) of this section to its UTP EBIE, using any reasonable method (including, for example, FIFO and LIFO) to determine which UTP EBIE is treated as business interest expense paid or accrued pursuant paragraph (g) of this section. If paragraph (m)(3) of this section applies, upper-tier partnership shall treat all of its UTP EBIE from lower-tier partnership as business interest expense paid or accrued.

(B) Second, with respect to any UTP EBIE treated as business interest expense paid or accrued in paragraph (j)(5)(i)(A) of this section, allocate any business interest expense that was formerly such UTP EBIE to its specified partner. For purposes of this section, the term specified partner refers to the partner of upper-tier partnership that, due to the initial allocation of excess business interest expense from lower-tier partnership to upper-tier partnership, was required to reduce its section 704(b) capital account pursuant to paragraph (j)(2) of this section. Similar principles apply if the specified partner of such business interest expense is itself a partnership. See paragraph (j)(6) of this section for rules that apply if a specified partner disposes of its partnership interest.

(C) Third, in the manner provided in paragraph (j)(7)(ii) (or (iii), as the case may be) of this section, take into account any negative basis adjustments under section 734(b) previously made to the UTP EBIE treated as business interest expense paid or accrued in paragraph (j)(5)(i)(A) of this section. Additionally, persons treated as specified partners with respect to the UTP EBIE treated as business interest expense paid or accrued in paragraph (j)(5)(i)(A) shall take any negative basis adjustments under section 743(b) into account in the manner provided in paragraph (j)(7)(ii) (or (iii), as the case may be) of this section.

(ii) *Upper-tier partnership disposition of lower-tier partnership interest.* If upper-tier partnership disposes of a lower-tier partnership interest (transferred interest), upper-tier partnership shall—

(A) First, apply the rules in paragraph (h)(3) of this section (except as provided in paragraphs (j)(5)(ii)(B) and (C) of this section), using any reasonable method (including, for example, FIFO and LIFO) to determine which UTP EBIE is reduced pursuant paragraph (h)(3) of this section.

(B) Second, increase the adjusted basis of the transferred interest immediately before the disposition by the total amount of the UTP EBIE that was reduced in paragraph (j)(5)(ii)(A) of this section (the amount of UTP EBIE proportionate to the transferred interest).

(C) Third, in the manner provided in paragraph (j)(7)(iv) of this section, take into account any negative basis adjustments under sections 734(b) and 743(b) previously made to the UTP EBIE that was reduced in (A) earlier.

(6) *Disposition of a specified partner's partnership interest*—(i) *General rule.* If a specified partner (transferor) disposes of an upper-tier partnership interest (or an interest in a partnership that itself is a specified partner), the portion of any UTP EBIE to which the transferor's status as specified partner relates is not reduced pursuant to paragraph (j)(5)(ii) of this section. Rather, such UTP EBIE attributable to the interest disposed of is retained by upper-tier partnership and the transferee is treated as the specified partner for purposes of this section with respect to such UTP EBIE. Thus, upper-tier partnership must allocate any business interest expense that was formerly such UTP EBIE to the transferee. However, see paragraph (j)(8) of this section for rules regarding the deductibility of such transferee's business interest expense that was formerly UTP EBIE.

(ii) *Special rules*—(A) *Distribution in liquidation of a specified partner's partnership interest.* If a specified partner receives a distribution of property in complete liquidation of an upper-tier partnership interest, the portion of UTP EBIE of upper-tier partnership attributable to the liquidated interest shall not have a specified partner. If a specified partner (transferee) receives a distribution of an interest in upper-tier partnership in complete liquidation of a partnership interest, the transferee is the specified partner with respect to UTP EBIE of upper-tier partnership only to the same extent it was prior to the distribution. Similar principles apply where an interest in a partnership that is a specified partner is distributed in complete liquidation of a transferee's partnership interest. See paragraph (j)(8) of this section for rules regarding the treatment of UTP EBIE that does not have a specified partner.

(B) *Contribution of a specified partner's partnership interest.* If a specified partner (transferor) contributes an upper-tier partnership interest to a partnership (transferee), the transferee is treated as the specified partner with respect to the portion of the UTP EBIE attributable to the contributed interest. Following the transaction, the transferor continues to be the specified partner with respect to the UTP EBIE attributable to the contributed interest. Similar principles apply where an interest in a partnership that is a specified partner is contributed to a partnership.

(7) *Effect of basis adjustments allocated to UTP EBIE*—(i) *In general.* Negative basis adjustments under sections 734(b) and 743(b) allocated to UTP EBIE do not affect the carryforward component (described in paragraph (j)(4) of this section) of such UTP EBIE. Rather, negative basis adjustments under sections 734(b) and 743(b) affect only the basis component of such UTP EBIE. For purposes of §§ 1.743–1(d), 1.755–1(b), and 1.755–1(c), the amount of tax loss that would be allocated to a transferee from a hypothetical disposition by upper-tier partnership of its UTP EBIE equals the adjusted basis of the UTP EBIE to which the transferee's status as specified partner relates. Additionally, solely for purposes of § 1.755–1(b), upper-tier partnership shall treat UTP EBIE as an ordinary asset of upper-tier partnership.

(ii) *UTP EBIE treated as deductible business interest expense.* If UTP EBIE that was allocated a negative section 734(b) adjustment is subsequently treated as deductible business interest expense, then such deductible business interest expense does not result in a deduction to the upper-tier partnership or the specified partner of such deductible business interest expense. If UTP EBIE that was allocated a negative section 743(b) adjustment is subsequently treated as deductible business interest expense, the specified partner of such deductible business interest expense recovers any negative section 743(b) adjustment attributable to such deductible business interest expense (effectively eliminating any deduction for such deductible business interest expense).

(iii) *UTP EBIE treated as excess business interest expense.* If UTP EBIE that was allocated a negative section 734(b) or 743(b) adjustment is subsequently treated as excess business interest expense, the specified partner's basis decrease in its upper-tier partnership interest required under paragraph (h)(2) of this section is reduced by the amount of the negative section 734(b) or 743(b) adjustment previously made to such excess business interest expense. If such excess business interest expense is subsequently treated as business interest expense paid or accrued by the specified partner, no deduction shall be allowed for any of such business interest expense. If the specified partner of such excess business interest expense is a partnership, such excess business interest expense is considered UTP EBIE that was previously allocated a negative section 734(b) adjustment for purposes of this section.

(iv) *UTP EBIE reduced due to a disposition.* If UTP EBIE that was allocated a negative section 734(b) or 743(b) adjustment is reduced pursuant to paragraph (j)(5)(ii)(A) of this section, the amount of upper-tier partnership's basis increase under paragraph (j)(5)(ii)(B) of this section to the disposed of lower-tier partnership interest is reduced by the amount of the negative section 734(b) or 743(b) adjustment previously made to such UTP EBIE.

(8) *Anti-loss trafficking*—(i) *Transferee specified partner.* No deduction shall be allowed to any

transferee specified partner for any business interest expense derived from a transferor's share of UTP EBIE. For purposes of this section, the term transferee specified partner refers to any specified partner that did not reduce its section 704(b) capital account due to the initial allocation of excess business interest expense from lower-tier partnership to upper-tier partnership pursuant to paragraph (j)(2) of this section. However, the transferee described in paragraph (j)(6)(ii)(B) of this section is not a transferee specified partner for purposes of this section. If pursuant to paragraph (j)(5)(i)(B) of this section a transferee specified partner is allocated business interest expense derived from a transferor's share of UTP EBIE (business interest expense to which the partner's status as transferee specified partner relates), the transferee specified partner is deemed to recover a negative section 743(b) adjustment with respect to, and in the amount of, such business interest expense and takes such negative section 743(b) adjustment into account in the manner provided in paragraph (j)(7)(ii) (or (iii), as the case may be) of this section, regardless of whether a section 754 election was in effect or a substantial built-in loss existed at the time of the transfer by which the transferee specified partner acquired the transferred interest. However, to the extent a negative section 734(b) or 743(b) adjustment was previously made to such business interest expense, the transferee specified partner does not recover an additional negative section 743(b) adjustment pursuant to this paragraph.

(ii) *UTP EBIE without a specified partner.* If UTP EBIE does not have a specified partner (as the result of a transaction described in paragraph (j)(6)(ii)(A) of this section), upper-tier partnership shall not allocate any business interest expense that was formerly such UTP EBIE to its partners. Rather, for purposes of applying paragraph (f)(2) of this section, upper-tier partnership shall treat such business interest expense as the allocable business interest expense (as defined in paragraph (f)(2)(ii) of this section) of a § 1.163(j)–6(j)(8)(ii) account. Additionally, if UTP EBIE that does not have a specified partner (as the result of a transaction described in paragraph (j)(6)(ii)(A) of this section) is treated as paid or accrued pursuant to paragraph (g) of this section, upper-tier partnership shall make a § 1.163(j)–6(h)(5) basis adjustment to its property in the amount of the adjusted basis (if any) of such UTP EBIE at the time such UTP EBIE is treated as business interest expense paid or accrued pursuant to paragraph (g) of this section.

(iii) *Disallowance of addback.* No basis increase under paragraph (j)(5)(ii) of this section shall be allowed to upper-tier partnership for any disallowed UTP EBIE. For purposes of this section, the term disallowed UTP EBIE refers to any UTP EBIE that has a specified partner that is a transferee specified partner (as defined in paragraph (j)(8)(i) of this section) and any UTP EBIE that does not have a specified partner (as the result of a transaction described in paragraph (j)(6)(ii)(A) of this section). For purposes of applying paragraph (j)(5)(ii) of this section, upper-tier partnership shall treat any disallowed UTP EBIE in the same manner as UTP EBIE that has previously been allocated a negative section 734(b) adjustment and take such negative section 734(b) adjustment into account in the manner provided in paragraph (j)(7)(iv) of this section. However, upper-tier partnership does not treat disallowed UTP EBIE as though it were allocated a negative section 734(b) adjustment pursuant to this paragraph to the extent a negative section 734(b) or 743(b) adjustment was previously made to such disallowed UTP EBIE.

(9) *Determining allocable ATI and allocable business interest income of upper-tier partnership partners*—(i) *In general.* When applying paragraph (f)(2)(ii) of this section, an upper-tier partnership determines the allocable ATI and allocable business interest income of each of its partners in the manner provided in this paragraph. Specifically, if an upper-tier partnership's net amount of tax items that comprise (or have ever comprised) ATI is greater than or equal to its ATI, upper-tier partnership applies the rules in paragraph (j)(9)(ii)(A) of this section to determine each partner's allocable ATI. See *Example 32* in paragraph (o)(32) of this section. However, if an upper-tier partnership's net amount of tax items that comprise (or have ever comprised) ATI is less than its ATI, upper-tier partnership applies the rules in paragraph (j)(9)(ii)(B) of this section to determine each partner's allocable ATI. See *Example 33* in paragraph (o)(33) of this section. To determine each partner's allocable business interest income, an upper-tier partnership applies the rules in paragraph (j)(9)(iii) of this section.

(ii) *Upper-tier partner's allocable ATI*—(A) If an upper-tier partnership's net amount of tax items that comprise (or have ever comprised) ATI is greater than or equal to its ATI (as determined under § 1.163(j)–1(b)(1)), then an upper-tier partner's allocable ATI (for purposes of paragraph (f)(2)(ii) of this section) is equal to the product of—

(*1*) Such partner's distributive share of gross income and gain items that comprise (or have ever comprised) ATI, minus such partner's distributive share of gross loss and deduction items that comprise (or have ever comprised) ATI; multiplied by

(*2*) A fraction, the numerator of which is upper-tier partnership's ATI (as determined under § 163(j)–1(b)(1)), and the denominator of which is upper-tier partnership's net amount of tax items that comprise (or have ever comprised) ATI.

(B) If an upper-tier partnership's net amount of tax items that comprise (or have ever comprised) ATI is less than its ATI (as determined under § 1.163(j)–1(b)(1)), then an upper-tier partner's allocable ATI (for purposes of paragraph (f)(2)(ii) of this section) is equal to—

(*1*) The excess (if any) of such partner's distributive share of gross income and gain items that comprise (or have ever comprised) ATI, over such partner's distributive share of gross loss and deduction items that comprise (or have ever comprised) ATI; increased by

(*2*) The product of—

(*i*) Such partner's share of residual profits expressed as a fraction; multiplied by

(*ii*) Upper-tier partnership's ATI (as determined under § 1.163(j)–1(b)(1)), minus the aggregate of all the partners' amounts determined under paragraph (j)(9)(ii)(B)(*1*) of this section.

(iii) *Upper-tier partner's allocable business interest income.* An upper-tier partner's allocable business interest income (for purposes of paragraph (f)(2)(ii) of this section) is equal to the product of—

(A) Such partner's distributive share of items that comprise (or have ever comprised) business interest income; multiplied by

(B) A fraction, the numerator of which is upper-tier partnership's business interest income (as determined under § 1.163(j)–1(b)(4)), and the denominator of which is the upper-tier partnership's amount of items that comprise (or have ever comprised) business interest income.

* * * * *

(l) * * *

(4) * * *

(iv) *S corporation deductions capitalized by an S corporation shareholder.* The ATI of an S corporation shareholder is increased by the portion of such S corporation shareholder's allocable share of qualified expenditures (as defined in section 59(e)(2)) to which an election under section 59(e) applies.

* * * * *

(n) *Treatment of self-charged lending transactions between partnerships and partners.* In the case of a lending transaction between a partner (lending partner) and partnership (borrowing partnership) in which the lending partner owns a direct interest (self-charged lending transaction), any business interest expense of the borrowing partnership attributable to the self-charged lending transaction is business interest expense of the borrowing partnership for purposes of this section. If in a given taxable year the lending partner is allocated excess business interest expense from the borrowing partnership and has interest income attributable to the self-charged lending transaction (interest income), the lending partner is deemed to receive an allocation of excess business interest income from the borrowing partnership in such taxable year. The amount of the lending partner's deemed allocation of excess business interest income is the lesser of such lending partner's allocation of excess business interest expense from the borrowing partnership in such taxable year or the interest income attributable to the self-charged lending transaction in such taxable year. To prevent the double counting of business interest income, the lending partner includes interest income that was treated as excess business interest income pursuant to this paragraph (n) only once when calculating its own section 163(j) limitation. In cases where the lending partner is not a C corporation, to the extent that any interest income exceeds the lending partner's allocation of excess business interest expense from the borrowing partnership for the taxable year, and such interest income otherwise would be properly treated as investment income of the lending partner for purposes of section 163(d) for that year, such excess amount of interest income will continue to be treated as investment income of the lending partner for that year for purposes of section 163(d).

See *Example 26* in paragraph (o)(26) of this section.

(o) * * *

(24) *Example 24*—(i) *Facts.* On January 1, 2020, L and M form LM, a publicly traded partnership (as defined in § 1.7704–1), and agree that each will be allocated a 50 percent share of all LM items. The partnership agreement provides that LM will make allocations under section 704(c) using the remedial allocation method under § 1.704–3(d). L contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. The property is depreciated using the straight-line method with a 10-year recovery period and has 4 years remaining on its recovery period. M contributes $10,000 in cash, which LM uses to purchase land. Except for the depreciation deductions, LM's expenses equal its income in each year of the 10 years commencing with the year LM is formed. LM has a valid section 754 election in effect.

(ii) *Section 163(j) remedial items and partner basis items.* LM sells the asset contributed by L in a fully taxable transaction at a time when the adjusted basis of the property is $4,000. Under § 1.163(j)–6(e)(2)(ii), solely for purposes of § 1.163(j)–6, the tax gain of $6,000 is allocated equally between L and M ($3,000 each). To avoid shifting built-in gain to the non-contributing partner (M) in a manner consistent with the rule in section 704(c), a remedial deduction of $3,000 is allocated to M (leaving M with no net tax gain), and remedial income of $3,000 is allocated to L (leaving L with total tax gain of $6,000).

(25) *Example 25*—(i) *Facts.* The facts are the same as *Example 24* in paragraph (o)(24) of this section except the property contributed by L had an adjusted tax basis of zero. For each of the 10 years following the contribution, there would be $500 of section 704(c) remedial income allocated to L and $500 of remedial deductions allocated to M with respect to the contributed asset. A buyer of M's units would step into M's shoes with respect to the $500 of annual remedial deductions. A buyer of L's units would step into L's shoes with respect to the $500 of annual remedial income and would have an annual section 743(b) deduction of $1,000 (net $500 of deductions).

(ii) *Analysis.* Pursuant to § 1.163(j)–6(d)(2)(ii), solely for purposes of § 1.163(j)–6, a buyer of L's units immediately after formation of LM would offset its $500 annual section 704(c) remedial income allocation with $500 of annual section 743(b) adjustment (leaving the buyer with net $500 of section 743(b) deduction). As a result, such buyer would be in the same position as a buyer of M's units. Each buyer would have net deductions of $500 per year, which would not affect ATI before 2022.

(26) *Example 26*—(i) *Facts.* X and Y are partners in partnership PRS. In Year 1, PRS had $200 of excess business interest expense. Pursuant to § 1.163(j)–6(f)(2), PRS allocated $100 of such excess business interest expense to each of its partners. In Year 2, X lends $10,000 to PRS and receives $1,000 of interest income for the taxable year (self-charged lending transaction). X is not in the trade or business of lending money. The $1,000 of interest expense resulting from this loan is allocable to PRS's trade or business assets. As a result, such $1,000 of interest expense is business interest expense of PRS. X and Y are each allocated $500 of such business interest expense as their distributive share of PRS's business interest expense for the taxable year. Additionally, in Year 2, PRS has $3,000 of ATI. PRS allocates the items comprising its $3,000 of ATI $0 to X and $3,000 to Y.

(ii) *Partnership-level.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $900 ($3,000 × 30 percent). Thus, PRS has $900 of deductible business interest expense, $100 of excess business interest expense, $0 of excess taxable income, and $0 of excess business interest income. Pursuant to § 1.163(j)–6(f)(2), $400 of X's allocation of business interest expense is treated as deductible business interest expense, $100 of X's allocation of business interest expense is treated as excess business interest expense, and $500 of Y's allocation of business interest expense is treated as deductible business interest expense.

(iii) *Lending partner.* Pursuant to § 1.163(j)–6(n), X treats $100 of its $1,000 of interest income as excess business interest income allocated from PRS in Year 2. Because X is deemed to have been allocated $100 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 business interest income is allocated from such partnership to a partner, X treats its $100 allocation of excess business interest expense from PRS in Year 2 as business interest expense paid or accrued in Year 2. X, in computing its limit under section 163(j), has $100 of business interest income ($100 deemed allocation of excess business interest income from PRS in Year 2) and $100 of business interest expense ($100 allocation of excess business interest expense treated as paid or accrued in Year 2). Thus, X's $100 of business interest expense is deductible business interest expense. At the end of Year 2, X has $100 of excess business interest expense from PRS ($100 from Year 1). X treats $900 of its $1,000 of interest income as investment income for purposes of section 163(d).

(27) *Example 27*—(i) *Formation.* A, B, and C formed partnership UTP in Year 1, each contributing $1,000 cash in exchange for a one third interest. Also in Year 1, UTP, D, and E formed partnership LTP, each contributing $1,200 cash in exchange for a one third interest. LTP borrowed $9,000, resulting in each of its partners increasing its basis in LTP by $3,000. Further, the partners of UTP each increased their bases in UTP by $1,000 each as a result of the LTP borrowing.

(ii) *Application of section 163(j) to LTP.* In Year 1, LTP's only item of income, gain, loss, or deduction was $900 of BIE. As a result, LTP had $900 of excess business interest expense. Pursuant to § 1.163(j)–6(f)(2), LTP allocated $300 of excess business interest expense to each of its partners.

(iii) *Section 704(b) capital account adjustments.* Solely for purposes of section 704(b) and the regulations thereunder, each direct and indirect partner of LTP treats its allocation of excess business interest expense from LTP as a section 705(a)(2)(B) expenditure pursuant to § 1.163(j)–6(j)(2). Further, each indirect partner of LTP that reduced its section 704(b) capital account as a result of the $300 allocation of excess business interest expense to UTP is the specified partner of such UTP EBIE, as defined in § 1.163(j)–6(j)(5)(i)(B). Each partner of UTP reduced its capital account by $100 as a result of the $300 allocation of excess business interest expense from LTP to

UTP. As a result, A, B, and C are each a specified partner with respect to $100 of UTP EBIE.

(iv) *Basis adjustments.* Pursuant to § 1.163(j)–6(h)(2), D, E, and UTP each reduce its basis in LTP by the amount of its allocation of excess business interest expense from LTP. As a result, each partner's basis in its LTP interest is $3,900. Pursuant to § 1.163(j)–6(j)(3), the direct partners of UTP (A, B, and C) do not reduce the bases of their interests in UTP as a result of the allocation of excess business interest expense from LTP to UTP. UTP treats its $300 allocation of excess business interest expense from LTP as UTP EBIE, as defined in § 1.163(j)–6(j)(4). At the end of Year 1, the section 704(b) and tax basis balance sheets of LTP and UTP are as follows:

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Table 60 to paragraph (o)(27)(iv)--UTP Balance Sheet - End of Year 1

	Assets			Liabilities and Capital		
	Tax	Book		Tax	Book	
Cash	$1,800	$1,800	Liability	$3,000	$3,000	
LTP	3,900	3,900	Capital:			Basis
UTP EBIE	300	0	A	1,000	900	$2,000
			B	1,000	900	2,000
			C	1,000	900	2,000
Total	6,000	5,700	Total	6,000	5,700	6,000

Table 61 to paragraph (o)(27)(iv)--LTP Balance Sheet - End of Year 1

	Assets			Liabilities and Capital		
	Tax	Book		Tax	Book	
Cash	$11,700	$11,700	Liability	$9,000	$9,000	
			Capital:			Basis
			D	900	900	$3,900
			E	900	900	3,900
			UTP	900	900	3,900
Total	11,700	11,700	Total	11,700	11,700	11,700

Table 62 to paragraph (o)(27)(iv)--UTP EBIE - End of Year 1

	Specified partner			Partnership	
	Basis	Carryforward		Basis	Carryforward
A	$100	$100	UTP	$300	$300
B	100	100			
C	100	100			
Total	300	300	Total	300	300

(28) *Example 28*—(i) *Facts.* The facts are the same as *Example 27* in paragraph (o)(27) of this section. In Year 2, while a section 754 election was in effect, C sold its UTP interest to D for $900. In Year 3, LTP's only item of income, gain, loss, or deduction was $240 of income, which it allocated to UTP. Such $240 of income resulted in $240 of excess taxable income, which LTP allocated to UTP pursuant to § 1.163(j)–f(2). Further, in Year 3, UTP's only item of income, gain, loss, or deduction was its $240 allocation of income from LTP. UTP allocated such $240 of income equally among its partners. In Year 4, UTP sold its interest in LTP to X for $1,140.

(ii) *Sale of specified partner's UTP interest.* C's section 741 loss recognized on the sale of its partnership interest to D in Year 2 is $100 (amount realized of $900 cash, plus $1,000 relief of liabilities, less $2,000 basis in UTP). D's initial adjusted basis in the UTP interest acquired from C in Year 2 is $1,900 (the cash paid for C's interest, $900, plus $1,000, D's share of UTP liabilities). D's interest in UTP's previously taxed capital is $1,000 ($900, the amount of cash D would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $0, the amount of tax gain allocated to D from the hypothetical transaction, and increased by $100, the amount of tax loss that would be allocated to D from the hypothetical transaction). D's share of the adjusted basis to the partnership of the partnership's property is $2,000 ($1,000 share of previously taxed capital, plus $1,000 share of the partnership's liabilities). Therefore, the amount of the basis adjustment under section 743(b) to partnership property is negative $100 (the difference between $1,900 and $2,000). D's negative $100 section 743(b) adjustment is allocated among UTP's assets under section 755. Under § 1.755–1(b)(2), the amount of D's section 743(b) adjustment allocated to ordinary income property is equal to the total amount of income or loss that would be allocated to D from the sale of all ordinary income property in a hypothetical transaction. Solely for purposes of § 1.755–1(b), any UTP EBIE is treated as ordinary income property. Thus, D's negative $100 section 743(b) basis adjustment is allocated to UTP EBIE.

(iii) *Application of section 163(j) to UTP.* In Year 3, UTP was allocated excess taxable income from LTP. Thus, UTP applies the rules in § 1.163(j)–6(j)(5)(i). First, pursuant to § 1.163(j)–6(j)(5)(i)(A), UTP applies the rules in § 1.163(j)–6(g) to its UTP EBIE. Because UTP was allocated $240 of excess taxable income from LTP in Year 3, UTP treats $240 of its UTP EBIE as business interest expense paid or accrued in Year 3. Specifically, UTP treats $80 of each partner's share of UTP EBIE as business interest expense paid or accrued. Under these circumstances, UTP's method for determining which UTP EBIE is treated as business interest expense paid or accrued is reasonable. Second, pursuant to § 1.163(j)–6(j)(5)(i)(B), UTP allocates such business interest expense that was formerly UTP EBIE to its specified partner. Accordingly, A and B are each allocated $80 of business interest expense. Pursuant to § 1.163(j)–6(j)(6)(i), D is treated as the specified partner with respect to $100 of UTP EBIE (C's share of UTP EBIE prior to the sale). Further, pursuant to § 1.163(j)–6(j)(5)(i)(A), $80 of the UTP EBIE to which D is the specified partner was treated as business interest expense paid or accrued. Accordingly, D is allocated such $80 of business interest expense. After determining each partner's allocable share of section 163(j) items used in its own section 163(j) calculation, UTP determines each partner's allocable share of excess items pursuant to § 1.163(j)–6(f)(2).

TABLE 62 TO PARAGRAPH (o)(28)(iii)—UTP'S APPLICATION OF § 1.163(j)–6(f)(2)(II) IN YEAR 3

	A	B	D	Total
Allocable ATI	$80	$80	$80	$240
Allocable BII	0	0	0	0
Allocable BIE	80	80	80	240

TABLE 63 TO PARAGRAPH (o)(28)(iii)—UTP'S APPLICATION OF § 1.163(j)–6(f)(2)(xi) IN YEAR 3

	A	B	D	Total
Deductible BIE	$24	$24	$24	$72
EBIE allocated	56	56	56	168
ETI allocated	0	0	0	0
EBII allocated	0	0	0	0

(iv) *Treatment of business interest expense that was formerly UTP EBIE.* After determining each partner's share of deductible business interest expense and section 163(j) excess items, UTP takes into account any basis adjustments under section 734(b) and the partners take into account any basis adjustments under section 743(b) to business interest expense that was formerly UTP EBIE pursuant to § 1.163(j)–6(j)(5)(i)(C). None of the UTP EBIE treated as business interest expense paid or accrued in Year 3 was allocated a section 734(b) adjustment. Additionally, neither A's nor B's share of business interest expense that was formerly UTP EBIE was allocated a section 743(b) basis adjustment. Further, neither A nor B is a transferee specified partner, as defined in § 1.163(j)–6(j)(8)(i). Therefore, no special adjustments are required to A's or B's $24 of deductible business interest expense and $56 of excess business interest expense. At the end of Year 3, A and B each has an adjusted basis in UTP of $2,000 and each is the specified partner with respect to $20 of UTP EBIE. D's share of business interest expense that was formerly UTP EBIE was allocated a negative $80 section 743(b) adjustment. Pursuant to § 1.163(j)–6(j)(7)(ii), D recovers $24 of the negative section 743(b) adjustment, effectively eliminating the $24 deduction resulting from its $24 allocation of deductible business interest expense. Additionally, pursuant to § 1.163(j)–6(j)(7)(iii), the $56 basis decrease required under § 1.163(j)–6(h)(2) for D's allocation of excess business interest expense is reduced by the negative section 743(b) adjustment attributable to such excess business interest expense ($56). Consequently, D does not reduce the basis of its interest in UTP pursuant § 1.163(j)–6(h)(2) upon being allocated such excess business interest expense. As a result, D has $56 of excess business interest expense with a basis of $0. At the end of Year 3, D has an adjusted basis in UTP of $1,980 and is the specified partner with respect to $20 of UTP EBIE.

(v) *Application of anti-loss trafficking rules.* Although D is a transferee specified partner, as defined in § 1.163(j)–6(j)(8)(i), with respect to its $80 allocation of business interest expense from UTP, no special basis adjustments under § 1.163(j)–6(j)(8)(i) are required because all $80 of such business interest expense was already fully offset by negative section 743(b) adjustment. However, if such $80 of business interest expense was not fully offset by a negative section 743(b) adjustment, D's status as transferee specified partner would cause such business interest expense to be fully offset by a negative section 743(b) adjustment pursuant to § 1.163(j)–6(j)(8)(i), regardless of whether a section 754 election was not in effect with respect to the sale of UTP from C to D. Such negative section 743(b) adjustment would be taken into account in the manner described in § 1.163(j)–6(j)(7).

Table 64 to paragraph (o)(28)(v)--UTP EBIE - End of Year 3

	Specified partner				Partnership	
	Basis	743(b)	Carryforward		Basis	Carryforward
A	$20		$20	UTP	$60	$60
B	20		20			
D	20	(20)	20			
Total	60		60	Total	60	60

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(vi) *Sale of LTP interest.* In Year 4, UTP disposed of its interest in LTP. Thus, UTP applies the rules in § 1.163(j)–6(j)(5)(ii). First, pursuant to § 1.163(j)–6(j)(5)(ii)(A), UTP applies the rules in § 1.163(j)–6(h)(3) to its UTP EBIE. Because UTP disposed of all of its LTP interest, UTP reduces its UTP EBIE by $60. Second, pursuant to § 1.163(j)–6(j)(5)(ii)(B), UTP increases the adjusted basis of its LTP interest by $60 (the total amount of UTP EBIE that was reduced pursuant to § 1.163(j)–6(j)(5)(ii)(A)). Third, pursuant to § 1.163(j)–6(j)(5)(ii)(C), this $60 increase is reduced by $20 to take into account the negative $20 section 743(b) adjustment allocated in Year 2 to the $20 of UTP EBIE reduced pursuant to § 1.163(j)–6(j)(5)(ii)(A). As a result, UTP's adjusted basis in its LTP interest immediately prior to the sale to X is $4,180 ($3,900 at the end of Year 1, plus $240 allocation of income from LTP in Year 3, plus $40 increase immediately prior to the sale attributable to the basis of UTP EBIE). UTP's section 741 loss recognized on the sale is $40 (amount realized of $1,140 cash, plus $3,000 relief of liabilities, less $4,180 adjusted basis in LTP). No deduction under section 163(j) is allowed to the UTP or X under chapter 1 of subtitle A of the Code for any of such UTP EBIE reduced under § 1.163(j)–6(h)(3). Pursuant to § 1.163(j)–6(h)(5), LTP has a § 1.163(j)–6(h)(5) basis adjustment of $40. LTP does not own property of the character required to be adjusted. Thus, under § 1.755–1(c)(4), the adjustment is made when LTP subsequently acquires capital gain property to which an adjustment can be made. Regardless of whether a $20 negative section 743(b) adjustment was allocated to the $20 of UTP EBIE reduced pursuant to § 1.163(j)–6(j)(5)(ii)(A), UTP would only increase its basis in LTP pursuant to § 1.163(j)–6(j)(5)(ii) by $40. The specified partner of such $20 of UTP EBIE is a transferee specified partner. Therefore, it is treated as disallowed UTP EBIE under § 1.163(j)–6(j)(8)(iii) of this section. As a result, UTP would treat such $20 of UTP EBIE for purposes of § 1.163(j)–6(j)(5)(ii) as though it were allocated a negative section 734(b) adjustment of $20.

(29) *Example 29*—(i) *Facts.* The facts are the same as *Example 27* in paragraph (o)(27) of this section. In Year 2, while a section 754 election was in effect, UTP distributed $900 to C in complete liquidation of C's partnership interest. In Year 3, LTP's only item of income, gain, loss, or deduction was $240 of income, which it allocated to UTP. Such $240 of income resulted in $240 of excess taxable income, which LTP allocated to UTP pursuant to § 1.163(j)–f(2). Further, in Year 3, UTP's only item of income, gain, loss, or deduction was its $240 allocation of income from LTP. UTP allocated such $240 of income equally among its partners. In Year 4, UTP sold its interest in LTP to X for $1,140.

(ii) *Liquidating distribution to specified partner.* C's section 731(a)(2) loss recognized on the disposition of its partnership interest is $100 ($2,000 basis in UTP, less amount realized of $900 cash, plus $1,000 relief of liabilities). Because the election under section 754 is in effect, UTP has a section 734(b) decrease to the basis of its assets of $100 (the amount of section 731(a)(2) loss recognized by C). Under section 755, the entire negative $100 section 734(b) adjustment is allocated to UTP EBIE. Following the liquidation of C, UTP's basis in its assets ($900 of cash, plus $3,900 interest in LTP, plus $200 basis of UTP EBIE) equals the aggregate outside basis of partners A and B ($5,000).

(iii) *Application of section 163(j) to UTP.* In Year 3, UTP was allocated excess taxable income from LTP. Thus, UTP applies the rules in § 1.163(j)–6(j)(5)(i). First, pursuant to § 1.163(j)–6(j)(5)(i)(A), UTP applies the rules in § 1.163(j)–6(g) to its UTP EBIE. Because UTP was allocated $240 of excess taxable income from LTP in Year 3, UTP treats $240 of its UTP EBIE as business interest expense paid or accrued in Year 3. Specifically, UTP treats $100 of A's share, $100 of B's share, and $40 of the UTP EBIE that does not have a specified partner as business interest expense paid or accrued. Under these circumstances, UTP's method for determining which UTP EBIE is treated as business interest expense paid or accrued is reasonable. Second, pursuant to § 1.163(j)–6(j)(5)(i)(B), UTP allocates such business interest expense that was formerly UTP EBIE to its specified partner. Accordingly, each of A and B is allocated $100 of business interest expense.

(iv) *Application of anti–loss trafficking rules.* Following the liquidating distribution to C in Year 2 (a transaction described in § 1.163(j)–6(j)(6)(ii)(A)), the $100 of UTP EBIE to which C was formerly the specified partner does not have a specified partner. Thus, UTP does not allocate any deductible business interest expense or excess business interest expense that was formerly C's share of UTP EBIE to A or B. Rather, pursuant to § 1.163(j)–6(j)(8)(ii), UTP treats such business interest expense as the allocable business interest expense, as defined in § 1.163(j)–6(f)(2)(ii), of a § 1.163(j)–6(j)(8)(ii) account for purposes of applying § 1.163(j)–6(f)(2). After determining each partner's allocable share of section 163(j) items used in its own section 163(j) calculation, UTP determines each partner's allocable share of excess items pursuant to § 1.163(j)–6(f)(2).

TABLE 65 TO PARAGRAPH (o)(29)(iv)—UTP'S APPLICATION OF § 1.163(j)–6(f)(2)(ii) IN YEAR 3

	A	B	§ 1.163(j)–6(j)(8)(ii) account	Total
Allocable ATI	$120	$120	$0	$240
Allocable BII	0	0	0	0
Allocable BIE	100	100	40	240

TABLE 65 TO PARAGRAPH (o)(29)(iv)—UTP'S APPLICATION OF § 1.163(j)–6(f)(2)(xi) IN YEAR 3

	A	B	§ 1.163(j)–6(j)(8)(ii) account	Total
Deductible BIE	$36	$36	$0	$72
EBIE allocated	64	64	40	168
ETI allocated	0	0	0	0
EBII allocated	0	0	0	0

(v) *Treatment of business interest expense that was formerly UTP EBIE.* After determining each partner's share of deductible business interest expense and section 163(j) excess items, UTP takes into account any basis adjustments under section 734(b) and the partners take into account any basis under section 743(b) to business interest expense that was formerly UTP EBIE pursuant to § 1.163(j)–6(j)(5)(i)(C). None of the UTP EBIE treated as business interest expense paid or accrued in Year 3 was allocated a section 743(b) adjustment. Further, neither A nor B is a transferee specified partner, as defined in § 1.163(j)–6(j)(8)(i). Therefore, no special basis adjustments are required under § 1.163(j)–6(j)(8)(i). The $40 of excess business interest expense allocated to the § 1.163(j)–6(j)(8)(ii) account is not allocated to A or B and is not carried over by UTP. Additionally, UTP does not have a § 1.163(j)–6(h)(5) basis adjustment because such $40 of business interest expense does not have any basis. Thus, A and B each has $36 of deductible business interest expense and $64 of excess business interest expense. At the end of Year 3, A and B each has an adjusted basis in UTP of $2,520 ($2,500 outside basis, plus $120 allocation of income, less $36 of deductible business interest expense, less $64 of excess business interest expense), and neither A nor B is a specified partner with respect to any of UTP's $60 of UTP EBIE.

TABLE 66 TO PARAGRAPH (o)(29)(v)—UTP EBIE—END OF YEAR 3

	Specified partner			Partnership	
	Basis	Carryforward		Basis	Carryforward
A	$0	$0	UTP	$0	$60
B	0	0			
§ 1.163(j)–6(j)(8)(ii) account	0	60			
Total	0	60	Total	0	60

(vi) *Sale of LTP interest.* In Year 4, UTP disposed of its interest in LTP. Thus, UTP applies the rules in § 1.163(j)–6(j)(5)(ii). First, pursuant to § 1.163(j)–6(j)(5)(ii)(A), UTP applies the rules in § 1.163(j)–6(h)(3) to its UTP EBIE. Because UTP disposed of all of its LTP interest, UTP reduces its UTP EBIE by $60. Second, pursuant to § 1.163(j)–6(j)(5)(ii)(B), UTP increases the adjusted basis of its LTP interest by $60 (the total amount of UTP EBIE that was reduced pursuant to § 1.163(j)–6(j)(5)(ii)(A)). Third, pursuant to § 1.163(j)–6(j)(5)(ii)(C), this $60 increase is reduced by $60 to take into account the negative $60 section 734(b) adjustment allocated in Year 2 to the $60 of UTP EBIE reduced pursuant to § 1.163(j)–6(j)(5)(ii)(A). As a result, UTP's adjusted basis in its LTP interest immediately prior to the sale to X is $4,140 ($3,900 at the end of Year 1, plus $240 allocation of income from LTP in Year 3). UTP has no section 741 gain or loss recognized on the sale (amount realized of $1,140 cash, plus $3,000 relief of liabilities, equals $4,140 adjusted basis in LTP). No deduction under section 163(j) is allowed to the UTP or X under chapter 1 of subtitle A of the Code for any of such UTP EBIE reduced under § 1.163(j)–6(h)(3). Regardless of whether the $60 of UTP EBIE's basis was reduced by a $60 negative section 734(b) adjustment, UTP would not increase its basis in LTP pursuant to § 1.163(j)–6(j)(5)(ii) of this section as a result of the sale to X. The $60 of UTP EBIE does not have a specified partner. Therefore, it is treated as disallowed UTP EBIE under § 1.163(j)–6(j)(8)(iii) of this section. As a result, UTP would treat such $60 of UTP EBIE for purposes of § 1.163(j)–6(j)(5)(ii) as though it were allocated a negative section 734(b) adjustment of $60.

(30) *Example 30*—(i) X, Y and Z are partners in partnership PRS, PRS and A are partners in UTP, and UTP is a partner in LTP. LTP allocates $15 of excess business interest expense to UTP. Pursuant to § 1.163(j)–6(j)(2), UTP reduces its section 704(b) capital account (capital account) in LTP by $15, A reduces its capital account in UTP by $5, PRS reduces its capital account in UTP by $10, X reduces its capital account in PRS by $4, and Y reduces its capital account in PRS by $6. Thus, A, PRS, X, and Y are the specified partner with respect to $5, $10, $4, and $6 of UTP EBIE, respectively.

(ii) Assume the same facts in (i) except that PRS distributed cash to Y in complete liquidation of Y's interest in PRS. As a result, pursuant to § 1.163(j)–6(j)(6)(ii)(A), Y's share of UTP EBIE would not have a specified partner. In a subsequent year, if LTP allocated UTP $15 of excess business interest income, UTP would apply the rules in § 1.163(j)–6(j)(5)(i) and allocate $5 of deductible business interest expense to A and $10 of deductible business interest expense to PRS (the specified partners of such deductible business interest expense). Because the $10 of deductible business interest expense allocated to PRS was formerly UTP EBIE, PRS must also apply the rules in § 1.163(j)–6(j)(5)(i). PRS would allocate $4 of such deductible business interest expense to X (the specified partner of such $4). However, as a result of the liquidating distribution to Y, the remaining $6 of deductible business interest expense does not have a specified partner. Thus, pursuant to § 1.163(j)–6(j)(8)(ii), PRS would make a § 1.163(j)–6(h)(5) basis adjustment to its property in the amount of the adjusted basis (if any) of such $6 of deductible business interest expense.

(iii) Assume the same facts as in (i) except that PRS distributed its interest in UTP to Y in complete liquidation of Y's interest in PRS. Pursuant to § 1.163(j)–6(j)(6)(ii)(A), Y is the specified partner with respect to UTP EBIE of UTP only to the same extent it was prior to the distribution ($6). As a result, the UTP EBIE of UTP in excess of the UTP EBIE for which Y is the specified partner (X's $4) does not have a specified partner. If in a subsequent year LTP allocated UTP $15 of excess business interest income, UTP would apply the rules in § 1.163(j)–6(j)(5)(i) and allocate $5 of deductible business interest expense to A and $6 of deductible business interest expense to Y. Regarding the $4 of DBIE without a specified partner, UTP would apply the rules in § 1.163(j)–6(j)(8)(ii) and make a § 1.163(j)–6(h)(5) basis adjustment to its property in the amount of the adjusted basis (if any) of such $4 of deductible business interest expense.

(iv) Assume the same facts as in (i) except that A contributes its UTP interest to a new partnership, PRS2. Following the contribution, PRS2 is treated as the specified partner with respect to the portion of the UTP EBIE attributable to the contributed interest ($5). Further, A continues to be the specified partner with respect to the UTP EBIE attributable to the contributed interest ($5). If in a subsequent year LTP allocated UTP $15 of excess business interest income, UTP would apply the rules in § 1.163(j)–6(j)(5)(i) and allocate $5 of deductible business interest expense to PRS2, and PRS2 would allocate such $5 of deductible business interest expense to A.

(31) *Example 31*—(i) *Facts.* In Year 1, A, B, and C formed partnership PRS by each contributing $1,000 cash. PRS borrowed $900, causing each partner's basis in PRS to increase by $300 under section 752. Also in Year 1, PRS purchased Capital Asset X for $200. In Year 2, PRS pays $300 of business interest expense, all of which is disallowed and treated as excess business interest expense. PRS allocated the $300 of excess business interest expense to its partners, $100 each. Pursuant to § 1.163(j)–6(h)(2), each partner reduced its adjusted basis in its PRS interest by its $100 allocation of excess business interest expense to $1,200. In Year 3, when the fair market value of Capital Asset X is $3,200 and no partner's basis in PRS has changed, PRS distributed $1,900 to C in complete liquidation of C's partnership interest in a distribution to which section 737 does not apply. PRS had a section 754 election in effect in Year 3.

(ii) *Consequences to selling partner.* Pursuant to § 1.163(j)–6(h)(3), C increases the adjusted basis of its interest in PRS by $100 immediately before the disposition. Thus, C's section 731(a)(1) gain recognized on the disposition of its interest in PRS is $900 (($1,900 cash + $300 relief of liabilities) − ($1,200 outside basis + $100 excess business interest expense add-back)).

(iii) *Partnership basis.* Pursuant to § 1.163(j)–6(h)(5), PRS has a $100 increase to the basis of its assets attributable to a § 1.163(j)–6(h)(5) basis increase immediately before C's disposition. Under section 755, the entire $100 adjustment is allocated to Capital Asset X. Pursuant to § 1.163(j)–6(h)(5), regardless of whether Capital Asset X is a depreciable or amortizable asset, none of the $100 of § 1.163(j)–6(h)(5) basis increase allocated to Capital Asset X is depreciable or amortizable. Additionally, PRS has a section 734(b) increase to the basis of its assets of $900 (the amount of section 731(a)(1) gain recognized by C). Under section 755, the entire $900 adjustment is allocated to Capital Asset X. As a result, PRS's basis in Capital Asset X is $1,200 ($200 + $100 § 1.163(j)–6(h)(5) basis increase + $900 section 734(b) adjustment). Following the liquidation of C, PRS's basis in its assets ($600 cash + $1,200

Capital Asset X) equals the aggregate adjusted basis of partners A and B in PRS ($1,800).

(32) *Example 32*—(i) *Facts.* X and Y are equal partners in partnership UTP, which is a partner in partnership LTP. In Year 1, LTP allocated $100 of income to UTP. LTP, in computing its limit under section 163(j), treated such $100 of income as ATI. Accordingly, in LTP's § 1.163(j)–6(f)(2)(ii) calculation, UTP's allocable ATI was $100. Additionally, pursuant to § 1.163(j)–6(f)(2), LTP allocated $50 of excess taxable income to UTP. UTP's only items of income, gain, loss or deduction in Year 1, other than the $100 allocation from LTP, were $100 of trade or business income and $30 of business interest expense. UTP allocated its $200 of income and gain items $100 to X and $100 to Y, and all $30 of its business interest expense to X.

(ii) *Partnership-level.* Pursuant to § 1.163(j)–6(e)(1), UTP, in computing its limit under section 163(j), does not increase or decrease any of its section 163(j) items by any of LTP's section 163(j) items. Pursuant to § 1.163(j)–1(b)(1), UTP determines it has $150 of ATI in Year 1 ($100 of ATI resulting from its $100 of trade or business income, plus $50 of excess taxable income from LTP). UTP's section 163(j) limit is 30 percent of its ATI, or $45 ($150 × 30 percent). Thus, UTP has $50 of excess taxable income and $30 of deductible business interest expense.

(iii) *Partner-level allocations.* UTP allocates its $50 of excess taxable income and $30 of deductible business interest expense to X and Y pursuant to § 1.163(j)–6(f)(2). To determine each partner's share of the $50 of excess taxable income, UTP must determine each partner's allocable ATI and allocable business interest expense (as defined in § 1.163(j)–6(f)(2)(ii)). X's allocable business interest expense is $30 and Y's allocable business interest expense is $0. Because UTP is an upper-tier partnership, UTP determines the allocable ATI of each of its partners in the manner provided in § 1.163(j)–6(j)(9). Specifically, because UTP's net amount of tax items that comprise (or have ever comprised) ATI is $200 ($100 of trade or business income that UTP treated as ATI, plus UTP's $100 allocation from LTP of items that comprised ATI to LTP), which is greater than its $150 of ATI, UTP must apply the rules in § 1.163(j)–6(j)(9)(ii)(A) to determine each of its partner's allocable ATI. UTP determines X's allocable ATI is $75 (X's $100 distributive share of gross income and gain items that comprise (or have ever comprised) ATI, multiplied by ($150/$200), the ratio of UTP's ATI to its tax items that comprise (or have ever comprised) ATI). In a similar manner, UTP determines Y's allocable ATI also equals $75. Therefore, pursuant to § 1.163(j)–6(f)(2), X is allocated $30 of deductible business interest expense and Y is allocated $50 of excess taxable income.

(33) *Example 33*—(i) *Facts.* X and Y are equal partners in partnership UTP, which is a partner in partnership LTP. Further, X and Y share the residual profits of UTP equally. In Year 1, LTP allocated ($99) of income to UTP. LTP, in computing its limit under section 163(j), treated such ($99) of income as ATI. Accordingly, in LTP's § 1.163(j)–6(f)(2)(ii) calculation, UTP's allocable ATI was ($99). UTP's only items of income, gain, loss or deduction in Year 1, other than the ($99) allocation from LTP, were $100 of trade or business income and $15 of business interest expense. UTP allocated $1 of income to X and $0 to Y pursuant to section 704(c), the ($99) of loss and remaining $99 of income equally pursuant to section 704(b), and all $15 of its business interest expense to X.

(ii) *Partnership-level.* Pursuant to § 1.163(j)–6(e)(1), UTP, in computing its limit under section 163(j), does not increase or decrease any of its section 163(j) items by any of LTP's section 163(j) items. Pursuant to § 1.163(j)–1(b)(1), UTP determines it has $100 of ATI in Year 1 ($100 of ATI resulting from its $100 of trade or business income). UTP's section 163(j) limit is 30 percent of its ATI, or $30 ($100 × 30 percent). Thus, UTP has $50 of excess taxable income and $15 of deductible business interest expense.

(iii) *Partner-level allocations.* UTP allocates its $50 of excess taxable income and $15 of deductible business interest expense to X and Y pursuant to § 1.163(j)–6(f)(2). To determine each partner's share of the $50 of excess taxable income, UTP must determine each partner's allocable ATI and allocable business interest expense (as defined in § 1.163(j)–6(f)(2)(ii)). X's allocable business interest expense is $15 and Y's allocable business interest expense is $0. Because UTP is an upper-tier partnership, UTP determines the allocable ATI of each of its partners in the manner provided in § 1.163(j)–6(j)(9). Specifically, because UTP's net amount of tax items that comprise (or have ever comprised) ATI is $1 ($100 of trade or business income that UTP treated as ATI, plus UTP's ($99) allocation from LTP of items that comprised ATI to LTP), which is less than its $100 of ATI, UTP must apply the rules in § 1.163(j)–6(j)(9)(ii)(B) to determine each of its partner's allocable ATI. UTP determines X's allocable ATI is $50.50 ($1, which is the excess of X's distributive share of gross income and gain items that comprise (or have ever comprised) ATI, $100, over X's distributive share of gross loss and deduction items that comprise (or have ever comprised) ATI, $99; increased by $49.50, which is the product of 50 percent, X's residual profit sharing percentage, and $99, UTP's $100 of ATI minus $1, which is the aggregate of all the partners' amounts determined under § 1.163(j)–6(j)(9)(ii)(B)(*1*)). In a similar manner, UTP determines Y's allocable ATI is $49.50. Therefore, pursuant to § 1.163(j)–6(f)(2), X is allocated $15 of deductible business interest expense and $0.50 of excess taxable income, and Y is allocated $49.50 of excess taxable income.

(34) *Example 34*—(i) *Facts.* X and Y are equal partners in partnership PRS. Further, X and Y share the profits of PRS equally. In 2019, PRS had ATI of $100. In 2020, PRS's only items of income, gain, loss or deduction was $1 of trade or business income, which it allocated to X pursuant to section 704(c).

(ii) *Partnership-level.* In 2020, PRS makes the election described in § 1.163(j)–6(d)(5) to use its 2019 ATI in 2020. As a result, PRS has $100 of ATI in 2020. PRS does not have any business interest expense. Therefore, PRS has $100 of excess taxable income in 2020.

(iii) *Partner-level allocations.* PRS allocates its $100 of excess taxable income to X and Y pursuant to § 1.163(j)–6(f)(2). To determine each partner's share of the $100 of excess taxable income, PRS must determine each partner's allocable ATI (as defined in § 1.163(j)–6(f)(2)(ii)). Because PRS made the election described in § 1.163(j)–6(d)(5), PRS must determine the allocable ATI of each of its partners pursuant to paragraph (j)(9) of this section in the same manner as an upper-tier partnership. Specifically, because PRS's amount of tax items that comprise ATI before the election is $1, which is less than its $100 of ATI following the election, PRS must apply the rules in § 1.163(j)–6(j)(9)(ii)(B) to determine each of its partner's allocable ATI. PRS determines X's allocable ATI is $50.50 ($1, which is the excess of X's distributive share of gross income and gain items that would have comprised ATI had PRS not made the election, $1, over X's distributive share of gross loss and deduction items that would have comprised ATI had PRS not made the election, $0; increased by $49.50, which is the product of 50%, X's residual profit share, and $99, PRS's $100 of ATI minus $1, the aggregate of all the partners' amounts determined under § 1.163(j)–6(j)(9)(ii)(B)(*1*)). In a similar manner, PRS determines Y's allocable ATI is $49.50. Therefore, pursuant to § 1.163(j)–6(f)(2), X is allocated $50.50 of excess taxable income, and Y is allocated $49.50 of excess taxable income.

(35) *Example 35*—(i) *Facts.* X, a partner in partnership PRS, was allocated $20 of excess business interest expense from PRS in 2018 and $10 of excess business interest expense from PRS in 2019. In 2020, PRS allocated $16 of excess taxable income to X.

(ii) *Analysis.* X treats 50 percent of its $10 of excess business interest expense allocated from PRS in 2019 as § 1.163(j)–6(g)(4) business interest expense. Thus, $5 of § 1.163(j)–6(g)(4) business interest expense is treated as paid or accrued by X in 2020 and is not subject to the section 163(j) limitation at X's level. Because X was allocated $16 of excess taxable income from PRS in 2020, X treats $16 of its $25 of excess business interest expense as business interest expense paid or accrued pursuant to § 1.163(j)–6(g)(2). X, in computing its limit under section 163(j) in 2020, has $16 of ATI (as a result of its allocation of $16 of excess taxable income from PRS), $0 of business interest income, and $16 of business interest expense ($16 of excess business interest expense treated as paid or accrued in 2020). Pursuant to § 1.163(j)–2(b)(2)(i), X's section 163(j) limit in 2020 is $8 ($16 × 50 percent). Thus, X has $8 of business interest expense that is deductible under section 163(j). The $8 of X's business interest expense not allowed as a deduction ($16 business interest expense subject to section 163(j), less $8 section 163(j) limit) is treated as business interest expense paid or accrued by X in 2021. At the end of 2020, X has $9 of excess business interest expense from PRS ($20 from 2018, plus $10 from 2019, less $5 treated as paid or accrued pursuant to § 1.163(j)–6(g)(4), less $16 treated as paid or accrued pursuant to § 1.163(j)–6(g)(2)).

(36) *Example 36*—(i) *Facts.* X is a partner in partnership PRS. At the beginning of 2018, X's outside basis in PRS was $100. X was

allocated $20 of excess business interest expense from PRS in 2018 and $10 of excess business interest expense from PRS in 2019. X sold its PRS interest in 2019 for $70.

(ii) *Analysis.* X treats 50 percent of its $10 of excess business interest expense allocated from PRS in 2019 as § 1.163(j)–6(g)(4) business interest expense. Thus, $5 of § 1.163(j)–6(g)(4) business interest expense is treated as paid or accrued by X in 2020 and is not subject to the section 163(j) limitation at X's level. Pursuant to paragraph (h)(3) of this section, immediately before the disposition, X increases the basis of its PRS interest to $95. Thus, X has a $25 section 741 loss recognized on the sale ($70–$95).

(p) *Applicability dates*—(1) *In general.* * * *

(2) *Paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5) and (6), (f)(1)(iii), (g)(4), (h)(4) and (5), (j), (l)(4)(iv), (n), and (o)(24) through (29).* Paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5) and (6), (f)(1)(iii), (g)(4), (h)(4) and (5), (j), (l)(4)(iv), (n), and (o)(24) through (29) of this section apply to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of those paragraphs to a taxable year beginning after December 31, 2017, and before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**], provided that they also apply the provisions of § 1.163(j)–6 in the section 163(j) regulations, and consistently apply all of the rules of § 1.163(j)–6 in the section 163(j) regulations to that taxable year and to each subsequent taxable year.

* * * * *

■ **Par. 8.** As added in a final rule elsewhere in this issue of the **Federal Register**, effective November 13, 2020, § 1.163(j)–7 is amended by revising paragraph (a), adding paragraphs (c) through (f), (g)(3) and (4), (h), and (j) through (l), and revising paragraph (m) to read as follows:

§ 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 and United States shareholders of relevant foreign corporations. Paragraph (b) of this section provides the general rule regarding the application of section 163(j) to a relevant foreign corporation. Paragraph (c) of this section provides rules for applying section 163(j) to CFC group members of a CFC group. Paragraph (d) of this section provides rules for determining a specified group and specified group members. Paragraph (e) of this section provides rules and procedures for treating a specified group member as a CFC group member and for determining a CFC group. Paragraph (f) of this section provides rules regarding the treatment of a CFC group member that has ECI. Paragraph (g) of this section provides rules concerning the computation of ATI of an applicable CFC. Paragraph (h) of this section provides a safe-harbor that exempts certain stand-alone applicable CFCs and CFC groups from the application of section 163(j) for a taxable year. Paragraph (i) of this section is reserved. Paragraph (j) of this section provides rules concerning the computation of ATI of a United States shareholder of an applicable CFC. Paragraph (k) of this section provides definitions that apply for purposes of this section. Paragraph (l) of this section provides examples illustrating the application of this section.

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(c) *Application of section 163(j) to CFC group members of a CFC group*—(1) *Scope.* This paragraph (c) provides rules for applying section 163(j) to a CFC group member. Paragraph (c)(2) of this section provides rules for computing a single section 163(j) limitation for a specified period of a CFC group. Paragraph (c)(3) of this section provides rules for allocating a CFC group's section 163(j) limitation to CFC group members for specified taxable years. Paragraph (c)(4) of this section provides currency translation rules. Paragraph (c)(5) of this section provides special rules for specified periods beginning in 2019 or 2020.

(2) *Calculation of section 163(j) limitation for a CFC group for a specified period*—(i) *In general.* A single section 163(j) limitation is computed for a specified period of a CFC group. For purposes of applying section 163(j) and the section 163(j) regulations, the current-year business interest expense, disallowed business interest expense carryforwards, business interest income, floor plan financing interest expense, and ATI of a CFC group for a specified period equal the sums of each CFC group member's respective amounts for its specified taxable year with respect to the specified period. A CFC group member's current-year business interest expense, business interest income, floor plan financing interest expense, and ATI for a specified taxable year are generally determined on a separate-company basis.

(ii) *Certain transactions between CFC group members disregarded.* Any transaction between CFC group members of a CFC group that is entered into with a principal purpose of affecting a CFC group or a CFC group member's section 163(j) limitation by increasing or decreasing a CFC group or a CFC group member's ATI for a specified taxable year is disregarded for purposes of applying section 163(j) and the section 163(j) regulations.

(iii) *CFC group treated as a single C corporation for purposes of allocating items to an excepted trade or business.* For purposes of allocating items to an excepted trade or business under § 1.163(j)–10, all CFC group members of a CFC group are treated as a single C corporation.

(iv) *CFC group treated as a single taxpayer for purposes of determining interest.* For purposes of determining whether amounts, other than amounts in respect of transactions between CFC group members of a CFC group, are treated as interest within the meaning of § 1.163(j)–1(b)(22), all CFC group members of a CFC group are treated as a single taxpayer.

(3) *Deduction of business interest expense*—(i) *CFC group business interest expense*—(A) *In general.* The extent to which a CFC group member's current-year business interest expense and disallowed business interest expense carryforwards for a specified taxable year that ends with or within a specified period may be deducted under section 163(j) is determined under the rules and principles of § 1.163(j)–5(a)(2) and (b)(3)(ii), subject to the modifications described in paragraph (c)(3)(i)(B) of this section.

(B) *Modifications to relevant terms.* For purposes of paragraph (c)(3)(i)(A) of this section, the rules and principles of § 1.163(j)–5(b)(3)(ii) are applied by—

(*1*) Replacing "§ 1.163(j)–4(d)(2)" in § 1.163(j)–5(a)(2)(ii) with "§ 1.163(j)–7(c)(2)(i)";

(*2*) Replacing the term "allocable share of the consolidated group's remaining section 163(j) limitation" with "allocable share of the CFC group's remaining section 163(j) limitation";

(*3*) Replacing the terms "consolidated group" and "group" with "CFC group";

(*4*) Replacing the term "consolidated group's remaining section 163(j) limitation" with "CFC group's remaining section 163(j) limitation";

(*5*) Replacing the term "consolidated return year" with "specified period";

(*6*) Replacing the term "current year" or "current-year" with "current specified period" or "specified taxable year with respect to the current specified period," as the context requires;

(*7*) Replacing the term ''member'' with ''CFC group member''; and

(*8*) Replacing the term ''taxable year'' with ''specified taxable year with respect to a specified period.''

(ii) *Carryforwards treated as attributable to the same taxable year.* For purposes of applying the principles of § 1.163(j)–5(b)(3)(ii), as required under paragraph (c)(3)(i) of this section, CFC group members' disallowed business interest expense carryforwards that arose in specified taxable years with respect to the same specified period are treated as disallowed business interest expense carryforwards from taxable years ending on the same date and are deducted on a pro rata basis, under the principles of § 1.163(j)–5(b)(3)(ii)(C)(*3*), pursuant to paragraph (c)(3)(i) of this section.

(iii) *Multiple specified taxable years of a CFC group member with respect to a specified period.* If a CFC group member has more than one specified taxable year (each year, an *applicable specified taxable year*) with respect to a single specified period of a CFC group, then all such applicable specified taxable years are taken into account for purposes of applying the principles of § 1.163(j)–5(b)(3)(ii), as required under paragraph (c)(3)(i) of this section, with respect to the specified period. The portion of the section 163(j) limitation allocable to disallowed business interest expense carryforwards of the CFC group member for its applicable specified taxable years is prorated among the applicable specified taxable years in proportion to the number of days in each applicable specified taxable year.

(iv) *Limitation on pre-group disallowed business interest expense carryforward*—(A) *General rule*—(*1*) *CFC group member pre-group disallowed business interest expense carryforward.* This paragraph (c)(3)(iv) applies to pre-group disallowed business interest expense carryforwards of a CFC group member. The amount of the pre-group disallowed business interest expense carryforwards described in the preceding sentence that are included in any CFC group member's business interest expense deduction for any specified taxable year under this paragraph (c)(3) may not exceed the aggregate section 163(j) limitation for all specified periods of the CFC group, determined by reference only to the CFC group member's items of income, gain, deduction, and loss, and reduced (including below zero) by the CFC group member's business interest expense (including disallowed business interest expense carryforwards) taken into account as a deduction by the CFC group member in all specified taxable years in which the CFC group member has continuously been a CFC group member of the CFC group (*cumulative section 163(j) pre-group carryforward limitation*).

(*2*) *Subgrouping.* In the case of a CFC group member with a pre-group disallowed business interest expense carryforward (the *loss member*) that joined the CFC group (the *current group*) for a specified taxable year with respect to a specified period (the *relevant period*), if the loss member was a CFC group member of a different CFC group (the *former group*) immediately prior to joining the current group, a pre-group subgroup is composed of the loss member and each other CFC group member that became a CFC group member of the current group for a specified taxable year with respect to the relevant period and was a member of the former group immediately prior to joining the current group. For purposes of this paragraph (c), the rules and principles of § 1.163(j)–5(d)(1)(B) apply to a pre-group subgroup as if the pre-group subgroup were a SRLY subgroup.

(B) *Deduction of pre-group disallowed business interest expense carryforwards.* Notwithstanding paragraph (c)(3)(iv)(A)(*1*) of this section, pre-group disallowed business interest expense carryforwards are available for deduction by a CFC group member in its specified taxable year only to the extent the CFC group has remaining section 163(j) limitation for the specified period 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 specified taxable years of CFC group members with respect to the specified period. See paragraph (c)(3)(i) of this section and § 1.163(j)–5(b)(3)(ii)(A). Pre-group disallowed business interest expense carryforwards are deducted on a pro rata basis (under the principles of paragraph (c)(3)(i) of this section and § 1.163(j)–5(b)(3)(ii)(C)(*3*)) with other disallowed business interest expense carryforwards from taxable years ending on the same date.

(4) *Currency translation.* For purposes of applying this paragraph (c), items of a CFC group member are translated into a single currency for the CFC group and back to the functional currency of the CFC group member using the average rate for the CFC group member's specified taxable year, using any reasonable method, consistently applied. The single currency for the CFC group may be the U.S. dollar or the functional currency of a plurality of the CFC group members.

(5) *Special rule for specified periods beginning in 2019 or 2020*—(i) *50 percent ATI limitation applies to a specified period of a CFC group.* In the case of a CFC group, § 1.163(j)–2(b)(2) (including the election under § 1.163(j)–2(b)(2)(ii)) applies to a specified period of the CFC group beginning in 2019 or 2020, rather than to a specified taxable year of a CFC group member. An election under § 1.163(j)–2(b)(2)(ii) for a specified period of a CFC group is not effective unless made by each designated U.S. person. Except as otherwise provided in this paragraph (c)(5)(i), the election is made in accordance with Revenue Procedure 2020–22, 2020–18 I.R.B. 745. For purposes of applying § 1.964–1(c), the election is treated as if made for each CFC group member.

(ii) *Election to use 2019 ATI applies to a specified period of a CFC group*—(A) *In general.* In the case of a CFC group, for purposes of applying paragraph (c)(2) of this section, an election under § 1.163(j)–2(b)(3)(i) is made for a specified period of a CFC group beginning in 2020 and applies to the specified taxable years of each CFC group member with respect to such specified period, taking into account the application of paragraph (c)(5)(ii)(B) of this section. The election under § 1.163(j)–2(b)(3)(i) does not apply to any specified taxable year of a CFC group member other than those described in the preceding sentence. An election under § 1.163(j)–2(b)(3)(i) for a specified period of a CFC group is not effective unless made by each designated U.S. person. Except as otherwise provided in this paragraph (c)(5)(ii)(A), the election is made in accordance with Revenue Procedure 2020–22, 2020–18 I.R.B. 745. For purposes of applying § 1.964–1(c), the election is treated as if made for each CFC group member.

(B) *Specified taxable years that do not begin in 2020.* If a specified taxable year of a CFC group member with respect to the specified period described in paragraph (c)(5)(ii)(A) of this section begins in 2019, then, for purposes of applying paragraph (c)(2) of this section, § 1.163(j)–2(b)(3) is applied to such specified taxable year by substituting ''2018'' for ''2019'' and ''2019'' for ''2020.'' If a specified taxable year of a CFC group member with respect to the specified period described in paragraph (c)(5)(ii)(A) of this section begins in 2021, then, for purposes of applying paragraph (c)(2) of this section, § 1.163(j)–2(b)(3) is applied to such specified taxable year by substituting ''2020'' for ''2019'' and ''2021'' for ''2020.''

(d) *Determination of a specified group and specified group members*—(1) *Scope.* This paragraph (d) provides rules for determining a specified group and specified group members. Paragraph (d)(2) of this section provides rules for determining a specified group. Paragraph (d)(3) of this section provides rules for determining specified group members.

(2) *Rules for determining a specified group*—(i) *Definition of a specified group.* Subject to paragraph (d)(2)(ii) of this section, the term *specified group* means one or more chains of applicable CFCs connected through stock ownership with a specified group parent (which is included in the specified group only if it is an applicable CFC), but only if—

(A) The specified group parent owns directly or indirectly stock meeting the requirements of section 1504(a)(2)(B) in at least one applicable CFC; and

(B) Stock meeting the requirements of section 1504(a)(2)(B) in each of the applicable CFCs (except the specified group parent) is owned directly or indirectly by one or more of the other applicable CFCs or the specified group parent.

(ii) *Indirect ownership.* For purposes of applying paragraph (d)(2)(i) of this section, stock is owned indirectly only if it is owned under section 318(a)(2)(A) through a partnership or under section 318(a)(2)(A) or (B) through an estate or trust not described in section 7701(a)(30).

(iii) *Specified group parent.* The term *specified group parent* means a qualified U.S. person or an applicable CFC.

(iv) *Qualified U.S. person.* The term *qualified U.S. person* means a United States person described in section 7701(a)(30)(A) or (C). For purposes of this paragraph (d), members of a consolidated group that file (or that are required to file) a consolidated U.S. federal income tax return are treated as a single qualified U.S person and individuals described in section 7701(a)(30)(A) whose filing status is married filing jointly are treated as a single qualified U.S. person.

(v) *Stock.* For purposes of paragraph (d)(3)(i) of this section, the term *stock* has the same meaning as ''stock'' in section 1504 (without regard to § 1.1504–4, except as provided in paragraph (d)(2)(vi) of this section) and all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(vi) *Options treated as exercised.* For purposes of this paragraph (d)(2), options that are reasonably certain to be exercised, as determined under § 1.1504–4(g), are treated as exercised. For purposes of this paragraph (d)(2)(vi), options include call options, warrants, convertible obligations, put options, and any other instrument treated as an option under § 1.1504–4(d), determined by replacing the term ''a principal purpose of avoiding the application of section 1504 and this section'' with ''a principal purpose of avoiding the application of section 163(j).''

(vii) *When a specified group ceases to exist.* The principles of § 1.1502–75(d)(1), (d)(2)(i) through (d)(2)(ii), and (d)(3)(i) through (d)(3)(iv), apply for purposes of determining when a specified group ceases to exist. Solely for purposes of applying these principles, each applicable CFC that is treated as a specified group member for a taxable year with respect to a specified period is treated as affiliated with the specified group parent from the beginning to the end of the specified period, without regard to the beginning or end of its taxable year.

(3) *Rules for determining a specified group member.* If an applicable CFC is included in a specified group on the last day of a taxable year of the applicable CFC that ends with or within a specified period, the applicable CFC is a *specified group member* with respect to the specified period for its entire taxable year ending with or within the specified period. If an applicable CFC has multiple taxable years that end with or within a specified period, this paragraph (d)(3) is applied separately to each taxable year to determine if the applicable CFC is a specified group member for such taxable year.

(e) *Rules and procedures for treating a specified group as a CFC group*—(1) *Scope.* This paragraph (e) provides rules and procedures for treating a specified group member as a CFC group member and for determining a CFC group for purposes of applying section 163(j) and the section 163(j) regulations.

(2) *CFC group and CFC group member*—(i) *CFC group.* The term *CFC group* means, with respect to a specified period, all CFC group members for their specified taxable years.

(ii) *CFC group member.* The term *CFC group member* means, with respect to a specified taxable year and a specified period, a specified group member of a specified group for which a CFC group election is in effect.

(3) *Duration of a CFC group.* A CFC group continues until the CFC group election is revoked, or there is no longer a specified period with respect to the specified group.

(4) *Joining or leaving a CFC group.* If an applicable CFC becomes a specified group member for a specified taxable year with respect to a specified period of a specified group for which a CFC group election is in effect, the CFC group election applies to the applicable CFC and the applicable CFC becomes a CFC group member. If an applicable CFC ceases to be a specified group member for a specified taxable year with respect to a specified period of a specified group for which a CFC group election is in effect, the CFC group election terminates solely with respect to the applicable CFC.

(5) *Manner of making or revoking a CFC group election*—(i) *In general.* An election is made or revoked under this paragraph (e)(5) (a *CFC group election*) with respect to a specified period of a specified group. A CFC group election remains in effect for each specified period of the specified group until revoked. A CFC group election that is in effect with respect to a specified period of a specified group applies to each specified group member for its specified taxable year that ends with or within the specified period. The making or revoking of a CFC group election is not effective unless made or revoked by each designated U.S. person.

(ii) *Revocation by election.* A CFC group election cannot be revoked with respect to any specified period beginning prior to 60 months following the last day of the specified period for which the election was made. Once a CFC group election has been revoked, a new CFC group election cannot be made with respect to any specified period beginning prior to 60 months following the last day of the specified period for which the election was revoked.

(iii) *Timing.* A CFC group election must be made or revoked with respect to a specified period of a specified group no later than the due date (taking into account extensions, if any) of the original Federal income tax return for the taxable year of each designated U.S. person in which or with which the specified period ends.

(iv) *Election statement.* Except as otherwise provided in publications, forms, instructions, or other guidance, to make or revoke a CFC group election for a specified period of a specified group, each designated U.S. person must attach a statement to its relevant Federal tax or information return. The statement must include the name and taxpayer identification number of all designated U.S. persons, a statement that the CFC group election is being made or revoked, as applicable, the specified period for which the CFC group election is being made or revoked, and the name of each CFC group member and its specified taxable year with respect to the specified period. The statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance.

(v) *Effect of prior CFC group election.* A CFC group election is made solely pursuant to the provisions of this paragraph (e)(5), without regard to whether the election described in proposed § 1.163(j)–7(f)(7) that was included in a notice of proposed rulemaking (REG–106089–18) that was published on December 28, 2018, in the **Federal Register** (83 FR 67490) was in effect.

(f) *Treatment of a CFC group member that has ECI*—(1) *In general.* If a CFC group member has ECI in its specified taxable year, then for purposes of section 163(j) and the section 163(j) regulations—

(i) The items, disallowed business interest expense carryforwards, and other attributes of the CFC group member that are ECI are treated as items, disallowed business interest expense carryforwards, and attributes of a separate applicable CFC (such deemed corporation, an *ECI deemed corporation*), subject to § 1.163(j)–8(d), that has same taxable year and shareholders as the applicable CFC; and

(ii) The ECI deemed corporation is not treated as a specified group member for the specified taxable year.

(2) *Ordering rule.* Paragraph (f)(1) of this section applies before application of § 1.163(j)–8(d).

(g) * * *

(3) *Treatment of certain taxes.* For purposes of computing the ATI of a relevant foreign corporation for a taxable year, tentative taxable income takes into account any deduction for foreign taxes. See section 164(a).

(4) *Anti-abuse rule*—(i) *In general.* If a specified group member of a specified group or an applicable partnership (*specified lender*) includes an amount (the *payment amount*) in income and such amount is attributable to business interest expense incurred by another specified group member or an applicable partnership of the specified group (a *specified borrower*) during its taxable year, then the ATI of the specified borrower for the taxable year is increased by the ATI adjustment amount if—

(A) The business interest expense is incurred with a principal purpose of reducing the Federal income tax liability of any United States shareholder of a specified group member (including over multiple taxable years);

(B) Absent the application of this paragraph (g)(4), the effect of the specified borrower treating all or part of the payment amount as disallowed business interest expense would be to reduce the Federal income tax liability of any United States shareholder of a specified group member; and

(C) Either no CFC group election is in effect with respect to the specified group or the specified borrower is an applicable partnership.

(ii) *ATI adjustment amount*—(A) *In general.* For purposes of this paragraph (g)(4), the term *ATI adjustment amount* means, with respect to a specified borrower and a taxable year, the product of 3⅓ and the lesser of the payment amount or the disallowed business interest expense, computed without regard to this paragraph (g)(4).

(B) *Special rule for taxable years or specified periods beginning in 2019 or 2020.* For any taxable year of an applicable CFC or specified taxable year of a CFC group member with respect to a specified period for which the section 163(j) limitation is determined based, in part, on 50 percent of ATI, in accordance with § 1.163(j)–2(b)(2), paragraph (g)(4)(ii)(A) of this section is applied by substituting ''2'' for ''3⅓.''

(iii) *Applicable partnership.* For purposes of this paragraph (g)(4), the term *applicable partnership* means, with respect to a specified group, a partnership in which at least 80 percent of the interests in capital or profits is owned, directly or indirectly through one or more other partnerships, by specified group members of the specified group.

(h) *Election to apply safe-harbor*—(1) *In general.* If an election to apply this paragraph (h)(1) (*safe-harbor election*) is in effect with respect to a taxable year of a stand-alone applicable CFC or a specified taxable year of a CFC group member, as applicable, then, for such year, no portion of the applicable CFC's business interest expense is disallowed under the section 163(j) limitation. This paragraph (h) does not apply to excess business interest expense, as described in § 1.163(j)–6(f)(2), until the taxable year in which it is treated as paid or accrued by an applicable CFC under § 1.163(j)–6(g)(2)(i). Furthermore, excess business interest expense is not taken into account for purposes of determining whether the safe-harbor election is available for a stand-alone applicable CFC or a CFC group until the taxable year in which it is treated as paid or accrued by an applicable CFC under § 1.163(j)–6(g)(2)(i).

(2) *Eligibility for safe-harbor election*—(i) *Stand-alone applicable CFC.* The safe-harbor election may be made for the taxable year of a stand-alone applicable CFC only if business interest expense of the applicable CFC is less than or equal to 30 percent of the lesser of qualified tentative taxable income or the eligible amount of the applicable CFC for its taxable year.

(ii) *CFC group*—(A) *In general.* The safe-harbor election may be made for the specified period of a CFC group only if the business interest expense of the CFC group for the specified period is less than or equal to 30 percent of the lesser of the sum of qualified tentative taxable income or the sum of the eligible amounts of each CFC group member for its specified taxable year with respect to the specified period, and no CFC group member has pre-group disallowed business interest expense carryforward.

(B) *Currency translation.* For purposes of applying paragraph (h)(2)(ii) of this section, qualified tentative taxable income and eligible amounts of each CFC group member are translated into the currency in which the business interest expense of the CFC group is denominated using the method used under paragraph (c)(4) of this section. See paragraph (c)(2)(i) of this section for rules for determining the business interest expense of a CFC group.

(3) *Eligible amount*—(i) *In general.* Subject to paragraph (h)(3)(ii) of this section, the term *eligible amount* means, with respect to the taxable year of an applicable CFC, the sum of the following amounts, computed without regard to the application of section 163(j) and the section 163(j) regulations (including without regard to any disallowed business interest expense carryforwards)—

(A) Subpart F income (within the meaning of section 952);

(B) The product of—

(*1*) The excess of 100 percent over the percentage described in section 250(a)(1)(B), taking into account section 250(a)(3)(B), and

(*2*) The excess, if any, of tested income (within the meaning of section 951A(c)(2)(A) and § 1.951A–2(b)(1)), over the CFC-level net deemed tangible income return.

(ii) *Amounts properly allocable to a non-excepted trade or business.* For purposes of computing an eligible amount, subpart F income and tested income are determined by only taking into account items properly allocable to a non-excepted trade or business.

(4) *Qualified tentative taxable income.* The term *qualified tentative taxable income* means, with respect to a taxable year of an applicable CFC, the applicable CFC's tentative taxable income, determined by only taking into

account items properly allocable to a non-excepted trade or business.

(5) *Manner of making a safe-harbor election*—(i) *In general.* A safe-harbor election is an annual election made under this paragraph (h)(5) with respect to a taxable year of a stand-alone applicable CFC or with respect to a specified period of a CFC group. A safe-harbor election that is made with respect to a specified period of a CFC group is effective with respect to each CFC group member for its specified taxable year. A safe-harbor election is only effective if made by each designated U.S. person with respect to a stand-alone applicable CFC or a CFC group. A safe-harbor election is made with respect to a taxable year of a stand-alone applicable CFC, or a specified period of a CFC group, no later than the due date (taking into account extensions, if any) of the original Federal income tax return for the taxable year of each designated U.S. person, respectively, in which or with which the taxable year of the stand-alone applicable CFC ends or the specified period of the CFC group ends.

(ii) *Election statement.* Unless otherwise provided in publications, forms, instructions, or other guidance, to make a safe-harbor election, each designated U.S. person must attach to its relevant Federal income tax return or information return a statement that includes the name and taxpayer identification number of all designated U.S. persons, a statement that a safe-harbor election is being made pursuant to § 1.163(j)–7(h) and that the requirements for making the election are satisfied, and the taxable year of the stand-alone applicable CFC or the specified period of the CFC group, as applicable, for which the safe-harbor election is being made. In the case of a CFC group, the statement must also include the name of each CFC group member and its specified taxable year that ends with or within the specified period for which the safe-harbor election is being made. The statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance.

(6) *Special rule for taxable years or specified periods beginning in 2019 or 2020.* In the case of a stand-alone applicable CFC, for any taxable year beginning in 2019 or 2020, paragraph (h)(2)(i) of this section is applied by substituting ''50 percent'' for ''30 percent.'' In the case of a CFC group, for any specified period beginning in 2019 or 2020, paragraph (h)(2)(ii)(A) of this section is applied by substituting ''50 percent'' for ''30 percent.''

* * * * *

(j) *Rules regarding the computation of ATI of certain United States shareholders of applicable CFCs*—(1) *In general.* For purposes of computing ATI of a United States shareholder of an applicable CFC, for the taxable year of the United States shareholder in which or with which the taxable year of the applicable CFC ends, there is added to the United States shareholder's tentative taxable income the product of—

(i) The portion of the adjustment, if any, made to the United States shareholder's tentative taxable income under § 1.163(j)–1(b)(1)(ii)(G) (regarding specified deemed inclusions) that is attributable to the applicable CFC, but for this purpose excluding the portion of the adjustment that is attributable to an inclusion under section 78 with respect to the applicable CFC; and

(ii) A fraction, expressed as a percentage, but not greater than 100 percent, the numerator of which is CFC excess taxable income and the denominator of which is the ATI of the applicable CFC for the taxable year.

(2) *Rules for determining CFC excess taxable income*—(i) *In general.* The term *CFC excess taxable income* means, with respect to a taxable year of an applicable CFC, the amount described in paragraph (j)(2)(ii) or (j)(2)(iii) of this section, as applicable.

(ii) *Applicable CFC is a stand-alone applicable CFC.* If an applicable CFC is a stand-alone applicable CFC for a taxable year, its CFC excess taxable income for the taxable year is the amount that bears the same ratio to the applicable CFC's ATI as—

(A) The excess (if any) of—

(*1*) 30 percent of the applicable CFC's ATI; over

(*2*) The amount (if any) by which the applicable CFC's business interest expense exceeds its business interest income and floor plan financing interest expense; bears to

(B) 30 percent of the applicable CFC's ATI.

(iii) *Applicable CFC is a CFC group member.* If an applicable CFC is a CFC group member for a specified taxable year, its CFC excess taxable income is equal to the product of the CFC group member's ATI percentage and the amount that bears the same ratio to the CFC group's ATI for the specified period as—

(A) The excess (if any) of—

(*1*) 30 percent of the CFC group's ATI; over

(*2*) The amount (if any) by which the CFC group's business interest expense exceeds the CFC group's business interest income and floor plan financing interest expense; bears to

(B) 30 percent of the CFC group's ATI.

(iv) *ATI percentage.* For purposes of this paragraph (j), the term *ATI percentage* means, with respect to a specified taxable year of a CFC group member and a specified period of the CFC group, a fraction (expressed as a percentage), the numerator of which is the ATI of the CFC group member for the specified taxable year, and the denominator of which is the ATI of the CFC group for the specified period. If either the numerator or denominator of the fraction is less than or equal to zero, the ATI percentage is zero.

(3) *Cases in which an addition to tentative taxable income is not allowed.* Paragraph (j)(1) of this section is not applicable for a taxable year of a United States shareholder if, with respect to the taxable year of the applicable CFC described in paragraph (j)(1) of this section—

(i) A safe-harbor election (as described in paragraph (h) of this section) is in effect; or

(ii) The applicable CFC is neither a stand-alone applicable CFC nor a CFC group member.

(4) *Special rule for taxable years or specified periods beginning in 2019 or 2020.* In the case of a stand-alone applicable CFC, for any taxable year beginning in 2019 or 2020 to which the election described in § 1.163(j)–2(b)(2)(ii) does not apply, paragraph (j)(2)(ii) of this section is applied by substituting ''50 percent'' for ''30 percent'' each place it appears. In the case of a CFC group member, for any specified taxable year with respect to a specified period beginning in 2019 or 2020 to which the election described in § 1.163(j)–2(b)(2)(ii) does not apply, paragraph (j)(2)(iii) of this section is applied by substituting ''50 percent'' for ''30 percent'' each place it appears.

(k) *Definitions.* The following definitions apply for purposes of this section.

(1) *Applicable partnership.* The term *applicable partnership* has the meaning provided in paragraph (g)(4)(iii) of this section.

(2) *Applicable specified taxable year.* The term *applicable specified taxable year* has the meaning provided in paragraph (c)(3)(iii) of this section.

(3) *ATI adjustment amount.* The term *ATI adjustment amount* has the meaning provided in paragraph (g)(4)(ii) of this section.

(4) *ATI percentage.* The term *ATI percentage* has the meaning provided in paragraph (j)(2)(iv) of this section.

(5) *CFC excess taxable income.* The term *CFC excess taxable income* has the meaning provided in paragraph (j)(2)(i) of this section.

(6) *CFC group.* The term *CFC group* has the meaning provided in paragraph (e)(2)(i) of this section.

(7) *CFC group election.* The term *CFC group election* means the election described in paragraph (e)(5) of this section.

(8) *CFC group member.* The term *CFC group member* has the meaning provided in paragraph (e)(2)(ii) of this section.

(9) *CFC-level net deemed tangible income return*—(i) *In general.* The term *CFC-level net deemed tangible income return* means, with respect to a taxable year of an applicable CFC, the excess (if any) of—

(A) 10 percent of the qualified business asset investment, as defined in section 951A(d)(1) and § 1.951A–3(b), of the applicable CFC, over

(B) The excess, if any, of—

(*1*) Tested interest expense, as defined in § 1.951A–4(b)(1), of the applicable CFC, over

(*2*) Tested interest income, as defined in § 1.951A–4(b)(2), of the applicable CFC.

(ii) *Amounts properly allocable to a non-excepted trade or business.* For purposes of computing CFC-level net deemed tangible income return, qualified business asset investment is determined by only taking into account assets properly allocable to a non-excepted trade or business, as determined in § 1.163(j)–10(c)(3), and tested interest expense and tested interest income are determined by only taking into account items properly allocable to a non-excepted trade or business, as determined in § 1.163(j)–10(c).

(10) *Cumulative section 163(j) pre-group carryforward limitation.* The term *cumulative section 163(j) pre-group carryforward limitation* has the meaning provided in paragraph (c)(3)(iv)(A)(*1*) of this section.

(11) *Current group.* The term *current group* has the meaning provided in paragraph (c)(3)(iv)(A)(*2*) of this section.

(12) *Designated U.S. person.* The term *designated U.S. person* means—

(i) With respect to a stand-alone applicable CFC, each controlling domestic shareholder, as defined in § 1.964–1(c)(5) of the applicable CFC; or

(ii) With respect to a specified group, the specified group parent, if the specified group parent is a qualified U.S. person, or each controlling domestic shareholder, as defined in § 1.964–1(c)(5), of the specified group parent, if the specified group parent is an applicable CFC.

(13) *ECI deemed corporation.* The term *ECI deemed corporation* has the meaning provided in paragraph (f)(1)(i) of this section.

(14) *Effectively connected income.* The term *effectively connected income* (or *ECI*) means income or gain that is ECI, as defined in § 1.884–1(d)(1)(iii), and deduction or loss that is allocable to, ECI, as defined in § 1.884–1(d)(1)(iii).

(15) *Eligible amount.* The term *eligible amount* has the meaning provided in paragraph (h)(3)(i) of this section.

(16) *Former group.* The term *former group* has the meaning provided in paragraph (c)(3)(iv)(A)(*2*) of this section.

(17) *Loss member.* The term *loss member* has the meaning provided in paragraph (c)(3)(iv)(A)(*2*) of this section.

(18) *Payment amount.* The term *payment amount* has the meaning provided in paragraph (g)(4)(i) of this section.

(19) *Pre-group disallowed business interest expense carryforward.* The term *pre-group disallowed business interest expense carryforward* means, with respect to a CFC group member and a specified taxable year, any disallowed business interest expense carryforward of the CFC group member that arose in a taxable year during which the CFC group member (or its predecessor) was not a CFC group member of the CFC group.

(20) *Qualified tentative taxable income.* The term *qualified tentative taxable income* has the meaning provided in paragraph (h)(4) of this section.

(21) *Qualified U.S. person.* The term *qualified U.S. person* has the meaning provided in paragraph (d)(2)(iv) of this section.

(22) *Relevant period.* The term *relevant period* has the meaning provided in paragraph (c)(3)(iv)(A)(*2*) of this section.

(23) *Safe-harbor election.* The term *safe-harbor election* has the meaning provided in paragraph (h)(1) of this section.

(24) *Specified borrower.* The term *specified borrower* has the meaning provided in paragraph (g)(4)(i) of this section.

(25) *Specified group.* The term *specified group* has the meaning provided in paragraph (d)(2)(i) of this section.

(26) *Specified group member.* The term *specified group member* has the meaning provided in paragraph (d)(3) of this section.

(27) *Specified group parent.* The term *specified group parent* has the meaning provided in paragraph (d)(2)(iii) of this section.

(28) *Specified lender.* The term *specified lender* has the meaning provided in paragraph (g)(4)(i) of this section

(29) *Specified period*—(i) *In general.* Except as otherwise provided in paragraph (k)(29)(ii) of this section, the term *specified period* means, with respect to a specified group—

(A) If the specified group parent is a qualified U.S. person, the period ending on the last day of the taxable year of the specified group parent and beginning on the first day after the last day of the specified group's immediately preceding specified period; or

(B) If the specified group parent is an applicable CFC, the period ending on the last day of the specified group parent's required year described in section 898(c)(1), without regard to section 898(c)(2), and beginning on the first day after the last day of the specified group's immediately preceding specified period.

(ii) *Short specified period.* A specified period begins no earlier than the first date on which a specified group exists. A specified period ends on the date a specified group ceases to exist under paragraph (d)(2)(vii) of this section. If the last day of a specified period, as determined under paragraph (k)(29)(i) of this section, changes, and, but for this paragraph (k)(29)(ii), the change in the last day of the specified period would result in the specified period being longer than 12 months, the specified period ends on the date on which the specified period would have ended had the change not occurred.

(30) *Specified taxable year.* The term *specified taxable year* means, with respect to an applicable CFC that is a specified group member of a specified group and a specified period, a taxable year of the applicable CFC that ends with or within the specified period.

(31) *Stand-alone applicable CFC.* The term *stand-alone applicable CFC* means any applicable CFC that is not a specified group member.

(32) *Stock.* The term *stock* has the meaning provided in paragraph (d)(2)(v) of this section.

(l) *Examples.* The following examples illustrate the application of this section. For each example, unless otherwise stated, no exemptions from the application of section 163(j) are available, no foreign corporation has ECI, and all relevant taxable years and specified periods begin after December 31, 2020.

(1) *Example 1. Specified taxable years included in specified period of a specified*

group—(i) *Facts.* As of June 30, Year 1, USP, a domestic corporation, owns 60 percent of the common stock of FP, which owns all of the stock of FC1, FC2, and FC3. The remaining 40 percent of the common stock of FP is owned by an unrelated foreign corporation. FP has a single class of stock. FP acquired the stock of FC3 from an unrelated person on March 22, Year 1. The acquisition did not result in a change in FC3's taxable year or a close of its taxable year. USP's interest in FP and FP's interest in FC1 and FC2 has been the same for a number of years. USP has a taxable year ending June 30, Year 1, which is not a short taxable year. Each of FP, FC1, FC2, and FC3 are applicable CFCs. Pursuant to section 898(c)(2), FP and FC1 have taxable years ending May 31, Year 1. Pursuant to section 898(c)(1), FC2 and FC3 have taxable years ending June 30, Year 1.

(ii) *Analysis*—(A) *Determining a specified group and specified period of the specified group.* Pursuant to paragraph (d) of this section, FP, FC1, FC2, and FC3 are members of a specified group, and FP is the specified group parent. Because the specified group parent, FP, is an applicable CFC, the specified period of the specified group is the period ending on June 30, Year 1, which is the last day of FP's required year described in section 898(c)(1), without regard to section 898(c)(2), and on beginning July 1, Year 0, which is the first day following the last day of the specified group's immediately preceding specified period (June 30, Year 0). See paragraph (k)(29)(i)(B) of this section.

(B) *Determining the specified taxable years with respect to the specified period.* Pursuant to paragraph (d)(3) of this section, because each of FP and FC1 are included in the specified group on the last day of their taxable years ending May 31, Year 1 and such taxable years end with or within the specified period ending June 30, Year 1, FP and FC1 are specified group members with respect to the specified period ending June 30, Year 1, for their entire taxable years ending May 31, Year 1, and those taxable years are specified taxable years. Similarly, because each of FC2 and FC3 are included in the specified group on the last day of their taxable years ending June 30, Year 1, and such taxable years end with or within the specified period ending June 30, Year 1, FC2 and FC3 are specified group members with respect to the specified period ending June 30, Year 1, for their entire taxable years ending June 30, Year 1, and those taxable years are specified taxable years. The fact that FC3 was acquired on March 22, Year 1, does not prevent FC3 from being a specified group member with respect to the specified period for the portion of its specified taxable year prior to March 22, Year 1.

(2) *Example 2. CFC groups*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (l)(1)(i) of this section. In addition, a CFC group election is in place with respect to the specified period ending June 30, Year 1.

(ii) *Analysis.* Because a CFC group election is in place for the specified period ending June 30, Year 1, pursuant to paragraph (e)(2)(ii) of this section, each specified group member is a CFC group member with respect to its specified taxable year ending with or within the specified period. Accordingly, FP, FC1, FC2, and FC3 are CFC group members with respect to the specified period ending June 30, Year 1, for their specified taxable years ending May 31, Year 1, and June 30, Year 1, respectively. Pursuant to paragraph (e)(2)(i) of this section, the CFC group for the specified period ending June 30, Year 1, consists of FP, FC1, FC2, and FC3 for their specified taxable years ending May 31, Year 1, and June 30, Year 1, respectively. Pursuant to paragraph (c)(2) of this section, a single section 163(j) limitation is computed for the specified period ending June 30, Year 1. That section 163(j) calculation will include FP and FC1's specified taxable years ending May 31, Year 1, and FC2 and FC3's specified taxable years ending June 30, Year 1.

(3) *Example 3. Application of anti-abuse rule*—(i) *Facts.* USP, a domestic corporation, is the specified group parent of a specified group. The specified group members include CFC1 and CFC2. USP owns (within the meaning of section 958(a)) all of the stock of all specified group members. USP has a calendar year taxable year. All specified group members also have a calendar year taxable year and a functional currency of the U.S. dollar. CFC1 is organized in, and a tax resident of, a jurisdiction that imposes no tax on certain types of income, including interest income. With respect to Year 1, USP expects to pay no residual U.S. tax on its income inclusion under section 951A(a) (GILTI inclusion) and expects to have unused foreign tax credits in the category described in section 904(d)(1)(A). A CFC group election is not in effect for Year 1. With a principal purpose of reducing USP's Federal income tax liability, on January 1, Year 1, CFC1 loans $100x to CFC2. On December 31, Year 1, CFC2 pays interest of $10x to CFC1 and repays the principal of $100x. Absent application of paragraph (g)(4)(i) of this section, CFC2 would treat all $10x of interest expense as disallowed business interest expense and therefore would have $10x of disallowed business interest expense carryforward to Year 2. In Year 2, CFC2 disposes of one of its businesses at a substantial gain that gives rise to tested income (within the meaning of section 951A(c)(2)(A) and § 1.951A–2(b)(1)). Assume that as a result of the gain being included in the ATI of CFC2, absent application of paragraph (g)(3)(i) of this section, CFC2 would be allowed to deduct the entire $10x of disallowed business interest expense carryforward and therefore reduce the amount of CFC2's tested income. Also, assume that USP would have residual U.S. tax on its GILTI inclusion in Year 2, without regard to the application of paragraph (g)(4)(i) of this section.

(ii) *Analysis.* The $10x of interest expense paid in Year 1 is a payment amount described in paragraph (g)(4)(i) of this section because it is between specified group members, CFC1 and CFC2. Furthermore the requirements of paragraph (g)(4)(i)(A), (B), and (C) of this section are satisfied because the business interest expense is incurred with a principal purpose of reducing USP's Federal income tax liability; absent the application of paragraph (g)(4)(i) of this section, the effect of CFC2 treating the $10x of business interest expense as disallowed business interest expense in Year 1 would be to reduce USP's Federal income tax liability in Year 2; and no CFC group election is in effect with respect to the specified group in Year 1. Because the requirements of paragraph (g)(4)(i)(A), (B), and (C) of this section are satisfied, CFC2's ATI for Year 1 is increased by $33.33x, which is the amount equal to 3 ⅓ multiplied by $10x (the lesser of the payment amount of $10x and the disallowed business interest expense of $10x). As a result, the $10x of business interest expense is not treated by CFC2 as disallowed business interest expense in Year 1, and therefore does not give rise to a disallowed business interest expense carryforward to Year 2.

(m) *Applicability dates*—(1) *General applicability date.* Except as provided in paragraph (m)(2) of this section, this section applies to taxable years of a foreign corporation beginning on or after November 13, 2020 However, except as provided in paragraph (m)(2) of this section, 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 to each subsequent taxable year and 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 and each subsequent taxable year.

(2) *Exception.* Paragraphs (a), (c) through (f), (g)(3) and (4), and (h) through (k) of this section apply to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply paragraphs (a), (c) through (f), (g)(3) and (4), and (h) through (k) of this section in their entirety for a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties also apply § 1.163(j)–8 for the taxable year. For taxable years beginning before November 13, 2020, taxpayers and their related parties may not choose to apply paragraphs (a), (c) through (f), (g)(3) and (4), and (h) through (k) of this section unless they also apply paragraphs (b) and (g)(1) and (2) of this section in accordance with

the second sentence of paragraph (m)(1) of this section. Notwithstanding paragraph (e)(5)(iii) or (h)(5)(i) of this section, in the case of a specified period of a specified group or a taxable year of a stand-alone applicable CFC that ends with or within a taxable year of a designated U.S. person ending before November 13, 2020, a CFC group election or a safe-harbor election may be made on an amended Federal income tax return filed on or before the due date (taking into account extensions, if any) of the original Federal income tax return for the first taxable year of each designated U.S. person ending after November 13, 2020.

■ **Par. 9.** As reserved in a final rule elsewhere in this issue of the **Federal Register**, effective November 13, 2020, § 1.163(j)–8 is added to read as follows:

§ 1.163(j)–8 Application of the section 163(j) limitation to foreign persons with effectively connected income.

(a) *Overview.* This section provides rules concerning the application of section 163(j) to foreign persons with ECI. Paragraph (b) of this section modifies the application of section 163(j) for a specified foreign person with ECI. Paragraph (c) of this section sets forth rules for a specified foreign partner in a partnership with ECI. Paragraph (d) of this section allocates disallowed business interest expense for relevant foreign corporations with ECI. Paragraph (e) of this section provides rules concerning disallowed business interest expense. Paragraph (f) of this section coordinates the application of section 163(j) with § 1.882–5 and the branch profits tax under section 884. Paragraph (g) of this section provides definitions that apply for purposes of this section. Paragraph (h) of this section illustrates the application of this section through examples.

(b) *Application to a specified foreign person with ECI*—(1) *In general.* If a taxpayer is a specified foreign person, then the taxpayer applies the modifications described in this paragraph (b), taking into account the application of paragraph (c) of this section.

(2) *Modification of adjusted taxable income.* Adjusted taxable income for a specified foreign person for a taxable year means the specified foreign person's adjusted taxable income, as determined under § 1.163(j)–1(b)(1), taking into account only items that are ECI.

(3) *Modification of business interest expense.* Business interest expense for a specified foreign person means business interest expense described in § 1.163(j)–1(b)(3) that is ECI, taking into account the application of paragraph (f)(1)(iii) of this section.

(4) *Modification of business interest income.* The business interest income of a specified foreign person means business interest income described in § 1.163(j)–1(b)(4) that is ECI.

(5) *Modification of floor plan financing interest expense.* The floor plan financing interest expense of a specified foreign person means floor plan financing interest expense described § 1.163(j)–1(b)(19) that is ECI.

(6) *Modification of allocation of interest expense and interest income that is allocable to a trade or business.* For purposes of applying § 1.163(j)–10(c) to a specified foreign person, only interest income and interest expense that are ECI and only assets that are U.S. assets, as defined in § 1.884–1(d), are taken into account. If the specified foreign person is also a specified foreign partner, this paragraph (b)(6) does not apply to any trade or business of the partnership.

(c) *Rules for a specified foreign partner*—(1) *Characterization of excess taxable income*—(i) *In general.* The portion of excess taxable income allocated to a specified foreign partner from a partnership pursuant to § 1.163(j)–6(f)(2) that is ECI is equal to the specified foreign partner's allocation of excess taxable income from the partnership multiplied by its specified ATI ratio with respect to the partnership, and the remainder is not ECI.

(ii) *Specified ATI ratio.* The term *specified ATI ratio* means the fraction described in this paragraph (c)(1)(ii). If the specified foreign partner's distributive share of ECI and distributive share of non-ECI are both positive, the numerator of this fraction is the specified foreign partner's distributive share of ECI and the denominator is the specified foreign partner's distributive share of partnership items of income, gain, deduction, and loss. If the specified foreign partner's distributive share of ECI is negative or zero and its distributive share of non-ECI is positive, this fraction is treated as zero. If the specified foreign partner's distributive share of non-ECI is negative or zero and its distributive share of ECI is positive, this fraction is treated as one. If the specified foreign partner's distributive share of ECI and distributive share of non-ECI are both negative, the numerator of this fraction is its distributive share of non-ECI and the denominator is its distributive share of partnership items of income, gain, deduction, and loss.

(iii) *Distributive share of ECI.* The term *distributive share of ECI* means the net amount of the specified foreign partner's distributive share of partnership items of income, gain, deduction, and loss that are ECI.

(iv) *Distributive share of non-ECI.* The term *distributive share of non-ECI* means the net amount of the specified foreign partner's distributive share of partnership items of income, gain, deduction, and loss that are not ECI.

(2) *Characterization of excess business interest expense*—(i) *Allocable ECI excess BIE.* The portion of excess business interest expense allocated to a specified foreign partner from a partnership pursuant to § 1.163(j)–6(f)(2) or paragraph (e)(2) of this section that is ECI (*allocable ECI excess BIE*) is equal to the excess, if any, of allocable ECI BIE over allocable ECI deductible BIE.

(ii) *Allocable non-ECI excess BIE.* The portion of excess business interest expense allocated to a specified foreign partner from a partnership pursuant to § 1.163(j)–6(f)(2) or paragraph (e)(2) of this section that is not ECI (*allocable non-ECI excess BIE*) is equal to the excess, if any, of allocable non-ECI BIE over allocable non-ECI deductible BIE.

(3) *Characterization of deductible business interest expense*—(i) *In general.* The portion of deductible business interest expense, if any, that is allocated to a specified foreign partner from a partnership pursuant to § 1.163(j)–6(f)(2) that is ECI (*allocable ECI deductible BIE*) is equal to the sum of the amounts described in paragraphs (c)(3)(ii)(A)(*1*)(*i*) and (c)(3)(ii)(B)(*1*) of this section. The portion of deductible business interest expense, if any, that is allocated to a specified foreign partner from a partnership pursuant to § 1.163(j)–6(f)(2) that is not ECI (*allocable non-ECI deductible BIE*) is equal to the sum of the amounts described in paragraphs (c)(3)(ii)(A)(*1*)(*ii*) and (c)(3)(ii)(B)(*2*) of this section.

(ii) *Allocation between allocable ECI deductible BIE and allocable non-ECI deductible BIE.* For purposes of paragraph (c)(3)(i) of this section—

(A) *Allocation to hypothetical deductible amounts*—(*1*) *In general.* Subject to paragraph (c)(3)(ii)(A)(*2*) of this section, deductible business interest expense that is allocated to the specified foreign partner from the partnership pursuant to § 1.163(j)–6(f)(2) is allocated pro rata to—

(*i*) Hypothetical partnership ECI deductible BIE; and

(*ii*) Hypothetical partnership non-ECI deductible BIE.

(*2*) *Limitation.* The amount allocated to hypothetical partnership ECI deductible BIE in paragraph (c)(3)(ii)(A)(*1*)(*i*) of this section cannot exceed the lesser of hypothetical partnership ECI deductible BIE or allocable ECI BIE, and the amount allocated to hypothetical partnership non-ECI deductible BIE in paragraph (c)(3)(ii)(A)(*1*)(*ii*) of this section cannot exceed the lesser of hypothetical partnership non-ECI deductible BIE or allocable non-ECI BIE.

(B) *Allocation of remaining deductible amounts.* Deductible business interest expense that is allocated to the specified foreign partner from the partnership pursuant to § 1.163(j)–6(f)(2) in excess of the amount allocated in paragraph (c)(3)(ii)(A) of this section, if any, is allocated pro rata to—

(*1*) Allocable ECI BIE, reduced by the amount described in paragraph (c)(3)(ii)(A)(*1*)(*i*) of this section; and

(*2*) Allocable non-ECI BIE, reduced by the amount described in paragraph (c)(3)(ii)(A)(*1*)(*ii*) of this section.

(iii) *Hypothetical partnership deductible business interest expense*—(A) *Hypothetical partnership ECI deductible BIE.* The term *hypothetical partnership ECI deductible BIE* means the deductible business interest expense of the partnership, as defined in § 1.163(j)–6(b)(5), determined by only taking into account the specified foreign partner's allocable share of items that are ECI (including by reason of paragraph (f)(1)(iii) of this section).

(B) *Hypothetical partnership non-ECI deductible BIE.* The term *hypothetical partnership non-ECI deductible BIE* means the deductible business interest expense of the partnership, as defined in § 1.163(j)–6(b)(5), determined by only taking into account the specified foreign partner's allocable share of items that are not ECI (including by reason of paragraph (f)(1)(iii) of this section).

(4) *Characterization of excess business interest income*—(i) *In general.* The portion of excess business interest income allocated to a specified foreign partner from a partnership pursuant to § 1.163(j)–6(f)(2) that is ECI is equal to the specified foreign partner's allocation of excess business interest income from the partnership multiplied by its specified BII ratio with respect to the partnership, and the remainder is not ECI.

(ii) *Specified BII ratio.* The term *specified BII ratio* means the ratio of the specified foreign partner's allocable ECI BII to allocable business interest income (determined under § 1.163(j)–6(f)(2)(ii)).

(iii) *Allocable ECI BII.* The term *allocable ECI BII* means the specified foreign partner's allocable BII, as determined under § 1.163(j)–6(f)(2)(ii), computed by only taking into account income that is ECI.

(5) *Rules for determining ECI.* Except as described in paragraph (f)(1) of this section, if the determination as to whether partnership items are ECI is made by a direct or indirect partner, rather than the partnership itself, then for purposes of this paragraph (c), the partnership must use a reasonable method to characterize such items as ECI or as not ECI.

(d) *Characterization of disallowed business interest expense by a relevant foreign corporation with ECI*—(1) *Scope.* A relevant foreign corporation that has ECI and disallowed business interest expense for a taxable year determines the portion of its disallowed business interest expense and deductible business interest expense that is characterized as ECI or as not ECI under this paragraph (d). A relevant foreign corporation that is a specified foreign partner also applies the rules in paragraph (c) of this section. See also § 1.163(j)–7(f) for rules regarding CFC group members with ECI.

(2) *Characterization of disallowed business interest expense*—(i) *FC ECI disallowed BIE.* For purposes of this section, the portion of disallowed business interest expense of a relevant foreign corporation that is ECI (*FC ECI disallowed BIE*) is equal to the excess, if any, of FC ECI BIE over FC ECI deductible BIE.

(ii) *FC non-ECI disallowed BIE.* For purposes of this section, the portion of disallowed business interest expense of a relevant foreign corporation that is not ECI (*FC non-ECI disallowed BIE*) is equal to the excess, if any, of FC non-ECI BIE over FC non-ECI deductible BIE.

(3) *Characterization of deductible business interest expense*—(i) *In general.* The portion of deductible business interest expense, if any, that is ECI (*FC ECI deductible BIE*) is equal to the sum of the amounts described in paragraphs (d)(3)(ii)(A)(*1*)(*i*) and (d)(3)(ii)(B)(*1*) of this section. The portion of deductible business interest expense, if any, that is allocable to income that is not ECI (*FC non-ECI deductible BIE*) is equal to the sum of the amounts described in paragraphs (d)(3)(ii)(A)(*1*)(*ii*) and (d)(3)(ii)(B)(*2*) of this section.

(ii) *Allocation between FC ECI deductible BIE and FC non-ECI deductible BIE.* For purposes of paragraph (d)(3)(i) of this section—

(A) *Allocation to hypothetical deductible amounts*—(*1*) *In general.* Subject to paragraph (d)(3)(ii)(A)(*2*) of this section, deductible business interest expense is allocated pro rata to—

(*i*) Hypothetical FC ECI deductible BIE; and

(*ii*) Hypothetical FC non-ECI deductible BIE.

(*2*) *Limitation.* The amount allocated to hypothetical FC ECI deductible BIE in paragraph (d)(3)(ii)(A)(*1*)(*i*) of this section cannot exceed the lesser of hypothetical FC ECI deductible BIE or FC ECI BIE, and the amount allocated to hypothetical FC non-ECI deductible BIE in paragraph (d)(3)(ii)(A)(*1*)(*ii*) of this section cannot exceed the lesser of hypothetical FC non-ECI deductible BIE or FC non-ECI BIE.

(B) *Allocation of remaining deductible amounts.* Deductible business interest expense in excess of the amount allocated in paragraph (d)(3)(ii)(A) of this section, if any, is allocated pro rata to—

(*1*) FC ECI BIE, reduced by the amount described in paragraph (d)(3)(ii)(A)(*1*)(*i*) of this section; and

(*2*) FC non-ECI BIE, reduced by the amount described in paragraph (d)(3)(ii)(A)(*1*)(*ii*) of this section.

(iii) *Hypothetical FC deductible business interest expense*—(A) *Hypothetical FC ECI deductible BIE.* The term *hypothetical FC ECI deductible BIE* means the deductible business interest expense of the relevant foreign corporation determined by only taking into account its items that are ECI.

(B) *Hypothetical FC non-ECI deductible BIE.* The term *hypothetical FC non-ECI deductible BIE* means the deductible business interest expense of the relevant foreign corporation determined by only taking into account its items that are not ECI.

(e) *Rules regarding disallowed business interest expense*—(1) *Retention of character in a succeeding taxable year.* Disallowed business interest expense of a specified foreign person or a relevant foreign corporation for a taxable year (including excess business interest expense allocated to a specified foreign partner under § 1.163(j)–6(f)(2) or paragraph (e)(2) of this section) that is ECI or is not ECI retains its character as ECI or as not ECI in a succeeding taxable year.

(2) *Deemed allocation of excess business interest expense of a partnership to a specified foreign partner.* For purposes of this paragraph (e) and paragraphs (c)(2), (g)(3), and (g)(7) of this section, a specified foreign partner's allocable share of business interest expense is deemed to include its allocable share of excess business interest expense of a partnership in which it is a direct or indirect partner. For purposes of this paragraph (e)(2), a specified foreign partner's allocable share of excess business interest

expense of a partnership in which it is a direct or indirect partner is determined as if the excess business interest expense of the partnership were deductible in the taxable year in which the interest expense is first paid or accrued.

(3) *Ordering rule for conversion of excess business interest expense to business interest expense paid or accrued by a partner.* A specified foreign partner's allocable share of excess business interest expense (determined under § 1.163(j)–6(f)(2) or paragraph (e)(2) of this section) is treated as business interest expense paid or accrued under § 1.163(j)–6(g)(2)(i) in the order of the taxable years in which the excess business interest expense arose, and pro rata between allocable ECI excess BIE and allocable non-ECI excess BIE that arose in the same taxable year. This paragraph (e)(3) applies before application of paragraph (b)(3) of this section.

(4) *Allocable ECI excess BIE and allocable non-ECI excess BIE retains its character when treated as business interest expense paid or accrued in a succeeding taxable year.* If excess business interest expense of a partnership in which a specified foreign partner is a direct or indirect partner is treated as business interest expense paid or accrued by the specified foreign partner or a partnership in which it is a direct or indirect partner under § 1.163(j)–6(g)(2)(i), then allocable ECI excess BIE is treated as business interest expense allocable to ECI and allocable non-ECI excess BIE is treated as business interest expense allocable to income that is not ECI.

(f) *Coordination of the application of section 163(j) with § 1.882–5 and similar provisions and with the branch profits tax*—(1) *Coordination of section 163(j) with § 1.882–5 and similar provisions*—(i) *Ordering rule.* A foreign corporation first determines its business interest expense allocable to ECI under § 1.882–5 or any other relevant provision (*§ 1.882–5 and similar provisions*) before applying section 163(j) to the foreign corporation. If a foreign corporation has a disallowed business interest expense carryforward from a taxable year, then none of that business interest expense is taken into account for purposes of determining business interest expense under § 1.882–5 and similar provisions in a succeeding taxable year.

(ii) *Treatment of excess business interest expense.* For purposes of applying § 1.882–5 and similar provisions, the business interest expense of a specified foreign partner that is a direct or indirect partner in a partnership is determined without regard to the application of section 163(j) to the partnership. As a result, for purposes of applying § 1.882–5 and similar provisions, the specified foreign partner's share of business interest expense on liabilities of a partnership in which it is a direct or indirect partner is determined as if any excess business interest expense of the partnership (determined under § 1.163(j)–6(f)(2) or paragraph (e)(2) of this section) were deductible in the taxable year in which the business interest expense is first paid or accrued and not in a succeeding taxable year.

(iii) *Attribution of certain § 1.882–5 interest expense among the foreign corporation and its partnership interests*—(A) *In general.* If a foreign corporation is a specified foreign partner in one or more partnerships, then, for purposes of section 163(j) and the section 163(j) regulations, interest expense determined under § 1.882–5(b) through (d) or § 1.882–5(e) (*§ 1.882–5 three-step interest expense*) is treated as attributable to liabilities of the foreign corporation or the foreign corporation's share of liabilities of each partnership in accordance with paragraphs (f)(1)(iii)(B) and (f)(1)(iii)(C) of this section. Accordingly, the portion of the § 1.882–5 three-step interest expense attributable to liabilities of the foreign corporation described in this paragraph (f)(1)(iii) is subject to section 163(j) and the section 163(j) regulations at the level of the foreign corporation. The portion of the § 1.882–5 three-step interest expense interest attributable to liabilities of a partnership described in this paragraph (f)(1)(iii) is subject to section 163(j) and the section 163(j) regulations at the partnership-level. See § 1.163(j)–6. This paragraph (f)(1)(iii) merely characterizes interest expense of the foreign corporation and its partnership interests as ECI or not ECI. It does not change the amount of interest expense of the foreign corporation or its partnership interests.

(B) *Attribution of interest expense on U.S. booked liabilities.* The § 1.882–5 three-step interest expense is treated as attributable, pro rata, to interest expense on U.S. booked liabilities of a foreign corporation, determined under § 1.882–5(d)(2)(ii)–(iii) or its interest expense on its share of U.S. booked liabilities of a partnership, determined under § 1.882–5(d)(2)(vii), as applicable, to the extent thereof (without regard to whether the foreign corporation uses the method described in § 1.882–5(b) through (d) or the method described in § 1.882–5(e) for purposes of determining § 1.882–5 interest expense).

(C) *Attribution of excess § 1.882–5 three-step interest expense*—(*1*) *In general.* The § 1.882–5 three-step interest expense in excess of interest expense attributable to U.S. booked liabilities described in § 1.882–5(d)(2), if any (*excess § 1.882–5 three-step interest expense*), is treated as attributable to liabilities of the foreign corporation or the foreign corporation's allocable share of liabilities of one or more partnerships, in accordance with paragraphs (f)(1)(iii)(C)(*2*) and (f)(1)(iii)(C)(*3*) of this section, subject to the limitation in paragraph (f)(1)(iii)(C)(*4*) of this section. For purposes of this paragraph (f)(1)(iii)(C), the term ''U.S. assets'' means U.S. assets described in § 1.882–5(b).

(*2*) *Attribution of excess § 1.882–5 three-step interest expense to the foreign corporation.* Excess § 1.882–5 three-step interest expense is treated as attributable to interest expense on liabilities of the foreign corporation (and not its partnership interests) in proportion to its U.S. assets other than its partnership interests over all of its U.S. assets.

(*3*) *Attribution of excess § 1.882–5 three-step interest expense to partnerships*—(*i*) *In general.* Excess § 1.882–5 three-step interest expense is treated as attributable to interest expense on the foreign corporation's direct or indirect allocable share of liabilities of a partnership in proportion to the portion of the partnership interest that is treated as a U.S. asset under paragraph (f)(1)(iii)(C)(*3*)(*ii*) of this section over all of the foreign corporation's U.S. assets.

(*ii*) *Direct and indirect partnership interests.* If a foreign corporation owns an interest in a partnership that does not own an interest in any other partnerships, the portion of the partnership interest that is a U.S. asset is determined under § 1.882–5(b). If a foreign corporation owns an interest in a partnership (the top-tier partnership) that owns an interest in one or more other partnerships, directly or indirectly (the lower-tier partnerships), the portion of the foreign corporation's direct or indirect interest in the top-tier partnership and lower-tier partnerships that is a U.S. asset is determined by re-attributing the portion of the top-tier partnership interest that is a U.S. asset, as determined under § 1.882–5(b), among the foreign corporation's direct interest in the top-tier partnership and indirect interests in each lower-tier partnership in proportion to their contribution to the portion of the foreign corporation's interest in the upper-tier partnership that is a U.S. asset. Each partnership interest's contribution is determined based on a reasonable method consistent with the method used to determine the portion of the top-tier partnership interest that is a U.S. asset under § 1.882–5(b).

(*4*) *Limitation on attribution of excess § 1.882–5 three-step interest expense.* The portion of excess § 1.882–5 three-step interest expense attributable to a foreign corporation under paragraph (f)(1)(iii)(C)(*2*) of this section or to a partnership under paragraph (f)(1)(iii)(C)(*2*) or (f)(1)(iii)(C)(*3*) of this section, as applicable, is limited to interest on liabilities of the foreign corporation or the foreign corporation's allocable share of liabilities of the partnership, reduced by the sum of the amounts of interest expense on its U.S. booked liabilities described in § 1.882–5(d)(2) and interest expense on liabilities described in § 1.882–5(a)(1)(ii)(A) or (B) (regarding direct allocations of interest expense). The portion of any excess § 1.882–5 three-step interest expense that would be treated as attributable to the foreign corporation or a partnership interest, as applicable, but for this paragraph (f)(1)(iii)(C)(*4*) is re-attributable in accordance with the rules and principles of this paragraph (f)(1)(iii)(C). The portion of any excess § 1.882–5 three-step interest expense that cannot be re-attributed under the rules of (f)(1)(iii)(C)(*1*) through (*3*) of this section because of the application of the first sentence of this paragraph (f)(1)(iii)(C)(*4*) is attributable, first to interest on liabilities of the foreign corporation, and then, pro rata, to the foreign corporation's allocable share of interest on liabilities of its direct or indirect partnership interests, to the extent such attribution is not in excess of the limitation described in this paragraph (f)(1)(iii)(C)(*4*), and without regard to whether the foreign corporation or its partnership interests have U.S. assets.

(2) *Coordination with the branch profits tax.* The disallowance and carryforward of business interest expense under § 1.163(j)–2(b) and (c) will not affect the computation of the U.S. net equity of a foreign corporation, as defined in § 1.884–1(c).

(g) *Definitions.* The following definitions apply for purposes of this section.

(1) *§ 1.882–5 and similar provisions.* The term *§ 1.882–5 and similar provisions* has the meaning provided in paragraph (f)(1)(i) of this section.

(2) *§ 1.882–5 three-step interest expense.* The term *§ 1.882–5 three-step interest expense* has the meaning provided in paragraph (f)(1)(iii)(A) of this section.

(3) *Allocable ECI BIE.* The term *allocable ECI BIE* means, with respect to a partnership, the specified foreign partner's allocable share of the partnership's business interest expense that is ECI, taking into account the application of paragraph (e)(2) of this section.

(4) *Allocable ECI BII.* The term *allocable ECI BII* has the meaning provided in paragraph (c)(4)(ii) of this section.

(5) *Allocable ECI deductible BIE.* The term *allocable ECI deductible BIE* has the meaning provided in paragraph (c)(3)(i) of this section.

(6) *Allocable ECI excess BIE.* The term *allocable ECI excess BIE* has the meaning provided in paragraph (c)(2)(i) of this section.

(7) *Allocable non-ECI BIE.* The term *allocable non-ECI BIE* means, with respect a partnership, the specified foreign partner's allocable share of the partnership's business interest expense that is not ECI, taking into account the application of paragraph (e)(2) of this section.

(8) *Allocable non-ECI deductible BIE.* The term *allocable non-ECI deductible BIE* has the meaning provided in paragraph (c)(3)(i) of this section.

(9) *Allocable non-ECI excess BIE.* The term *allocable non-ECI excess BIE* has the meaning provided in paragraph (c)(2)(ii) of this section.

(10) *Distributive share of ECI.* The term *distributive share of ECI* has the meaning provided in paragraph (c)(1)(iii) of this section.

(11) *Distributive share of non-ECI.* The term *distributive share of non-ECI* has the meaning provided in paragraph (c)(1)(iv) of this section.

(12) *Effectively connected income.* The term *effectively connected income* (or *ECI*) means income or gain that is ECI, as defined in § 1.884–1(d)(1)(iii), and deduction or loss that is allocable to, ECI, as defined in § 1.884–1(d)(1)(iii).

(13) *Excess § 1.882–5 three-step interest expense.* The term *excess § 1.882–5 three-step interest expense* has the meaning provided in paragraph (f)(1)(iii)(C)(*1*) of this section.

(14) *FC ECI BIE.* The term *FC ECI BIE* means, with respect to a relevant foreign corporation and a taxable year, business interest expense that is ECI, determined without regard to the application of section 163(j) and the section 163(j) regulations except for the application of paragraph (f)(1)(iii) of this section.

(15) *FC ECI deductible BIE.* The term *FC ECI deductible BIE* has the meaning provided in paragraph (d)(3)(i) of this section.

(16) *FC ECI disallowed BIE.* The term *FC ECI disallowed BIE* has the meaning provided in paragraph (d)(2)(i) of this section.

(17) *FC non-ECI BIE.* The term *FC non-ECI BIE* means, with respect to a relevant foreign corporation and a taxable year, business interest expense that is not ECI, determined without regard to the application of section 163(j) and the section 163(j) regulations except for the application of paragraph (f)(1)(iii) of this section.

(18) *FC non-ECI deductible BIE.* The term *FC non-ECI deductible BIE* has the meaning provided in paragraph (d)(3)(i) of this section.

(19) *FC non-ECI disallowed BIE.* The term *FC non-ECI disallowed BIE* has the meaning provided in paragraph (d)(2)(ii) of this section.

(20) *Hypothetical partnership ECI deductible BIE.* The term *hypothetical partnership ECI deductible BIE* has the meaning provided in paragraph (c)(3)(iii)(A) of this section.

(21) *Hypothetical partnership non-ECI deductible BIE.* The term *hypothetical partnership non-ECI deductible BIE* has the meaning provided in paragraph (c)(3)(iii)(B) of this section.

(22) *Hypothetical FC ECI deductible BIE.* The term *hypothetical FC ECI deductible BIE* has the meaning provided in paragraph (d)(3)(iii)(A) of this section.

(23) *Hypothetical FC non-ECI deductible BIE.* The term *hypothetical FC non-ECI deductible BIE* has the meaning provided in paragraph (d)(3)(iii)(B) of this section.

(24) *Specified ATI ratio.* The term *specified ATI ratio* has the meaning provided in paragraph (c)(1)(ii) of this section.

(25) *Specified BII ratio.* The term *specified BII ratio* has the meaning provided in paragraph (c)(4)(ii) of this section.

(26) *Specified foreign partner.* The term *specified foreign partner* means, with respect to a partnership that has ECI, a direct or indirect partner that is a specified foreign person or a relevant foreign corporation.

(27) *Specified foreign person.* The term *specified foreign person* means a nonresident alien individual, as defined in section 7701(b) and the regulations under section 7701(b), or a foreign corporation other than a relevant foreign corporation.

(28) *Successor.* The term *successor* includes, with respect to a foreign corporation, the acquiring corporation in a transaction described in section 381(a) in which the foreign corporation is the distributor or transferor corporation.

(h) *Examples.* The following examples illustrate the application of this section. For all examples, assume that all referenced interest expense is deductible but for the application of section 163(j), the small business exemption under § 1.163(j)–2(d) is not available, no entity is engaged in an excepted trade or business, no business interest expense is floor plan financing interest expense, all entities have the same taxable year, all entities use the U.S. dollar as their functional currency, no foreign corporation is a relevant foreign corporation, all relevant taxable years begin after December 31, 2020, and, for purposes of computing ATI, none of the adjustments described in § 1.163(j)–1(b) are relevant other than the adjustment for business interest expense.

(1) *Example 1. Limitation on business interest deduction of a foreign corporation*—(i) *Facts.* FC, a foreign corporation, has $100x of gross income that is ECI. FC has $60x of other income which is not ECI. FC has total expenses of $100x, of which $50x is business interest expense. Assume that FC has $30x of § 1.882–5 three-step interest expense. Under section 882(c) and the regulations, FC has $40x of other expenses that are ECI, none of which are business interest expense. FC does not have any business interest income. All amounts described in this paragraph (h)(1)(i) are with respect to a single taxable year of FC.

(ii) *Analysis.* FC is a specified foreign person under paragraph (g)(27) of this section. The amount of FC's business interest expense that is disallowed for the taxable year is determined under § 1.163(j)–2(b) with respect to business interest expense described in paragraph (b)(3) of this section. Under paragraph (b)(3) of this section, FC has business interest expense of $30x. Under paragraph (b)(2) of this section, FC has ATI of $60x ($100x − $40x). Accordingly, FC's section 163(j) limitation is $18x ($60x × 30 percent). Because FC's business interest expense ($30x) that is ECI exceeds the section 163(j) limitation ($18x), FC may only deduct $18x of business interest expense. Under § 1.163(j)–2(c), the remaining $12x is disallowed business interest expense carryforward, and under paragraph (f)(1)(i) of this section, the $12x is not taken into account for purposes of applying § 1.882–5 in the succeeding taxable year.

(2) *Example 2. Use of a disallowed business interest expense carryforward*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (h)(1)(i) of this section except that for the taxable year FC has $300x of gross income that is all ECI. Furthermore, assume that for the taxable year FC has a disallowed business interest expense carryforward of $25x with respect to business interest expense described in paragraph (b)(3) of this section.

(ii) *Analysis.* Under paragraph (f)(1)(i) of this section, FC's $25x of disallowed business interest expense carryforward is not taken into account for purposes of determining FC's interest expense under § 1.882–5 for the taxable year. Therefore, FC has $30x of § 1.882–5 three-step interest expense. Under paragraph (b)(2) of this section, FC has ATI of $260x ($300x of gross income reduced by $40 of expenses other than business interest expense). Accordingly, FC's section 163(j) limitation is $78x ($260x × 30 percent). Because FC's business interest expense ($55x) does not exceed the section 163(j) limitation ($78x), FC may deduct all $55x of business interest expense.

(3) *Example 3. Foreign corporation is engaged in a U.S. trade or business and is also a specified foreign partner*—(i) *Facts.* FC, a foreign corporation, owns a 50-percent interest in ABC, a partnership that has ECI. In addition to owning a 50-percent interest in ABC, FC conducts a separate business that is engaged in a trade or business in the United States, Business Y. Business Y produces $65x of taxable income before taking into account business interest expense and has U.S. assets with an adjusted basis of $300x, business interest expense of $15x on $160x of liabilities, and no business interest income. All of the liabilities of Business Y are U.S. booked liabilities for purposes of § 1.882–5(d). FC also has various foreign operations, some of which have U.S. dollar denominated debt. ABC has two lines of business, Business S and Business T. FC is allocated 50 percent of all items of income and expense of Business S and Business T. Business S produces $140x of taxable income before taking into account business interest expense, and Business T produces $80x of taxable income before taking into account business interest expense. Business S has business interest expense of $20x on $400x of liabilities and no business interest income. Business T has business interest expense of $10x on $150x of liabilities and no business interest income. With respect to FC, only Business S produces ECI. FC has an outside basis of $600x in the portion of its ABC partnership interest that is a U.S. asset for purposes of § 1.882–5(b), step 1. All of the liabilities of Business S are U.S. booked liabilities for purposes of § 1.882–5(d). FC computes its interest expense under the three-step method described in § 1.882–5(b) through (d) and for purposes of § 1.882–5(c), step 2, FC uses the fixed ratio of 50 percent described in § 1.882–5(c)(4) for taxpayers that are neither a bank nor an insurance company. Under § 1.882–5(d)(5)(ii), FC's interest rate on excess U.S. connected liabilities is 5 percent. For the taxable year, assume FC has total interest expense of $100x for purposes of § 1.882–5(a)(3). All amounts described in this paragraph (h)(3)(i) are with respect to a single taxable year of FC or ABC, as applicable.

(ii) *Analysis*—(A) *Application of § 1.882–5 to FC.* FC is a specified foreign person under paragraph (g)(27) of this section and a specified foreign partner under paragraph (g)(26) of this section. Under paragraph (f)(1) of this section, FC first determines its § 1.882–5 three-step interest expense and then applies section 163(j). Under § 1.882–5(b), step 1, FC has U.S. assets of $900x ($600x of basis in the portion of its ABC partnership interest that is a U.S. asset determined using the asset method described in § 1.884–1(d)(3)(ii) + $300x basis in U.S. assets of Business Y). Under § 1.882–5(c), step 2, applying the 50-percent fixed ratio described in § 1.882–5(c)(4), FC has U.S. connected liabilities of $450x ($900x × 50 percent). Under § 1.882–5(d), step 3, FC has U.S. booked liabilities of $360x ($200x attributable to its 50-percent share of Business S liabilities of ABC + $160x of Business Y liabilities) and interest on U.S. booked liabilities of $25x ($10x attributable to its 50-percent share of $20x interest expense of Business S + $15x of Business Y interest expense). FC has excess U.S. connected liabilities of $90x ($450x − $360x) and under § 1.882–5(d)(5) has interest expense on excess U.S. connected liabilities of $4.50x ($90x × 5 percent), which is excess § 1.882–5 three-step interest expense. FC's § 1.882–5 three-step interest expense is $29.50x ($25x + $4.50x).

(B) *Attribution of § 1.882–5 business interest expense between FC and ABC.* Under paragraph (f)(1)(iii) of this section, FC's § 1.882–5 three-step interest expense is attributable to interest on its liabilities or on its share of ABC liabilities. Under paragraph (f)(1)(iii)(B), FC's § 1.882–5 three-step interest expense of $29.50x is first attributable to $15 of interest expense on FC's (Business Y) U.S. booked liabilities and $10x of interest expense on FC's share of U.S. booked liabilities of ABC. Under paragraph (f)(1)(iii)(C)(*2*) of this section, of the excess § 1.882–5 three-step interest expense of $4.50x ($29.50x − $15x − $10x), 66.67 percent ($600x of basis in the portion of the ABC partnership interest that is a U.S. asset/$900x of total U.S. assets), or $3.00x, is attributable to interest expense on FC's share of liabilities of ABC and 33.33 percent ($300x U.S. assets other than partnership interests/$900x of total U.S. assets), or $1.50x, is attributable to interest expense on liabilities of FC. As a result, $16.50x of business interest expense ($15x + $1.50x) is attributed to FC and $13x of business interest expense ($10x + $3x) is attributed to ABC. The limitation under paragraph (f)(1)(iii)(C)(*4*) of this section does not change the result described in the preceding sentence. Specifically, under paragraph (f)(1)(iii)(C)(*4*) of this section, the amount attributed to ABC (tentatively, $3.00x) is limited to $5x (FC's 50-percent share of the $30x of business interest expense of ABC or $15x, reduced by FC's 50-percent share of the $20x of business interest expense on U.S. booked liabilities of Business S), and the amount attributed to FC (tentatively, $1.50x) is limited to $70x (FC's business interest expense of $100x, reduced by $15x of business interest expense on U.S. booked liabilities of Business Y and its $15x allocable share of ABC's business interest expense).

(C) *Application of the section 163(j) limitation to ABC.* Under § 1.163(j)–6(a), ABC computes a section 163(j) limitation at the partnership level. ABC has business interest expense of $30x ($20x from Business S and $10x from Business T). Under § 1.163(j)–6(d), ABC has ATI of $220x ($140 + $80). Under § 1.163(j)–2(b), ABC's section 163(j) limitation is $66x ($220x × 30 percent). Because ABC's business interest expense ($30x) does not exceed the section 163(j) limitation ($66x), all of ABC's business interest expense is deductible for the taxable year.

(D) *Excess taxable income of ABC.* Under § 1.163(j)–1(b)(15), ABC has excess taxable income of $120x ($220x × ($36x/$66x)). Under § 1.163(j)–6(f)(2), FC is allocated 50 percent of the $120x of ABC's excess taxable income or $60x of allocable excess taxable income. Under paragraph (c)(1) of this section, the amount of the allocable excess taxable income of $60x that is ECI is equal to FC's allocable excess taxable income multiplied by the specified ATI ratio. Under paragraph (c)(1)(iii) of this section, FC's distributive share of ECI of ABC is $57x (FC's 50-percent share of $140x (Business S income computed without regard to business interest expense) or $70x–$13x of business interest expense that is ECI). Under paragraph (c)(1)(iv) of this section, FC's distributive share of non-ECI of ABC is $38x (FC's 50-percent share of $80x (Business T income computed without regard to business interest expense) or $40x–$2x of business interest expense that is not ECI). FC's distributive share of partnership items of income, gain, deduction, and loss of ABC is $95x ($57x distributive share of ECI and $38x distributive share of non-ECI). Because both FC's distributive share of ECI and distributive share of non-ECI are positive, under paragraph (c)(1)(ii) of this section, the specified ATI ratio is 60 percent ($57x distributive share of ECI/$95x distributive share of partnership items of income, gain, deduction, and loss of ABC). As a result, the amount of FC's allocable excess taxable income from ABC that is ECI is $36x ($60 of allocable excess taxable income × 60 percent specified ATI ratio).

(E) *Application of section 163(j) to FC.* Under paragraph (b)(3) of this section, FC's business interest expense is $16.50x. Under § 1.163(j)–6(e)(1), FC's ATI is determined under § 1.163(j)–1(b)(1) without regard to FC's distributive share of any items of income, gain, deduction, or loss of ABC. Under paragraph (b)(2) of this section, FC's ATI is $101x ($65x of ECI from Business Y + $36x of allocable excess taxable income from ABC that is ECI). FC's section 163(j) limitation is $30.30x ($101x × 30 percent). Because FC's business interest expense ($16.50x) is less than FC's section 163(j) limitation ($30.30x) and all of its share of ABC's business interest expense that is allocable to ECI ($13x) is deductible, FC may deduct all $29.50x of § 1.882–5 three-step interest expense determined under paragraph (h)(3)(ii)(A) of this section.

(4) *Example 4. Specified foreign partner with excess business interest expense from a partnership*—(i) *Facts*—(A) *In general.* FC, a foreign corporation, owns a 50-percent interest in ABC, a partnership that has ECI. In addition to owning a 50-percent interest in ABC, FC conducts a separate business that is engaged in a trade or business in the United States, Business Y. Business Y produces $56x of taxable income before taking into account business interest expense and has U.S. assets with an adjusted basis of $800x, business interest expense of $16x on $200x of liabilities, and no business interest income. All of the liabilities of Business Y are U.S. booked liabilities for purposes of § 1.882–5(d). FC also has various foreign operations, some of which have U.S. dollar denominated debt.

(B) *ABC Partnership.* ABC has two lines of business, Business S and Business T, and owns a 50-percent interest in DEF, a partnership. FC is allocated 50 percent of all items of income and expenses of Business S and Business T and ABC's allocable share of items from partnership DEF. Business S produces $80x of taxable income before taking into account business interest expense, and Business T produces $90x of taxable income before taking into account business interest expense. Business S has business interest expense of $30x on $500x of liabilities and no business interest income. Business T has business interest expense of $50x on $500x of liabilities and no business interest income. With respect to FC, only Business S produces ECI. All of the liabilities of Business S are U.S. booked liabilities for purposes of § 1.882–5(d).

(C) *DEF Partnership.* DEF has two lines of business, Business U and Business V. ABC is allocated 50 percent of all items of income and expenses of Business U and Business V. Business U produces $100x of taxable income before taking into account business interest expense and Business V produces $140x of taxable income before taking into account business interest expense. Business U has business interest expense of $40x on $600x of liabilities and no business interest income. Business V has business interest expense of $60x on $600x of liabilities and no business interest income. With respect to FC, only Business U produces ECI. All of the liabilities of Business U are U.S. booked liabilities for purposes of § 1.882–5(d).

(D) *Section 1.882–5.* FC has an outside basis of $600x in the portion of its ABC partnership interest that is a U.S. asset for purposes of § 1.882–5(b), step 1, determined using the asset method described in § 1.884–1(d)(3)(ii). For purposes of § 1.884–1(d)(3)(ii), ABC has a total basis of $500 in assets that would be treated as U.S. assets if ABC were a foreign corporation, including a basis of $250x in the portion of its interest in DEF partnership interest that would be treated as a U.S. asset if ABC were a foreign corporation. FC computes its interest expense under the three-step method described in § 1.882–5(b) through (d), and for purposes of § 1.882–5(c), step 2, FC uses the fixed ratio of 50 percent described in § 1.882–5(c)(4) for taxpayers that are neither a bank nor an insurance company. FC has total interest expense of $100x for purposes of § 1.882–5(a)(3). Under § 1.882–5(d)(5)(ii), FC's interest rate on excess U.S. connected liabilities is 6 percent. All amounts described in this paragraph (h)(4)(i) are with respect to a single taxable year of FC, ABC, or DEF, as applicable.

(ii) *Analysis*—(A) *Application of § 1.882–5 to FC.* FC is a specified foreign person under paragraph (g)(27) of this section and a specified foreign partner under paragraph (g)(26) of this section. Under paragraph (f)(1) of this section, FC first determines its § 1.882–5 three-step interest expense and then applies section 163(j). Under § 1.882–5(b), step 1, FC has U.S. assets of $1400x ($600x of basis in the portion of its ABC partnership interest that is a U.S. asset + $800x basis in U.S. assets of Business Y). Under § 1.882–5(c), step 2, applying the 50-percent fixed ratio described in § 1.882–5(c)(4), FC has U.S. connected liabilities of $700x ($1400x × 50 percent). Under § 1.882–5(d), step 3, FC has U.S. booked liabilities of $600x ($250x attributable to its 50-percent share of Business S liabilities of ABC + $150x attributable to its indirect 25-percent share of Business U liabilities of DEF + $200x of Business Y liabilities), and interest on U.S. booked liabilities of $41x ($15x attributable to its 50-percent share of $30x interest expense of Business S + $10x attributable to its 25-percent share of $40 interest expense of Business U + $16x of Business Y interest expense). FC has excess U.S. connected liabilities of $100x ($700x − $600x) and under § 1.882–5(d)(5), interest expense on excess U.S. connected liabilities of $6x ($100x × 6 percent), which is excess § 1.882–5 three-step interest expense. FC's § 1.882–5 three-step interest expense is $47x ($41x + $6x).

(B) *Attribution of certain § 1.882–5 business interest expense among FC, ABC, and DEF.* Under paragraph (f)(1)(iii) of this section, FC's § 1.882–5 three-step interest expense is attributable to interest on its liabilities or on its share of ABC and DEF's liabilities. Under paragraph (f)(1)(iii)(B) of this section, FC's § 1.882–5 three-step interest expense of $47x is first attributable to $16 of interest expense on FC's U.S. booked liabilities, $15x of interest expense on FC's share of U.S. booked liabilities of ABC, and $10x of interest expense on FC's share of U.S. booked liabilities of DEF. Under paragraph (f)(1)(iii)(C)(*2*) of this section, of the excess § 1.882–5 three-step interest expense of $6x ($47x − $16x − $15x − $10x), 42.86 percent ($600x of basis in the portion of the ABC partnership interest that is a U.S. asset/ $1400x of total U.S. assets) or $2.57x is attributable to interest expense on FC's share of liabilities of ABC (and its partnership interests), and 57.14 percent ($800x U.S. assets other than partnership interests/ $1400x of total U.S. assets) or $3.43x is attributable to interest expense on liabilities of FC. Under paragraph (f)(1)(iii)(C)(*3*) of this section, of the $2.57x of business interest expense that is ECI and that is attributable to interest expense on FC's share of liabilities of ABC (and its partnership interests), 50 percent ($250x of basis in the portion of the DEF partnership interest that would be a U.S. asset if ABC were a foreign corporation/ $500x total basis in assets that would be U.S. assets if ABC were a foreign corporation), or $1.29x, is attributable to interest expense on FC's share of liabilities of ABC and 50 percent ($250x of basis in assets other than partnership interests that would be U.S. assets if ABC were a foreign corporation/ $500x of total basis in assets that would be U.S. assets if ABC were a foreign corporation), or $1.29x is attributable to interest expense on FC's share of liabilities of DEF. As a result, $19.43x ($16x + $3.43x) of business interest expense is attributed to FC, $16.29x ($15x + $1.29x) of business interest expense is attributed to ABC, and $11.29x ($10x + $1.29x) of business interest expense is attributed to DEF. The limitation under paragraph (f)(1)(iii)(C)(*4*) of this section does not change the result described in the preceding sentence. Specifically, under paragraph (f)(1)(iii)(C)(*4*) of this section, the amount attributed to FC (tentatively, $3.43x) is limited to $19x (FC's business interest expense of $100x, reduced by $16x of business interest expense on U.S. booked liabilities of Business Y, its $40x allocable share of ABC's business interest expense, and its $25 allocable share of DEF's business interest expense); the amount attributed to ABC (tentatively, $1.29x) is limited to $25x (FC's 50-percent share of the $80x of business interest expense of ABC, or $40x, reduced by FC's 50-percent share of the $30x of business interest expense on U.S. booked liabilities of Business S, or $15x); and the amount attributed to DEF (tentatively, $1.29x) is limited to $15x (FC's 25-percent share of the $100x of business interest expense of DEF, or $25x, reduced by FC's 25-percent share of the $40x of business interest expense on U.S. booked liabilities of Business U, or $10x).

(C) *Application of section 163(j) to DEF*—(*1*) *In general.* Under § 1.163(j)–6(a), DEF computes a section 163(j) limitation at the partnership-level. DEF has business interest expense of $100x ($40x from Business U + $60x from Business V). Under § 1.163(j)–6(d), DEF has ATI of $240x ($100x + $140x). Under § 1.163(j)–2(b), DEF's section 163(j) limitation is $72x ($240x × 30 percent). Because DEF's business interest expense ($100x) exceeds the section 163(j) limitation ($72x), only $72x of DEF's business interest expense is deductible and $28x is disallowed under section 163(j). Pursuant to paragraph (e)(2) of this section, FC is allocated $7x of excess business interest expense (25 percent × $28x) and $18x of deductible business interest expense (25 percent × $72x).

(*2*) *Deductible business interest expense.* Under paragraph (c)(3) of this section, in order to determine the portion of FC's allocable deductible business interest expense ($18x) that is allocable ECI deductible BIE and the portion that is allocable non-ECI deductible BIE, the hypothetical partnership ECI deductible BIE and hypothetical partnership non-ECI deductible BIE must be determined. Under paragraph (c)(3)(iii)(A) of this section, FC's hypothetical partnership ECI deductible BIE with respect to DEF is $7.50x ($25x of FC's allocable share of ECI before taking into account interest expense × 30 percent). Under paragraph (c)(3)(iii)(B) of this section, FC's hypothetical partnership non-ECI deductible BIE with respect to DEF is $10.50x ($35x of FC's allocable share of income that is not ECI before taking into account interest expense × 30 percent). Under paragraph (c)(3)(i) of this section, allocable ECI deductible BIE is equal to the amounts described in paragraphs (c)(3)(ii)(A)(*1*)(*i*) and (c)(3)(ii)(B)(*1*) of this section and allocable non-ECI deductible BIE is equal to the amounts described in paragraphs (c)(3)(ii)(A)(*1*)(*ii*) and (c)(3)(ii)(B)(*2*) of this section. Under paragraph (c)(3)(ii)(A)(*1*) of this section, FC's allocable deductible business interest expense ($18x) is allocated pro rata between hypothetical partnership ECI deductible BIE ($7.50x) and hypothetical partnership non-ECI deductible BIE ($10.50x). However, the amount allocated to hypothetical partnership ECI deductible BIE cannot exceed the lesser of hypothetical partnership ECI deductible BIE ($7.50x) or allocable ECI BIE ($11.29x), and the amount allocated to hypothetical partnership non-ECI deductible BIE cannot exceed the lesser of hypothetical partnership non-ECI deductible BIE ($10.50x) or allocable non-ECI BIE (total allocable business interest expense of $25x reduced by allocable ECI BIE of $11.29x, or $13.71x). The portion of FC's allocable deductible business interest expense ($18x) from DEF that is allocable ECI deductible BIE is 41.67 percent ($7.50x of hypothetical partnership ECI deductible BIE/$18x of total hypothetical partnership deductible BIE), or $7.5x. The portion of FC's allocable deductible business interest expense from DEF ($18x) that is allocable non-ECI deductible BIE is 58.33 percent ($10.50x of hypothetical partnership ECI deductible BIE/$18x of total hypothetical partnership deductible BIE), or $10.50x. Because the full amount of FC's allocable deductible business interest expense ($18x) is allocable under paragraph (c)(3)(ii)(A)(*1*) of this section, no portion is allocated under paragraph (c)(3)(ii)(B) of this section.

(*3*) *Excess business interest expense.* Under paragraph (c)(2)(i) of this section, the portion of excess business interest expense allocated to FC from DEF pursuant to paragraph (e)(2) of this section ($7x) that is allocable ECI excess BIE is $3.79x ($11.29x of allocable ECI BIE − $7.50x allocable ECI deductible BIE). Under paragraph (c)(2)(ii) of this section, the portion of excess business interest expense allocated to FC from DEF pursuant to paragraph (e)(2) of this section ($7x) that is allocable non-ECI excess BIE is $3.21x ($13.71x of allocable non-ECI BIE − $10.50x allocable non-ECI deductible BIE).

(D) *Application of section 163(j) to ABC*—(*1*) *In general.* Under § 1.163(j)–6(a), ABC computes a section 163(j) limitation at the partnership-level. ABC has business interest expense of $80x ($30x from Business S + $50x from Business T). Under § 1.163(j)–6(d), ABC has ATI of $170x ($80x + $90x). Under § 1.163(j)–2(b), ABC's section 163(j) limitation is $51x ($170x × 30 percent). Because ABC's business interest expense ($80x) exceeds the section 163(j) limitation ($51x), ABC may only deduct $51x of business interest expense, and $29x is disallowed under section 163(j). Pursuant to § 1.163(j)–6(f)(2), FC is allocated $14.50x of excess business interest expense (50 percent × $29x) and $25.50x of deductible business interest expense (50 percent × $51x).

(*2*) *Deductible business interest expense.* Under paragraph (c)(3) of this section, in order to determine the portion of FC's allocable deductible business interest expense ($25.50x) that is allocable ECI deductible BIE and the portion that is allocable non-ECI deductible BIE, the hypothetical partnership ECI deductible BIE and hypothetical partnership non-ECI deductible BIE must be determined. Under paragraph (c)(3)(iii)(A) of this section, FC's hypothetical partnership ECI deductible BIE with respect to ABC is $12x ($40x of FC's allocable share of ECI before taking into account interest expense × 30 percent). Under paragraph (c)(3)(iii)(B) of this section, FC's hypothetical partnership non-ECI deductible BIE with respect to ABC is $13.50x ($45x of FC's allocable share of income that is not ECI before taking into account interest expense × 30 percent). Under paragraph (c)(3)(i) of this section, allocable ECI deductible BIE is equal to the amounts described in paragraphs (c)(3)(ii)(A)(*1*)(*i*) and (c)(3)(ii)(B)(*1*) of this section and allocable non-ECI deductible BIE is equal to the amounts described in paragraphs (c)(3)(ii)(A)(*1*)(*ii*) and (c)(3)(ii)(B)(*2*) of this section. Under paragraph (c)(3)(ii)(A)(*1*) of this section, FC's allocable deductible business interest expense ($25.50x) is allocated pro rata between hypothetical partnership ECI deductible BIE ($12x) and hypothetical partnership non-ECI deductible BIE ($13.50x). However, the amount allocated to hypothetical partnership ECI deductible BIE cannot exceed the lesser of hypothetical partnership ECI deductible BIE ($12x) or allocable ECI BIE ($16.29x), and the amount allocated to hypothetical partnership non-ECI deductible BIE cannot exceed the lesser of hypothetical partnership non-ECI deductible BIE ($13.50x) or allocable non-ECI BIE (total allocable business interest expense of $40x reduced by allocable ECI BIE of $16.29x, or $23.71x). The portion of FC's allocable deductible business interest expense from ABC ($25.50x) that is allocable ECI deductible BIE is 47.06 percent ($12x of hypothetical partnership ECI deductible BIE/$25.50x of total hypothetical partnership deductible BIE), or $12x. The portion of FC's allocable deductible business interest expense from ABC that is allocable non-ECI deductible BIE is 52.94 percent ($13.50x of hypothetical partnership ECI deductible BIE/$25.50x of total hypothetical partnership deductible BIE), or $13.50x. Because the full amount of FC's allocable deductible business interest expense ($25.50x) is allocable under paragraph (c)(3)(ii)(A)(*1*) of this section, no portion is allocated under paragraph (c)(3)(ii)(B) of this section.

(*3*) *Excess business interest expense.* Under paragraph (c)(2)(i) of this section, the portion of excess business interest expense allocated to FC from ABC pursuant to § 1.163(j)–6(f)(2)($14.50x) that is allocable ECI excess BIE is $4.29x ($16.29x of allocable ECI BIE − $12x allocable ECI deductible BIE). Under paragraph (c)(2)(ii) of this section, the portion of excess business interest expense allocated to FC from ABC pursuant to § 1.163(j)–6(f)(2) ($14.50x) that is allocable non-ECI excess BIE is $10.21x ($23.71x of allocable non-ECI BIE − $13.50x allocable non-ECI deductible BIE).

(E) *Application of section 163(j) to FC.* Under paragraph (b)(3) of this section, FC's business interest expense is $19.43x. Under § 1.163(j)–6(e)(1), FC's ATI is determined under § 1.163(j)–1(b)(1) without regard to FC's distributive share of any items of income, gain, deduction, or loss of ABC or DEF. Under paragraph (b)(2) of this section, FC's ATI is $56x ($56x of ECI of Business Y before taking into account interest expense). FC's section 163(j) limitation is $16.80x ($56x × 30 percent). Because the portion of FC's business interest expense determined under § 1.882–5 that is attributed to FC ($19.43x) exceeds the section 163(j) limitation ($16.80x), FC may only deduction $16.80x of business interest expense, and $2.63x is disallowed business interest expense carryforward. After taking into account FC's allocable share of deductible business interest expense, FC may deduct $36.30x ($16.80x from FC + $12x allocable ECI deductible BIE from ABC + $7.50x allocable ECI deductible BIE from DEF). FC also has $2.63x disallowed business interest expense carryforward characterized as ECI, $4.29x allocable ECI excess BIE from ABC, $10.21x allocable non-ECI excess BIE from ABC, and, under paragraph (e)(2) of this section, is deemed to have $3.79x allocable ECI excess BIE from DEF and $3.21x allocable non-ECI excess BIE from DEF.

(i) [Reserved]

(j) *Applicability date.* This section applies to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply this section in its entirety for a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties also apply § 1.163(j)–7(a), (c) through (f), (g)(3) and (4), and (h) through (k) for the taxable year. For a taxable year beginning before November 13, 2020, taxpayers and their related parties may not choose to apply this section unless they also apply § 1.163(j)–7(b) and (g)(1) and (2) in accordance with the second sentence of § 1.163(j)–7(m)(1).

■ **Par. 10.** As added in a final rule elsewhere in this issue of the **Federal Register**, effective November 13, 2020, § 1.163(j)–10 is amended by:

■ 1. Designating paragraph (c)(5)(ii)(D) as paragraph (c)(5)(ii)(D)(*1*).

■ 2. Adding a subject heading for paragraph (c)(5)(ii)(D).

■ 3. Adding paragraph (c)(5)(ii)(D)(*2*).

■ 4. Designating paragraph (f) as paragraph (f)(1).

■ 5. Adding a subject heading for paragraph (f).

■ 6. Revising the subject heading of newly redesignated paragraph (f)(1).

■ 7. Adding paragraph (f)(2).

The additions and revision read as follows:

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

* * * * *

(c) * * *

(5) * * *

(ii) * * *

(D) *Limitations on application of look-through rules.* * * *

(*2*) *Limitation on application of look-through rule to C corporations.* Except as provided in § 1.163(j)–9(h)(4)(iii) and (iv) (for a REIT or a partnership making the election under § 1.163(j)–9(h)(1) or (7), respectively), for purposes of applying the look-through rules in paragraph (c)(5)(ii)(B) and (C) of this section to a non-consolidated C corporation (upper-tier entity), that upper-tier entity may not apply these look-through rules to a lower-tier non-consolidated C corporation. For example, assume that P wholly and directly owns S1 (the upper-tier entity), which wholly and directly owns S2. Further assume that each of these entities is a non-consolidated C corporation to which the small business exemption does not apply. S1 may not look through the stock of S2 (and may not apply the asset basis look-through rule described in paragraph (c)(5)(ii)(B)(*2*)(*iv*) of this section) for purposes of P's allocation of its basis in its S1 stock between excepted and non-excepted trades or businesses; instead, S1 must treat its stock in S2 as an asset used in a non-excepted trade or business for that purpose. However, S1 may look through the stock of S2 for purposes of S1's allocation of its basis in its S2 stock between excepted and non-excepted trades or businesses.

* * * * *

(f) *Applicability dates.*

(1) *In general.* * * *

(2) *Paragraph (c)(5)(ii)(D)(2).* The rules contained in paragraph (c)(5)(ii)(D)(*2*) of this section apply for taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. However, taxpayers may choose to apply the rules of paragraph (c)(5)(ii)(D)(*2*) of this section to a taxable year beginning after December 31, 2017, and before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**], so long as they consistently apply the rules in 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, 1.704–1, 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, and 1.383–1), and 1.1504–4 to that taxable year and each subsequent taxable year.

■ **Par. 11.** Section 1.469–4 is amended by adding paragraph (d)(6) to read as follows:

§ 1.469–4 Definition of activity.

* * * * *

(d) * * *

(6) *Activities described in section 163(d)(5)(A)(ii).* An activity described in section 163(d)(5)(A)(ii) that involves the conduct of a trade or business which is not a passive activity of the taxpayer and with respect to which the taxpayer does not materially participate may not be grouped with any other activity or activities of the taxpayer, including any other activity described in section 163(d)(5)(A)(ii).

* * * * *

■ **Par. 12.** As amended in a final rule elsewhere in this issue of the **Federal Register**, effective November 13, 2020, § 1.469–9 is further amended by revising paragraphs (b)(2)(ii)(A) and (B) to read as follows:

§ 1.469–9 Rules for certain rental real estate activities.

* * * * *

(b) * * *

(2) * * *

(ii) * * *

(A) *Real property development.* The term *real property development* means the maintenance and improvement of raw land to make the land suitable for subdivision, further development, or construction of residential or commercial buildings, or to establish, cultivate, maintain or improve timberlands (that is, land covered by timber-producing forest). Improvement of land may include any clearing (such as through the mechanical separation and removal of boulders, rocks, brush, brushwood, and underbrush from the land); excavation and gradation work; diversion or redirection of creeks, streams, rivers, or other sources or bodies of water; and the installation of roads (including highways, streets, roads, public sidewalks, and bridges), utility lines, sewer and drainage systems, and any other infrastructure that may be necessary for subdivision, further development, or construction of residential or commercial buildings, or for the establishment, cultivation, maintenance or improvement of timberlands.

(B) *Real property redevelopment.* The term *real property redevelopment* means the demolition, deconstruction, separation, and removal of existing buildings, landscaping, and infrastructure on a parcel of land to return the land to a raw condition or otherwise prepare the land for new development or construction, or for the establishment and cultivation of new timberlands.

* * * * *

■ **Par. 13.** Section 1.469–11 is amended by revising paragraphs (a)(1) and (4) to read as follows:

§ 1.469–11 Applicability date and transition rules.

(a) * * *

(1) The rules contained in §§ 1.469–1, 1.469–1T, 1.469–2, 1.469–2T, 1.469–3, 1.469–3T, 1.469–4, but not § 1.469–4(d)(6), 1.469–5 and 1.469–5T apply for taxable years ending after May 10, 1992. The rules contained in § 1.469–4(d)(6) apply for taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may choose to apply the rules of § 1.469–4(d)(6) to a taxable year beginning after December 31, 2017, and before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**], so long as they consistently apply the rules in 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, 1.704–1, 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, and 1.383–1), and 1.1504–4 to that taxable year and each subsequent taxable year.

* * * * *

(4) The rules contained in § 1.469–9(b)(2), other than paragraphs (b)(2)(ii)(A) and (B), apply to taxable years beginning on or after [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. Section 1.469–9(b)(2)(ii)(A) and (B) applies to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of § 1.469–9(b)(2), other than paragraphs (b)(2)(ii)(A) and (B), to a taxable year beginning after December 31, 2017, and before [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**] and may choose to apply the rules contained in 1.469–9(b)(2)(ii)(A) and (B) to taxable years beginning after December 31, 2017, and before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**], so long as they 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, 1.704–1, 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, and 1.383–1), and 1.1504–4 to that taxable year and each subsequent taxable year.

* * * * *

■ **Par. 14.** Section 1.1256(e)–2 is added to read as follows:

§ 1.1256 (e)–2 Special rules for syndicates.

(a) *Allocation of losses.* For purposes of section 1256(e)(3), *syndicate* means any partnership or other entity (other than a corporation that is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocated to limited partners or limited entrepreneurs (within the meaning of section 461(k)(4)).

(b) *Determination of loss amount.* For purposes of section 1256(e)(3), the amount of losses to be allocated under paragraph (a) of this section is calculated without regard to section 163(j).

(c) *Example.* The following example illustrates the rules in this section:

(1) *Facts.* Entity is an S corporation that is equally owned by individuals A and B. A provides all of the goods and services provided by Entity. B provided all of the capital for Entity but does not participate in Entity's business. For the current taxable year, Entity has gross receipts of $5,000,000, non-interest expenses of $4,500,000, and interest expense of $600,000.

(2) *Analysis.* Under paragraph (b) of this section, Entity has a net loss of $100,000 ($5,000,000 minus $5,100,000) for the current taxable year. One half (50 percent) of this loss is allocated to B, a limited owner. Therefore, for the current taxable year, Entity is a syndicate within the meaning of section 1256(e)(3)(B).

(d) *Applicability date.* This section applies to taxable years beginning on or after [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**]. However, taxpayers and their related parties, under sections 267(b) and 707(b)(1), may choose to apply the rules of this section for a taxable year beginning after December 31, 2017, and before [DATE 60 DAYS AFTER DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**], provided that they consistently apply the rules of this section to that taxable year and each subsequent taxable year.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

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