Bloomberg Tax

Tax Management
International Journal™

Multinationals Face an Irrevocable Decision Under the New Section §163(j) Proposed Regulations

By Adam S. Halpern and Ariel Love[*]

OVERVIEW

Since the 2017 tax act enacted the new §163(j) limitation on interest deductions, multinationals have been asking whether the limitation applies to controlled foreign corporations (CFCs).[1] Proposed regulations released November 26, 2018, would answer that question in the affirmative.[2] But other questions remain. The biggest decisions now for multinationals are (i) whether to elect into early application of the proposed regulations, starting in 2018, and (ii) whether to make the irrevocable election (CFC Group Election) to apply §163(j) to CFCs under modified rules: rules that are generally more favorable, but also far more complex.

The regulations are proposed to apply to tax years ending after final regulations are issued. But taxpayers may elect to apply the proposed regulations early. Taxpayers that choose to early adopt must apply the proposed rules *in their entirety* to all tax years beginning after December 31, 2017. Thus, calendar-year multinationals will need to make at least a preliminary assessment of the proposed rules as a whole, and the irrevocable election in particular, for their 2018 year-end tax provisions.

SECTION 163(j)

Section 163(j) generally limits the amount of business interest that can be deducted in the current year to the sum of: (1) the taxpayer's business interest income for the taxable year; (2) 30% of the taxpayer's adjusted taxable income (ATI) for the year; and (3) the taxpayer's floor plan financing interest expense for the taxable year. Any business interest not allowed as a deduction carries forward and can be deducted in a subsequent year, subject to that year's limitation.[3]

In the case of a C corporation (or a consolidated group), ATI means taxable income computed without regard to (i) interest income, interest expense or NOLs and (ii) for taxable years beginning before January 1, 2022, depreciation, amortization or depletion. The statute also authorizes Treasury to provide other adjustments.[4]

THE GILTI/SUBPART F HAIRCUT

The proposed regulations would require one very important additional adjustment for U.S. shareholders of CFCs: Their ATI would be computed by *subtracting* from taxable income the amount of their global intangible low-taxed income (GILTI) inclusions, Subpart F inclusions and the §78 gross-up, reduced by the portion of the §250 deduction allowed on GILTI or

---

[*] Adam Halpern is the Chair of the Tax Group at Fenwick & West LLP. Ariel Love is an associate in the Tax Group.

[1] *See* Pub. L. No. 115-97, §13301, effective for tax years beginning after December 31, 2017.

[2] *See* REG-106089-18 (Dec. 28, 2018). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder.

[3] §163(j)(1), (j)(2).

[4] §163(j)(8). For taxpayers other than C corporations, ATI is also determined without regard to the new 20% qualified business income deduction under §199A or any income or deduction not properly allocable to a trade or business.

ISSN 0090-4600

the §78 gross-up on GILTI.[5] The subtraction required by this GILTI/Subpart F taxable income ''haircut'' will materially reduce the §163(j) limitation for many U.S. multinationals. The preamble states that the haircut is needed to avoid double counting a CFC's taxable income already taken into account in determining the CFC's §163(j) limitation.

The haircut is a bit jarring in light of other positions the government has taken with respect to interest expense and GILTI. The recent expense allocation proposed regulations[6] would require U.S. taxpayers to allocate and apportion interest expense to the taxable portion of their GILTI. The theory behind this requirement is that money is fungible, and a taxpayer's borrowings support all of its income and activities, including those conducted through CFCs. But, if a U.S. shareholder's borrowing supports a CFC's GILTI-generating activities enough to justify an allocation of interest expense, does the borrowing not also support those activities enough to justify including the U.S. shareholder's GILTI in the taxable income base to which the §163(j) limitation applies? Treasury and the IRS need to adopt a consistent approach. It would seem the drafters of the §163(j) rules are not talking to the drafters of the expense allocation rules.

GENERAL RULE FOR APPLYING §163(j) TO CFCS

The proposed regulations would generally apply the §163(j) limitation to CFCs[7] in the same manner as it applies to domestic C corporations.[8] A CFC would generally apply §163(j) on a separate entity basis to determine the extent to which its interest expense is deductible for purposes of computing Subpart F income, GILTI tested income and ECI. Two modifications would apply in computing a CFC's ATI: The principles of Reg. §1.952-2 (or, for CFCs with ECI, the rules of §882) would apply, and dividends from a related person would be backed out of taxable income.

Taxpayers have been asking whether the §163(j) limitation applies to CFCs for almost a year. Proposed regulations under the old, pre-2018 §163(j) excepted CFCs from the rules. There is no compelling reason why the new §163(j) regulations could not do the same. If the CFC's country of residence allows interest expense to be deducted over and above the 30% limitation, disallowing the excess interest expense in the U.S. shareholder's GILTI calculation will create a mismatch. Moreover, the statutory GILTI calculation has its own, separate way of limiting the amount by which CFC interest expense deductions can reduce GILTI.[9] It is difficult to see how applying §163(j) to CFCs advances the policies behind the §163(j) rules or the GILTI rules.

THE IRREVOCABLE CFC GROUP ELECTION

As an alternative to separate entity application of §163(j), the proposed regulations offer an election for CFCs in a closely-related CFC group (''CFC Group Election'').[10] If the election is made, a CFC group member's §163(j) limitation is recomputed, taking into account the interest income and interest expense of the other CFC group members, as follows: If the group as a whole does not have net interest expense, §163(j) does not limit any group member's interest expense deduction. That would be the case, for example, where CFCs in the group only borrowed from other CFCs in the group.

If the group as a whole has net interest expense, each member that has net interest expense on a separate entity basis is allocated a proportionate share of the group's net interest expense. A CFC member's interest expense deduction is disallowed only to the extent that its allocated share of the group's net interest expense exceeds 30% of its adjusted taxable income.[11]

When the CFC Group Election is made, it alters the application of §163(j) in other ways as well. In computing its ATI, an upper-tier CFC can use any ''excess'' ATI of each lower-tier CFC in its group that it owns directly. The ATI of each member of a CFC group is thus computed through a ''tiering up'' pro-

---

[5] Prop. Reg. §1.163(j)-7(d)(1)(i). For this purpose, the §250 deduction is determined without regard to the taxable income limitation, §250(a)(2). The proposed regulations refer to the sum of GILTI, Subpart F, and the §78 gross-up collectively as the ''specified deemed inclusions.''

[6] REG-105600-18, 83 Fed. Reg. 63200 (Dec. 7, 2018); Prop. Reg. §1.861-8(d)(2)(ii).

[7] *See generally* Prop. Reg. §1.163(j)-7. The proposed regulations would generally apply only to ''applicable CFCs,'' i.e., CFCs that have at least one US shareholder that owns stock of the CFC directly or indirectly within the meaning of §958(a). Use of the term ''CFC'' herein refers to an ''applicable CFC.''

[8] This treatment generally also extends to CFCs in their role as partners in a partnership. Under Reg. §1.163(j)-7(b)(2), §163(j) and the proposed regulations would generally apply to the partnership in the same manner as those provisions would apply if the CFC were a domestic C corporation.

[9] Section 951A(b)(2)(B) reduces the U.S. shareholder's net deemed tangible income return by the amount of net interest expense in the CFC system.

[10] The proposed regulations define a ''CFC group'' to mean two or more CFCs if 80% or more of each CFC's stock is owned (within the meaning of §958(a)) by a single U.S. shareholder, or by multiple U.S. shareholders that are related persons if each CFC's stock is owned in the same proportion by each U.S. shareholder. A consolidated group is treated as a single U.S. shareholder for this purpose. Prop. Reg. §1.163(j)-7(f)(6).

[11] Prop. Reg. §1.163(j)-7(b)(3)(i).

ISSN 0090-4600

cess, starting with the lowest-tier CFC in the group. At each level, the member computes its §163(j) limitation. Any excess ATI - i.e., ATI in excess of the amount needed to deduct all of the CFC's interest expense - tiers up to the next higher-tier member, which then computes its §163(j) limitation taking into account any tiered up excess ATI. This process continues up the chain of ownership to the first-tier member.[12]

Additionally, a first-tier CFC's excess ATI tiers up to the CFC's U.S. shareholder. This excess ATI can be used by the U.S. shareholder to increase its §163(j) limitation, but only to the extent of the GILTI/Subpart F haircut that was previously subtracted from the U.S. shareholder's taxable income in computing its ATI.

The proposed regulations provide that these alternative rules apply only if each CFC within a CFC group and all related CFCs make the CFC Group Election. Once made, the CFC Group Election is irrevocable.[13]

WEIGHING THE CFC GROUP ELECTION

Multinationals will need to carefully consider whether to make the CFC Group Election. There are substantial downsides to making the election. Once made, the election can never be revoked. The election also adds significant complexity to the calculation of a CFC's (and a U.S. shareholder's) §163(j) limitation. Layers of calculations are required that otherwise would be unnecessary. Taxpayers who wish to make the election before the regulations are finalized will also have to early adopt the proposed regulations' CFC rules. The proposed rules allow for early adoption, but only if all CFCs, their U.S. shareholders, and all related parties consistently apply all of the proposed regulations. That will include, for example, the GILTI/Subpart F haircut, which would not apply absent the regulations.

On the other hand, the CFC Group Election can provide significant benefits. Without the election, a taxpayer's GILTI inclusion could be increased solely due to intercompany debt between related CFCs. The election could materially reduce, or even eliminate, that increased GILTI inclusion. The tiering up of excess ATI also could be very important to CFC groups where one CFC borrows to fund the operations of other CFCs. A CFC holding company, for example, might have no taxable income of its own. Absent the CFC Group Election, its interest expense could be completely disallowed under §163(j). Of course, even if the interest expense is allowed, ultimately, it might not reduce the U.S. shareholder's GILTI inclusion as a result of the reduction to the net deemed tangible income return for CFC interest expense with no corresponding CFC interest income.[14]

Consequently, multinationals will need to carefully weigh the pros and cons of making the irrevocable election. The mere availability of the election may require U.S. companies to model all of its impacts in order to make an informed decision.

---

[12] Prop. Reg. §1.163(j)-7(c)(3). The proposed regulations refer to ''excess ATI'' as ''CFC excess taxable income.''

[13] Prop. Reg. §1.163(j)-7(b)(5).

[14] §951A(b)(2)(B).

ISSN 0090-4600