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by Fred Feingold and Yishaya Marks

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Fred Feingold

Yishaya Marks

Fred Feingold is a partner and Yishaya Marks is an associate at Feingold & Alpert LLP. They thank Mark E. Berg for his helpful comments on many of the issues discussed here.

In this report, Feingold and Marks consider several aspects of the new section 163(j) limitation on the business interest expense deduction, including what has been done, who has been affected, whether the provisions are internally consistent, whether some effects of the limitation can be avoided with restructuring, and whether the limitation can be treated as violating treaty obligations.

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I. Introduction

Apart from tax treaty considerations, U.S. persons and non-U.S. persons alike are generally subject to U.S. federal income tax on business income. But for non-U.S. persons, only the portion of business income that is considered "effectively connected" with the conduct of a U.S. trade or business (and for a treaty resident, attributable to a U.S. permanent establishment) is subject to tax.[1] The base on which U.S. business income is subject to tax is generally computed after the deduction of allowable expenses incurred in connection with that income.[2] U.S. persons may also be subject to U.S. federal income tax on the net income of some non-U.S. entities.[3]

Allowable expenses generally include expenses ordinarily and necessarily incurred in the conduct of a trade or business[4] other than items that have found disfavor as a matter of public policy.[5] In some cases generally relating to amounts payable to related parties, a deduction for an otherwise allowable expense that has been

[1] Sections 1, 11, 61(a), 63, 162, 86, 871(b), and 882; *see also* 2016 U.S. Model Income Tax Convention, article 7 (U.S. model treaty).

[2] *See, e.g.*, sections 1, 11, 63, 162, and 163. *See also* articles 7, 23A, and 23B of the 2005, 2010, and 2017 Model Tax Convention on Income and on Capital (the OECD model treaty) and the commentary thereto and article 7, para. 3, of the 2006 and article 7 of the 2016 U.S. model treaty; *but cf.* section 882(c)(2).

[3] *See, e.g.*, sections 951 and 951A.

[4] Section 162.

[5] *See, e.g.*, section 162(b), (c), (e)-(g), (j), (k), (m), (q), and (r), and sections 163(e)(5) and 274 (collectively referred to as disfavored expenses).

incurred may be deferred until payment of the expense is made.[6] Subject to that limitation and with limited exceptions,[7] interest on advances properly characterized as debt for federal income tax purposes and incurred in connection with a business traditionally has been allowable as a deductible expense.[8] That is, before enactment of the Tax Cuts and Jobs Act, generally business interest expense[9] was not a disfavored expense.

Not all amounts denominated as interest are treated for federal income tax purposes as such: Only payments for the use of funds properly characterized as debt rather than equity could give rise to a deduction for interest. When and in what circumstances an advance of funds should be treated as debt rather than equity (sometimes referred to as the thin capitalization issue) has vexed Congress,[10] the courts,[11] Treasury,[12] and tax practitioners both in the United States and internationally[13] for generations. Because whether advances would be treated as debt rather than equity generally did not affect the tax payable by unincorporated entities or their interest holders, the thin capitalization issue was typically confined to corporate issuers of purported debt to related parties.[14] Indeed, the thin capitalization issue was principally relevant for preserving the integrity of the corporate tax base and effectively was just one manifestation of what has become known as the substance-over-form doctrine.

Significantly, the determination of whether an advance of funds should be treated as debt or equity is generally made at the time of issuance.[15] If an advance of funds passes muster as debt when issued, it generally retains its character as such regardless of any subsequent change in circumstances other than possibly a significant modification of the debt instrument.[16] However, under the law before the effective date of the TCJA, the deduction for interest otherwise allowable as a deduction and payable on debt (regardless of when) issued to a related "exempt"[17] party could nevertheless be limited, but only if the corporate borrower had a debt-to-equity ratio greater than 1.5 to 1. In that case, the current deductibility of a corporation's interest that was payable to a related person "exempt from tax" on the interest (referred to as disqualified interest[18]) was limited to the extent the corporate borrower's net interest expense exceeded 50 percent of a base, with that excess referred to as excess interest.[19] The applicable base[20] was computed by reference to taxable income of the corporate borrower after specific adjustments, resulting in a base roughly equivalent to earnings before interest, taxes, depreciation, and amortization.

And then section 163(j), as amended by the TCJA, was enacted in the context of a substantial reduction in the corporate rate of tax,[21] causing business interest expense exceeding specified limits payable on debt — to related and unrelated

[6] *See, e.g.*, sections 267 and 163(e)(3). *See also* section 404.

[7] *See* section 163(e)(5) and (j) in the latter case, before its amendment by the TCJA.

[8] Sections 162(a) and 163(a). Not all amounts purporting to be interest are treated that way for tax purposes. *See* section 385. Conversely, some amounts that would not be treated as interest under general principles would be treated as such for purposes of the section 163(j) limitation if the proposed regulations are finalized in their current form. *See* prop. reg. section 1.163(j)-1(b)(20).

[9] Interest is generally defined as a payment for the use or forbearance of money. *See Deputy v. Du Pont*, 308 U.S. 488, 498 (1940); and *Campbell v. Carter Foundation Production Co.*, 322 F.2d 827, 831 (5th Cir. 1963).

[10] *See* section 385.

[11] For a thorough collection of early cases, see William T. Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax L. Rev.* 369 (1971).

[12] *See generally* regulations under section 385.

[13] *See, e.g.*, OECD, "Thin Capitalisation" (report adopted by the OECD Council Nov. 26, 1986).

[14] *See* section 163(j) before its modification by the TCJA; *but see* TAM 8140017 (noting that the characterization of an advance of funds as debt or equity may have relevance in the partnership context whether as a capital contribution under section 721 or liability under section 752); *see also* OECD, "Thin Capitalisation," *supra* note 13, at para. 89 (noting that the "committee emphasizes that the application of the rules designed to deal with thin capitalization ought not normally to increase the taxable profits of the relevant domestic enterprise to an amount greater than the profit which would have accrued in the arm's length situation").

[15] *See* Boris Bittker and James Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 4.04[e] (2000); *see also* section 385(c)(1) and reg. section 1.385-1(c)(4)(iv), -2(c)(1)(iii) for examples in which the time of issuance is identified as the relevant time for determining the character as debt or equity.

[16] *See, e.g.*, reg. sections 1.1001-3 and 1.385-3(b)(3)(iii)(E)(1); *but see* reg. section 1.385-2(e)(3)(ii) (an expanded group interest "initially treated as indebtedness may be recharacterized as stock regardless of whether the indebtedness is altered or modified (as defined in section 1.1001-3(c))"); and Bittker and Eustice, *supra* note 15, at para. 4.04[e], for cases in which courts reclassified advances as debt or equity based on post-issuance events.

[17] *See* section 163(j)(3) and (5) as in effect before amendment by the TCJA.

[18] *See* section 163(j)(3) as in effect before amendment by the TCJA.

[19] *See* section 163(j)(2)(B) as in effect before amendment by the TCJA.

[20] Referred to as adjusted taxable income under old section 163(j) as well. *See* section 163(j)(6)(A) before its amendment by the TCJA.

[21] Section 11.

parties alike and regardless of whether the interest was taxable to the interest recipient — to become a disfavored expense, at least for some categories of debtors.[22] Why? In the words of the House Ways and Means Committee:

> The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system. The effective marginal tax rate on debt-financed investment is lower than that on equity-financed investment. Limiting the deductibility of interest along with reducing the corporate tax rate narrows the disparity in the effective marginal tax rates based on different sources of financing. This leads to a more efficient capital structure for firms. The Committee believes that it is necessary to apply the limitation on the deductibility of interest to businesses regardless of the form in which such businesses are organized so as not to create distortions in the choice of entity.[23]

It should be noted that the new provision does not ignore the corrosive effect that debt can have on the integrity of the corporate tax base; traditional issues of debt versus equity and thin capitalization remain relevant in characterizing instruments as debt or equity. Only after an instrument is characterized as debt rather than equity — using characterization tools that have not been changed by the TCJA and that are intended to preserve the corporate tax base — do the new rules spring into action. In this sense, the TCJA layers the new section 163(j) rules onto the complexity of debt-equity issues.[24] When the new rules apply, interest on instruments properly characterized as debt must run an excessive leverage gantlet to be currently deductible in full, with excessiveness determined not by notions of debt-equity ratios, but instead exclusively by "interest coverage ratios."[25] That is true whether payable to related or unrelated parties and regardless of whether the payee is subject to tax on the interest.

The new limitations can affect a non-exempt company for a year regardless of its financial strength or its projected interest coverage ratio at the time of the issuance of the debt on which the interest has accrued. All that matters under new section 163(j) is the applicable interest coverage ratio in the year for which the interest is being tested under section 163(j). And although the stated intention is to deter the issuance of excessive debt, new section 163(j) applies equally to interest on debt issued before and after the enactment of the TCJA.

Moreover, under new section 163(j), the deductibility of interest on conservatively issued debt — that is, debt that had a more than adequate interest coverage ratio when issued — could nevertheless be limited based on unforeseen events. Thus, the new section 163(j) limitation could penalize taxpayers whose fortunes have declined as well as companies that otherwise can least afford to pay the cost of an interest disallowance because they are in the worst financial condition. Those

[22] *See generally* section 163(j) as amended by the TCJA. For an early and customarily informative take on the underpinnings of section 163(j) and its shortcomings, see Jasper L. Cummings, Jr., "The Interest Deduction Limitation," *Tax Notes*, May 21, 2018, p. 1105.

[23] H.R. Rep. 115-409, at 247. Note that before the enactment of the TCJA, tax was a neutral factor in passthrough entities' decision to raise equity or debt because the payment of either would have been effectively deductible. The effect of extending the application of the section 163(j) limitation to passthrough entities is to distort that decision and favor equity financing over debt to the extent the limitation applies. For corporate entities, however, while the section 163(j) limitation is intended to neutralize the tax factor in deciding whether to raise equity or debt to the extent the limitation applies, tax considerations will continue to be significant: For example, repayment of the principal advanced will be treated differently to the recipient depending on the debt-equity characterization of the instrument, regardless of whether interest on the purported debt will be subject to a section 163(j) limitation.

[24] The old section 163(j) did so as well when it applied.

[25] To be sure, projected interest expense coverage ratios understandably may play a part in distinguishing between instruments that are properly characterized as debt rather than equity under the principles of section 385. *See* Plumb, *supra* note 11, at 526-529. And, as noted, effectively interest expense coverage ratios affected whether "disqualified interest" as determined under old section 163(j) payable to a related exempt party could be "excessive" and therefore not currently deductible; although under the new provision, the interest expense limitation ceiling is lowered, causing substantially more interest to be considered excessive. Also, a significant difference is that the application of new section 163(j) is not limited to interest payable to related parties, regardless of whether they are tax-exempt.

companies ironically may be in the worst position to deleverage by raising equity rather than debt[26] but may be the companies most likely to be penalized by being required to pay a higher effective tax rate and even a tax on phantom earnings. While some industries that traditionally use high rates of leverage have been excluded,[27] others have not.[28] Because of the way the rules work, their application to non-U.S. taxpayers resident in some treaty countries may not be as straightforward as one might think.[29]

Also, the application of the new rules to some taxpayers, such as securities trading partnerships,[30] regulated investment companies, and real estate investment trusts could lead to counterintuitive results.[31]

The purpose of this report is not to question the wisdom on policy grounds of the new section 163(j) limitation, but rather to make several observations regarding what has been done, who has been affected, whether the provisions are internally consistent, whether some effects of the limitation can be avoided with restructuring, and whether the limitation could be treated as violating treaty obligations.

II. The Applicable Rules

Under the new provision, what we will call "legitimate business interest expense" (that is, business interest expense which but for this provision would be deductible) is disallowed to the extent that the business interest expense exceeds the sum of the taxpayer's business interest income and floor plan financing interest plus 30 percent of the taxpayer's adjusted taxable income.[32] ATI is defined as the taxpayer's taxable income determined without regard to (1) nonbusiness items of income, gain, deduction, or loss; (2) business interest expense or income; (3) net operating losses; (4) section 199A deductions; and (5) for tax years beginning before January 1, 2022, depreciation, amortization, and depletion deductions.[33] Business interest expense disallowed in one tax year may be carried forward indefinitely to subsequent tax years and will be allowed in a subsequent year to the extent there is sufficient ATI, business interest income, or floor plan financing interest.[34]

As noted, some taxpayers are excepted from the section 163(j) limitation, including taxpayers having $25 million or less of gross receipts under the section 448(c) test.[35] Also, some business types are excepted, such as the business of performing services as an employee; electing real property businesses; electing farming businesses; and some price-regulated businesses involving sale or furnishing of electricity, water, or sewage disposal services, or the provision or transportation of gas and steam.[36] Notably, much of the oil and gas industry is not excepted.

For businesses held through an entity treated as a partnership, the section 163(j) limitation is applied

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[26] And unlike under the old section 163(j), such companies will not necessarily have a related party with which to reach a workout and restructuring to achieve the ideal capital structure under the new limitation. Moreover, the old section 163(j) limitation (which applied only to related exempt parties) denied a deduction only when there would be no matching inclusion, and therefore only one party would ultimately pay tax on the income in question. The new limitation, however, could cause a double inclusion of income by disallowing a borrower a deduction even when the lender must still include the corresponding interest payment in income and pay tax. *See infra* note 32. Thus, the new limitation's (potentially permanent) mismatch of deduction and inclusion will increase overall borrowing costs to a greater degree than the old limitation.

[27] Section 163(j)(7).

[28] Notably, the oil and gas industry is not exempted. *See* section 163(j)(7).

[29] *See generally* 2017 OECD model treaty and 2009 OECD model treaty, article 7; prop. reg. section 1.163(j)-8(b)(2), (3), and (g)(3) and the preamble, at 106; and discussion in Section VI.

[30] *See* discussion in Section IV.

[31] *See* discussion in Section III.

[32] Section 163(j)(1). Even though section 163(j) limits business interest deductions, the limitation does not affect the characterization of the interest so limited as being interest income and therefore subject to tax to the lender, except to the extent that the lender was somehow exempt from U.S. tax on interest (for example, exempt entities and non-U.S. persons entitled to treaty exemption (see, *e.g.*, article 11 of the 2016 U.S. model treaty and the U.S. income tax treaties with, among others, the Netherlands (article 12), the United Kingdom (article 11), and Germany (article 11), or the portfolio exemption under sections 871(h) and 881(c)). This creates at best a timing mismatch of inclusion and deduction (*cf.* sections 267 and 163(e)(3)) and at worst income inclusion without a corresponding deduction.

[33] Section 163(j)(8). Prop. reg. section 1.163(j)-7(d)(1) also requires a U.S. shareholder to subtract any (i) GILTI inclusion and corresponding section 250 deduction and (ii) inclusion attributable to subpart F income from ATI. The stated purpose is to prevent the U.S. shareholder from "double counting" the same dollar of income to increase the CFC's and the U.S. shareholder's section 163(j) limitation, which is consistent with a view that the GILTI regime effectively regards the CFC as a passthrough entity for computing the U.S. shareholder's GILTI inclusion. *See* Preamble at 102. This adjustment is presumably under a somewhat broad and possibly questionable application of its authority under section 163(j)(8)(B) to provide for "other adjustments."

[34] Section 163(j)(2).

[35] Section 163(j)(3).

[36] Section 163(j)(7).

at the partnership level by counting only partnership-level items of income and expense. The business interest expense allowed at the partnership level flows up to its partners as part of their distributive shares of the partnership's non-separately stated taxable income or loss.[37] Business interest disallowed at the partnership level will be carried forward at the partner level as "excess business interest" and will be allowed as a deduction in later years to the extent there is sufficient "excess taxable income" allocable to the partner from that partnership in the later year.[38] Excess taxable income is effectively "unused" ATI at the partnership level[39] and is allocated to each partner in the same manner as the partnership's non-separately stated income and (with limitations)[40] increases the partner's ATI when the partner determines its section 163(j) limitation.[41] Similar rules apply to entities treated as S corporations.[42]

An affiliated group of companies filing a consolidated return computes its limitation under section 163(j) as if it were one taxpayer.[43] However, the limitation so computed is then allocated to the members,[44] and the allocable portion of the interest deferred travels with the member upon leaving the group and is an attribute subject to sections 381 and 382.[45] The amount of a U.S. shareholder's required inclusion under section 951A (but not under section 951) can be affected by a section 163(j) limitation, and in some cases the computation of the section 163(j) limitation can be made by related controlled foreign corporations on a group basis if an irrevocable election to do so is made for all members of the group.[46] With a group election: (1) the business interest and income of all the group's members are netted and the remaining interest expense, if any, is reapportioned to the appropriate group member to calculate the limitation on a separate basis; and (2) excess ATI 'unused' by a lower-tier CFC passes-up to higher-tier CFCs and (to the extent of Subpart F and GILTI inclusions net the section 250 deduction to) the U.S. shareholder. It is unclear why the proposed regulations adopt the principle that excess ATI 'unused' by a CFC may only pass-up to the U.S. shareholder if a group election is made, particularly because a group election is only possible if the U.S. shareholder owns at least 80 percent of two or more CFCs.[47]

Foreign corporations doing business in the United States can also be affected by the section 163(j) limitation;[48] however, it does not appear that a loss of interest deductibility under section 163(j) can have the effect of that denied interest deduction being subject to a branch profits tax because the branch profits tax is imposed on effectively connected earnings and profits[49] and disallowed interest expense reduces E&P despite the section 163(j) limitation.[50] With these rules in mind,[51] it may be worth considering who will likely be affected by the provisions.

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[37] Section 163(j)(4)(A)(i). *But see infra* discussion in Section IV regarding securities trading partnerships.

[38] Section 163(j)(4)(B)(ii).

[39] That is, the partnership's ATI multiplied by the quotient of (1) the excess of 30 percent of the partnership's ATI over its business interest expense net its business interest income and floor plan financing interest divided by (2) 30 percent of the partnership's ATI. Section 163(j)(4)(C).

[40] *See* section 163(j)(4)(B)(ii) (flush language).

[41] Section 163(j)(4)(A) and (C).

[42] Section 163(j)(4)(D).

[43] Prop. reg. section 1.163(j)-4(d).

[44] Prop. reg. section 1.163(j)-5(b)(3)(ii)(C).

[45] Sections 381(c)(20), 382(d)(3), and (k)(1); and prop. reg. section 1.163(j)-5(b)(3)(iii); *see also* prop. reg. section 1.163(j)-3(b)(7) and (8).

[46] *See* prop. reg. section 1.163(j)-7(b)(3), (5)(ii) and (iii), and (d)(2). Note, however, that making the group election may be disadvantageous in some situations; for example, inter-company interest payments between sister CFCs, which otherwise may allow interest expense to be 'transferred' to a CFC with excess ATI, may be effectively disregarded for purposes of calculating the limitation due to the election's effect of netting interest expense and income on a group basis. Despite the above, as noted in a New York State Bar Association session titled "International Tax Planning Under TCJA" at the 2019 NYSBA tax section meeting, for many CFCs, section 163(j) may pose no real limitation given that (1) regarding its subpart F income, the subpart F income cannot be greater than the CFC's earnings (sections 952(c) and 163(j) do not reduce earnings (see prop. reg. section 1.163(j)-7(e))); and (2) regarding the CFC's GILTI inclusion, section 163(j) would have no impact if the total interest expense is equal to or less than 10 percent of the CFC's qualified business asset investment as described in section 951A(b)(2)(A), given that both the tested income and the net deemed tangible income return are reduced by interest expense. *See* section 951A(b) and (c)(2).

[47] *See* prop. reg. section 1.163(j)-7(d)(2) and (f)(6).

[48] *Cf.* reg. section 1.882-5. *But see infra* discussion in Section VI regarding the possible application of treaties.

[49] Section 884(a) and (b). *See generally* Fred Feingold and Mark E. Berg, "Whither the Branches?" 44 *Tax Law Rev.* 205 (1989).

[50] *See* prop. reg. section 1.163(j)-7(e).

[51] *See* proposed regulations under section 163(j), REG-106089-18. *See also* NYSBA tax section, "Report No. 1393 on Section 163(j)" (Mar. 28, 2018).

III. To Whom Is the Provision Likely to Apply?

A. Significance of Interest Coverage Ratios

A rough analysis using interest coverage ratios — as explained below — shows that on a macro level, the new limitation will not have much or any impact for most financially stable companies regardless of industry, especially before 2022.[52] Companies that may be most adversely affected by the new provision will be those that are already in poor financial health and that may be least able to afford a curtailment of the interest deduction. In some cases, the new provision may require an interest deduction curtailment of a magnitude that could result in taxation of such companies on phantom income. The data also indicate that companies in the energy sector may be negatively affected by the section 163(j) limitation after 2021 if they continue to perform as poorly as they have in recent years.

As a general matter, while interest coverage ratios (which are either earnings before interest and taxes (EBIT), earnings before interest, taxes, and amortization (EBITA), or EBITDA — in each case divided by interest expense) are not perfect given the difference between earnings in a financial sense and income for tax purposes, they are a good rough metric to determine the effect of section 163(j) on a specific company or industry. Given that before 2022 ATI will be determined after deducting depreciation, amortization, and depletion,[53] a company's EBITDA is a good rough substitute for ATI. And for tax years beginning on or after January 1, 2022, when ATI will be determined without regard to depreciation, amortization, and depletion, a company's EBIT would be the appropriate rough measure for its ATI. An interest coverage ratio of 3.33 ($1 of EBIT or EBITDA/$0.30 interest expense) or greater would mean that the company has sufficient ATI to fully deduct its interest expense, even assuming that it has no business interest income or floor plan financing interest.

Applying those principles, one can make some observations based on rough calculations gathered from various financial databases. The calculations assume for simplicity purposes that the companies incorporated in the databases have negligible business interest income, floor plan financing interest, or any income or expense items attributable to its foreign subsidiaries — each of which would alter the calculations. The calculations further assume that all interest expense as reported on the financial statements of the companies in the tables is business interest as defined in section 163(j)(5).

B. Pre-2022 Analysis

For years starting before 2022 and using historical EBITDA/interest expense ratios derived from a sampling of S&P indices, on a macro level *it appears that almost no index will be affected by the 163(j) limitation* given that all such indices have EBITDA/interest expense ratios above 3.3. As apparent from Table 1 below, only the S&P SmallCap 600 Pure Value index had an EBITDA/interest expense ratio below 3.3 for one year between 2003 to the present, which was 2.2 in 2008, a financially challenging year.

Table 1. EBITDA/Interest Expense — Relevant Before 2022

	1999-2016	2017	2018
S&P 500 Index	8.5-14.6	11.2	11.6
S&P 400 Energy	3.6-19.1 (2003-2016)[a]	4.8	5.2
S&P 500 Energy	6.9-35.1	10.8	13.7
S&P 900 Pure Growth	9.1-17.2 (2006-2016)[b]	12.5	6.5
S&P SmallCap 600 Pure Value	2.2-5.6 (2003-2016)[c]	3.9	4.2
S&P SmallCap 600 Growth	7.6-10.1 (2013-2016)[d]	7.3	5.9

The data is this table were obtained from the online database of S&P's Capital IQ.

One study based on interest coverage ratios from 2007-2017 of 333 S&P 500 companies notes that on average only 4.6 percent of the 333 companies would have been affected by the section 163(j) limitation in any given year, and only 1.5 percent of the 333 companies would have been affected in most of the 10-year span. *See* Luis Betancourt, Nancy B. Nichols, and Irana J. Scott, "Tax Reform's Interest Deduction Limitation: Preliminary Evidence," *Tax Notes*, Sept. 10, 2018, p. 1545, 1547-1548.

[a]Data for this index were not available for before 2003.

[b]Data for this index were not available for before 2006.

[c]Data for this index were not available for before 2003.

[d]Data for this index were not available for before 2013.

[52]*See* section 163(j)(8)(A)(v).

[53]Section 163(j)(8)(A)(v).

Even though on a macro level it appears that section 163(j) will not have much of an impact before 2022, a study of a Moody's report based on 2016 financial data of Moody's rated companies[54] reveals that poorly rated companies may still be affected by the new provision before 2022 and taxed on phantom income, as illustrated in Table 2:

Table 2. Section 163(j) Limitation Calculated Using Debt/EBITDA Ratios — Relevant Before 2022

	Rating	B	Caa-C
1	Debt/EBITDA ratio[a]	4.9	24.7
2	Interest rate[b]	5.4%	7.4%
3	ATI (i.e., EBITDA — assumed)	$100	$100
4	Debt (line 3 x line 1)	$490	$2,470
5	Interest expense (line 2 x line 4)	$27	$183
6	Section 163(j) limitation (line 3 x 30 percent)	$30	$30
7	Disallowed interest expense (line 5 - line 6)	$0	$153
8	Percentage of interest disallowed (line 7/line 5)	0%	84%
9	Taxable income (line 3 - (lesser of line 6 or line 5))	$73	$70
10	Tax (line 9 x 21 percent)	$15.4	$14.7
11	Effective tax rate on pretax earnings (line 10/(line 3 - line 5))	21%	infinite[c]

Table 2. Section 163(j) Limitation Calculated Using Debt/EBITDA Ratios — Relevant Before 2022 *(Continued)*

The table uses the mean figures reported in the aggregate cross-industry table. *See* Moody's, "Financial Metrics Key Ratios by Rating and Industry for Global Non-Financial Corporates: December 2016" (Sept. 25, 2017) (Moody's), at 34. This table did not rely on EBITDA/interest expense ratios to calculate the section 163(j) limitation given that such ratios were not available in the 2016 Moody's report. Instead, the table calculated the limitation using EBITDA/debt, FFO + interest expense/interest expense, and FFO/debt ratios as explained below.

[a]*Id.*

[b]The interest rates were derived by using the mean figures for the funds from operations (FFO) + interest expense/interest expense and FFO/debt ratios provided in the 2016 Moody's report cited above, at 28-31, by (1) subtracting 1 (the presumed interest expense) from the FFO + interest expense/interest expense ratio, which should equal the relative FFO; (2) dividing the difference in step 1 (the FFO amount) by the FFO/debt ratio, the quotient of which should be the relative debt amount; and (3) dividing the quotient in step 2 (*i.e.*, the relative debt amount) by 1 (the presumed interest amount). The quotient of step 3 is the interest rate.

[c]The tax in this case would be on phantom earnings.

C. Post-2021 Analysis

For years starting on or after January 1, 2022, and using historical EBIT/interest expense ratios from a sampling of S&P indices, it appears that the section 163(j) limitation may have a larger impact, particularly on the energy sector, which in recent years has performed poorly. And companies in the S&P SmallCap 600 Pure Value index appear to be chronically affected by the new limitation and may never benefit from its carryforward provision, based on data from 2003 to the present, as evident in Table 3:

Table 3. EBIT/Interest Expense — Relevant After 2022

	1999-2016	2017	2018
S&P 500 Index	5.1-10.6	7.8	8.2
S&P 400 Energy	0-13 (2003-2016)[a]	1.3	1.8
S&P 500 Energy[b]	0-27	3.5	6.6
S&P 900 Pure Growth	6.4-13.5 (2006-2016)[c]	9.5	3.7
S&P SmallCap 600 Pure Value	0.6-3.2 (2003-2016)[d]	1.8	2.2
S&P SmallCap 600 Growth	4.96-7.18 (2013-2016)[e]	5.09	3.8

[54]*See* Moody's, "Financial Metrics Key Ratios by Rating and Industry for Global Non-Financial Corporates: December 2016" (Sept. 25, 2017).

Table 3. EBIT/Interest Expense — Relevant After 2022 *(Continued)*

The data in this table were obtained from S&P's Capital IQ. One study based on interest coverage ratios from 2007-2017 of 333 S&P 500 companies notes that on average 10.4 percent of the 333 companies would have been affected by the section 163(j) limitation in any given year and 7.81 percent of the 333 companies would have been affected in the majority of the 10-year span. *See* Betancourt, Nichols, and Scott, "Tax Reform's Interest Deduction Limitation: Preliminary Evidence," *Tax Notes*, Sept. 10, 2018, at 1548.

[a]Data for this index were not available before 2003. The EBIT/ interest expense ratio for the S&P 400 Energy was 0.3, "non-material," 1.3, and 1.8 for 2015, 2016, 2017, and 2018, respectively. During the 12 years before that (*i.e.*, 2003-2014), the ratio never dipped below 3.5 (2009), which means there would have been no section 163(j) issue for that period.

[b]The EBIT/interest expense ratio for the S&P 500 Energy was 1.4 and "non-material" for 2015 and 2016 respectively. During the rest of the 20 period from 1999-2018, the lowest coverage ratios was 3.5 in 2017 and 5.5 in 1999.

[c]Data for this index were not available for before 2006.

[d]Data for this index were not available for before 2003.

[e]Data for this index were not available for before 2013.

Although the negative impact of the section 163(j) limitation is ameliorated (for corporations but not for noncorporate taxpayers) by the decrease in the corporate tax rate to 21 percent, companies with an interest coverage ratio below 1.72[55] will effectively pay tax at a rate greater than 35 percent on their pretax earnings (net interest expense), while some companies will be taxed on phantom income (in years in which the EBIT/ interest ratio is between 0.1-1 — which means they had zero or negative earnings after interest but may still have taxable income after computing the section 163(j) limitation). Moreover, shareholders and partners of passthrough entities and sole proprietors realized only a slight tax rate cut and may therefore be comparatively far worse off with the enactment of the TCJA given the section 163(j) limitation (for example, an interest coverage ratio of 1.72 results in a federal effective tax rate of 68.2 percent for individuals).[56] This result especially hurts companies that are chronically affected by the limitation and unable to use the carryforward provision of section 163(j), such as the companies in the S&P SmallCap 600 Pure Value index.

Likewise, a review of the effect of section 163(j) on companies based on Moody's ratings and using median EBITA/interest expense ratios[57] reveals that across all industries after 2022, section 163(j) will have a broader reach and will affect companies with a Moody's rating as high as B, as illustrated in Table 4.

Although there are outlier companies, the pattern of only the lowest-rated companies being affected by the section 163(j) limitation appears to hold true across all industries, which is not surprising given that the lowest-rated companies likely have the highest debt levels relative to income. The energy and environment sector stands out as an exception to this pattern, and, based on the rough analysis articulated above, even better-rated companies in the sector may be affected by the section 163(j) limitation. In particular, for years starting on or after January 1, 2022, and using the median EBITA/interest expense ratios,[58] it appears that even companies with a Moody's rating as high as Aa will be affected by the section 163(j) limitation, as illustrated in tables 5.1 and 5.2. This may be unsurprising given the sector's poor performance in 2016 (the year from which the data in tables 5.1 and 5.2 were drawn).

[55]Assuming interest expense of $100 and a coverage ratio of 1.72, the EBIT would be $172 (1.72 x $100). The section 163(j) limitation would be $51.60 ($172 x 30 percent), and $48.40 ($100 - $51.60) of interest expense would be disallowed. The taxable income would be $120.40 ($172 - $51.60), and the tax thereon would be $25.30 (21 percent x $120.40), which equals about 35 percent of pretax earnings of $72 ($172 of EBIT - $100 interest expense).

[56]For example, with an interest coverage ratio of 1.72 and assuming a $100 interest expense, the EBIT and ATI would be $172 (1.72 x $100), and the section 163(j) limitation would be $51.60 (30 percent x $172). The taxable income would be $120.40 ($172 - $51.60), and the tax would be $49.10 ($120.40 x 40.8 percent). Thus, the effective tax rate would be 68.2 percent ($49.10/($172 - $100)).

[57]As noted, the better rough metric is the EBIT/interest expense ratio given that ATI will be computed after depreciation, amortization, and depletion. Unfortunately, the 2016 Moody's report, *supra* note 54, only has the EBITA/interest expense ratio, which provides a more generous limitation given that EBITA is before amortization expense.

[58]*See supra* note 57.

Table 4. Post-2022 Cross-Industry Section 163(j) Limitation Rough Projection

	Rating	Ba	B	Caa-C
1	Median EBITA/interest expense ratio	3.7	1.9	0.7
2	Interest expense (assumed)	$100	$100	$100
3	ATI (line 1 x line 2)	$370	$190	$70
4	Section 163(j) limit (line 2 x 30 percent)[a]	$111	$57	$21
5	Disallowed interest (line 2 - line 4)	$0	$43	$79
6	Percentage of interest disallowed (line 5/line 2)	0%	43%	79%
7	Taxable income (line 3 - (lesser of line 2 and line 4))	$270	$133	$49
8	Tax (line 7 x 21 percent)	$56.70	$27.93	$10.29
9	Effective tax rate on pretax earnings (line 8/(line 3 - line 2))	21%	31%	infinite[b]

[a]*See* 2016 Moody's report, "Financial Metrics Key Ratios by Rating and Industry for Global Non-Financial Corporates: December 2016," at 22 (Sept. 25, 2017).

[b]The tax in the case would be imposed on phantom income.

Table 5.1. Post-2021 Energy Sector Section 163(j) Limitation Rough Projection

	Rating	Aa	A	Baa
1	Median EBITA/interest expense[a]	1.6	2.4	2.9
2	Interest expense (assumed)	$100	$100	$100
3	ATI (line 1 x line 2)	$160	$240	$290
4	Section 163(j) limit (line 2 x 30 percent)	$48	$72	$87
5	Disallowed interest (line 2 - line 4)	$52	$28	$13
6	Percentage of interest disallowed (line 5/line 2)	52%	28%	13%
7	Taxable income (line 3 - (lesser of line 2 and line 4))	$112	$168	$203
8	Tax (line 7 x 21 percent)	$23.52	$35.28	$42.63
9	Effective tax rate on pretax earnings (line 8/(line 3 - line 2))	39%	25%	22%

[a]*See* 2016 Moody's report, "Financial Metrics Key Ratios by Rating and Industry for Global Non-Financial Corporates: December 2016," at 22 (Sept. 25, 2017).

Table 5.2. Post-2021 Energy Sector Section 163(j) Limitation Rough Projection

	Rating	Ba	B	Caa-C
1	Median EBITA/interest expense ratio[a]	1.8	1.2	0
2	Interest expense (assumed)	$100	$100	$100
3	ATI (line 1 x line 2)	$180	$120	$0
4	Section 163(j) limit (line 2 x 30 percent)	$54	$36	$0
5	Disallowed interest (line 2 - line 4)	$46	$64	$100
6	Percentage of interest disallowed (line 5/line 2)	46%	64%	100%

Table 5.2. Post-2021 Energy Sector Section 163(j) Limitation Rough Projection *(Continued)*

	Rating	Ba	B	Caa-C
7	Taxable income (line 3 - (lesser of line 2 and line 4))	$126	$84	$0
8	Tax (line 7 x 21 percent)	$26.46	$17.64	$0
9	Effective tax rate on pretax earnings (line 8/(line 3 - line 2))	33%	88%	0%

[a]*See* 2016 Moody's report, "Financial Metrics Key Ratios by Rating and Industry for Global Non-Financial Corporates: December 2016," at 22 (Sept. 25, 2017).

Further, based on a sampling of industries reported in the Risk Management Association (RMA) annual statement studies for 2017-2018[59] (which includes data for private and public companies), although companies in the top two quartiles generally have EBIT/interest expense ratios above 3.3, it appears that the bottom quartile of companies in most industries have EBIT/interest expense ratios below 3.3 and will be negatively affected by section 163(j)'s limitation. For example, "Dairy Product (except Dried or Canned) Merchant Wholesalers" (North American Industry Classification System (NAICS) code 424430) companies at the 25th percentile had EBIT/interest expense ratios of -0.8, 1.9, and 2.4 for years ended March 31, 2015, 2016, and 2017, and the EBIT/interest ratios for "Fitness and Recreational Sports Centers" (NAICS code 713940) companies at the 25th percentile were 1, 1.1, and 0.7 for years ended March 31, 2015, 2016, and 2017, respectively.

D. Effect on Struggling Companies

As illustrated by the 2016 Moody's report and implied by the RMA data, companies in the worst financial straits may be most affected by the section 163(j) limitation. The limitation may have the effect of increasing a company's effective tax rate on its pretax net earnings to astronomical or infinite levels and exacerbate the financial woes that caused the limitation to take effect. Congress believed this result would dissuade companies from "undertaking more leverage than they would in absence of the tax system" and reduce the tax bias for debt over equity financing.[60] Yet the limitation applies without regard to any grandfather provision for existing debt. Thus, a company may be penalized under section 163(j) by a disallowance of interest on debt incurred before the enactment of section 163(j), with that penalty arising when the company may be doing so poorly that it is unable to meet its obligations, let alone pay down its debt to achieve the ideal capital structure under section 163(j).[61] Whether intended or not, the enactment of section 163(j) likely will have the effect of imposing a regressive tax on companies doing poorly, possibly to help pay for the general reduction in corporate tax rates that is of most benefit to highly profitable corporations.[62]

E. RICs and REITs

Section 163(j) may impose an even greater penalty on poorly performing or highly leveraged RICs[63] as well as so-called equity REITs[64] and

[59]Risk Management Association, "Annual Statement Studies: Financial Ratio Benchmarks" (2017).

[60]*See* H.R. Rep. 115-409, at 247.

[61]In some cases, an additional tax occasioned by a section 163(j) limitation could sufficiently adversely affect cash flow and result in a breach of a loan covenant and possibly an event of default. For example, one common covenant requires a minimum fixed charge coverage ratio (*i.e.*, EBITDA/(total debt service + capital expenditures + taxes) and may be triggered by the section 163(j) limitation given that compliance with the covenant is determined by reference to the relationship between EBITDA and tax. Another provision of the TCJA that has a similar effect relates to the deduction of NOLs. Under the TCJA, NOLs arising in tax years beginning after 2017 generally may no longer be carried back to prior years or offset more than 80 percent of a taxpayer's taxable income. Section 172(a) and (b)(1)(A).

[62]*See* Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" JCX-67-17, at Part II.D.2 (Dec. 18, 2017) (estimating that the new section 163(j) limitation will raise $253.4 billion in revenue between 2018 and 2027). Given the analysis in the tables referred to in the text, little or none of the projected $253.4 billion of revenue will come from companies enjoying the greatest benefits from the reduced corporate tax rate.

[63]Section 851 et seq.

[64]Section 856 et seq. For equity REITs, however, it would be possible to elect out of section 163(j) at the cost of slower depreciation. *See* section 163(j)(7)(A)(ii) and (B) and section 168(g)(1)(F) and (8). Mortgage REITs are not likely to be affected by section 163(j) because they are not likely to have interest expense after netting against interest income.

require them not only to pay tax on phantom income but to distribute dividends as well. By way of background, a RIC must pay out sufficient dividends each year so that its dividends paid deduction equals at least 90 percent of its taxable income for the year (computed without regard to the dividends paid deduction).[65] Its taxable income is computed after the determination of the amount of interest allowed under section 163(j).[66] To ensure the RIC has sufficient E&P to pay out the minimum dividend amount under section 852(a)(1)(A) (that is, 90 percent of its taxable income), the RIC's E&P is decreased only to the extent its interest expense is less than or equal to its section 163(j) limitation[67] (that is, the same amount of interest is deductible from E&P and taxable income). Similar rules apply to REITs.[68]

Because a RIC's minimum distribution amount under section 852(a)(1)(A) is determined with reference to its taxable income, which is computed after application of section 163(j), a RIC may be forced to distribute phantom income to maintain its status as a RIC. For example, assume a RIC has $100 of capital gains and a $50 interest expense and distributes the minimum amount required by section 852(a)(1)(A) (that is, 90 percent of its taxable income). As shown in the table below, it would have before-tax book earnings of $50 but would be required to distribute $63 and pay a tax of $1.47.[69]

Table 6. RIC With Tax Expense and Minimum Distribution Greater Than Pretax Net Earnings

1	Capital gains	$100
2	Interest expense	$50
3	ATI (line 1)	$100
4	163(j) limitation (line 3 x 30 percent)	$30
5	Disallowed interest expense (line 2 - line 4)	$20
6	Taxable income before DPD (section 852(a)(1); line 1 - line 4)	$70
7	E&P (line 1 - line 4)	$70
8	Minimum distribution (line 6 x 90 percent)	$63
9	Taxable income after DPD (line 6 - line 8)	$7
10	Corporate tax (line 9 x 21 percent)	$1.47
11	Pretax book earnings (line 1 - line 2)	$50
12	Total necessary cash in excess of pretax book earnings (line 10 + line 8 - line 11)	$14.47

The result may be even worse when the RIC has interest expense greater than its capital gains, with the effect that its pretax earnings are negative. Because of the section 163(j) limitation, it may still have taxable income and would be required to pay tax on and distribute phantom income, potentially forcing the RIC to liquidate assets or borrow (and thereby further exacerbate the section 163(j) limitation) to meet its tax and distribution obligations.[70]

Further, so-called equity REITs may likewise be forced to pay tax on and distribute phantom income given that REITs are treated similar to RICs under section 163(j) and have similar rules regarding minimum distribution and taxation of undistributed income.[71] However, unlike RICs, REITs may circumvent these issues by electing out of section 163(j) at the cost of slower depreciation.[72]

IV. Securities Trading and Flawed Constructions

Even though section 163(j) may have limited relevance to most financially stable taxpayers, particularly before 2022, its enactment raises mind-numbing statutory interpretive issues for

[65] Section 852(a)(1)(A).

[66] Sections 852(b)(2), 63(a), and 163(a) and (j). Its ATI under section 163(j)(8) is computed without regard to the dividends paid deduction under section 852(b)(2)(D). Prop. reg. section 1.163(j)-4(b)(4)(iii).

[67] Prop. reg. section 1.163(j)-4(c)(2), Example 2.

[68] *See* section 857(a) and (b); and prop. reg. section 1.163(j)-4(c)(2), Example 2.

[69] Section 852(b)(3).

[70] A RIC may raise new capital for this purpose, but a capital raise could have a dilutive effect on existing shareholders. Also, a RIC may pay the required distribution in the succeeding tax year (see section 855(a)), but that could put undue pressure on the succeeding tax year's required distributions.

[71] *See* section 857(a) and (b); and prop. reg. section 1.163(j)-4(c)(2), Example 2.

[72] *See* section 163(j)(7)(A)(ii) and (B) and section 168(g)(1)(F) and (8). As noted in *supra* note 64, mortgage REITs will likely not be affected by the section 163(j) limitation.

some securities trading partnerships, which may be of greater interest to investors and tax practitioners than macro analyses of who will be affected by the provision. By way of background, before the enactment of the TCJA and the new section 163(j), interest expense allocable to a non-materially participating partner of (that is, a typical investor in) a partnership that is engaged in the trade or business of trading securities (a securities trading partnership) would have been treated as an investment interest expense under section 163(d)(5)(A)(ii).[73] Conversely, the materially participating partners of the securities trading partnership would have been allowed to deduct their allocable share of interest expense without limitation, given that the expense is allocable to the business.[74]

Given the enactment of the new section 163(j), some have questioned whether the interstices between section 163(d) and (j) have been appropriately reflected. For materially participating partners of a securities trading partnership, there is no question that section 163(j) applies at the partnership level and the business interest expense is allowable to the extent the partnership has sufficient business interest income, floor plan financing, and ATI.[75] The more difficult issue is how a non-materially participating partner should be treated for that partner's distributive share of the interest expense of a securities trading partnership. While section 163(j) is applied at the partnership level,[76] it applies only regarding business interest, and the same interest expense cannot be both business interest and investment interest expense to the same taxpayer. Indeed, the statute provides that business interest "shall not include investment interest within the meaning of" section 163(d).[77] Under section 163(d)(5)(A)(ii), however, a non-materially participating partner's distributive share of interest expense of a securities trading partnership is considered investment interest, and thus could not also be considered business interest under section 163(j)(5).

Section 163(j)(4)(A)(i) requires section 163(j) to be applied at the partnership level and implies that the partner's status is irrelevant to determining whether interest is business interest that is subject to section 163(j). Section 163(d)(5)(A)(ii) characterizes the distributive share of a non-materially participating partner's interest expense as investment interest expense and therefore not business interest. At first blush, it seems impossible to reconcile those sections without running afoul of the proscription in section 163(j)(5) that the same interest expense cannot be both business interest expense at the partnership level and recharacterized as investment interest expense at the partner level based on the partners' status. But it could be argued that the two provisions can be read harmoniously if one takes the view that section 163(j) is not a characterization provision, but rather an interest deduction limitation provision "applied at the partnership level" and that section 163(d)(5)(A)(ii) is a recharacterization provision applicable only to a partner's distributive share of interest expense at the partner level.

Consistent with that argument, the preamble to the section 163(j) proposed regulations states that there is no statutory inconsistency or ambiguity on this issue, taking the position that (1) the interest expense of a securities trading partnership is per se business interest for the purpose of computing the limitation of deductibility of section 163(j) to the extent that such interest expense is allocable to the partnership's trade or business, presumably because section 163(j) must be applied at the partnership level,[78] and thus the partner's level of participation cannot be relevant to classifying the

[73] *See* reg. section 1.469-1T(e)(6) (a securities trading business is not a passive activity) and Rev. Rul. 2008-12, 2008-1 C.B. 520 (treating as investment interest under section 163(d) the allocable share of partnership interest expense to a non-materially participating partner in a securities trading partnership). As one practitioner has noted, securities trading partnership "aptly describes the overwhelming majority of domestic hedge funds where limited partners do not materially participate in the fund's activities, which are instead conducted by the general partner." Mark Leeds, "An IRS Trifecta: Three Public Releases Affecting Hedge Funds, Funds of Funds Issued on Single Day," 139 *DTR* J-1 (July 21, 2008).

[74] *See* sections 162 and 163(a) and (h)(2)(A).

[75] Section 163(j)(1) and (4).

[76] Section 163(j)(4)(A)(i).

[77] Section 163(j)(5).

[78] Section 163(j)(4)(A)(i).

interest expense;[79] and (2) to the extent that interest is not disallowed, section 163(j) has nothing to say about the characterization of that interest in the hands of its partners and the recharacterization rules of section 163(d)(5)(A)(ii) take over for the portion of the interest expense unaffected by section 163(j).[80]

It is astonishing that the preamble suggests its implicit conclusion on that topic is so clear that no further discussion of this point is required in either the text of the proposed regulations or any of its examples. It may well be that the conclusion in the preamble on this point is preferable to a middle approach some have suggested — which would treat a securities trading partnership's interest expense as per se business interest but would not allow that interest to be recharacterized as investment interest in its partners' hands,[81] given that such middle approach would severely curtail and perhaps even render impossible the application of section 163(d)(5)(A)(ii)[82] and nothing in section 163(j) or its legislative history suggests an intention to so severely curtail or override section 163(d)(5)(A)(ii). Nonetheless, the preamble's conclusion is not entirely without its problems; prop. reg. section 1.163(j)-3(b)(9) may itself cast some doubt on this conclusion.

> Except as otherwise provided in the section 163(j) regulations, provisions that characterize interest expense as something other than business interest expense under section 163(j), such as section 163(d), govern the treatment of that interest expense, and such interest expense will not be treated as business interest expense *for any purpose* under section 163(j).[83]

Further, a literal reading of the statute could suggest that the preamble's approach is in direct conflict with the statutory language. As a general matter, partnership items separately stated under section 702(a) are those that "if separately taken into account by any partner, would result in an income tax liability for that partner . . . different from that which would result if that partner did not take the item into account separately."[84] Thus, if a partnership's business interest expense not limited by section 163(j) may be subject to limitation under section 163(d) in the hands of the partner depending on the partner's level of participation in the business, that expense should be separately stated under section 702(a). However, section 163(j)(4)(A)(i) can be read to prohibit separately stating interest characterized at the partnership level as business interest. Thus, by requiring business interest to be accounted for in the partnership's non-separately stated income, it could be argued that Congress manifested an intention that business interest allowed by section 163(j) not be again subject to any partner-level limitation in the partners' hands[85] — under section 163(d) or otherwise — which appears to be a repudiation of the preamble's position that business interest allowed under section 163(j) may still be subject to limitation under section 163(d) in the partner's hands.

As noted, if one rejects the preamble's second conclusion — that a securities trading partnership's business interest allowable under section 163(j) may still be subject to limitation under section 163(d) in the partners' hands — section 163(d)(5)(A)(ii) may be rendered nugatory unless one also rejects the preamble's first conclusion that a securities trading partnership's interest expense is per se section 163(j)(6) business interest and not investment interest.[86] To do so

[79] *But see* section 163(d)(5)(A)(ii).

[80] Preamble to section 163(j) proposed regulations, at 85.

[81] *See* NYSBA tax section report, *supra* note 51, at 36-37. Although the bar report does not explicitly mention that it is discussing securities trading partnerships, it appears that its discussion covers such partnerships given that it discusses the interstices between section 163(d) and (j).

[82] It is difficult to imagine a situation in which section 163(d)(5)(A)(ii) could apply outside the partnership or S corporation context given the material participation rules under section 469. Given that section 163(d)(5)(A)(ii) appears to apply primarily (and perhaps only) in the partnership and S corporation context and the middle approach would consider the interest expense allocable to such entity's trade or business to be per se business interest subject to section 163(j) and never subject to section 163(d) even in the hands of a non-materially participating partner, the middle approach would effectively severely curtail and possibly render impossible the application of section 163(d)(5)(A)(ii).

[83] Prop. reg. section 1.163(j)-3(b)(9) (emphasis added). *Cf.* prop. reg. section 1.163(j)-6(c) ("Deductible business interest expense and excess business interest expense retain their character as business interest expense at the partner level.").

[84] Reg. section 1.702-1(a)(8)(ii).

[85] *Cf.* prop. reg. section 1.163(j)-3(b)(9) and -6(c) ("Deductible business interest expense and excess business interest expense retain their character as business interest expense at the partner level.").

[86] *See supra* note 82.

would require one to read section 163(j)(4)(A)(i)'s language that "this subsection shall be applied at the partnership level" as being relevant only after determining the threshold issue that there is business interest, absent which section 163(j) would not be triggered. To answer that threshold question, a taxpayer would have to determine whether interest is investment interest under section 163(d)(5)(A)(ii), which depends on the partner's level of participation.[87] Only interest not so determined to be investment interest (for example, interest allocable to the materially participating partners of a securities trading partnership) may be business interest subject to the limitations under section 163(j) at the partnership level.[88]

That reading may be supported by a textual argument using section 163(j)(5)'s language, which as noted states that business interest shall not include investment interest (within the meaning of section 163(d)). At first blush, that language would appear to be surplusage because interest that is allocable to property held for investment (under section 163(d)(3)(A)) is obviously investment interest and not business interest (that is, interest allocable to a trade or business), and thus there should be no need for the last sentence of section 163(j)(5) to state that.[89] But interest can be both allocable to investment property and incurred in a trade or business, when, for example, the interest is allocable to a non-materially participating owner of an interest in a trade or business described in section 163(d)(5)(A)(ii), such as a non-materially participating partner of a securities trading partnership. In that case, but for the last sentence of section 163(d)(5), the interest would have met both the definition of business interest and the definition of investment interest under section 163(d)(5)(A)(ii). Therefore, it could be argued that the last sentence of section 163(d)(5) clarifies that despite any language in section 163(j) suggesting that the characterization of business interest is determined at the partnership level, the language in section 163(d)(5)(A)(ii) characterizing interest with reference to the partner's level of participation is meant to carve out an exception to the rule under section 163(d)(4)(A)(i) applying section 163(j) at the partnership level.

Even though that reading may dodge some glaring issues with the preamble's language, it still has flaws and may complicate the reporting of partnership items. One difficulty with this interpretation is that the interest allocable to the passive partners (and thus subject to section 163(d) as investment interest) would have to be separately stated, but the interest allocable to the active partners (and thus covered under section 163(j) as business interest) would have to be accounted for in the partnership's non-separately stated income under section 163(j)(4)(A)(i). Although such non-separately stated income would have the same tax treatment in the hands of all the partners, a securities trading partnership would have to ensure that all the interest expense is allocated in accordance with all the partners' interests (and ensure that the passive partners do not get a double allocation of interest expense) by adjusting the amount of non-separately stated income allocated among the passive and active partners.[90] Although that may make the calculation and allocation of partnership items more complex,[91] that is but one more complexity among the myriad caused by the enactment of section 163(j).[92]

Even though this latter reading has its flaws, absent a technical amendment[93] it may be the necessary statutory construction to avoid rendering any statutory language as surplusage or effectively void or as directly contradicting the statutory language as the preamble's statutory

[87] *See* prop. reg. section 1.163(j)-3(b)(9).

[88] *See* section 163(j)(4)(A)(i) and (5).

[89] *Cf.* section 163(h)(2)(A) and (B); reg. section 1.163-8T(b)(3) and (7). Note that this textual argument identifies another flaw with the preamble's reading, which appears to render the last sentence under section 163(j)(5) surplusage unless it were possible to apply section 163(d)(5)(A)(ii) outside a passthrough context. *See supra* note 82.

[90] *But see* section 163(j)(4)(B)(II) (requiring the partnership's excess business interest to be allocated to each partner "in the same manner as the non-separately stated taxable income or loss of the partnership").

[91] *See*, *e.g.*, prop. reg. section 1.163(j)-6(f) for 11 steps to allocate partnership business interest expense and section 163(j) excess items.

[92] *See id*.

[93] *See* Tax Technical and Clerical Corrections Act, at 19 (Jan. 2, 2019) (proposing to remove the language in section 163(j)(4)(A)(ii) requiring that "any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership"). Should such a technical correction be enacted, retroactive application of the correction would likely be constitutionally permissible if the enacted legislation so provides. *See United States v. Carlton*, 512 U.S. 26 (1994); and *United States v. Darusmont*, 449 U.S. 292 (1981).

construction could be read to do. Given the ambiguity in the statute, an interpretative regulation explicitly adopting the approach in the preamble may be held to be valid. But without a final regulation or technical amendment, it appears that a non-materially participating partner in an adversely affected securities trading partnership could mount a challenge.

For a non-materially participating partner to be adversely affected by the application of the section 163(d) limitation to interest exceeding the limitation as the preamble's second conclusion would require, the partner would likely have to have investment losses outside the partnership giving rise to the interest. Of course, a non-materially participating partner could be adversely affected by application of the section 163(j) limitation determined at the partnership level to its distributive share of interest expense that would otherwise be treated as investment interest.[94]

Although perhaps not practical, non-materially participating partners in a securities trading partnership may avoid being subject to section 163(j) (and the statutory ambiguity as to the interstices between section 163(j) and (d)) by limiting the amount of debt incurred at the partnership level, borrowing money in their partner capacity, and contributing it as a capital contribution to the partnership. Although that debt and the interest payments thereon would be considered allocable to a trade or business,[95] they would likely not be considered business interest of the partnership and would be irrelevant to the partnership's calculation of its section 163(j) limitation given that section 163(j) applies at the partnership level and the debt is not held by the partnership.[96] Rather, each partner must determine the character of the debt as business or investment interest depending on his level of participation in the partnership's business. Such interest expense in the hands of a non-materially participating partner should be considered investment interest subject to section 163(d), and not business interest subject to section 163(j).[97] In the hands of a materially participating partner, however, that interest would be business interest subject to section 163(j) at the partner level.

V. A QEF Solution

For taxpayers engaged in security trading businesses that can obtain an exclusion from being considered engaged in a U.S. trade or business were they a non-U.S. person[98] and that require high leverage as part of their business model so that they would be subject to the section 163(j) limitations, there may be advantages in operating through a non-U.S. corporation that can avoid classification as a CFC.[99] Such a corporation would likely be classified as a passive foreign investment company[100] and could elect to be treated as a qualifying electing fund (QEF election) under section 1295, which would require the PFIC's U.S. shareholders to include in gross income their pro rata shares of the PFIC's earnings each year.[101] The character of any long-term capital gain realized at the entity level is preserved and flows through to the shareholder as long-term capital gain[102] and is taxed accordingly at the long-term capital gain rates. Moreover, because the shareholder's income inclusion is determined with reference to the PFIC's E&P and not its taxable income,[103] section 163(j) would effectively

[94]That is, the preamble's first conclusion.

[95]*See* Notice 89-35, 1989-1 C.B. 675 (providing that interest expense is to be allocated by any reasonable method, including allocating the debt among all the assets of the entity or tracing the debt proceeds to all of the expenditures of the entity "as if the contributed debt proceeds were the proceeds of a debt incurred by the entity"). *See also* reg. section 1.163-8T(h)) (reserving on this question).

[96]This is particularly true under the preamble's approach, which interprets the section 163(j)(4)(A)(i) language requiring "this subsection [to be] applied at the partnership level" to mean that the partnership is forbidden to look through to its partner's participation level under section 163(d)(5)(A)(ii) and determine that the interest is investment interest. It logically follows from this approach that the partnership's section 163(j) limitation must be computed without regard to debt held in its partners' hands.

[97]Section 163(d)(5)(A)(ii) and (j)(5).

[98]*See* section 864(b)(2)(A)(ii).

[99]*See* section 957.

[100]Generally, a PFIC is any foreign corporation if 75 percent or more of its gross income is passive income or at least 50 percent of the "average percentage" of its assets produce or are held for the production of passive income. Section 1297(a).

[101]Section 1293(a).

[102]Section 1293(a)(1)(B).

[103]Section 1293(a)(1) and (e).

be circumvented and would not limit the deductibility of interest. That is because interest disallowed under section 163(j) is deductible for purposes of determining E&P.[104]

Similarly, the section 163(j) limitation will not affect a CFC's E&P and its U.S. shareholders' subpart F inclusion.[105] But using a CFC to avoid section 163(j) is less advantageous given that capital gain characterization does not pass through a CFC to its U.S. shareholders. Moreover, in the case of a CFC, section 163(j) is not avoidable for the CFC's section 951A global intangible low-taxed income inclusion because "tested income" of a CFC is not limited by E&P, although for GILTI purposes section 163(j) may have less of a bite given the 50 percent deduction (reduced to 37.5 percent for tax years beginning after 2025)[106] and the reduction of tested income by the net deemed tangible income return — both of which are reduced by interest expense.[107]

Although using a PFIC is preferable to using a CFC, using a PFIC rather than a partnership has downsides — namely, losses incurred at the corporate level, as well as foreign tax credits, will not pass through to its noncorporate shareholders.[108] Moreover, absent planning for the purpose of avoiding the so-called withholding tax,[109] U.S.-source dividends received by the PFIC will likely incur a U.S. tax under section 881(a) and be subject to withholding under section 1442. Despite the downsides, the use of a PFIC could well have the effect of the avoidance of the section 163(j) limitation even for the materially participating principals of a securities trading partnership. As noted above, not every securities trading partnership will run afoul of the interest expense coverage ratio. But for those that are likely to do so, and if the interest expense limitation could be material, some consideration might be given to carrying on business through a foreign vehicle.

VI. Interest Limitation Under Tax Treaty

In addition to statutory construction questions, such as the interstices between section 163(d) and (j) in the context of securities trading partnerships, section 163(j) may raise interpretive issues regarding apparent conflicts between a treaty and the statute. To elaborate, before the enactment of the new section 163(j), foreign entities operating in the U.S. through a branch were permitted to deduct their interest expense allocable to their U.S. trade or business under U.S. tax principles,[110] assuming that the interest expense was legitimately characterized as a business interest expense.[111] For example, under the old section 163(j), interest payments on debt issued or guaranteed by related exempt parties may have been disallowed out of a concern that a portion of that debt effectively should be treated as disguised equity and interest payments on a corresponding portion of those interest payments as a distribution of profits.[112] However, when there was no question of the characterization of the interest payment as interest and its legitimacy as a business expense, then the interest was fully deductible.

With the enactment of the new section 163(j), Congress for the first time limited the deductibility of legitimate business interest expense when there is no question as to its character as interest and it would be deductible

[104] *See* prop. reg. section 1.163(j)-7(e).

[105] *See* prop. reg. section 1.163(j)-7(e). Although the section 163(j) limitation technically applies regarding a CFC in determining the subpart F inclusion amount (see prop. reg. section 1.163(j)-7(b)(2) and the preamble, at 92), a CFC's subpart F income will be shielded from the application of section 163(j) because of section 952(c)(1)(A), limiting a subpart F inclusion to the extent of E&P.

[106] Section 250(a).

[107] *See supra* note 46, noting that the section 163(j) limitation may have no impact if the total interest expense is equal to or less than 10 percent of the CFC's qualified business asset investment as described in section 951A(b)(2)(A).

[108] *But see* section 1293(f) (allowing FTCs for some 10 percent corporate shareholders).

[109] A subject at least as interesting as the interest that is the subject of this report, but alas beyond the scope of this limited report. *See*, *e.g.*, reg. section 301.7701-4(c).

[110] *See* reg. section 1.882-5.

[111] Sections 873 and 882(c).

[112] *See* H.R. Rep. 101-247, at 1242 (1989), to accompany H.R. 3299 (explaining that the reason for enacting the old section 163(j) was, *inter alia*, because of "the difficulties encountered in distinguishing debt from equity, and [that] effectively enforcing that distinction, may lead to undue freedom to manipulate the U.S. tax system"). *See also* OECD "Thin Capitalisation," *supra* note 13, at paras. 12 and 89 (noting that "thin capitalization" loosely "describes the whole range of forms of hidden equity capitalisation," the latter of which involves disguising equity as debt, and emphasizing "that the application of the rules designed to deal with thin capitalization ought not normally to increase the taxable profits of the relevant domestic enterprise to an amount greater than the profit which would have accrued in the arm's length situation").

but for section 163(j).[113] As noted, the House report explains that the purpose of limiting such legitimate and properly characterized business interest expenses under the new section 163(j) is to prevent companies from "undertaking more leverage than they would in the absence of the tax system," but it does not indicate that there is any concern about the legitimacy of its characterization as a business interest expense.[114]

For treaty residents operating a U.S. business through a PE, this new limitation on what is concededly a legitimate business interest expense may conflict with treaty provisions based on the 2006 U.S. model treaty, which allows the United States to tax the business profits attributable to a PE of a foreign entity that is a resident of a treaty partner.[115] In determining those profits, the United States must allow "as deductions expenses that are incurred for the purposes of the permanent establishment."[116] The 2005 OECD model treaty contains the same language in its business profits article, and comment 43 notes by implication that interest expense properly allocable to the PE must be allowed as a deduction under article 7, paragraph 3.[117]

Thus, under treaties that follow the 2006 U.S. model treaty, although the United States may determine whether a purported business interest expense is indeed legitimate and properly characterized as such and properly allocable to the PE,[118] there is substantial question whether the United States may disallow a treaty resident's deductions for interest expense when there is no question about its character and legitimacy as a business interest expense. To the extent section 163(j) disallows such legitimate and properly characterized interest expense because of U.S. internal policy reasons regarding the use of "excessive" leverage, it may conflict with U.S. treaty provisions that follow the 2005 OECD and 2006 U.S. model treaties.

Taxpayers have raised similar challenges regarding reg. section 1.882-4(a)(3)(v)'s denial of any deduction when a treaty resident failed to file a timely return. There, taxpayers have argued that denial of all deductions for business expenses violated article 7, paragraph 3, which requires a treaty partner to allow deduction for business expenses, and article 24, which prohibits discrimination between domestic and treaty-resident taxpayers. The IRS has ruled that reg. section 1.882-4(a)(3)(v)'s denial of deductions violates neither of those treaty provisions because reg. section 1.882-4(a)(3)(v) is not a substantive denial of a deduction but rather an administrative and procedural measure intended to encourage timely reporting and filing and to prevent tax evasion by foreign persons who are "not similarly situated" to U.S. taxpayers "with respect to the Service's ability to identify and examine noncompliant taxpayers."[119] Those IRS rulings, however, may be of limited relevance to a conflict between section 163(j) and a treaty, given that the section 163(j) does not purport to deny deduction on procedural or administrative grounds.

Also, section 163(j) and the treaty may be reconciled by arguing that section 163(j) does not deny interest deductions but is merely a timing provision that determines when the deduction is allowed.[120] Moreover, the limitation will not affect taxpayers that are not highly leveraged. However, for taxpayers that are adversely affected by the section 163(j) limitation — particularly taxpayers whose business models on a long-term basis rely on high leverage and have high interest expense relative to their income — the effect of the disallowance is to permanently deny an interest deduction despite its legitimacy as a business expense.

Despite the possible conflict between section 163(j) and the 2005 OECD and 2006 U.S. model treaties, the most recent 2016 U.S. model tax treaty and the 2017 OECD model treaty lack the article 7, paragraph 3, language regarding the allowance of deductions contained in the earlier model treaties.

[113] *See* sections 162, 163(a), (j)(1), and (5), and (h)(2)(A).

[114] *See* H.R. Rep. 115-409, at 247.

[115] 2006 U.S. model treaty, article 7, para. 1.

[116] *Id.* at para. 3.

[117] Note that the language in article 7 of the OECD model treaty remained substantially the same until it was changed in 2010 as explained below.

[118] *See generally* OECD Model Tax Convention, comments 27-51.

[119] FSA 199944026 (regarding the U.S.-U.K. treaty); *see also* TAM 199941007 (regarding the U.S.-Canada treaty); and FSA 199940012 (regarding the U.S.-Germany treaty).

[120] *See* section 163(j)(2) (allowing carryforward of disallowed interest expense).

In particular, the comments on article 7 of the 2017 OECD model treaty strongly imply that a treaty partner may determine the timing and amount of deductible business expenses provided that it does not discriminate between domestic and foreign treaty resident taxpayers.[121] Later-executed treaties with language similar to the 2017 OECD model tax treaty and the 2016 U.S. model treaty may be interpreted accordingly as allowing treaty party countries to determine the timing and to deny and limit interest deductions as the limitation in section 163(j) does.

Regarding prior executed treaties: Although later commentary on a treaty may be viewed as a technical correction to an earlier comment to a treaty that merely reveals the parties' intent when entering into the prior treaty,[122] the comments to the 2010 OECD model treaty — the version of the OECD model treaty that removed the article 7, paragraph 3, language requiring allowance of deductions for business expenses — make it clear that the revision to the model treaty and the comments thereunder "was not constrained by either the original intent or by the historical practice and interpretation of article 7. Instead, the focus was on formulating the most preferable approach to attributing profits to a permanent establishment under article 7 given modern-day multinational operations and trade."[123] Thus, the comments to the 2017 OECD model treaty and the revisions to article 7 in the 2016 U.S. model treaty[124] should not have any relevance to interpreting treaties ratified before 2010 and modeled on the 2005 OECD and 2006 U.S. model treaties. Further, interpreting the 2006 U.S. model treaty, article 7, paragraph 3, language as allowing a complete denial of a deduction, as provided in comments 30-34 to the 2017 OECD model treaty, article 7, would render such language surplusage, especially given that article 24 already prohibits a treaty country from discriminating between domestic and foreign treaty resident taxpayers.

To the extent that section 163(j) could be read as conflicting with prior enacted treaties modeled on the 2006 U.S. model treaty, courts will generally attempt to construe the statute and treaty to give effect to both.[125] However, to the extent that they are irreconcilable, the rule is that the later enacted statute overrides the prior enacted treaty only when there is clear evidence that Congress intended to override the treaty.[126] It is significant that the section 163(j) legislative history does not provide any evidence of an intent to override prior treaties. Therefore, to the extent section 163(j) conflicts with the treaty, the treaty should govern, and a treaty resident should be able to claim benefit under the treaty in contravention of the section 163(j) limitation. It is worth noting that although somewhat unclear, the proposed regulations to section 163(j) appear to imply that a treaty resident would be subject to the section 163(j) limitation on interest deductions allocable to its business profits.[127] To the extent that there is a conflict between a U.S. treaty and section 163(j), the treaty should prevail.[128]

VII. Partnership Audit

It is also worth noting that the issue regarding the deductibility of interest under section 163(j) or (d) for partnerships is a matter in which the partnership and its partners may have conflicting

[121] *See* 2017 OECD model treaty, article 7, comments 30-34.

[122] *See The Taisei Fire and Marine Insurance Co. Ltd. v. Commissioner*, 104 T.C. 535, 550 (1995).

[123] 2010 OECD model treaty, article 7, comment 6. The comments also note that "in order to provide improved certainty for the interpretation of treaties that had already been concluded on the basis of the previous wording of Article 7, the Committee decided that a revised Commentary for that previous version of the Article should also be prepared, to take into account those aspects of the report that did not conflict with the Commentary as it read before the adoption of the 2008 Report." *Id*. at comment 7. The revised comments for the old article 7 language do not contain the language in comments 30-34 to the 2017 OECD model treaty, article 7, allowing permanent disallowance of business deductions.

[124] *See Crow v. Commissioner*, 85 T.C. 376, 378-383 (1985) (holding that a change in treaty policy resulting from the enactment of section 877 may not override the literal terms of the U.S.-Canada income tax treaty).

[125] Rev. Rul. 80-223, 1980-2 C.B. 217; *see also* section 7852(d).

[126] Rev. Rul. 80-223.

[127] *See* prop. reg. section 1.163(j)-8(b)(2), (3), and (g)(3) and the preamble, at 106.

[128] *Cf. Crow*, 85 T.C. at 378-383 (declining to follow a revenue ruling that as interpreted would override the literal terms of the U.S.-Canada income tax treaty).

interests, especially because under the relatively new partnership-level audit rules,[129] the deductibility of interest paid or accrued by a partnership is a "partnership-related item."[130] Thus, absent an election out of this regime in accordance with section 6221(b) or a "push-out" under section 6226, any adjustment by reason of section 163(j) must be determined at the partnership level, and any tax attributable thereto must be assessed and collected at the partnership level.[131]

VIII. A Few Additional Complexities

In addition to several other issues identified in this report, the interactions among the limitations required by section 163(j) and sections 59A, 172, and 461(l) will add a layer of complexity to tax planning with results that may not be so easy to discern. For example, regarding section 59A, the first dollar of interest expense limited by section 163(j) is deemed to be unrelated party interest to the extent of that unrelated party interest.[132] The effect of this rule is to potentially increase the amount of deductible related-party interest and thereby increase the base erosion minimum tax.[133] It is difficult to determine the principle underlying this rule other than perhaps the principle of raising additional revenue under the guise of section 59A.

The interaction between sections 163(j) and 172 provides another illustration. Although the effect of the section 163(j) limitation is generally unfavorable for taxpayers, a taxpayer who has NOL carryforwards substantially exceeding its projected taxable income over a several-year period may benefit if some of its business interest expense were limited by section 163(j). For example, assume that in 2022, Corp. A has a $1,000 NOL carryover available, $30 ATI, and $50 of interest expense. In that case, $41 of interest expense will be disallowed under section 163(j) (that is, $50 - ($30 x 30 percent)), only $16.80 of NOL will be allowed under section 172(a) (limiting NOL allowed as a deduction to 80 percent of taxable income), and its taxable income will be $4.20 (that is, $30 ATI minus $9 interest expense minus $16.80 NOL).

Assume in 2023, Corp. A has $150 ATI and no interest expense other than a $41 business interest carryforward under section 163(j)(2), with the effect that the entire $41 interest carryforward and $87.20 of NOL (($150 - $41) x 80 percent) is allowed. Its taxable income would be $21.80 ($150 - $41 - $87.20), and its remaining NOL for future years would be $896 ($1,000 - $16.80 - $87.20). In contrast, had section 163(j) been struck out of the code in 2022 and the facts otherwise remained the same, Corp. A would have a $20 loss in 2022 and $1,020 NOL carryforward to 2023, of which $120 ($150 x 80 percent) would be allowed, and taxable income of $30, which is greater than the $26 of taxable income ($4.20 in 2022 and $21.80 in 2023) Corp. A would have under section 163(j).

Regarding section 461(l), although business interest allowed by section 163(j) generally won't be subject to limitation under section 461(l), section 461(l) may still limit a loss, a component of which may be business interest expense, given the differences between ATI and taxable income.

IX. Conclusion

The limitation of the deductibility of otherwise deductible business interest expense introduced by new section 163(j) was projected to raise $253.4 billion over 10 years, a significant amount undoubtedly thought necessary to enable the cost of the TCJA to come within the $1.5 trillion limit politically required for passage.[134] None of the amount projected to be raised will come from either so-called small companies or excepted companies.[135] Nor, as demonstrated from the data summarized in this report, will the

[129] Section 6221 et seq., effective for partnership tax years beginning after 2017.

[130] Section 6241(2)(B). *See also* prop. reg. section 301.6241-6(b)(1) and (2) and (d)(1) (providing that partnership-related items include items or amounts that are required to be shown or reflected on the partnership return and items or amounts that are in the partnership's books and records, and giving as an example of a partnership-related item: "the character, timing, source, and amount of the partnership's . . . deductions").

[131] Section 6221(a). Even in a partnership-level audit, section 6225(c)(2) affords the partnership the opportunity to modify the amount collectible at the partnership level by means of amended returns filed by the partners for the year(s) being audited or the so-called push-in procedure in lieu of amended returns.

[132] Section 59A(c)(3).

[133] *See* section 59A(a), (b)(1), and (c)(1) and (2).

[134] *See* JCX-67-17, *supra* note 62, at 8.

[135] Section 163(j)(3) and (7).

additional tax sought to be raised generally come from companies whose debt has a Moody's rating of at least B before 2022 and Ba after 2021 because those companies are likely to have interest coverage ratios that equal or exceed 3.3.[136] Thus, generally only companies of any significant size whose debt has a Moody's rating of less than B before 2022 and Ba after 2021 will be adversely affected because they have the most modest interest coverage ratios. Some companies within this potential class of affected companies may have used leverage that Congress now believes to be excessive but that was not so regarded when the leverage was used. Nevertheless, those companies have effectively been "asked" to pay for a portion of the reduction in corporate tax rates introduced by the TCJA. It is significant that the data show that the most prosperous companies — which likely will benefit most from the corporate tax rate reduction — have not been asked to bear any portion of the taxes sought to be collected under the new provision.

Some affected companies (particularly passthrough entities such as securities trading partnerships) that use high rates of leverage may wish to consider alternative structures that would allow them to avoid the new limitations. Other passthrough entities will be faced with considerable additional complexity regarding the required calculations under this provision. RICs that use high levels of leverage resulting from their trading strategy may find themselves in a bind in meeting their distribution requirements. U.S. affiliated groups will find they have one more thing to keep track of. Companies with subsidiaries that are CFCs and that have subpart F income will find that the section 163(j) limitation effectively does not apply to them, but that the new provision could affect the calculation of GILTI inclusions required by section 951A but may end up not costing anything. Foreign companies entitled to treaty benefits under treaties coming into force before 2010 may raise questions concerning whether the section 163(j) limitation is inconsistent with their treaty entitlements, possibly giving rise to competent authority claims.

Companies acquired in a leveraged buyout may be penalized through a current and possibly permanent denial of deduction of interest expense even when valid business exigencies require the use of debt rather than equity, with the interest deduction curtailment affecting returns and possibly the viability of some transactions. Potentially affected companies that are well advised will no doubt consider alternatives that will enable them to execute their business plans. Although it is too early to tell whether the new provision will meet its goal of reducing leverage, it is not too early to conclude that for those affected, the new provision will add complexity,[137] cause disruption, and undoubtedly require amendment.[138] ■

[136] *See supra* Section III, but there likely will be outlier companies that have better ratings and will still be affected by the limitation.

[137] The TCJA has not generally been advertised as accomplishing tax simplification in the business area.

[138] *See supra* note 92. *See also* NYSBA, "Report on Proposed Section 163(j) Regulations" (Feb. 26, 2019).