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U.S. — New Interest Expense Limitation Regs and Guidance

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Canadian companies that do business in the United States should determine how they will be affected by changes to the U.S. rules on interest expenses. The IRS issued final and new proposed regulations, as well as other related administrative guidance and frequently asked questions, for the expanded application of the interest expense limitations under section 163(j) of the Internal Revenue Code (the Code) on July 28, 2020. The final regulations provide clarity on several issues, including calculating the interest expense limitation and what qualifies as interest for purposes of the limitation.

These regulations, which are sometimes referred to as "earnings stripping rules", may deny a deduction for certain interest expenses paid to both related and unrelated lenders. Previously, these rules only applied to interest paid to foreign related parties. This edition of *TaxNewsFlash-Canada* provides a high level review of the final regulations, effective dates and important changes that may affect Canadian multinational companies.

Background
The United States proposed sweeping U.S. tax reform changes in late 2017 in the *Tax Cuts and Jobs Act*, Pub. L. No. 115-97. Among other changes, these measures significantly limited the deductibility of business interest expense for tax years beginning after December 31, 2017 by amending section 163(j) of the Internal Revenue Code of 1986, as Amended, to disallow a deduction for business interest when net business interest expense exceeds:

- 30% of adjusted taxable income (ATI)
- The taxpayer's business interest income for the tax year, plus

- Floor plan financing interest expense.

For details, see *TaxNewsFlash-Canada* 2017-65, "Canadian Multinationals — Prepare for U.S. Tax Changes".

The United States further amended these rules under *the Coronavirus Aid, Relief, and Economic Security Act* (CARES Act) on March 27, 2020. These changes, which were intended to help business and individuals mitigate the impact of COVID-19, temporarily increased the net business interest deduction limit from 30% of ATI to 50% for tax years beginning in 2019 or 2020, with special rules provided for partnerships. For this purpose, ATI equals a taxpayer's taxable income computed without regard to

- Any item of income, gain, deduction, or loss that is not properly allocable to a trade or business,
- Business interest expense or business interest income,
- The amount of any net operating loss (NOL) deduction,
- The deductions under section 199A, and
- In the case of tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

Business interest expense that is disallowed under section 163(j) is treated as paid or accrued in the succeeding taxable year and may be carried forward indefinitely.

The business interest expense deduction limitation does not apply to certain small businesses whose gross receipts are $25 million or less, electing real property trades or businesses, electing farming businesses, and certain regulated public utilities. For the 2019 tax year and subsequent years, the $25 million amount will be adjusted for inflation.

For details, *see TaxNewsFlash-Canada* 2020-31, "U.S. COVID-19 Response Provides New Tax Relief".

Tentative taxable income

"Tentative taxable income" (TTI) is a new term in the final regulations that is defined as taxable income (computed in accordance with section 63), without regard the section 163(j) limitation and disallowed business interest expense carryforwards. Under the final regulations, taxpayers must then adjust TTI to derive ATI, generally following the rules under the 2018 proposed regulations with additional modifications. Notably, the final regulations allow taxpayers to add back any depreciation, amortization or depletion that is capitalized into inventory under section 263A during taxable years beginning before

January 1, 2022, to their TTI when calculating ATI for that taxable year, regardless of when the capitalized amount is recovered through cost of goods sold.

Furthermore, the final regulations eliminate the “lesser of” rule for calculating ATI with respect to sales or dispositions of property with depreciation attributable to EBITDA years, unlike the 2018 proposed regulations. Because deductions for depreciation, amortization, and depletion for tax years beginning after December 31, 2017 and before January 1, 2022 are added back to taxable income in computing ATI, the final regulations require taxpayers to reduce ATI by the depreciation deduction attributable to the earnings before interest, taxes, depreciation, and amortization (EBITDA) years in the disposal year to avoid “potential double counted deductions.”

KPMG observation
A taxpayer that relied on the 2018 proposed regulations in their entirety for tax years beginning before the final regulations are effective can choose to follow the section 263A rule in the final regulations rather than the in the 2018 proposed regulations. Thus, a calendar-year taxpayer may amend its returns for the 2018 and 2019 taxable years to adopt the section 263A rules under the final regulations, but only if the taxpayer also applies the 2018 proposed regulations in their entirety.

Definition of interest expense

The final regulations narrow the definition of “business interest” and set out four categories of interest, as compared to the proposed regulations. For example, among other changes, the final regulations clarify that loan commitment fees, debt issuance costs and hedging transaction costs are not considered interest subject to section 163(j) of the Code. However, amounts treated as interest (compensation for use or forbearance of money) under the Code or regulations, such as stated interest and original issue discount, remain unchanged in the final regulations.

KPMG observation
The final regulations have a narrower anti-avoidance rule compared to the 2018 proposed regulations. In general, if a taxpayer structured a transaction with a principal purpose of reducing an amount incurred that would otherwise have been treated as interest under one of the other three categories, the IRS may recharacterize any expense economically equivalent to interest to be treated as interest for the purposes of section 163(j) under the anti-avoidance rule in the final regulations.

In addition, although guaranteed payments for the use of capital are not explicitly included in the definition of interest under the final regulations, the interest anti-avoidance rule includes an example of a situation in which such a guaranteed payment is treated as interest expense and interest income.

Consolidated return rules

The final regulations generally take a single-entity approach and apply a single section 163(j) limitation to a consolidated group, consistent with the 2018 proposed regulations. Accordingly, taxpayers can generally disregard intercompany obligations in determining a member's business interest expense and income. The final regulations also consistently provide that taxpayers can disregard intercompany items for the purposes of a group's ATI to the extent they offset each other.

KPMG observations
For state purposes, a member of the federal consolidated group is often required to file a separate company state return. However, determining state taxable income, beginning with federal taxable income calculated without regard to these federal consolidated return rules, can add complexity in determining how section 163(j) applies at the state level.

Effective dates

In general, the final regulations will apply to taxable years beginning on or after the date that is 60 days after the regulations are published in the Federal Register, although this date has not yet been announced. Taxpayers (and their related parties) may apply the final regulations, in their entirety, to taxable years beginning after December 31, 2017, as long as these rules are consistently applied. Alternatively, the taxpayers (and their related parties) are allowed to apply the 2018 proposed regulations before the final regulations become effective.

KPMG observation
Although there is no requirement for taxpayers to apply the new rules of the final regulations for 2019, taxpayers should analyze and consider whether applying the final regulations retroactively could generate net tax benefits.

We can help

Your KPMG advisor can help you assess how the section 163(j) regulations and related guidance may affect your tax obligations and planning.
