KPMG report: Final regulations under section 163(j), limitation on deductions for certain business interest expenses

January 19, 2021
Introduction

Final regulations under section 163(j) concerning the limitation on deductions for certain business interest expense (“BIE”) are published today, January 19, 2021, in the Federal Register.

The U.S. Treasury Department and the IRS (collectively, “Treasury”) on January 13, 2021, filed for public display in the Federal Register these final regulations (the “2021 Final Regulations”).

Read the 2021 Final Regulations [PDF 452 KB] (46 pages)

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1 On January 5, 2021, the IRS posted a version of these regulations on the IRS website, with a statement that the version published in the Federal Register would be the official version.
Background

The 2021 Final Regulations are the latest in a series of regulations implementing changes made to section 163(j) by the 2017 tax law (Pub. L. No. 115-97)—often referred to as the “Tax Cuts and Jobs Act” (“TCJA”)—and amendments made by the 2020 “Coronavirus Aid, Relief, and Economic Security Act” (“CARES Act”) (Pub. L. No. 116-136).

The 2021 Final Regulations relate to proposed regulations that were published in the Federal Register on September 14, 2020 (the “2020 Proposed Regulations”). Read the 2020 Proposed Regulations [PDF 770 KB] (77 pages)

The preamble to the 2021 Final Regulations states that Treasury intends to finalize other portions of the 2020 Proposed Regulations in the future once additional comments have been considered. Also relevant for purposes of understanding these latest regulations, concurrent with the 2020 Proposed Regulations, Treasury published a different set of section 163(j) final regulations (the “2020 Final Regulations”). Read the 2020 Final Regulations [PDF 893 KB] (160 pages)

The 2021 Final Regulations modify aspects of the 2020 Final Regulations.

Applicability date provisions

The 2021 Final Regulations will generally apply to tax years beginning on or after March 22, 2021.

The 2021 Final Regulations generally allow retroactive application. If taxpayers choose this option for a pre-applicability date tax year, they must: (1) also apply the rules from the 2020 Final Regulations, as modified by the 2021 Final Regulations, and (2) then apply those provisions to subsequent tax years.

More specifically, taxpayers and their related parties may opt to apply the 2021 Final Regulations to tax years beginning after December 31, 2017, and before March 20, 2021, if they consistently apply the 2020 Final Regulations as modified by (1) the Final 2021 Regulations and (2) if applicable, certain other non-section 163(j) regulations,4 and they apply such rules to that tax year and each subsequent tax year.

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2 The 2020 Final Regulations related to proposed regulations [PDF 737 KB] (121 pages) issued on December 28, 2018 (83 FR 67490) (the “2018 Proposed Regulations”).

3 The effective date of the 2021 Final Regulations is January 13, 2021—the date the regulations were filed with the Federal Register. Typically, the effective date of regulations is the date that they are published in the Federal Register or 60 days after such date. There may be procedural questions about this particular effective date, but regardless of that, the actual applicability dates in the 2021 Final Regulations are based on the publication date and are consistent with past practice.

4 Sections 1.263A-9, 1.263A-15, 1.381(c)(20)-1, 1.382-1, 1.382-2, 1.382-5, 1.382-6, 1.382-7, 1.383-0, 1.383-1, 1.469-9, 1.469-11, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-36, 1.1502-79, 1.1502-90, 1.1502-91 through 1.1502-
Notably, in the 2021 Final Regulations, "related parties" for these purposes are those within the meaning of sections 267(b) and 707(b)(1), but section 267(b) is applied without regard to section 267(c)(3). In the preamble, Treasury explicitly observes that it has narrowed the scope of relatedness in this context. The narrower definition appears to be in response to the concerns raised by commenters that the prior rule could treat individual partners in a partnership as related to a corporation owned by the partnership, even if the individual partners owned only a small interest. This could in turn impede the ability to retroactively apply the regulations.

There are two exceptions to the more restrictive retroactive application of the Final 2021 Regulations described above: Reg. §§1.163-15 (regarding debt proceeds distributed from taxpayer accounts) and 1.1256(e)-2 (providing special rules for the allocation of syndicate losses). These provisions may be applied retroactively on their own (i.e., without applying the entirety of the Final 2021 Regulations) provided that taxpayers and their related parties consistently apply these sections to a given tax year and each subsequent tax year.

With respect to the rules from the 2020 Proposed Regulations that were not finalized as part of the 2021 Final Regulations, taxpayers and their related parties may rely on such rules for tax years beginning after March 20, 2021, provided that they consistently follow all of the non-finalized rules from the 2020 Proposed Regulations for that tax year and all subsequent tax years until those rules are finalized or other guidance is provided.

Finally, as an alternative to retroactive application of the 2021 Final Regulations, taxpayers and their related parties may continue to rely on the 2020 Proposed Regulations to the extent provided in such regulations.\(^5\)

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**Changes to Reg. §1.163(j)-1: Changes to the "claw back" of certain prior depreciation, amortization, and depletion deductions in calculating ATI**

The 2021 Final Regulations provide rules governing the “claw-back” negative adjustments to tentative taxable income (“TTI”), including (1) setting forth the “lesser of” rule under the alternative computation method for computing those claw-back negative adjustments, and (2) creating a new claw-back negative adjustment limitation rule (the “negative adjustment cap”), as well as various other special rules, discussed below.

The 2021 Final Regulations also clarify the adjusted taxable income (“ATI”) computation and provide new examples.

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\(^{99}\) (to the extent they effectuate the rules of sections 1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4 from the 2020 Final Regulations, as modified by the 2021 Final Regulations.

\(^{5}\) Read [TaxNewsFlash](#) for a discussion of the 2020 Proposed Regulations and their effective date provisions.
Background

A taxpayer’s section 163(j) limitation is based in large part on the taxpayer’s ATI, which the 2020 Final Regulations define as TTI computed with various adjustments. For tax years beginning on or after January 1, 2018, and before January 1, 2022 (the “EBITDA period”), taxpayers generally can add back to TTI their deductions for depreciation, amortization, and depletion (“EBITDA-period DAD deductions”).

However, the 2020 Final Regulations (consistent with the 2018 Proposed Regulations) impose an ATI claw-back adjustment with respect to a sale or other disposition of certain property to reverse prior ATI adjustments for EBITDA-period DAD deductions. Under the claw-back rule, on the sale or other disposition of property, any EBITDA-period DAD deductions with respect to such property must be subtracted from ATI—even in tax years after 2021 and even if the add back of EBITDA-period DAD deductions in a prior year did not increase the taxpayer’s BIE deduction in such prior tax year.

KPMG observation

The preamble to the 2020 Final Regulations states that Congress intended the ATI add-back for EBITDA-period DAD deductions “to be a timing provision that delays the inclusion of depreciation deductions in calculating a taxpayer’s section 163(j) limitation.” The preamble, however, did not cite (nor are we aware of) any legislative history that substantiates this assertion.

The 2020 Final Regulations also apply an analogous rule to claw back the benefit of EBITDA-period DAD deductions in the context of a sale or other disposition of stock of a member of a consolidated group (“member stock”), including a deemed disposition on a deconsolidation of a member, as described in more detail below. Specifically, on the actual or deemed sale or other disposition of member stock, any investment adjustments under Reg. §1.1502-32 with respect to such stock that are attributable to EBITDA-period DAD deductions must be subtracted from ATI, again even in tax years after 2021. This is perceived as appropriate because under the investment adjustment rules of Reg. §1.1502-32, a group member’s tax basis in the member stock generally is reduced to reflect deductions claimed by that member (an adjustment that can “tier-up” and result in adjustments to the stock basis of higher-tier group members). Thus, basis in member stock can indirectly reflect EBITDA-period DAD deductions.

In addition, a similar rule applies to claw back the benefit of EBITDA-period DAD deductions in the context of a sale or other disposition of an interest in a partnership with respect to the taxpayer’s distributive share of any EBITDA-period DAD deductions from property held by the partnership at the time of such sale or other disposition, to the extent such EBITDA-period DAD deductions were allowable under section 704(d).

Changes in the 2021 Final Regulations

The “lesser of” rule is adopted

The 2018 Proposed Regulations had provided that the amount of EBITDA-period DAD deductions subject to the ATI claw-back rule with respect to the sale or other disposition of property was the lesser of: (1) the taxpayer’s gain recognized on the sale or other disposition of the property, or (2) the EBITDA-period DAD deductions with respect to the property. The 2020 Final Regulations, however, removed this “lesser of” rule, thus requiring a taxpayer that sells or otherwise disposes of property with respect to which it had claimed EBITDA-period DAD deductions to reduce its ATI for the year of disposition by the full amount of the EBITDA-period DAD deductions previously claimed with respect to the property.
In the preamble to the 2020 Final Regulations, the government stated that it withdrew the “lesser of” rule to eliminate the discrepancy between the ATI claw-back rule that applied to the sale or other disposition of an asset as opposed to member stock. The government also asserted that eliminating the “lesser of” rule would make the ATI claw-back rule simpler for taxpayers to administer. In the preamble to the 2020 Proposed Regulations, the government recognized that the “lesser of” rule might not create administrative difficulties for taxpayers, and thus a “lesser of” rule was included in the 2020 Proposed Regulations with respect to sales and other dispositions of both property as well as member stock, for electing taxpayers.

Consistent with the 2020 Proposed Regulations, the 2021 Final Regulations adopt the “lesser of” rule in the form of the alternative computation method. Under this method, taxpayers can apply the “lesser of” rule not only to sales or other dispositions of depreciable, amortizable or depletable assets, but also to sales or other dispositions of member stock and partnerships interests. As a condition to using the alternative computation method, a taxpayer is required to apply the method to all dispositions of assets, member stock, and partnership interests for which an adjustment is required.

As an example, assume taxpayer P acquires asset X in 2018 for $100, which it fully expenses under the bonus depreciation rules. P’s 2018 TTI would be increased by the $100 of depreciation in calculating P’s 2018 ATI. In 2021, P sells asset X for $40, resulting in a $40 gain. P’s 2021 ATI would reflect this $40 gain on the sale of asset X. Under the 2020 Final Regulations, P’s 2021 ATI includes the $40 gain but is also reduced by $100 (i.e., the full amount of the EBITDA-period DAD deductions). However, if P elects to apply the “lesser of” rule under the 2021 Final Regulations with respect to the sale of asset X, P’s 2021 ATI would only be reduced by $40, as the $40 gain recognized on the sale is less than the $100 of EBITDA-period DAD deductions.

It appears that once a taxpayer applies the “lesser of” rule in a tax year, the taxpayer must apply the “lesser of” rule in all subsequent tax years, although arguably the 2021 Final Regulations could be interpreted to allow taxpayers to elect to apply the “lesser of” rule on a year-by-year basis.

It is not entirely clear how the consistency requirement for the “lesser of” rule applies if an acquiring corporation (in a section 381 transaction) or a consolidated group (in a transaction described under Reg. §1.1502-13(i)(5)(i) (i.e., a whole-group acquisition)) that has elected to apply the “lesser of” rule acquires a target corporation or consolidated group that does not (or vice versa).
Modifications to the “lesser of” rule

As noted above, the ATI claw-back rule applies not only with respect to the sale or other disposition of an asset depreciated, amortized or depleted during the EBITDA period, it also applies with respect to the sale or other disposition of member stock where the basis in the member stock reflects investment adjustments that are attributable to EBITDA-period DAD deductions.

The application of the ATI claw-back rule is relatively straightforward with respect to the sale or other disposition of the stock of the member that directly owned and depreciated an asset, but the issue becomes more complex in the context of a tiered ownership structure. Moreover, for purposes of the ATI claw-back rule for member stock, the deconsolidation of a member (i.e., transaction in which a member is no longer included in the consolidated group) is treated as a sale or other disposition of its stock. If P owns S1, which owns multiple other consolidated subsidiaries, P’s sale of S1 to an unrelated buyer will result in the deconsolidation of (and implicate the ATI claw-back rule for) S1 as well as each of its consolidated subsidiaries. If S1’s subsidiaries had claimed EBITDA-period DAD deductions, S1’s stock basis in those members generally would include investment adjustments that are attributable to those deductions, as would P’s stock basis in S1. At the same time, P’s gain on the stock of S1 might have little relationship to the depreciation deductions previously claimed by any particular subsidiary.

In the preamble to the 2021 Final Regulations, Treasury acknowledged that with respect to sales or other dispositions of member stock, gain on upper-tier member stock generally becomes further removed from asset gain at each additional tier within a consolidated group. Therefore, the 2021 Final Regulations provide that for purposes of applying the “lesser of” rule with respect to member stock, the only stock gain that is relevant is the gain that is deemed recognized on the stock of the member that took a depreciation, amortization or depletion deduction with regard to an item of property (or the stock of a “successor” to that member).

KPMG observation

While the government’s decision to adopt the “lesser of” rule is appreciated, the articulation of the rule creates certain complexities. First, applying the “lesser of” rule to a sale or other disposition of lower-tier member stock requires the determination of the gain in the stock of a lower-tier member that took EBITDA-period DAD deductions, even though there often will be no clear objective indication of the value of that lower-tier member. For example, assume (i) P owns S1, which owns S2, which owns S3, and all are a part of a consolidated group, (ii) S3 claims EBITDA-period DAD deductions, and (iii) P sells S1 to an unrelated buyer. The “lesser of” rule would require P to determine its gain on the stock of S3, even though the stock that was sold was S1 stock (not S3’s stock). Stated differently, while the purchase price generally establishes gain on the stock of the member that is sold, there may be no clear objective measurement of (and no other reason to determine) the amount of the purchase price attributable to any lower-tier subsidiaries for purposes of calculating the gain on those lower-tier subsidiaries, in order to apply the “lesser of” rule. When the potential ATI claw-back adjustments may be material, consolidated taxpayers should consider how to establish valuations for lower-tier members when engaging in divestment transactions.

KPMG observation

There are additional issues with respect to the application of the “lesser of” rule. For example, consider the fact pattern above, when P owns S1, which owns S2, which owns S3; S3 claims EBITDA-period DAD deductions; and P sells the stock of S1. P’s sale of S1 results in the
deconsolidation of S1, S2, and S3, and is treated as a disposition of all of the stock in each of those entities for purposes of the ATI claw-back rule. The “lesser of” rule would look solely to the stock of S3 because it is the member that claimed the EBITDA-period DAD deductions (and because there is no successor entity to S3 or successor asset to the S3 stock). It is not clear whether the “lesser of” rule would apply at all with respect to the disposition of the S1 or S2 stock (those members did not claim the underlying deductions), or if it did apply to S1 and S2 whether the benefit of the “lesser of” rule would extend to the dispositions of their stock.

KPMG observation

The actual calculations involved in applying the “lesser of” rule to the sale or other disposition of member stock may be quite complex in certain circumstances. For example, if a member that is deconsolidated has a loss (determined on a separate company basis) for the year of disposition, the circular stock basis rules of Reg. §1.1502-11(b) could preclude the member’s deduction of certain items, thus affecting the calculation of the amount of gain on the sale or other disposition of the member.

Limitation of ATI claw-back adjustments

The additions to TTI for EBITDA-period DAD deductions do not necessarily increase a taxpayer’s ability to deduct BIE. For example, the taxpayer’s section 163(j) limitation already may be sufficiently large (or its interest expense sufficiently modest) to permit a deduction of all of the taxpayer’s BIE even without such additions to TTI. Commenters stated that, in such a situation, applying the claw-back adjustments to reduce ATI could inappropriately decrease the amount of the taxpayer’s BIE deduction in the year the property, member stock or partnership interest is sold. The commenters recommended limiting the ATI claw-back adjustments to apply only to the extent that the prior-year addback of EBITDA-period DAD deductions resulted in an increase in deductible BIE.

The government agreed with this recommendation, and the 2021 Final Regulations provide that an ATI claw-back adjustment is reduced to the extent the taxpayer establishes, through its books and records, that its previous additions to TTI for EBITDA-period DAD deductions did not result in an increase in the amount allowed as a deduction for BIE for such year. Specifically, the 2021 Final Regulations define the “negative adjustment cap” for a prior tax year as the amount of the additions to TTI for EBITDA-period DAD deductions in that year, but only to the extent those additions increased the amount allowed as a deduction for BIE. The negative adjustment cap for a prior tax year is then reduced to the extent of the negative claw-back adjustments made with respect to that prior year, with the intent of preventing any further claw-back adjustments once any prior BIE deduction benefit has been effectively recaptured.

KPMG observation

In the 2020 Final Regulations, Treasury had declined to adopt a concept similar to the negative adjustment cap, stating that it would result in significant administrative complexity. The inclusion of the negative adjustment cap in the 2021 Final Regulations is a welcome change in position. However, it will likely create significant record-keeping obligations for many taxpayers (and their successors) to keep track of the “cap” applicable with respect to each prior year in the EBITDA period to appropriately apply the “cap” on subsequent asset dispositions. For example, assume a taxpayer purchased an asset in 2016, and claimed depreciation or amortization deductions on that asset in each year through 2023, when it sells the asset. To apply the negative adjustment cap, the
taxpayer should separately consider for each tax year in the 2018-2021 EBITDA period (1) the EBITDA-period DAD deductions on that asset for the year, (2) the extent to which its BIE deductions were increased as a result, and (3) the remaining, unused balance, if any, in its negative adjustment cap.

Further, to the extent the taxpayer is a “successor entity” as a result of a section 381 transaction or a transaction described in Reg. §1.1502-13(j)(5)(ii) (discussed below), it appears that the acquiring corporation or consolidated group must also take into account the relevant items of the acquired corporation or consolidated group, respectively, in calculating its negative adjustment cap for prior tax years, though no guidance is provided on how this should be implemented. This is a diligence item to consider in acquisition transactions.

### Capitalized depreciation

The 2020 Final Regulations provide that EBITDA-period DAD deductions that are capitalized under section 263A (“capitalized depreciation”) during the tax year are deemed to be included in the computation of the taxpayer’s TTI for such year, regardless of when the capitalized amount is recovered. Commenters requested clarification regarding how the ATI claw-back rule would apply with respect to capitalized depreciation. In response, the 2021 Final Regulations provide that a negative adjustment under the ATI claw-back rule would be required upon the sale or other disposition of property with respect to which an EBITDA-period DAD deduction was allowed or allowable during the EBITDA period (as opposed to, for example, the inventory into which the deduction is capitalized pursuant to section 263A) because it is the allowed or allowable depreciation, amortization or depletion of that property that is added back to TTI. The 2021 Final Regulations also clarify that successor asset rules would apply if such property subsequently were transferred to another member in an intercompany transaction.

### KPMG observation

It is not clear that the ATI claw-back rule for the sale or other disposition of member stock captures capitalized depreciation. For example, assume P owns the stock of S1; S1 generates capitalized depreciation in 2019; and P sells S1 to an unrelated buyer in 2024. The ATI claw-back rule that applies to the sale or other disposition of member stock (including the alternative computation method’s “lesser of” rule) refers to “the investment adjustments... with respect to such stock that are attributable to deductions described in paragraph (b)(1)(iii)(C)” (i.e., EBITDA-period DAD deductions). Because S1 would recover its costs reflected in the capitalized depreciation through an allowance for cost of goods sold (rather than through a deduction), and the investment adjustments in S1’s stock appear to be based on S1’s gross profit generated from the sale of its inventory (rather than on a deduction), it appears that the S1 stock will not have any investment adjustments that are attributable to deductions. This issue was raised with the government in the comments process. The preamble to the 2021 Final Regulations states that Treasury is continuing to consider this issue.

### Nonrecognition transactions

The 2021 Final Regulations, consistent with the 2020 Final Regulations, provide that in general the term sale or other disposition does not include a transfer of an asset to an acquiring corporation in a section 381(a) transaction (generally, a tax-free asset reorganization or subsidiary liquidation). The 2021 Final Regulations explicitly provide that the acquiring corporation in a section 381(a) transaction is a “successor entity” that generally steps into the shoes of the distributor or transferor corporation for purposes of the
ATI claw-back rule. The 2021 Final Regulations further provide that the disposition of property, including member stock and partnership interests, in a nonrecognition transaction (e.g., a section 351 or section 721 transaction) other than a section 381(a) transaction (or an intercompany transaction between members of a consolidated group), is treated as a taxable disposition for purposes of the “lesser of” rule. However, as noted below, a section 381(a) transaction in which a member leaves a consolidated group generally is treated as a sale or other disposition, unless the transaction is described under Reg. §1.1502-13(j)(5)(i) (i.e., a whole-group acquisition).

KPMG observation

The treatment of certain nonrecognition transactions as taxable for purposes of the ATI claw-back rule is only relevant to the extent a taxpayer is applying the “lesser of” rule (which requires a determination of the amount of gain deemed recognized on the nonrecognition transaction). In certain cases, treating a nonrecognition transaction as a taxable transaction for purposes of the “lesser of” rule may require valuing the transferred property.

Consolidated groups

The 2021 Final Regulations revise the ATI claw-back rule to clarify that the term “sale or other disposition” excludes all intercompany transactions to the extent necessary to achieve single-entity taxation of the consolidated group. The preamble to the 2021 Final Regulations provides that this change was intended to clarify that the net gain on a sale or other disposition of property outside of the consolidated group is the same regardless of whether the property is transferred in an intercompany transaction before leaving the group.

Consistent with the 2020 Final Regulations, the 2021 Final Regulations include a deconsolidation rule, pursuant to which any transaction (including a section 381(a) transaction) in which a member leaves a consolidated group is generally treated as a taxable disposition of all of the stock of that member. As a consequence, the consolidated group that benefitted from the prior increases to TTI for EBITDA-period DAD deductions would generally bear the “cost” of the negative claw-back adjustments when the property leaves the consolidated group. The 2021 Final Regulations expand the exception to the deconsolidation rule to transactions described in Reg. §1.1502-13(j)(5)(i)(A) and (B) (the exception to the deconsolidation rule in the 2020 Final Regulations applied only to whole-group acquisitions described in Reg. §1.1502-13(j)(5)(i)(A), but not to whole-group acquisitions that take the form of reverse acquisitions). To the extent this exception to the deconsolidation rule applies, the 2021 Final Regulations provide that the surviving group in the transaction is treated as a successor to the terminating group for purposes of the ATI claw-back rule.

KPMG observation

The expansion of the exception to the deconsolidation rule to include “reverse acquisitions” and other transactions described in Reg. §1.1502-13(j)(5)(i)(B) is a welcome change, as there had not been any apparent policy reason to limit the exception to solely whole-group acquisitions described in Reg. §1.1502-13(j)(5)(i)(A).

The 2021 Final Regulations also modify an apparent “glitch” in the 2020 Final Regulations, under which, if a transaction was exempt from the deconsolidation rule under the whole-group exception, any potential claw-back adjustments with respect to deductions taken in the acquired group were effectively disregarded and never taken into account by any taxpayer. The 2021 Final Regulations...
The 2021 Final Regulations, similar to the 2020 Final Regulations, contain successor asset rules, pursuant to which member stock received in exchange for property is treated as a successor asset for purposes of the claw-back rule with respect to that member stock. The 2021 Final Regulations also clarify the anti-duplication rule introduced in the 2020 Final Regulations to confirm that once an item of property is no longer held by any member of a consolidated group, no further adjustments to ATI are made in relation to the same property with respect to any subsequent stock disposition.

**Section 163(j) dividends distributed on regulated investment company (RIC) shares**

The 2021 Final Regulations adopt the rule in the 2020 Proposed Regulations that treats as interest a dividend paid by a RIC and identified as a section 163(j) interest dividend, subject to holding period requirements and other limitations. The total amount of a RIC’s section 163(j) interest dividends for a tax year is limited to the excess of the RIC’s BII for the tax year over the sum of the RIC’s BIE for the tax year and the RIC’s other deductions for the tax year that are properly allocable to the RIC’s BII.

**Implications of section 163(j) for partnerships and S corporations**

The 2021 Final Regulations address some of the rules contained in the 2020 Proposed Regulations that are applicable to passthrough entities. The provisions that were finalized are discussed below.

Among the notable proposed section 163(j) passthroughs regulations that were not finalized are (1) rules dealing with the tracing and the characterization of debt incurred in connection with a debt-financed distribution; (2) the proposed non-depreciable, non-amortizable basis increase to a partnership’s assets in connection with a partner’s disposition of a partnership interest with non-paid or accrued excess BIE; and (3) proposed tiered-partnership excess BIE tracking provisions. These items are subject to additional study by Treasury and may be finalized in the future. For a discussion of these items, read [TaxNewsFlash](#).

**Self-charged interest**

The self-charged interest rules in the 2020 Proposed Regulations were adopted without change. Thus, the rules apply only to lending transactions between a lending partner and a borrowing partnership in which the lending partner owns a direct interest.

The preamble to the 2021 Final Regulations specifically rejects the extension of the rule to indirect partners through tiered partnerships. However, the preamble indicates that additional consideration will be given to extending the application of the self-charged interest rules to an indirect lender that is a member of a corporate partner’s consolidated group. The preamble also notes that the self-charged interest rule is not extended to cover loans to an S corporation from a shareholder.
Trading partnerships

With respect to partnerships engaged in trading activities, the 2020 Proposed Regulations were largely adopted in the 2021 Final Regulations without change, except for the addition of a transition rule. The rules provide that the character of the interest expense allocated to a partner depends on whether the partner is considered to not materially participate in the trading activity, within the meaning of section 469, and is subject to the investment interest expense rules in section 163(d)(5)(A)(ii).

Specifically, under the 2021 Final Regulations, interest expense allocated by the trader fund to a partner that does not materially participate in the trading activity is treated as investment interest expense subject to section 163(d). Conversely, interest expense allocated to a partner that materially participates is subject to section 163(j) at the trader fund level. Similarly, other items of income and loss allocated to a non-materially participating partner in the trader fund are not included in the partnership’s ATI and are separately stated as investment items to the non-materially participating partner.

KPMG observation

While not entirely clear, the preamble to the 2021 Final Regulations seems to suggest that in a tiered structure, a partnership partner is not treated as a non-materially participating partner and, therefore, interest expense allocated to such partner will be treated as BIE, and not investment interest expense. As such, interest expense allocated to a feeder partnership would continue to be subject to section 163(j) at the master fund level. Most investors hold their interests in trader funds indirectly through entities, so the special trader fund rule will not be applicable in most cases. However, the interest expense subjected to section 163(j) at the trader fund level would not be subject to retesting under section 163(d) at the upper-tier partner level.

The 2018 Proposed Regulations provided that a trading partnership’s interest expense is first subject to section 163(j) at the partnership level and then, to the extent it is allocated to a non-materially participating partner, is also subject to 163(d) at the partner level. In years prior to the issuance of the 2020 Proposed Regulations, some partnerships that relied on the 2018 Proposed Regulations may have allocated excess BIE to partners that did not materially participate. Under the 2021 Final Regulations, passive partners cannot be allocated excess taxable income (“ETI”) and, thus, such partners may never be able to deduct the previously allocated excess BIE. To address this inequity, the 2021 Final Regulations contain a transition rule.

The 2021 Final Regulations provide that any excess BIE that was allocated to a non-materially participating partner in a prior tax year is treated as paid or accrued (without regard to the amount of ETI or excess BII allocated to the partner from the partnership) in the first tax year ending on or after the effective date of the 2021 Final Regulations—which should be the 2021 tax year for most partners. In addition, the 2021 Final Regulations provide that the paid or accrued excess BIE is deductible without any limitation under section 163(j) or section 163(d).

Application of CARES Act section 163(j) provisions

Special disposition rule with respect to 2019 excess BIE

Pursuant to the CARES Act, in the case of excess BIE of a partnership for any tax year beginning in 2019 that is allocated to a partner, 50% of such excess BIE is treated as BIE that is paid or accrued by the
partner in the partner’s first tax year beginning in 2020 and is not subject to the section 163(j) limitation at partner level (the “50% of 2019 EBIE Rule”).

The 2021 Final Regulations retain the taxpayer-favorable provision from the 2020 Proposed Regulations that allows a partner that disposes of its partnership interest in the partnership’s 2019 or 2020 tax year to still apply the 50% of 2019 EBIE Rule. In that case, the disposition will not result in a basis increase with respect to such excess BIE. The 2021 Final Regulations clarify that section 163(j) limited interest allocated to a partner that has not been treated as excess BIE because it was limited under section 704(d) is not eligible for the 50% of EBIE Rule.

The 2021 Final Regulations add further clarification that the election out of the 50% of 2019 EBIE Rule is made with respect to each partnership interest. Allowing partners to make the election out of the 50% EBIE Rule with respect to each partnership interest provides partners with greater flexibility in managing their tax consequences.

**Election to use 2019 ATI for tax years beginning in 2020**

Pursuant to the CARES Act, for any tax year beginning in 2020, taxpayers can elect to use their ATI from their last tax year beginning in 2019 for their ATI in the 2020 tax year. This raises questions in a partnership context as to how the 2019 ATI should affect the allocation of the partnership’s deductible BIE, as well as the partnership’s excess BIE or ETI, among the partners in 2020.

The 2021 Final Regulations reversed course from the formulaic rules provided in the 2020 Proposed Regulations in favor of a more simplified method for a partnership that elects to use its 2019 ATI in 2020. Under this simplified method, a partnership determines each partner’s allocable ATI by using the partnership’s 2019 section 704 income, gain, loss, and deduction items in determining its 2020 allocable ATI.

**KPMG observation**

The simplified method does not specifically address situations when there are changes in the partner constituency (e.g., new or departing partners) or differences in income allocations between 2019 and 2020. Because the applicability date of the 2021 Final Regulations is 60 days after the date of publication in the Federal Register, it appears that partnerships have flexibility to use other reasonable methods to determine each partner’s allocable ATI to the extent they are not otherwise relying on the provisions in the 2021 Final Regulations.

**Publicly traded partnerships**

In order to maintain the fungibility of publicly traded partnership units, the 2021 Final Regulations adopt the publicly traded partnership provisions in the 2020 Proposed Regulations without change. For a summary and observations of these provisions, read [TaxNewsFlash](#).

**Exempt small business entities and BIE look-through rules**

In a change from the 2018 Proposed Regulations, the 2020 Final Regulations allow an exempt small business entity to make an excepted business election for that entity’s eligible activity, such as a real property trade or business. However, for purposes of applying the look-through rules under Reg.
§1.163(j)-10 to determine whether a taxpayer’s BIE is properly allocable to an excepted or non-excepted trade or business, the 2020 Final Regulations only allow a taxpayer to look-through an exempt small business entity if that entity has made an excepted business election.

If a taxpayer indirectly holds an interest in an excepted trade or business conducted by a lower-tier entity through an exempt upper-tier holding entity that does not conduct its own trade or business and that could not make an excepted business election (such as an upper-tier holding partnership), the taxpayer would be ineligible to allocate the taxpayer’s BIE to the excepted trade or business. The 2021 Final Regulations do not provide relief for this issue and note in the preamble that the issue exceeds the scope of the 2021 Final Regulations. However, the preamble indicates that this issue will continue to be studied for potential future guidance.

**Implications of section 163(j) for foreign corporations**

The 2021 Final Regulations largely maintain the general organization and operative framework of the controlled foreign corporation (“CFC”) level BIE deduction limitation rules contained in the 2020 Proposed Regulations, but also reserve on certain significant features of the CFC Group Method that were included in the 2020 Proposed Regulations—read TaxNewsFlash for a detailed description of the rules applying section 163(j) to CFCs under the 2020 Proposed Regulations. The 2021 Final Regulations also clarify and narrowly revise certain rules in the 2020 Proposed Regulations that address certain taxpayer comments in a tailored fashion.

**Fully reserve on the effect of CFC inclusions and attributes on U.S. Shareholder ATI**

The 2020 Proposed Regulations would allow U.S. shareholders to include in ATI a certain portion of CFC inclusion items under the CFC Group Method as well as with respect to any stand-alone applicable CFC. In response to taxpayer comments, Treasury declared that further review of the computational methodology is required and, thus, the 2021 Final Regulations reserve entirely on the rules for determining the portion of a U.S. shareholder’s subpart F and GILTI inclusions that the U.S. shareholder would be allowed to include in ATI. In effect, U.S. shareholder ATI fully excludes CFC income inclusion items under the Final Regulations.

**KPMG observation**

The 2021 Final Regulations provide a complicated maze of reliance and retroactive application rules, which have been made more challenging by Treasury’s decision to fully reserve on this key feature of the CFC Group Method while finalizing the vast majority of the CFC-level computational rules contained in the 2020 Proposed Regulations. Subject to consistency and related-party requirements, taxpayers are permitted to apply the “unfinalized” rules contained in the 2020 Proposed Regulations (e.g., the U.S. Shareholder ATI add-back rule for CFC inclusion items) that were expressly reserved in the 2021 Final Regulations in prospective tax years when the taxpayer is required to apply the 2021 Final Regulations (e.g., 2022 for a calendar-year taxpayer).

Also, the “Applicability Dates” section provides that taxpayers and their related parties may choose to apply either the 2021 Final Regulations or the 2020 Final Regulations (or 2020 Final and Proposed Regulations) to tax years earlier than their required applicability (e.g., calendar year taxpayers may choose to rely on the 2021 Final Regulations in 2018), subject to robust consistency.
requirements. Nonetheless, if a taxpayer were to apply the 2021 Final Regulations retroactively, it appears that such taxpayer would be precluded from applying any of the “unfinalized” rules contained in the 2020 Proposed Regulations, and thus such taxpayer ostensibly could not apply any U.S. shareholder ATI add-back rule for CFC inclusion items in such earlier tax year. This apparent result is puzzling, and it is unclear whether such result was actually intended by Treasury.

The decision to preclude taxpayers from relying on the U.S. shareholder ATI add-back rule for CFC inclusion items contained in the 2020 Proposed Regulations when retroactively applying the 2021 Final Regulations will discourage many U.S. shareholder-ATI sensitive taxpayers from applying the 2021 Final Regulations to earlier tax years. Such taxpayers instead may prefer to retroactively apply the 2020 Final and 2020 Proposed Regulations in their entirety.

ATI computation for an applicable CFC

For purposes of computing CFC-level ATI, the 2020 Proposed Regulations provided that a CFC’s tentative taxable income would be net of foreign income taxes. In response to taxpayer comments, Treasury acknowledged that it is appropriate to determine the ATI of an applicable CFC without regard to a deduction for foreign income taxes that are eligible to be claimed as a foreign tax credit. Accordingly, the 2021 Final Regulations provide that CFC-level ATI is determined gross of foreign income taxes (as defined in Reg. §1.960-1(b)), regardless of whether an election is made to claim a tax credit for these foreign income taxes.

KPMG observation

The decision to change the computation of CFC-level ATI from an amount net of foreign taxes to gross of foreign taxes is perhaps the most significant taxpayer-favorable revision to the international rules contained in the 2020 Proposed Regulations. For taxpayers that have highly leveraged CFCs that operate in high-tax jurisdictions, this new rule could meaningfully enhance CFC-level interest expense deduction capacity under section 163(j).

Application of CFC Group method under the 2021 Final Regulations

Single section 163(j) limitation for a CFC Group and application of U.S. consolidated return group principles

Consistent with the 2020 Proposed Regulations, the 2021 Final Regulations provide that a single section 163(j) limitation is computed for a CFC Group by application of U.S. consolidated return group principles, subject to certain modifications.

For this purpose, the current-year BIE, disallowed BIE carryforwards, BII, and ATI would be determined first on a separate-company basis for each CFC Group Member. The CFC Group’s single section 163(j) limitation would be computed based on the sum of all of these separately determined amounts.

Treasury clarifies in the 2021 Final Regulations that the general rule that ATI of a taxpayer cannot be less than zero (the “no negative ATI rule”) is applied at the CFC Group level rather than at the CFC Group Member-level. In other words, the ATI of CFC Group Members may take into account negative amounts for purposes of determining the ATI of a CFC Group.
While the 2020 Proposed Regulations would have treated all CFC Group Members as a single C corporation for certain purposes—such as the allocation of BIE to excepted trades or businesses and treating amounts as interest—the 2021 Final Regulations generally reserve on these rules, and they remain subject to further study.

Treasury rejected taxpayer comments to remove the application of separate return limitation year (“SRLY”) principles to pre-group disallowed BIE carryforwards. Treasury also clarified that section 382 applies to disallowed BIE carryforwards of CFCs. Certain other aspects of the interaction of sections 382 and 163(j) to CFCs remain under further study and may be addressed in future guidance.

KPMG observation

The application of U.S. consolidated return group principles to CFCs could be challenging for taxpayers, as these rules have not been applied previously in the CFC context. The incorporation of SRLY principles to pre-group disallowed BIE carryforwards may increase compliance complexity, as taxpayers must separately track such carryforwards.

While the confirmation that section 382 applies to CFC disallowed BIE carryforwards is not surprising, the application of section 382 principles at the CFC-level is likely to remain challenging for taxpayers in the absence of additional guidance and coordination rules.

Definition of specified groups and CFC Groups

The 2021 Final Regulations generally retain the definition of specified groups and CFC Groups contained in the 2020 Proposed Regulations, including the 80% ownership threshold, subject to certain limited clarifications. Read TaxNewsFlash for a detailed description of the specified group and CFC Group definitions.

The 2021 Final Regulations modify the definition of a specified group to clarify that such term includes fully horizontal first-tier CFCs structures. The definition of a specified group member is modified to clarify that an applicable CFC is not a specified group member unless a specified group exists (i.e., there must be at least two or more applicable CFCs that form a specified group).

Making or revoking a CFC Group election

Treasury rejected taxpayer comments requesting the right to make or revoke the CFC Group election on an annual basis. Instead, the 2021 Final Regulations retain the 60-month lock-in period approach contained in the 2020 Proposed Regulations, which provides that a CFC Group election cannot be revoked for at least 60 months following the end of the specified period for which it was made. Once revoked, the CFC Group election cannot be made again for another 60-month period.

The 2021 Final Regulations also broadly retain the CFC Group election time and manner disclosure rules contained in the 2020 Proposed Regulations, but now also require that each designated U.S. person must attach the CFC Group election statement to its U.S. tax return for each year in which the CFC Group election remains in effect.
Other miscellaneous rules

Expanded CFC intragroup transactions anti-abuse rule

As noted above, the U.S. consolidated return principles approach under the CFC Group method generally does not apply to CFC intragroup transactions. The 2020 Proposed Regulations contain an anti-abuse rule, however, that would disregard an intragroup transaction between CFC Group Members if a principal purpose of entering into the transaction was to affect the CFC Group’s or CFC Group Member’s section 163(j) limitation by increasing or decreasing the CFC Group or CFC Group Member’s ATI.

The 2021 Final Regulations retain and expand this anti-abuse rule to intragroup transactions if a principal purpose of such transactions is to affect the section 163(j) limitation computation by increasing the CFC Group or CFC Group Member’s BII. Treasury explained that intragroup transactions that increase BII are potentially abusive because they may affect the location of the section 163(j) deduction within the CFC Group, which can affect the amount of a CFC Group Member’s subpart F and tested income (or tested loss).

Expanded safe-harbor election eligibility

The 2021 Final Regulations narrowly broaden the annual safe-harbor election eligibility threshold contained in the 2020 Proposed Regulations that, if made, precludes the disallowance under section 163(j) of any BIE of CFC Group Members and/or stand-alone applicable CFCs, as applicable. Under the 2020 Proposed Regulations, a stand-alone applicable CFC and/or CFC Group would be eligible for the safe-harbor election only if the BIE of the stand-alone applicable CFC and/or CFC Group does not exceed 30% of the applicable CFC’s “eligible amount” (i.e., subpart F income and GILTI inclusion, ignoring tested losses) (not to exceed the CFC’s qualified tentative taxable income) attributable to non-excepted trades or businesses.

The 2021 Final Regulations expand the eligibility threshold to also include applicable CFCs without net BIE. In addition, the 2021 Final Regulations narrowly modify the “eligible amount” definition to take into account CFC tested losses.

KPMG observation

According to the preamble, the safe-harbor election is intended to reduce the compliance burden on applicable CFCs that would not have disallowed BIE if they applied the section 163(j) calculations.

The extent to which the safe-harbor election mitigates the section 163(j) compliance burden for CFCs remains unclear, however, as neither the 2020 Proposed Regulations nor the 2021 Final Regulations nor Form 8990 provides guidance as to the extent to which the Form 8990 filing obligation in respect of an applicable CFC is affected by a safe-harbor election.

High-tax exceptions

In response to taxpayer comments, Treasury in the 2021 Final Regulations clarified the interaction between the application of section 163(j) to CFCs and the subpart F and GILTI high-tax exceptions. Specifically, the 2021 Final Regulations reject a taxpayer recommendation first to apply section 163(j) on a CFC-by-CFC basis, regardless of whether a section 163(j) CFC Group election is in effect, for purposes
of applying the subpart F high-tax exception and GILTI high-tax exclusion followed by reapplying the section 163(j) CFC Group method by excluding the ATI and BIE of high-tax CFC Group members. In rejecting this multi-step approach, Treasury confirmed that the application of the section 163(j) CFC Group method is not modified for purposes of applying the subpart F and GILTI high-tax exceptions.

In addition, the 2021 Final Regulations confirm that a CFC to which the high-tax exceptions apply can still have disallowed BIE carryforwards. For example, if a CFC has disallowed BIE arising in a tax year in which the CFC’s income is fully excluded under the high-tax exceptions, such CFC’s disallowed BIE nonetheless may be carried forward and utilized in a future tax year in which the high-tax exceptions do not apply to reduce the CFC’s income.

**CFC Group Members with ECI**

The 2020 Proposed Regulations provided that an applicable CFC with ECI would not be precluded from being a CFC Group Member. The ECI items of the applicable CFC, however, would not be included in the CFC Group calculations. The ECI of the applicable CFC would be treated as income of a separate CFC (an “ECI Deemed Corporation”), which would be excluded from the CFC Group and subject to a separate section 163(j) calculation for its ECI in accordance with the proposed rules that apply to foreign persons with ECI.

In response to a taxpayer comment requesting clarification regarding the proper method for allocating assets between the CFC Group Member and the ECI Deemed Corporation, Treasury declined to provide a specific allocation rule and instead instructed taxpayers to use a “reasonable method” for allocating such assets that is consistently applied to all CFC Group Members and each specified period of the CFC Group. Future consideration of this issue remains subject to Treasury’s broader endeavor to study the application of section 163(j) to foreign corporations with ECI.

**Application of section 163(j) to foreign persons with U.S. ECI—Reg. §1.163(j)-8**

The 2021 Final Regulations fully reserve on the rules contained in the 2020 Proposed Regulations that would apply section 163(j) to foreign persons with U.S. ECI. Treasury stated that the methods of determining the amount of deductible BIE and disallowed BIE carryforwards allocable to ECI remain subject to further study and that future guidance that addresses section 163(j)’s application to foreign persons with ECI is anticipated.

**State and local tax implications of section 163(j) regulations**

**State corporate income tax considerations**

The 2020 and 2021 Final Regulations answer many key federal issues and raise some new ones.

On the state and local tax side, the complexities associated with a state’s conformity to section 163(j) and now the 2021 Final Regulations generally stem from three main issues. The first is conformity in general. Currently, eight states have specifically decoupled from section 163(j). Other states do not adopt section 163(j) because they have unusual conformity to the Internal Revenue Code (IRC) or update their conformity only sporadically (e.g., Arkansas, California, Mississippi, and Texas). Take California, for example, which generally adopts the Internal Revenue Code as of January 1, 2015, and conforms to a few TCJA changes but did not adopt revised section 163(j). The conformity question is made more
complicated by the CARES Act changes to section 163(j).

Certain states adopt these changes and other states do not—either because they have not updated their conformity to capture a version of the IRC that incorporates the CARES Act, or because they have specifically decoupled from the taxpayer-favorable CARES Act changes. Tax professionals expect that conformity to the CARES Act changes will be an issue certain states will address during their 2021 legislative sessions.

KPMG observation

Another area of state conformity that may raise issues for taxpayers is state conformity to most federal elections. The 2021 Final Regulations note the ability for taxpayers to make elections to apply different versions of the proposed and final regulations under section 163(j) to certain tax years. In most states, those elections carry over to the computation of state taxable income. This can be detrimental in instances when an election made at the federal level may produce a favorable tax result for a group of corporations filing a consolidated federal income tax return, but that same election may cause a worse state tax result in a state that requires filing on a separate company basis. Similar issues arise in many states when the state filing group or methodology differs from the federal filing group.

Beyond the issues related to federal conformity and elections, the second main issue that needs to be considered for state tax purposes is how the section 163(j) limitation is computed when the state filing group or filing methodology differs from the federal filing group or federal filing method. Earlier iterations of the section 163(j) proposed and final regulations confirmed that a federal consolidated group has a single section 163(j) limitation.

The 2021 Final Regulations provide further clarifications regarding the application of certain rules to taxpayers filing a federal consolidated return. For state corporate income tax purposes, a number of states will require the federal consolidated group member to file a separate state return and calculate state taxable income beginning with federal taxable income determined “as if” the corporation had not elected to file a federal consolidated return. This is the general approach in states that require separate entity filing. In other states, combined or consolidated reporting is allowed, but the state’s law requires the computation of the group’s taxable income to be computed as if the group members had filed separate federal returns.

Even in states that adopt the federal consolidated return regulations, the state group will likely differ from the federal group. If the 163(j) limitation must be computed on a separate entity basis or on a state group basis, there may be significant differences in the section 163(j) limitation for state purposes. In some cases, there may not be a group limitation for federal purposes, but on a separate entity basis a taxpayer may have a limit. Certain states—far from all—have issued guidance on calculating the state limitation. And the states that have issued guidance have not been consistent in their approaches.

Finally, corporate taxpayers must consider the interaction between state related-party interest addback rules and the section 163(j) limitation. Many states have statutes that require an addback of interest or intangible-related interest paid to related parties, unless an exception applies. With the advent of section 163(j), the question arises as to what to do when there is a federal limit to the amount of interest that can be deducted and also a separate state rule that limits the deductibility of intercompany interest. The intersection of these two provisions creates an ordering problem. Is the state related-party interest addback applied before or after the section 163(j) limitation? Certain states have provided guidance on this issue and generally, taxpayers are required to proportionally apply the limitation to related and third-party interest expense. At least one state (Massachusetts) applies a different approach. Massachusetts
requires taxpayers to apply the section 163(j) limitation after applying the related-party addback rules.

State considerations specific to partnerships

As with corporations, the effects of section 163(j) on the state taxation of partnerships and their partners vary depending on whether states conform to the federal provision. Even if a state adopts section 163(j) generally, it may not conform to the amendments to section 163(j) in the CARES Act, or it may have its own state law provisions that alter the application of section 163(j) for state purposes. For a state that does not conform to a computation used in determining federal taxable income—such as section 163(j)—a disconnect arises that leads to separate computations, reporting, and tracking.

For example, if the section 163(j) federal limitation applies for a partnership and its partners in a particular tax year, the partnership and its partners would likely be allowed a greater interest deduction for this tax year in a decoupling state, which does not apply the section 163(j) limitation to partnerships. In a subsequent tax year, if the partnership’s “excess items” result in the partners taking a deduction for the interest expense from the prior tax year on their federal returns, then the partners, who already deducted this interest expense for the prior tax year in the decoupling state, would not be permitted another deduction in the decoupling state for this same interest expense. Tracking is required as a result of this variance in timing of deductibility between a potential future tax year federal deduction for this interest expense at the partner level and the current state deduction taken, without limitation, at both the partnership and partner levels in a decoupling state.

KPMG observation

In the partnership context, the various filings that are potentially affected by section 163(j) limitations can include tax returns for partnerships taxed at the entity level, partnership filings that report state income to partners, nonresident withholding returns, partner composite tax returns, and partner individual or corporate tax returns. While partnerships are required to report state source income and nonresident withholding credits up through multiple layers of tiered partnerships, for conforming states, the “entity approach” for section 163(j) correspondingly limits the state reporting for section 163(j) to the direct partner level. However, for decoupling states, the additional deduction for interest expense paid or accrued in the current tax year results in the need to report that adjustment up through multiple tiers. This also requires reporting a corresponding adjustment in a later tax year if the interest expense disallowed by section 163(j) becomes deductible in computing federal income, so that the expense is not deducted again in computing income for that decoupling state.

State computations for decoupling from CARES Act provisions may be required for partners in addition to partnerships. For example, the federal rules can provide partners with a deduction beginning in 2020 for 50% of excess business interest expense that was allocated to a partner in tax years beginning in 2019. If a state has adopted the application of section 163(j) to partnerships, but has not adopted this CARES Act provision, then the partner may still have an excess interest expense for state purposes that needs to be tracked for the partner to prepare future tax year state computations properly. Adjustments may be needed in jurisdictions like New York State and New York City, which conform to section 163(j) under the TCJA but generally decouple from the CARES Act changes to section 163(j). This also affects entity-level taxes imposed on partnerships, such as the New York City unincorporated business tax.
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