CFC Rule Reserved in Final Interest Regs Creates Predicament

by Emily L. Foster

The recently finalized business interest deduction regulations unexpectedly reserved on a favorable rule for U.S. shareholders of controlled foreign corporations, presenting a quandary for taxpayers looking to apply the rules.

In the final regs (T.D. 9943) issued January 5, Treasury and the IRS clarified how to apply the section 163(j) rules for limiting business interest deductions to CFCs, but they left in proposed form several rules, including a critical one affecting U.S. shareholders. That decision shocked practitioners and complicates taxpayers' calculus for determining which rules to apply retroactively, in the current year, and prospectively.

With Treasury and the IRS's apparent rush to get guidance out and their decision to reserve on several areas, the law is still unclear, Kevin M. Jacobs of Alvarez & Marsal Taxand LLC told *Tax Notes*.

Despite criticism from some industry groups, the government never wavered from its position in 2018 proposed regulations (REG-106089-18) that the section 163(j) regulations apply to CFCs. But it endeavored to create a construct — a CFC group election — for determining adjustments that would increase shareholders' adjusted taxable income, and therefore the basis for computing their business interest deduction limit.

However, no provision exists in the final rules because Treasury and the IRS decided not to finalize prop. reg. section 1.163(j)-7(j), which was included in 2020 proposed regs (REG-107911-18) and provided a beneficial rule for U.S. shareholders of CFCs making the group election. Still, the government said taxpayers may apply the proposal subject to some requirements.

Treasury and the IRS continue "to study the method for determining the portion of the specified deemed inclusions of a U.S. shareholder that should increase its ATI," the preamble to the final regs states. The government might address the issue in future guidance and will consider the comments it has received at that time, according to the preamble.

The Tax Cuts and Jobs Act amended section 163(j) to limit the business interest expense deduction to the sum of business interest income, 30 percent of ATI, and floor plan financing interest. Taxpayers may indefinitely carry forward business interest expense disallowed as a deduction for any tax year. That amount of disallowed interest expense is treated as business interest paid or accrued in the subsequent year.

The Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136) increased the net business interest deduction limit from 30 percent of ATI to 50 percent for tax years beginning in 2019 or 2020, with special rules provided for partnerships.

Significant Transition Issue

Like the 2020 proposed rules, the final regs include a simplified approach for determining business interest expense deductibility for CFCs and their U.S. shareholders.

Under reg. section 1.163(j)-7, multinationals that make the CFC group election apply the section 163(j) limitation on an aggregate basis. The single section 163(j) limitation is determined by adding up the applicable items for all CFC group members and allocating the limitation to each member. The regulations leverage the rules applicable to consolidated groups with some distinctions.

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The CFC group approach in the 2020 proposed regs provided multinationals with an alternative to determine the applicable business interest expense limitation in which global intangible low-taxed income and subpart F inclusions attributable to an applicable CFC can be taken into account in determining the U.S. shareholder's ATI.

However, Jacobs explained, the government has effectively decoupled the rules for determining the ATI and excess taxable income of the CFC group — which are in the final 2021 regs — from the rules that provide for the addback to the U.S. shareholder.

That means the only mechanism for increasing ATI — likely the most important aspect for highly leveraged multinationals with CFCs with GILTI but without any debt — is the 2020 proposed rule, said David E. Sites of Grant Thornton LLP.

That raises the question whether taxpayers can rely on the proposed regs, as permitted in the final rules, without additional concerns about other provisions they must also apply, Sites said.

Apparently Troublesome Allocations

Neither the 2020 proposed rules nor the simultaneously released final regs (T.D. 9905) provided sufficient guidance for computing the increases to ATI, commentators argued, prompting requests for clarifications.

A critical question raised was how a U.S. shareholder with subpart F income or GILTI should determine whether that income is allocable to an excepted trade or business, Jacobs said.

In a November 2020 report, the New York State Bar Association Tax Section recommended that specified deemed inclusions be treated similarly to dividends under reg. section 1.163(j)-10(b)(3). Thus, the deemed inclusion "should be treated as allocable to excepted or non-excepted trades or businesses based upon the relative amounts of the CFC's adjusted basis in its assets used in the trades or businesses," the group said.

Jacobs pointed out that by virtue of not finalizing those rules, Treasury and the IRS chose not to adopt that approach. "So taxpayers are left with determining . . . what is or isn't allocable to an excepted trade or business," he said.

According to the preamble to the new final regs, the government also continues to study how section 163(j) applies to foreign corporations with effectively connected income, and thus taxpayers "should use a reasonable method for allocating assets between the CFC group member and the ECI deemed corporation" and apply that method consistently to all group members and for each specified period after the first period it's applied.

Retroactive Maze

I. Lee Holt of EY explained that practitioners and taxpayers spent a lot of time working through the options for applying section 163(j) for tax years 2020 and earlier — that is, either applying the statute, the 2018 proposed regulations, or the 2020 final and proposed regs.

With the new final regs added to the mix, taxpayers will face new questions in trying to understand the options for different tax years, such as 2021 and 2022, and how the new reg package might affect decisions regarding prior years, Holt said.

Different provisions of the reg package have different applicability rules, Holt said, so taxpayers must methodically work through "several important procedural aspects even before [getting] into the nuts and bolts of the regulations." With the temporary relief in the CARES Act, some taxpayers might have skirted the limitation, and therefore haven't had to delve into the rules and nuances, he said.

And with the net business interest expense limit reverting back to 30 percent of ATI this year, "everybody will have to sharpen their pencil on their positions" for tax year 2021, Holt warned.

For calendar-year taxpayers, the 2020 final regulations are generally applicable to tax years beginning in 2021, while the 2021 final rules are generally applicable to tax years beginning in 2022 — that is, for tax years beginning on or after the date that is 60 days after the rules are published in the *Federal Register*, which hasn't yet occurred.

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Each time the government has issued new section 163(j) regulations, it has allowed taxpayers to retroactively rely on those rules, Jacobs said. He pointed out that taxpayers could choose which rules to apply on a year-by-year basis, but if they adopted the 2020 proposed regs, they also had to apply the final 2020 rules and do so prospectively — with some exceptions.

Taxpayers and their related parties generally may apply the 2021 final regs to tax years beginning after December 31, 2017, and before their applicability date, provided they consistently apply the 2020 final regs, as modified by the new rules and other applicable provisions, to the applicable tax year and each subsequent year.

Alternatively, taxpayers and their related parties may rely on the rules in the 2020 proposed regulations as provided in those regs.

For a rule in the 2020 proposed regs that hasn't been finalized, taxpayers and their related parties may rely on that rule for tax years beginning on or after the applicability date of the final 2021 regs if they consistently follow all of the 2020 proposed rules that haven't been finalized for the applicable tax year and subsequent years until the rule is issued as final or other guidance regarding continued reliance is issued.

Picking and Choosing

The section 163(j) consolidated group rules apply to CFCs except when they don't.

Treasury and the IRS disregarded several recommendations they received on the CFC group rules that they deemed inconsistent with consolidated return rules.

For example, the government dismissed business groups' pleas to modify the proposed rule providing that the group election can be revoked only after five years and that once revoked, it can't be made again for five years. Recommendations included making it an annual election.

Similarly, the government rejected recommendations to reduce the 80 percent ownership threshold for determining eligible CFC group members to 50 percent, which commentators said would ease administrative burden and be consistent with ownership thresholds for applying other rules, such as the GILTI and subpart F regimes.

Jacobs observed that in many cases, Treasury and the IRS appeared to be aiming to align the rules with the consolidated group principles and then justify their decisions based on that. But he said in other places — such as transactions among

CFC group members — the government said it must respect the fact that the group isn't a consolidated group, resulting in those transactions being taken into account subject to an antiabuse rule.

Because there's not a bright line, "the government seems to have the ability of choosing when [a CFC group] should or shouldn't be like a consolidated group," Jacobs said. He added that some areas Treasury and the IRS reserved on in the final regs also reflect their balancing act in applying the rules to CFC groups.

Sites noted that the government is apparently reconsidering the proposed regs that would have treated all CFC group members as a single C corporation or as a single taxpayer for some purposes.

Treasury and the IRS said they continue to study the proper method for allocating items of a CFC group member to an excepted trade or business and when it's appropriate to treat a CFC group as a single entity.

High-Tax Exception

Responding to comments, Treasury and the IRS clarified the interplay between the section 163(j) interest deduction rules and the high-tax exceptions that could be applicable to some CFC group members: the subpart F high-tax exception under reg. section 1.954-1(d) and the GILTI high-tax exclusion under reg. section 1.951A-2(c)(7).

The final regs explain that the high-tax exception doesn't modify the rules for determining the interest deduction limitation or the amount of an applicable CFC's disallowed business interest expense carryforward, and therefore a CFC to which the high-tax exceptions can apply in a tax year might have disallowed business interest carryforwards in the years in which business interest expense is disallowed.

NYSBA suggested that if a U.S. shareholder "elects to exclude certain high tax GILTI income from a CFC's tested income, Treasury and the IRS should consider whether the related ATI and interest expense should be taken into account for purposes of applying section 163(j) to the remaining income of the CFC or CFC group."

Treasury and the IRS nixed the group's specific multistep recommendation, explaining that "applying section 163(j) first to each CFC group member on a separate-entity basis, then applying the high-tax exceptions, and then reapplying section 163(j) to a CFC group by excluding income eligible for the high-tax exceptions, would significantly increase the administrative and compliance burdens of section 163(j) and therefore reduce the benefits of making a CFC group election."

Further, the preamble says the approach would be "inconsistent with the general concept and purpose of a consolidated approach to the CFC group election; for example, it would increase the relevance of the location of intragroup debt and ATI within a CFC group and could inappropriately enhance the effective foreign tax rate of such income." ■