Glitches Persist in Consolidated Group Interest Deduction Rules

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By Emily L. Foster

The IRS is considering unexpected consequences that could arise in computing the business interest deduction limits upon the sale or disposition of stock of a consolidated group member with depreciable property.

The government published final section 163(j) regulations (T.D. 9943) in the *Federal Register* January 13 — which followed up on 2020 final (T.D. 9905) and proposed regs (REG-107911-18) — but issues raised in the consolidated group context continue to be worked on, according to John Lovelace, branch 3 senior counsel, IRS Office of Associate Chief Counsel (Corporate), who spoke during a February 23 webinar hosted by the District of Columbia Bar Taxation Community.

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 adjusted taxable income, and floor plan financing interest. 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.

Congress provided taxpayers with some relief on the deductibility of business interest for the first four years after the TCJA's enactment by allowing them to add back allowable depreciation, amortization, and depletion in determining ATI for tax years beginning before January 1, 2022.

Section 163(j)(8)(B) grants Treasury the authority to require other adjustments — beyond those enumerated in section 163(j)(8)(A) — for the purposes of computing ATI, which the IRS did for the sale or other disposition of depreciable property if the depreciation was allowed or allowable for tax years beginning in 2018 through 2021.

Treasury and the IRS designed rules to prevent taxpayers from getting a potential double benefit — that is, receiving a benefit in computing the business interest expense cap for those years with immediate full expensing of property available under section 168(k) and then getting another boost on the gain recognized when selling the asset.

Still Some Anomalous Results

For dispositions of a consolidated group member's stock, complexities arise in determining the negative adjustment, also referred to as recapture or "clawback adjustment," for computing ATI.

The 2021 final regulations include a "lesser of" option for computing the adjustment — the lesser of the gain on the sale or disposition of member stock and the reg. section 1.1502-32 investment adjustment attributable to the depreciation, amortization, or depletion deductions on the property for which there was an increase in the amount allowed for business interest expense deduction under section 163(j).

An accompanying provision is the consolidated group anti-duplication rule, which is designed to prevent a double reduction in computing ATI if, for example, it was reduced for depreciation upon the disposition of assets or stock of a member while it was in the group and the parent later sells its stock in the subsidiary in a transaction that could trigger a second reduction.

Kevin M. Jacobs of Alvarez & Marsal Taxand LLC analyzed several examples to showcase unexpected results in applying the "lesser of" and anti-duplication rules.

In the first situation, P is the parent of a consolidated group, of which S and T are members. P owns the stock of S, and S owns the stock of T. In 2021 T purchases equipment with a fair market value of $90x and fully depreciates the asset under section 168(k). In 2024 S sells all its stock in T to an unrelated person for $40x.

In the second scenario, rather than S selling its stock in T, P sells all its stock in S to an unrelated person for a gain of $50x, of which $40x is attributable to T stock and $10x is attributable to nondepreciable property.

Jacobs explained that in the sale of the lower-tier entity (T), the "lesser of" rule applies, resulting in a negative ATI adjustment of $40x. In the sale of S, there's a deconsolidation of both S and T, in which the "lesser of" rule applies in the S stock disposition but not in the T stock disposition, he explained, noting that in the latter the anti-duplication rule steps in to limit the ATI adjustment to $90x.

The clawback adjustment, however, should be the same regardless of whether S sold T or P sold S, "but it doesn't appear that that's actually how the regulations work," Jacobs said.

Lovelace agreed, saying it wasn't the intended result. He noted that "the 'lesser of' rule contemplates either a sale of stock of the entity holding the property or a sale of stock that is a successor asset."

In the second example, S isn't holding property, and its stock isn't a successor asset, and so "if you read the 'lesser of' rule literally, it wouldn't apply," Lovelace said. "We're aware of this issue and this is something we're actively considering."

'Host of Tracing'

Jacobs pointed out that under the "lesser of" rule, the gain determination is on the member's stock — on the disposition of the stock of the group member that holds the property — but the anti-duplication rule applies at the property level. If that's the correct synopsis, then it will be important to keep that in mind, he added.

"The purpose of the anti-duplication rule is to prevent taxpayers from ever having a negative adjustment that's greater than the amount of increased ATI they've received from the addback. So yes, we felt it was absolutely necessary to put some sort of backstop in place," Lovelace said.

That means that in determining how much depreciation has been taken on an asset, taxpayers need to consider the depreciation taken by all members, Lovelace said.

Gregory Fairbanks of Grant Thornton LLP emphasized that accurately implementing the rules requires "two fairly robust data sets" — the valuation of the subsidiary's stock and the adjustments under reg. section 1.1502-32.

"That's going to involve a host of tracing," Jacobs added, which is evident in a third example he discussed in which the only difference is that S has depreciable equipment, for which the "lesser of" rule would apply but raises additional questions when applying the regs.

It's hard to address the issues in that hybrid example, in which the S stock is a successor asset for some property and not others, because the IRS is still considering what to do about the second example, Lovelace said.

"We might want to consider a bottom-up approach [but] . . . because we haven't gotten to the point where we know what the right answer is, I can't say exactly" how taxpayers should deal with that situation, Lovelace said.