

IRS Previews Upcoming Guidance on Interest Deduction Limitation

The IRS announces certain key aspects of the interest deduction limitation that will be addressed in upcoming Treasury regulations.

Key Points:

- The 30% Cap (as defined below) will apply at the consolidated group level.
- All interest income and interest expense of a C Corporation will constitute business interest.
- The 30% Cap will not affect the computation of the earnings and profits of a C corporation.

On April 2, 2018, the Internal Revenue Service (the IRS) issued Notice 2018-28 (the Notice), describing certain provisions of proposed regulations that the US Treasury and IRS intend to issue under Section 163(j) of the Internal Revenue Code (the Code) (the Proposed Regulations).¹ Section 163(j), enacted as part of the Tax Cuts and Jobs Act (the Act),² limits interest deductibility for corporations and pass-through entities by imposing a 30% cap on net business interest (the 30% Cap), effective for taxable years beginning after December 31, 2017. The Notice confirms that the Treasury and IRS intend to take the approach generally anticipated by commentators in interpreting several key aspects of the 30% Cap. Taxpayers may rely on the rules as described in the Notice prior to the issuance of the Proposed Regulations. The Notice thus removes some uncertainty in the application of these key provisions and allows borrowers and lenders to better model the impact of the 30% Cap on financings.

Latham & Watkins has published additional [materials analyzing the 30% Cap and its impact on leveraged finance](#), as well as [the provisions of the Tax Cuts and Jobs Act more generally](#), and will continue to provide resources, including worthwhile third-party content materials, and insights through the [Latham & Watkins US Tax Reform Resource Center](#).

The 30% Cap will apply at the consolidated group level.

The Notice confirms that the Proposed Regulations will follow the legislative history and apply the 30% Cap at the consolidated group level.

- Only interest expense incurred on indebtedness to parties outside the consolidated group will be subject to the 30% Cap. Intercompany debt within the consolidated group will be disregarded.
- The relevant adjusted taxable income for purposes of computing the 30% Cap will be based on the consolidated taxable income of the consolidated group that includes the borrower.
- The Notice lists certain other consolidated return issues that will be addressed in the Proposed Regulations, including:

- Allocation of the 30% Cap among consolidated group members, issues arising from members leaving or joining the group, and intra-group stock basis adjustments resulting from the 30% Cap.
- The application of the 30% Cap to a consolidated group that includes one or more members engaged in real estate, farming, or utilities businesses, which are not subject to the 30% Cap.

All interest income and interest expense of a C Corporation will be business interest.

The 30% Cap applies only with respect to “business interest.” The Notice confirms that the Proposed Regulations will follow the legislative history and will treat all interest income earned and interest expense incurred by a C Corporation as business interest.

- S Corporations will not be covered by this rule.
- The Proposed Regulations will address whether and to what extent interest expense and interest income of a non-corporate entity in which a C Corporation holds an ownership interest will be characterized to such C Corporation as business interest expense or business interest income. Although the Notice does not indicate what approach the Proposed Regulations will take in that regard, it is possible that such interest expense or interest income would not automatically be treated as business interest solely because of being allocated to a corporate partner.
- The Notice provides no guidance on what constitutes business interest expense or interest income for non-corporate businesses.

The 30% Cap does not impact the computation of a C Corporation’s earnings and profits.

The disallowance and carryforward of interest under the 30% Cap will not affect whether or when such business interest expense reduces earnings and profits of the borrower C Corporation.

Proposed regulations will also address pre-2018 disallowed interest carryovers and flow-through entities.

- *Disallowed disqualified interest under the “earnings stripping” rule from pre-2018 tax years.* The disqualified interest previously disallowed under the earnings stripping rule (Section 163(j) prior to its amendment by the Act) will be carried over to the first post-2017 tax year and treated as business interest expense incurred in such tax year. Such interest expense would be subject to limitations applicable to business interest expense incurred in such subsequent year, including the application of the 30% Cap and of the base erosion and anti-abuse tax under Section 59A. Further, there will be no carryover of “excess limitation” from pre-2018 years, which under pre-Act earnings stripping provision, increased the amount of disqualified interest allowed as a deduction in the year to which the excess limitation was carried over. Thus, although the carryover of disallowed disqualified interest for pre-2018 years will be allowed to the first post-2017 year, it will be treated in the same manner as any other business interest expense incurred post 2017 and only be deductible to the extent permitted under the 30% Cap.
- *Business interest income of flow-through entities.* The Proposed Regulations will provide rules to prevent double-counting. Specifically, in calculating its own partner-level 30% Cap, a partner will be able to include its share of the business interest income of the partnership only to the extent of his or her share of the *net* business interest income of the partnership.

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Endnotes

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- ¹ All references to "Section" are to sections of the Code.
 - ² Public Law No. 115-97 (Dec. 22, 2017). Shortly before final Congressional approval of the Act, the Senate parliamentarian ruled that the previously attached short title, the "Tax Cuts and Jobs Act," violated procedural rules governing the Senate's consideration of the legislation. Accordingly, the Act does not bear a short title, although commentators generally have continued to refer to it as the Tax Cuts and Jobs Act.