February 26, 2019

Internal Revenue Service
CC:PA:LPD:PR (REG-106089-18)
Courier's Desk
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Section 163(j) Proposed Regulations

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (SIFMA)[1] appreciates the opportunity to submit comments on the proposed regulations (the "Proposed Regulations") under Section 163(j) of the Internal Revenue Code (the "Code"). We appreciate and acknowledge the significant effort that went into the drafting of the Proposed Regulations, and the consideration that the government devoted to the numerous issues that are raised by Section 163(j).[2]

We note that this letter does not include a comprehensive discussion of all of the issues that our members have identified with respect to the Proposed Regulations -- rather it is intended to address the most critical issues under the Proposed Regulations that we believe should be addressed when the Proposed Regulations are finalized (the "Final Regulations").

I. Overview of Recommendations

The following is a brief outline of the primary recommendations that are set forth in this letter. Each of these recommendations is discussed in more detail in Part II of this letter.

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1 SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

2 Unless otherwise indicated, references to "Sections" herein are to Sections of the Code.

A. Definition of Interest

1. The Final Regulations should withdraw the broad definition of interest that is set forth in the Proposed Regulations, or, at a minimum, provide that this definition does not apply to financial institutions. Any abusive transactions could be addressed by the general Section 163(j) anti-avoidance rule contained in Prop. Treas. Regs. Section 1.163(j)-2(h).

2. If the Final Regulations retain the broad definition of interest, they should withdraw the rule in the Proposed Regulations under which amounts that are realized in respect of certain hedging transactions are treated as an adjustment to interest income or expense for Section 163(j) purposes. This rule should, at a minimum, be withdrawn in the case of financial institutions.

3. If the Final Regulations retain the broad definition of interest, they should provide that interest should not be imputed for Section 163(j) purposes in respect of nonperiodic payments on cleared swaps and uncleared collateralized swaps.

4. The Final Regulations should withdraw the definition of interest anti-avoidance rule that is set forth in the Proposed Regulations. If this recommendation is not adopted, then the anti-avoidance rule should only apply to transactions that have a principal purpose of avoiding Section 163(j) in a manner that is inconsistent with the intent of the Section 163(j) and the Regulations thereunder. If this recommendation is not adopted, then the anti-avoidance rule should, at a minimum, (a) exclude financial institutions and (b) likewise impute interest income in the case of transactions in which there is an advance of funds and a return received by the taxpayer that is predominantly attributable to the time value of money.

B. Application of Section 163(j) to CFCs

1. The Final Regulations should provide that Section 163(j) does not apply to interest expense of a CFC that does not recognize ECI (subject to the general anti-avoidance rule), or, at a minimum, does not apply to a CFC that is a financial institution.

2. If the Final Regulations retain the application of Section 163(j) to CFCs, then they should withdraw the rule under which a group of CFCs that conducts a financial services business is treated as a separate subgroup that is subject to an independent CFC group election.

3. If the recommendations above are not adopted, then the Final Regulations should provide that a financial services subgroup includes any CFC that constitutes a "financial services entity" under the Section 904 Regulations rather than, as set forth in the Proposed Regulations, only including entities that satisfy the more restrictive definitions under the CFC rules.

C. Application of Section 163(j) to Partnerships

1. If all of the partners of a partnership are members of a single affiliated corporate group, the partnership should be treated as an aggregate (i.e., a pass-through) for Section 163(j) purposes. Under this approach, the partnership would not be subject to an independent Section 163(j) limitation, and each partner in the partnership would include its allocable share of the income and deductions of the partnership for purposes of determining its own Section 163(j) limitation.

2. Interest that is paid by a partnership to a partner should not be taken into account for Section 163(j) purposes to the extent that the deduction for the interest is allocated to the partner that received the interest. Similarly, interest that is paid by a partner to a partnership should not be taken into account for Section 163(j) purposes to the extent that the partnership's interest income from the payment is allocated to the partner that paid the interest. Furthermore, interest income and expense from loans between partnerships that are owned by the same partners in the same proportion should not be taken into account for Section 163(j) purposes.

II. Discussion of Recommendations

A. Definition of Interest

The Proposed Regulations provide that amounts generally treated as interest for tax purposes are also treated as interest for Section 163(j) purposes.[3] Moreover, solely for purposes of Section 163(j), the Proposed Regulations broaden the definition of "interest" to encompass various types of payments having similar effects to interest, even if such payments are not otherwise treated as interest for tax purposes (the "broad definition of interest"). Under this definition, interest would include, among other items, amortizable bond premium deductions, partnership guaranteed payments for capital, income or loss from certain hedging transactions

[3] Prop. Treas. Regs. Section 1.163(j)-1(b)(20)(i). Accordingly, "interest" includes, among other items, original issue discount, market discount, acquisition discount, deductible repurchase premium, certain deferred payments in exchange for property that are treated as interest for tax purposes, imputed interest with respect to certain below-market loans, and amounts treated as interest under certain rental agreements that provide for deferred or prepaid rent.

described below, substitute interest payments on a securities loan, commitment fees, gain from Section 1258 conversion transactions, factoring income, and imputed interest in respect of certain swaps. The broad definition of interest would generally apply for purposes of determining both the interest income and expense of a taxpayer.

We first note that the Proposed Regulations and the preamble state that the expansive definition of interest in the Proposed Regulations applies solely for purposes of Section 163(j) and does not apply for purposes of defining interest in other areas of the Code.[4] Accordingly, our comments herein only address the application of this definition to Section 163(j) and do not address the very significant tax issues that would arise if this definition is used for other tax purposes. We are concerned, however, that notwithstanding the disclaimer in the Proposed Regulations, the government may be considering employing this definition in other contexts, particularly in light of the fact that the government recently issued proposed regulations under the Section 267A hybrid rules that incorporates a very similar definition of interest.[5] We believe that it would be unwise, impractical and unsound tax policy for the government to employ this definition more broadly without undertaking a comprehensive analysis, which would include opportunities for taxpayer comment, as to whether such a definition would be appropriate in such other contexts. If the government is considering employing this definition in other areas of tax law, we would be pleased to submit comments that would address the many policy, practical and administrative issues that we believe should be considered in this regard.

1. <u>Broad Definition of Interest</u>

As discussed below, we believe that the broad definition of interest described above is not permitted, or contemplated by, the statutory language of Section 163(j). Furthermore, as discussed below, we believe that it is not necessary or appropriate to institute a special definition of interest for Section 163(j) purposes. Accordingly, we recommend that the Final Regulations withdraw the broad definition of interest,[6] or, at a minimum, provide that this definition does not apply to financial institutions.[7]

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4 REG-106089-18, 83 FR 67490, 67493.

5 *See* Prop. Treas. Regs. Section 1.267A-5(a)(12).

6 For purposes of clarity, we do not recommend the withdrawal of the provision in the Proposed Regulations that clarifies that amounts that are generally treated as interest for tax purposes (even if there is technically no underlying indebtedness for tax purposes) are also treated as interest for Section 163(j) purposes. See note 3 above.

7 This letter makes a number of recommendations regarding the application of Section 163(j) to financial institutions. If these recommendations are adopted, we recommend that the Final Regulations define a financial institution as any entity that is a “financial services entity” under Treas. Regs. Section 1.904-4(e)(3). We note that this would include entities that may not independently constitute a financial services entity, but that are part of an affiliated group of

The text of Section 163(j) defines business interest as "any interest paid or accrued on indebtedness properly allocable to a trade or business."[8] The Section 163(j) legislative history states that "any amount treated as interest for purposes of the Code is treated as interest for purposes of Section 163(j)."[9] This indicates that Congress intended that Section 163(j) should only apply to amounts that are otherwise treated as interest for tax purposes.

In addition, Section 163(j) does not provide for a delegation of regulatory authority to expand the definition of interest under Section 163(j) or to otherwise expand the application of Section 163(j) to transactions that are not addressed by the statute. This differs from the many other provisions under The Tax Cuts and Jobs Act that specifically include a delegation of authority to enact regulations that interpret the statute as a whole or certain specific provisions under the statute.[10] Moreover, the Section 163(j) statute that was amended in the Tax Cuts and Jobs Act ("old Section 163(j)") specifically included a provision that delegated authority to issue Regulations,[11] and the legislative history to old Section 163(j) specifically authorized the government to issue Regulations that could expand the definition of interest.[12] Thus, the fact that

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financial services entities (*See* Prop. Treas. Regs. Section 1.904-4(e)(3)(ii) which treats an entity as a financial services entity if it is a member of an affiliated group of financial services entities).

8 Section 163(j)(5).

9 H.R. Rep. 115-409, at 248.

10 *See, e.g.*, Section 59A(i) (authorizing regulations necessary or appropriate to carry out the provisions that govern the Base Erosion and Anti-abuse Tax, including regulations that prevent avoidance by using unrelated persons, conduit transactions, or other intermediaries, or by using transactions or arrangements that affect the characterization of payments for purposes of Section 59A); Section 267A(e) (authorizing regulations necessary or appropriate to carry out the provisions that govern hybrid transactions and entities, including regulations with respect to conduit arrangements, structured transactions, and foreign entities that are considered residents of multiple or no countries); Section 951A (d)(4) (authorizing regulations appropriate to prevent avoidance of the purposes of Section 951A(d), which defines "qualified business asset investment" for purposes of the "global intangible low-taxed income" taxation regime).

11 *See* Former Section 163(j)(9) (authorizing regulations necessary or appropriate to carry out the purposes of former Section 163(j), including "such regulations as may be appropriate to prevent the avoidance of the purposes of" former Section 163(j)).

12 "In granting Treasury authority to adjust the measurement of net interest expense, the conferees understand that regulations could reduce net interest expense where all or a portion of income items not denominated as interest are appropriately characterized, in the Treasury's view, as equivalent to interest income. The conferees expect that an amount would not be so characterized unless it predominantly reflects the time value of money or is a payment in substance for the use or forbearance of money. Similarly, the conferees understand that Treasury might choose to

the current Section 163(j) includes no such delegation of authority indicates that Congress did not intend that Regulations could be issued that materially departs from the definition of interest in the statute itself.

We acknowledge, of course, that the government can issue regulations even in the absence of a specific regulatory delegation pursuant to the general authority to issue regulations under Section 7805 of the Code. However, it is generally understood that the government can only issue "interpretive regulations" under Section 7805 (i.e., regulations that interpret the statute) and not regulations that go beyond the stated meaning of the statutory language.[13] If that were not the case, the specific regulatory delegation that is often found in the Code would have no meaning since any such regulations could in any case be issued pursuant to the authority that is granted under section 7805 of the Code.

The preamble to the Proposed Regulations notes that the proposed definition of interest is similar to the expansive definition of interest under Regulations pursuant to the Sections 861 Regulations that address the allocation of interest deductions for sourcing purposes[14] and the Section 954 regulations that define foreign personal holding company income for purposes of the subpart F income rules.[15] In the case of Section 954, however, the Regulations were issued pursuant to a specific statutory provision that provides that income that is equivalent to interest is treated as foreign personal holding company income.[16] In addition, in the case of the Section 861 Regulations, the Regulations were issued pursuant to a specific delegation of authority in the Section 864 provision that addresses the allocation of interest deductions for purposes of the

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increase net interest expense, under regulations, by all or a portion of expense items not denominated interest but appropriately characterized as equivalent to interest expense." H.R. Conf. Rep. No. 101-386, at 567 (1989).

13 *See e.g., Tutor-Saliba Corp. v. Commissioner*, 115 T.C. 1, 7-8 (2000) ("Regulations are either legislative or interpretive in character . . . . An interpretive regulation is issued under the general authority vested in the Secretary by section 7805, whereas a legislative regulation is issued pursuant to a specific congressional delegation to the Secretary. . . . Under the traditional standard of review, interpretive regulations are to be found valid if they 'implement the congressional mandate in some reasonable manner'. . . . A regulation may not contradict the unambiguous language of a statute." (quoting *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 476 (1979)).

14 Treas. Regs. Section 1.861-9T(b).

15 Treas. Regs. Section1.954-2(h).

16 Section 954(c)(1)(E) (treating "[a]ny income equivalent to interest, including income from commitment fees (or similar amounts) for loans actually made" as foreign personal holding company income).

sourcing of income rules.[17] Accordingly, those Regulations do not provide a basis or precedent to apply a similar definition for Section 163(j) purposes.

The broad definition of interest in the Proposed Regulations would impose a significant burden on taxpayers and would make it more difficult for the government to administer Section 163(j). Taxpayers and the government would be required to track interest expense and income for Section 163(j) purposes separately from the manner in which they generally track interest for other tax purposes. This would be particularly problematic for financial institutions, because, as discussed in more detail below, they regularly engage in ordinary course financial transactions that generate income and expense that might be treated as interest under the Proposed Regulations, but that are not otherwise treated as interest for tax purposes.

In addition, it is inconsistent to create a unique definition of "interest" for purposes of Section 163(j), and to then rely on the general definition of interest for purposes of other important federal income tax regimes, such as withholding and information reporting, BEAT, Section 163(d), and others.[18] Section 163(j) does not seem to present any special or compelling federal tax policy that that warrants imposing this special definition of interest and the associated burden and complexity solely for purposes of Section 163(j).

Furthermore, as a tax policy matter, if the government is considering whether interest should be defined more broadly than under current law, then it should undertake a project to examine this issue on a more global basis, rather than by providing for unique definitions solely for Section 163(j) purposes. Such an approach would seek to achieve consistency in the definition of interest, and would consider the relevant issues in a more comprehensive manner than could be accomplished by independently addressing the definition of interest for Section 163(j) purposes.

We understand that Treasury and the IRS may be concerned about abusive transactions in which taxpayers deliberately convert interest expense into an expense that is technically not treated as interest expense for tax purposes. We believe, however, that the best way to address

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17 Section 864(e)(7).

18 In addition, in some cases these different definitions of interest apply for purposes of applying Section 163(j) itself. For example, (a) the Proposed Regulations include rules regarding the application of Section 163(j) to interest deductions of foreign corporations under Treas. Regs. Section 1.882-5 and (b) the Section 59A Proposed Regulations include rules regarding the interaction of Section 163(j) and related party interest deductions that are subject to the BEAT rules under Section 59A. *See* Proposed Regulations Section 1.163(j)-8(e); Proposed Regulations Section 1.59A-3(c)(4). The application of such rules, however, is complicated by the fact that the definition of interest under Section 163(j) differs from the definition of interest under these rules.

such transactions is not via a broad definition of interest that will encompass ordinary course transactions and that will significantly increase the administrative costs of taxpayers and the IRS. Rather, this concern would be best addressed in the same manner that other abusive transactions are addressed under Section 163(j) -- specifically via the general Section 163(j) anti-avoidance rule that applies to transactions that are primarily intended to circumvent Section 163(j) in a manner that is inconsistent with the purpose of the statute.[19]

2. Hedging Transactions

As noted above, we recommend that the Final Regulations withdraw the broad definition of interest that is currently in the Proposed Regulations. Accordingly, this letter does not include comments on each additional category of interest under the Proposed Regulations. However, the discussion in the remaining three subsections addresses three specific additional categories of interest that are of particular significance to financial institutions -- namely, the hedge rule described below, nonperiodic payments on swaps, and the definition of interest anti-avoidance rule. These subsections only apply if our recommendation above is not adopted in the Final Regulations.

The Proposed Regulations provide that amounts that are realized in respect of a derivative that alters a taxpayer's effective cost of borrowing or effective yield from holding a debt instrument are treated as an adjustment to interest income or expense for Section163(j) purposes (the "Hedge Rule").[20] As discussed below, we recommend that the Final Regulations withdraw the Hedge Rule, and should, at a minimum, provide that the Hedge Rule does not apply to financial institutions acting in the ordinary course of business.

As an initial matter, the Regulations provide for specific rules as to when a debt instrument should be integrated with an associated hedge for tax purposes.[21] The Proposed Regulations would effectively require integration for Section 163(j) purposes even if the hedge is not otherwise integrated with the debt instrument for tax purposes. That would compel taxpayers that are not otherwise required (or permitted) to integrate a debt instrument with a hedge to maintain two sets of books for tax purposes -- one set of books that treats the debt instrument and the hedge as separate instruments for tax purposes and a second set of books that integrates the debt instrument and the hedge solely for Section 163(j) purposes. This will create significant complexity for taxpayers and the government, and there is no reason to force integration for Section 163(j) purposes when doing so would be contrary to longstanding tax policy that generally does not require integration of debt instruments with associated hedges for tax purposes. The government could address abusive transactions via the general anti-avoidance rule described above without requiring the integration of ordinary course business transactions.

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19 *See* Prop. Treas. Regs. Section 1.163(j)-2(h).

20 Prop. Treas. Regs. Section 1.163(j)-1(b)(20)(iii)(E).

21 *See* Treas. Regs. Section 1.1275-6 and Treas. Regs. Section 1.988-5.

If the Final Regulations retain the Hedge Rule described above, they should, at a minimum, provide for an exception for financial institutions, because they often hedge interest rate and foreign currency positions on a "macro" basis. More specifically, financial institutions often do not hedge foreign currency and interest rate exposure from the issuance or ownership of a particular debt instrument by entering into a hedge that can be specifically identified as a hedge of the specific debt instrument. Rather, a financial institution will often hedge its firm-wide interest rate and foreign currency positions by entering into a macro hedge -- that is, by identifying on daily basis its firm-wide foreign currency and interest rate positions and then hedging those positions on a daily basis. Under this approach, there is no specific foreign currency or interest rate hedge that can be identified with a particular debt instrument. Nonetheless, a portion of each daily hedge arguably alters the taxpayer's effective cost of borrowing or effective yield from issuing or holding a debt instrument because the daily hedge in part takes into account the taxpayer's positon under each debt instrument that the taxpayer issues or holds. However, under the Proposed Regulations, a taxpayer would have no practical way of determining the portion of the macro hedge that should be treated as generating interest rate income or expense for Section 163(j) purposes. Accordingly, the Hedge Rule cannot be practically applied in such a case, and in any case there is no policy reason to treat the income or loss from such a hedge as interest expense or income for Section 163(j) purposes. We therefore recommend that the Hedge Rule should not apply to financial institutions that enter into hedging transactions in the ordinary course of business.

Moreover, even if a financial institution could identify the hedges that are associated with specific debt instruments, the application of the Hedge Rule to financial institutions would impose an undue burden on such taxpayers in the absence of a meaningful policy objective. More specifically, the business model of a financial institution is fundamentally different than other businesses in that non-financial businesses borrow money as a means of obtaining capital, whereas borrowing money and then lending or investing the money is the primary business of most financial institutions. Accordingly, financial institutions regularly issue debt and enter into hedges as a fundamental part of their financial intermediation business. In addition, these activities are subject to extensive regulatory restrictions that further constrain and complicate their lending and hedging activities. Thus, the application of the Hedge Rule to financial institutions would present a unique and undue burden on such taxpayers in light of the volume and complexity of their ordinary financial operations.

If our recommendation above that the Hedge Rule should be withdrawn (or that, at a minimum, should not apply to financial institutions) is not accepted, we recommend that the Final Regulations provide that gains and losses that are realized upon a sale of a hedge, or a deemed sale of a hedge under the mark to market rules, will not be treated as interest income or expense for Section 163(j) purposes. The need for such a rule could be illustrated by an example in which a taxpayer that is subject to a mark-to market method of tax accounting acquires a fixed rate note and then enters into a fixed-to-floating rate interest rate swap that it does not elect to integrate with the note for tax purposes. In such a case, the swap would be subject to the Hedge Rule, and any income or expense in respect of the swap would be treated as interest income or expense under the Proposed Regulations. Assume, however, that the swap declines in value by $100 by the end of year one due to changes in market interest rates, and that the note appreciates in value by a corresponding amount. Under the Proposed Regulations, the mark-to-market loss would apparently be treated as additional interest expense under the Hedge Rule, notwithstanding that the taxpayer has not made any additional payments on the swap. Moreover, this would seemingly be the case even though the taxpayer would not treat the corresponding mark-to-market gain on the note as additional interest income. There is no policy reason to treat the mark-to-market loss in such a case as interest expense for Section 163(j) purposes. We therefore recommend that the Final Regulations provide that the Hedge Rule will only apply to actual payments on a hedging transaction that affect the yield of a debt instrument but will not apply to gain or loss that is recognized in respect of an actual or deemed disposition of the hedge of a debt instrument.

3. Cleared Swaps

The Proposed Regulations provide that a swap, other than a cleared swap, with significant nonperiodic payments is treated as two separate transactions consisting of a level payment swap and a loan.[22] Interest on the loan would then be imputed for Section 163(j) purposes in accordance with Treas. Regs. Section 1.446-3(f)(2)(ii)(A). The Proposed Regulations reserve regarding the application of this rule to a swap that is cleared by a derivatives clearing organization or by a clearing agency (a "cleared swap").[23] The preamble to the Proposed Regulations states that the exception for cleared swaps would not require testing the assets used for collateralization or condition the exception for cleared swaps on the extent of the collateralization under the swaps. The preamble requests comments regarding the application of Section 163(j) to cleared swaps, including "any requirements with respect to collateralization that would be necessary or appropriate to identify swaps that could be used to effectively advance funds through the use of nonperiodic payments."[24]

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22 Prop. Treas. Regs. Section 1.163(j)-1(b)(20)(ii)(B).

23 Prop. Treas. Regs. Section 1.163(j)-1(b)(20)(ii)(B). More specially, the Proposed Regulations define a cleared swap as "a swap that is cleared by a derivatives clearing organization, as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a), or by a clearing agency, as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively, if the derivatives clearing organization or clearing agency requires the parties to the swap to post and collect margin or collateral". Prop. Treas. Regs. Section 1.163(j)-1(b)(5).

24 REG-106089-18, 83 FR 67490, 67494.

We recommend that the Final Regulations provide that interest should not be imputed in respect of a nonperiodic payment on a cleared swap because the recipient of such a payment is not entitled to retain the payment -- rather it must immediately transmit an amount equal to the payment as variation margin to the counterparty that made the nonperiodic payment. Thus, the nonperiodic payment is part of a circular cash flow in which no cash actually changes hands. Accordingly, the nominal recipient of a nonperiodic payment under a cleared swap will not receive any funding, and there is no loan component in which it would be appropriate to impute interest for Section 163(j) purposes.[25]

In addition, we recommend that the Final Regulations not include any specific rules regarding the amount or type of collateral that is required to be posted in order to qualify under the exception for cleared swaps. Rather, it is sufficient to include, as the Proposed Regulations do, a definition for the term "cleared swaps" that ensures that such swaps are subject to a comprehensive non-tax regulatory regime that will require the recipient of a nonperiodic payment to post an initial amount of collateral that is substantially equal to the amount of the nonperiodic payment.[26]

We further recommend that the Final Regulations extend the exception for cleared swaps to uncleared swaps that require the recipient of a nonperiodic payment to post an initial amount of collateral with the counterparty that is substantially equal to the nonperiodic payment (subject to adjustment in the future to take into account market or credit changes). There are many uncleared swaps, including affiliate swaps, that provide for collateralization requirements that are very similar to those of cleared swaps.[27] In such a case, the reasons described above as to why interest should not be imputed in respect of cleared swaps would equally apply to such uncleared swaps. Moreover, such an approach would be consistent with the (now expired)

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25 For a more comprehensive discussion of the background regarding the increased use of cleared swaps with upfront payments and the appropriate tax treatment of such payments, see the letter that we (along with three other industry groups) submitted to the government in 2014 requesting guidance regarding the tax treatment of such payments. *See* CME Group, Inc. et al, Letter to the Department of the Treasury and the Internal Revenue Service Re: Request for Guidance Relating to Upfront Payments on Swaps (June 12, 2014), *available at* https://www.sifma.org/wp-content/uploads/2017/05/sifma-and-other-associations-submit-comments-to-the-treasury-and-irs-requesting-guidance-relating-to-upfront-payments-on-swaps.pdf (the "2014 Letter").

26 We are concerned that if the IRS were to adopt tax rules regarding the amount and type of required collateral, such rules could differ from the corresponding non-tax regulatory requirements in non-meaningful ways that could nonetheless cause a cleared swap to fail to qualify under the cleared swap exception.

27 For more background regarding the collateral requirements for certain non-cleared swaps, see the 2014 Letter at pp 5-7.

Temporary Regulations governing nonperiodic payments on notional principal contracts which provide that interest should not be imputed in respect of cleared swaps as well as other uncleared swaps that satisfy certain collateralization requirements.[28]

In addition, financial institutions would be subject to a particular undue burden if they are required to impute interest in respect of significant nonperiodic payments on cleared and collateralized swaps, because they typically hold a large volume of such swaps and interest is not otherwise recorded on such instruments for financial accounting purposes. Accordingly, financial institutions would need to develop sophisticated systems that would track such payments and compute and record the associated Section 163(j) accruals of interest income and expense.

Finally, in the case of swaps that are not eligible for the exception described above, we recommend that the Final Regulations provide objective rules as to when a nonperiodic payment is treated as "significant" and as to when a financial instrument is treated as a "swap" for purposes of these rules,[29] so that taxpayers can apply these rules in a consistent manner without accompanying uncertainty.

4. Definition of Interest Anti-Avoidance Rule

The Proposed Regulations include an anti-avoidance rule under which "any expenses or loss, to the extent deductible, incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time is treated as interest expense of the taxpayer if such expense or loss is predominantly incurred in consideration of the time value of money".[30] As discussed below, we recommend that the Final Regulations should withdraw this rule, and if this recommendation is not adopted, that the anti-avoidance rule should be modified in the manner described below.

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[28] Temporary Regulations Section 1.446-3T(g)(4)(ii)(B) (the "Temporary Regulations"). This letter does not address all of the requirements that are set forth in the Temporary Regulations and whether they would be appropriate in this context. We recommend that the government review the comments that were submitted in respect of the Temporary Regulations. In particular, *see* North American Tax Committee of the International Swaps and Derivatives Association, Letter to the Department of the Treasury and the Internal Revenue Service Re: Comments on the Embedded Loan Rules in Prop. Treas. Reg. § 1.446-3(g) (March 11, 2016), *available at* https://www.isda.org/a/MgiDE/nonperiodic-swap-payment-isda-letter.pdf.

[29] The Final Regulations may want to employ the "notional principal contract" definition under Treas. Regs. Section 1.446-3(g)(1).

[30] Prop. Treas. Regs. Section 1.163(j)-1(b)(20)(iv).

Although the preamble and the Proposed Regulations call this provision an anti-avoidance rule, the rule, as drafted, does not require that the taxpayer have an intent or motive to avoid the application of Section 163(j). This differs from a typical anti-avoidance or anti-abuse rule which only applies if tax avoidance is "a principal purpose" or "the principal purpose" for a transaction. There is no reason to apply a broader anti-avoidance rule solely for purposes of the Section 163(j) definition of interest, which would apply to ordinary course transactions that have no tax avoidance motive.

The application of the anti-avoidance rule to ordinary course transactions that do not have a tax avoidance motive is particularly problematic for financial institutions, because they often engage in non-loan transactions in the ordinary course of business in which they obtain the use of funds and in which a portion of the return is attributable to the time value of money. For example, many financial institutions issue structured notes that provide for a maturity payment that is determined by reference to the performance of an underlying asset (e.g., a reference equity or index). The notes often do not provide for principal protection, in which case the notes are generally treated as a pre-paid derivative (or forward) contract, rather than as a debt instrument, for tax purposes. It is well accepted that interest is generally not imputed for tax purposes in respect of such notes, although the IRS issued a Notice in 2008 in which it stated that it is considering, among other issues, whether to issue future guidance that would impute interest in respect of such instruments.[31] No such guidance has been issued to date.

In the case of the notes described above, the issuer will "obtain the use of funds" upon the issuance of the notes. Accordingly, the issuer’s expense under the note will be partially attributable to the time value of money, and thus could possibly be treated as interest expense under the anti-avoidance rule, particularly if the note references a non-volatile asset.

This is just one example of an ordinary course financial transaction in which there is a funding component that does not generate interest under current law. There are many other ordinary course transactions, including the issuance of call options and leases, in which a portion of the return in respect of the transaction is attributable to the time value of money. These transactions are generally not done in order to achieve funding, but are rather done because financial institutions are in the business of engaging in financial transactions. If the anti-avoidance rule could potentially apply to such ordinary course transactions, then financial institutions could be effectively forced to examine thousands of financial transactions each day that have some funding component, in order to determine whether the return on each transaction is predominantly attributable to the time value of money. Aside from the enormous complexity that this would create, taxpayers will often be unable to objectively determine whether the projected return under an instrument is predominantly attributable to the time value of money, which would create significant uncertainty in the market. Moreover, the IRS would then be

[31] Notice 2008-2, 2008-2 I.R.B. 252.

compelled to examine multitudes of financial instruments that potentially have a funding component in order to determine whether the predominance test has been satisfied. This would require an economic analysis of countless financial instruments that is impracticable and unwarranted. There is no policy reason to impute interest in respect of ordinary course transactions for Section 163(j) purposes if interest is not otherwise imputed for general tax purposes, particularly when the general Section 163(j) anti-avoidance rule of Prop. Treas. Regs. § 1.163(j)-2(h) can apply to abusive transactions.

Moreover, we note that the policy basis for Section 163(j) is presumably to discourage corporations from incurring an excessive amount of debt capitalization (as opposed to equity capitalization) and to limit the base erosion that arises when corporations raise capital via the issuance of debt rather than equity. These policy concerns will generally not be implicated in the case of a financial institution that receives an upfront payment in the ordinary course of business that is not classified as debt for tax purposes. In such a case, the financial institution would generally not view the upfront payment as an alternative to equity capitalization (or as a method of capitalization at all). More importantly, such instruments do not generate current deductions and thus do not raise the same base erosion concerns as debt instruments that generate interest deductions for tax purposes. Accordingly, the application of the definition of interest anti-avoidance rule to ordinary course financial transactions with a funding component is not consistent with, and possibly contrary to, the policy of Section 163(j).

We also note in this regard that we anticipate that most financial institutions will recognize net interest income for tax purposes, even after application of the broad definition of interest and the anti-avoidance rule, for Section 163(j) purposes. That is because the primary business of many (if not most) financial institutions is to borrow money and to then invest that money in higher yielding interest-bearing assets. However, such institutions will nevertheless need to engage in the difficult and complex process of determining the amount of their net interest expense in order to properly document that Section 163(j) does not apply to them. Accordingly, the application of the broad definition of interest, and in particular, the anti-avoidance rule, to financial institutions is likely to impose significant economic and administrative costs on such taxpayers without yielding meaningful additional tax revenue for the government.

The anti-avoidance rule only applies to impute interest expense and does not likewise apply to impute interest income. This differs from the remainder of the definition of interest provisions in the Proposed Regulations which apply for purposes of determining both the interest income and expense of a taxpayer. The one-sided nature of this rule is particularly problematic for financial institutions because they often act as dealers and market-makers in which they enter into offsetting positions under two corresponding transactions. For example, a taxpayer that acquires a non-debt financial contract in which it obtains funding (the "first contract") may hedge its position by acquiring an identical financial contract (the "second contract’) in which it provides funding to the counterparty under the contract. If the return on the first contract is predominantly attributable to the time value of money, then the anti-avoidance rule would impute interest expense in respect of the first contract, and the taxpayer would not recognize a corresponding amount of interest income in respect of the second contract. This would be the case even though (a) the taxpayer has not obtained any net funding under the two contracts and (b) the taxpayer may have entered into the two transactions in the ordinary course of its business as a dealer or market-maker. This would be an unfair result without any policy basis if, as is currently the case, the anti-avoidance rule applies to ordinary course transactions without any tax avoidance motive.

The Proposed Regulations include a general tax avoidance rule which provides that arrangements entered into with a principal purpose of avoiding the rules of Section 163(j) or the Proposed Regulations may be disregarded or recharacterized to the extent necessary to carry out the purposes of Section 163(j).[32] Thus, in determining whether an item of expense is treated as interest for Section 163(j) purposes, there are two anti-avoidance rules that could potentially apply -- the more specific definition of interest anti-avoidance rule and the more general Section 163(j) anti-avoidance rule. There is no reason to impose two anti-avoidance rules for this purpose -- rather, transactions that are intended to circumvent the definition of interest rules under Section 163(j) can be adequately addressed by the general Section 163(j) anti-avoidance rule described above.

Based on the above, we recommend that the Final Regulations withdraw the definition of interest anti-avoidance rule. We further recommend that the general Section 163(j) anti-avoidance rule provide that an item of expense will not be treated as interest expense under the anti-avoidance rule unless the taxpayer has "obtained the use of funds" and the return on the applicable transaction is "predominantly attributable to the time value of money".[33] In addition, we recommend that the anti-avoidance rule include examples regarding transactions in which amounts that are otherwise not treated as interest would be treated as interest for tax purposes. In particular, such examples could include (a) the hedged loan of gold example that is currently in the definition of interest anti-avoidance rule and (b) an example in which the borrower obtains the use of funds via a borrowing and subsequent sale of debt securities; but in each case only to the extent that these are transactions in which the taxpayer has a principal purpose of avoiding Section 163(j) so that they are not ordinary course business transactions.

If this recommendation is not adopted, then the anti-avoidance rule should only apply to transactions that have a principal purpose of avoiding Section 163(j) in a manner that is inconsistent with the statute or the Final Regulations. If this recommendation is not adopted, then the anti-avoidance rule should, at a minimum, (a) exclude financial institutions and (b)

32 Prop. Treas. Regs. Section 1.163(j)-2(h).

33 Otherwise there may be uncertainty as to whether the anti-avoidance rule could apply to transactions (e.g., a lease) in which the taxpayer has not obtained the use of funds.

likewise impute interest income in the case of transactions in which the taxpayer advances funds for a period of time and realizes income or gain that "is predominantly incurred in consideration of the time value of money".

B. Application of Section 163(j) to Controlled Foreign Corporations

The Proposed Regulations provide that a CFC's business interest expense is also subject to Section 163(j) even if the CFC is not a U.S. taxpayer.[34] As a result, under the Proposed Regulations, Section 163(j) would limit the extent to which a CFC's business interest expense is deductible for purposes of computing the subpart F income, GILTI tested income or loss, and income effectively connected to a United States trade or business ("ECI") for the CFC and its US shareholders, as appropriate.

This section discusses whether and how Section 163(j) should apply to CFCs that do not recognize ECI. (For purposes of simplicity, all references to a CFC below assume that the CFC does not recognize ECI).

1. Section 163(j) Should not Apply to CFCs

The following subsection addresses whether Section 163(j) should apply to the interest expense of a CFC.

As an initial matter, it is not entirely clear whether, based on the technical statutory language of Section 163(j), Section 163(j) applies to a CFC. More specifically, Section 163(j) states that it applies to interest deductions that are realized by a taxpayer.[35] On the one hand, a CFC does not realize deductions because it is not subject to the federal corporate income tax in respect of its income. This supports the position that Section 163(j) should not apply to the interest expense of a CFC.

On the other hand, a US shareholder of a CFC is subject to tax on its share of the subpart F income of the CFC and on the GILTI that it realizes in respect of a CFC. The subpart F and GILTI rules provide that the interest expense of a CFC is treated as a deduction for purposes of determining the taxable income of a US shareholder of a CFC.[36] Accordingly, it is possible that the relevant taxpayer for Section 163(j) purposes in the case of a CFC is the US shareholder of the CFC, and that Section 163(j) should therefore also apply to the interest expense of a CFC.

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[34] Prop. Treas. Regs. SectionSection 1.163(j)-7, -8.

[35] *See* Section 163(j)(5).

[36] Section 951(c)(2)(A)(ii); Section 954(b)(5).

Although the statutory language is unclear in this regard, the fact that the Section 163(j) legislative history does not discuss whether or how Section 163(j) applies to a CFC suggests that Congress did not intend to apply Section 163(j) to a CFC. As illustrated by the extensive and complex rules in the Proposed Regulations, the application of Section 163(j) to CFCs requires numerous technical rules and guidance. If Congress intended that Section 163(j) should apply to a CFC, one would expect that the legislative history would have included some discussion as to how Section 163(j) applies to a CFC, particularly in light of the detailed discussion therein regarding the application of Section 163(j) to partnerships.[37]

Moreover, Section 163(j) was enacted at the same time as the GILTI rules in Section 951A. If Section 163(j) applies to a CFC, then the primary impact would relate to the determination of the GILTI of a US shareholder of a CFC. If Congress intended that Section 163(j) should apply for that purpose, then the legislative history of Section 163(j) and/or Section 951A would presumably have included some reference to the interaction of the Section 163(j) rules and the newly enacted GILTI regime.

In addition, the legislative history to Section 163(j) provides that Section 163(j) should apply to a consolidated tax group at the consolidated group level.[38] If Section 163(j) was intended to apply to CFCs, then one would have expected that there would be some reference in the legislative history as to how Section 163(j) applies to an affiliated group of CFCs.

In any case, it is at least unclear whether Section 163(j) applies to CFCs, and therefore the government would not be acting inconsistently with the statue if it were to provide that Section 163(j) does not apply to a CFC. For the following reasons, we recommend that the Final Regulations provide that Section 163(j) should not apply to interest expense of a CFC that does not recognize ECI (subject to the generally applicable anti-avoidance rule).

Base Erosion. Section 163(j) is presumably intended to prevent a US taxpayer from eroding its taxable income with an excessive amount of interest deductions. A CFC is not subject to US tax, and thus interest deductions would not reduce the US tax liability of a CFC. Although a US shareholder of a CFC may be able to reduce its subpart F income and GILTI inclusions in respect of a CFC by the interest deductions of the CFC, the benefit of this deduction is limited because such inclusions will (a) generally be fully or partially offset by foreign tax credits[39] and (b) in the case of GILTI inclusions, will be subject to a reduced tax rate.[40]

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[37] H.R. Rep. No. 115-466, at 232-33.

[38] H.R. Rep. No. 115-466, at 228.

[39] Section 960.

[40] Section 250(a)(1)(B). Furthermore, as discussed below, in some cases interest deductions will not reduce a U.S. shareholder's GILTI inclusion.

Accordingly, the policy concerns regarding excessive interest deductions for US taxpayers do not similarly apply in the case of a CFC.

Location of Interest Expense. US tax policy should encourage US multinationals to incur interest expense in foreign subsidiaries rather than in domestic corporations that are subject to the federal corporate income tax. The imposition of the Section 163(j) interest disallowance on foreign corporations would undermine that objective. For example, consider a US corporation with a foreign subsidiary that recognizes "tested income" for GILTI purposes and/or subpart F income and that anticipates that (a) it will incur net interest expense that is significantly less than 30% of its ATI and (b) the foreign subsidiary will incur interest expense that will be disallowed under Section 163(j). The US corporation might then be motivated to increase its own interest expense and decrease the expense of the subsidiary so that neither incurs interest expense that is disallowed under Section 163(j).[41] This could reduce the aggregate amount of tax that would be collected by the US government, and it would not be sound tax policy to create incentives under Section 163(j) that might yield such a result.

Interest that is Allocated to GILTI. In the case of a CFC that recognizes "tested income", a US shareholder will have a limited ability to reduce its GILTI inclusions as a result of increased interest deductions of the CFC. More specifically, a US shareholder's GILTI inclusion in respect of a CFC is generally equal to its share of the "tested income" of the CFC minus the "net deemed tangible income return" ("NDTIR") of the CFC.[42] The NDTIR of a CFC is generally equal to (a) ten percent of the "qualified business asset investment" of the CFC minus (b) the net interest expense that is allocable to the "tested income" of the CFC.[43] Thus, if a US shareholder holds shares of a single CFC and the CFC's interest expense that is allocable to its "tested income" does not exceed its NDTIR, (a) a US shareholder of the CFC will not reduce its GILTI inclusions via increased interest deductions of the CFC, and (b) the disallowance of interest expense that is allocable to "tested income" of the CFC will not impact the amount of GILTI that is recognized by a US shareholder of the CFC. Accordingly, in such a case there is

41 A taxpayer's motivation to do this would also presumably depend upon (a) whether the CFC can deduct the interest for foreign tax purposes, (b) the marginal foreign tax rate that applies to the CFC's income, (c) whether the US shareholders of the CFC could credit any foreign taxes against its US taxable income and (d) whether, as discussed below, a US shareholder's tax liability will be increased if Section 163(j) disallows a portion of the interest expense of the CFC. However, this example nevertheless illustrates that the application of Section 163(j) to a CFC could incentivize taxpayers to migrate debt, and the associated interest deductions, from foreign entities that are not US taxpayers into US entities that are US taxpayers.

42 As a technical matter, this test is applied on a combined basis based on all of the CFCs in which a US person is a US shareholder; however, for purposes of simplicity the discussion above presents the test as applied to a single CFC.

43 *See* Section 951A(b)(2)(B).

no reason to apply Section 163(j) to such interest deductions because (a) the US shareholder will in any case be unable to reduce its GILTI inclusion through additional interest deductions and (b) the disallowance of any such interest deductions under Section 163(j) will in any case have no impact on the GILTI inclusion of the US shareholder.

We acknowledge that in some cases the interest expense of a CFC that is allocated to "tested income" may exceed its NDTIR, in which case the disallowance of interest under Section 163(j) could increase the GILTI inclusion of a US shareholder of the CFC. The example above, however, nevertheless illustrates that in many cases the application of Section 163(j) to interest expense that is allocable to "tested income" will have no tax impact and no tax policy benefit, which calls into question whether the application of Section 163(j) to such interest expense -- even in the limited cases where it could have a tax impact -- is warranted in light of the associated costs and complexity.

Interest that is Allocated to Subpart F Income. The Section 163(j) limitation generally will have no impact in the case of a CFC that solely recognizes subpart F income, because (a) any interest that is disallowed under Section 163(j) would reduce the earnings and profits of the CFC[44] and (b) the subpart F income of a US shareholder is limited to the earnings and profits of the CFC.[45] A US shareholder of the CFC would therefore in any case effectively realize the benefit of the disallowed interest deduction due to the fact that its subpart F income would be limited to the earnings and profits of the CFC.

If a CFC recognizes subpart F income and other income (e.g., “tested income” for GILTI purposes), then a US shareholder of the CFC could be affected by Section 163(j) disallowed interest that is allocated to subpart F income, because its subpart F inclusions may not be subject to the earnings and profits cap described above. If Section 163(j) does not effectively apply to interest deductions that are allocated to subpart F income if the CFC solely recognizes subpart F income, then it makes little sense as a policy matter to apply Section 163(j) to such interest simply because a CFC happens to recognize non-subpart F income.

Allocation of Section 163(j) Disallowance. The Proposed Regulations do not provide for any rules that would allocate interest expense that is disallowed under Section 163(j) between subpart F income, “tested income”, and income that is not subpart F income or “tested income”. If CFCs are subject to Section 163(j), then such rules are necessary, because otherwise taxpayers would have no way of determining the category of income to which the disallowed interest expense should be allocated. Any such rules would be complex and difficult to administer, and would increase the cost to comply with these rules.

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44 Prop. Treas. Regs. Section 1.163(j)-7(e).

45 Section 952(c)(1)(A).

Application of Section 163(j) to CFCs Could Decrease Tax Revenue. In some cases, the application of Section 163(j) to a CFC could enable taxpayers to decrease their tax liability. This could be illustrated by an example in which a US shareholder that holds shares in a single CFC recognizes excess foreign tax credits in a particular year in respect of its GILTI inclusion but does not expect to recognize such excess foreign tax credits in future years. If a portion of the CFC's interest expense is disallowed under Section 163(j), the US shareholder's GILTI inclusion would increase (assuming, as discussed above, that the interest expense exceeds the NDTIR of the CFC), thereby enabling the US shareholder to use a portion of the foreign tax credits that would otherwise expire. The CFC could, however, carry forward the Section 163(j) disallowed interest to future taxable years, which could enable the US shareholder to reduce its GILTI inclusion in such years.

Complexity. The application of Section 163(j) to a CFC would be extremely complex and would create significant administrative costs for taxpayers and the government. This is particularly the case in respect of financial institutions that recognize significant amounts of interest income and expense and that are subject to extensive regulatory restrictions regarding the location and amount of their assets and liabilities.[46]

In addition, as noted above, we anticipate that most financial institutions -- including financial institutions that are CFCs -- will recognize net interest income for tax purposes, even after application of the broad definition of interest and the anti-avoidance rule, for Section 163(j) purposes. However, if Section 163(j) applies to CFCs that are financial institutions, such CFCs will nevertheless need to engage in the difficult and complex process of determining the amount of their net interest expense under Section 163(j) in order to properly document whether they are subject to Section 163(j). Accordingly, the application of Section 163(j) to financial institutions that are CFCs will generally impose significant economic and administrative costs on such taxpayers without yielding meaningful additional tax revenue for the government.

Conclusion. Based on the discussion above, the policy reasons that support the application of Section 163(j) to domestic corporations do not likewise apply to CFCs. A CFC will have limited ability to reduce the taxable income of a US shareholder through increased interest deductions, and the application of Section 163(j) to a CFC will generate limited additional revenue to the government. We therefore recommend that the Final Regulations provide that Section 163(j) does not apply to interest expense of a CFC and thus does not affect the subpart F and GILTI inclusions of a US shareholder of a CFC.

If this recommendation is not adopted, then we recommend that, at a minimum, Section 163(j) should not apply to a CFC that is a financial institution. That is because, as described in

46 The complexity and costs would be further increased if the Final Regulations retain the expansive definition of interest described above.

more detail above, financial institutions (a) would be subject to greater costs and complexity if they were subject to Section 163(j) in light of the volume and complexity of their financial operations, and (b) are subject to significant regulatory constraints that restrict their ability to artificially increase the amount or location of their net interest income and expense.

2. CFC Group Election Should not Segregate Financial Services Entities

The following recommendation applies if our recommendation above that Section 163(j) should not apply to CFCs (or, at a minimum, should not apply to a CFC that is a financial institution) is not accepted.

As a general matter, the Proposed Regulations provide that each CFC in an affiliated group is subject to an independent Section 163(j) limitation, and there is no equivalent to the rule that applies a single Section 163(j) limitation to a domestic consolidated tax group. The Proposed Regulations, however, provide that an affiliated group of CFCs can make a "CFC group election" under which Section 163(j) would not apply to any CFC in the group if the group does not have net interest expense.[47] The Proposed Regulations also provide that a CFC group that is subject to a CFC group election may "roll up" a lower-tier CFC group member's "excess Section 163(j) limitation" (i.e., income in excess of the amount necessary to deduct its interest expense under Section 163(j)) to higher-tier CFC group members, until the highest-tier CFC group member.[48] Any "excess Section 163(j) limitation" of the highest-tier CFC group member would roll up to such member's U.S. shareholders, up to the amount of their subpart F and GILTI inclusions.[49]

The CFC group rules provide that a group of CFCs that conduct a financial services business (each, a "financial services CFC") is treated as a separate subgroup that is subject to an independent grouping mechanism.[50] The preamble to the Proposed Regulations states that this rule is necessary because financial services CFCs recognize significant amounts of interest income and expense and it would thus be distortive to include such CFCs within a larger group of CFCs that do not conduct a financial services business.[51] For the following reasons, we

47 Prop. Treas. Regs. Section 1.163(j)-7(b)(3)(i); *see also* Preamble to the Proposed Regulations ("[I]f an election is made to apply the alternative method and if a CFC group has only intercompany debt within the CFC group, then the amount of the CFC group's applicable net business interest expense is zero, and no business interest expense of any CFC group member would be subject to the section 163(j) limitation.").

48 Prop. Treas. Regs. Section 1.163(j)-7(c)(3).

49 Prop. Treas. Regs. Section 1.163(j)-7(d)(2).

50 *See* Prop. Treas. Regs. Section 1.163(j)-7(b)(3)(i), (b)(5).

51 REG-106089-18, 83 FR 67490, 67513.

recommend that the Final Regulations withdraw this rule, and that financial services CFCs should therefore be eligible to be included in a single CFC group election with other CFCs.

First, a domestic consolidated group is generally treated as single taxpayer for Section 163(j) purposes, and entities that conduct a financial services business are not segregated for this purpose within a consolidated tax group.[52] There is no policy reason to impose greater segregation, and consequentially greater complexity, within a foreign affiliated group for Section 163(j) purposes than within a domestic consolidated group.

Second, the preamble to the Proposed Regulations states that a CFC group election is primarily intended to prevent the distortion, and potential double inclusion of income, that would result if Section 163(j) applied to intercompany loans even if the affiliated CFC group does not have any net third party interest expense.[53] This concern equally applies in the case of a CFC group that includes financial services CFCs and other CFCs, because such groups often include loans between the two types of entities. Thus, the requirement that financial services CFCs be treated as a separate subgroup would, rather than eliminating distortions, potentially create the specific type of distortion that the CFC group election was designed to prevent.

For example, assume that an affiliated group that includes financial services CFCs and other CFCs has a single entity that conducts a centralized cash management function for the group, whereby all of the members of the group lend their excess cash to such entity. The group that includes the cash management entity (e.g., the financial services subgroup if the cash management entity is a financial services entity) could be subject to Section 163(j) as a result of the interest that the cash management entity pays to the non-financial services CFCs even if the group as a whole has no net third party interest expense. Moreover, as described in the preamble with respect to intercompany loans, such a loan could effectively create double taxation if the deduction for the interest payment is disallowed and a US shareholder is subject to tax (under the subpart F or GILTI rules) on the receipt of the interest payment.[54]

Third, we believe that allowing financial services CFCs and other CFCs to be part of a single CFC group would not create a distortion for purposes of computing the Section 163(j) limitation of the CFC group. While it is true that financial services entities typically recognize more interest income and expense than other entities, that does not alter the fact that as a policy

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52 Prop. Treas. Regs. Section 1.163(j)-5(b)(3). We note in this regard that the Section 163(j) legislative history specifically contemplates that Section 163(j) should be applied to a domestic consolidated group on a combined basis and there is no indication therein that financial services entities should be segregated for this purpose. *See* H.R. Rep. 115-409, at 248 ("In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.").

53 REG-106089-18, 83 FR 67490, 67512-13.

54 *Id.*

matter an affiliated group of CFCs should not be subject to Section 163(j) if the group does not incur any third party net interest expense. Furthermore, if anything, it is more difficult for multinational financial services entities to shift interest expense among related entities since they are typically subject to extensive regulatory restrictions across multiple jurisdictions that generally restrict the amount of debt that can be incurred by specific entities.

Finally, the financial services subgroup rules would contribute additional and unnecessary complexity to the already complex CFC group election rules. These rules would make it more difficult and expensive for taxpayers and the government to administer the CFC group election rules, and as discussed above, would not further any meaningful policy objective.

3. Definition of Financial Services Entity

The following recommendation applies if both of our recommendations above are not adopted (i.e., that Section 163(j) should not apply to CFCs and that financial services entities should not be treated as a separate subgroup for purposes of the CFC grouping rules).

The Proposed Regulations provide that a CFC is included in a financial services subgroup if the CFC is (a) an "eligible controlled foreign corporation" as defined in Section 954(h) of the Code, (b) a "qualified insurance company" as defined in Section 953(e) of the Code, or (c) eligible for the dealer exception to the foreign personal holding company income rules under Section 954(c) of the Code.[55] While this definition will generally include most financial services businesses, it will generally not include (a) holding companies for a group of financial services entities, (b) entities that primarily transact with related financial services entities and (c) entities that recognize significant amounts of passive income that are not attributable to customer transactions (even if otherwise engaged in a financial services business). There is no reason why such entities should not be treated as part of a financial services subgroup, particularly in light of the stated policy of segregating financial entities that are more likely to recognize significant amounts of interest income and expense from other non-financial entities. In fact, under this definition, an affiliated group whose only business is financial services could include some CFCs that are not within a financial services subgroup simply because they do not independently conduct a sufficient amount of customer business. This could lead to significant distortions of the type that the CFC group election was designed to prevent.

Accordingly, we recommend that the Final Regulations instead provide that a financial services subgroup includes any CFC that constitutes a “financial services entity” under Treas. Regs. Section 1.904-4(e).[56] Under that definition, the term “financial services entity” includes

55 Prop. Treas. Regs. Section 1.163(j)-7(f)(9).

56 Treas. Regs. Section 1.904-4(e)(3). The Final Regulations should clarify in this regard that this definition includes entities that are treated as financial services entities under the rules in the

an individual or entity that is “predominantly engaged in the active conduct of a banking, insurance, financing, or similar business (active financing business) for any taxable year.” Furthermore, under this definition, an entity that does not independently satisfy the requirements to be a financial services entity will nevertheless be treated as a financial services entity for this purpose if it is a member of a group of affiliated financial services entities.[57] Accordingly, the Section 904 definition would generally incorporate the entities described above that would be excluded from a financial services subgroup under the applicable definitions in the Proposed Regulations. This would result in a more equitable application of the financial services subgroup rules that is more consistent with the purported policy objective of such rules.[58]

C. Application of Section 163(j) to Partnerships

The Section 163(j) interest disallowance rule applies to partnerships at the entity level even though a partnership is not subject to an entity level income tax.[59] Accordingly, a partnership that is subject to the Section 163(j) disallowance would allocate the disallowed interest (as well as certain other Section 163(j) specific items) to its partners pursuant to complex allocation rules that are set forth in the Proposed Regulations.[60]

This section addresses the application of these rules to partnerships that are wholly owned by members of single affiliated group and to loans between partners and partnerships or between commonly owned partnerships ("self-charged interest"). These issues are of particular importance to financial institutions because (a) they often are required to create wholly owned entities, which are sometimes classified as partnerships for tax purposes, for regulatory reasons and (b) they often employ (or are required to employ as a regulatory matter) intercompany financing arrangements.

Section 904 Regulations with respect to a group of affiliated financial services entities. *See* Prop. Treas. Regs. Section 1.904-4(e)(3)(ii).

57 *See* Prop. Treas. Regs. Section 1.904-4(e)(3)(ii).

58 We note that the Proposed Regulations already incorporate the Section 904 definition of "financial services entity" in respect of the rules that allocate interest expense between exempt and non-exempt businesses. *See* Treas Regs. Section 1.163-10(d)(2). Accordingly, under the recommendation above, there would be a more consistent definition of financial services entities within the Proposed Regulations.

59 Section 163(j)(4)(A)(i).

60 Prop. Treas. Regs. Section 1.163(j)-6(f)(2).

1. Partnerships Wholly Owned by Members of an Affiliated Group

We recommend that the Final Regulations provide that the general rule under which partnerships are subject to an independent Section 163(j) limitation does not apply to a partnership that is wholly owned, directly or indirectly, by a single affiliated group of corporations (a "controlled partnership"). More specifically, we recommend that the term "controlled partnership" be defined in this regard as a partnership if members of the same controlled group of corporations (as defined in Section 1563) own, directly or indirectly, 100 percent of the capital and profits interests of such partnership. Under this approach, the partnership would not be subject to an independent Section 163(j) limitation, and each partner in the partnership would include its allocable share of the income and deductions of the partnership for purposes of determining its own Section 163(j) limitation.

While Section 163(j) by its terms applies to partnerships at the entity level, that rule was presumably intended to apply to partnerships with third party partners in which the partnership conducts a business that is meaningfully distinct from the business conducted by its partners. In the case of a controlled partnership, however, the business of the partnership typically has minimal economic significance or identity apart from the business of the corporate group that owns the controlled partnership. In such a case, there is little, if any, policy reason to impose an independent Section 163(j) limitation on the controlled partnership, particularly in light of the increased cost and complexity of subjecting such a partnership to an independent Section 163(j) limitation.[61]

Moreover, in the case of a controlled partnership that would be a member of a consolidated tax group if it were a corporation, this recommendation is supported by the legislative history that states that Section 163(j) applies to partnerships at the entity level so that taxpayers do not elect to form a partnership or corporation based on Section 163(j) considerations (which could be the case if a partnership were instead treated as an aggregate of its partners for Section 163(j) purposes).[62] If that is the case, then the same tax policy would support treating a partnership that is wholly owned by members of a consolidated tax group in the same manner as if it were classified as a corporation for tax purposes. That is because, in the absence of such a rule, a corporation could elect whether to form an affiliate as a partnership or corporation based on whether it would obtain a better Section 163(j) result if the entity is subject

61 The Proposed Regulations already acknowledge that a controlled partnership is treated differently from other partnerships for Section 163(j) purposes insofar as the CFC group election rules provide that a partnership that is wholly owned by members of a CFC group is treated as if it were a corporation for purposes of the CFC group election. *See* Prop. Treas Regs. Section 1.163(j)-7(b)(4).

62 H.R. REP. 115-409, at 247 ("The Committee believes that it is necessary to apply the limitation on the deductibility of interest to businesses regardless of the form in which such businesses are organized so as not to create distortions in the choice of entity.").

to an independent Section 163(j) limitation (in which case it would form the affiliate as a partnership) or a single Section 163(j) limitation with the rest of the consolidated group (in which case it would form the affiliate as a corporation). Thus, at least in the case of a controlled partnership that would be a member of a consolidated group if it were a corporation, treating such a partnership as an aggregate would further the legislative objective of treating partnerships and corporations in a similar manner for Section 163(j) purposes.[63]

2. <u>Self-Charged Interest</u>

The preamble to the Proposed Regulations states that the Treasury Department and the IRS intend to adopt rules to recharacterize business interest expense and business interest income that may be allocable to an owner of a partnership where such income or expense arises from lending transactions between the partnership and an owner of the entity in order "to prevent such business interest income and expense from entering or affecting the Section 163(j) limitation calculations for both the lender and the borrower in such situations."[64]

As a policy matter, self-charged interest should be disregarded for Section 163(j) purposes if partnership interest expense is allocated to the partner that receives the interest or if partnership interest income is allocated to the partner that paid the interest. In such a case, the interest is effectively paid to oneself, and accordingly does not have a meaningful economic impact on the applicable partnership and partner. Furthermore, the base erosion concern that motivates Section 163(j) would not be present in such a case, because the applicable interest deduction would be matched by a corresponding interest income inclusion.

In addition, if self-charged interest is taken into account for Section 163(j) purposes, taxpayers could artificially incur debt between partners and partnerships (or related partnerships) in order to improve the Section 163(j) position of the combined group. For example, consider a partnership that expects to incur interest expense that would be disallowed under Section 163(j)

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63 While this argument would not equally apply to a controlled partnership that would not be a member of a consolidated group if it were a corporation, we think that as a policy matter there is little reason to apply Section 163(j) differently to a controlled partnership solely based on whether the partnership would be a member of a consolidated tax group if it were a corporation. However, if the government rejects this argument, it should, at a minimum, provide that Section 163(j) does not apply to a controlled partnership at the entity level if it would be a member of a consolidated group if it were a corporation. In such a case, this rule could either treat the partnership as an aggregate or as a corporation -- in either case the income and expenses of the controlled partnership would be included within the consolidated group for Section 163(j) purposes.

64 REG-106089-18, 83 FR 67490, 67503. As a technical matter, the preamble addresses partnerships and "S" corporations; however, for purposes of simplicity, the discussion herein refers to self-charged interest that is paid or received by a partnership.

and that is owned by partners that expect to recognize a significant amount of "excess business income" (i.e., income in excess of the amount necessary to deduct their interest expense under Section 163(j)). In such a case, in the absence of a special rule for self-charged interest, the partners could simply borrow money from the partnership in proportion to their interests in the partnership and thereby artificially increase the interest income of the partnership.

Accordingly, we recommend that the Final Regulations provide that interest that is paid by a partnership to a partner should not be taken into account for purposes of determining the partnership's Section 163(j) limitation and the partner's "adjusted taxable income" to the extent that the deduction for the interest is allocated to the partner that receives the interest payment. We similarly recommend that interest that is paid by a partner to a partnership should not be taken into account for purposes of determining the partner's Section 163(j) limitation and the "adjusted taxable income" of the partnership to the extent that the partnership's interest income from the payment is allocated to the partner that paid the interest. Furthermore, interest income and expense from loans between partnerships that are owned by the same partners in the same proportions should not be taken into account for Section 163(j) purposes.[65] This would be similar to the rules regarding self-charged interest under the passive activity loss rules[66] and the rules regarding the "Medicare tax" on net investment income .[67]

In addition, we recommend that the Final Regulations provide that the rules described above regarding self-charged interest should also apply if the partner that is allocated the interest income or expense is a member of the same consolidated group as the lender or borrower under the partnership loan. This could be illustrated by an example in which (a) there is a consolidated tax group that consists of a parent corporation A that owns all of the shares of corporation B and corporation C, (b) corporation B and corporation C own of all the interests of partnership D, and (c) corporation A makes a loan to partnership D. In such a case, the Final Regulations should provide that the interest expense of partnership D, and the interest income of corporation A, in respect of the loan should be disregarded for Section 163(j) purposes, notwithstanding that the

65 Under this approach, a portion of the self-charged interest would be taken into account for Section 163(j) purposes to the extent that the interest is allocated to other partners in the partnership. For example, if a partner makes a loan to a partnership and is allocated half of the interest expense on the loan, then the partnership would take into account half of the interest expense on the loan for purposes of determining its own Section 163(j) limitation, and the recipient of the interest payment would include half of the interest income in determining its own ATI.

66 Treas. Regs. Section 1.469-7.

67 *See also* Treas. Regs. Sec. 1.1411-5(g)(5) (providing that a taxpayer's interest income is not treated as "net investment income" to the extent that such interest income would be recharacterized as passive activity gross income under Treasury Regulations Section 1.469-7 if the payor of such interest were a passive activity of the taxpayer).

partnership interest expense is allocated to its partners and not to corporation A. This would be consistent with the fact that Section 163(j) generally treats a consolidated group as a single taxpayer for Section 163(j) purposes. Thus, an allocation of interest expense to corporations B and C in this example is functionally the same for Section 163(j) purposes as if the interest expense were allocated to corporation A.

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We appreciate your consideration of our views and concerns, and we would appreciate the opportunity to discuss the issues in this submission with you and your colleagues.

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