26 CFR Part 1

[INTL-870-89]

RIN 1545-A024

Earnings Stripping (Section 163(j)); Correction

AGENCY: Internal Revenue Service, Treasury.

ACTION: Correction to notice of proposed rulemaking.

SUMMARY: This document contains corrections to the notice of proposed rulemaking (INTL-870-89), which was published in the Federal Register on June 18, 1991 (56 FR 27907). The proposed rules contain Income Tax Regulations relating to section 163(j) of the Internal Revenue Code, regarding "earnings stripping".

FOR FURTHER INFORMATION CONTACT: Jack Feldman (202) 566-6645 or Jeffrey Vinnik (202) 566-6442; concerning § 1.163(j)-8, Elizabeth Karzon (202) 566-6442 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking that is the subject of these corrections contains proposed amendments to the income Tax Regulations (26 CFR part 1) under section 163(j) of the Internal Revenue Code.

Need for Correction

As published, the proposed rulemaking contains errors which may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of proposed rulemaking (INTL-870-89), which was the subject of FR Doc. 91-14243, is corrected as follows:

§ 1.163 [Corrected]

1. On page 27919, column 2, § 1.163(j)-5(b)(7), paragraph (iii) of *Example 1*, line 5, the language "exempt related person interest, or $300. This" is corrected to read "exempt related person interest expense, or $300. This".

2. On page 27921, column 3, § 1.163(j)-5(c)(3), paragraph (b)(3) of *Example 1*, second line from the bottom of that paragraph, the language "carried forward to their next succeeding" is corrected read "carried forward to their succeeding".

3. On page 27921, column 2, § 1.163(j)-5(c)(3), paragraph (c) of *Example 2*, first line, the language "Under Step 4, A, B, and C must allocate" is corrected to read "*Step 4 determinations.* Under Step 4, A, B, and C must allocate".

4. On page 27922, column 3, § 1.163(j)-5(c)(3), under *Example 3*, lines 3 and 4 (top of column), the language "debt-equity ratio safe harbor test described in § 1.163(j)-1(b), and that all interest expense" is corrected to read "debt-equity ratio safe harbor test, and that all interest expense".

5. On page 27922, column 2 (middle of column), § 1.163(j)-5(c)(3), paragraph (d)(2) of *Example 3*, line 2, the language "separately determined taxable incomes of A," is corrected to read "separately determined taxable income of A,".

Dale D. Goode,

Federal Register Liaison Officer, Assistant Chief Counsel (Corporate).

[FR Doc. 91-18639 Filed 8-13-91; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[INTL-0870-89]

RIN 1545-AO24

Earnings Stripping (Section 163(j))

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed Income Tax Regulations relating to section 163(j) of the Internal Revenue Code, regarding "earnings stripping." This action is necessary because of changes to the applicable tax law made by the Omnibus Budget Reconciliation Act of 1989, Public Law 101-239, 103 Stat. 2106.

DATES: Written comments must be received by August 19, 1991. Requests to speak at a public hearing (with outlines of oral comments) scheduled for September 25, 1991, must be received by September 4, 1991. See notice of hearing published elsewhere in this issue of the **Federal Register.**

ADDRESSES: Send comments, requests to appear at the public hearing, and outlines of comments to be presented, to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, attention: CC:CORP:T:R (INTL-0870-89), room 5228, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the regulation generally, phone Jack Feldman, at (202) 566-6045, or Jeffrey Vinnik, at (202) 566-6442; concerning § 1.163(j)-6, phone Elizabeth Karzon, at (202) 566-6442 (not toll-free calls), or write to the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, attention: CC:CORP:T:R (INTL-0870-89), Washington, DC 20044. Concerning the hearing, phone Felicia Daniels, Regulations Unit, at (202) 566-3935 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Management and Budget, attn: Desk Officer for the

Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, attn: IRS Reports Clearance Officer T:FP, Washington, DC 20224.

The collection of information in these regulations is in § 1.163(j)–6(d). This information is required by the Internal Revenue Service to verify elections made by the taxpayer. The likely respondents are businesses or for profit institutions.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on information is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Estimated total annual reporting burden: 1,196 hours.

The estimated annual burden per respondent varies from 20 minutes to 40 minutes, depending on individual circumstances, with an estimated average of .52 hours.

Estimated number of respondents: 2,300.

Estimated annual frequency of responses: 1.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 163(j) of the Internal Revenue Code.

Explanation of Provisions

Section 163(j) was added to the Internal Revenue Code of 1986 by the Omnibus Budget Reconciliation Act of 1989, Public Law 101–239, 103 Stat. 2106, to prevent erosion of the U.S. base by means of excessive deductions for interest paid by a taxable corporation to a tax exempt (or partially tax exempt) related person. The payment of excessive deductible interest that is tax exempt (or partially tax exempt) in the hands of a related person is referred to as "earnings stripping." These proposed regulations implement section 163(j) as follows.

Section 1.163(j)–1

Section 1.163(j)–1(a) provides the primary operative rule that no deduction shall be allowed for interest expense paid or accrued directly or indirectly by a corporation to a related person if no tax is imposed with respect to such interest. The disallowance rules do not apply if the payor corporation is either an S corporation or a foreign corporation (except as provided under § 1.163(j)–6, relating to foreign corporations with effectively connected income). Paragraph (a)(2) provides that the amount of disallowed interest expense (the year's disallowed interest expense) is limited to the lesser of exempt related person interest expense (defined in paragraph (a) of § 1.163(j)–2) or excess interest expense (defined in paragraph (b) of § 1.163(j)–2). Paragraph (a)(3) provides that interest expense disallowed in a taxable year is carried forward to succeeding taxable years as disallowed interest expense carryforwards.

Paragraph (b) provides that, in addition to the limitation on disallowance provided under paragraph (a)(2), a deduction for exempt related person interest expense shall not be disallowed for any taxable year in which the debt-equity ratio of the payor corporation is less than or equal to 1.5 to 1 determined on the last day of that year. Although section 163(j)(2)(A)(ii) grants the Service the authority to determine the debt-equity ratio more frequently than anhually, a more frequent determination was not adopted because many taxpayers might have difficulty in obtaining the required information prior to the close of their taxable years. However, to prevent possible manipulation of a strictly annual determination of the debt equity ratio, paragraphs (b)(4) and (c)(5) of § 1.163(j)–3 provide anti-avoidance rules.

Paragraph (c) provides that disallowed interest expense carryforward is allowable in the carryforward year only to the extent of any excess limitation for that year as defined in § 1.163(j)–2(c). In determining whether a deduction is allowed in a carryforward year for disallowed interest expense carryforward, the payor corporation's debt-equity ratio in such year is not relevant.

Paragraph (d) provides rules for the carryforward of excess limitation. Excess limitation is carried forward to each of the three succeeding taxable years and reduces (and is also reduced by) excess interest expense in a carryforward year without regard to whether the payor corporation has exempt related person interest expense or whether the payor corporation satisfies the debt-equity ratio safe harbor test in a carryforward year. Pre-effective date notional excess limitation may be carried forward to post-effective date taxable years in certain cases, as provided under § 1.163(j)–10(c).

Paragraph (e) provides that the disallowance of interest under section 163(j) does not affect the payor corporation's determination of earnings and profits.

Paragraph (f) provides a general anti abuse rule to prevent the avoidance of section 163(j) and these regulations.

Section 1.163(j)–2

Section 1.163(j)–2 provides definitions. Paragraph (a) defines "exempt related person interest expense" as interest paid or accrued by a corporation described in § 1.163(j)–1 to a related person (as defined in paragraph (g)) if no tax is imposed on such interest under the rules of § 1.163(j)–4. Paragraph (b) defines "excess interest expense" as the excess of the payor corporation's net interest expense over 50 percent of its adjusted taxable income plus the amount of any excess limitation carryforward. Paragraph (c) defines "excess limitation" as the excess of 50 percent of a corporation's adjusted taxable income over its net interest expense. Paragraph (d) defines "net interest expense" as the excess of a corporation's interest expense over its interest income for the taxable year. Net interest expense is computed without regard to any disallowed interest expense carryforward.

Paragraph (e) provides rules for the determination of interest income and expense, including rules dealing with the treatment of bond premium and market discount and rules for determining the interest income and expense of a corporate partner in a partnership. Under these rules, a corporate partner is treated as the payor of its share of the partnership's interest expense. The Internal Revenue Service plans to publish rules which treat interest equivalents as interest for purposes of section 163(j) and solicits comments regarding the scope and operation of such rules. These rules will generally be prospective with respect to transactions entered into in the ordinary course of business. However, in the case of transactions entered into with a purpose of avoiding section 163(j), the rules regarding interest equivalents may be retroactive.

Paragraph (e) also contains an anti-avoidance rule providing that certain substitute payments under section 1058 will be treated as interest expense.

Paragraph (f) defines adjusted taxable income as taxable income computed without regard to carryforwards and disallowances under section 163(j) and with certain adjustments. Some of these adjustments are stipulated in section 163(j); others have been added pursuant to regulatory authority granted by section 163(j)(6)(A)(ii). In general, the purpose of these adjustments is to

modify taxable income to more closely reflect the cash flow of the corporation. Thus, for example, paragraph (f) provides for an addback of interest excluded from gross income under section 103, since such amounts increase cash available to the payor corporation. Similarly, cash expended with respect to amounts which are permanently disallowed as deductions under sections 265 and 279 are subtracted under paragraph (f) in computing adjusted taxable income, since such expenditures have reduced the amount of available cash to service loans. Paragraph (f)(4) provides special rules dealing with the effect of an adjusted taxable loss on other computations required by these regulations.

Except as provided in § 1.163(j)–8, only the adjustments prescribed in paragraph (f) shall be made in determining adjusted taxable income. The Service, however, solicits comments on whether particular adjustments should either be added to, or deleted from, paragraph (f). Such comments should address, among other issues, the administrative burden of the proposed rules and any suggested revisions.

Under paragraph (g)(1), a related person is defined as a person related to the taxpayer within the meaning of section 267(b) or 707(b)(1). For this purpose, the attribution rules of section 267(c) apply. In determining whether persons are related, the substance of ownership, rather than its form, controls. Under paragraph (g)(3), the date for testing relatedness is the date upon which an item of interest expense accrues. Thus, changes in the relationship between the payor corporation and the payee after the accrual date are irrelevant. The daily accrual rule of section 1272(a) applies, regardless of the taxpayer's method of accounting. Paragraph (g)(4) provides special rules for certain partnerships regarding relatedness.

Section 1.163(j)–3

Section 1.163(j)–3 provides rules for the computation of the debt-equity ratio. Debt is determined under paragraph (b)(1) in accordance with generally applicable tax principles. Thus, in general, a contingent liability for financial accounting purposes that has not accrued for tax purposes will not be treated as a liability for purposes of section 163(j). Paragraph (b)(1) also has special rules for discount obligations consistent with section 163(j)(2)(C)(ii). Paragraph (b)(2)(i) provides a limited exclusion from debt for certain short term liabilities, and paragraph (b)(2)(ii) provides a similar exclusion for commercial financing liabilities. Paragraph (b)(3) provides that liabilities incurred by a partnership are treated as incurred by each partner in accordance with the rules of section 752. Paragraph (b)(4) provides an anti-rollover rule to prevent abuse by a corporation of the year-end determination of the debt-equity ratio.

Equity is defined under paragraph (c)(1) as the sum of money and the adjusted basis of assets (determined according to generally applicable tax principles) reduced, but not below zero, by the corporation's debt. Paragraph (c)(2) provides for adjustments to be made to the basis of stock in certain nonincludible corporations based on the principles of section 864(e)(4). Under paragraph (c)(3), assets are reduced by the amount of short term liabilities excluded from debt under paragraph (b)(2). Paragraph (c)(4) provides that in determining the assets of a corporation that owns an interest in a partnership, the partner shall treat the adjusted basis of its partnership interest as an asset. Paragraph (c)(5) provides a general anti-avoidance rule, plus an anti-stuffing rule to prevent possible abuse by a corporation of the year-end determination of debt-equity ratio.

Paragraph (d) provides that the spot rate on the last day of the taxable year is used to translate the debt and equity of a qualified business unit with a non-dollar functional currency.

Comments are solicited with respect to determining the debt and assets of financial institutions and insurance companies, including the effect of reserves on such determinations.

Section 1.163(j)–4

Section 1.163(j)–4 provides rules addressing whether interest paid or accrued is subject to U.S. tax. Paragraph (a) states the general rule that interest paid or accrued by a corporation is not subject to tax for purposes of section 163(j) if no U.S. tax is imposed under subtitle A of the Internal Revenue Code or if U.S. tax is reduced under a treaty. Paragraph (b) provides that income subject to U.S. tax at a reduced rate under a treaty will be treated in part as interest subject to tax and in part as tax-exempt interest.

Paragraph (c) provides that the determination as to whether interest is subject to U.S. tax is made on the date the interest is received or accrued by the payee, whichever is relevant for purposes of taxing the payee.

Paragraph (d) provides rules under which certain interest paid to special entities, including controlled foreign corporations ("CFCs"), passive foreign investment companies ("PFICs"), foreign personal holding companies, and DISCs, is treated as subject to U.S. tax. See H.R. Rep. No. 247, 101st Cong., 1st Sess. 1240, 1244 (1989) (hereafter, "House Report"). Paragraph (d)(1) generally provides that interest paid or accrued to a CFC is treated as subject to U.S. tax to the extent that such interest is included in the CFC's net foreign personal holding company income under § 1.954–1T(c) and results in an inclusion in the gross income of a U.S. shareholder under section 951(a)(1)(A)(i). A similar rule is provided for foreign personal holding companies in paragraph (d)(3). Interest paid or accrued to a PFIC that is not a CFC, with respect to which a QEF election has been made by a U.S. shareholder, is treated as subject to U.S. tax to the extent that such interest is included in the QEF's ordinary earnings and results in an inclusion in such shareholder's income under section 1293(a)(1)(A). Producer's loan interest that is treated as a deemed distribution to a DISC's shareholder under section 995(b)(1)(A) also is treated as subject to U.S. tax.

Section 1.163(j)–5

Section 1.163(j)–5 implements the directive of section 163(j)(6)(C) that all members of the same affiliated group be treated as one taxpayer. In order to implement this directive, the basic rules of these regulations have been modified as necessary to carry out the purposes of section 163(j). See section 163(j)(7) (A) and (B).

Section 1.163(j)–5(b) applies the rules of section 163(j) (other than the debt-equity ratio computations discussed below) to consolidated groups. For this purpose, all of the members of the consolidated group make the computations required by section 163(j) and these regulations on a consolidated basis. If a corporation ceases to be a member of the consolidated group, any disallowed interest expense carryforward of the group is apportioned to the member based on the ratio of the member's excess related person interest expense to the group's excess related person interest expense. However, corporations ceasing to be members of the group generally may not carry forward any portion of the group's excess limitation carryforward to separate return years.

Section 1.163(j)–5(c) provides comparable rules applicable to other affiliated groups. For this purpose, section 1.163(j)-5(a)(3) expands the definition of affiliated groups under section 1504(a) by applying the attribution rules of section 318 to determine stock ownership. Thus, an affiliated group under these rules may

include a consolidated group, and the consolidated group is treated as a single member of the affiliated group for purposes of making computations for the affiliated group. Section 1.163(j)–5(c) requires each group member to take into account the relevant items of income, expense, and carryover of all group members. If members of an affiliated group have different taxable years, then the computations required by section 163(j) are separately determined for each member on an affiliated group basis by aggregating the relevant items for all group members whose taxable years end with or within the taxable year of the member making the computations.

Section 1.163(j)–5(c)(2) provides a four step process for making the affiliated group computations and for allocating amounts among group members. The four step process is necessary because the group members do not all join in filing the same return.

Section 1.163(j)–5(d) generally provides that for purposes of applying the debt-equity ratio safe harbor test described in § 1.163(j)–1(b), the debt-equity ratio of a corporation that is a member of an affiliated group (whether or not a consolidated group) is determined by aggregating the separately determined debt and assets of the members (adjusted as described in paragraphs (d)(2) and (d)(3)). Debt and assets arising from certain interaffiliate transactions are disregarded.

Section 163(j)–5(e) provides special rules that address distortions in the debt-equity ratio that may arise in a qualified stock purchase, as defined in section 338(d)(3), if no election is made to step up the basis of the assets of the target corporation and its affiliates. (This distortion may arise because the affiliated group rules of section 163(j) look through to the underlying assets of an acquired corporation rather than its stock basis.) If the purchasing corporation so elects, the special rules of § 1.163(j)–5(e) look to the adjusted basis of the target's stock (adjusted for liabilities) and amortize these amounts (the "special basis") over a fixed period. At the end of any taxable year, a taxpayer may elect out of the fixed stock write-off method and use the adjusted basis of the assets of the target corporation in determining the group's debt-equity ratio.

The Service recognizes the complexity of the affiliated group rules in § 1.163(j)–5 and solicits comments on how these rules might be improved, simplified or clarified, whether in the context of consolidated groups or otherwise. Comments are also solicited as to whether, under what circumstances, and to what extent it might be appropriate to extend the fixed stock write-off method to nontaxable acquisitions of stock or assets. Finally, the Service is considering whether and how to impose a conformity requirement under paragraph (e) of this section that would prevent a group from selectively applying the fixed stock write-off method only when the purchase price of a target company exceeds the target's basis in its assets. The Service solicits comments on the appropriateness of such a rule, and on how such a rule might be implemented.

Section 1.163(j)–6

This section limits the carryover of certain tax attributes by corporations which join consolidated groups or affiliated groups (as defined in § 1.163(j)–5(a)), as well as with respect to transactions described in section 381(a).

Paragraph (a) limits the use of disallowed interest expense carried forward from non-affiliation years by corporations joining a group or that transfer or distribute their assets in a transaction described in section 381(a). The only restriction under these regulations on the use of such disallowed interest expense is with respect to the use of non-affiliation year excess limitation carryforward to absorb the disallowed interest expense. The same limitation applies with respect to corporations joining groups, whether the groups are consolidated groups or affiliated groups. See §§ 1.163(j)–5(b) (relating to consolidated groups) and (c) (relating to other affiliated groups). Where there is a section 382 ownership change, the disallowed interest expense carryforward may be limited by the section 382 limitation. In addition, the deductibility of a corporation's disallowed interest expense carried forward to a taxable year after it joins a consolidated group may be limited by the separate return limitation year rules under § 1.1502–15.

Paragraph (b)(1) limits the use of excess limitation carried forward from non-affiliation years by corporations joining a group. The limitation is similar to the limitation on the carryover of net operating losses under the "SRLY" rules of § 1.1502–21(c) (i.e., generally such carryforward may be used by the corporation to the extent that it would have been available for use had no affiliation occurred). If a consolidated group acquires another group, whether or not consolidated, the amount of the acquired group's excess limitation carryforward (if any) from non-affiliation years that may be used by the consolidated group is determined by treating the former members of the acquired group as a single member of the acquiring group. Computations with respect to the acquired group are made under § 1.163(j)–5(c), and the results of these computations are taken into account by the group under § 1.163(j)–5(b).

Paragraph (b)(2) provides that a corporation's excess limitation carryforward from a non-affiliation year is reduced to zero immediately after a transfer or distribution of its assets in a transaction described in section 381(a) (other than a transaction described in section 368(a)(1)(F)). Paragraph (b)(3) provides an anti-abuse rule. Paragraphs (c) and (d) provide definitions and anti-duplication rules.

The Service recognizes the complexity of the affiliated group rules and solicits comments on how these rules might be improved, simplified or clarified, whether in the context of consolidated groups or otherwise.

Section 1.163(j)–7

This section addresses the interaction of section 163(j) and certain other Code provisions. Paragraph (a) provides that interest expense is not considered paid or accrued for purposes of section 163(j) until such interest would be deductible but for such section.

Paragraph (b) addresses other Code provisions which permanently disallow interest, which defer the deductibility of interest, or which limit the deductibility of certain deductions including interest, specifically the "at risk" rules under section 465 and the passive activity loss rules under section 469. In each of these cases, section 163(j) is applied after the application of such provisions. Thus, section 163(j) will not apply to interest expense which is permanently disallowed as a deduction under provisions such as sections 265 and 279. Where the deductibility of interest expense is deferred as under sections 163(e)(3) and 267(a)(3), section 163(j) will not apply until a deduction for such interest expense is otherwise allowable. Similarly, sections 465 and 469 are applied before section 163(j) to disallow interest expense. Once section 163(j) is applied, section 469 is not reapplied.

Paragraph (b)(4) addresses the interaction of section 163(j) and Code provisions relating to the capitalization of certain interest expense. Under this paragraph, the capitalization rules are applied before section 163(j). For all purposes under section 163(j), capitalized interest is not treated as interest expense. It is anticipated that regulations to be issued under section

263A(f) will provide: (1) That exempt related person interest expense which is attributable to traced debt will be capitalized; and (2) with respect to interest expense that is not attributable to traced debt, interest expense that is not exempt related person interest expense will be capitalized before interest expense that is exempt related person interest expense.

The Service proposes to adopt these rules for capitalized interest, notwithstanding the legislative history of section 163(j) (see House Report at 1244), because it believes that other approaches would require substantial additional complexity. The Service will revisit this decision if it believes that the proposed rule gives rise to significant tax avoidance.

Paragraph (b)(5) provides that section 246A is applied before section 163(j). Any reduction in the dividends received deduction under section 246A reduces interest expense taken into account under section 163(j).

Section 1.163(j)–8

This section concerns the application of section 163(j) to foreign corporations that have incomes gain, or loss that is effectively connected, or deemed effectively connected, with the conduct of a U.S. trade or business. A foreign corporation is permitted to allocate a portion of its worldwide interest expense to the effectively connected income of its U.S. trade or business. This section disallows the exempt related person interest expense of a foreign corporation based on the same principles that apply to disallow a domestic corporation's exempt related person interest expense. To determine if interest allocated to the effectively connected income of the U.S. trade or business is paid to an exempt related person, the rules of section 884(f) apply. Thus, interest paid by the U.S. trade or business (within the meaning of section 884(f)(1)(A)) is treated as paid directly to the recipient of the interest, and will be treated as paid to a related person if the recipient is related to the foreign corporation. Excess interest (within the meaning of section 884(f)(1)(B)) is treated as paid by a wholly owned domestic subsidiary of the foreign corporation to the foreign corporation, and hence is treated as paid to a related person. Additional rules provide that this section does not affect the computation of a foreign corporation's effectively connected earnings and profits or U.S. net equity for purposes of section 884.

Section 1.163(j)–9

The Service expects to publish regulations addressing guarantees in the near future. The rules with respect to guarantees will be prospective. Nonetheless, in cases presenting fact patterns similar to that described in *Plantation Patterns, Inc.* v. *Commissioner*, 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972), the Service will continue to seek to characterize purported guaranteed debt as equity. The Service's position on back-to-back loans is set forth in revenue rulings including Rev. Rul. 84–152, 1984–2 C.B. 381, Rev. Rul. 84–153, 1984–2 C.B. 383, and Rev. Rul. 87–89, 1989–2 C.B. 195.

Comments are solicited on rules regarding guarantees and back-to-back loans.

Section 1.163(j)–10

In general, section 163(j) provides for disallowance of interest paid or accrued in taxable years beginning after July 10, 1989. However, interest that would otherwise be disallowed under the general rule will not be disallowed if paid with respect to a fixed-term obligation outstanding on July 10, 1989 (a grandfathered obligation). An obligation will cease to be treated as grandfathered if its term is extended, or if it is revised in a transaction that results in the obligee being deemed to have made an exchange of debt instruments under section 1001 of the Code. Under an anti-avoidance rule, a grandfathered obligation also will cease to be so treated if it is acquired by a person related to the obligor as part of a transaction that otherwise would circumvent the purposes of the effective date rules.

A limited grandfathering also exists under section 163(j) for interest paid with respect to obligations issued pursuant to a written contract binding on July 10, 1989. A contract will be treated as binding for this purpose only if it was enforceable by an unrelated third party on July 10, 1989, and at all times thereafter until the obligation is issued.

A very limited transition rule exists with respect to demand obligations outstanding on July 10, 1989. Interest paid or accrued prior to September 1, 1989, with respect to such demand loans shall not be disallowed by section 163(j) even though it was paid or accrued in a taxable year beginning after July 10, 1989.

A final effective date rule concerns the computation of excess limitation carryforward with respect to the first three taxable years to which section 163(j) applies. In computing a taxpayer's disallowed interest expense under section 163(j), the taxpayer may take into account amounts that would have been excess limitation carryforward had the statute been in effect with respect to interest paid or accrued in taxable years beginning after July 10, 1989.

General Comments

The Service solicits comments on whether, and to what extent, the rules of section 163(j) and these regulations comport with the arm's length standards for "thin capitalization." In particular, the Service invites comments on the proper application of the arm's length standard to related party debt; on the use of a cash-flow versus a debt-equity standard; and on the problems of tax administration in this area. See H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 568–570 (1989).

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held on September 25, 1991. See notice of hearing published elsewhere in this issue of the Federal Register.

Drafting Information

The principal authors of these regulations are Jack Feldman and Jeffrey Vinnik. However, the principal author of § 1.163(j)–8 is Elizabeth Karzon. Messrs. Feldman and Vinnik and Ms. Karzon are of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. Other personnel from the Internal Revenue Service and Treasury

Department participated in developing the regulations.

List of Subjects in 26 CFR 1.161–1 through 1.194–4

Income taxes, Reporting and recordkeeping requirements.

Proposed amendments to the regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAX REGULATIONS; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

PARAGRAPH 1. The authority for part 1 continues to read in part:

Authority: 26 U.S.C. 7805 * * *

PAR. 2. Sections 1.163(j)–0 through 1.163(j)–10 are added as follows:

§ 1.163(j)–0 Table of contents.

This section contains a listing of the major headings of §§ 1.163(j)–1 through 1.163(j)–10.

§ 1.163(j)–1 Limitation on deduction for certain interest paid or accrued by a corporation to related persons.

(a) *In general.*—(1) *Deduction for exempt related person interest expense disallowed.* Except as provided in this section, no deduction shall be allowed for exempt related person interest expense (as defined in § 1.163(j)–2(a)) paid or accrued during the taxable year directly or indirectly by—

(i) A domestic corporation (other than an S corporation as defined in section 1361), or

(ii) Under the special rules described in § 1.163(j)–8, a foreign corporation with income, gain, or loss that is

effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

(2) *Limitation on disallowance of deduction.* The amount of exempt related person interest expense disallowed as a deduction in any taxable year (described hereafter as the year's "disallowed interest expense") shall not exceed the payor corporation's excess interest expense (as defined in § 1.163(j)–2(b)) for that year.

(3) *Disallowed interest expense carryforward.* Disallowed interest expense shall be carried forward to the succeeding taxable year (hereafter, a "disallowed interest expense carryforward"). A deduction for disallowed interest expense carryforward may be allowed as provided in paragraph (c) of this section.

(b) *Debt-equity ratio safe harbor test.* No deduction shall be disallowed under paragraph (a) of this section for exempt related person interest expense paid or accrued in any taxable year in which the payor corporation's debt-equity ratio (determined as provided in § 1.163(j)–5) is less than or equal to 1.5 to 1 on the last day of the taxable year.

(c) *Treatment of disallowed interest expense carryforward*—(1) *In general.* A deduction for disallowed interest expense carryforward is allowed in a carryforward year if and to the extent that there is excess limitation (as defined in § 1.163(j)–2(c)) for such year. Any disallowed interest expense carryforward not so deductible shall be carried forward to the succeeding taxable year.

(2) *Effect of debt-equity safe harbor.* The debt-equity ratio in a carryforward year is not relevant in determining whether disallowed interest expense carryforward is deductible in such year. Rather, disallowed interest expense carryforward is deductible only to the extent of the excess limitation for such year.

(d) *Carryforward of excess limitation.* If a corporation has excess limitation (as defined in § 1.163(j)–2(c)) for any taxable year, the amount of such excess limitation, reduced by disallowed interest expense carryforward to that year, shall be carried forward to each of the three succeeding taxable years. In each of those years, such carryforward shall reduce, and be reduced by, the amount, if any, of the corporation's excess interest expense for such year computed without regard to the carryforward. The excess limitation carryforward shall reduce, and be reduced by, excess interest expense in a carryforward year without regard to whether the corporation pays or accrues any exempt related person interest expense in that year, or whether the corporation satisfies the debt-equity ratio safe harbor test described in paragraph (b) of this section for that year. If a corporation has carryforwards from more than one taxable year, such carryforwards shall reduce, and be reduced by, excess interest expense in the order in which they arose. For purposes of all the reductions described in this paragraph, excess limitation, excess limitation carryforward, and excess interest expense shall not be reduced below zero. For rules regarding the effect of an adjusted taxable loss with respect to excess limitation carryforward, see § 1.163(j)–2(f)(4)(ii).

(e) *Effect on earnings and profits.* The disallowance and carryforward of a deduction for interest expense under this section shall not affect whether or when such interest expense reduces earnings and profits of the payor corporation.

(f) *Anti-avoidance rule.* Arrangements, including the use of partnerships or trusts, entered into with a principal purpose of avoiding the rules of section 163(j) and these regulations shall be disregarded or recharacterized to the extent necessary to carry out the purposes of section 163(j).

(g) *Examples.* The following examples illustrate the rules of this section.

Example 1 (i) A, a domestic corporation, is a wholly owned subsidiary of F, a foreign corporation. During its taxable year ending December 31, 1990, A has adjusted taxable income of $100, which includes $20 of interest income, and $90 of interest expense, of which $60 is paid or accrued to F. The balance of the interest expense is paid to unrelated persons. Interest paid to F by A is not subject to U.S. tax due to a tax treaty. A does not satisfy the debt-equity ratio safe harbor test in 1990, and has no excess limitation carried forward to that year.

(ii) A's excess interest expense for 1990 is $20, which is the difference between its net interest expense and 50 percent of its adjusted taxable income ($70 − $50 = $20). Since for 1990, the amount of A's exempt related person interest expense ($60) is greater than its excess interest expense ($20), a deduction for $20 of A's exempt related person interest expense is disallowed under paragraph (a) of this section. A's 1990 disallowed interest expense is carried forward to A's succeeding taxable year.

Example 2 (i) The facts are the same as in paragraph (i) of Example 1. In 1991, A has $120 of adjusted taxable income, net interest expense of $50, and $20 of disallowed interest expense carried forward from 1990. All of A's interest expense for 1991 is paid to unrelated persons. A does not satisfy the debt-equity ratio safe harbor test in 1991.

(ii) A has excess limitation (as defined in § 1.163(j)–2 (c)) of $10 ($60 [50% of adjusted taxable income) − $50 (net interest expense)] in 1991. In 1991, A may deduct the interest expense paid or accrued in that year to unrelated persons, plus $10 of disallowed interest expense carryforward from 1990. The balance of A's disallowed interest expense carryforward from 1990 ($10) is carried forward to A's 1992 taxable year.

Example 3 (i) The facts are the same as in paragraph (i) of Example 2. In 1992, A satisfies the debt-equity ratio safe harbor test, has adjusted taxable income of $210, and net interest expense of $100. All A's interest expense for 1992 is paid or accrued to F.

(ii) In 1992, A has excess limitation of $5 [$105 [50% of adjusted taxable income) − $100 (net interest expense)]. Applying the principles of paragraph (c) of this section, A's $10 of disallowed interest expense carryforward from 1991 (see Example 2, paragraph (ii)) is allowed in 1992 only to the extent of the $5 of excess limitation for that year. The remaining $5 of disallowed interest expense carried forward from 1991 is carried forward to A's 1993 taxable year.

Example 4(i) The facts are the same as in paragraph (i) of Example 3. In 1993, A satisfies the debt-equity ratio safe harbor test, has adjusted taxable income of $100, and has net interest expense of $75, all of which is paid or accrued to F.

(ii) A's excess interest expense for 1993 is $25 ($75 (A's net interest expense)—$50 (50% of its adjusted taxable income)). Applying the principles of paragraphs (a) and (b) of this section, section 163(j) does not disallow a deduction in 1993 for any of A's excess interest expense that is exempt related person interest expense. Under paragraph (c) of this section, A's $5 of disallowed interest expense carryforward from 1992 (see Example 3, paragraph (ii)) is not deductible in 1993, and is carried forward to A's 1994 taxable year.

(h) *Cross-references.* For rules regarding affiliated groups for purposes of section 163(j), see § 1.163(j)–5. For rules limiting the deductibility of disallowed interest expense carryforward and restricting the use of excess limitation carried forward to taxable years after the occurrence of certain corporate transactions, see § 1.163(j)–6.

§ 1.163(j)–2 Definitions.

(a) *Exempt related person interest expense.* The term "exempt related person interest expense" means interest expense that is (or is treated as) paid or accrued by a corporation described in § 1.163(j)–1 (a) to a related person (within the meaning of paragraph (g) of this section) if no tax is imposed with respect to such interest under rules provided in § 1.163(j)–4.

(b) *Excess interest expense.* The term "excess interest expense" means the excess, if any, of a corporation's net interest expense (as defined in paragraph (d) of this section) over the sum of 50 percent of its adjusted taxable income (as defined in paragraph (f) of

this section) plus any excess limitation carried forward to the taxable year (under the rules of § 1.163(j)–2(d)). See paragraph (f)(4)(ii) of this section for rules regarding the effect of an adjusted taxable loss on the computation of excess interest expense.

(c) *Excess limitation.* The term "excess limitation" means the excess, if any, of 50 percent of a corporation's adjusted taxable income (as defined in paragraph (f) of this section) over its net interest expense (as defined in paragraph (d) of this section). (d) *Net interest expense.* The term "net interest expense" means the excess, if any, of the amount of interest expense paid or accrued (directly or indirectly) by a corporation during the taxable year over the amount of interest includible (directly or indirectly) in its gross income for such year.

(d) *Net interest expense.* The term "net interest expense means the excess, if any, of the amount of interest expense paid or accrued (directly or indirectly) by a corporation during the taxable year over the amount of interest includible (directly or indirectly) in its gross income for such year.

(e) *Interest income and expense*—(1) *In general.* Interest income shall generally be determined under section 61 and shall include original issue discount as provided in sections 1272 through 1275 (adjusted, under section 1272(a)(7), for any acquisition premium paid by a subsequent holder), acquisition discount as provided in sections 1281 through 1283, and amounts that are treated as original issue discount under section 1286 (pertaining to stripped bonds). Interest expense shall generally be determined under section 163(a) and shall include original issue discount as provided in section 163(e). Interest expense for a taxable year does not take into account any disallowed interest expense carried forward to that year under the rules of § 1.163(j)–1. Interest income or expense with respect to a debt instrument denominated in a nonfunctional currency (or the payments of which are determined with reference to a nonfunctional currency) shall be determined in accordance with section 988 and the regulations thereunder. For rules regarding the relationship of section 163(j) to other Code provisions under which a deduction for interest expense may be disallowed or deferred, see § 1.163(j)–7.

(2) *Treatment of bond premium and market discount*—(i) *Bond Premium.* In the case of any bond with respect to which an election made under section 171(c) is in effect, amortizable bond premium (as defined in section 171(b)) shall reduce interest income. Bond premium included in income by the issuer under the principles of § 1.61–12 (or the successor provision thereof) shall reduce interest expense.

(ii) *Market discount.* Gain treated as ordinary income on the disposition of a market discount bond under section 1276(a) shall be treated as interest income.

(3) *Interest equivalents.* [Reserved]

(4) *Interest income of partnerships.* Interest paid or accrued to a partnership shall be treated under section 163(j) and these regulations (other than paragraph (g) of this section) as paid or accrued to the partners of the partnership in proportion to each partner's distributive share (as defined in section 704) of the partnership's interest income for the taxable year.

(5) *Interest expense of partnerships.* Interest expense paid or accrued by a partnership and the tax exempt interest expense of a partnership (within the meaning of § 1.163(j)–4) shall be treated for all purposes under section 163(j) and these regulations as paid or accrued by the partners of the partnership in proportion to each partner's distributive share (as defined in section 704) of the partnership's interest expense and tax exempt interest expense, respectively, for the taxable year. Thus, a corporation which is a partner in a partnership shall be treated as paying or accruing its share of the partnership's interest expense, and is treated as the payor of such interest expense.

(6) *Certain substitute payments*—(i) *In general.* If pursuant to an agreement meeting the requirements of section 1058(b), there is a transfer of securities (as defined in section 1236(c)) between related persons (within the meaning of paragraph (g) of this section), payments described in section 1058(b)(2) with respect to such transferred securities ("substitute payments") shall be treated as interest expense for purposes of section 163(j) and these regulations.

(ii) *Effective date.* This paragraph (e)(6) shall be effective with respect to substitute payments paid or accrued after July 18, 1991.

(f) *Adjusted taxable income*—(1) *In general.* The term "adjusted taxable income" means a corporation's taxable income for the taxable year, computed without regard to any carryforwards or disallowances under section 163(j), and determined with the modifications described in paragraphs (f)(2) and (f)(3) of this section. A corporation's adjusted taxable income may be a negative amount (*i.e.* an adjusted taxable loss). See paragraph (f)(4) of this section for rules regarding the effect of an adjusted taxable loss.

(2) *Additions.* The following amounts shall be added to a corporation's taxable income to determine its adjusted taxable income:

(i) The net interest expense (as defined in paragraph (d) of this section) for the taxable year;

(ii) The net operating loss deduction under section 172;

(iii) Deductions for depreciation under sections 167 and 168;

(iv) Deductions for the amortization of intangibles and other amortized expenditures (*e.g.*, start-up expenditures under section 195 and organizational expenditures under section 248);

(v) Deductions for depletion under section 611;

(vi) Carryovers of excess charitable contributions (within the meaning of section 170 (d)(2)), to the extent allowable as a deduction in the taxable year;

(vii) The increase, if any, between the end of the preceding year and the end of the current year in accounts payable (other than interest payable) that are included in the computation of taxable income;

(viii) The decrease, if any, between the end of the preceding taxable year and the end of the current taxable year in accounts receivable (other than interest receivable) that are included in the computation of taxable income;

(ix) Interest which is excluded from gross income under section 103;

(x) The dividends received deduction as provided under section 243 (other than deductions under section 243 (a)(3));

(xi) The increase, if any, in the LIFO recapture amount (as defined in section 312(n)(4)(B)) between the end of the preceding taxable year and the end of the current taxable year; and

(xii) Any deduction in the taxable year for capital loss carrybacks or carryovers.

(3) *Subtractions.* The following amounts shall be subtracted from taxable income to determine adjusted taxable income:

(i) With respect to the sale or disposition of property (including a sale or disposition of property by a partnership), any depreciation, amortization, or depletion deductions which were allowed or allowable for the taxpayer's taxable years beginning after July 10, 1986, with respect to such property;

(ii) With respect to the sale or disposition of stock of a member of a consolidated group that includes the selling corporation, an amount equal to the investment adjustments (as defined under §§ 1.1502–32 and 1.1502–32T) with respect to such stock that are attributable to deductions described in paragraph (f)(3)(i) of this section;

(iii) With respect to the sale or other disposition of an interest in a partnership, an amount equal to the taxpayer's distributive share of

deductions described in paragraph (f)(3)(ii) of this section with respect to property held by the partnership at the time of such sale or other disposition;

(iv) The decrease, if any, between the end of the preceding taxable year and the end of the current taxable year in accounts payable (other than interest payable) which are included in the computation of the corporation's taxable income;

(v) The increase, if any, between the end of the preceding taxable year and the end of the current taxable year in accounts receivable (other than interest receivable) which are included in the computation of the corporation's taxable income;

(vi) Amounts that would be deductible but for section 265 (regarding expenses and interest relating to tax-exempt income) or 279 (regarding interest on indebtedness incurred by a corporation to acquire stock or assets of another corporation);

(vii) The amount of any charitable contribution (as defined in section 170(c)) made during the taxable year that exceeds the amount deducible in that year by reason of section 170(b)(2);

(viii) The decrease, if any, in the LIFO recapture amount (as defined in section 312 (n)(4)(B)) between the end of the preceding taxable year and the end of the current taxable year; and

(ix) The amount of any net capital loss (as defined in section 1222(10)) for the taxable year.

(4) *Effect of adjusted taxable loss*—(i) *In general.* If a payor corporation has an adjusted taxable loss for the taxable year, then its adjusted taxable income shall be treated as zero.

(ii) *Effect on excess limitation carryforward.* The amount of an adjusted taxable loss reduces excess limitation carryforward for the purpose of determining whether there is excess interest expense for a taxable year.

(iii) *Adjusted taxable loss not carried forward.* An adjusted taxable loss in one taxable year shall not affect the determination of a corporation's adjusted taxable income for any other taxable year.

(g) *Related persons*—(1) *In general.* The term "related person" means any person who is related to the taxpayer within the meaning of sections 267(b) or 707(b)(1). For this purpose, the constructive ownership and attribution rules of section 267(c) shall apply.

(2) *Anti-abuse rule.* In determining whether persons are related, the substance, rather than the form, of ownership is controlling. Thus, for example, the principles of § 1.957-1 (b)(2) shall apply to determine whether an arrangement to shift formal voting power or formal ownership of shares away from any person for the purpose of avoiding the application of section 163 (j) shall be given effect.

(3) *When related person status is tested.* Whether a person is related to a payor corporation under section 163(j) is determined with respect to an item of interest expense when such interest expense accrues. For this purpose (notwithstanding the rules in § 1.163(j)-7), interest expense (including amounts treated as interest under this section) shall be treated as accruing daily under principles similar to section 1272(a). Also for this purpose, interest described in paragraph (e)(5) of this section shall be treated as accrued by a partner as it is accrued, under the principles of the preceding sentence, by the partnership. Changes in the relationship between the payor corporation and the payee after an item of interest expense accrues shall not be taken into account.

(4) *Special rule for certain partnerships*—(i) *Less than 10 percent of partnership held by tax exempt persons.* Any interest expense paid or accrued to a partnership directly or indirectly by a payor corporation that (without regard to this paragraph (g)(4)) is related to the partnership within the meaning of this paragraph (g) shall not be treated as paid or accrued to a related person if less than 10 percent of the capital and profits interests in such partnership are held by persons with respect to whom no tax is imposed on such interest by subtitle A of the Internal Revenue Code under rules provided in § 1.163(j)-1. However, the preceding sentence shall not apply to treat as interest paid to an unrelated person any interest that (under rules described in this section) is includible in the gross income of a partner in such a partnership who is itself a related person with respect to the payor of such interest.

(ii) *Reduction of tax by treaty.* If a treaty between the United States and a foreign country reduces the rate of tax imposed by subtitle A of the Code on a partner's distributive share of any interest paid or accrued to a partnership, such partner's interest in the partnership shall, for purposes of § 1.163(j)-7(g)(4)(i), be treated as held in part by a taxable person and in part by a tax exempt person in accordance with the rules described in § 1.163(j)-1(b).

(5) *Examples.* The principles of this paragraph (g) are illustrated by the following examples.

Example 1. (i) Fifty-one percent of the total combined voting power and value of domestic corporation A is owned by a domestic tax-exempt corporation, D1; the remainder is owned by foreign corporation F1. F1 is organized under the laws of country Z. Under a U.S. tax treaty with country Z, interest paid by A to F1 is exempt from U.S. tax under the rules of § 1.163 (j)-1.

(ii) Under these facts, D1 is related to A under section 267(b)(3) (because D1 and A are members of the same controlled group of corporations, as defined in section 267(f)), and interest payments made by A to D1 are exempt related person interest expense, a deduction for which may be disallowed under section 163(j). F1 is not related to A within the meaning of sections 267(b) or 707(b)(1). Deductions for interest paid by A to F1 are not subject to disallowance under section 163(j).

Example 2. (i) The facts are the same as in paragraph (i) of Example 1, except that D1 and F1 each own 50 percent of the vote and value of X's stock.

(ii) Unless the substance of D1's and F1's ownership differs from its form, so that paragraph (g)(2) of this section (regarding abusive ownership structures) applies, none of the interest paid by A to D1 or F1 is subject to disallowance under section 163(j).

Example 3. (i) A, a domestic corporation whose taxable year is the calendar year, is a wholly owned subsidiary of F, a foreign corporation. A is a partner, with a one-third share in the capital and profits interests, of P, a domestic partnership whose taxable year is the calendar year. During its taxable year ending December 31, 1990, and taking into account its interest in P, A has adjusted taxable income of $126.67. A's directly incurred interest income and expense for the taxable year are $20 and $30. Of the $30 of interest expense, $60 is paid or accrued to F.

(ii) P's interest income and interest expense for the taxable year of the partnership ending December 31, 1990, are $20 and $50, respectively. A's share of these amounts (determined under rules described in § 1.163(j)-2) are $6.67 and $16.67, respectively. Of P's $50 interest expense for the taxable year, $30 is paid or accrued to F, and the balance is paid or accrued to persons unrelated to A or to any of the other partners of P.

(iii) Interest paid or treated as paid to F by A is not subject to U.S. tax due to a tax treaty. Taking into account A's investment in the partnership (under rules described in § 1.163 (j)-3), A does not satisfy the debt-equity ratio safe harbor test in 1990.

(iv) Under § 1.163(j)-1(a) and paragraphs (c) (4) and (5) of this section, in its taxable year ending December 31, 1990, A is required to take into account the interest income and interest expense it directly incurs, plus its share of P's interest income and interest expense. Thus, A's interest income for 1990 is $26.67, and its interest expense is $106.67. A's excess interest expense for 1990 is $16.67, which is the difference between its net interest expense ($106.67 (interest expense) − $26.67 (interest income) = $60) and 50 percent of its adjusted taxable income ($126.67 x 50% = $63.33).

(v) For 1990, under the rule described in paragraph (e)(5) of this section, the amount of A's exempt related person interest expense is $66.67 ($60 + $6.67 = $66.67). Since that amount is greater than its excess interest expense ($16.67), section 163 (j) disallows a

deduction for $18.67 of A's interest expense for the taxable year. That disallowed interest expense is carried forward to A's 1991 taxable year.

Example 4. (i) X, a domestic corporation, is wholly owned by Y, a partnership. A treaty between the United States and foreign country U reduces the rate of tax on interest paid to residents of country U from 30 percent (the applicable rate for related person interest under sections 871 and 881 in the absence of a treaty) to 15 percent. Nineteen percent of the capital and profits interests of partnership Y are held by Z, a country U corporation entitled to claim the reduced (treaty) rate of tax on interest income; the balance is held by unrelated persons not exempt from U.S. tax on their distributive shares of interest paid by the corporation to the partnership.

(ii) Under paragraph (g)(4) of this section, less than ten percent (19 percent divided by two (30/15)) of Y's capital and profits interests are treated as held by persons who are tax exempt. Accordingly, all interest paid to partnership Y by corporation X is treated as paid to an unrelated person.

§ 1.163(j)–3 Computation of debt-equity ratio.

(a) *In general.* For purposes of section 163(j), the term "debt-equity ratio" means the ratio that the debt of the corporation bears to the equity of the corporation. For rules defining debt and equity, see paragraphs (b) and (c) of this section. For rules regarding the computation of the debt and equity of an affiliated group or a foreign corporation, see §§ 1.163(j)–5 or 1.163(j)–6, respectively.

(b) *Debt*—(1) *In general.* The debt of a corporation means its liabilities determined according to generally applicable tax principles. Thus, the amount taken into account on the issue date with respect to a debt instrument which is not issued at a discount or a premium shall be the issue price. The amount taken into account with respect to any debt with original issue discount shall be its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to section 1272(a)(7) or (b)(4)). In addition, with respect to the issuer, unamortized bond premium shall be treated as debt.

(2) *Exclusions.* Short-term liabilities as defined in paragraph (b)(2)(i) of this section and commercial financing liabilities as defined in paragraph (b)(2)(ii) of this section shall be excluded from characterization as debt.

(i) *Short-term liabilities.* The term "short-term liabilities" means accrued operating expenses, accrued taxes payable, and any account payable for the first 90 days of its existence, provided that no interest is accrued with respect to any portion of such 90 day period.

(ii) *Commercial financing liabilities.* The term "commercial financing liabilities" means any liability if it—

(A) Is incurred by the obligor under a commercial financing agreement (such as an automobile "floorplan" agreement) to buy an item of inventory;

(B) Is secured by the item;

(C) Is due on or before sale of the item; and

(D) If entered into between related parties, has terms that are comparable to the terms of such financing agreements between unrelated parties in the same (or a similar) industry.

(3) *Liabilities of a partnership.* In determining the debt of a corporation that owns an interest in a partnership (directly or indirectly through one or more pass-through entities), liabilities of the partnership shall be treated as liabilities incurred directly by each partner in the same manner and proportions that the liabilities of the partnership are treated as shared by its partners under section 752.

(4) *Anti-rollover rule.* Decreases in a corporation's aggregate debt during the last 90 days of its taxable year shall be disregarded to the extent that the corporation's aggregate debt is increased during the first 90 days of the succeeding taxable year.

(c) *Equity*—(1) *In general.* Equity means the sum of money and the adjusted basis of all other assets of the corporation reduced (but not below zero) by the taxpayer's debt (as defined in paragraph (b) of this section). Whether an item constitutes an asset shall be determined according to generally applicable tax principles.

(2) *Treatment of stock of certain nonincludible corporations.* Under the general rule of paragraph (c)(1) of this section, assets include the adjusted basis of stock of any corporation which is not an includible corporation (as defined under section 1504(b)). The adjusted basis of stock held in a corporation which is not an includible corporation shall be further adjusted under principles similar to those in section 864(e)(4) if the taxpayer (or the members of an affiliated group of which the taxpayer is a member) owns stock in the corporation satisfying the requirements of section 864(e)(4)(B)(ii). *Cf.* § 1.861–12T(c)(2).

(3) *Reduction in assets for excluded liabilities.* The amount of a taxpayer's equity under paragraph (c) (1) and (2) of this section shall be reduced (but not below zero) by an amount equal to the amount of liabilities excluded under paragraph (b)(2) of this section.

(4) *Partnership interests owned by a corporation.* In determining the assets of a corporation that owns an interest in a partnership, the corporation shall treat as an asset the adjusted basis of its partnership interest.

(5) *Anti-avoidance rules*—(i) *In general.* An asset of the taxpayer shall be disregarded in computing the taxpayer's debt-equity ratio if the principal purpose for acquiring the asset was to reduce the taxpayer's debt-equity ratio.

(ii) *Anti-stuffing rule.* In determining a corporation's equity, any transfer of assets made by a related person to the corporation during the last 90 days of its taxable year shall be disregarded to the extent that there is a transfer of the same or similar assets by the corporation to a related person during the first 90 days of the corporation's succeeding taxable year. However, this rule shall not apply to the extent that there is full consideration for a transfer in money or property (as that term is defined in section 317(a)).

(d) *Determining the debt and equity of a non-dollar functional currency QBU.* In determining the dollar value of liabilities and assets on the books of a qualified business unit that has a functional currency other than the dollar, such liabilities and assets shall be translated at the spot rate on the last day of the taxable year.

§ 1.163(j)–4 Interest not subject to tax.

(a) *In general.* Interest paid or accrued by a corporation under the rules of § 1.163(j)–1 is not subject to tax for purposes of section 163(j) if no U.S. tax is imposed with respect to such interest under subtitle A of the Internal Revenue Code (determined without regard to net operating losses or net operating loss carryovers), taking into account any applicable treaty obligation of the United States. For this purpose, whether interest paid or accrued to a partnership is subject to tax is determined at the partner level.

(b) *Partially exempt interest.* Interest that is subject to a reduced rate of tax under any treaty obligation of the United States applicable to the recipient shall be treated as in part subject to the statutory tax rate under sections 871 or 881 and in part not subject to tax, based on the proportion that the rate of tax under the treaty bears to the statutory tax rate. Thus, for purposes of section 163(j), if the statutory tax rate is 30 percent, and pursuant to a treaty U.S. tax is instead limited to a rate of 10 percent, two-thirds of such interest shall be considered interest not subject to tax.

(c) *Date for determining whether interest is subject to U.S. tax.* The determination of whether interest is subject to U.S. tax is made on the date the interest is received or accrued by the payee, whichever is relevant under normally applicable U.S. tax principles for purposes of determining the tax, if any, on the payee.

(d) *Certain interest paid to special entities*—(1) *Controlled foreign corporations*—(i) *In general.* Interest that is paid or accrued to a foreign corporation described in section 957(a) (a "controlled foreign corporation") and that is not otherwise subject to tax under paragraph (a) of this section shall be deemed subject to tax to the extent that such interest is included in the foreign corporation's net foreign personal holding company income under § 1.954–1T(c) and results in an inclusion in the gross income of a United States shareholder under section 951(a)(1)(A)(i) (or would have been included in a United States shareholder's gross income but for an election under § 1.954–1T(d)).

(ii) *Effect of section 952(c)(1)(A) (earnings and profits) limitation.* For purposes of paragraph (d)(1) of this section, if a controlled foreign corporation's subpart F income for the taxable year is limited under section 952(c)(1)(A), each category of subpart F income described in section 952(a), and, within each such category, each component thereof, shall be treated as reduced ratably.

(iii) *Net foreign personal holding company income.* To determine whether an item of interest income is included in a controlled foreign corporation's net foreign personal holding company income for the taxable year, the expenses allocable to such interest shall be deemed to bear the same ratio to the total expenses allocable to the controlled foreign corporation's net foreign personal holding company income (determined pursuant to § 1.954–1T(c)) as the amount of such interest bears to the controlled foreign corporation's gross foreign personal holding company income (determined under § 1.954–1T(a)(2)(i)).

(iv) *Related person interest.* If related person interest is allocated to the item of interest under the provisions of § 1.904–5(c)(2) and paragraph (d)(1)(iii) of this section, and if the United States shareholder receiving such related person interest is subject to United States tax, then, for purposes of paragraph (d)(1)(i) of this section, such allocable related person interest shall be deemed to be net foreign personal holding company income that results in an inclusion under section 951(a)(1)(A)(i).

(v) *Section 78 amount.* Any foreign taxes that are allocable to an item of interest income satisfying the requirements of paragraph (d)(1)(i) of this section and that are included in a United States shareholder's income under section 78 (or would have been included, but for an election under § 1.954–1T(d)) shall, for purposes of paragraph (d)(1)(i) of this section, be deemed to be net foreign personal holding company income that results in an inclusion under section 951(a)(1)(A)(i).

(2) *Passive foreign investment companies*—(i) *In general.* Interest that is not otherwise subject to tax under paragraph (a) of this section, and that is paid or accrued to a passive foreign investment company (as defined in section 1296) that is not a controlled foreign corporation, and which a U.S. person has elected under section 1295 to treat as a qualified electing fund ("QEF"), shall be treated as subject to tax to the extent that such interest is included in the QEF's ordinary earnings (as defined in section 1293(c)(1)) and results in an inclusion in income of such U.S. person under section 1293(a)(1)(A).

(ii) *Ordinary earnings.* In determining whether an item of interest income is included in the ordinary earnings of a passive foreign investment company, the item shall be reduced by deductions allocable and apportionable to that item under §§ 1.861–8 through 1.861–14T.

(iii) *Section 78 amount.* Any foreign taxes that are allocable to an item of interest income satisfying the requirements of paragraph (d)(2)(i) of this section and that are included in a U.S. person's income under section 78 pursuant to section 1293(f) shall, for purposes of paragraph (d)(2)(i) of this section, be deemed to be ordinary earnings that are included in the income of a U.S. person under section 1293(a)(1)(A).

(3) *Foreign personal holding companies*—(i) *In general.* Interest that is not otherwise subject to tax under paragraph (a) of this section, and that is paid or accrued to a foreign personal holding company (as defined in section 552) that is neither a passive foreign investment company nor a controlled foreign corporation, shall be treated as subject to tax to the extent that such interest is included in the company's undistributed foreign personal holding company income (as defined in section 556) and results in an inclusion in income of a U.S. person under section 551(a).

(ii) *Undistributed foreign personal company income.* In determining whether an item of interest income is included in the undistributed foreign personal holding company income of a foreign personal holding company, the item shall be reduced by deductions allocable and apportionable to that item under §§ 1.861–8 through 1.861–14T.

(iii) *Effect of distributions.* Any amount that would be treated as subject to tax by virtue of this paragraph (d)(3) but for a dividends paid deduction under section 561 shall be treated subject to tax.

(4) *Producer's loan interest paid to a DISC.* Interest paid or accrued with respect to a DISC (as defined in section 992) that is treated as interest with respect to a producer's loan (as defined in section 993(d)) is treated as subject to U.S. tax if such interest is taxed to the shareholders of the DISC under section 995(b)(1)(A).

§ 1.163(j)–5 Affiliated group rules.

(a) *Certain related corporations treated as one taxpayer*—(1) *Scope.* This section applies section 163(j) to certain related corporations which are (or are treated as) members of an affiliated group and which under section 163(j)(6)(C) and (7) are treated as a single taxpayer. Paragraphs (a)(2) and (a)(3) of this section describe the corporations that are subject to such treatment. (For purposes of section 163(j) and these regulations, the rules in regulations under section 1502 apply, but unless the context otherwise requires, the term "member" means a corporation that is, or is treated as, a member of an affiliated group under this paragraph (a), and the term "group" refers collectively to the member and the other corporations that are so treated.) Paragraph (a)(4) of this section provides rules that treat a corporation as a member of a single affiliated group if the rules of this paragraph (a) would otherwise cause it to be treated as a member of more than one affiliated group. Paragraph (b) of this section provides rules regarding the computation of items of income, expense, and carryovers under section 163(j) for an affiliated group of corporations if all of the members of such group join in the filing of a single consolidated return for the taxable year under section 1501. Paragraph (c) of this section provides rules for corporations that are not members of consolidated groups which are subject to the rules of § 1.163(j)–5(b). Paragraph (d) of this section provides rules regarding the computation of the debt-equity ratio for purposes of applying the debt-equity

ratio safe harbor test described in § 1.163(j)–1(b). Paragraph (e) of this section provides rules regarding the treatment of, and an election pertaining to, assets of certain acquired corporations.

(2) *Affiliated corporations.* To the extent provided in this section, all the members of an affiliated group (as defined in section 1504(a)) of which a corporation is a member on the last day of its taxable year shall be treated as one taxpayer for purposes of section 163(j) and this section, without regard to whether such affiliated group files a consolidated return pursuant to section 1501.

(3) *Certain unaffiliated corporations*—(i) *In general.* If at least 80 percent of the total voting power and total value of the stock of an includible corporation (as defined in section 1504(b)) is owned, directly or indirectly, by another includible corporation, the first corporation shall be treated as a member of an affiliated group that includes the other corporation and its affiliates. The attribution rules of section 318 shall apply for purposes of determining indirect stock ownership under this paragraph (a)(3).

(ii) *Example.* The principles of this paragraph (a)(3) are illustrated by the following example.

Example. X and Y are wholly owned domestic subsidiaries of F, a foreign corporation. X and Y are not members of an affiliated group under section 1504(a) because F is not itself an includible corporation under section 1504(b)(3). However, under paragraph (a)(3) of this section, X and Y are treated as members of an affiliated group, since, under section 318(a)(3)(C), X is treated as owning indirectly 100 percent of Y, and Y is treated as owning indirectly 100 percent of X.

(4) *Tie-breaker rules.* If the rules of this paragraph (a) would treat a corporation as a member of more than one affiliated group, then the principles of section 1563(b)(4) and the regulations thereunder shall determine the group of which such corporation shall be treated as a member.

(b) *Operative rules for consolidated groups*—(1) *In general.* If all of the members of the affiliated group are members of a single consolidated group for the taxable year, the computations required by section 163(j) and these regulations (other than the computation of the group's debt-equity ratio under paragraph (d) of this section) shall be made in accordance with the rules of this paragraph (b). See paragraph (c) of this section for rules applicable to affiliated groups not described in the preceding sentence.

(2) *Items determined on a consolidated basis.* The computations required by section 163(j) and these regulations shall be determined for the group on a consolidated basis. For example, the group's taxable income shall be the consolidated taxable income determined under § 1.1502–11 (without regard to any carryforwards or disallowances under section 163(j)), and the group's net interest expense shall be the excess, if any, of the group's aggregate interest expense over the group's aggregate interest income (as provided in §§ 1.163(j)–2 (d) and (e)). Similarly, the group's excess interest expense shall be determined by reference to the group's net interest expense, adjusted taxable income, and excess limitation carryforward (as determined under paragraph (b)(5) of this section). Except as provided in paragraphs (b) (5) and (6) of this section, disallowed interest expense carryforwards and excess limitation carryforwards shall also be determined on a consolidated basis.

(3) *Exempt related person interest expense.* In determining the group's exempt related person interest expense, interest expense shall be treated as paid or accrued to a related person (within the meaning of § 1.163(j)–2(g)) if it would be so treated if paid or accrued to the same payee by any member of the group.

(4) *Deferred intercompany gain.* For purposes of determining the adjusted taxable income of the group, the following special rules shall apply—

(i) Any gain on a deferred intercompany transaction (including any gain described in § 1.1502–14T(a)) that is restored in accordance with the rules under §§ 1.1502–13(d) or 1.1502–13T(l) shall be subtracted from the group's consolidated taxable income.

(ii) If property is disposed of under § 1.1502–13 (e)(2) or (f) or § 1.1502–13T(m), any amount subtracted from the group's consolidated taxable income in a previous taxable year with respect to such property under paragraph (b)(4)(i) of this section shall be added to the group's consolidated taxable income.

(iii) *Example.* The principles of this paragraph (b)(4) are illustrated by the following example.

Example (i) On January 1, 1991, X, a member of an affiliated group which files a consolidated return for the calendar year, purchases property for $200 from an unrelated person. X depreciates the property over a 5-year period. On January 1, 1996, when X's basis in the property is $0, X sells the property to Y, another member of the group, for $200, which is the property's fair market value at such time. The sale is a deferred intercompany transaction under § 1.1502–13, and X's gain of $200 is deferred under § 1.1502–13(c). In the hands of Y, the property is once again depreciable over a 5-year period. The group claims a depreciation deduction with respect to the property of $40 in 1996, which results in the restoration of $40 of X's deferred gain under § 1.1502–13T(l) for such year.

(ii) As provided in paragraph (b)(3)(i) of this section, the group's taxable income for 1996 is reduced by $40, the amount of restored gain under § 1.1502–13T(l) with respect to the transferred property. In addition, as provided in § 1.163(j)–2(f)(2)(iii) and paragraph (b)(2) of this section, the group's taxable income for 1996 is increased by $40, the amount of the group's depreciation deduction with respect to the transferred property for such year.

(iii) On January 1, 1997, Y sells the property for $200 to an unrelated person and recognizes gain of $40. The sale results in restoration of $160 of gain under § 1.1502–13T(m) with respect to the earlier transfer of property from X to Y. Thus, Y's sale results in the group's 1997 consolidated taxable income increasing by $200 prior to any adjustment under section 163(j). Under § 1.163(j)–2(f)(3)(i), the consolidated taxable income is reduced by $240 to reflect previous depreciation deductions with respect to such property. In addition, as provided in paragraph (b)(4)(ii) of this section, the consolidated taxable income is increased by $40, the amount subtracted from the group's 1996 consolidated taxable income by virtue of the restoration of $40 of deferred gain in that year.

(5) *Carryforwards to current taxable year.* The group's disallowed interest expense carryforward or excess limitation carryforwards to the current taxable year shall be the relevant carryforwards from the group's prior taxable years, plus any disallowed interest expense carryforward or excess limitation carryforwards from separate return years permitted to be used by the group under the rules of § 1.163(j)–6.

(6) *Members leaving the group*—(i) *Disallowed interest expense carryforward.* A member leaving the group shall carry forward to its separate return years a portion of the group disallowed interest expense carryforward determined as of the end of the last consolidated return year during which the corporation was a member of the group. Such portion shall equal the amount of the group's disallowed interest expense carryforward multiplied by a fraction, the numerator of which is the aggregate amount of exempt related person interest expense paid or accrued by such member during the period when it was a member of the group, and the denominator of which is the aggregate amount of exempt related person interest expense paid or accrued by all members of the group. If a member has pre-affiliation disallowed interest expense carryforward upon entering the group, the amount of such member's

disallowed interest expense carryforward shall be treated as exempt related person interest expense of both the member and the group. Further, the group's disallowed interest expense carryforward shall be reduced by the amount allocated to the member. If the member leaves the group during the consolidated return year, rules similar to the rules of § 1.1502-21(b)(2) shall apply.

(ii) *Excess limitation carryforward.* A member leaving the group shall not carry forward to its separate return years any portion of the group's excess limitation carryforward, and the group's excess limitation carryforward shall not be reduced by virtue of such member's departure from the group. However, if all the members of a consolidated group become members of another consolidated group, the acquired group's excess limitation carryforward shall become excess limitation carryforward of the corporation that was the common parent of the acquired group. For purposes of determining the extent to which this excess limitation carryforward becomes excess limitation carryforward of the acquiring group under paragraph (b)(5) of this section, see § 1.163(j)-6 (b).

(7) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1 (i) X, Y, and Z are domestic corporations that are members of a newly formed consolidated group described in paragraph (b) of this section. X owns 100 percent of the stock of Y, and Y owns 80 percent of the stock of Z. F1, a foreign corporation, owns 60 percent of the stock of X. Any interest paid or accrued by X, Y, or Z to F1 is exempt under section 163(j) because it is exempt from U.S. withholding tax under a treaty with F1's country of residence. Such interest (including interest paid by Z) is also paid or accrued to a related person within the meaning of § 1.163(j)-2 (g) and paragraph (b)(3) of this section.

(ii) For 1991, the group's first taxable year, X, Y, and Z have the following relevant items of income and expense—

Company	Interest income	Interest expense	Exempt related person interest expense
X	$600	$500	
Y	200	900	$600
Z		200	150
Total	800	1,600	750

(iii) Under § 1.1502-11, the group's consolidated taxable income for the 1991 year is $150. Adjustments to consolidated taxable income total $50, resulting in consolidated adjusted taxable income of $200. The group's net interest expense for 1991 is $800 ($1,600-$800), and its excess interest expense is $300 ($800-($1,000/2)). The group's exempt related person interest expense for 1991 is $750. The group's disallowed interest expense for 1991 is the lesser of its excess interest expense or its exempt related person interest, or $300. This $300 is a group disallowed interest expense carryforward to the group's 1992 taxable year.

Example 2—(i) The facts are the same as in Example 1. In the group's 1992 taxable year, the members have the following relevant items of income and expense—

Company	Interest income	Interest expense	Exempt related person interest expense
X	$600	$500	$50
Y	200	900	600
Z		200	150
Total	800	1,600	800

(ii) Under § 1.1502-11, the group's consolidated taxable income for 1992 is $1,100. Adjustments to consolidated taxable income total $200, resulting in consolidated adjusted taxable income of $1,300. The group's net interest expense for 1992 is $800 ($1,600-$800), its excess interest expense is $0 ($800-($2,100/2)), and it has excess limitation for the year of $250 ($2,100/2-$800). The group is permitted to deduct all of its current exempt related person interest expense ($800), plus an amount of its disallowed interest expense carryforward from 1991 equal to its 1992 excess limitation, or $250. This leaves a disallowed interest expense carryforward to the group's 1993 taxable year of $50.

Example 3. The facts are the same as in Example 2, except that Z leaves the group on December 31, 1992. Under the rules of paragraph (b)(6)(i) of this section, Z's disallowed interest expense carryforward to its 1993 separate return year is equal to the group's remaining carryforward at the end of 1992 ($50), multiplied by a fraction, the numerator of which is $300 (the total amount of exempt related person interest expense paid or accrued by Z while it was a member of the group) and the denominator of which is $1,550 (the total amount of exempt related person interest expense paid or accrued by all members of the group). Thus, Z's carryforward to its 1993 separate return year is $9.68. The XY group's carryforward to its consolidated 1993 taxable year is reduced by that amount, and is therefore $40.32.

(c) *Operative rules for other groups*—(1) *In general*—(i) *Group members' computation years.* This paragraph (c) provides rules for the application of section 163(j) and these regulations to corporations that are members of a group not governed by paragraph (b) of this section. Under this paragraph (c), a corporation that is a group member is required to take into account the items of income, expense, and carryovers that are pertinent under section 163(j) for all group members whose taxable years end with or within the taxable year of the member with respect to which computations are required (hereafter, a "computation year").

(ii) *Treatment of consolidated subgroup.* If some of the members of a group subject to this paragraph (c) join in filing a consolidated return under section 1501 for a taxable year ("consolidated subgroup"), such consolidated subgroup shall be treated as a single member of the group for purposes of applying this paragraph (c). The consolidated subgroup's items of income, expense and carryover that are pertinent under section 163(j) and these regulations shall be determined on a consolidated group basis, as if the consolidated subgroup were described in paragraph (b) of this section.

(2) *Determination and allocation of group items.* The computations required to be made under this paregraph (c) shall be made as follows—

(i) *Step 1—Certain items determined separately.* The exempt related person interest expense, interest income, interest expense, taxable income, and adjustments to taxable income required by § 1.163(j)-2 (f), other than the adjustment for net interest expense described in § 1.163(j)-2(f)(2)(i), shall be determined separately for each member of the group.

(ii) *Step 2—Computation of certain group items*—(A) *Net interest expense.* The separately determined amounts of interest income and interest expense for each member shall be aggregated and then netted to determine the group's net interest expense.

(B) *Adjusted taxable income.* To determine the group's adjusted taxable income, the separately determined taxable income of each member and adjustments thereto (other than net interest expense) shall be aggregated, and the amount of the group's net interest expense (as determined under paragraph (c)(2)(ii)(A) of this section) shall be added to such amount.

(C) *Exempt related person interest expense.* To determine the amount of the group's exempt related person interest expense, the separately determined amounts of exempt related person interest expense for each member shall be aggregated. In making this determination, interest expense shall be treated as paid or accrued to a related person (within the meaning of § 1.163 (j)-2(g)) if it would be so treated if paid or accrued to the same payee by any member of the group.

(D) *Excess limitation carryforward.* To determine the amount of the group's excess limitation carryforward from each of the three prior computation years, the amount of each member's

excess limitation carryforward from each of such prior years shall be aggregated.

(E) *Disallowed interest expense carryforward.* To determine the amount of the group's disallowed interest expense carryforward, the amounts of disallowed interest expense carryforward of each member shall be aggregated.

(iii) *Step 3—Determination of the group's interest deduction—*(A) *Excess interest expense of the group.* The group's excess interest expense for the computation year shall be determined by reference to its net interest expense, adjusted taxable income, and excess limitation carryforward (as determined in Step 2). The ordering rule of § 1.163(j)–1(d) shall apply in determining which, if any, of the group's excess limitation carryforwards from prior years are absorbed in this computation.

(B) *Disallowed interest expense of the group.* The group's disallowed interest expense for the computation year shall be determined by reference to its exempt related person interest expense and excess interest expense as determined in Step 2 and Step 3, respectively. Disallowed interest expense of the group arising in the computation year shall be allocated to each member based on the following ratio:

$$\frac{\text{Exempt related person interest expense of the member for the computation year}}{\text{Exempt related person interest expense of the group for the computation year.}}$$

(C) *Excess limitation and deduction of disallowed interest expense carryforward—(1) Excess limitation.* The group's excess limitation for the computation year shall be determined by reference to its net interest expense and adjusted taxable income (as determined in *Step 2*).

(2) *Deduction of disallowed interest expense carryforward.* The amount of the group's disallowed interest expense carried forward to the current computation year (as determined in *Step 2*) that is deductible therein under § 1.163(j)–1(c) shall be determined by reference to the excess limitation of the group. The deduction for such carryforward shall be allocated to each member of the group based on the following ratio:

$$\frac{\text{Disallowed interest expense carryforward of the member from the preceding computation year}}{\text{Disallowed interest expense carryforward of the group from the preceding computation year.}}$$

(iv) *Step 4—Carryforwards to next computation year—* (A) *Amounts not deductible in the current computation year.* Each member's disallowed interest expense carryforward to the next computation year shall consist of such member's allocable share of the group's disallowed interest expense for the current year (as determined in Step 3), plus such member's allocable share of the group's disallowed interest expense carryforward to the current year that is not deductible in the current year (because such amount exceeds any excess limitation of the group for that year). The group's unused disallowed interest expense carryforward to the current year shall be allocated to each member of the group based on the following ratio:

$$\frac{\text{Disallowed interest expense carryforward of the member from the preceding computation year}}{\text{Disallowed interest expense carryforward of the group from the preceding computation year}}$$

(B) *Excess limitation carryforward.* The excess limitation carryforward of the group, if any, from each of the two prior computation years that is not absorbed in the current computation year (as provided in Step 3) shall be allocated, by year, to each member of the group (succeeding computation years) based on the following ratio:

$$\frac{\text{Excess limitation carryforward of the member from the specific prior computation year}}{\text{Excess limitation carryforward of the group from the same prior computation year}}$$

(The group's excess limitation carryforward from the third prior computation year expires after the current computation year and therefore cannot be carried forward to the next year. See § 1.163 (j)-1 (d).)

(C) *Allocation of remaining excess limitation of the group for the computation year—(1) In general.* Excess limitation of the group for the computation year remaining after the deduction of disallowed interest expense carryforward to such year is allocated to each member of the group based on the following ratio:

$$\frac{\text{Separate excess limitation for each member of the group for the computation year}}{\text{Total of the separate excess limitations of each member of the group for the computation year}}$$

(2) Separate excess limitation. The separate excess limitation of each member shall be computed as if the member was not a member of an affiliated group for the computation year. The separate excess limitation of each member shall be determined under the rules of § 1.163 (j)-2 (c) and before reduction for the amount of any disallowed interest expense carried forward to that year by such member. For purposes of these computations, a member that has net interest income for the computation year has net interest expense of zero, and a member that has excess interest expense for the computation year has separate excess limitation of zero.

(D) *Members leaving a group.* A member leaving a group shall carry forward to succeeding taxable years any excess limitation or disallowed interest expense allocated to it under this paragraph (c). For rules limiting the use of such carryforwards when such member becomes a member of another affiliated group, or has transferred its assets in a transaction to which section 381 (a) applies, see § 1.163 (j)-6.

(3) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. A, B, and C are calendar-year domestic corporations that are members of an affiliated group. Table 1 depicts amounts determined in Step 1 for these corporations for their taxable years ending December 31, 1991. Under rules described in paragraph (d) of this section, this group does not satisfy the

debt-equity ratio safe harbor test for 1991. Assume, for purposes of this example, that there are no excess limitation carryforwards and no disallowed interest expense carryforwards to the 1991 taxable year for any member of the group.

TABLE 1

	Interest income	Interest expense	Taxable income before applying § 163 (j)	Adjustments to taxable income (not including net interest expense)	Exempt related person interest expense
A	$600.00	$500.00	$50.00	$25.00	
B	200.00	900.00	200.00	75.00	$600.00
C	—	200.00	50.00	—	150.00
Total	800.00	1,600.00	300.00	100.00	750.00

(a) *Step 2 determinations.* The group's Step 2 determinations are as follows:

(1) *Net interest expense.* The separately determined interest income and interest expense of A, B, and C are aggregated. Thus, the net interest expense of the group is $800 ($1,600 − $800).

(2) *Adjusted taxable income.* The separately determined taxable income and the separately determined adjustments (other than net interest expense) of A, B, and C are aggregated and added to the group's net interest expense to determine the group's adjusted taxable income of $1,200 ($300 + $100 + $800 = $1,200).

(3) *Exempt related person interest expense.* The separately determined amounts of exempt related person interest expense of A, B, and C are aggregated to determine the group's exempt related person interest expense of $750 ($600 + $150).

(b) *Step 3 determinations.* The group's Step 3 determinations are as follows:

(1) *Excess interest expense.* The group's excess interest expense is equal to its net interest expense less one-half of its adjusted taxable income (each as determined in Step 2) ($800 − (½ × $1,200) = $200).

(2) *Disallowed interest expense.* The group's disallowed interest is $200, which is the lesser of its exempt related person interest expense (as determined in Step 2 ($750)) or its excess interest expense (as determined in this Step 3 ($200)).

(3) *Disallowed interest expense allocations.* Disallowed interest expense for the computation year shall be allocated among A, B, and C under Step 3 based on the ratio of each member's exempt related person interest expense to the group's exempt related person interest expense. Since A has no exempt related person interest expense, no disallowed interest expense is allocated to it. Disallowed interest expense of $160 is allocated to B ($600/$750) × $200). Disallowed interest expense of $40 is allocated to C ($150/$750) × $200). Thus, B and C have $160 and $40, respectively, of disallowed interest expense which shall be carried forward to their next succeeding taxable years under Step 4.

Example 2. The facts are the same as in Example 1, and thus B and C have $160 and $40, respectively, of disallowed interest expense carried forward to the computation year ending December 31, 1992. Table 2 depicts the separately determined items as determined in Step 1 for the taxable years of A, B, and C ending December 31, 1992. Under rules described in paragraph (d) of this section, this group does not satisfy the debt-equity ratio safe harbor test for 1992.

TABLE 2

	Interest income	Interest expense	Taxable income before applying § 163 (j)	Adjustments to taxable income (not including net interest expense)	Exempt related person interest expense
A	$200.00	$800.00	$400.00	$50.00	$300.00
B	100.00	500.00	500.00	100.00	200.00
C	300.00	200.00	500.00	50.00	100.00
Total	600.00	1,500.00	1,500.00	200.00	700.00

(a) *Step 2 determinations.* For the 1992 computation year, the Step 2 determinations of A, B, and C are as follows:

(1) *Net interest expense.* The separately determined interest income and interest expense of A, B, and C are aggregated to determine the group's net interest expense of $900 ($1,500 − $600).

(2) *Adjusted taxable income.* The separately determined taxable income and adjustments to taxable income (other than net interest expense) of A, B, and C are aggregated and added to the group's net interest expense to yield the group's adjusted taxable income of $2,600 ($1,500 + $200 + $900 = $2,600).

(3) *Exempt related person interest expense.* Each member's separately determined amounts of exempt related person interest expense are aggregated to determine the group's exempt related person interest expense of $700 ($300 + $300 + $100).

(b) *Step 3 determinations.* The group has excess limitation of $400 in 1992 ((⅓ × $2,600) (adjusted taxable income) − $900 (net interest expense)). All $200 of the group's disallowed interest expense carried forward to 1992 is deductible by B and C (in accordance with the allocation described in Step 3) and reduces the group's excess limitation arising in 1992 to $200 ($400 − $200).

(c) Under Step 4, A, B, and C must allocate the $200 of remaining excess limitation among themselves based on the ratio that each member's separate excess limitation bears to the sum of the members' separate excess limitations.

(1) *Computation of each member's separate excess limitation.* The separate excess limitation for each member shall be determined separately, as if each member was not a member of an affiliated group. Accordingly, the separate excess limitations of A, B, and C are determined as follows. A has separate excess interest expense of $75 ($600 − (⅓ × $1,050)). B has a separate excess limitation of $150 (⅓ × $1,100) − $400). C has separate excess limitation of $275 (⅓ × $500).

(2) *Allocation of group excess limitation.* Since A has separate excess interest expense rather than separate excess limitation, no excess limitation is allocated to A. The group's excess limitation of $200 is allocated between B and C as follows. B is allocated $70.59 ($200 × ($150/$425)) and C is allocated $129.41 ($200 × ($275/$425)). Thus, B and C will carry forward $70.59 and $129.41 of excess limitation, respectively, to their succeeding taxable years.

Example 3. A, B, and C are domestic corporations that are members of the same affiliated group under the rules of paragraph (a) of this section. Table 3 depicts their Step 1 determinations for A's taxable year ending September 30, 1990, B's taxable year ending December 31, 1990, and C's taxable year ending January 31, 1991. Assume, for the taxable years illustrated in Table 3, that there is no pre-effective date excess limitation carryforward, that (under the rules described in paragraph (d) of this section) the group does not satisfy the debt-equity ratio safe harbor test the group does not satisfy the debt-equity ratio safe harbor test described in § 1.163 (j)-1 (b), and that all interest expense paid by A, B, and C is exempt related person interest expense.

TABLE 3

	Interest income	Interest expense	Taxable income before applying § 163 (j)	Adjustments to taxable income (not including net interest expense)	Exempt related person interest expense
A	$100.00	$500.00	$150.00	$50.00	$500.00
B	200.00	600.00	350.00	50.00	600.00
C		500.00	300.00	100.00	600.00
Total	300.00	1,700.00	800.00	200.00	1,700.00

(a) *A's determinations.* With respect to A's computation year ending September 30, 1990, only A is treated as a member of the affiliated group (since for B and C these are pre-effective date years). Therefore, A's disallowed interest expense is $100, which is the lesser of its excess interest expense of $100 ($400 − (½ × $600)) or its exempt related person interest expense ($500). A's disallowed interest expense of $100, is carried forward to A's next computation year.

(b) *B's Step 2 determinations.* For purposes of computing B's disallowed interest expense for its taxable year ending December 31, 1990, only A and B are treated as affiliated group members (since for C this is a pre-effective date year). B's Step 2 determinations are as follows:

(1) *Net interest expense.* The separately determined interest income and interest expense of A and B are aggregated to determine their net interest expense of $800 [($500 + $800) − ($100 + $200)].

(2) *Adjusted taxable income.* The separately determined taxable income of A and B ($150 + $350) and the separately determined adjustments to their taxable income (other than net interest expense) ($50 + $50) are aggregated and added to their net interest expense (as provided in Step 2) ($800) to yield the adjusted taxable income of A and B of $1,400 ($500 + $100 + $800).

(3) *Exempt related person interest expense.* The separately determined amounts of exempt related person interest expense of A and B are aggregated to determine their exempt related person interest expense of $1,000 ($500 + $600).

(c) *B's Step 3 determinations.* B's Step 3 determinations are as follows:

(1) *Excess interest expense.* The excess interest expense of A and B is $100, which is equal to their net interest expense less one-half of their adjusted taxable income, each as determined in Step 2 ($800 − (½ × $1,400)).

(2) *Disallowed interest expense.* The disallowed interest expense of A and B is $100, which is the lesser of the exempt related person interest expense of A and B (as determined in Step 2 ($1,100)) or their excess interest expense (as determined in Step 3 ($100)).

(3) *Disallowed interest expense allocations.* Disallowed interest expense for the computation year is allocated to B under Step 3 based on the ratio of B's separate exempt related person interest expense ($600) to the sum of A and B's exempt related person interest expense ($1,100). Thus, the amount of disallowed interest expense allocated to B with respect to its computation year ending December 31, 1990, is $54.55 [($600/$1,100) × $100], which is carried forward to B's next computation year under Step 4. Because this is B's computation year, no allocation of disallowed interest expense for the computation year is made to A.

(d) *C's Step 2 determinations.* To compute its disallowed interest for its computation year ending January 31, 1991, C's Step 2 determinations are as follows:

(1) *Net interest expense.* The separately determined interest income and interest expense of A, B, and C are aggregated. Thus, the net interest expense of A, B, and C is $1,400 ($1,700 − $300).

(2) *Adjusted taxable income.* The separately determined taxable incomes of A, B, and C ($150 + $350 + 300) and the separately determined adjustments (other than net interest expense) of A, B, and C ($50 + $50 + $100) are aggregated and combined with the net interest expense of A, B, and C ($1,400, as determined in Step 2) to yield the adjusted taxable income of A, B, and C of $2,400 ($800 + $200 + $1,400).

(3) *Exempt related person interest expense.* The separately determined amounts of exempt related person interest expense of A, B, and C are aggregated to determine their exempt related person interest expense of $1,700 ($500 + $600 + $600).

(e) *C's Step 3 determination.* C's Step 3 determinations for its computation year ending January 31, 1991 are as follows:

(1) *Excess interest expense.* The excess interest expense of A, B, and C is equal to $200, which is the net interest expense of A, B, and C less one-half of their adjusted taxable incomes, each as determined in Step 2 ($1,400 − (½ × $2,400)).

(2) *Disallowed interest expense.* The disallowed interest expense of A, B, and C is $200, which is the lesser of the sum of the exempt related person interest expense of A, B, and C as determined in Step 2 ($1,700) or their excess interest expense as determined in this Step 3 ($200).

(3) *Disallowed interest expense allocations.* For C's computation year ending January 31, 1991, C is allocated disallowed interest expense under Step 3 based on the ratio that its exempt related person interest expense ($600) bears to the sum of the exempt related person interest expense of A, B, and C ($500 + $600 + $600 = $1,700). The amount of disallowed interest expense allocated to C with respect to that computation year is $70.59 [($600/$1,700) × $200], which is carried forward to C's next computation year under Step 4. Because this is C's computation year, no allocation of disallowed interest expense for the computation year is made to A or B.

(d) *Debt-equity ratio of related corporations treated as one taxpayer—* (1) *In general.* In the case of an affiliated group subject to the rules of paragraphs (b) or (c) of this section, the debt-equity ratio safe harbor test described in § 1.163(j)–1(b) shall be applied on a group basis. In the case of a consolidated group subject to paragraph (b) of this section, the debt-equity ratio of the group shall be determined by aggregating the separately determined debt and assets (adjusted as described in paragraphs (d)(2) and (3) of this section) of each member of the group as of the last day of the consolidated return year. In the case of an affiliated group subject to the rules of paragraph (c) of this section, the debt-equity ratio of the group shall be determined, with respect to any member's computation year, by aggregating the separately determined debt and assets (adjusted as described in paragraphs (d)(2) and (3) of this section) of each member of the group as of the last day of its taxable year that is included in the computing member's computation year. For rules regarding the special treatment of, and an election pertaining to, assets of certain acquired corporations, see paragraph (e) of this section.

(2) *Adjustments to group members' debt.* A member's debt shall be reduced by the amount of its liabilities to another member, and by the amount of any other liability which, if included, would result in duplication of amounts in the group's aggregate debt.

(3) *Adjustments to group members' assets.* The assets of a member of a group shall be adjusted as follows—

(i) Any amount which represents direct or indirect stock ownership if any member of the affiliated group shall be eliminated from total assets of the affiliated group;

(ii) A note or other evidence of indebtedness between members of an affiliated group shall be eliminated as an asset;

(iii) With respect to transactions between members of an affiliated group in which gain or loss is deferred under §§ 1.1502-13, 1.1502-13T, 1.1502-14, or 1.1502-14T, the adjusted basis of any asset involved in such transaction shall be decreased to the extent of deferred intercompany gain, if any, that has not been taken into account; and

(iv) There shall be eliminated from the assets of the affiliated group any other amount which, if included, would result in duplication of the assets of the affiliated group.

(e) *Election to use fixed stock write-off method for certain stock acquisitions*—(1) *In general.* Notwithstanding paragraph (d)(3) of this section, in the case of a qualified stock purchase, an election may be made, in the manner described in paragraph (e)(4) of this section, to determine the group's assets in accordance with the following rules—

(i) The stock of the target corporation and target affiliates (other than stock that is described in paragraph (d)(1)(ii) of this section) shall be treated as an asset of the purchasing corporation. The basis of such stock shall be determined under section 1012, and shall be increased by the amount of the liabilities of the target corporation and target affiliates as of the close of the acquisition date. Solely for purposes of this section, these amounts (together, the "special basis") shall be amortized ratably, on a monthly basis, over the applicable fixed stock write-off period (as described in paragraph (e)(5)(vi) of this section), beginning with the first day of the month in which the acquisition date occurs.

(ii) All assets of the target corporation, target affiliates, and any other members of the affiliated group, the stock of which is owned directly or indirectly by the target or a target affiliate, shall be disregarded.

(iii) Adjustments shall be made to the special basis of the stock of the target corporation and target affiliates solely as provided in paragraphs (e)(1)(i) and (e)(2) of this section. Thus, for example, the special basis shall not be adjusted under the rules of § 1.1502-32.

(2) *Post-acquisition adjustments to special basis.* The following adjustments shall be made to the special basis of the target corporation and target affiliates—

(i) The special basis of the stock of the target corporation and target affiliates shall be increased under the rules of section 358 for any property contributed to such corporations following the acquisition date;

(ii) The special basis of the stock of the target corporation and target affiliates shall be reduced by the fair market value of any property distributed by such corporations. Solely for purposes of the preceding sentence, any transfer of assets by the target corporation, by any target affiliate, or by any corporation that would be a target affiliate but for the fact that it is not an includible corporation, to any member of the affiliated group other than such corporations, shall be deemed to be a distribution that reduces special basis, but only if such transfer qualifies for nonrecognition under any provision of the Code or is an interaffiliate loan; and

(iii) Where an adjustment is made pursuant to paragraphs (e)(2) (i) or (ii) of this section, the special basis shall be adjusted as of the last day of the month which includes the date of the transaction (or the last day of the shareholder's taxable year, whichever comes first), and the adjusted amount shall be amortized over the remaining amortization period.

(3) *Election out of fixed stock write-off method.* a taxpayer may elect out of the fixed stock write-off method for any year during the amortization period and use the adjusted tax basis of the assets of the target corporation and its target affiliates to determine its debt-equity ratio for that year and all future years.

(4) *Method for making elections*—(i) *Election to use method.* An election to use the fixed stock write-off method is made by attaching a statement to the return of the purchasing corporation (including a consolidated return, where appropriate) for the taxable year in which the election is to become effective. The election must be signed by an authorized official of, and is effective for, each member of the purchasing corporation's affiliated group.

(ii) *Election to cease to use method.* An election to cease to use the fixed stock write-off method is made by attaching a statement to the return of the purchasing corporation (including a consolidated return, where appropriate) for the taxable year in which the election is to become effective. The election must be signed by an authorized official of, and is effective for, each member of the purchasing corporation's affiliated group.

(5) *Definitions*—(i) *Qualified stock purchase.* For purposes of this paragraph (e), the term "qualified stock purchase" means a qualified stock purchase (as defined under section 338(d)(3)) with respect to which no election has been made under section 338(g), but only if the purchase is made by a corporation which is an includible corporation (as defined in section 1504(b)).

(ii) *Target corporation.* For purposes of this paragraph (e), the term "target corporation" shall mean a target corporation as defined under section 338(d)(2), but only if such corporation is includible within the purchasing corporation's affiliated group for purposes of this section.

(iii) *Target affiliate.* For purposes of this paragraph (e), the term "target affiliate" shall mean a target affiliate as defined under section 338(h)(6), but only if such corporation is includible within the purchasing corporation's affiliated group for purposes of this section.

(iv) *Purchasing corporation.* For purposes of this paragraph (e), the term "purchasing corporation" shall mean a purchasing corporation as defined under section 338(d)(1).

(v) *Acquisition date.* For purposes of this paragraph (e), the term "acquisition date" shall mean the acquisition date as defined under section 338(h)(2).

(vi) *Fixed stock write-off period*—(A) *In general.* Except as provided in paragraph (e)(5)(vi)(B) of this section, the applicable "fixed stock write-off period" means 96 months.

(B) *Acquired corporations owning long-lived assets.* If more than fifty percent, by value, of the assets of the target corporation and any target affiliates on the acquisition date are described in this paragraph (e)(5)(vi)(B), then the applicable "fixed stock write-off period means 180 months. An asset is described in this paragraph (e)(5)(vi)(B) if—

(*1*) It is inventory or a non-wasting tangible or intangible asset (*e.g.*, land or goodwill);

(*2*) In the case of a depreciable asset, it has a recovery period in excess of 25 years;

(*3*) In the case of a depletable asset, it has a recovery period for purposes of cost depletion in excess of 25 years;

(v) In the case of an amortizable asset, it has an amortization period in excess of 25 years.

Determinations for purposes of this paragraph (e)(5)(vi)(B) shall be made as if the asset were sold on the acquisition date, and cash, cash items, and marketable securities shall be disregarded for all purposes. A purchasing corporation is only entitled to the benefit of the paragraph (e)(5)(vi)(B) if it demonstrates that it satisfies the requirements of this paragraph in a statement attached to its return accompanying its election to use the fixed stock write-off method. Such statement must provide all necessary information, including all appropriate computations.

(6) *Inclusion of target debt notwithstanding use of fixed stock write-off method.* Debt of the affiliated group includes the liabilities of a target corporation and any target affiliates notwithstanding that the assets of such corporations are determined using the fixed stock write-off method.

§ 1.163(j)–6 Limitation on carryforward of tax attributes.

(a) *Disallowed interest expense carryforward*—(1) *Affiliated groups.* If a corporation becomes a member of an affiliated group, the amount of any disallowed interest expense carryforward from a non-affiliation year that may be deducted by the members of an affiliated group under § 1.163(j)–5 (b) or (c) may not exceed the amount, if any, of the current year's excess limitation of the affiliated group (determined under §§ 1.163(j)–2(c) and 1.163(j)–5 (b) or (c)).

(2) *Section 381(a) transactions.* The amount of any disallowed interest expense carryforward from a non-affiliation year of a transferor or distributor corporation that may be deducted by the transferee or distributee corporation (or the consolidated group of which it is a member) following a transaction described in section 381 (a) may not exceed the amount, if any, of the current year's excess limitation (determined under § 1.163(j)–2(c)).

(3) *Section 382 and SRLY.* For the application of additional limitations governing disallowed interest expense carryovers, see section 382(h) (relating to built-in deductions of loss corporations) and the regulations thereunder (including § 1.1502–91, relating to section 382(h) rule for built-in deductions of consolidated groups) and § 1.1502–15 (relating to separate return limitation year rules for built-in deductions of consolidated groups)).

(4) *Example.* The provisions of this paragraph (a) are illustrated by the following example.

Example. In 1992, Z, a non-affiliated corporation, becomes a member of a consolidated group. There is no section 382 ownership change. Under § 1.163(j)–1, Z has $3,000 of disallowed interest expense carryforward from separate return limitation years. Under § 1.163(j)–5(b), the consolidated group (including Z) has excess limitation of $2,000 for 1992 (computed without regard to any disallowed interest expense carryforward). In addition, the consolidated group has excess limitation carryforward of $1,000 from 1991. Under paragraph (a)(1) of this section, only $2,000 (the amount of the consolidated group's excess limitation for 1992) of Z's separate return limitation year disallowed interest expense carryforward is deductible in 1992. The remaining $1,000 of Z's disallowed interest expense carryforward is carried forward to subsequent years and remains subject to the limitations described in paragraph (a) of this section.

(b) *Excess limitation carryforward*—(1) *Affiliated groups*—(i) *General rule.* If a corporation becomes a member of an affiliated group, the amount of any excess limitation carryforward from a non-affiliation year that may be used by members of the group under § 1.163(j)–5 (b) or (c) may not exceed the excess, if any, of the corporation's separately computed net interest expense over 50 percent of the corporation's separately computed adjusted taxable income.

(ii) *Special rule for acquired groups.* If all the members of a group, whether or not consolidated, become members of a consolidated group, the amount of the acquired group's excess limitation carryforward (if any) from non-affiliation years that may be used by the consolidated group may not exceed the acquired group's excess interest expense (if any) for the taxable year. For this purpose, the acquired group's excess interest expense for any taxable year equals the excess interest expense of the former members of the acquired group for the taxable year computed as if they were members of a separate affiliated group making computations under § 1.163(j)–5(c).

(2) *Section 381(a) transactions.* If a corporation transfers or distributes its assets to another corporation in a transaction described in section 381(a) (other than a transaction described in section 368(a)(1)(F)), the excess limitation carryforward, if any, of the transferor or distributor from a non-affiliation year is reduced to zero immediately after the transaction.

(3) *Anti-avoidance rules.* Solely for purposes of paragraph (b)(1) of this section, in determining the net interest expense of a member or a group, interest expense paid or accrued with respect to loans incurred or assumed by such member in connection with or after becoming a member of the group are disregarded unless the loan proceeds are actually utilized by the member in its pre-affiliation business. For example, if a loan is incurred by one member of the affiliated group with excess limitation carryforward from non-affiliation years, but the proceeds of the loan are actually utilized by another member of the group, the interest expense with respect to the loan is disregarded for purposes of applying paragraph (b)(1) of this section. In addition, interest on a loan used for the acquisition of the stock of a corporation which is incurred by the acquired corporation may be disregarded for purposes of paragraph (b)(1) of this section if the facts indicate that one of the purposes for the acquired corporation's incurring the loan was to avoid the limitation of such paragraph.

(c) *Affiliation and non-affiliation years*—(1) *In general.* For purposes of this section, the taxable year of a member of an affiliated group (as defined in § 1.163(j)–5(a)) is an "affiliation year" with respect to another member if the members were members of an affiliated group (whether or not the same affiliated group as the current affiliated group) with each other on the last day of the taxable year. A "non-affiliated year" is any taxable year that is not an affiliation year.

(2) *Predecessors and successors.* For purposes of this section, any reference to a corporation or member or the years of a corporation or member includes, as the context may require, a reference to a successor or predecessor (as defined in § 1.1502–1(f)(4)) or to the years of a successor or predecessor.

(3) *Formation of affiliated groups.* For purposes of determining whether a corporation has become a member of another corporation's affiliated group solely by reason of § 1.163(j)–5(a), corporations (or affiliated groups) with greater value are deemed to acquire corporations (or affiliated groups) with lesser value and the principles of § 1.1502–75(d)(3) (governing "reverse acquisitions") shall apply.

(d) *Anti-duplication rule.* The same item of income, expense, or carryforward may not be taken into account more than once if inconsistent with the principles of section 163(j) or these regulations.

§ 1.163(j)–7 Relationship to other provisions affecting the deductibility of interest.

(a) *Paid or accrued.* For purposes of section 163(j), interest expense is not

considered "paid or accrued" until such interest would be deductible but for such section.

(b) *Coordination of section 163(j) and certain other provisions*—(1) *Disallowed interest provisions.* Except as provided under § 1.163(j)–2(f)(3)(vi), interest expense which is permanently disallowed as a deduction (e.g. under sections 265 or 279) is not taken into account under section 163(j).

(2) *Deferred interest provisions.* Provisions which defer the deductibility of interest (such as sections 163(e)(3) and 267(a)(3)) apply before the application of section 163(j).

(3) *At risk rules and passive activity loss provisions.* Sections 465 and 469 shall be applied before applying section 163(j). There shall be no recomputation of deductions under section 469.

(4) *Capitalized interest expenses.* Provisions that require the capitalization of interest shall be applied before section 163(j). Capitalized interest is not treated as interest for any purpose under section 163(j). See regulations under section 263A(f) for ordering rules that determine whether exempt related person interest expense is capitalized under section 263A(f).

(5) *Reductions under section 246A.* Section 246A shall be applied before section 163(j). Any reduction in the dividends received deduction under section 246A shall reduce interest expense taken into account under section 163(j).

(c) *Examples.* The provisions of this section are illustrated by the following examples.

Example 1 (i) In 1990, Z, a domestic corporation that does not satisfy the debt-equity ratio safe harbor test, has $30,000 of interest expense, all of which is paid to related persons, and no interest income. Of Z's interest expense, $10,000 is permanently disallowed under section 265. The remaining $20,000 of interest expense is exempt from tax under the rules of § 1.163(j)–4. Z's adjusted taxable income for the year is $42,000.

(ii) Under paragraph (b)(1) of this section, the $10,000 interest expense that is permanently disallowed is not taken into consideration for purposes of section 163(j). Therefore, in 1990, none of Z's $20,000 interest expense is disallowed under section 163(j) since that amount is less than 50 percent of Z's 1990 adjusted taxable income ($21,000).

Example 2 (i) In 1990, Q, a domestic corporation that does not satisfy the debt-equity ratio safe harbor test, has $90,000 of adjusted taxable income and $60,000 of interest expense, of which $50,000 is exempt related person interest expense. Q has no interest income. Of Q's exempt related person interest expense, $20,000 is not currently deductible under section 267(a)(3). Assume that the $20,000 expense will be allowed as a deduction under section 267(a)(3) in 1991.

(ii) Under paragraph (b)(2) of this section, section 267(a)(3) is applied before section 163(j). Thus, in computing Q's excess interest expense for 1990, the $20,000 is not taken into account. Accordingly, in 1990, Q has no excess interest expense, since its net interest expense of $40,000 ($60,000 − $20,000) is equal to 50 percent of its adjusted taxable income for the taxable year. The $20,000 of interest expense not allowed as a deduction in 1990 under section 267(a)(3) is taken into account under section 163(j) in 1991, the year in which it is allowed as a deduction under section 267(a)(3).

Example 3 (i) For 1990, H, a closely held domestic corporation that does not satisfy the debt-equity ratio safe harbor test, has $2,000 of rental income and $3,000 of deductions consisting of $1,500 of interest expense, all of which is exempt related person interest expense, $600 of rental expense, and $900 of depreciation expense. Under the passive activity loss provisions of section 469, only $2,000 of H's total expenses are allowable as deductions. These consist of $1,000 ($2,000/$3,000 × $1,500) of interest expense, $400 ($2,000/$3,000 × $600) of rental expense, and $600 of depreciation expense ($2,000/$3,000 × $900). No deduction is allowed in 1990 for H's passive activity loss of $1,000, which consists of $500 of interest expense, $200 of rental expense, and $300 of depreciation expense.

(ii) Under paragraph (b)(3) of this section, section 469 is first applied to determine the amount of interest expense allowable as a deduction ($1,000), after which the rules of section 163(j) are applied. Under section 163(j), H's $1,000 of interest expense is allowable to the extent of 50 percent of its adjusted taxable income ($1,600, determined by adding to H's taxable income (zero) its allowable deductions for interest expense ($1,000) and depreciation deductions ($600). Since H's interest expense of $1,000 (determined after applying section 469) exceeds 50 percent of its adjusted taxable income for 1990 ($800), H's excess interest expense of $200 is disallowed under section 163(j). There is no recomputation of deductions under section 469.

§ 1.163 (j)–6 Application of section 163 (j) to certain foreign corporations.

(a) *Scope.* A foreign corporation that has income, gain or loss that is effectively connected (or is treated as effectively connected) with the conduct of a trade or business in the United States for the taxable year will be subject to the rules of this section for the taxable year, provided that it has a debt-equity ratio that exceeds 1.5 to 1 on the last day of the taxable year, computed using the definitions of debt and equity under paragraph (e) of this section.

(b) *Disallowed interest expense.* In computing its effectively connected taxable income for a taxable year, a foreign corporation described in paragraph (a) of this section will not be allowed to deduct interest expense allocated to its effectively connected income that it has paid, or is deemed to have paid, to a related person (as determined under paragraph (d) of this section) if no tax is imposed with respect to such interest as determined under § 1.163(j)–4. The amount of interest expense disallowed under this paragraph (b), however, shall not exceed the corporation's excess interest expense (as defined in paragraph (c)(2) of this section). Any interest expense that is disallowed under this section may be carried forward to a subsequent taxable year of the foreign corporation and allowed in such year to the extent provided in §§ 1.163 (j)–1(c) and 1.163(j)–6 (a)(2) and (3). See § 1.163(j)–7 for rules relating to the coordination of this section with other provisions of the Code affecting the deductibility of interest.

(c) *Definitions*—(1) *In general.* The terms "net interest expense", "adjusted taxable income", "excess interest expense", and "excess limitation" shall have the same meanings as provided elsewhere in these regulations under section 163(j), with the following additions and modifications. All other terms used in this section shall have the same meanings as provided elsewhere in these regulations under section 163(j).

(2) *Net interest expense.* The net interest expense of a foreign corporation means the excess, if any, of interest expense that is allocated to the effectively connected income of the foreign corporation for the taxable year and that is taken into account under section 163(j) as provided in § 1.163(j)–7, over the amount of interest includible in its effectively connected gross income for the taxable year.

(3) *Adjust taxable income.* The adjusted taxable income of a foreign corporation is its effectively connected taxable income that is not exempt from tax by reason of a U.S. income tax treaty, modified by the additions and subtractions provided in § 1.163(j)–2(f) that are attributable to such effectively connected income.

(4) *Excess interest expense.* The excess interest expense of a foreign corporation is the excess of its net interest expense determined under paragraph (c)(2) of this section over the sum of 50 percent of its adjusted taxable income determined under paragraph (c)(3) of this section plus any excess limitation carryforward determined under §§ 1.163 (j)–1 (d) and 1.163 (j)–6 (b) (2).

(5) *Excess limitation.* The excess limitation of a foreign corporation means the excess, if any, of 50 percent

of the adjusted taxable income of the foreign corporation (determined under paragraph (c)(3) of this section), over its net interest expense (determined under paragraph (c)(2) of this section). For rules regarding the carryforward of any excess limitation of a foreign corporation, see §§ 1.163(j)–1(d) and 1.63(j)–6(b)(2).

(d) *Determination of interest paid to a related person.* For purposes of this section, the amount of interest that is paid, or deemed paid, by a foreign corporation to a related person, as defined in § 1.163(j)–2(g), shall equal the sum of the amount of interest paid by a U.S. trade or business of the foreign corporation under section 884(f)(1)(A) to a person that is related to the foreign corporation and the amount of interest described in section 884(f)(1)(B) ("excess interest" within the meaning of § 1.884–4T(a)).

(e) *Debt-equity ratio.* For purposes of computing the debt-equity ratio of a foreign corporation subject to the rules of this section, the debt of the foreign corporation shall equal the amount of its worldwide liabilities for purposes of Step 2 of § 1.882–5, adjusted in accordance with the rules in § 1.163(j)–3(b) without regard to § 1.163(j)–(b)(3). The equity of the foreign corporation shall equal the amount of its worldwide assets for purposes of Step 2 of § 1.882–5, adjusted in accordance with the rules in § 1.163(j)–3(c) without regard to § 1.163(j)–3(c)(4), less its worldwide liabilities as determined in the preceding sentence.

(f) *Example.* The rules of paragraphs (b) through (e) of this section may be illustrated with the following example.

Example. FC, a country X corporation, is engaged in the active conduct of a trade or business in the United States. FP, a country X corporation, owns all the stock of FC. The debt-equity ratio of FC under paragraph (e) of this section is 3:1. FC has $700 of adjusted taxable income under paragraph (c)(3) of this section, and net interest expense of $600 ($600 of interest expense allocated under § 1.882–5 over $0 of effectively connected interest income) under paragraph (c)(2) of this section. Under § 1.884–4T, $500 of FC's allocated interest expense is treated as interest paid by the U.S. trade or business of FC to FP, and $100 of FC's allocated interest expense is treated as if it were paid by a wholly owned domestic corporation to FC. FC and FP are both qualified residents of country X. Under the treaty, the rate of tax on the $500 of interest paid to FP and on FC's $100 of excess interest is reduced from 30 percent to 10 percent. Thus, of the $600 of interest paid or deemed paid by FC to related persons, two-thirds of the interest is treated as tax-exempt, or $400. The excess interest expense of FC is the excess of FC's net interest expense ($600) over 50 percent of FC's adjusted taxable income ($350) or $250. Thus, $250 of the $400 of interest paid by FC to tax-exempt related persons will be disallowed in computing FC's effectively connected taxable income for the taxable year but may be carried over by FC to a subsequent taxable year.

(g) *Coordination with branch profits tax.*—(1) *Effect on effectively connected earnings and profits.* The disallowance and carryforward of interest expense under this section shall not affect when such interest expense reduces the effectively connected earnings and profits of a foreign corporation, as defined in § 1.884–1T(f).

(2) *Effect on U.S. net equity.* The disallowance and carryforward of interest expense under this section shall not affect the computation of the U.S. net equity of a foreign corporation, as defined in § 1.884–1T (c).

(3) *Example.* The principles of this § 1.163(j)–8(g) are illustrated by the following example.

Example. Assume foreign corporation FC uses money that is treated as a U.S. asset under § 1.884–1T(d)(6) in order to pay interest described in paragraph (d) of this section, and that under this section a deduction for such interest expense is disallowed. Assuming that FC's U.S. assets otherwise remain constant during the year, the U.S. assets of FC will have decreased by the amount of money used to pay the interest expense, and the U.S. net equity of FC will be computed accordingly.

§ 1.163 (j)–9 Guarantees and back-to-back loans. [Reserved]

§ 1.163 (j)–10 Effective dates.

(a) *In general.* Section 163 (j) generally applies to interest paid or accrued directly or indirectly by the payor corporation in its taxable years beginning after July 10, 1989.

(b) *Exceptions.*—(1) *Interest paid on certain fixed-term obligations outstanding on July 10, 1989*—(i) *In general.* Interest paid or accrued with respect to a fixed-term debt obligation outstanding on July 10, 1989, shall not be treated as disallowed interest expense, even though such interest is paid or accrued in a taxable year of the payor corporation beginning after July 10, 1989. Such interest expense is, however, taken into account under section 163(j) for all other purposes (e.g. determining whether other interest expense paid or accrued during the taxable year is treated as excess interest expense).

(ii) *Certain obligations issued pursuant to written contracts binding on July 10, 1989*—(A) *In general.* Interest paid or accrued with respect to a fixed-term obligation that is issued after July 10, 1989, pursuant to a written contract binding on that date and at all times thereafter until the issuance of the obligation, shall be treated in the same manner as interest paid or accrued with respect to a fixed-term debt obligation outstanding on July 10, 1989.

(B) *Whether a contract is binding.* In determining whether a contract is a binding contract, the following rules apply:

(*1*) A written contract between related persons (as defined in § 1.163(j)–2(g)) shall only be treated as binding on a particular date if it was enforceable on that date (whether on the basis of reliance or otherwise) by an unrelated third party.

(*2*) A written contract duly executed by authorized individuals on or before July 10, 1989, will not be considered non-binding solely because it is subject to a condition outside the control of the parties; insubstantial contract terms remain to be negotiated by the parties; or it is subject to approval by the board of directors of a corporate party where, prior to July 11, 1989, the board had authorized or been apprised of the status of negotiations and formal board approval occurred reasonably promptly following extension of the written contract without further change to the agreement (except for insubstantial contract terms).

(iii) *Modification of certain fixed-term obligations outstanding on July 10, 1989*—(A) *In general.* If an obligation described in paragraphs (b)(1)(i) or (b)(1)(ii) of this section is modified after July 10, 1989, it shall be treated thereafter as a new obligation for purposes of section 163 (j).

(B) *Modification defined*—(*1*) *In general.* Except as provided in this paragraph (b)(1)(iii)(B), an obligation described in paragraphs (b)(1)(i) or (b)(1)(ii) of this section shall be treated as modified for purposes of paragraph (b)(1)(iii)(A) of this section if it is revised (whether by renegotiation, assumption, reissuance, or otherwise) in a manner that would give rise to a deemed exchange of debt instruments by the obligee under section 1001. In any case, an obligation shall not be treated as modified under this paragraph (b)(1)(iii)(A) solely because a new obligor is substituted for the original obligor to reflect the terms of a reorganization described in section 368(a) or incident to a liquidation described in section 332(a).

(*2*) *Extension of maturity date.* An obligation shall be treated as modified if its maturity date is extended even if such extension would not give rise to a deemed exchange of debt instruments under section 1001.

(*3*) *Anti-abuse rule.* If a fixed-term debt obligation outstanding on July 10, 1989, or an obligation described in

paragraph (b)(1)(ii)(A) of this section, is acquired by a person related to the obligor (within the meaning of § 1.163(j)-2(g)) from an obligee that is not so related, and the obligor (or any member of its affiliated group) issues new debt that has the effect of replacing the acquired debt (whether or not such issuance is to the original obligee), the acquired obligation shall be treated as modified for purposes of paragraph (b)(1)(iii) of this section.

(2) *Demand loans.* Interest paid or accrued prior to September 1, 1989, on a demand loan (or other obligation with no fixed term) outstanding on July 10, 1989, shall not be treated as disallowed by section 163(j) even though it is paid or accrued in a taxable year beginning after the latter date. Such interest expense is, however, taken into account under section 163(j) for all other purposes.

(c) *Carryforward of excess limitation from pre-effective date taxable years to post-effective date taxable years.* In computing a corporation's excess limitation carryforwards for its first, second, and third taxable years beginning after July 10, 1989, a corporation shall take into account amounts that would have been treated as excess limitation carryforwards to those years as if section 163(j) had been in effect throughout the corporation's taxable years beginning after July 10, 1986. For this purpose, such corporation shall be treated as having had zero excess limitation or disallowed interest expense carried forward to its first taxable year beginning after July 10, 1986.

(d) *Examples.* The following examples illustrate the operation of this section.

Example 1 (i) S is a calendar year domestic corporation. In each of 1987, 1988, 1989, and 1990, S's adjusted taxable income is $100. In 1987, 1988, 1989, and 1990, S's net interest expense is $40, $54, $55, and $50, respectively. All of S's interest expense for these years is exempt related person interest expense incurred with respect to demand loans. S does not satisfy the debt-equity ratio safe harbor test in 1990.

(ii) Pursuant to § 1.163 (j)-2 (c) and this section, S has excess limitation of $10 in 1987 which (subject to the limitations described in § 1.163 (j)-1 (d)) can be carried forward to its next three succeeding taxable years. In 1988, S's excess limitation carryforward from 1987 is reduced by $4 (its excess interest expense ($54) over 50 percent of its adjusted taxable income ($50)).

(iii) In 1989, $5 of S's $6 excess limitation carryforward from 1988 is applied against, and reduced by, S's $5 excess interest expense.

(iv) In 1990, the $1 balance of S's excess limitation carryforward from 1987 expires without tax benefit to S.

Example 2 (i) The facts are the same as in Example 1, except as follows: In 1988, S's net interest expense is $49. S's net interest expense is $55 in 1989, $50 in 1990, and $55 in 1991. S does not satisfy the debt-equity ratio safe harbor test in 1991.

(ii) In 1988, S has excess limitation carried forward from 1987 of $10, none of which is used or expires in 1988, and has excess limitation of $1 for 1988. In 1989, $5 of S's excess limitation carryforward from 1987 reduces to zero the amount of S's excess interest expense in that year. Thus, in 1990, S has total available excess limitation carryforward of $6, of which $5 is from 1987 and $1 from 1988. All $5 of S's remaining excess limitation carryforward from 1987 expires without tax benefit to S in 1990. In 1991, the $1 of excess limitation carryforward from 1988 reduces S's disallowed interest expense to $4.

Example 3 (i) D is a calendar-year domestic corporation. In 1987 and 1988, D's adjusted taxable income is $120 and its net interest expense is $60. In 1989, D's adjusted taxable income is $100 and its net interest expense is $30. In 1990, D has negative adjusted taxable income (i.e., an adjusted taxable loss) of $100 and $50 of net interest expense. In each year, all of D's net interest expense is exempt related person interest expense incurred with respect to demand loans.

(ii) D has neither excess limitation nor excess interest expense from 1987 and 1988. In 1989, D has $20 ($50–$30) of excess limitation which (subject to the limitations described in § 1.163 (j)–1 (d)) can be carried forward to its next three succeeding taxable years. In 1990, D's first taxable year in which its interest expense may be disallowed as a deduction under section 163 (j), the $20 of excess limitation D carried forward from 1989 is reduced (but not below zero) by its $100 adjusted taxable loss for that year under § 1.163 (j)–2 (f) (4). Therefore, none of D's excess limitation carryforward from 1989 can be applied to reduce D's $50 excess interest expense in 1990.

Fred T. Goldberg, Jr.,

Commissioner of Internal Revenue.

[FR Doc. 91-14243 Filed 6-12-91; 11:25 am]

BILLING CODE 4830-01-M

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26 CFR Part 1

[INTL-0870-89]

RIN 1545-AO24

Earnings Stripping (Section 163(j)); Hearing

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of public hearing on proposed regulations.

SUMMARY: This document provides notice of public hearing on proposed regulations relating to section 163(j) of the Internal Revenue Code, regarding "earnings stripping."

DATES: The public hearing will be held on Wednesday, September 25, 1991, beginning at 10 a.m. Requests to speak and outlines of oral comments must be received by Wednesday, September 4, 1991.

ADDRESSES: The public hearing will be held in the Cash Room, Department of the Treasury Building, 1500 Pennsylvania Avenue, NW., Washington, DC. The requests to speak and outlines of oral comments should be submitted to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, attn: CC:CORP:T:R, (INTL–0870–89), room 5228, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Felicia A. Daniels of the Regulations Unit, Assistant Chief Counsel (Corporate), 202–377–9228 or 202–566–3935 (not a toll-free number).

SUPPLEMENTARY INFORMATION: The subject of the public hearing is proposed regulations under section 163(j) of the Internal Revenue Code of 1986. The proposed regulations appear elsewhere in this issue of the Federal Register.

The rules of § 601.601(a)(3) of the "Statement of Procedural Rules" (26 CFR part 601) shall apply with respect to the public hearing. Persons who have submitted written comments within the time prescribed in the notice of proposed rulemaking and who also desire to present oral comments at the hearing on the proposed regulations should submit not later than Wednesday, September 4, 1991, an outline of oral comments/testimony to be presented at the hearing and the time they wish to devote to each subject.

Each speaker (or group of speakers representing a single entity) will be limited to 10 minutes for an oral presentation exclusive of the time consumed by questions from the panel for the government and answers to these questions.

Because of controlled access restrictions, attendees cannot be permitted beyond the lobby of the Department of the Treasury Building until 9:45 a.m.

An agenda showing the scheduling of the speakers will be made after outlines are received from the persons testifying. Copies of the agenda will be available free of charge at the hearing.

By direction of the Commissioner of Internal Revenue.

Dale D. Goode,

Federal Register Liaison Officer, Assistant Chief Counsel (Corporate).

[FR Doc. 91-14244 Filed 6-12-91; 11:25 am]

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individual who was an officer or em
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idual serving as Commissioner of In
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post of duty outside the District of Columbia upon the completion of such duty.

(g) Delinquent internal revenue officers and employees. If any officer or employee of the Treasury Department acting in connection with the internal revenue laws fails to account for and pay over any amount of money or property collected or received by him in connection with the internal revenue laws, the Secretary shall issue notice and demand to such officer or employee for payment of the amount which he failed to account for and pay over, and, upon failure to pay the amount demanded within the time specified in such notice, the amount so demanded shall be deemed imposed upon such officer or employee and assessed upon the date of such notice and demand, and the provisions of chapter 64 and all other provisions of law relating to the collection of assessed taxes shall be applicable in respect of such amount.

In 1998, P.L. 105-206, Sec. 1104(a), amended Code Sec. 7804, effective 7/22/98.

Prior to amendment, Code Sec. 7804 read as follows.

"SEC. 7804. EFFECT OF REORGANIZATION PLANS.

"(a) Application. The provisions of Reorganization Plan Numbered 26 of 1950 and Reorganization Plan Numbered 1 of 1952 shall be applicable to all functions vested by this title, or by any act amending this title (except as otherwise expressly provided in such amending act), in any offices, employee, or agency, of the Department of the Treasury.

"(b) Preservation of existing rights and remedies. Nothing in Reorganization Plan Numbered 26 of 1950 or Reorganization Plan Numbered 1 of 1952 shall be considered to impair any right or remedy, including trial by jury, to recover any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority, or any sum alleged to have been excessive or in any manner wrongfully collected under the internal revenue laws. For the purpose of any action to recover any such tax, penalty, or sum, all statutes, rules, and regulations referring to the collector of internal revenue, the principal officer for the internal revenue district, or the Secretary, shall be deemed to refer to the officer whose act or acts referred to in the preceding sentence gave rise to such action. The venue of any such action shall be the same as under existing law."

In 1976, P.L. 94-455, Sec. 1906(b)(13)(A), substituted "Secretary" for "Secretary or his delegate" in Code Sec. 7804, effective 2/1/77.

Sec. 7805. Rules and regulations.

(a) Authorization.

Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

(b) Retroactivity of regulations.

(1) In general. Except as otherwise provided in this subsection, no temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates:

(A) The date on which such regulation is filed with the Federal Register.

(B) In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register.

(C) The date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public.

(2) Exception for promptly issued regulations. Paragraph (1) shall not apply to regulations issued within 18 months of the date of the enactment of the statutory provision to which the regulation relates.

(3) Prevention of abuse. The Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.

(4) Correction of procedural defects. The Secretary may provide that any regulation may apply retroactively to correct a procedural defect in the issuance of any prior regulation.

(5) Internal regulations. The limitation of paragraph (1) shall not apply to any regulation relating to internal Treasury Department policies, practices, or procedures.

(6) Congressional authorization. The limitation of paragraph (1) may be superseded by a legislative grant from Congress authorizing the Secretary to prescribe the effective date with respect to any regulation.

(7) Election to apply retroactively. The Secretary may provide for any taxpayer to elect to apply any regulation before the dates specified in paragraph (1).

(8) Application to rulings. The Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.

(c) Preparation and distribution of regulations, forms, stamps, and other matters.

The Secretary shall prepare and distribute all the instructions, regulations, directions, forms, blanks, stamps, and other matters pertaining to the assessment and collection of internal revenue.

(d) Manner of making elections prescribed by Secretary.

Except to the extent otherwise provided by this title, any election under this title shall be made at such time and in such manner as the Secretary shall prescribe.

(e) Temporary regulations.

(1) Issuance. Any temporary regulation issued by the Secretary shall also be issued as a proposed regulation.

(2) 3-Year duration. Any temporary regulation shall expire within 3 years after the date of issuance of such regulation.

(f) Review of impact of regulations on small business.

(1) Submissions to small business administration. After publication of any proposed or temporary regulation by the Secretary, the Secretary shall submit such regulation to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact of such regulation on small business. Not later than the date 4 weeks after the date of such submission, the Chief Counsel for Advocacy shall submit comments on such regulation to the Secretary.

(2) Consideration of comments. In prescribing any final regulation which supersedes a proposed or temporary regulation which had been submitted under this subsection to the Chief Counsel for Advocacy of the Small Business Administration—

(A) the Secretary shall consider the comments of the Chief Counsel for Advocacy on such proposed or temporary regulation, and

(B) the Secretary shall discuss any response to such comments in the preamble of such final regulation.

(3) Submission of certain final regulations. In the case of the promulgation by the Secretary of any final regulation (other than a temporary regulation) which does not supersede a proposed regulation, the requirements of paragraphs (1) and (2) shall apply; except that—

(A) the submission under paragraph (1) shall be made at least 4 weeks before the date of such promulgation, and

(B) the consideration (and discussion) required under paragraph (2) shall be made in connection with the promulgation of such final regulation.

In 1998, P.L. 105-206, Sec. 3704, deleted "by regulations or forms" after "the Secretary shall" in subsec. (d), effective 7/22/98.

In 1996, P.L. 104-168, Sec. 1101(a), amended subsec. (b), effective for regulations which relate to statutory provisions enacted on or after 7/30/96.

Prior to amendment, subsec. (b) read as follows:

"(b) Retroactivity of regulations or rulings. The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."

—P.L. 104-117, Sec. 2, substituted "October 1, 2003" for "October 1, 2000" in Sec. 10511(c) of P.L. 100-203, reproduced below [as amended by Sec. 743 of P.L. 103-465 and Sec. 11319(a) of P.L. 101-508, see below].

In 1994, P.L. 103-465, Sec. 743, substituted "October 1, 2000" for "October 1, 1995" in Sec. 10511(c) of P.L. 100-203, reproduced below [as amended by Sec. 11319(a) of P.L. 101-508, see below].

In 1990, P.L. 101-508, Sec. 11319(a), added the sentence at the end of Sec. 10511(c) of P.L. 100-203, reproduced below, effective 9/29/90, except that no advance payment shall be required for any fee for any requests filed after 9/29/90, and before the 30th day after 11/5/90.

—P.L. 101-508, Sec. 11621(a), amended subsec. (f), effective for regulations issued after the date which is 30 days after 11/5/90.

Prior to amendment, subsec. (f) read as follows:

"(f) Impact of regulations on small business reviewed. After the publication of any proposed regulation by the Secretary and before the promulgation of any final regulation by the Secretary which does not supersede a proposed regulation, the Secretary shall submit such regulation to the Administrator of the Small Business Administration for comment on the impact of such regulation on small business. The Administrator shall have 4 weeks from the date of submission to respond."

In 1988, P.L. 100-647, Sec. 6232(a), added subsecs. (e) and (f), effective for any regulation issued after the date which is 10 days after 11/10/88.

In 1987, P.L. 100-203, Sec. 10511, [as amended by Sec. 11319(a) of P.L. 101-508, Sec. 743 of P.L. 103-465, and Sec. 2 of P.L. 104-117, see above] provides the following rules for tax-related user fees:

"SEC. 10511. FEES FOR REQUESTS FOR RULING, DETERMINATION, AND SIMILAR LETTERS.

"(a) General rule. The Secretary of the Treasury or his delegate (hereinafter in this section referred to as the 'Secretary') shall establish a program requiring the payment of user fees for requests to the Internal Revenue Service for ruling letters, opinion letters, and determination letters and for similar requests.

"(b) Program criteria.

"(1) In general. The fees charged under the program required by subsection (a)—

"(A) shall vary according to categories (or subcategories) established by the Secretary,

"(B) shall be determined after taking into account the average time for (and difficulty of) complying with requests in each category (and subcategory), and

"(C) shall be payable in advance.

"(2) Exemptions, etc. The Secretary shall provide for such exemptions (and reduced fees) under such program as he determines to be appropriate.

"(3) Average fee requirement. The average fee charged under the program required by subsection (a) shall not be less than the amount determined under the following table:

"Category	Average Fee
Employee plan ruling and opinion	$ 250
Exempt organization ruling	$ 350
Employee plan determination	$ 300
Exempt organization determination	$ 275
Chief counsel ruling	$200.

"(c) Application of section. Subsection (a) shall apply with respect to requests made on or after the 1st day of the second calendar month beginning after the date of the enactment of this Act and before September 30, 1990. Subsection (a) shall also apply with respect to requests made after September 30, 1990, and before October 1, 2003."

In 1984, P.L. 98-369, Sec. 43(b), added subsec. (d), effective for tax. yrs. end. after 7/18/84.

In 1976, P.L. 94-455, Sec. 1906(b)(13)(A), substituted "Secretary" for "Secretary or his delegate" each place it appeared in Code Sec. 7805, effective 2/1/77.

Sec. 7806. Construction of title.

(a) Cross references.

The cross references in this title to other portions of the title, or other provisions of law, where the word "see" is used, are made only for convenience, and shall be given no legal effect.

(b) Arrangement and classification.

No inference, implication, or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular section or provision or portion of this title, nor shall any table of contents, table of cross references, or similar outline, analysis, or descriptive matter relating to the contents of this title be given any legal effect. The preceding sentence also applies to the sidenotes and ancillary tables contained in the various prints of this Act before its enactment into law.

Sec. 7807. Rules in effect upon enactment of this title.

(a) Interim provision for administration of title.

Until regulations are promulgated under any provision of this title which depends for its application upon the promulgation of regulations (or which is to be applied in such manner as may be prescribed by regulations) all instructions, rules or regulations which are in effect immediately prior to the enactment of this title shall, to the extent such instructions, rules, or regulations could be prescribed as regulations under authority of such provision, be applied as if promulgated as regulations under such provision.

(b) Provisions of this title corresponding to prior internal revenue laws.

(1) Reference to law applicable to prior period. Any provision of this title which refers to the application of any portion of this title to a prior period (or which depends upon the application to a prior period of any portion of this title) shall, when appropriate and consistent with the purpose of such provision, be deemed to refer to (or depend upon the application of) the corresponding provision of the Internal Revenue Code of 1939 or of such other internal revenue laws as were applicable to the prior period.

(2) Elections or other acts. If an election or other act under the provisions of the Internal Revenue Code of 1939 would, if this title had not been enacted, be given effect for a period subsequent to the date of enactment of this title, and if corresponding provisions are contained in this title, such election or other act shall be given effect under the corresponding provisions of this title.

Sec. 7808. Depositaries for collections.

The Secretary is authorized to designate one or more depositaries in each State for the deposit and safe-keeping of the money collected by virtue of the internal revenue laws; and the receipt of the proper officer of such depositary to the proper officer or employee of the Treasury Department for the money deposited by him shall be a sufficient voucher for such Treasury officer or employee in the settlement of his accounts.

In 1976, P.L. 94-455, Sec. 1906(b)(13)(A), substituted "Secretary" for "Secretary or his delegate" in Code Sec. 7808, effective 2/1/77.

Sec. 7809. Deposit of collections.

(a) General rule.

Except as provided in subsections (b) and (c) and in sections 7651, 7652, 7654, and 7810, the gross amount of all taxes and revenues received under the provisions of this title, and collections of whatever nature received or collected by authority of any internal revenue law, shall be paid daily into the Treasury of the United States under instructions of

(ii) 5 percentage points, and

(C) such instrument has significant original issue discount.

For purposes of subparagraph (B)(i), the Secretary may by regulation permit a rate to be used with respect to any debt instrument which is higher than the applicable Federal rate if the taxpayer establishes to the satisfaction of the Secretary that such higher rate is based on the same principles as the applicable Federal rate and is appropriate for the term of the instrument.

(2) SIGNIFICANT ORIGINAL ISSUE DISCOUNT.—For purposes of paragraph (1)(C), a debt instrument shall be treated as having significant original issue discount if—

(A) the aggregate amount which would be includible in gross income with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date 5 years after the date of issue, exceeds—

(B) the sum of—

(i) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and

(ii) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity.

(3) SPECIAL RULES.—For purposes of determining whether a debt instrument is an applicable high yield discount obligation—

(A) any payment under the instrument shall be assumed to be made on the last day permitted under the instrument, and

(B) any payment to be made in the form of another obligation of the issuer (or a related person within the meaning of section 453(f)(1)) shall be assumed to be made when such obligation is required to be paid in cash or in property other than such obligation).

Except for purposes of paragraph (1)(B), any reference to an obligation in subparagraph (B) of this paragraph shall be treated as including a reference to stock.

(4) DEBT INSTRUMENT.—For purposes of this subsection, the term "debt instrument" means any instrument which is a debt instrument as defined in section 1275(a).

(5) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection and subsection (e)(5), including—

(A) regulations providing for modifications to the provisions of this subsection and subsection (e)(5) in the case of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, conversion rights, or other circumstances where such modifications are appropriate to carry out the purposes of this subsection and subsection (e)(5), and

(B) regulations to prevent avoidance of the purposes of this subsection and subsection (e)(5) through the use of issuers other than C corporations, agreements to borrow amounts due under the debt instrument, or other arrangements.

Amendments

P.L. 101-508, § 11701(b)(2):

Act Sec. 11701(b)(2) amended Code Sec. 163(i)(3) by striking "(or stock)" after "obligation" each place it appears in subparagraph (B), and by adding at the end thereof a new sentence to read as above.

The above amendment is effective as if included in the provision of the Revenue Reconciliation Act of 1989 (P.L. 101-239) to which it relates.

P.L. 101-239, § 7202(b):

Act Sec. 7202(b) amended Code Sec. 163 by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) a new subsection (i) to read as above.

The above amendment applies generally to instruments issued after July 10, 1989. For exceptions, see Act Sec. 7202 (c)(2) following Code Sec. 163(e), above.

[Sec. 163(j)]

(j) LIMITATION ON DEDUCTION FOR CERTAIN INTEREST PAID BY CORPORATION TO RELATED PERSON.—

(1) LIMITATION.—

(A) IN GENERAL.—If this subsection applies to any corporation for any taxable year, no deduction shall be allowed under this chapter for disqualified interest paid or accrued by such corporation during such taxable year. The amount disallowed under the preceding sentence shall not exceed the corporation's excess interest expense for the taxable year.

(B) DISALLOWED AMOUNT CARRIED TO SUCCEEDING TAXABLE YEAR.—Any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest paid or accrued in the succeeding taxable year.

(2) CORPORATIONS TO WHICH SUBSECTION APPLIES.—

(A) IN GENERAL.—This subsection shall apply to any corporation for any taxable year if—

(i) such corporation has excess interest expense for such taxable year, and

(ii) the ratio of debt to equity of such corporation as of the close of such taxable year (or on any other day during the taxable year as the Secretary may by regulations prescribe) exceeds 1.5 to 1.

(B) EXCESS INTEREST EXPENSE.—

(i) IN GENERAL.—For purposes of this subsection, the term "excess interest expense" means the excess (if any) of—

(I) the corporation's net interest expense, over

(II) the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward under clause (ii).

(ii) EXCESS LIMITATION CARRYFORWARD.—If a corporation has an excess limitation for any taxable year, the amount of such excess limitation shall be an excess limitation carryforward to the 1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward taken into account for any such succeeding taxable year shall not exceed the excess interest expense for such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation).

(iii) EXCESS LIMITATION.—For purposes of clause (i), the term "excess limitation" means the excess (if any) of—

(I) 50 percent of the adjusted taxable income of the corporation, over

(II) the corporation's net interest expense.

(C) RATIO OF DEBT TO EQUITY.—For purposes of this paragraph, the term "ratio of debt to equity" means the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. For purposes of the preceding sentence—

(i) the amount taken into account with respect to any asset shall be the adjusted basis thereof for purposes of determining gain,

(ii) the amount taken into account with respect to any indebtedness with original issue discount shall be its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to subsection (a)(7) or (b)(4) thereof), and

(iii) there shall be such other adjustments as the Secretary may by regulations prescribe.

(3) DISQUALIFIED INTEREST.—For purposes of this subsection—

(A) IN GENERAL.—Except as provided in subparagraph (B), the term "disqualified interest" means any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no tax is imposed by this subtitle with respect to such interest.

(B) EXCEPTION FOR CERTAIN EXISTING INDEBTEDNESS.—The term "disqualified interest" does not include any interest paid or accrued under indebtedness with a fixed term—

(i) which was issued on or before July 10, 1989, or

(ii) which was issued after such date pursuant to a written binding contract in effect on such date and all times thereafter before such indebtedness was issued.

(4) RELATED PERSON.—For purposes of this subsection—

(A) IN GENERAL.—Except as provided in subparagraph (B), the term "related person" means any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer.

(B) SPECIAL RULE FOR CERTAIN PARTNERSHIPS —

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(i) IN GENERAL.—Any interest paid or accrued to a partnership which (without regard to this subparagraph) is a related person shall not be treated as paid or accrued to a related person if less than 10 percent of the profits and capital interests in such partnership are held by persons with respect to whom no tax is imposed by this subtitle on such interest. The preceding sentence shall not apply to any interest allocable to any partner in such partnership who is a related person to the taxpayer.

(ii) SPECIAL RULE WHERE TREATY REDUCTION.—If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on a partner's share of any interest paid or accrued to a partnership, such partner's interests in such partnership shall, for purposes of clause (i), be treated as held in part by a tax-exempt person and in part by a taxable person under rules similar to the rules of paragraph (5)(B).

(5) SPECIAL RULES FOR DETERMINING WHETHER INTEREST IS SUBJECT TO TAX.—

(A) TREATMENT OF PASS-THRU ENTITIES.—In the case of any interest paid or accrued to a partnership, the determination of whether any tax is imposed by this subtitle on such interest shall be made at the partner level. Rules similar to the rules of the preceding sentence shall apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

(B) INTEREST TREATED AS TAX-EXEMPT TO EXTENT OF TREATY REDUCTION.—If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on any interest paid or accrued by the taxpayer to a related person, such interest shall be treated as interest on which no tax is imposed by this subtitle to the extent of the same proportion of such interest as—

(i) the rate of tax imposed without regard to such treaty, reduced by the rate of tax imposed under the treaty, bears to

(ii) the rate of tax imposed without regard to the treaty.

(6) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) ADJUSTED TAXABLE INCOME.—The term "adjusted taxable income" means the taxable income of the taxpayer—

(i) computed without regard to—

(I) any deduction allowable under this chapter for the net interest expense,

(II) the amount of any net operating loss deduction under section 172, and

(III) any deduction allowable for depreciation, amortization, or depletion, and

(ii) computed with such other adjustments as the Secretary may by regulations prescribe.

(B) NET INTEREST EXPENSE.—The term "net interest expense" means the excess (if any) of—

(i) the interest paid or accrued by the taxpayer during the taxable year, over

(ii) the amount of interest includible in the gross income of such taxpayer for such taxable year.

The Secretary may by regulations provide for adjustments in determining the amount of net interest expense.

(C) TREATMENT OF AFFILIATED GROUP.—All members of the same affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer.

(7) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including—

(A) such regulations as may be appropriate to prevent the avoidance of the purposes of this subsection,

(B) regulations providing such adjustments in the case of corporations which are members of an affiliated group as may be appropriate to carry out the purposes of this subsection, and

(C) regulations for the coordination of this subsection with section 884.