Chapter 12  Related Party Interest Expense

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a. Introduction

Internal Revenue Code (IRC) §163(j), known as the earnings stripping rules, was added to the IRC in 1989. The purpose of adding IRC §163 was to limit the deductibility of interest paid or accrued by United States (US) and certain foreign corporations to related persons in situations where all or a portion of such interest is exempt from US tax. California conforms to IRC §163 except as otherwise provided by California law. (Revenue and Taxation Code (R&TC) §24344.)

Proposed federal regulations for IRC §163(j) were issued in 1991 and are still in proposed status. California conforms to temporary and final regulations but does not address proposed regulations. (R&TC §23051.5(d).) The proposed regulations provide guidance on the application of the code. This chapter discusses key definitions and computations as prescribed by IRC §163(j), including proposed treasury regulations under §163(j).

Note: The Tax Cuts and Jobs Act (TCJA) signed into law on December 22, 2017, made changes to the IRC. In general, California R&TC does not conform to the changes. California taxpayers continue to follow the IRC as of the specified date of January 1, 2015, with modifications. References in this Chapter are to the IRC as of January 1, 2015. (R&TC §23051.5.)
b. Impact of IRC §163(j)

IRC §163(j) may limit deductions for any "disqualified interest" paid or accrued during the taxable year (e.g. interest paid to a "related person" that is not subject to US tax). IRC §163(j) applies to any corporation if such corporation has excess interest expense for a taxable year and the ratio of debt to equity for such taxable year exceeds 1.5 to 1 (the "debt-to-equity safe harbor"). IRC §163(j)(2)(A)(ii) states that the debt to equity ratio is computed at the close of the tax year (unless the IRS sets a different date in the regulations). If IRC §163(j)(1) applies, then a portion or all of the taxpayer's disqualified interest expense may be disallowed in the current year.

To summarize, for IRC §163(j) to apply, the following conditions must be satisfied:

1. A US corporation or a US branch of a foreign corporation must pay interest to:
   • A related person, or to
   • An unrelated person (such as a third party bank) if there is a "disqualified guarantee" of the underlying debt;
2. The payee above must be exempt from US tax on some portion of the income (or subject to a reduced rate of tax under a treaty).
3. The payor corporation must not meet the debt equity ratio safe harbor (1.5 or less), and
4. The corporation's net interest expense must exceed 50 percent of adjusted taxable income (ATI) plus any excess limitation (EL) carryforward.

The disallowed interest expense is carried over to future years and treated as interest paid or accrued in the succeeding taxable year.

c. Disqualified Interest

IRC §163(j)(3) states that disqualified interest is:

• Interest paid or accrued (directly or indirectly) to a related person not subject to US income tax on the interest and
• Interest paid or accrued on indebtedness held by an unrelated person if there is a disqualified guarantee of the indebtedness
and the interest is not subject to a US gross basis income tax (a tax figured on the gross amount of an item of income without reduction for any allowed deduction.

- Interest paid or accrued (directly or indirectly) by a taxable REIT subsidiary as defined in IRC §856(l) of a real estate investment trust to such trust.

Effective for interest paid or accrued in tax years beginning on or after January 1, 1994 (for federal purposes), IRC §163(j)(3) states that disqualified interest also includes interest paid on indebtedness guaranteed by a disqualified guarantee if no gross basis tax is imposed on the interest income.

California conformed to this federal provision for taxable years beginning on or after January 1, 1996. (R&TC §24344.7.)

d. Related Persons

IRC §163(j)(4) states that "related person" means any person who is related to the taxpayer within the meaning of IRC §267(b) or §707(b)(1). The constructive ownership and attribution rules of IRC §267(c) apply. For corporations to be a related party, generally a more than 50 percent ownership interest is required. In determining whether persons are related, the substance of ownership, rather than its form controls (anti-abuse rule). (Proposed Treasury Regulation (Treas. Reg.) §1.163(j)-2(g)(2).)

Example 1

United States (US) Corporation A is owned 51% by Corporation B and 49% by Corporation C. Corporations B and C are United Kingdom (UK) corporations. Since B meets the relationship test, A's interest payments to B are subject to the provisions of IRC §163(j) because B is exempt from tax on this interest income. The interest paid to C by A is not subject to the disallowance because C does not own more than 50% of A.

Example 2

US Corporation A is owned 50% by US Corporation B and 50% by Corporation C, a UK corporation. Unless the substance of ownership differs from its form (constituting abuse), none of the interest paid by A is subject to disallowance under IRC §163(j) since the ownership
requirement is not met. (i.e., no entity owns, directly or indirectly, more than 50 percent.)

NOTE: There is no requirement that the related person be a foreign corporation. A US entity that is not a California taxpayer and is not unitary with a taxpayer falls within this definition.

e. Disqualified Guarantee

IRC §163(j)(6)(D) states that a disqualified guarantee is generally a guarantee by a related person that is a tax-exempt organization or a foreign person, unless the corporation owns a controlling interest in the tax-exempt organization or foreign person.

Disqualified guarantee does not include a guarantee, identified by the Secretary by regulation, where the interest would have been subject to a net basis tax if the interest had been paid to the guarantor (IRC §163(j)(6)(D)(ii)(I)), or if the taxpayer owns a controlling interest in the guarantor (IRC §163(j)(6)(D)(ii)(II)).

Guarantee is defined broadly and includes any arrangement in which a person assures, on a conditional or unconditional basis, the payment of another's obligation. (IRC §163(j)(6)(D)(iii).)

f. No Tax Is Imposed, Gross Basis Tax and Net Basis Tax

1. No Tax Imposed

There is a federal/state difference concerning this issue. The actual language used in IRC §163(j)(3)(A) is as follows:

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.

The term subtitle means Subtitle A which includes IRC §1 - §1563. The federal tax in question will usually be the 30 percent withholding tax imposed by IRC §881. The tax can also be the federal income tax following Proposed Treas. Reg. §1.163(j)-4(a). For California purposes, R&TC §23051.5(h)(3) requires us to substitute "this part" for "this subtitle." This part means Part II, which consists of §23001 through §25141 of the R&TC. Accordingly, interest paid to a foreign corporation that is excluded from the water's-edge group generally will
not be subject to tax under Part II. Such interest payments will therefore constitute disqualified interest for California purposes.

2. Gross Basis Tax

Interest paid on indebtedness guaranteed by a disqualified guarantee is disqualified interest if no gross basis tax is imposed on the corresponding income. IRC §163(j)(6)(E)(i) states that a gross basis tax is any tax imposed by Subtitle A of the IRC which is determined by reference to the gross amount of any item of income without reduction by deductions. The gross basis tax that is relevant for purposes of IRC §163(j) is the 30 percent withholding tax required by IRC §881(a).

The R&TC does not assess gross basis taxes. All interest paid on indebtedness guaranteed by a disqualified guarantee is disqualified interest for California purposes.

3. Net Basis Tax

IRC §163(j)(6)(E)(ii) states that a net basis tax is any tax imposed that is not a gross basis tax. Interest paid to a related person or on a debt that is guaranteed by a disqualified guarantee is not disqualified. The interest income would have been subject to a net basis tax if the interest had been paid to the guarantor.

It is possible to have a net basis tax on interest income if the interest income is Effectively Connected Income (ECI). ECI of an affiliate would be includible in the water's-edge combined report.

g. Net Interest Expense

A corporation's net interest expense is the excess of:

- The interest paid or accrued by the corporation during the tax year, over
- The interest includible in the gross income of the corporation for the tax year. (IRC §163(j)(6)(B).)

Example 3

Corporation A has total interest expense of $110 and total interest income of $10. Its net interest expense is $100 ($110 - $10).
h. Excess Interest Expense

IRC §163(j)(2)(B)(i) states that a corporation's excess interest expense is the excess of:

- The corporation's net interest expense, over
- The sum of 50 percent of the adjusted taxable income of the corporation plus an excess limitation carryforward for the tax year.

Example 4

Corporation A has net interest expense of $100, current adjusted taxable income of $150, and $10 of excess limitation carryforward from a previous year. The excess interest expense is $15. (100 - [(50% x 150) + $10].)

i. Computation of Ratio of Debt to Equity

For the IRC §163(j) interest expense limitation to apply, the Debt Equity ratio must exceed 1.5 to 1. (IRC §163(j)(2)(A)(ii).)

The debt-equity ratio is determined as follows:

\[
\frac{\text{Total Debt}}{\text{Total Equity}} = \frac{\text{Total Debt}}{(\text{Cash} + \text{Other Assets}) - \text{Debt}}
\]

The term debt means the corporation's liabilities determined under general tax principles, and as the adjusted issue price in the case of a discounted bond.

The term Equity includes cash and adjusted basis of all other assets, minus Total Debt.

The debt-to-equity ratio is determined on the last day of the taxable year, but keep in mind the "anti-abuse" rules in Proposed Treas. Reg. §1.163(j)-3.

- Assets are disregarded if "the principal purpose" of acquisition was to reduce the debt-to-equity ratio.
- Decreases in debt during the last 90 days of the year are ignored if aggregate debt increased in first 90 days after the year.
- Certain transfers of assets between related parties during last 90 days of the year are disregarded.
j. Computation of Adjusted Taxable Income

The purpose of computing a corporation's adjusted taxable income is to convert its taxable income to an amount that more closely approximates operating cash flow. IRC §163(j)(6)(A) provides that adjusted taxable income is computed as follows:

Federal Taxable Income (loss) before application of §163(j)

Plus:
1. Net Interest Expense
2. NOL deduction
3. Depreciation
4. Amortization
5. Depletion
6. Domestic Production deduction under IRC §199
7. Other adjustments (prescribed in regulations)

Proposed Treas. Reg. §1.163(j)-2(f) provides for additional adjustments.

For California, the computation should be based on net income after state adjustments but prior to apportionment. California does not have standalone regulations pertaining to IRC §163(j); therefore, we follow federal law and make modifications to account for federal/state differences (i.e., depreciation methods).

k. Disqualified Interest Disallowed

If there is disqualified interest and excess interest expense, then a portion or all of the disqualified interest may be disallowed. The amount disallowed is equal to the lesser of:

- The disqualified interest or
- Excess interest expense

IRC §163(j)(1)(B) states that if any disqualified interest is disallowed, the disallowed portion is carried forward and treated as disqualified interest paid or accrued in the subsequent year. Proposed Treas. Reg. §1.163(j)-1(d) states that the carryover amount is not, however, added to the subsequent year's interest expense for purposes of computing net interest expense for that year. The taxpayer may
deduct this amount in the subsequent year to the extent it has excess limitation following Proposed Treas. Reg. §1.163(j)-1(c).

Disqualified interest refers to the condition of being paid to an exempt related person, whereas disallowed interest, refers to interest that is subject to the limitation of IRC §163(j) and deferred to tax years subsequent to the disallowance year.

I. Excess Limitation Carryforward

IRC §163(j)(2)(B)(iii) states that a corporation's excess interest expense limitation is the excess (if any) of:

- 50 percent of the adjusted taxable income of the corporation, over
- The corporation's net interest expense.

Example 5

Corporation A has adjusted taxable income of $100, interest expense of $30, and interest income of $20. Its excess limitation is $40. \((100 \times 50\%) - ($30-$20) = $40\)

IRC §163(j)(2)(B)(ii) states that if a corporation has an excess limitation for any taxable year, the amount of such excess limitation is the excess limitation carryforward to the 1\(^{st}\) succeeding taxable year and to the 2\(^{nd}\) and 3\(^{rd}\) succeeding taxable years to the extent not previously taken into account. The amount of such a carryforward taken into account for any such succeeding taxable year may not exceed the excess interest expense for each succeeding taxable year (determined without regard to the carryforward).

Any disallowed interest carried forward from a prior year is added to any current year disqualified interest and may be deducted to the extent of the excess limitation amount. The excess limitation amount is then reduced by the amount of disallowed interest expense carryforward which was allowed as a deduction in the current year. (Proposed Treas. Reg. §1.163(j)-1(d).)

Example 6

Assume the same facts as Example 5 except $10 of disqualified interest was disallowed in the prior year. The $10 carryforward can be deducted to the extent of the $40 excess limitation. (The amount
deductible is the lesser of disallowed interest carryforward or the excess limitation.) The excess limitation of $40 is reduced by the $10 of disallowed interest expense carryforward allowed as a deduction in the current year. The excess limitation carryforward is $30. 

\[(100 \times 50\%) - 10 - (30 - 20)\]

The excess limitation can only be carried forward to three succeeding taxable years. The taxpayer can use the excess limitation carryforward to reduce any excess interest expense in the subsequent year. The carryforwards are applied in the order in which they arose (FIFO).

IRC §163(j)(2)(B)(iii) states that the amount of excess limitation used in a subsequent year is the lesser of:

- The excess limitation carryforward, or
- Net interest expense less 50 percent of adjusted taxable income (excluding any excess limitation carryforward).

**Example 7**

US Corporation X has an excess limitation carryforward from Year 1 of $1,000. During Year 2, X does not pay or accrue disqualified interest. Thus, X is not subject to disallowance under IRC §163(j) for interest paid in Year 2. During Year 2, however, X has $600 in excess interest expense (i.e. net interest expense exceeds 50% of its adjusted taxable income by $600 (without considering any excess limitation carryforward)). Thus, $600 of the $1,000 excess limitation carryforward will be added to Year 2 adjusted taxable income to reduce the excess interest expense to "0." The taxpayer will have an excess limitation carryforward to Year 3 of $400 ($1,000 - $600 used in Year 2).

**m. Comprehensive Example**

**Example 8**

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>10,000</td>
<td>5,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>3,000</td>
<td>2,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Disqualified interest – current year</td>
<td>5,000</td>
<td>1,000</td>
<td>3,000</td>
</tr>
</tbody>
</table>
Disqualified interest –
carryforward 4,000

Adjusted taxable income

\[
\begin{array}{ccc}
\text{ATI} & 6,000 & 18,000 & 7,000 \\
\end{array}
\]

(Assume debt to equity ratio exceeds 1.5 to 1 for all years.)

- **Year 1**

  Net interest expense  
  \[= 7,000 \ (10,000 - 3,000)\]

  Excess interest expense  
  \[= 4,000 \ (\text{Net Interest Expense of } \$7,000 \text{ over } 50\% \text{ of ATI} - \ (\$6,000 \times 50\% = \$3,000)\]

  Disqualified interest disallowed  
  \[= 4,000 \ (7,000 - \lfloor 50\% \times 6000 \rfloor)\]

  Disallowed interest carryforward  
  \[= 4,000 \ (\text{the lesser of excess interest or disqualified interest expense})\]

- **Year 2**

  Net interest expense  
  \[= 3,000 \ (5,000 - 2,000)\]

  Excess interest expense  
  \[= 0 \ (3,000 - \lfloor 50\% \times 18,000 \rfloor) \ (\text{Excess interest cannot be a negative number})\]

  Excess limitation  
  \[= 6,000 \ (\lfloor 50\% \times 18,000 \rfloor - 3,000)\]

  Disqualified interest  
  \[= 5,000 \ (1,000 \text{ for Year 2} + 4,000 \text{ carryforward or excess limitation})\]

  Excess limitation carryforward  
  \[= 2,000 \ (6,000 - 4,000)\]

- **Year 3**

  Net interest expense  
  \[= 6,000 \ (9,000 - 3,000)\]
Excess interest expense = 500 \[6,000 - [50\% \times 7,000] - 2,000\] (The 2000 = excess limitation carryforward)

Disallowed interest expense = 500 (The lesser of excess interest or disqualified interest expense)

The excess limitation carryforward reduces Year 3 excess interest expense, and thus would be reduced to zero in Year 3 even if there was zero disqualified interest or the debt to equity ratio was less than 1.5 to 1.

For tax years beginning on or after January 1, 2008, corporations are required to complete federal Form 8926-Disqualified Corporate Interest Expense Disallowed under IRC §163(j) to figure the amount of any corporate interest expense deduction disallowed by IRC §163(j). It is often helpful to use federal Form 8926 and any supporting workpapers as the starting point of your analysis.

NOTE: Public Law 115-97, repealed the disqualified corporate interest expense rules for tax years beginning after 2017. Form 8926 and its instructions will be obsolete for tax years beginning after 2017.

For disqualified corporate interest expense disallowed under prior law for tax years beginning before 2018, and Business Interest Expense for tax years beginning 2018 and after, see Form 8990, Limitation on Business Interest Expense under Section 163(j) and its instructions.

n. Water's-Edge Application

California Code of Regulations (CCR) §25110(d)(2)(F) provides that a foreign entity must include its Effectively Connected Income (ECI) if it is business income. WEM 5 discusses ECI. Since ECI is included in the water's-edge combined report, IRC §163(j) is generally inapplicable to payments made by members of the water's-edge combined report to related foreign corporations if the following conditions are met:

- The income has a US source under federal law,
- The foreign corporation is unitary with the taxpayer, and
- The income is business ECI.
IRC §163(j) generally does not apply because the foreign entity is required to be included in the combined report to the extent of the US source interest payments if the interest constitutes ECI. (R&TC §25110(a)(2)(A)(i); CCR §25110(d)(2)(F).) In cases where this interest is included in the water's-edge combined report under, the interest income is subject to California tax. Thus the interest expense would not be considered disqualified interest. (Including the interest and expense in the same return will also create a wash.)

IRC §163(j) will continue to apply to payments to nonunitary domestic and foreign affiliates that are not subject to tax in California.

The IRS proposed regulations also cover situations where the interest income is paid to entities such as controlled foreign corporations (CFCs), passive foreign investment companies (PFICs), and foreign personal holding companies. (Proposed Treas. Reg. §1.163(j)4(b) and (d).) For federal purposes, such interest is considered subject to US tax to the extent that it is included in the gross income of the US shareholders (as subpart F income, for an example). California does not tax the earnings of these entities as deemed dividends to the US shareholders. In most cases, the interest paid to these entities (i.e., CFCs) will only be considered subject to tax to the extent that the entity is partially (or fully) included in the water’s-edge combined report. The interest paid to a unitary foreign corporation that is partially included would generally be partially included in the water's-edge combined report if the interest income is business income, so IRC §163(j) will not usually be applicable to that portion of interest.

The computation of the amount to be disallowed for California purposes (under IRC §163(j)) is different than the computation for federal purposes. IRC §163(j)(6)(C) states that for federal purposes, the computation is made on an affiliated group basis. R&TC §24344(e) states that for California purposes, the computation is made using amounts from the combined report filed pursuant to R&TC §25101.