May 30, 2018

Douglas Poms, Esq.
International Tax Counsel
U.S. Treasury Department
1500 Pennsylvania Avenue, N.W.
Washington, DC 20224

Interaction of Section 163(j) Carryforward of Disallowed Interest with Section 59A

Dear Mr. Poms:

We are submitting this comment letter on behalf of a group of companies in response to the request for comments contained in section 9 of Notice 2018-28 (the "Notice"). This letter discusses the application of section 59A (commonly referred to as "the Base Erosion and Anti-Abuse Tax", or "BEAT"), enacted as part of Public Law 115-97 (the 2017 Tax Act), to interest disallowed under section 163(j) for years beginning prior to January 1, 2018, and carried forward to years beginning after December 31, 2017. Section 59A is effective for base erosion payments paid or accrued in taxable years beginning after December 31, 2017.[1]

In section 3 of the Notice, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") announced their intention to permit taxpayers to carry forward interest that was disallowed under prior section 163(j) into taxable years beginning after December 31, 2017. This conclusion is appropriate and welcome.

The Notice also provides, however, that regulations will provide that such an amount carried forward will be "treated as a base erosion payment described in section 59A(d)(1) and subject to the rules under section 59A(c)(3)," a position that is inconsistent with the effective date of section 59A. The deduction of interest from pre-2018 tax years is not a base erosion payment paid in a taxable year to which section 59A applies. As a result, interest paid in a pre-effective date period and disallowed under former section 163(j) that is subsequently allowed as a deduction under amended section 163(j) should not be added back to determine modified taxable income as a base erosion tax benefit in the year in which the deduction is allowed.

The interest carryforward of section 163(j) was intended to ameliorate the cyclical impact of the interest limitation, which is a ratio of interest expense to adjusted taxable income. Like section 163(j), the BEAT has a cyclical impact. Subjecting to the BEAT amounts paid in pre-effective date years would exacerbate that cyclical effect. While the BEAT was intended to and will result in taxpayers altering their behavior going forward, there is no action that taxpayers can take to

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[1] Section 14401(e) of the 2017 Tax Act.

undo the impact of the BEAT with respect to interest payments actually paid or accrued in prior years.

Accordingly, we request that Treasury and IRS reconsider the conclusion reached in the Notice and confirm that pre-2018 interest carried forward is not subject to section 59A.

I. Background

Section 59A imposes a minimum tax equal to the excess of 10 percent of the taxpayer's "modified taxable income" over the taxpayer's regular tax liability (with certain adjustments).[2] Modified taxable income for these purposes is generally defined as taxable income increased by any "base erosion tax benefit" with respect to any "base erosion payment" and increased by the base erosion percentage of any net operating loss deduction allowed under section 172 for the taxable year.[3]

A "base erosion tax benefit" includes any deduction allowed for amounts paid or accrued by the taxpayer with respect to any "base erosion payment".[4] A "base erosion payment" includes any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable.[5] A taxpayer making a base erosion payment has a base erosion tax benefit with respect to such payment if and when a deduction is allowed under chapter 1 of the Code with respect to the base erosion payment, and only to the extent that no withholding tax under section 871 or 881 was imposed with respect to such payment.[6]

Section 59A applies to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.[7]

Prior to its amendment, section 163(j) limited the current deduction for net interest expense paid or accrued to a related party (disqualified interest) to the extent the net interest expense exceeded a threshold amount. Disallowed interest expense is carried over to subsequent years by treating it as disqualified interest paid or accrued in the succeeding taxable year under former section

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2 For taxable years beginning in 2018, the BEAT rate generally is 5 percent, and for taxable years beginning after December 31, 2025, the BEAT rate generally is 12.5 percent.

3 Section 59A(c)(1).

4 Section 59A(c)(2)(i).

5 Section 59A(d)(1).

6 Sec. 59A(c)(2)(A)(i) and (c)(2)(B).

7 Section 14401(e) of the 2017 Tax Act.

163(j)(1)(B).[8] Section 163(j) did not change the year in which the interest was paid or accrued, but merely determined the year in which the interest could be deducted.

Section 163(j) deems the interest paid in a subsequent year only for purposes of calculating the timing of the interest expense deduction in a subsequent year. All other tax attributes of the interest payment are determined in the year of actual payment and not subsequent taxable years to which the disallowed interest expense is carried forward. Thus, for purposes of determining whether interest constitutes a base erosion payment under section 59A(d)(1), the relevant date is the date the interest is actually paid, not the year or years to which it is carried. The fact that interest is allowable as a deduction in a post-effective date year is a necessary, but insufficient condition for the BEAT to apply.

II. Analysis

A. Statutory Framework

1. Section 163(j)

Section 163(a) provides a general rule that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. This general rule is subject to a number of exceptions, including under amended section 163(j).

Prior to its amendment, section 163(j)(1)(A) provided that, if it applied to a corporation for any taxable year, "no deduction shall be allowed… for disqualified interest paid or accrued by such corporation during such taxable year…." However, the amount disallowed under section 163(j) may not exceed the corporation's excess interest expense, *i.e.*, the extent to which the corporation's net interest expense exceeds 50 percent of its adjusted taxable income.[9] Disqualified interest, broadly speaking, is interest paid to a related party to the extent such related party is not subject to U.S. federal income tax with respect to such interest income (including under section 871 or 881).

Prior section 163(j)(1)(B) provided that any amount disallowed under section 163(j) for any taxable year would be treated as disqualified interest paid or accrued in the succeeding taxable year. Therefore, when such interest was carried forward, it could be deducted in subsequent taxable years, subject to the application of section 163(j) in such years. Accordingly, section

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8 Amended section 163(j) includes a similar feature for carrying forward disallowed interest. Section 163(j)(2).

9 Former section 163(j)(1)(A) and (j)(2)(B). Adjusted taxable income, broadly speaking, is similar to EBITDA.

163(j) generally operated to defer the deductibility of net interest expense, rather than to disallow it entirely.[10]

For section 163(j) to apply to limit the interest expense that may be allowed in a given tax year, there needs to be an actual accrual or payment of interest that may otherwise be deducted. Then if interest expense is disallowed under section 163(j), the disallowed interest expense is treated as if it were paid or accrued in succeeding tax years to determine whether the expense (in whole or in part) may be allowed as a deduction in a later year. All other provisions limiting the deductibility of interest are applied before section 163(j); that is, the tax characteristics of the interest payment are determined in the year of payment, not in the succeeding tax years in which the disallowed interest may become deductible.[11]

The 2017 Act substantially amended section 163(j). Amended section 163(j) no longer has a concept of "disqualified interest" but instead limits the deduction of business interest expense to the sum of business interest income for the taxable year plus 30 percent of the taxpayer's adjusted taxable income plus the taxpayer's floor plan financing interest for the taxable year. Similar to prior section 163(j), any interest expense that is not currently deductible may be carried forward into succeeding taxable years, using the same mechanics of treating the disallowed interest expense as if it were paid or accrued in a succeeding taxable year.[12]

Thus, both former and amended section 163(j) apply to deny a current deduction of interest expense if the expense exceeds certain thresholds where such deduction would otherwise be allowable.

2. Section 59A

Under Section 59A, modified taxable income is calculated, in part, by reference to taxable income without regard to any base erosion tax benefit with respect to a base erosion payment. Under section 59A(d)(1), a base erosion payment means any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer *and* with respect to which a deduction is allowable. As noted, section 59A applies only with respect to base erosion payments paid or accrued in taxable years beginning after December 31, 2017. A base erosion tax benefit is defined to mean (as applicable to interest) any deduction that is described in section 59A(d)(1) that is allowed for the taxable year with respect to any base erosion payment.[13]

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10 Contrast rules such as section 163(l), which permanently disallow the deduction of certain interest expense.

11 See Prop. Reg.§1.163(j)-7. "For purposes of section 163(j), interest expense is not considered "paid or accrued" until such interest would be deductible but for such section."

12 Section 163(j)(2).

13 Section 59A(c)(2)(A).

Therefore, in determining modified taxable income, an interest payment must be both a base erosion payment paid or accrued in a taxable year beginning after December 31, 2017, and provide a base erosion tax benefit.

For purposes of applicability of the BEAT, the question with respect to interest paid to a foreign related party prior to the effective date of section 59A and not allowed until a year after the effective date under former section 163(j) is whether the year of actual payment or allowance controls. That is, is the interest considered paid or accrued in the year of actual payment or the later taxable year when it is *treated* as paid and allowable as a deduction?

It should be noted that interest was treated as paid or accrued in a succeeding taxable year under section 163(j) only for purposes of applying the section 163(j) limitation in that year. It does not otherwise have an impact on other provisions of the Code. The tax characteristics of the interest payment are determined in the year of payment, not in the subsequent tax year in which the disallowed interest becomes deductible under section 163(j).[14] Taxpayers need not apply other interest limitation rules again to such interest, because only the year of actual payment or accrual was relevant to such limitations.

Specifically, other provisions of the Code that would defer the deductibility of interest, such as sections 163(e) and 267(a)(3), at risk rules and passive activity loss provisions, and provisions that require the capitalization of interest are applied before the limitation of section 163(j).[15] Of course, the relevant payment date for purposes of determining whether the interest is subject to U.S. income and withholding tax is also the actual payment date. These longstanding provisions in the Code all support the position that the deemed payment date under section 163(j) is not an actual payment date, but rather the means for determining the year (if any) in which the interest may be deducted. It should not convert an interest payment made prior to a 2018 taxable year into a post-effective date base erosion payment.

Similar principles should apply for purposes of section 59A. For payments subsequent to the effective date of section 59A, the limitations of section 163(j) will be relevant for purposes of determining the existence of a base erosion tax benefit. But that is insufficient to subject a payment to the BEAT.

A payment is only subject to the BEAT if two conditions are satisfied. First, there must be a base erosion payment paid or accrued on or after the BEAT effective date. Second, there must be a tax benefit taken with respect to that base erosion payment. If both conditions are not satisfied, BEAT does not apply. In the case of an interest payment made in a pre-BEAT

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[14] See Prop. Reg.§1.163(j)-7. "For purposes of section 163(j), interest expense is not considered "paid or accrued" until such interest would be deductible but for such section."

[15] Prop. Reg. Sec. 1.163(j)-7(b)(2) – (4).

effective date year, the first condition cannot be met. Prior section 163(j)'s treatment of pre-BEAT effective date disallowed interest as paid or accrued in a succeeding tax year addresses only the second condition, the year in which the interest may be deducted. It does not otherwise change the payment date for general tax purposes to which the BEAT provisions apply.

Thus, the determination of whether a payment is a base erosion payment should be made as of the date of actual payment of interest. No provision in section 59A would indicate that the actual payment date – which is the relevant date for all general Code provisions including general interest limitation and U.S. income and withholding tax provisions – is not the relevant payment date for purposes of determining whether a pre-effective date payment is within the ambit of section 59A.

As noted, if interest is paid in a post-effective date year but disallowed in that year under section 163(j) and carried over into a subsequent year, it is clear that such interest and the associated interest deduction are subject to section 59A in the year in which the deduction is allowed. For purposes of the effective date of the BEAT, however, only the actual payment date is relevant. As such, for purposes of applying section 59A, interest actually paid or accrued and disallowed under former section 163(j) before December 31, 2017, should not be treated as a base erosion payment paid or accrued in a taxable year beginning after December 31, 2017, when subsequently allowed under section 163(j).

B. Policy Considerations

Section 59A principally functions to prevent corporate taxpayers from inappropriately eroding the U.S. tax base through, among other payments, certain payments to foreign related parties that are not subject to U.S. withholding tax. It imposes a minimum tax amount on the profits of such taxpayers. However, the minimum tax is imposed only to the extent that the taxpayer makes base erosion payments that are taken into account in determining a base erosion tax benefit.

Section 59A logically should be focused on base erosion resulting from taxpayer actions taken in years after section 59A's enactment. As noted at the outset, the construct of section 163(j) and the BEAT have a cyclical effect. There are two sides to application of the BEAT. The first is the amount of base erosion payments the taxpayer makes. The second is the taxpayer's profitability. The BEAT is more likely to apply when a taxpayer's profitability, without regard to the amount of its base erosion payments, has declined. Declines in profitability may occur because of a downturn in the business cycle, in an industry, or in a particular taxpayer's operations. Section 163(j) operates similarly, but has a built-in mechanism providing relief in the form of the interest carry forward. The BEAT has no relief mechanism. As a result, it should not be construed expansively to include amounts paid or accrued prior to the effective date. Taxpayers can alter their operations to avoid making base erosion payments for the future, but they have no means of altering the past or of controlling the cyclicality that may have resulted in an interest disallowance in the first place.

Practically speaking, treating interest actually paid or accrued prior to 2018 and allowable after 2017 overrides the statutory effective date. Consider, for example, a debt instrument entered into in 2017, under which the U.S. borrower paid interest to a foreign related party in both the 2017 and 2018 taxable years. If the 2017 interest deduction were disallowed under former section 163(j), carried over into 2018, and treated as a base erosion payment in the same manner as interest paid in 2018, it would render the effective date provision meaningless with respect to interest paid prior to 2018. If Congress had intended to treat pre-effective date interest as subject to BEAT, it could have written the effective date rule simply to state that section 59A applies to taxable years beginning after December 31, 2017. Instead, Congress chose an effective date rule with specific reference to base erosion payments, as defined in section 59A(d), paid or accrued in taxable years beginning after December 31, 2017. This formulation indicates that Congress' intent was not to increase modified taxable income by section 163(j) carryforwards where the interest was actually paid or accrued in taxable years beginning prior to January 1, 2018. In other words, Congress chose not to impose a tax detriment on an amount paid in taxable years prior to that date, a detriment that was not in the law at the time nor contemplated by the taxpayer at the time of actual payment.

III. Conclusion

We commend the Treasury and IRS for providing, pursuant to the Notice, for the carryover of pre-enactment disallowed interest under former section 163(j) into taxable years beginning after December 31, 2017. We respectfully request, however, that the Treasury and IRS reconsider the conclusion reached in the Notice regarding the applicability of the BEAT to such interest. Consistent with the analysis set forth above, we request that the Treasury and IRS provide that interest expense paid or accrued in taxable years beginning before January 1, 2018, and carried forward to years beginning after December 31, 2017, is not included in modified taxable income under section 59A.

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We look forward to meeting with you to discuss the above and answer any questions you may have.

Very truly yours,

Pam Olson

Pamela F. Olson
Partner, PricewaterhouseCoopers LLP

Cc: Kevin Nichols
Daniel Winnick
Brett York
Brenda Zent
Peter Merkel
Tony Marra
Kevin Jacobs
Marie Milnes-Vasquez
Nancy McLernon, President & CEO, Organization for International Investment