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Treas. Reg. Section 1.163(j)-3(b)(4)

Relationship of the section 163(j) limitation to other provisions affecting interest.

(a)Overview. This section contains rules regarding the relationship between section 163(j) and certain other provisions of the Code. Paragraph (b) of this section provides the general rules concerning the relationship between section 163(j) and certain other provisions of the Code. Paragraph (c) of this section provides examples illustrating the application of this section. For rules regarding the relationship between sections 163(j) and 704(d), see §1.163(j)-6(h)(1) and (2).

(b)Coordination of section 163(j) with certain other provisions.

(1)In general. Section 163(j) and the regulations in this part under section 163(j) of the Code generally apply only to business interest expense that would be deductible in the current taxable year without regard to section 163(j). Thus, for example, a taxpayer must apply §1.163-8T, if applicable, to determine which items of interest expense are investment interest under section 163(d) before applying the rules in this section to interest expense. Except as otherwise provided in this section, section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization, or other limitation. For the rules that must be applied in determining whether excess business interest is paid or accrued by a partner, see section 163(j)(4)(B)(ii) and §1.163(j)-6.

(2)Disallowed interest provisions. For purposes of section 163(j), business interest expense does not include interest expense that is permanently disallowed as a deduction under another provision of the Code, such as in section 163(e)(5)(A)(i), (f), (l), or (m), or section 264(a), 265, 267A, or 279.

(3)Deferred interest provisions. Other than sections 461(l), 465, and 469, Code provisions that defer the deductibility of interest expense, such as section 163(e)(3) and (e)(5)(A)(ii), 267(a)(2) and (3), 1277, or 1282, apply before the application of section 163(j).

(4)At risk rules, passive activity loss provisions, and limitation on excess business losses of noncorporate taxpayers. Section 163(j) generally applies to limit the deduction for business interest expense before the application of sections 461(l), 465, and 469. However, in determining tentative taxable income for purposes of computing ATI, sections 461(l), 465, and 469 are taken into account.

(5)Capitalized interest expenses. Section 163(j) applies after the application of provisions that require the capitalization of interest, such as sections 263A and 263(g). Capitalized interest expense under those sections is not treated as business interest expense for purposes of section 163(j). For ordering rules that determine whether interest expense is capitalized under section 263A(f), see the regulations under section 263A(f), including §1.263A-9(g).

(6)Reductions under section 246A. Section 246A applies before section 163(j). Any reduction in the dividends received deduction under section 246A reduces the amount of interest expense taken into account under section 163(j).

(7)Section 381. Disallowed business interest expense carryforwards are items to which an acquiring corporation succeeds under section 381(a). See section 381(c)(20) and §§1.163(j)-5(c) and 1.381(c)(20)-1.

(8)Section 382. For rules governing the interaction of sections 163(j) and 382, see section 382(d)(3) and (k)(1), §§1.163(j)-5(e) and 1.163(j)-11(c), the regulations in this part under sections 382 and 383 of the Code, and §§1.1502-91 through 1.1502-99.

(c)Examples. The examples in this paragraph (c) illustrate the application of section 163(j) and the provisions of this section. Unless otherwise indicated, X and Y are calendar-year domestic C corporations; D is a U.S. resident individual not subject to any foreign income tax; none of the taxpayers have floor plan financing interest expense; and the exemption for certain small businesses in §1.163(j)-2(d) does not apply.

(1) Example (1). Disallowed interest expense.

(i)Facts. In 2021, X has $30x of interest expense. Of X's interest expense, $10x is permanently disallowed under section 265. X's business interest income is $3x and X's ATI is $90x.

(ii)

Analysis. Under paragraph (b)(2) of this section, the $10x interest expense that is permanently disallowed under section 265 cannot be taken into consideration for purposes of section 163(j) in the 2021 taxable year. X's section 163(j) limitation, or the amount of business interest expense that X may deduct is limited to $30x under §1.163(j)-2(b), determined by adding X's business interest income ($3x) and 30 percent of X's 2019 ATI ($27x). Therefore, in the 2021 taxable year, none of the $20x of X's deduction for its business interest expense is disallowed under section 163(j).

(2)Example (2). Deferred interest expense.

(i) Facts. In 2021, Y has no business interest income, $120x of ATI, and $70x of interest expense. Of Y's interest expense, $30x is not currently deductible under section 267(a)(2). The $30x expense is allowed as a deduction under section 267(a)(2) in 2022.

(ii) Analysis. Under paragraph (b)(3) of this section, section 267(a)(2) is applied before section 163(j). Accordingly, $30x of Y's interest expense cannot be taken into consideration for purposes of section 163(j) in 2021 because it is not currently deductible under section 267(a)(2). Accordingly, in 2021, if the interest expense is properly allocable to a non-excepted trade or business, Y will have $4x of disallowed business interest expense because the $40x of business interest expense in 2021 ($70x-$30x) exceeds 30 percent of its ATI for the taxable year ($36x). The $30x of interest expense not allowed as a deduction in the 2021 taxable year under section 267(a)(2) will be taken into account in determining the business interest expense deduction under section 163(j) in 2022, the taxable year in which it is allowed as a deduction under section 267(a)(2), if it is allocable to a trade or business. Additionally, the $4x of disallowed business interest expense in 2021 will be carried forward to 2022 as a disallowed business interest expense carryforward. See §1.163(j)-2(c).

(3)Example (3). Passive activity loss.
(i) Facts. D is engaged in a rental activity treated as a passive activity within the meaning of section 469. For the 2021 taxable year, D receives $200x of rental income and incurs $300x of expenses all properly allocable to the rental activity, consisting of $150x of interest expense, $60x of maintenance expenses, and $90x of depreciation expense. D's ATI is $400x.
(ii) Analysis. Under paragraph (b)(4) of this section, section 163(j) is applied before the section 469 passive loss rules apply, except that section 469 is taken into account in the determination of tentative taxable income for purposes of computing ATI. D's section 163(j) limitation is $120x, determined by adding to D's business interest income ($0), floor plan financing ($0), and 30 percent of D's ATI ($120x). See §1.163(j)-2(b). Because D's business interest expense of $150x exceeds D's section 163(j) limitation for 2021, $30x of D's business interest expense is disallowed under section 163(j) and will be carried forward as a disallowed business interest expense carryforward. See §1.163(j)-2(c). Because the section 163(j) limitation is applied before the limitation under section 469, only $120x of the business interest expense allowable under section 163(j) is included in determining D's passive activity loss limitation for the 2021 tax year under section 469. The $30x of disallowed business interest expense is not an allowable deduction under section 163(j) and, therefore, is not a deduction under section 469 in the current taxable year. See §1.469-2(d)(8).

(4)Example (4). Passive activity loss by taxpayer that also participates in a non-passive activity.
(i) Facts. For 2021, D has no business interest income and ATI of $1,000x, entirely attributable to a passive activity within the meaning of section 469. D has business interest expense of $1,000x, $900x of which is properly allocable to a passive activity and $100x of which is properly allocable to a non-passive activity in which D materially participates. D has other business deductions that are not subject to section 469 of $600x, and a section 469 passive loss from the previous year of $250x.
(ii) Analysis. Under paragraph (b)(4) of this section, section 163(j) is applied before the section 469 passive loss rules apply. D's section 163(j) limitation is $300x, determined by adding D's business interest income ($0), floor plan financing ($0), and 30 percent of D's ATI ($300x)). Next, applying the limitation under section 469 to the $300x business interest expense deduction allowable under section 163(a) and (j), $270x (a proportionate amount of the $300x (0.90 x $300x)) is business interest expense included in determining D's passive activity loss limitation under section 469, and $30x (a proportionate amount of the $300x (0.10 x $300)) is business interest expense not included in determining D's passive activity loss limitation under section 469. Because D's interest expense of $1,000x exceeds 30 percent of its ATI for 2021, $700x of D's interest expense is disallowed under section 163(j) and will be carried forward as a disallowed business interest expense carryforward. Section 469 does not apply to any portion of the $700x disallowed business interest expense because that business interest expense is not an allowable deduction under section 163(j) and, therefore, is not an allowable deduction under section 469 in the current taxable year. See §1.469-2(d)(8).

(5)Example (5). ATI calculation with passive activity loss.

(i) Facts. D is an individual who engages in a trade or business, V, as a sole proprietorship. D relies on employees to perform most of the work and, as a result, D does not materially participate in V. Therefore, V is a passive activity of D. V is not an excepted trade or business. In Year 1, V generates $500x of passive income, $400x of business interest expense, and $600x of ordinary and necessary expenses deductible under section 162 (not including any interest described in §1.163(j)-1(b)(22)). No disallowed business interest expense carryforward has been carried to Year 1 from a prior year, and no amounts have been carried over to Year 1 from a prior year under either section 465(a)(2) or section 469(b).
(ii) Tentative taxable income. Under §1.163(j)-1(b)(43), tentative taxable income is determined as though all business interest expense was not subject to the section 163(j) limitation. Sections 461(l), 465, and 469 apply in the determination of tentative taxable income. For year 1, D has $500x of allowable deductions and a $500x tentative passive activity loss under section 469, because D's $1000x of passive expenses exceeds D's $500x of passive income from V. The tentative disallowance of $500x is generally allocated pro rata between D's passive expenses under §1.469-1T(f)(2)(ii)(A). In this case, fifty percent ($500x of passive activity loss divided by $1000x of total passive expenses) of each category of passive expense is tentatively disallowed: $200x of business interest expense and $300x of section 162 expense. D's tentative taxable income is $0 (zero), which is determined by reducing $500x of gross income by the remaining $200x of business interest expense and $300x of section 162 expense ($500x-$200x-$300x).
(iii) ATI. Under section §1.163(j)-1(b)(1), to determine ATI, D must add business interest expense to tentative taxable income, but only to the extent that the business interest expense reduced tentative taxable income, or $200x. The $200x of business interest expense that was tentatively disallowed under section 469 is not added to tentative taxable income to determine ATI. D's ATI is $200x, which is determined by adding the $200x of business interest expense that reduced tentative taxable income to D's tentative taxable income, or $0 (0 + $200x).
(iv) Section 163(j) limitation. D's section 163(j) limitation in Year 1 is D's business interest income, or $0, plus 30 percent of ATI, or $60x (30 percent x $200x ATI), plus D's floor plan financing, or $0, for a total of $60x ($0 + $60x + $0). Before the application of section 469, D has $60x of deductible business interest expense and $340x of disallowed business interest expense carryforward under §1.163(j)-2(c).
(v) Passive activity loss. Because D's passive deductions exceed the passive income from V, and D does not have any passive income from other sources, section 469 applies to limit D's passive loss from V. Having first applied section 163(j), D has $660x of passive expenses, determined by adding D's $60x of business interest expense that is allowed by section 163(j) as a deduction and $600x of section 162 expense ($60x + $600x). D offsets $500x of the passive expenses against $500x of passive income; therefore, D has a passive activity loss of $160x in Year 1, determined as the excess of D's total passive expenses over D's passive income ($660x-$500x). The amount of D's loss from the passive activity that is disallowed under section 469 ($160x) is generally ratably allocated to each of D's passive activity deductions under §1.469-1T(f)(2)(ii)(A). As a general rule, each deduction is multiplied by the ratio of the total passive loss to total passive expenses (160x/660x). Of D's $60x business interest expense, $14.55x (($160x/$660x) x $60x) is disallowed in Year 1. Additionally, of D's $600x section 162 expense, $145.45x (($160x/$660x) x $600x) is disallowed. The amounts disallowed under section 469(a)(1)

and §1.469-2T(f)(2) are carried over to the succeeding taxable year under section 469(b) and §1.469-1(f)(4).

(6)Example (6). Effect of passive activity loss carryforwards.
(i) Facts. The facts are the same as in Example 5 in paragraph (c)(5)(i) of this section. In Year 2, V generates $500x of passive income, $100x of business interest expense, and $0 (zero) of other deductible expenses. D is not engaged in any other trade or business activities. A disallowed business interest expense carryforward of $340x has been carried to Year 2 from Year 1. Under section 469, D has a suspended loss from Year 1 that includes $14.55x of business interest expense and $145.45x of section 162 expense. These amounts are treated as passive activity deductions in Year 2.
(ii) Tentative taxable income. To determine D's tentative taxable income, D must first determine D's allowable deductions. In year 2, D has $260x of allowable deductions, which includes $100x of business interest expense generated Year 2, $14.55x of business interest expense disallowed in Year 1 by section 469, and $145.45x of section 162 expense disallowed in Year 1 by section 469 ($100x + $14.55x + $145.45x)). D's disallowed business interest expense carryforward from Year 1 is not taken into account in determining tentative taxable income. See §1.163(j)-1(b)(43). Additionally, the $14.55x of business interest expense disallowed in Year 1 by section 469 is not business interest expense in Year 2 because it was deductible after the application of section 163(j) (but before the application of section 469) in Year 1. D does not have a tentative passive activity loss in Year 2, because D's $500x of passive income from V exceeds D's $260x of tentative passive expenses. Therefore, D's tentative taxable income in Year 2 is $240x, which is determined by subtracting D's allowable deductions other than disallowed business interest expense carryforwards, or $260x, from D's gross income, or $500x ($500x-$260x).
(iii) ATI. D's ATI in Year 2 is $340x, which is determined by adding D's business interest expense, or $100x, to D's tentative taxable income, or $240x ($240x + $100x). Because disallowed business interest expense carryforwards are not taken into account in determining tentative taxable income, there is no corresponding adjustment for disallowed business interest expense carryforwards in calculating ATI. Therefore, there is no adjustment for D's $340x of disallowed business interest expense carryforward in calculating D's ATI. D has no other adjustments to determine ATI.
(iv) Section 163(j) limitation. D's section 163(j) limitation in Year 2 is $102x, which is determined by adding D's business interest income, or $0, 30 percent of D's ATI for year 2, $102 ($340x x 30 percent), and D's floor plan financing for Year 2, or $0 ($0 + ($102x) + $0). Accordingly, before the application of section 469 in Year 2, $102x of D's $440x of total business interest expense (determined by adding $340x of disallowed business interest expense carryforward from Year 1 and $100x of business interest expense in Year 2) is deductible. D has $338x of disallowed business interest expense carryforward that will carry forward to subsequent taxable years under §1.163(j)-2(c), determined by subtracting D's deductible business interest expense in Year 2, or $102x, from D's total business interest expense in Year 2, or $440x ($440x-$102x).
(v) Section 469. After applying the section 163(j) limitation, D applies section 469 to determine if any amount of D's expense is a disallowed passive activity loss. For Year 2, D has $262x of passive expenses, determined by adding D's business interest expense deduction allowed by section 163(j) ($102x), D's section 162 expense carried forward from Year 1 under section 469 ($145.45x), and D's interest expense carried forward from Year 1 under section 469 which is not business interest expense in Year 2, or $14.55x

($102x + $145.45x + $14.55x). Therefore, D has $238x of net passive income in Year 2, determined by reducing D's total passive income in Year 2 ($500x), by D's disallowed passive activity loss, or $262x ($500x-$262x). D does not have a passive activity loss in Year 2, and no part of D's $262x of passive expenses is disallowed in Year 2 under section 469.

(7)Example (7). Capitalized interest expense.
(i) Facts. In 2020, X has $50x of interest expense. Of X's interest expense, $10x is required to be capitalized under section 263A. X capitalizes this interest expense to a depreciable asset. X's business interest income is $9x and X's ATI is $80x. X makes the election in §1.163(j)-2(b)(2)(ii) to use 30 percent, rather than 50 percent, of ATI in determining X's section 163(j) limitation for the 2020 taxable year.
(ii) Analysis. Under paragraph (b)(5) of this section, section 263A is applied before section 163(j). Accordingly, $10x of X's interest expense cannot be taken into consideration for purposes of section 163(j) in 2020. Additionally, under paragraph (b)(5) of this section, X's $10 of capitalized interest expense is not business interest expense for purposes of section 163(j). As a result, when X recovers its capitalized interest expense through depreciation deductions, such capitalized interest expense will not be taken into account as business interest expense in determining X's section 163(j) limitation. X's section 163(j) limitation in 2020, or the amount of business interest expense that X may deduct, is limited to $33x under §1.163(j)-2(b), determined by adding X's business interest income ($9x) and 30 percent of X's 2020 ATI ($24x). X therefore has $7x of disallowed business interest expense in 2020 that will be carried forward to 2021 as a disallowed business interest expense carryforward.

(d)Applicability date. This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§1.263A-9, 1.263A-15, 1.381(c)(20)-1, 1.382-1, 1.382-2, 1.382-5, 1.382-6, 1.382-7, 1.383-0, 1.383-1, 1.469-9, 1.469-11, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-36, 1.1502-79, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4, to that taxable year.