

Interest Limitations for Private Investment Funds and Investments



Steven D. Bortnick
Steven.Bortnick@troutman.com



Morgan Klinzing
Morgan.Klinzing@troutman.com

December 3, 2021

These materials and commentary are intended for educational purposes only. No portion may be construed as rendering legal advice for specific cases, or as creating an attorney-client relationship between the audience and the author. The opinions expressed herein are solely those of the author.



Financial Executives Alliance
A First Republic Affinity Group

Agenda

Background on Section 163(j)

Application of 163(j) to Partnerships

Additional Considerations for Trading Partnerships

Impact of Legislative Proposals



US Earnings Stripping

Pre-2018

- Focus on payments of interest to related foreign shareholders
- Only applied where D:E ratio exceeded certain thresholds

2018

- Generally applicable 30% limitation on deductibility of interest

Proposed

- Limit interest deduction for US member of a global reporting group to the proportionate share of the whole group's net interest expense.
- Designed to prevent over leverage in the US

Continuing

- Code includes multiple limitations on interest deductibility that continue to apply



General Rule

Annual business interest deduction limitation

- Business interest income
- 30% adjusted taxable income
- Floor plan interest expense

Excess business interest expense carried over indefinitely

Excess limitation for year is eliminated

- No benefit in future years





Has 163(j) had a significant impact on your portfolio companies (or clients' portfolios) ?

- A. Yes
- B. No, because companies not highly leveraged.
- C. No because limitation applies to EBITDA not EBIT.

Calculating Adjusted Taxable Income

Start with taxable income

- No NOL deduction
- Ignore business interest expense limitation
- Add back depreciation, amortization and depletion (through 2021)
- On sale of property, partnership interests or stock of member of consolidated group, reduce ATI for depreciation, amortization or depletion allowed or allowable in 2018-2021 tax years
 - Limited to gain on property, stock or partnership interest, or depreciation, amortization or depletion allowed or allowable
 - May reduce negative adjustment (essentially increasing limitation) if can show that prior year additions did not increase the deductible business interest expense (e.g., had sufficient limitation anyway, or had no business interest expense in that period)



Application to Partnerships

Apply limitation at partnership level

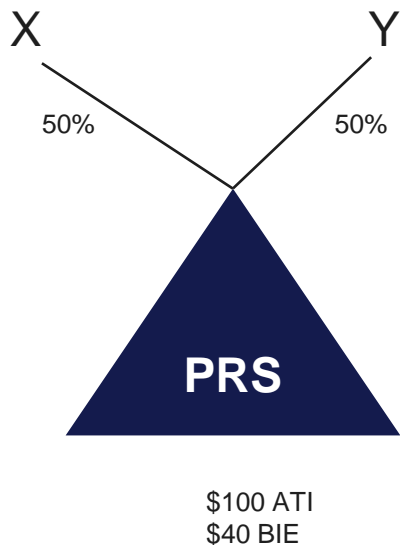
- If business interest expense does not exceed the limitation, allocate to partners and no further imputation at partner level
- Partner adjusted taxable income increased by the unused portion of the partnership's adjusted taxable income (*i.e.*, excess taxable income)
- Excess business interest expense (*i.e.*, in excess of the partnership's limitation) carried forward at partner level

Regulations reserved on tiered partnerships

Proposed legislation would apply limitations at partner level



Partnership Example – Year 1



PRS has \$100 ATI and \$40 business interest expense (BIE).

Partnership-Level

PRS limitation = $30\% * \$100 = \30

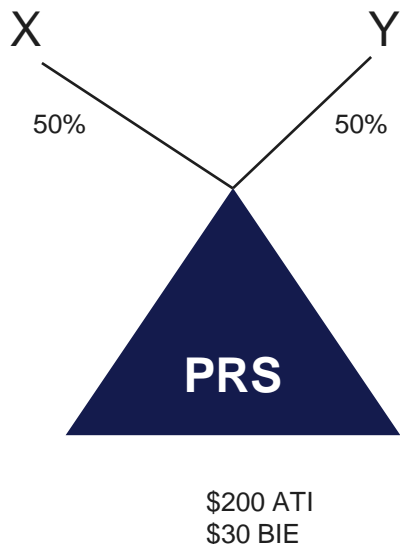
PRS has \$30 deductible BIE and \$10 excess BIE.

Partner-Level

X and Y are each allocated \$15 deductible BIE and \$5 excess BIE.

X and Y increase their basis in PRS interests by \$30 (\$50-\$20).

Partnership Example – Year 2 Carryforward



PRS has \$200 ATI and \$30 BIE.

Partnership-Level

PRS limitation = $30\% * \$200 = \60

PRS has \$30 deductible BIE, \$100 excess taxable income (ETI),
\$0 excess BIE.

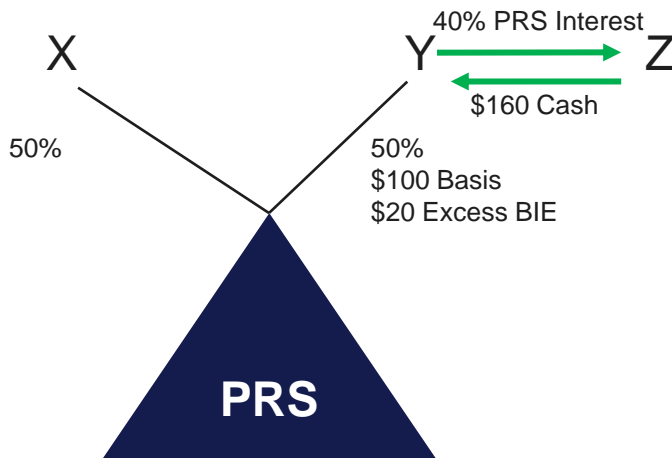
Partner-Level

X and Y are each allocated \$15 deductible BIE, \$0 excess BIE
and \$50 excess taxable income (ETI).

Treat \$5 of excess BIE from Y1 as paid in Y2.

X and Y increase their basis in PRS interests by \$85 (\$100-\$15).

Sale of Partnership Interest with Excess BIE



Y sells 40% interest in PRS (which is 80% of Y's total interest) to Z for \$160.

Y's Tax Impact

$$(80\% * \$100 \text{ basis}) + (80\% * \$20 \text{ excess BIE}) = \$96$$

$$\text{Gain} = \$160 - \$96 = \$64$$

Post-Sale

Y's basis is \$20 and Y has \$4 excess BIE.

Trader Partnerships

Bifurcate investment interest and business interest.

Qualification as investment interest expense or business interest expense depends on the participation of the partner.

- No material participation = investment interest expense.
- Material participation = business interest expense.

Updates regulations on grouping activities for determining participation.

Confusion in the 2018 Preamble led to transition rules that allow passive investors to deduct any prior excess business interest expense.





What are the odds we get guidance on tiered partnerships in 2022?

- A. Slim to none.
- B. More likely than not.
- C. Definitely expected.

Self-Charged Interest

Applies to partner loan to partnership

- Does not apply to indirect partner loan to partnership

Special rule to avoid lending partners from being subject to limitation



Application to Controlled Foreign Corporations (“CFCs”)

Applies in determining interest expense for Subpart F and GILTI

CFC group election

- Apply limitation on group basis
- Group includes one or more chains of CFCs connected by 80% ownership
- Individual can be parent (as well as corporation, S corporation and CFC, but not US partnership)
- Clarified that if US shareholder directly owns multiple CFCs, shareholder can make the group election even though no “chains” of CFCs involved
- Applies to ownership through partnerships (even though that would break consolidation in corporate context)



Separately compute

- Business interest expense
- Business interest expense carryforwards
- Business interest income
- Adjusted taxable income

Then combine to come up with group limitation

Although adjusted taxable income generally cannot be negative, for purpose of determining group adjusted taxable income, an individual member's adjusted taxable income may be negative (prevents overstating the limitation)

Include intra group transactions

- Not if principal purpose is to increase business interest income or adjusted taxable income



Do you foresee an adverse impact as a result of the switch to EBIT based limitation?

- A. No - We planned bonus depreciation acquisitions with this in mind.
- B. Yes – 197 amortization deductions likely to cannibalize interest deductions.
- C. We haven't thought this through yet.

Proposed Limitation for Members of Global Group – 163(n)

Applies in coordination with 163(j) – Subject to lower limitation

Designed to preclude stuffing of interest expenses into the US

Like 163(j) limitation only applies to excess of interest expense over interest income

Who:

- Domestic corporation / Foreign corporation with respect to ECI
- Must be: member of international financial reporting group

Exceptions:

- 3 year average net interest expense not in excess of \$12m
- Certain small businesses
- S Corp, REIT, RIC

163(n) Terminology

International financial reporting group

- 2 or more corporations
- At least 1 is domestic or foreign ETB in US
- Included in same applicable financial statement for year
- Regulations may include 20% owned corporations
 - All or nothing?

EBITDA

- Determined on stand alone basis ignoring distributions from other members
- If group EBITDA 0 or negative, then limitation not applicable
- If specified domestic entity EBITDA 0 or negative, limitation is 0

163(n) Example

	Domestic	Foreign	Total
Net interest expense	\$800	\$200	\$1,000
EBITDA	\$7,500	\$2,500	\$10,000
Allocable Share of Interest (Domestic share of EBITDA) $[\$7,500/\$10,000]$ Limit – 100%	75%		
Allowable Percentage (Allocable Share of Interest x Total Interest Expense / Domestic Interest Expense) $[(75\% \times \$1,000) / \$800]$	93.75%		
110% of Allowable Percentage $[93.75\% \times 110\%]$	103.125%		
Company's 163(n) Limit (110% of allowable percentage x domestic net interest expense) $[103.125\% \times \$800]$	\$825		
Net Domestic Interest Expense [No limitation because less than limit]	\$800		



Certain Issues/Concerns/Timing

Focus on EBITDA over debt:equity ratio could impose limitation as a result of interest rate differences rather than tax planning

How to deal with corporations that are partners (regulations)

Ignores Subpart F/GILTI inclusions (regulations)

Treatment of US consolidated groups versus standalone EBITDA calculation

Effective date: Tax years beginning after December 31, 2022.



Partner, Tax
609.610.4171 mobile
609.951.4117 office
steven.bortnick@troutman.com

- Steve guides clients in transactional matters involving complex domestic and international tax issues with particular experience in the private equity space.
- Steve handles a broad range of transactions, including asset, stock, cross-border, and domestic acquisitions, recapitalizations and reorganizations. A significant portion of his practice focuses on structuring domestic and international private equity transactions. Steve also is regularly involved in the formation of global private equity funds.
- He is highly rated in Chambers USA: America's Leading Lawyers for Business for tax matters and is an active speaker and author.

Morgan Klinzing

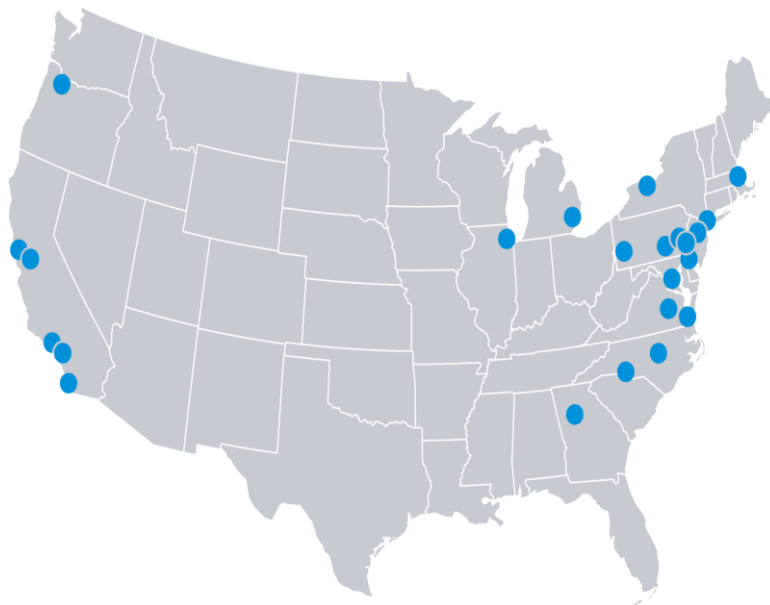


Associate, Tax
215.981.4560
morgan.klinzing@troutman.com

- Morgan Klinzing's practice focuses on federal and international income tax, with a focus on the private equity arena and pass-throughs.
- Morgan represents clients in domestic and cross border M&A, fund formation and structuring, reorganizations and partnership agreements.
- Morgan is an adjunct professor at Temple University Beasley School of Law, chair of the Partnership CLE Committee of the Tax Section of the American Bar Association, and a frequent speaker on a variety of transaction tax matters.



Office Locations



Atlanta	Pittsburgh
Berwyn	Portland
Boston	Princeton
Charlotte	Raleigh
Chicago	Richmond
Detroit	Rochester
Harrisburg	San Diego
Los Angeles	San Francisco
New York	Silicon Valley
Orange County	Virginia Beach
Philadelphia	Washington, D.C.
	Wilmington

