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INSIGHTS

IRS Provides Long-Awaited Guidance for Partially-Regulated Energy Companies under Code Section 163(j)

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On November 26, 2018, the Treasury Department and IRS released ***proposed regulations*** (the Proposed Regulations) interpreting the limitation on the deductibility of business interest expense (Interest Expense) under Code Section 163(j), enacted under the Tax Cuts and Jobs Act (the TCJA). As described in greater detail ***The Proposed Regulations, along with previously-released*** ***Notice 2018-28***, address a number of questions regarding the application of Code Section 163(j). One critical question for the energy sector is how taxpayers must determine their Interest Limitation if they are engaged in certain regulated businesses to which the Interest Limitation does not apply and other businesses to which the Interest Limitation does apply. Regulated businesses in the energy sector to which the Interest Limitation does not apply include businesses that furnish or sell electrical energy, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, but only to the extent the rates for such furnishing or sale have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative (a Regulated Utility Business).

This article focuses on the rules in the Proposed Regulations for allocating Interest Expense, Interest Income and ATI among businesses to which the Interest Limitation does not apply (Excepted Businesses) and other businesses to which the Interest Limitation applies (Non-Excepted Businesses). Although the Proposed Regulations are likely to be modified before they are enacted in final form, the general framework of these allocation rules is unlikely to change and therefore should allow taxpayers with Excepted Businesses to work toward optimizing their capital structures in light of Code Section 163(j) with reasonable certainty.

Allocation of Interest Expense and Interest Income among Excepted Businesses and Non-Excepted Businesses

As expected, the Proposed Regulations require that Interest Expense and Interest Income be allocated among a taxpayer's Excepted Businesses and Non-Excepted Businesses based on the relative adjusted tax bases of assets in each business (the Adjusted Basis Regime). The preamble to the Proposed Regulations (the Preamble) explains that the Adjusted Basis Regime, while not perfect, represents the most viable and administrable approach to applying Code Section 163(j) to different lines of business. Other methodologies considered by the Treasury Department and IRS were (i) allocation based on a tracing method, whereby taxpayers would be required to trace debt proceeds to specific expenditures, (ii) allocation based on the relative fair market value of assets in the taxpayer's various businesses, and (iii) allocation based on the relative gross income generated by the taxpayer's various businesses. The tracing method was rejected, in part, because it would create a significant administrative burden, and may even be impossible to administer with respect to debt issued years before the enactment of the TCJA. Also, because cash is fungible, the tracing method could be distortive and subject to manipulation. Allocation based on relative asset values also was determined to be likely to create an undue administrative burden on taxpayers, and some assets likely would not have a readily determinable fair market value. Finally, an allocation based on relative gross income of a taxpayer's businesses was rejected, in part, because it could lead to unpredictable results, since gross income can vary dramatically from year to year, and may be subject to manipulation to the extent income recognition is within the taxpayer's control. The adjusted tax bases of assets, by contrast, is a reasonably objective metric that taxpayers already are required to maintain for tax reporting purposes.

To allocate Interest Expense and Interest Income under the Adjusted Basis Regime, a taxpayer engaged in at least one Excepted Business and at least one Non-Excepted Business would be required to determine the adjusted bases in the assets of each business on a quarterly basis and, for each year, apply the average of these quarterly amounts to determine the relative adjusted tax basis for its Excepted Business(es) and Non-Excepted Business(es). If, however, 90 percent or more of a taxpayer's aggregate asset basis for the taxable year is allocable to Excepted Businesses or Non-Excepted Businesses, then all of the taxpayer's Interest Expense and Interest Income for that year is properly allocable to Excepted Businesses or Non-Excepted Businesses, respectively.

The Proposed Regulations also provide allocation methodologies for any asset used in an Excepted Business and a Non-Excepted Business in the same quarter. Taxpayers are required to utilize the methodology that most properly reflects the proportional benefit derived from the use of the asset in each business. If an Excepted Business and a Non-Excepted Business of a taxpayer produce the same unit of output, the adjusted tax basis of shared assets is allocated based on the relative output of each business. For example, if an asset is used in connection with the sale of electric energy, a portion of which is sold at market rates and the remainder of which is sold at regulated rates, the taxpayer must allocate the basis of such asset between the businesses based on the relative kilowatt hours generated by each business. If, however, 90 percent or more of the output of a utility business is sold at regulated rates, the taxpayer's entire business is treated as an Excepted Business.

The Proposed Regulations provide the following additional rules with respect to the Adjusted Basis Regime:

- A consolidated group is treated as a single taxpayer for purposes of applying the Adjusted Basis Regime. A consolidated group determines the percentage of its Interest Expense that is allocable to Excepted Businesses for each taxable year, and such exempt percentage is applied to the Interest Expense of each member during the taxable year.

- Taxpayers owning 80 percent or more of the stock in a non-consolidated domestic C-corporation or a controlled foreign corporation, or 80 percent or more of the capital or profits interests in a partnership, generally are required to look-through to the assets of the entity. Taxpayers owning less than 80 percent of the capital and profits of a partnership may look through to the assets of the partnership, but are not required to do so.

- Adjusted basis in tangible depreciable property, other than inherently permanent structures, is determined using the alternative depreciation system (ADS). Accordingly, bonus depreciation is ignored.

- In the case of land, non-depreciable improvements to land, and inherently permanent structures, unadjusted tax basis rather than adjusted tax basis is utilized.

- Assets that have been acquired or are under development but are not yet used in a trade or business, self-created intangibles, customer receivables, and cash and cash equivalents are ignored for purposes of the Adjusted Basis Regime.

- Interest Expense related to qualified nonrecourse indebtedness generally is allocable to the property acquired, constructed, or improved with the proceeds of such indebtedness.

- Special allocation rules apply to taxpayers engaged in a Regulated Utility Business. For example, a taxpayer is deemed to have made a Code Section 336(e), 338 or 754 for any acquisition of stock or partnership interest for purposes of the Adjusted Basis Regime, if the taxpayer was actually or effectively precluded from making the election by a regulatory or ratemaking body.

Finally, the Proposed Regulations include a broad anti-abuse rule, pursuant to which a taxpayer's adjusted basis in an asset would not be taken into account if a principal purpose of the acquisition, disposition, or change in use of such asset is to increase artificially the amount of basis allocable to Excepted Businesses or Non-Excepted Businesses.

Allocation of Other Items among Excepted and Non-Excepted Businesses

Under the Proposed Regulations, a taxpayer is required to allocate items of income, gains, expense, and deduction, other than Interest Income and Interest Expense, for purposes of determining ATI as follows:

- Dividend income generally is allocable to Non-Excepted Businesses, unless a taxpayer owns at least 80 percent of the stock of a domestic C-corporation or a controlled foreign corporation, in which case such income is treated as allocable to an Excepted Business or Non-Excepted Business in a manner consistent with the Adjusted Basis Regime.

- Gross income, other than Interest Income and dividends, is allocated to the business that generated such gross income.

- Gain or loss from the sale of stock of a member of a consolidated group to a nonmember is treated as a sale of the assets of such member.

- Gain or loss from the sale of stock of a non-consolidated C-corporation or controlled foreign corporation, and gain or loss from the sale of a partnership interest, generally is allocated on a look-through basis in a manner consistent with the Adjusted Basis Regime. If an equity interest in such a C-corporation, controlled foreign corporation or partnership is not subject to look-through treatment, such gain or loss generally is allocable to a Non-Excepted Business.

- Expenses, losses, and deductions incurred as a result of, or incident to, an activity of a business or in connection with property used in the business, would be allocable to such business. All other expenses are ratably apportioned to gross income.

Reporting Requirements

The Proposed Regulations require taxpayers to keep books of account and other records and data as necessary to substantiate its use of an asset in an Excepted Business, and to comply with various reporting requirements with respect to the determination of asset basis in Excepted Businesses and Non-Excepted Businesses. If a taxpayer fails to properly file such information statements, the IRS is permitted to treat all of the taxpayer's Interest Expense as properly allocable to a Non-Excepted Business, unless the taxpayer demonstrates there was reasonable cause for failing to comply with these reporting requirements and the taxpayer acted in good faith.

Looking Ahead

The Proposed Regulations will not be effective until final regulations are published in the Federal Register. An extended review and comment period is likely. In fact, the Treasury Department has made more than 60 specific requests for comments in the Preamble, which generally are attributable to the novelty and complexity of certain rules and methodologies in the Proposed Regulations. Some of these requests relate to requirements that may create excessive administrative burden for taxpayers. Comments must be submitted within 60 days after the date of publication of the Proposed Regulations in the Federal Register, and a public hearing has been scheduled for February 25, 2019.

Until the Proposed Regulations are issued in final form, taxpayers have the discretion to apply the Proposed Regulations retroactively to any year beginning after December 31, 2017, but all rules contained in the Proposed Regulations must be applied on a consistent basis by the taxpayer and its related parties, including shareholders. Taxpayers that are engaged in Excepted Businesses and Non-Excepted Businesses are not expected to apply the Proposed Regulations retroactively if they do not have the systems or procedures in place to make proper determinations under the Adjusted Basis Regime or comply with the various reporting and recordkeeping requirements. Taxpayers opting not to apply the Proposed Regulations retroactively, however, should consider whether the Treasury Department and IRS would consider their allocation method to be reasonable if inconsistent, in whole or in part, with the Adjusted Basis Regime provided in the Proposed Regulations.