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Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-106089-18)
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Interest Expense Regulations

On behalf of the National Association of Manufacturers (NAM), this letter offers comments in response to REG-106089-18 (the Proposed Regulations), guidance related to the interest deductibility that implements changes made by the *Tax Cuts and Jobs Act* (TCJA).[1] The NAM is the largest industrial association in the United States, representing manufacturers in every sector and all 50 states. We appreciate this opportunity to help ensure that the implementation of the TCJA has the intended effect of spurring economic growth and innovation.

Debt financing plays an important role in manufacturing growth. Investments in equipment and facilities are necessary for U.S. manufacturers to compete in an increasingly global marketplace and help fuel our economy. In order to finance these pro-growth investments, many manufacturers borrow funds; in turn, these debt-finance investments support continued manufacturing job growth. Policies that increase the cost of financing capital expenditures would harm U.S. manufacturing growth and would run contrary to the intent of the TCJA.

The Proposed Regulations are important to manufacturers, as they implement the TCJA's limitations on the ability of taxpayers to deduct interest on debt instruments in a manner contrary to congressional intent. As discussed in detail in this letter, manufacturers would be adversely impacted if the regulations are finalized without modification, and the resulting costs could slow the growth of our economy, which has been led by a thriving manufacturing sector.

In particular, the Proposed Regulations define the base upon which interest deductions are calculated in a manner that would increase the cost to invest in depreciable equipment in the United States—going against congressional intent in doing so. As some of our member companies have reported, creating such an artificial barrier to capital investment would increase effective U.S. tax rates and serve as a "deterrent to investment and job creation in the manufacturing sector," making it more difficult for manufacturers to grow and expand. We urge Treasury to exercise its authority and modify the Proposed Regulations in a manner that would give full effect to congressional intent and support manufacturing growth.

[1] Pub. L. No. 115-97.

A. **Congressional Intent Regarding Section 163(j)**

Prior to enactment of the TCJA, taxpayers had broad authority to deduct interest on debt incurred for business purposes.[2] Section 13301 of the TCJA imposed substantial new limits on this broad authority, capping the total amount of available interest deductions to the sum of (1) business interest income, (2) 30 percent of adjusted taxable income ("ATI") and (3) a taxpayer's floor plan financing interest.[3] Interest expense in excess of this limit can be carried forward indefinitely. Starting on January 1, 2022, the earnings base to which the 30 percent limit applies will change from earnings before interest, taxes, depreciation and amortization (EBITDA) to earnings before interest and taxes (EBIT).

There are three ways in which Congress expressed its clear intent that an EBIDTA base be used to calculate interest deduction through 2021. First, the statute is explicit on this point. Section 163(j)(8) defines ATI as taxable income determined without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (ii) any business interest or business interest income, (iii) the amount of any net operating loss deduction under Section 172, (iv) the amount of any deduction allowed under Section 199A, and (v) *in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion*.

Second, whether to employ an EBITDA or EBIT base was a key point of contention between the House of Representatives and Senate during tax reform. The House version of the bill adopted an approach that allowed taxpayers to use an EBITDA base for all taxable years, while the Senate version implemented an EBIT approach for all years. The resolution of this difference is explicit in the conference report, which states:

> The conference agreement generally follows the Senate amendment, with the following modifications. Under the conference agreement, for taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion.[4]

Third, the score of the provision reflects a significant increase in federal tax revenues that is attributable to a smaller EBIT base employed in years after 2021. This difference had a significant effect on the revenue estimates prepared by the Joint Committee on Taxation (JCT). JCT estimated the House and Senate provisions to raise $171.7 billion and $307.5 billion, respectively, over ten years. The enacted compromise was estimated to raise $253.4 billion – $90.2 billion in the first five years and $163.2 billion in the second five years.

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[2] For example, the earnings stripping provisions in Internal Revenue Code (IRC) Section 163(j) limited the ability of highly-leveraged corporations to deduct interest on related-party debt in certain circumstances.
[3] Under new Section 163(j)(3), this limitation does not apply to very small entities, which have gross receipts of no more than $25 million.
[4] H. Rept. 115-466 at 392. *See also* Joint Committee on Taxation, General Explanation of Public Law 115-97 (Dec. 2018) at 174:

> [F]or taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to any deduction allowable for depreciation, amortization, or depletion. For taxable years beginning after December 31, 2021, adjusted taxable income is computed with regard to deductions allowable for depreciation, amortization, or depletion.

The TCJA did not make any amendments to Section 263A with respect to interest expense. Accordingly, longstanding rules governing the treatment of indirect costs continue to apply. Treas. Reg. sec. 1.263A-1(e) provides that taxpayers must capitalize “indirect costs” (such as depreciation and amortization) allocable to property produced or acquired for resale. These costs are then recovered through the cost of goods sold (COGS), rather than deducted as separate items. The statutory language governing the treatment of indirect costs was enacted in the *Tax Reform Act* of 1986. Importantly, the purpose of this provision was to prevent timing shifts with respect to cost recovery deductions. As explained in the Bluebook accompanying the 1986 tax reform bill, Congress enacted the rules because prior law “produced a mismatching of expenses and the related income and an unwarranted deferral of federal income taxes.”[5]

B. <u>The Proposed Regulations’ Definition of ATI Would Harm Manufacturers</u>

1. The Proposed Regulations Would Harm Manufacturers by Effectively Imposing an EBIT Standard Years Earlier than Congress Intended

The statutory shift from EBITDA to EBIT will disproportionately burden capital-intensive industries, such as manufacturing, in that an EBIT basis does not reflect the depreciation deductions which flow from capital equipment investments that manufacturers must make in order to produce goods. The NAM is deeply concerned that the Proposed Regulations implement Section 163(j) in a manner that adopts an EBIT standard for manufacturers years earlier than Congress intended.

Specifically, Prop. Reg. sec. 1.163(j)-1(b)(1)(iii) provides that depreciation, amortization or depletion expenses that are capitalized into inventory under Section 263A are not added back to taxable income to determine the ATI base from which a taxpayer’s allowable interest deduction is calculated. In other words, under the Proposed Regulations, depreciation, amortization, and depletion that reduce gross income as separate line-item deductions are added back in computing pre-2022 ATI, but depreciation, amortization, and depletion that reduce gross income via costs of goods sold are not.

Taxpayers subject to Section 263A are required to capitalize all direct costs and certain indirect costs into the basis of property produced or acquired for resale. Among the indirect costs required to be capitalized are depreciation, amortization and cost recovery allowances on equipment and facilities used to produce inventory. The Proposed Regulations do not allow depreciation and amortization that is capitalized into cost of goods sold to be added back in determining ATI. As a result, the Proposed Regulations require capital-intensive businesses that manufacture or produce inventory to compute ATI without an addback for a substantial amount of their depreciation, subjecting manufacturers to an artificially low interest limitation relative to other businesses. For most manufacturers, the Proposed Regulations have the practical effect of converting the pre-2022 Section 163(j) interest limitation to one based on EBIT, rather than EBITDA. Moreover, as noted below, manufacturers have indicated that approach of the Proposed Regulations acts as a disincentive to claiming “bonus depreciation.”

This is clearly not the result intended by Congress. The statutory text, legislative history and score of the changes to Section 163(j) make it abundantly clear that lawmakers intended to provide an EBITDA standard for taxable years that begin prior to 2022. Accordingly, the Proposed Regulations should be modified to provide that the pre-2022 ATI additions for

[5] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (May 4, 1987).

depreciation and amortization include amounts that are capitalized to inventory under Section 263A and included in cost of goods sold.

This proposed modification will prevent manufacturers from being subject to the more restrictive EBIT limitation in pre-2022 years, rather than EBITDA, consistent with the enacted compromise between the House and Senate versions of Section 163(j). Revising the Proposed Regulations in this manner will fulfill the congressional intent to provide equal treatment to all taxpayers subject to Section 163(j) and prevent unintended harm to those in the business of manufacturing or producing goods for sale to customers, rather than undermine other provisions in TCJA that encourage capital investment and would not create additional administrative complexity for taxpayers or the IRS.

The NAM asked its members to describe the impact of the approach taken in the Proposed Regulations, and a selection of their responses is provided below:

> *Our company is capital intensive and has significant US manufacturing activities. The products that we produce are critical to other manufacturers in industries such as oil & gas refineries, petrochemical, semiconductor, steel and others. As a result of the provision in the Section 163(j) Proposed Regulations that does not treat depreciation that is allocated to COGS under Section 263A as an addback to ATI, we have estimated that over $400 million of our depreciation would not be allowed as an addback. This depreciation includes bonus depreciation. This will result in significantly curtailing our ability to deduct interest expense from debt that is needed to invest in new capital purchases. Also, we will be reevaluating whether or not we elect to utilize the 100% bonus depreciation provided under the TCJA.*
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> --Manufacturer in the industrial gas sector

> *Restricting interest deductions with the Section 263A interaction would cost our company approximately $30 million of deductible interest annually. This would add between four and 12 percent to our US effective tax rate depending on the magnitude of taxable income in a particular year, meaning we would be at 25% to 33% based only on this limitation.*
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> --Manufacturer of packaging products

> *In the cases of manufacturing companies that only have production facilities or that lease their retail, distribution and headquarters facilities, the vast majority of their depreciation will be in COGS. For example, it would be typical of a large manufacturing/distribution company to have $500 million of tax depreciation and amortization and for at least $450 million of it to be in COGS. Using the 30 percent of EBITDA limitation this would create an additional restriction on interest deductibility annually of $135 million (30 percent of the $450 million of depreciation and amortization in COGS) for the years through 2021, whereas a large distribution and retail company without production facilities would not face such limitation.*

Creating an annual cash flow penalty for manufacturers through 2021 does not seem equitable as it is a deterrent to investment and job creation in the manufacturing sector.

--Manufacturer in the automobile supply chain

Prior to the release of the proposed regulations, we believed that Section 163(j) would produce a modest limitation during the pre-2021 EBITDA period; however, the impact of the proposed regulations almost entirely eliminates any interest deduction in this same period. Based on the language in Section 163(j), which allows for the add-back of "any deduction allowable for depreciation, amortization, or depletion", we believed that any depreciation, depletion and amortization (DD&A) expenses that have reduced the basis of property (consistent with the usage of the term allowable under Section 1016) is added back to adjusted taxable income in the years before 2021. Under the proposed regulations, we would immediately be subject to the EBIT regime as the vast majority of our DD&A deductions are allocable to our oil-and-gas production activity and, therefore, fall within the mechanics of Section 263A. Our production is for the most part immediately sold at the wellhead, and therefore the timing of our cost-recovery deductions is not largely affected by Section 263A. Thus, our DD&A deductions that are otherwise allowable and that reduce our taxable income will not be available to add back, and as a result of this, we estimate that the majority of our interest will become limited instead of the more modest limitation originally expected.

--Manufacturer in the oil and gas industry

2. *The Proposed Regulations' Approach to ATI is Inconsistent with Congressional Intent*

It is clear that the longstanding rules of Section 263A require a portion of depreciation and amortization to be allocated to inventory and recovered as a cost of goods sold. It is also clear that for taxable years beginning prior to 2022, Section 163(j)(8) allows taxpayers to add back *any deduction allowable* for depreciation, amortization, or depletion when calculating ATI. In integrating these two provisions, a key question arises: do depreciation and amortization constitute "deductions allowable" for purposes of the EBIDTA addback if they are required to be capitalized under Section 263A?

The Proposed Regulations conclude that Section 263A should control, resulting in an effective adoption of an EBIT standard for manufacturers. This result is likely based on three theories, each of which is discussed and rebutted below. Manufacturers believe that Treasury is not compelled to adopt the Proposed Regulations' approach under any of these theories: (i) Congress intended for Section 163(j) to apply after other provisions of the code that defer, capitalize, or limit interest, such as Section 263A, (ii) amounts incurred for cost recovery but capitalized to inventory and included in cost of goods sold are not literally "deductions" but rather, they are reductions to gross receipts and (iii) an approach to ATI adjustments that would approximate cash flow would create an administrative burden.

A. The Proposed Regulations' Approach Is Contrary To The Purpose of Both Sections 263A and 163(j) and Lacks Evidence That It Was Intended By Congress

Congress clearly expressed its intent regarding the manner in which Sections 163(j) and 263A interact. As described in both the Conference Report and the JCT Bluebook, they envisioned a system in which 263A would apply to limit otherwise allowable interest deductions, but gave no indication that Section 263A would apply in determining ATI:

> It is generally intended that, similar to prior law, Section 163(j) apply after the application of provisions that subject **interest** to deferral, capitalization, or other limitation. Thus, as with prior-law Section 163(j), the provision applies to interest deductions that are deferred, for example under Section 163(e) or Section 267(a)(3)(B), in the taxable year to which such deductions are deferred. Also, as with prior-law Section 163(j), **the provision applies after Section 263A is applied to capitalize interest** and after, for example, Section 265 or Section 279 is applied to disallow any interest deduction.[6] (Emphasis added)

The clear purpose of this coordination rule is to determine the amount of interest expense that is subject to limitation under Section 163(j). There is no indication that Congress intended to apply Section 263A to limit the ATI base from which interest expense itself is determined.

In addition to being inconsistent with Congress' intent to provide an EBITDA base for ATI in years to 2022, the approach taken in the Proposed Regulations also represents a dramatic departure from the purpose of Section 263A. As noted above, the uniform capitalization rules of Section 263A were enacted to govern the *timing* of cost recovery. The role of the capitalization rules was made clear by the Supreme Court in *INDOPCO v. Commissioner*, "the primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the *timing* of the taxpayer's cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset."[7] (Emphasis added)

By applying a concept from Section 263A to the determination of ATI, the Proposed Regulations elevate a rule that was meant to govern the timing and method of recovery of allowable deductions into one that functions as a limit on the potential amount of tax items. That serves the purposes of neither Section 263A nor Section 163(j). With respect to Section 163(j), the legislative history indicates that Section 263A is applied after a taxpayer determines its interest deductions – not during the calculation of the taxable base from which those deductions are determined.

In light of the longstanding understanding that the purpose of the uniform capitalization rules is to determine timing, Congress would have clearly stated if it intended to apply Section 263A in a different manner. Congressional silence should be read as an indication that lawmakers did not intend to transform Section 263A from a timing rule to an operative rule that limits the total amount of interest deductions in the TCJA.

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[6] H. Rept. 115-466 at 387 (description of House Bill). *See also*, Joint Committee on Taxation, General Explanation of Public Law 115-97 (Dec. 2018) at 175.
[7] 503 U.S. 79 at 83-84 (1992).

B. The Proposed Regulations Employ An Overly-Literal Interpretation Of The Phrase “Allowable As A Deduction” That Is Inconsistent With Prior IRS Positions

As noted above, for taxable years beginning before 2022, the TCJA amended Section 163(j) to provide an ATI addback for “any *deduction allowable* for depreciation, amortization, or depletion.”[8] One theory for the approach taken in the Proposed Regulations is that depreciation required to be capitalized under Section 263A is recovered via cost of goods sold and is not technically a “deduction allowable.” However, such a theory employs an overly-literal reading of the term “deduction allowable” that is inconsistent with the approach taken in prior guidance. Prior guidance indicates that Treasury should look to congressional intent to resolve the question.

Section 1016(a)(2)(A) requires adjustments to the basis of property for amounts of depreciation and amortization allowed or allowable in computing taxable income. This language is interpreted to include amounts capitalized to inventory.

In a 2009 legal memorandum, the IRS considered whether costs incurred to remove components in a nuclear power facility could give rise to a specified liability loss under Section 172(f)(3).[9] If a loss qualified as a “specified liability loss,” the period for which the taxpayer could carry back the loss and offset prior year taxable income is extended from two years to 10 years. Prior to amendment by the TCJA, Section 172(f)(1)(B) provided that a specified liability loss could only arise from “any amount allowable as a deduction.” Similar to the issue at hand, the IRS was required to determine whether nuclear decommissioning costs allocable to inventory under Section 263A could give rise to a specified liability loss notwithstanding the fact that such amounts would be recovered via cost of goods sold instead of deducted immediately – in short, whether capitalized costs could be “allowable as a deduction.” To resolve the question, the IRS looked to congressional intent, stating:

> In our view, Congress used the phrase "allowable as a deduction" in Section 172(f)(1)(B)(i) to mean amounts that may be taken into account in computing taxable income. Congress did not mean to distinguish "deductions" from "cost of goods sold." For example, amounts such as fines and penalties that are nondeductible by reason of Section 162(f) cannot qualify as specified liability losses. This interpretation is consistent with Section 263A. Treas. Reg. sec. 1.263A-1(c)(2)(i) prohibits taxpayers from treating as inventoriable costs amounts that "may not be taken into account in computing taxable income for any taxable year." As an example, the regulations refer to the Section 274(n) disallowance of meal and entertainment expenses.

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[8] This interpretive question is not resolved by examining old section 163(j). Old section 163(j)(6)(A)(i)(III) contained language identical to present law section 163(j)(8)(A)(v) (“any deduction allowable for depreciation, amortization, or depletion”) and prior Proposed Regulations section 1.163(j)-2(f)(2)(iii) used similar language to Prop. Reg. section 1.163(j)-1(b)(1)(i)(D) (“deductions for depreciation under sections 167 and 168”). However, comments on the prior Proposed Regulations demonstrate a lack of clarity regarding the treatment of capitalized depreciation and amortization. See, e.g., Coopers & Lybrand (Aug. 23, 1991), Tax Analysts, DOC 91-7440 (seeking clarity that depreciation and amortization included in cost of goods sold is an acceptable addback); Ernst & Young (Sep. 3, 1991), Tax Analysts, DOC 91-7607 (seeking clarity that addbacks for depreciation and amortization capitalized under section 263A are not added back).

[9] CCA 200931007 (Mar. 11, 2009).

> Unlike fines and penalties disallowed by Section 162(f), and meals and entertainment disallowed by Section 274(n), nuclear decommissioning costs that must be recovered through cost of goods sold, though not deductible by the producer of electricity under Section 162(a), are "allowable" deductions that can be taken into account in computing taxable income under the Code. As "allowable" deductions, such nuclear decommissioning costs are both (1) eligible to be allocated to inventory to the extent required by Section 263A, and (2) eligible for treatment as a specified liability loss to the extent the other requirements of Section 172(f) are met.
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> We conclude that to the extent repair costs, required to be treated as inventory costs under Section 263A and incurred to satisfy a liability to decommission a nuclear power plant, are taken into account as cost of goods sold resulting in a net operating loss, such costs generate a specified liability loss under Section 172(f)(1)(B).[10]

More generally, U.S. tax authorities have warned against overly-literal interpretation of the word "deduction" for decades. In 1977, the IRS chose to nonacquiese to a Tax Court decision that rested on the court's reading of the word "deduction."[11] In its decision to challenge the ruling, the IRS said "the decision of the Tax Court applies an overly-literal interpretation of the word 'deduction'…the term 'deduction' should be interpreted to refer to items which reduce gross income whether included in the cost of goods sold or deducted from gross income in the technical sense."[12] In choosing to challenge the Tax Court decision, the IRS cited its decisions in 1958[13] and 1968[14] to follow cases that "embody the view that [the tax code provision at issue] ought to be interpreted to effectuate the underlying Congressional purpose."[15]

As noted above, Congress gave no indication that Section 263A should be applied to limit the ATI base from which a taxpayer's Section 163(j) amount is calculated. If Congress intended to limit the addback to deductions allowed under Sections 167 or 168 (to the exclusion of amounts incurred that are included in cost of goods sold), it could have done so with that specific language, as Congress did for the Section 199A deduction addback, which provides for the addback of "any *deduction allowed* under Section 199A."[16]

Similarly, Congress could have chosen to exclude items included in cost of goods sold from being added back in computing ATI, but it did not do so. In fact, Congress clearly made such a choice elsewhere in the TCJA and declined to do so with respect to Section 163(j). The conference report states that deductible payments subject to new Section 59A (the Base Erosion and Anti-Abuse Tax), "do not include payments for cost of goods sold (which is not a deduction but rather a reduction to income)." The specific exclusion of cost of goods sold as a

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[10] *Id*. *See also* IRS, LMSB Industry Director's Directive #2 on Specified Liability Losses IRC 172(f), Attachment 5 – Remediation of Environmental Contamination (June 19, 2009) ("Thus, since environmental remediation costs that are allocated to inventory under IRC section 263A and recovered through cost of goods sold are taken into account in computing taxable income, they constitute SLLs to the extent they are taken into account in computing a net operating loss for the taxable year.") and FSA 200143003 (May 11, 2001) (citing IRS AOD 1977-77 (April 4, 1977), discussed *infra*).
[11] *B.C. Cook & Sons v. Comm'r*, 59 T.C. 516 (1972), *action on dec.,* 1977-77 (Apr. 4, 1977).
[12] *Id.*
[13] Rev. Rul. 58-327, 1958-1 C.B. 316.
[14] Rev. Rul. 68-152, 1968-2 C.B. 369.
[15] *B.C. Cook & Sons v. Comm'r*, 59 T.C. 516 (1972), *action on dec.,* 1977-77 (Apr. 4, 1977).
[16] Section 163(j)(8)(iv).

deductible payment in one section of the TCJA and silence in new Section 163(j) indicates that Congress did not mean to apply such a limitation to the calculation of ATI. As the Supreme Court noted in *Russello v. United States,* "where Congress includes particular language in one section of a statute but omits it in another . . .it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."[17]

C. Congress intended for ATI to approximate cash flow

As noted by Treasury and IRS, the prior Proposed Regulations under pre-TCJA Section 163(j) included several adjustments beyond those in the statute. According to Treasury and IRS, "the purpose of these adjustments [was] to modify taxable income to more closely reflect the cash flow of the corporation." The Proposed Regulations, however, do not adopt this approach, citing the lack of a statutory directive and administrative concerns raised in comments to the prior Proposed Regulations.

While the words of the statute do not specify a cash flow approach to determining ATI, various communications indicate that the House version of Section 163(j) appears to be consistent with an EBITDA approach. Members of Congress were keenly aware that the primary difference between the House and Senate versions of amended Section 163(j) was the ATI addback for depreciation and amortization, as demonstrated by the significant difference in JCT's revenue estimates (discussed above) and comment letters received from stakeholders. It is difficult to reconcile the JCT revenue estimates for the House and Senate provisions and the increase in the post-2021 estimates for the enacted provision with the notion embodied in the Proposed Regulations that Congress intended for the more restrictive EBIT-based limitation to apply to manufacturers from the outset. That was also clearly not what was envisioned by manufacturers. For example, in a December 6, 2017 letter to TCJA conferees, the NAM said:

> Both bills would fundamentally alter the tax treatment of interest expense by imposing two new limitations on the ability to deduct interest expense. First, it would limit the amount of deductible interest expense to 30 percent of a company's adjusted taxable earnings. Significantly, the House and Senate differ on the base upon which this limitation is calculated. We have significant concerns with the Senate approach, which would base the limitation on earnings before interest and taxes ("EBIT"), and support the House approach, which employs an [EBITDA] standard. Manufacturers invest in depreciable equipment to produce goods. Limiting the base for the 30 percent calculation to EBIT would harm manufacturers by failing to account for the depreciation that is associated with capital equipment purchases.

Accordingly, it appears that members of Congress understood the House's version of ATI to approximate a tax measure of EBITDA, a common financial metric used to evaluate a business's economic strength and ability to service debt across industry sectors. Under this metric, it is irrelevant whether depreciation and amortization are included in a manufacturer's cost of goods sold or in a non-manufacturer's operating expenses. The enacted compromise was to initially apply the House's EBITDA limitation for tax years beginning before 2022, and the Senate's EBIT limitation thereafter. While the legislative history does not state the reasons for the compromise, it was likely due to revenue constraints and an intent to provide taxpayers with a less restrictive limitation in the initial post-enactment period and allow time for necessary adjustment to capital structures.

[17] 464 U.S. 16, 23 (1983).

As applied to manufacturers, however, the Proposed Regulations repudiate that compromise and apply the more restrictive Senate version from the outset. Depreciation and amortization are likely to be the most significant ATI addbacks, considering the adoption of 100 percent expensing in Section 168(k). Congress could not have intended for Section 163(j) to apply unevenly and in a way that harms manufacturers by turning the intended pre-2022 EBITDA standard into an EBIT measure only for manufacturers, as the Proposed Regulations would do.

3. Giving Full Effect to Congressional Intent Does Not Create Additional Burdens for Taxpayers or the IRS

Taxpayers subject to Section 263A are required to (1) identify costs that are capitalized to inventory for financial accounting purposes; (2) identify additional costs that are required to be capitalized for tax purposes; (3) allocate the additional costs in step 2 to production activities to determine total additional Section 263A costs; and (4) allocate the total additional Section 263A costs in step 3 between ending inventory and cost of goods sold. While compliance with these rules is by no means simple, there should be no additional burden on taxpayers to identify depreciation and amortization deducted as cost of goods sold for purposes of determining the ATI addback – they are already required to perform this calculation annually in order to comply with the rules under Section 263A. However, if there is a concern about additional taxpayer burden, a safe-harbor election could be provided to exclude depreciation in cost of goods sold from the ATI addback.

Annual depreciation and amortization amounts are reported on Form 4562. These are total amounts, including amounts capitalized to inventory. Cost of goods sold is reported on Form 1125-A, which requires taxpayers to report and attach a schedule of additional Section 263A costs capitalized to inventory for the year (i.e., step 3 above). If Treasury and IRS have administration concerns, Form 1125-A could be modified to also require taxpayers to report amounts of depreciation and amortization included in ending inventory and cost of goods sold (step 4 above).

4. Conclusion Regarding ATI

If finalized without amendment, the Proposed Regulations would harm manufacturers. It is clear that Congress intended for EBITDA to serve as the ATI base from which a taxpayer’s Section 163(j) limitation is calculated for tax years beginning before 2022. As currently drafted, the Proposed Regulations would effectively force manufacturers into an EBIT standard years earlier than Congress intended. Neither the statutory text nor the legislative history compels such a result. Consistent with the approach taken by the IRS over the last five decades, Treasury should give effect to congressional intent. Accordingly, the Proposed Regulations should be modified to provide that the pre-2022 ATI additions for depreciation and amortization include amounts that are capitalized to inventory under Section 263A and included in cost of goods sold.

C. Other Issues Arising Under the Proposed Regulations

1. The Proposed Regulations’ Definition of “Interest” is Overly Broad.

The Proposed Regulations define “interest” broadly to include not only amounts treated as interest for federal income tax purposes, but also many other types of payments that the preamble describes as having similar effects to interest, even if such payments are not otherwise treated as interest for tax purposes. This expansion of the term “interest” far exceeds congressional intent and creates significant complexity and burdens without meaningfully improving the policy behind Section 163(j).

Section 163(j) imposes limits on a taxpayer's ability to deduct "business interest", which the statute defines as "any interest paid or accrued on indebtedness properly allocable to a trade or business" other than investment interest.[18] The JCT's explanation of the TCJA changes to Section 163(j) provides only that "[a]ny amount treated as interest for purposes of the Code is interest for purposes of the provision."[19] Neither the text nor the legislative history indicates an intent to expand the scope of Section 163(j) beyond traditional debt instruments. However, the Proposed Regulations would apply the Section 163(j) limitation to amounts that are "closely related" to interest but are not actually compensation for the use or forbearance of money.

The preamble cites Treas. Reg. secs. 1.954-2 and 1.861-9T as examples of regulations that treat amounts closely related to interest as interest. However, Treas. Reg. sec. 1.954-2 was issued pursuant to specific statutory authority under Section 954(c)(1)(E) that explicitly addressed interest equivalent amounts. Similarly, Treas. Reg. sec. 1.861-9T addresses interest equivalents, but was supported by congressional intent that items economically similar to interest should be included.[20] In contrast, there is no indication that Section 163(j) was intended to apply to interest equivalents.

In addition to being beyond the scope of congressional intent, the expansion of the definition of "interest" creates unnecessary complexity and administrative burdens for taxpayers. Although the preamble suggests that the definition is consistent with definitions developed in Treas. Reg. secs. 1.861-9T and 1.954-2, the interest definition in the Proposed Regulations is far broader.[21] The Proposed Regulations would force taxpayers to evaluate all expenses paid and accrued for interest equivalents under the expanded definition and require taxpayers to simultaneously maintain multiple sets of records for what is and is not treated as interest for purposes of Section 163(j), which may be different from "interest" for other provisions. Additionally, the broad definition creates uncertainty by adopting an entirely new definition of interest.

The issues arising from this newly-expanded definition of interest are compounded by the anti-avoidance rule set forth in Prop. Reg. sec. 1.163(j)-1(b)(20)(iv), which is intended to prevent taxpayers from avoiding the application of Section 163(j) by structuring transactions that are essentially financing transactions. Yet the anti-avoidance rule as written does not establish a requirement that a taxpayer must have an "avoidance" purpose for the rule to apply. This section effectively treats any payment having a time value of money component as an

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[18] Section 163(j)(5).

[19] *See* Joint Committee on Taxation, General Explanation of Public Law 115-97 (2017) at 174.

[20] *See* Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (1987) at 947-8 ("Congress did not intend that labels control whether expenses are interest expenses for [purposes of Section 864(e), but rather] that economic reality govern."). Moreover, Treas. Reg. section 1.861-9T(b) includes interest equivalents solely for purposes of determining how items should be allocated and apportioned between different categories of income under Section 861. Items not explicitly listed in Section 861 are sourced by analogy to similar items for which there is an explicit sourcing rule. thus, interest equivalents aren't treated as interest in Section 861, they are treated in the same manner as interest purely for sourcing purposes. *See Bank of America v. U.S.*, 680 F.2d 142 (Fed. Cir. 1982), *E.g.*, *Howkins v. Commissioner*, 49 T.C. 689 (1968).

[21] For example, Prop. Reg. section 1.163(j)-1(b)(20)(iii)(E) and (F) are inconsistent with Treas. Reg. section 1.861-9T(b) as there neither (E) or (F) contains a requirement that the payment be incurred substantially in consideration of the time value of money and guaranteed payments (Prop. Reg. section 1.163-1(b)(20)(iii)(I)) are not treated as interest under either Treas. Reg. section 1.861-9T(b) or 1.954-2).

avoidance transaction, regardless of whether the transaction is entered into for legitimate non-tax business reasons. This provision is unnecessarily broad and will create additional uncertainty for taxpayers.

Given the explicit statutory language and lack of legislative history suggesting Congress intended to expand the definition of interest purely for purposes of Section 163(j), we believe Prop. Reg. sec. 1.163(j)-1(b)(20)(iii) is inconsistent with the definition of interest for purposes of Section 163(j) and should be stricken from the regulations.

2. *Concerns Regarding the Treatment of CFC Interest Expense*

The Proposed Regulations significantly broaden the scope of Section 163(j) with respect to controlled foreign corporations (CFCs) without any evidence of Congressional intent to do so. Regulations proposed under pre-reform Section 163(j) (issued in 1991) carved out from the Section 163(j) limitation the interest expense of any CFC that did not conduct a U.S. trade or business. Congress made no indication, either in the statute or in the legislative history, that new Section 163(j) should apply to CFCs in a more expansive manner than in years past.

By broadly applying Section 163(j) to CFCs, the Proposed Regulations introduce significant and unreasonable administrative complexity by requiring taxpayers to perform Section 163(j) calculations on each of its CFCs. These rules create an unreasonable compliance burden without justification given the statutory language and lack of express legislative intent. To address these concerns, Treasury should amend the Proposed Regulations to apply only to CFCs with a U.S. trade or business, similar to the 1991 regulations proposed under old Section 163(j).

Should Treasury limit the scope of the Proposed Regulations with respect to CFCs, it should continue to provide a CFC group election, with several modifications.

First, Treasury should reduce the ownership threshold necessary to qualify for the election. The Proposed Regulations currently require 80 percent of the value of each CFC to be owned by a single U.S. shareholder or related shareholders. We recommend that this threshold be reduced to greater than 50 percent, as ownership of more than 50 percent of a CFC's stock is sufficient to establish control of an entity's financing decisions.

Second, Treasury should make the CFC group election effective for a reasonable period of time, rather than irrevocable, as the fact and circumstances supporting an election may change over the years.

Third, Treasury should provide relief from the administrative burden required to comply with the election. For example, Treasury could permit taxpayers to calculate a CFC group's limitation on an aggregate basis, only requiring a CFC-by-CFC calculation if the group's net interest expense exceeds its limitation.

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Thank you for the opportunity to comment. If you have questions or would like to discuss this matter further, please contact me at 202-637-3077.

Sincerely,

Chris Netram

Vice President

Tax & Domestic Economic Policy