

LB&I International Practice Service Process Unit – Audit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Business Inbound	–	–
Volume	7	Inbound Financing	Level 1 UIL	9423
Part	7.5	Interest Expense Limitation under §163(j) and Application of §267(a)(3) to Interest	Level 2 UIL	9423.05
Chapter	7.5.2	Interest Expense Limitation Computation under §163(j)	Level 3 UIL	N/A
Sub-Chapter	N/A	N/A	–	–

Unit Name	Interest Expense Limitation Computation under §163(j)
------------------	---

Document Control Number (DCN)	IBF/9423.05_04(2016)
Date of Last Update	01/06/16

Table of Contents

(View this PowerPoint in “Presentation View” to click on the links below)

[Process Overview](#)

[Determination of Process Applicability](#)

[Summary of Process Steps](#)

[Process Steps](#)

[Other Considerations and Impacts to Audit](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Issues](#)

Process Overview

Interest Expense Limitation Computation under IRC §163(j)

Process Description

Foreign businesses often capitalize their U.S. subsidiaries (USS) with both equity and intercompany debt. The use of intercompany debt may allow for deductible interest expense which reduces U.S. taxable income. Such related party debt may be from the foreign parent company or one of its offshore affiliates, often in a low tax jurisdiction.

This Practice Unit examines the process of computing the limitation and deferral of deductible corporate interest expense under IRC §163(j) in a given tax period. Interest expense attributable to bona fide debt between a U.S. Taxpayer (borrower) and its foreign parent/affiliate (lender) is limited to interest considered paid under the cash method of accounting regardless of the Taxpayer's overall method of accounting, under IRC § 267(a)(3) or IRC §163(e)(3), related to Original Issue Discount (OID) instruments. Provisions which defer the deductibility of interest under these sections apply before the application of IRC §163(j).

The purpose of IRC §163(j) is to limit the deductibility of interest by a thinly capitalized corporation where the interest is paid to a related payee that is totally or partially exempt from U.S. tax on the distribution. Additionally, IRC §163(j) applies to interest that is paid or accrued to an unrelated person if there is a disqualified guarantee on the debt and no gross basis tax is imposed on such interest. Disqualified Guarantee is discussed in detail later on in Process Step 5 of this IPS Unit.

Generally, the taxpayer will calculate its Interest Expense limitation under the rules provided by IRC §163(j). This process unit explores the computation and the key components of the interest expense limitation prescribed by IRC §163(j) and Proposed Treas. Regulations §1.163(j). The calculation is based on the statutory formula and amounts reported on Form 8926, Disqualified Corporate interest Expense Disallowed Under IRC §163(j) . Furthermore, this process unit will cover audit techniques during various steps of the computation of the IRC §163(j) limitation.

Process Overview (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Process Description

For IRC §163(j) to apply, the following conditions must be satisfied:

- A U.S. corporation or a U.S. branch of a foreign corporation must pay interest to:
 - a related person, or to
 - an unrelated person (such as a third party bank) if there is a "disqualified guarantee" of the underlying debt;
- The payee above must be exempt from U.S. tax on some portion of the income (or subject to a reduced rate of tax under a treaty).
- The payer corporation does not meet the debt equity ratio safe harbor (1.5 or less), and
- The corporation's net interest expense exceeds 50% of adjusted taxable income (ATI) plus any excess limitation (EL) carryforward.

Disallowed interest expense is carried over to future years and treated as interest paid or accrued in the succeeding taxable year.

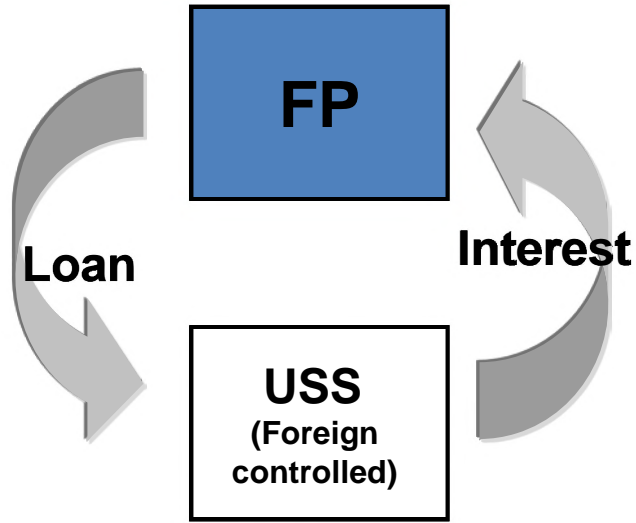
The examiner should determine early on in the audit process by reviewing the balance sheet and the income statement of the U.S. Taxpayer the total amount of intercompany debt and interest deduction reported. In addition, Form 8926 should be reviewed to determine if there is Disqualified Interest, a Disqualified Guarantee, or a carryforward of Disqualified Interest from a previous year affected by the limitations of IRC §163(j). This will allow the examiner to determine the tax impact of any potential adjustment.

IRC §163(j) was first enacted by the Omnibus Act of 1989. Proposed Regulations were issued in June 1991. The regulations have not yet been finalized. See Chief Counsel Notice (CC-2003-014) dated May 8, 2003 for the effect of proposed regulations.

Process Overview (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Example Circumstances Under Which Process Applies



Note:

- A variation of the Example Circumstances, includes the same structure, but with a third party lender (such as a bank) instead of FP, and the loan is instead Guaranteed by the FP or related party.
- In any event, the overall Process of determining the Interest Expense Limitation under IRC 163(j) is still the same.

Determination of Process Applicability

Interest Expense Limitation Computation under IRC §163(j)

The following criteria should be verified before determining if §163(j) applies.

Criteria	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Taxpayer is claiming an interest expense deduction on its books and/or Form 1120 ▪ The limitations under IRC §267(a)(3) and IRC §163(e)(3) have already been considered in determining interest expense as applied below. ▪ For IRC §163(j) to apply, the following conditions must be satisfied: <ul style="list-style-type: none"> – A U.S. corporation or a U.S. branch of a foreign corporation must pay interest to: <ul style="list-style-type: none"> – a related person, or – an unrelated person (such as a third party bank) if there is a "disqualified guarantee" of the underlying debt; – The payee above must be exempt from U.S. tax on some portion of the income (or subject to a reduced rate of tax under a treaty). – The payer corporation must have a debt-to-equity ratio of more than 1.5 to 1 and – The payer corporation must have net interest expense that exceeds the sum of 50% of adjusted taxable income plus any excess limitation carryforward. 	<ul style="list-style-type: none"> ▪ Form 1120 Line 18 ▪ Form 1120, Sch. L ▪ Form 5472 Line 19 (2011) ▪ Form 8926 (2011) ▪ Form 1042-S (2011) ▪ Taxpayer Financial Statements, (corresponding to Form 1120, Sch. M-3) 	<p style="text-align: right;">Back to Table Of Contents</p>

Summary of Process Steps

Interest Expense Limitation Computation under IRC §163(j)

Step 1	Determine the Debt to Equity Ratio
Step 2	Determine the Net Interest Expense
Step 3	Determine Adjusted Taxable Income
Step 4	Determine Excess Interest Expense

Summary of Process Steps (cont'd)

Interest Expense Limitation Computation under IRC §163(j)	
Step 5	Determine Disqualified Interest and/or Interest subject to a Disqualified Guarantee
Step 6	Determine Total Disqualified Interest for the tax year
Step 7	Determine interest deduction Disallowed under IRC §163(j) for the current year and carried forward to the next tax year.
Step 8	Determine Excess limitation for the current year and Excess limitation carryforward to the next tax year.

Step 1

Interest Expense Limitation Computation under IRC §163(j)

Step 1: Determine the Debt to Equity Ratio

The Debt to Equity Ratio involves a factual determination using the rules and computation discussed below.


Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ For the IRC §163(j) Interest Expense limitation to apply, the Debt Equity ratio must exceed 1.5. This is determined on the last day of the taxable year. ▪ The debt-equity ratio is determined as follows: <p>Debt Equity Ratio =</p> $\frac{\text{Total Debt}}{\text{Total Equity}} = \frac{\text{Total Debt}}{(\text{Cash} + \text{Other Assets}) - \text{Debt}}$ <ul style="list-style-type: none"> ▪ The term Debt means the corporation's liabilities determined under general tax principles, and as the adjusted Issue Price in the case of a discounted bond. ▪ The term Equity includes cash and adjusted basis of all other assets, minus Total Debt determined above. 	<ul style="list-style-type: none"> ▪ IRC §163(j)(2)(A) ▪ Form 8926, Lines (1a-1f) ▪ IRC §163(j)(2)(C) 	
<ul style="list-style-type: none"> ▪ Audit Tip: At each step, it is often helpful to use Form 8926 and any supporting workpapers as the starting point. 		

Step 1 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 1: Determine the Debt to Equity Ratio

The Debt to Equity Ratio involves a factual determination using the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Debt to Equity ratio <p> DECISION POINT: If the Debt to Equity Ratio exceeds 1.5, Disqualified Interest paid or accrued in the current tax year will be disallowed (and treated as Disqualified Interest in succeeding years) by IRC §163(j) to the extent the corporation has excess interest expense for the current tax year.</p> <ul style="list-style-type: none"> ▪ If the ratio is exactly 1.5 or less disqualified interest paid or accrued in the current tax year will not be disallowed by IRC §163(j). ▪ In any event, the process and computation should be completed to determined the correct Excess Limitation carryforward or Disqualified Interest carryforward disallowed. 	<ul style="list-style-type: none"> ▪ Form 8926, Line 1f ▪ IRC §163(j)(2)(A) ▪ Form 8926, Lines (1a-1f) ▪ IRC §163(j)(2)(C) 	
<ul style="list-style-type: none"> ▪ Audit Tip: At each step, it is often helpful to use Form 8926 and any supporting workpapers as the starting point. 		

Step 1 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 1: Determine the Debt to Equity Ratio

The Debt to Equity Ratio involves a factual determination using the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Audit Tips: Consider the following criteria to determine if the taxpayer has a potential and material IRC §163(j) issue: <ul style="list-style-type: none"> – A large interest deduction. – A debt-to-equity ratio of more than 1.5 (not in safe harbor). – Interest paid to related parties that is partially or wholly exempt from taxation. – Taxable Income that is not significantly larger than interest expense. ▪ If the conditions above exist, then request and review the taxpayer's computations for consideration of the Debt to Equity ratio. 	<ul style="list-style-type: none"> ▪ Form 8926, Lines (1a-1f) ▪ Taxpayer's Form 8926 and supporting Tax Return schedules ▪ Taxpayer's financial statements, Trial Balance, and General Ledger ▪ IRC §163(j)(2)(C) 	

Step 1 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 1: Determine the Debt to Equity Ratio

The Debt to Equity Ratio involves a factual determination using the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Audit Tips: ▪ Review the computation of the taxpayer's debt-to-equity ratio, especially when it is close to 1.5, or it appears that there are apparent misstatements. ▪ Determine if the adjusted basis, rather than market value of assets was used in the computation. Form 8926 will provide a good starting point on whether the adjusted basis of stock, tangible assets, or intangible assets were material in the computation. 	<ul style="list-style-type: none"> ▪ Form 8926, Lines (1a-1f) ▪ Taxpayer's Form 8926 and supporting Tax Return schedules ▪ Taxpayer's financial statements, Trial Balance, and General Ledger ▪ IRC §163(j)(2)(C) ▪ Form 8926, Lines 1 (g – j) 	

Step 2

Interest Expense Limitation Computation under IRC §163(j)

Step 2: Determine the Net Interest Expense

Determining the Net Interest Expense is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The next step is computing the Net Interest Expense ▪ Net Interest Expense means the excess of the amount of interest expense paid or accrued to all persons over the interest income includible in gross income. ▪ Net Interest Expense = Interest Expense Paid or Accrued – Interest Income ▪ (cannot be less than zero - 0 -) 	<ul style="list-style-type: none"> ▪ Form 8926, Lines 2(a-c) ▪ Form 1120, Lines 18 and 5, respectively ▪ IRC §163(j)(6)(B) ▪ IRC §163(j)(8) 	
<ul style="list-style-type: none"> ▪ Audit Tip: ▪ Interest Expense is determined after applying any limitations. ▪ Consult with other members of the Audit Team (i.e. Financial Products, domestic) who may have other issues with respect to Interest Expense, as Interest Expense as Corrected will be the relevant amount to use for this computation. ▪ Review whether the treatment of Corporate Partner provisions are applicable. 		

Step 3

Interest Expense Limitation Computation under IRC §163(j)

Step 3: Determine Adjusted Taxable Income

Determining the Adjusted Taxable Income is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The purpose of computing a corporation's adjusted taxable income is to convert its taxable income to an amount that more closely approximates operating cash flow. Certain additions and subtractions of non-cash items achieve this. In addition, net interest expense is added back into adjusted taxable income. ▪ Adjusted Taxable Income is computed as follows: ▪ Taxable income (loss) before application of IRC §163(j) ▪ Add: <ul style="list-style-type: none"> – Net Interest Expense (computed in Step 2) – NOL deduction taken under IRC §172 – Domestic Production deduction under IRC §199 – Deductions for depreciation, amortization, or depletion – Other adjustments (prescribed in Regulations) – Sum = Adjusted Taxable Income 	<ul style="list-style-type: none"> ▪ IRC §163(j)(6)(A) ▪ Form 8926, Lines 3 (a – g) ▪ Form 8926, Line 3g 	

Step 3 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 3: Determine Adjusted Taxable Income

Determining the Adjusted Taxable Income is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ From the taxpayer's point of view, a larger adjusted taxable income is desirable since an IRC §163(j) disallowance of interest only occurs if total Net interest expense (Step 2) exceeds one-half of the adjusted taxable income. 	<ul style="list-style-type: none"> ▪ IRC §163(j)(6)(A) ▪ Form 8926, Lines 3 (a – g) ▪ Taxpayer's Form 8926 and supporting Tax Return schedules ▪ Taxpayer's financial statements, Trial Balance, and General Ledger ▪ Section 163(j) computation worksheet 	
<ul style="list-style-type: none"> ▪ Audit Tips: ▪ Adjusted Taxable Income (ATI) is computed after taking into account all other audit adjustments (i.e. Taxable Income as Corrected). ▪ The taxpayer will often have an attachment schedule or workpapers on ATI, which should be requested. ▪ Review adjustments for year to year consistency, and use the pertinent audit tool. 		

Step 4

Interest Expense Limitation Computation under IRC §163(j)

Step 4: Determine Excess Interest Expense

Determining the Excess Interest Expense is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ IRC §163(j) provides the following calculation of Excess Interest expense, which can be divided into 4 computation steps (A – D) corresponding to Form 8926: ▪ Computation Step A: Multiply Adjusted Taxable Income (line 3g) by 50% ▪ Computation Step B: Determine if there is any excess limitation carryforward from prior 3 tax years (line 4b), the prior year Forms 8926 will be needed. ▪ Computation Step C: Add the sum amounts from Computation Steps A and B. ▪ Computation Step D: Subtract the result of Computation Step C from Net Interest Expense (determined previously in Step 2). This result is the Excess Interest Expense, (i.e., the excess of net interest expense of the corporation over the sum of 50 percent of the corporation's adjusted taxable income plus any excess limitation carryforward). 	<ul style="list-style-type: none"> ▪ IRC §163(j)(2)(B) ▪ Form 8926, Line 4a ▪ Form 8926, Line 4b ▪ Form 8926, Line 4c ▪ Form 8926, Line 4d 	

Step 5

Interest Expense Limitation Computation under IRC §163(j)

Step 5: Determine Disqualified Interest and/or Interest subject to a Disqualified Guarantee

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Disqualified Interest is: <ul style="list-style-type: none"> – Interest paid or accrued (directly or indirectly) to a related person not subject to U.S. income tax on the interest, – Interest paid or accrued on indebtedness held by an unrelated person (such as a bank) if there is a Disqualified Guarantee (See Disqualified Guarantee, further below) of the indebtedness and the interest is not subject to a U.S. gross basis income tax, or – Interest paid or accrued (directly or indirectly) by a taxable REIT subsidiary (as defined in IRC §856(i) of a Real Estate Investment Trust (REIT) to such trust. ▪ Add the sum of the above Disqualified Interest/Disqualified Guarantee items. 	<ul style="list-style-type: none"> ▪ IRC §163(j)(3) ▪ Form 8926, Line 5a ▪ Form 8926, Line 5b ▪ Form 8926, Line 5c ▪ Form 8926, Line 5d 	

Step 5 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 5: Determine Disqualified Interest and/or Interest subject to a Disqualified Guarantee

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ Related person means any person who is related (within the meaning of IRC §267(b) or IRC §707(b)(1) to the taxpayer.▪ Information about related persons receiving disqualified interest should be reported on Form 8926, Lines 6 (a-e), and can also be found on Form 5472.▪ There are special rules for certain partnerships. (See IRC §163(j)(4)(B))	<ul style="list-style-type: none">▪ Form 8926, Line 6	

Step 5 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 5: Determine Disqualified Interest and/or Interest subject to a Disqualified Guarantee

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<p>T TREATY IMPLICATIONS: If a treaty between the U.S. and a foreign country reduces the rate of income tax imposed on the interest paid or accrued, such interest shall be treated as interest on which no tax is imposed (i.e. Disqualified Interest), to the extent of the same proportion of such interest as:</p> <ul style="list-style-type: none"> ▪ The rate imposed without regard to such treaty, reduced by the treaty rate, bears to ▪ The rate of tax imposed without regard to the treaty 	<ul style="list-style-type: none"> ▪ Form 8926, Line 5 ▪ Publication 901, US Tax Treaties ▪ IRC §163(j)(5)(B) 	

Step 5 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 5: Determine Disqualified Interest and/or Interest subject to a Disqualified Guarantee

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Treaty rate Examples: ▪ U.S. subsidiary (USS) of Foreign Parent (FP) pays \$100 of interest to FP. ▪ FP is a resident of a country with an income tax treaty with the United States. ▪ Under the treaty, the 30 percent statutory rate of withholding on interest (under ▪ IRC §881) is reduced to 15 percent. <ul style="list-style-type: none"> – Under IRC §163(j)(5)(B), \$50 ($\\$100 \times 15/30$) is considered as tax-exempt, or Disqualified Interest, paid to a related person. ▪ What happens if the treaty rate is reduced to 10 percent? <ul style="list-style-type: none"> – Under the statute, \$66.67 ($\\$100 \times (20/30)$) is considered as Disqualified Interest. ▪ What happens if the treaty rate is reduced to zero? <ul style="list-style-type: none"> – All \$100 is Disqualified Interest. ($\\$100 \times 30/30$) 	<ul style="list-style-type: none"> ▪ Form 8926, Line 5 ▪ Publication 901, US Tax Treaties ▪ IRC §163(j)(5)(B) 	

Step 5 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 5: Determine Disqualified Interest and/or Interest subject to a Disqualified Guarantee

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Disqualified Guarantee ▪ A guarantee includes any arrangement under which a person (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another person's obligation under any indebtedness. ▪ A Disqualified Guarantee is generally a guarantee by a related person that is a tax-exempt organization or a foreign person, unless the corporation owns a controlling interest in the tax-exempt organization or foreign person. (See IRC §163(j)(6)(D)(ii)(I)). ▪ For this purpose, a controlling interest is direct or indirect ownership of at least 80% of the total voting power and value of all classes of stock of a corporation, or 80% of the profit and capital interests in any other entity. 	<ul style="list-style-type: none"> ▪ Form 8926, Line 5b ▪ IRC §163(j)(6)(D) 	

Step 6

Interest Expense Limitation Computation under IRC §163(j)

Step 6: Determine Total Disqualified Interest for the tax year

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Total Disqualified Interest for the tax year is: <ul style="list-style-type: none"> – Disqualified Interest (sum of items determined in Step 5), and – Any Disqualified interest disallowed under section IRC §163(j) for prior tax years that is treated as paid or accrued in the current year. (Disqualified Interest carryover) – Sum = Total Disqualified interest for the tax year 	<ul style="list-style-type: none"> ▪ IRC §163(j)(1)(B) ▪ Form 8926, Line 5d ▪ Form 8926, Line 5e ▪ Form 8926, Line 5f 	
<ul style="list-style-type: none"> ▪ Key Point: ▪ Disqualified Interest refers to the condition of being paid to an exempt Related Person, whereas Disallowed interest, refers to interest that is subject to the limitation of IRC §163(j) and deferred to tax years subsequent to the disallowance year. 		

Step 7

Interest Expense Limitation Computation under IRC §163(j)

Step 7: Determine interest deduction Disallowed under 163(j) for the current year and carried forward to the next tax year

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The Disallowance of Disqualified interest under IRC §163(j) for the current year is only applicable if the Debt to Equity ratio (as determined in Step 1) exceeds 1.5. ▪ If the Debt to Equity ratio exceeds 1.5, then the: <ul style="list-style-type: none"> – interest deduction Disallowed under IRC §163(j) for the current year is the lesser of: <ul style="list-style-type: none"> – Excess Interest Expense (determined in Step 4) – Disqualified Interest (as determined in Step 5) ▪ Such Disallowed interest is carried forward and treated as Disqualified Interest in the succeeding taxable year. 	<ul style="list-style-type: none"> ▪ Form 8926, Line 7 ▪ IRC §163(j)(1)(B) 	

Step 7 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 7: Determine interest deduction Disallowed under 163(j) for the current year and carried forward to the next tax year

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The Disallowance of Disqualified interest under IRC §163(j) for the current year is only applicable if the Debt to Equity ratio (as determined in Step 1) exceeds 1.5. ▪ If the Debt to Equity ratio is less than or equal to 1.5, then no interest deduction is Disallowed under IRC §163(j) for the current year. ▪ The IRC §163(j) Disallowed Disqualified interest to be carried forward to future tax years is the smaller of : <ul style="list-style-type: none"> – Excess Interest Expense (step 4) for the current year and – Disqualified Interest Disallowed and carried over from prior years, 	<ul style="list-style-type: none"> ▪ Form 8926, Line 7 	
<ul style="list-style-type: none"> ▪ Note: The earlier version of Form 8926 (for years 2008-2010) has a difference in the line items used. 		

Step 7 (cont'd)

Interest Expense Limitation Computation under IRC §163(j)

Step 7: Determine interest deduction Disallowed under 163(j) for the current year and carried forward to the next tax year

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none">▪ Key Point: Disqualified Interest refers to the condition of being paid to an exempt Related Person, whereas Disallowed interest, refers to interest that is subject to the limitation of IRC §163(j) and deferred to tax years subsequent to the disallowance year.▪ Audit Tips: The taxpayer will often have an attachment schedule or workpapers on Disallowed interest under IRC §163(j) and carried forwards, which should be requested.▪ Review adjustments for year to year consistency.	<ul style="list-style-type: none">▪ Form 8926, Line 7▪ Section163(j) computation worksheet	

Step 8

Interest Expense Limitation Computation under IRC §163(j)

Step 8: Determine Excess limitation for the current year and Excess limitation carryforward to the next tax year

This Step is a factual determination involving the rules and computation discussed below.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ An Excess Limitation occurs if the Net Interest Expense of a given year is less than 50% of Adjusted Taxable Income (the reverse situation with respect to the applicability of IRC §163(j)). An Excess Limitation carryforward from up to 3 preceding tax years may be used as an adjustment to Adjusted Taxable Income for any current tax year. <ul style="list-style-type: none"> – Consider if there is any unused Excess Limitation carryforward from the prior 2 years. ▪ Then determine if there is any Excess Limitation (EL) for the current tax year. <ul style="list-style-type: none"> – (50% of Adjusted Taxable Income) – Net Interest Expense = EL current year (positive) – The Sum of the above equals the Excess Limitation carryforward to the next tax year. 	<ul style="list-style-type: none"> ▪ Form 8926, Line 8a ▪ Form 8926, Line 8b ▪ Form 8926, Line 8c ▪ Section 163(j) computation worksheet 	
<ul style="list-style-type: none"> ▪ Audit Tip: Use the pertinent audit tool to assist with the Excess Limitation computation 		

Other Considerations / Impact to Audit

Interest Expense Limitation Computation under IRC §163(j)

Considerations	Resources
<ul style="list-style-type: none">▪ All members of an Affiliated Group (described in IRC §1504(a)) are treated as one corporation (whether filing consolidated or not).▪ Consider the effects of Excess Limitation Carryforwards from prior years, and the current year Disallowance of interest expense on future audit years.▪ Consider the effects of any audit adjustments related to IRC § 267(a)(3), IRC §163(e), or capitalized interest. The rules under IRC §163(j) are determined only after consideration of other IRC provisions.▪ Consider the effects of other Audit adjustments both Internationally and Domestically on Taxable Income (as corrected). Adjusted Taxable Income (as corrected) is computed after taking account any audit adjustments.	<ul style="list-style-type: none">▪ IRC §163(j)(6)(C)▪ Section163(j) computation worksheet

Training and Additional Resources

Chapter 7.5.2 Interest Expense Limitation Computation under IRC §163(j)

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> ▪ 2012 CPE Centra – Inbound Financing Transactions and Issues – Part I ▪ 2012 CPE Centra – Inbound Financing Transactions and Issues – Part II 	<ul style="list-style-type: none"> ▪ 2012 (IBC) CPE Centra Inbound Financing Part I ▪ 2012 (IBC) CPE Centra Inbound Financing Part II
White Papers / Guidance	<ul style="list-style-type: none"> ▪ Disqualified Corporate Interest Expense Information – information that is available on irs.gov for disqualified corporate Interest Expense 	<ul style="list-style-type: none"> ▪ Form 8926, Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information
Podcasts / Videos	<ul style="list-style-type: none"> ▪ CPE 2011 Inbound Financing – this was Face-to-Face training presented in 2011, Business Inbound Track Day 2. The resources include the handout as well as a video. 	<ul style="list-style-type: none"> ▪ 2011 (IBC) CPE – Inbound Financing September 2011
Other Training Materials	IE Phase I Modules: Module D <ul style="list-style-type: none"> ▪ Lesson 1 Withholding at Source ▪ Lesson 2 Transactions with Related Foreign Persons 	Training - IE Phase I Modules: Module D 3135-207
Other Training Materials	IE Phase III Module: Module I <ul style="list-style-type: none"> ▪ Earnings Stripping 	Training – IE Phase III Module III – 3135-517

Glossary of Terms and Acronyms

Term/Acronym	Definition
ATI	Adjusted Taxable Income
CFC	Controlled Foreign Corporation
ECI	Effectively Connected Income
EL	Excess Limitation
ETR	Effective Tax Rate
FP	Foreign Parent
USS	A corporation organized in the United States that is a subsidiary of another corporation

Index of Related Issues

Issue	Associated UIL(s)	References
Interest on loan through a low-tax affiliate	▪ 9423.01	▪ Bona fide debt determination IPS Unit
Interest expense limitation under §267(a)(3)	▪ 9423.05	▪ IRC §267(a)(3) IPS Unit
Circular cash flow argument under § 267(a)(3)	▪ 9423.05	▪ IPS Unit coming soon
Netting with book entries	▪ 9423.05	▪ IPS Unit coming soon
Loans to finance interest	▪ 9423.05	▪ IPS Unit coming soon
Cash pooling and the definition of economic ownership for purpose of § 267(a)(3)	▪ 9423.05	▪ IPS Unit coming soon
Cash method of accounting as it relates to § 267(a)(3)	▪ 9423.05	▪ IPS Unit coming soon
Arm's length standard under §482 for rate of interest charged on intercompany debt	▪ 9423.07	▪ IRC § 482 IPS Unit
Withholding tax under §1441	▪ 9423.07	▪ IPS Unit coming soon
Dual Consolidated Loss under §1503	▪ 9423.07	▪ IRC §1503 IPS Unit