Office of Chief Counsel
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from: Roy Hirschhorn
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subject: Removing the limitation of deduction for interest on certain indebtedness under IRC § 163(j)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

X =

Y =

Z =

ISSUE

Does removing the limitation of deduction for interest on certain indebtedness under IRC § 163(j) qualify as a change in accounting method under IRC § 446?

CONCLUSION

Removing the limitation of deduction for interest on certain indebtedness under IRC § 163(j) does not qualify as a change in accounting method under IRC § 446.

FACTS

The taxpayer is the parent corporation of a U.S. affiliated group that files a consolidated federal income tax return. It is jointly owned, indirectly, by X foreign entities. These X foreign entities also own a foreign entity that has provided loans to the taxpayer and other members of the taxpayer's affiliated group.

For the taxpayer's taxable years ended Y, the taxpayer viewed the foreign entity from which it had received loans as a related party for purposes of applying the IRC § 163(j) limitation. Therefore, the taxpayer limited its deduction for interest on indebtedness under IRC § 163(a) by applying the interest limitation provision of IRC § 163(j). As required by IRC § 163(j), the taxpayer had calculated the amount of the excess between what would have been its interest deduction under IRC § 163(a) each year without taking into account the limitation of IRC § 163(j) and the interest deduction it was permitted given that limitation. That excess amount was carried to the taxpayer's succeeding taxable years.

Upon examination and inquiry, the Government questioned whether the taxpayer was related to the foreign affiliate that had provided loans to the taxpayer. It was recently determined that the foreign affiliate from which the taxpayer had received loans was not a related party for purposes of applying the IRC § 163(j) limitation. As a result, IRC § 163(j) was not applicable to the taxpayer. Accordingly, in Z, the taxpayer was not subject to the IRC § 163(j) limitation. The Government questions whether the removal of the IRC § 163(j) limitation is a change in accounting method under IRC § 446.

LAW AND ANALYSIS

IRC § 163(a) generally permits a deduction of all interest paid or incurred within a taxable year on indebtedness.

IRC § 163(j) limits a corporation's interest deduction otherwise permitted by IRC § 163(a) in certain situations. The amount of the interest deduction that is disallowed by IRC § 163(j) each year is carried to the succeeding taxable years.

Treas. Reg. § 1.446-1(a)(1) defines the term "method of accounting" to include not only the over-all method of accounting of a taxpayer but also the accounting treatment of any item of gross income or deduction.

Treas. Reg. § 1.446-1(e)(2)(ii)(*a*) states that an accounting method change includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan of accounting. Moreover, Treas. Reg. § 1.446-1(e)(2)(ii)(*a*) provides that a material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. The key characteristic of a material item "is that it determines the timing of income or deductions." Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 798 (11th Cir. 1984).

For purposes of Treas. Reg. § 1.446-1(e)(2)(ii)(*a*), the item involved in the taxpayer's case is the taxpayer's deduction for interest on certain indebtedness. The taxpayer is not changing this item or the treatment of that item. What the taxpayer is changing is the limitation placed upon that specific item. The effect of removing the limitation is that the taxpayer would be able to recognize the full amount of the interest on certain indebtedness that is otherwise deductible under its accounting method in a given taxable year while before it was limited under IRC § 163(j) in its recognition of the item. By removing the IRC § 163(j) limitation, the taxpayer may also permanently change the amount of its taxable income over its lifetime. This is because IRC § 163(j) does not provide a mechanism that ensures that in every situation a taxpayer will enjoy the interest deductions that it had been denied in one taxable year and had been required to carry forward to succeeding taxable years. Because removing the IRC § 163(j) limitation can permanently change the taxpayer's lifetime income, the change is not merely a change in the timing of income and therefore is not a change in method of accounting. See Treas. Reg. § 1.446-1(e)(2)(ii)(*b*).

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Please contact us at 202-622-4970 if you have any further questions.