**BRIEF COMMENTARY ON THE TERM “INTEREST” UNDER SECTION 163(j) AND OTHER RECENT REGULATIONS**

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December 9, 2019

1. The proposed section 163(j) regulations[[1]](#footnote-1) proposed a new rule that would treat items of expense that were not technically “interest” on indebtedness as interest expense anyway in applying new section 163(j).
2. Among the items that were listed as not technically interest expense under the Internal Revenue Code but which were to be treated as interest expense were guaranteed payments on capital (GPUCs) under section 163(j). The proposed section 163(j) preamble explained the reason for the adoption of a broad rule that would include items such as GPUCs under section 707(c) without expressly mentioning or discussing the reasons and support for the inclusion of GPUCs as interest expense under section 163(j):

[An] option considered would have been to adopt a definition of interest but limit the scope of the definition to cover only amounts associated with conventional debt instruments and amounts that are generally treated as interest under the Code or regulations for all purposes prior to the passage of the TCJA....While this would bring clarity to many transactions regarding what would be deemed interest for the section 163(j) limitation, the Treasury Department and the IRS believe that this approach would potentially distort future financing transactions. Some taxpayers would choose to use financial instruments and transactions that provide a similar economic result to using a conventional debt instrument, but would avoid the label of interest expense under such a definition, potentially enabling these taxpayers to avoid the section 163(j) limitation without a substantive change in capital structure.

1. GPUCs have historically not been treated as interest expense or interest income for the simple reason that these payments are merely quantitatively fixed but are payable on partnership equity and not on partnership debt[[2]](#footnote-2).
2. Those authorities and arguments related thereto are not repeated here. However, it should be noted that the IRS has itself recognized the distinction between “obligations” and “indebtedness” in Revenue Ruling 95-8[[3]](#footnote-3), which is not cited in any of the regulation preambles dealing with the guaranteed payment issue and is still outstanding and effective.
3. The ruling dealt with “acquisition indebtedness” under section 514 and whether a short sale created such acquisition indebtedness. The ruling stated:

Income attributable to a short sale can be income derived from debt-financed property only if the short seller incurs acquisition indebtedness within the meaning of section 514 with respect to the property on which the short seller realizes that income. In Deputy v. du Pont, 308 U.S. 488, 497-98 (1940), 1940-1 C.B. 118, 122, the Supreme Court held that although a short sale created an obligation, it did not create indebtedness for purposes of the predecessor of section 163.

The U.S. Supreme Court stated in that seminal case that “although an indebtedness is an obligation, an obligation is not necessarily an ‘indebtedness’ within the meaning of §[163], and “In the business world ‘interest on indebtedness’ means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense.”

1. The final GILTI regulations[[4]](#footnote-4) deleted the separate definition of “interest” and deferred to the final section 163(j) regulations stating:

The Treasury Department and the IRS did not intend to create a new standard of interest solely for purposes of determining specified interest expense. [T]he Treasury Department and the IRS have determined that taxpayers and the government would benefit from the application of a single definition of interest for both [GILTI] and section 163(j) (rather than the application of two partially overlapping, but ultimately different standards). Accordingly, the final [GILTI] regulations define “interest expense” and “interest income” by reference to the definition of interest expense and interest income under section 163(j)....The regulations under section 163(j), when finalized, will address comments on the validity of the definition of interest expense and interest income that are used in those regulations. Because the final [GILTI] regulations adopt this definition for purposes of determining specified interest expense, the discussion in the regulations under section 163(j) will, by extension, address the validity of the definitions as used in these final regulations.

1. The proposed foreign tax credit regulations[[5]](#footnote-5) had this to say about the treatment of interest expense under the section 861 regulations and the treatment of “income equivalent to interest” for GPUCs under the subpart F income rules:

[T]he Treasury Department and the IRS are aware that some taxpayers may be converting existing partnership debt structures that were used to increase a taxpayer's foreign tax credit limitation before the issuance of....from partnership debt into partnership equity that provides for guaranteed payments for the use of capital. The taxpayer then takes the position that the guaranteed payments are neither allocated and apportioned under the rules in §1.861-9 nor included in subpart F income by reason of §1.954-2(h).....Guaranteed payments for the use of capital are similar to a loan from the partner to the partnership because the payment is for the use of money and is generally deductible. See section 707(c). Because these arrangements raise the same policy concerns as ordinary debt instruments, the proposed regulations revise §1.861-9(b) and §1.954-2(h)(2)(i) explicitly to provide that guaranteed payments for the use of capital described in section 707(c) are treated similarly to interest deductions for purposes of allocating and apportioning deductions under §§1.861-8 through 1.861-14 and are treated as income equivalent to interest under section 954(c)(1)(E). No inference is intended as to whether or not §1.861-9T(b) or §1.954-2(h)(2) include guaranteed payments for taxable years before the proposed regulations are applicable.

1. There were rumors floating around that the final section 163(j) regulations would not include GPUCs as interest expense. However, the recent treatment of GPUCs under the proposed foreign tax credit regulations belie that rumor. We shall see.
1. REG-106089-18, Dec. 28, 2018. [↑](#footnote-ref-1)
2. For an excellent article summarizing the state of the law on GPUCs and its treatment as interest or not as interest, see Alexandre Marcellesi, *Guaranteed Payments and Interest: Why Treasury Is Overreaching,* 165 Tax Notes Federal 1577 (Dec. 9, 2019). [↑](#footnote-ref-2)
3. 1995-1 C.B. 107. [↑](#footnote-ref-3)
4. T.D. 9866, June 21, 2019. [↑](#footnote-ref-4)
5. REG-105495-19, Dec. 2, 2019. [↑](#footnote-ref-5)