Asset Management Tax Update

Interest Deductibility Limitations
New Final and Proposed Regulations Under Section 163(j)

On July 28, 2020, the IRS and Treasury released final regulations under Section 163(j), further refining the rules related to the interest deductibility limitations imposed by the Tax Cut and Jobs Act at the end of 2017. The following are the highlights of the new guidance as it relates to the asset management industry.

With respect to trader funds, the interest limitations of Section 163(j) will no longer apply to limited partners (i.e., partners that do not materially participate in the business of the fund).

The initial set of proposed regulations under Section 163(j), published on December 28, 2018 (the “Original Proposed Regulations”), contained a statement within the preamble that it was Treasury’s view that hedge funds engaged in a trade or business (i.e., trader funds as opposed to investor funds), were subject to the business interest limitation rules of Section 163(j). The statement indicated that, to the extent the Section 163(j) limitation was applicable at the partnership level it would apply to all partners regardless of whether the partner materially participated in the activities of the partnership. Moreover, the preamble instructed that non-materially participating partners would still be subject to the investment income limitations of Section 163(d) in addition to the limitations of Section 163(j).

The final regulations take note of the many comment letters that instructed Treasury that such a view was at odds with the statute. Thus, the final regulations do not address trader funds but rather such partnerships are addressed in a new set of proposed regulations issued simultaneously with the final regulations (the “New Proposed Regulations”). The New Proposed Regulations state that Section 163(j) will apply to partners in a trader fund who are materially participating partners and that Section 163(d) will apply to those partners that do not materially participate. In essence, the New Proposed Regulations allow limited partners of a trading fund to be allocated investment interest under Section 163(d) instead of the business interest rules of Section 163(j). General partners of a trading fund, on the other hand, would be allocated business interest subject to the limitation rules of Section 163(j) at the partnership level.

The New Proposed Regulations instruct that, in order for a trading partnership to bifurcate its interest expense between investment interest and business interest, the trading partnership must bifurcate all of its other items of income, gain, loss and deduction from its trading activity between partners that materially participate in the partnership’s trading activity and partners that are passive investors. The portion of the partnership’s other items of income, gain, loss or deduction from its trading activity properly allocable to the passive investors in the partnership will not be taken into account at the partnership level as items from a trade or business for purposes of applying section 163(j) at the partnership level. Instead, all such partnership items properly allocable to passive investors will be treated as items from an investment activity of the partnership, for purposes of sections 163(j) and 163(d).

While the thrust of the proposed rule is that general partners will be subject to the business interest limitations while limited partners will be subject to the investment interest limitations, the details are more complicated. There remains an open issue as to which partners materially participate in the trading activities of the partnership. Material participation is a passive activity Section 469 concept. The New Proposed Regulations provide a proposed change for the Section 469 activity grouping rules to provide that any activity described in section 163(d)(5)(A)(ii) (i.e., trading activities) may not be grouped with any other activity of the taxpayer, including any other activity described in section 163(d)(5)(A)(ii). This rule, while intended to assist a partnership in identifying partners who materially participate (e.g., the GP), actually complicates the analysis of whether any particular GP member or employee of the management company may be considered to materially participate in a trading fund’s activity. For example, a particular portfolio manager may work on numerous funds and not spend significant time with any one fund. Absent a grouping election, such a partner may not be seen a materially participating in a fund in which such partner has trading responsibilities. This particular Section 469 proposed change will surely elicit comments to allow the final regulations to reach the correct result.

As the New Proposed Regulations do not contain any transition rule but can be applied retroactively to taxable years beginning after December 31, 2017, it’s unclear how trader funds that had a Section 163(j) limitation applied to limited partners in 2018 and/or 2019 are to proceed. It is unclear if trader funds are to file amended returns, continue to follow the Original Proposed Regulations until the excess business interest expense is released at the limited partner level, or if some other mechanic should be utilized, such as immediately releasing previously disallowed expense. Comments expressing the need for a clear transition rule will surely be submitted to Treasury.

Definition of “Interest” and Hedging Rules

The Original Proposed Regulations included an expansive definition of interest. The definition included not only traditional interest and OID but encompassed income and expense from derivative instruments that altered the yield on a fixed income asset or the cost of a borrowing. The definition also included other items which are not technically interest but are closely related to interest such as debt issuance costs, substitute payments made pursuant to securities lending or repo transactions with respect to debt instruments, as well as guaranteed payments for the use of capital. Additionally, the definition mandated the bifurcation of non-cleared swaps with significant non-periodic payments to produce a level payment swap and a loan component. Many comments were submitted criticizing the expansive definition. As a result, the final regulations adopt a more tailored definition of interest.

First, the final regulations confirm that all items traditionally treated as interest under the Code will be treated as interest income and expense for purposes of Section 163(j).

Second, the final regulations also retain the rule that substitute interest payments under securities loans and repos with respect to debt instruments will be treated as interest. However, the final regulations refine the rule such that a substitute interest payment is treated as interest only where the payment is made or received under a repo or securities lending transaction that is not entered into by the taxpayer in its ordinary course of business. This may have a dramatic effect on certain credit funds’ calculation of their net business interest income and expense. Additionally, with respect to securities loans, it should be noted that short dividend expense is treated as investment interest pursuant to Section 163(d)(3)(C). Thus, for limited partners all interest expense and short dividends will be combined into a single investment interest expense figure for K-1 reporting purposes on both trader funds and investor funds.

Third, the final regulations remove commitment fees and other fees paid in connection with lending transactions from the definition of interest.

Fourth, the final regulations remove guaranteed payments for the use of capital from the definition of interest. However, the anti-abuse rule included in the final regulations contain an example of where a guaranteed payment for capital is treated as business interest expense. Unfortunately, the example describes a common guaranteed payment situation which will make it difficult for funds to clearly identify guaranteed payment for capital situations that fall outside the anti-abuse rule. Thus, the industry will need to be cognizant of the rule and take positions to include or not include the payment as business interest.

Fifth, the hedging rule has been eliminated in the final regulations. That is, the income and expense of derivatives entered into with respect to fixed income assets and borrowings will not normally be treated as interest for purposes of Section 163(j). Again, however, the anti-abuse rule may apply in certain circumstances. It should be noted that the examples with respect to the anti-abuse rule within the definition of interest include certain hedging transactions where the taxpayer obtains the use of funds for a period of time. Even though a prerequisite for the interest expense anti-abuse rule to apply is that the taxpayer have a principal purpose of reducing what would otherwise be business interest expense, the examples may cast a broader net and should be considered in commercial hedging transactions.

Finally, the final regulations adopt the embedded loan rule for swaps with significant non-periodic payments. Importantly, the final regulations note that the treatment of such swaps applies generally and not just for purposes of Section 163(j). As such, the final regulations amend the Section 446 regulations to impose the same treatment. Note, this was the rule within Section 446 for over 20 years from 1993 until 2015. The regulations continue to excuse cleared swaps from this rule and add an exemption for non-cleared swaps that provide for margin or collateral requirements that are substantially similar to cleared swaps. Note, the final regulations delay by one year the applicability date of the embedded loan rule (although not applicable to the anti-abuse provision). As this rule within the final regulations only applies to swaps with significant non-periodic payments it will not affect the treatment of normal total return swaps. Such swaps generally have a collateral amount but no non-periodic payments. Additionally, while the typical credit default swap or “CDS” does have significant non-periodic payments, such swaps will normally be exchange cleared swaps and thus exempt from this rule.

Interest related dividends from regulated investment companies will be treated as interest income.

The New Proposed Regulations helpfully make clear that interest related dividends from regulated investment companies will be treated as interest for purposes of Section 163(j). This is a positive development for fixed income RICs and a money market funds. However, the regulations are clear that this treatment does not extend to foreign money market funds.

The treatment of upper tier partnerships has been clarified.

The New Proposed Regulations section 1.163-6(j) importantly clarifies the treatment of Section 163(j) items allocated to a partner that is a partnership. Specifically, the section clarifies the treatment of basis adjustments and excess items by the upper tier partnership. In summary, the Section 163(j) items are held at the upper tier partnership and not passed on to its partners. Any Section 163(j) limitation of the lower tier partnership (“LTP”) allocated to the upper tier partnership (“UTP”) is accounted for and tracked by the UTP. When and if excess taxable income or excess business income is allocated from the LTP to the UTP, the UTP will treat its excess business interest expense as paid or accrued. There is a tracing rule to allocate the UTP excess business interest expense to a “specified partner”, that being a UTP partner whose Section 704(b) capital account was reduced due to the initial allocation of excess business interest expense from LTP to UTP.

Effective Dates.

In general, the Final Regulations become effective 60 days after being published in the federal register. Taxpayers may apply the rules set forth in §§1.163(j)-1 through 1.163(j)-11, in their entirety, to taxable years beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply these rules. Alternatively, taxpayers may rely on the December 28, 2018 Proposed Regulations, for taxable years beginning after December 31, 2017 and before the final regulations effective date, subject to a similar consistency rule. Certain provisions, such as the rule with respect to embedded loans, have effective dates that may differ.

With respect to the Proposed Regulations, many of the provisions allow the rules to be related back to tax years beginning after December 31, 2017, but certain sections may have specific rules around applicability.

Kevin Valek
National Leader, Asset Management Tax
T: 212-872-5520
kvalek@kpmg.com

David Neuenhaus
National Institutional Investors Tax Segment Leader
T: 973-912-6348
dneuenhaus@kpmg.com

Jay Freedman
Global and National Hedge Fund Tax Segment Leader
T: 212-954-3693
jayfreedman@kpmg.com

Deborah A. Fields
Partner, Washington National Tax
T: 202-533-4580
dafields@kpmg.com

Jeff Millen
National Private Equity Tax Segment Leader
T: 212-872-4490
jmillen@kpmg.com

Sarah Staudenraus
Partner, Washington National Tax
T: 202-533-4574
sarahstaudenraus@kpmg.com

Chris Turner
National Real Estate Tax Segment Leader
T: 404-222-3334
cturner@kpmg.com

Anthony J. Tuths
Asset Management Tax Principal
T: 973-315-2640
atuths@kpmg.com

COVID-19: Reaction, Resilience, Recovery, New Reality
Visit the COVID-19 resource center for KPMG analysis, insights, and perspectives.

kpmg.com/socialmedia

Privacy | Legal

You have received this message from KPMG LLP. If you wish to unsubscribe from Alternative investment tax matters, please click here. If you wish to unsubscribe from all KPMG communications, please click here.

KPMG LLP, 3 Chestnut Ridge Road, Montvale, NJ 07645

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. NDP111156-1A

The KPMG name and logo are registered trademarks or trademarks of KPMG International.