Defending America's Small & Family Owned Businesses

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CC:PA:LPD:PR (REG-106089-18)
Room 5203
Internal Revenue Service
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Re: REG-106089-18 Relating to the Proposed Regulations under Section 163(j)

Dear Mr. Paul:

The S Corporation Association appreciates the opportunity to comment on the proposed regulations to implement Section 163(j), as amended by the Tax Cuts and Jobs Act of 2017 (TCJA).

As the background summarizes, the amended Section 163(j) "generally limits the amount of business interest expense that can be deducted… to the sum of (1) the taxpayer's business interest income for the taxable year; (2) 30 percent of the taxpayer's adjusted taxable income (ATI) for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year."

The TCJA defines ATI "as the taxable income of the taxpayer without regard to… business interest and business interest income; net operating loss deductions; and deductions for qualified business income under Section 199A. *ATI also generally excludes deductions for depreciation, amortization, and depletion with respect to taxable years beginning before January 1, 2022* and includes other adjustments provided by the Secretary of the Treasury." (Emphasis added)

Generally speaking, then, the new cap on interest deductibility is 30 percent of a taxpayer's taxable income before interest, tax, depreciation and amortization (EBITDA) in tax years 2018 through 2021, and 30 percent of a taxpayer's taxable income before interest and tax (EBIT) in tax years 2022 and beyond.

The proposed rules, however, do not follow this general approach in the case of manufacturers. This is because the rules effectively prevent taxpayers from adding back depreciation that is capitalized under Section 263A into inventory and recovered through cost of goods sold. Since manufacturers are required to capitalize to inventory their depreciation relating to investments in equipment and facilities, the rules block this depreciation from being added back to taxable income when determining ATI.

As a result, while other businesses will be subject to a cap on interest deductions equal to 30 percent of EBITDA through tax year 2021, manufacturers will be subject to a more onerous cap equal to 30 percent of EBIT beginning immediately.

Unchanged, this result is guaranteed to blindside many manufacturing businesses when they file their taxes this year. S-Corp has a number of members who are unaffected by a cap based on EBITDA, but will pay significantly higher taxes under a cap based on EBIT. This is clearly not the result Congress intended when it adopted the TCJA.

It is also unnecessary. The proposed rules are inconsistent with the clear intent of Congress in crafting changes to Section 163(j), but they are also inconsistent with prior interpretations by the IRS.

While the IRS has long made the distinction between "deductions" and "cost of goods sold" (COGS), which the IRS views as a component of gross receipts, this distinction is merely a convenience to distinguish between amounts properly includible in gross receipts versus amounts deductible as Selling, General and Administrative (SG&A) expenses for those taxpayers who maintain inventories and must allocate their costs under Section 263A. While a valuable tool for making those inventory calculations, the distinction is wholly inappropriate in the context of revised Section 163(j). ATI, as used in revised Section 163(j), was clearly modeled after the financial accounting concept of EBITDA, which is a commonly used concept in financial accounting and many debt covenants. EBITDA makes no distinction between amounts deductible through COGS versus SG&A costs, because EBITDA is utilized as a rough approximation of the cash earnings of a company and such a distinction is not meaningful in that context.

There are several indications in the Code and in prior documents published by the IRS that the distinction between COGS and SG&A costs is not always applicable. To wit:

Section 1016 provides the rules which govern adjustments to the cost basis of assets held by a taxpayer. Paragraph (a)(2) of that section provides guidance for adjusting the cost basis of a depreciable, amortizable, or depletable asset to reflect the impact of depreciation, amortization, or depletion claimed in computing taxable income. The section reads as follows: "Proper adjustment in respect of the property shall in all cases be made…in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount…allowed as deductions in computing taxable income under this subtitle….and…resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle". If the position taken by the IRS in the proposed regulations were applied to Section 1016, then the adjusted basis of a piece of manufacturing machinery would not be reduced by any portion of the depreciation claimed which is attributable under Section 263A to COGS. In that case, upon sale of the equipment, gain or loss would be calculated with no reduction for the depreciation allocated to COGS. No one seriously believes that the IRS would apply their position to achieve this result.

Section 1312 is a relief provision of the Code for situations where inconsistent treatment of an item cannot be rectified because the closing of the statute of limitations prevents adjustment of part of the transaction. The ability to use the provision is carefully proscribed to protect both the government and the taxpayer. In Section 1312(2) the law refers to a "deduction or credit which was erroneously allowed to the taxpayer." In B.C. Cook and Sons, Inc. 65 TC 422, the court denied access to the relief provisions on the theory that an adjustment to COGS was not a "deduction" as used in Section 1312(2). However, in Action on Decision 1977-77, 04/4/1977, the IRS Chief Counsel opined:

> *"The decision of the Tax Court applies an overly-literal interpretation of the word "deduction" as used in Code §1312(2). The term deduction in Code §1312(2) should be interpreted to refer to items which reduce gross income in the technical sense. This is especially true for items such as theft losses which may, at the taxpayer's option, be included in either the cost of goods or deducted from gross income."*

This same conclusion is found in a Chief Counsel's Memorandum (GLAM 2008-12) regarding the "Application of Section 172(f) to Costs included in Inventory Under Section 263A." Section 172(f) provides special net operating loss carryback rules in the case of certain specified liability losses, and Section 172(f)(1)(B)(i) used similar language in defining the eligible loss, referring to "any amount allowable as a deduction under this chapter…" Key portions of the Memorandum read:

> *"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"….*
>
> *"If Congress had intended to limit Section 172(f) so, it would have stated it explicitly….*
>
> *We conclude that Congress did not intend the phrase "allowable as a deduction" in Section 172(f)(1)(B)(i) to disqualify expenditures merely because those expenditures are allocated to inventories under Section 263A and recovered through cost of goods sold….*

Given the clear Congressional intent to incentivize manufacturers to accelerate their acquisition of productive equipment (as evidenced by the enactment of the new Section 168(k) provisions), to turn around and penalize those same taxpayers by disallowing a greater portion of the interest incurred to make such purposes is a clear frustration of Congressional intent. The IRS Chief Counsel, on at least two previous occasions, has conceded that the COGS versus SG&A distinction is not iron-clad, and the long-standing IRS practice of adjusting cost basis under Section 1016 regardless of whether the depreciation was claimed through COGS or SG&A, make it clear that there is no requirement for the IRS to take such an extreme position in these proposed regulations.

The arguments made in the AOD and the Memorandum apply to Section 163(j) and the proposed regulations. If Congress had intended to exclude from "any deduction allowable" those costs allocated to COGS, it would have said so.

The S Corporation Association appreciates the opportunity to comment on these proposed rules and welcomes additional communication on this important issue.

Sincerely,

Brian Reardon
President
S Corporation Association