

BUSINESS INTEREST DEDUCTION LIMITATION: THE NEW CODE SECTION 163(j)



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With the enactment of the Tax Cuts and Jobs Act (“Act”),¹ Congress created a new set of rules limiting business interest deductions that is expected to impact many taxpayers with outstanding debt obligations. Historically, these businesses enjoyed the benefit of deducting all of their interest expenses paid or incurred during the taxable year, subject to certain exceptions or restrictions. The Act effectively put a cap on many of those business interest deductions, particularly for highly leveraged mid-to-large sized businesses, and will require businesses to reevaluate both their business needs for debt financing and the potential additional after-tax cost of securing such debt. Moreover, as interest rates are forecasted to gradually rise, this cost-benefit analysis will have particular significance in the coming years. This article covers the basic mechanics of the new business interest deduction limitation and describes certain planning considerations businesses will face under the Act.

I. GENERAL RULE

Prior to the passage of the Act, Internal Revenue Code (“Code”) Section 163(j) included earnings stripping rules denying certain interest deductions for “disqualified interest” paid by a corporation to a related person who pays no U.S. tax such interest income. The Act repealed the earnings stripping rules and replaced

them with a new set of rules limiting the deduction of business interest expenses under amended Code Section 163(j).² Unlike the earnings stripping rules, the new business interest deduction limitation is applicable to all types of taxpayers involved in a trade or business, including partnerships, S corporations, trusts, and sole proprietorships, subject to several exceptions described below.

Effective for tax years beginning after December 31, 2017, a taxpayer’s business interest deduction for a particular tax year is limited to the sum of:

- Business interest income of the taxpayer;
- Thirty percent (30%) of the taxpayer’s adjusted taxable income; and
- The floor plan financing interest of the taxpayer.³

Thus, to the extent that a taxpayer’s business interest expense exceeds its business interest income and floor plan financing interest, the deduction for the net interest expense is limited to 30 percent (30%) of its adjusted taxable income.⁴

This limitation applies at the taxpayer level. For a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return

filing level.⁵ As discussed below, there are also special rules applicable to pass through entities.

Any amount of business interest deduction disallowed under Code Section 163(j) is treated as business interest paid or accrued in the following tax year and may be carried forward indefinitely, subject to certain restrictions on partnerships (as discussed below).⁶ In this way, interest deductions limited under Code Section 163(j) are generally deferred until the taxpayer has sufficient business interest income, adjusted taxable income, or floor plan financing interest to take the deduction. As a result, a leveraged business that suffers through a series of unsuccessful financial years may see their interest deductions limited throughout the downturn, an unfortunate outcome for some struggling businesses.

Example #1. Basic Application of the General Rule⁷

In 2018, Taxpayer A, a calendar year corporation, has \$30,000 of adjusted taxable income, \$6,000 of business interest income, \$30,000 of business interest expense, and no floor plan financing interest. On its 2018 Form 1120, A may deduct only \$15,000 of its business interest expense. That amount is equal to the sum of A's \$6,000 of business interest income plus thirty percent (30%) of its adjusted taxable income ($30\% \times \$30,000 = \$9,000$). The \$15,000 of disallowed business interest expense is carried forward indefinitely.

In 2019, A has \$100,000 of adjusted taxable income, \$12,000 of business interest income, \$40,000 of business interest expense (including the \$15,000 in disallowed interest carried forward from 2018), and no floor plan financing interest. A will be permitted to deduct all \$40,000 of the business interest expenses, which includes interest carried forward from the prior tax year, since that amount is less than the sum of A's \$12,000 of business interest income plus 30 percent of its adjusted taxable income ($30\% \times \$100,000 = \$30,000$).

II. EXCEPTIONS TO THE DEDUCTION LIMITATION⁸

A. Small Business Exemption

Under the Act, certain small businesses are exempted from the business interest deduction limitation of Code Section 163(j). A taxpayer with average annual gross receipts of \$25 million or less for the three-year period ending with the previous tax year are exempt from the interest deduction limitation for such taxable

year.⁹ This exemption eliminates the concern of most small businesses regarding the deductibility of their interest expenses, notwithstanding any other interest limitations that could otherwise apply under the Code.¹⁰

B. Electing Real Property Trade or Business

The Act also permits certain real property trade or businesses otherwise subject to the business interest deduction limitation rules to elect to avoid their application. Under Code Section 163(j)(7)(B), an "electing real property trade or business," which is defined by reference to Code Section 469(c)(7)(C) as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business, may make an irrevocable election to be exempted from the business interest deduction limitation rules.¹¹ The election is available to any taxpayer involved in such a real property trade or business, including a corporation or real estate investment trust ("REIT").¹²

However, there is a cost to a taxpayer making such election: it must thereafter depreciate its nonresidential real property, residential rental property, and qualified improvement property (certain improvements to nonresidential real property) under the alternative depreciation system ("ADS") rather than the general modified accelerated cost recovery system ("MACRS") of Code Section 168.¹³ This will require the electing real property trade or business to depreciate such property on a straight line over a longer period rather than under an accelerated method of depreciation. In some cases, the depreciation trade off may be a rather significant after-tax cost to the electing taxpayer.

Therefore, eligible real estate businesses with gross receipts in excess of \$25 million during previous tax years¹⁴ should consider whether the election to avoid the business interest deduction limitation rules provides sufficient benefit in non-deferrals of interest deductions to offset the opportunity cost of depreciating their subject property under ADS rather than general MACRS. This analysis will depend upon the types of assets the real estate business holds (i.e., whether they are a type that would be subject to ADS upon an election), the amount of debt and interest outstanding, and the taxpayer's current and projected gross receipts and adjusted taxable income.¹⁵ Furthermore,

since the election is irrevocable, real estate businesses will need to consider the long-term impact of the election as the value of the real estate market and interest rates fluctuate over time.

III. CODE SECTION 163(J) DEFINITIONS

Section 163(j), as amended by the Act, includes several definitions relevant to the interest deduction limitation rules. While a review of each of these defined terms is beyond the scope of this article, this section highlights a few of the critical definitions for purposes of the operation of the interest deduction rules.

A. “Business Interest” and “Business Interest Income”

For purposes of Code Section 163(j), “business interest” and “business interest income” mean any interest paid or accrued on indebtedness or interest includible in gross income which is properly allocable to a trade or business.¹⁶ Any amount treated as interest for purposes of the Code is interest for purposes of the interest limitation rules.¹⁷

B. “Adjusted Taxable Income”

The adjusted taxable income of a taxpayer means the taxable income of the taxpayer computed without regard to any non-trade or business related items of income or deduction, business interest or business interest income, net operating loss deductions under Code Section 172, and any deduction under Code Section 199A (for qualified business income). In addition, for the tax years beginning before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion—i.e., earnings before interest, taxes, depreciation (and depletion) and amortization (“EBITDA”).¹⁸ Unless this provision is extended by Congress, for years beginning after 2021, the amount of a taxpayer’s adjusted taxable income for purposes of Code Section 163(j) will be significantly reduced when adjusted taxable income includes a taxpayer’s earnings before only interest and taxes (“EBIT”).

As a result, a taxpayer that may not be subject to the interest limitation in the next four years because 30 percent of its EBITDA exceeds interest expenses, could find its deductions curbed in 2022 when the limit applies to 30 percent of EBIT. This will be of considerable concern to taxpayers with substantial depreciation or amortization deductions and interest expenses, including those

real property trade or businesses that decide not to make an election to avoid the application of Code Section 163(j).

C. “Floor Plan Financing Interest”

Floor plan financing interest refers to interest paid or accrued on debt used to finance the acquisition of motor vehicles, including automobiles, trucks, boats, farm machinery and equipment, and self-propelled vehicles designed for transporting people or property, held for sale or lease and secured by the inventory so acquired.¹⁹ The interest limitation rules operate to allow floor plan financing interest to be fully deductible.²⁰

IV. SPECIAL RULES FOR PARTNERSHIPS

As mentioned above, the business interest limitation rules provide special rules applicable to partnerships. The Code Section 163(j) limitation applies to partnerships at the partnership level. To prevent the partnership’s income or losses to be double counted for purposes of the interest limitation rules (i.e., counted at both the partnership and partner level), each partner’s adjusted taxable income is determined without regard to the partner’s distributive share of any of the partnership’s items of income, gain, deduction, or loss.²¹

Additionally, for purposes of the limitation rules, a partner’s adjusted taxable income is increased by its distributive share of the partnership’s “excess taxable income.” A partnership’s “excess taxable income” is the amount which bears the same ratio to the partnership’s adjusted taxable income as the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership bears to 30 percent of the adjusted taxable income of the partnership. Excess taxable income is allocated in the same manner as nonseparately stated income and loss.²²

This treatment allows a partner to deduct an additional interest expense the partner may have otherwise paid or accrued outside of the partnership to the extent the partnership could have deducted more business interest (i.e., in the event the partnership’s interest deduction is below the Code Section 163(j) limitation). Rules similar to these rules also apply to S corporations and their shareholders.²³

Example #2. Application of the Limitation in the Partnership Context

Taxpayer B, a partnership owned 50-50 by X Corporation and an individual, earns \$500 of business (non-interest) income and has \$150 of business interest expenses in 2018. B's deduction for business interest is limited to 30% of its adjusted taxable income, which is \$150 (30% x \$500). For the 2018 tax year, B deducts all \$150 of its business interest expense and reports \$350 in ordinary business income.

X's distributive share of B's ordinary business income is \$175. X has no taxable income or interest income from its business operations and incurs a business interest expense of \$50. Under the double-counting rules described above, X's adjusted taxable income is computed without regard to its \$175 distributive share of B's nonseparately stated income. Thus, X has adjusted taxable income of \$0. As a result, X may not deduct any of its \$50 in interest expenses, and instead, this amount must be carried forward as disallowed business interest.²⁴

Example #3. Partnership with Excess Taxable Income

Assume the same facts as in Exhibit #2 above except that B has only \$100 of business interest in 2018. As in Example #2, B's interest deduction limit is \$150 and the excess of this limit over B's business interest is \$50 (\$150 - \$100). Therefore, B's "excess taxable income" is \$166.67 $[(\$50 \div \$150) \times \$500]$. X's distributive share of the excess taxable income from B is \$83.33 (50% of \$166.67). In this scenario, X's deduction for business interest is limited to 30 percent of the sum of its adjusted taxable income plus its \$25 distributive share of the excess taxable income from B $[30\% \times (\$0 + \$83.33)]$. Thus, X may deduct \$25 of business interest and has an interest deduction disallowance of \$25.²⁵

A. Carryforwards of Disallowed Partnership Interest

Code Section 163(j) also contains a special set of rules for dealing with the carryforward of disallowed

partnership interest. Under this provision, any business interest that is not deductible by a partnership for any tax year because of the business interest limitation is treated as excess business interest that is allocated to each partner in the same manner as the partnership's nonseparately stated taxable income or loss under Code Section 163(j)(4)(B)(i)(II).

A partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership that threw off the excess business interest carryforward.²⁶ Any such deduction requires a corresponding reduction in excess taxable income.²⁷

B. Basis Adjustments for Partners

Any excess business interest allocated to a partner reduces that partner's adjusted basis in its partnership interest (but not below zero).²⁸ In the event a partner disposes of a partnership interest, then the partner's adjusted basis in the partnership interest is increased immediately before the disposition by any excess of the amount of the basis reduction over the part of any excess business interest allocated to the partner that has previously been treated as business interest paid or accrued by the partner.²⁹

V. CONCLUSION

In light of the new business interest limitation rules, businesses will now need to examine whether borrowing money is a cost-efficient means to raising funds. Under Code Section 163(j), debt financing may become more expensive for highly leveraged businesses subject to the limitation. This could be of critical concern to private equity funds that historically preferred to utilize third party debt to fund acquisitions and certain real estate trade or businesses. Tax advisors and financial decision-makers for all businesses impacted by the new businesses interest limitation rules will need to work in conjunction to determine the true after tax cost of borrowing under the Act. 🍂

Notes

- 1 H.R. 1, Pub. L. No. 115-97.
- 2 Section 13301 of the Act. All references to Code Sections in this article are to the Code Sections as amended by the Act except as otherwise indicated.
- 3 Code Section 163(j)(1)(A)-(B). The amount of the taxpayer's adjusted taxable income cannot be less than zero for purposes of the deduction limitation.
- 4 Conference Rep't 115-466, 387 (Dec. 15, 2017). See below for a discussion of the key definitions for purposes of this limitation rule.
- 5 Conference Rep't 115-466, 386 (Dec. 15, 2017).
- 6 Code Section 163(j)(2). This carryforward is similar to the carryforward available for net operating losses, except that

- with respect to the Code Section 163(j) interest deduction limitation the carryforward period is indefinite.
- 7 In each example provided in this article it is assumed that the taxpayer is subject to the interest limitation rules and ineligible for any of the Code Section 163(j) exceptions.
 - 8 In addition to the exceptions described below, the Act also excludes from the application of the business interest deduction limitation rules the trade or business of performing services as an employee, an electing farming business and certain trades or businesses of regulated public utilities. A discussion of those exceptions is beyond the scope of this article. See Code Section 163(j)(7)(A).
 - 9 Code Section 163(j)(3) references the gross receipts test of Code Section 448(c) for purposes of determining eligibility for the small business exemption. For a taxpayer other than a corporation or partnership, the Code Section 448(c) gross receipts test is applied in the same manner as if the taxpayer were a corporation or partnership. Additionally, the small business exemption does not apply to tax shelters prohibited from using the cash method of accounting under Code Section 448(a)(3).
 - 10 See, e.g., Code Sections 163(e)(5) (original issue discount), 163(f) (unregistered debt obligations), 163(g) (issuance of mortgage credit certificate), 163(h) (personal interest), 264 (certain life insurance contracts), 265 (relating to tax-exempt income), and 263A and 461(g) (requiring capitalization).
 - 11 Code Section 163(j)(7)(B) does not indicate the time and manner for making such an election. It is anticipated that the Internal Revenue Service (IRS) will provide guidance regarding the mechanics of the election and operation of Code Section 163(j).
 - 12 Conference Rep't 115-466, fn. 697 (Dec. 15, 2017).
 - 13 Code Sections 168(g)(1)(F) and 168(g)(8), as amended by Section 13204(a)(3) of the Act.
 - 14 A real estate trade or businesses with gross receipts falling below the threshold for the small business exemption would be advised to refrain from making the election to be treated as an "electing real property trade or business" as they are already exempt from the application of Code Section 163(j) (1).
 - 15 Eligible taxpayers should also consider that, effective after December 31, 2021, the determination of "adjusted gross income" for purposes of Code Section 163(j) will include a taxpayer's earnings before interest and taxes but not depreciation, depletion, or amortization, as discussed below.
 - 16 Code Sections 163(j)(5), 163(j)(6).
 - 17 Conference Rep't 115-466, 386 (Dec. 15, 2017). Note that business interest does not include investment interest or investment income within the meaning of Code Section 163(d), which is applicable to non-C corporations. Therefore, interest income and interest expense of a corporation is properly allocable to a trade or business, unless the trade or business is otherwise specifically excluded. *Id.* at fn. 688.
 - 18 Code Section 163(j)(8).
 - 19 Code Section 163(j)(9).
 - 20 Conference Rep't 115-466, 387 (Dec. 15, 2017).
 - 21 Code Section 163(j)(4)(A)(ii)(I); Conference Rep't 115-466, 390 (Dec. 15, 2017).
 - 22 Conference Rep't 115-466, 390 (Dec. 15, 2017).
 - 23 Code Section 163(j)(4)(D). However, the rules discussed below regarding the carryforward of disallowed partnership interest and the partnership basis adjustments do not apply in the S corporation context.
 - 24 See Conference Rep't 115-466, 388 Example 1 (Dec. 15, 2017). In the absence of a double-counting rule, the \$175 of taxable income from X's distributive share of B's income would allow X to deduct up to an additional \$52.50 of interest (30% x \$175). This would generate \$127.50 of interest deductions, well in excess of the intended 30 percent limitation. The Congressional Report also cautioned that, if X were a pass-through entity rather than a corporation, additional deductions might be available to its partners as well, and so on.
 - 25 *Id.* Example 2.
 - 26 Conference Rep't 115-466, 391 (Dec. 15, 2017).
 - 27 It should also be noted that excess taxable income allocated to a partner from a partnership for any tax year is not taken into account for any business interest the partner may have other than excess business interest from the partnership until all of the excess business interest for that tax year and all preceding tax years has been treated as paid or accrued. Code Section 163(j)(4)(B)(ii).
 - 28 This is true even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest. Conference Rep't 115-466, 391 (Dec. 15, 2017).
 - 29 *Id.* See Code Sec. 163(j)(4)(B)(iii)(II). The Act also included certain rules regarding the treatment of interest carryovers in corporate transactions, including distributions or transfers in Code Section 332 liquidations or for certain transfers under Code Section 361. See Code Sec. 381(c)(20), as amended by Section 13301(b)(1) of the Act.