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Decoding the Tax Cuts and Jobs Act – Part V: Changes to IRC §163(j) and the Business Interest Deduction Rules

By Larry Brant and Steven Nofziger on 2.6.18 | Posted in Legislation, Tax Laws, Tax Planning, Tax Procedure

"Neither a borrower nor a lender be..." or at least, if you insist on borrowing (and we understand the appeal), we are here to help you stay abreast of the new rules on deducting interest.

BACKGROUND/PRIOR LAW

Interest on a business or investment related debt is, in most instances, a deductible expense of the borrower and taxed as income to the lender. With a few exceptions, such as mortgage interest on a personal residence, borrowers generally cannot deduct personal interest. A borrower's deduction is subject to a number of limitations set forth in Code Section 163. The Tax Cuts and Jobs Act ("TCJA") has changed some of these limitations.

Before the enactment of the TCJA, nondeductible interest included any interest on a taxpayer's debt ***not*** arising from a trade or business, home mortgage, investment activity, or qualified student loans (in other words, interest arising from those debts was deductible).

Code Section 163 permitted corporations—only corporations—to deduct interest paid or accrued on debts related to their trades or businesses. Historically, some corporations used to take advantage of this deduction through "earnings stripping" as a means of reducing taxable income: They would borrow from related taxpayers who were not subject to U.S. taxes. These corporations would then deduct their interest payments, but the related lenders would not pay tax on the corresponding interest income.

Code Section 163(j), enacted in 1989, curbed this activity by disallowing the interest deduction for certain interest payments, including interest paid or accrued to related parties not subject to federal income tax on the interest income, and to unrelated parties in instances where a related party guaranteed the debt.

Code Section 163(j) also disallowed a deduction if two tests were met: a safe harbor test and debt-to-income ratio test. The safe harbor test was whether the borrower had more than 1.5 times debt to equity. The ratio test was whether the borrower's net interest expense exceeded

50 percent of its adjusted taxable income. In applying the ratio test, adjusted taxable income was computed without regard to deductions for net interest expense, net operating losses, domestic production activities under Code Section 199 (now repealed), depreciation, amortization and depletion.

TAX CUTS AND JOBS ACT

Limitation

The TCJA overhauled Code Section 163(j). Starting in tax year 2018, taxpayers, regardless of the type of business entity, may deduct net business interest expenses (not including interest paid on investments). However, the deduction is generally limited to 30 percent of the taxpayer's "adjusted taxable income," plus the amount of any business interest income and floor plan financing interest. The 30-percent limit (the "business interest limitation") is generally calculated at the taxpayer level. For these purposes, floor plan financing interest is interest used to finance an inventory of motor vehicles held for lease or sale and secured by the acquired inventory.

Adjusted Taxable Income

Both the House and Senate agreed on limiting the business interest deduction to 30 percent of a taxpayer's income, but they disagreed on how to calculate taxpayer income. The House wanted taxpayer income to be based on a broader EBITDA-type definition that took into account earnings without regard for depreciation, amortization or depletion. The Senate wanted a narrower EBIT-type definition that did not add back any deductions allowable for depreciation, amortization or depletion. The Senate's definition of taxpayer income, of course, would result in a lower amount of income, and therefore a smaller deduction. The resulting law was a compromise.

Under the TCJA, the business interest limitation is determined by calculating "adjusted taxable income," which is defined as the taxable income of the taxpayer without regard to:

- Items of income, gain, deduction or loss not allocable to a trade or business;
- Any business interest or business interest income;
- Any net operating loss deduction;
- Any "pass-through" deduction under Code Section 199A; and
- For tax years commencing prior to January 1, 2022, any depreciation, amortization or depletion deductions.

The final bullet item was the compromise between the House and Senate. Under this definition, “adjusted taxable income” is determined in a manner similar to EBIDTA for tax years beginning prior to January 1, 2022, and it is determined in a manner similar to EBIT for tax years beginning on or after January 1, 2022. Thus, for tax years 2022 and later, a narrower definition is used, which, everything being equal, will generally result in a smaller interest deduction.

For example, prior to 2022, a taxpayer with $100,000 of net income, $100,000 of business interest expenses and $200,000 of depreciation deductions would be limited to a deduction of $90,000.[1] However starting in 2022, the taxpayer’s business interest deduction would drop to $30,000,[2] since the taxpayer’s “adjusted taxable income” would no longer include the add-back for depreciation.

General Carryforward Rules

The amount of any business interest in excess of the business interest limitations (*i.e.,* amounts exceeding 30 percent of adjusted taxable income) is carried forward and treated as business interest paid or accrued in the following tax year. Code Section 163(j) does not limit how far into the future amounts can be carried forward. Absent regulatory guidance, it appears that such amounts can be carried forward indefinitely, though it will be interesting to see what Treasury says on that point.

Special Rules for Partnerships and S Corporations

<u>Carryforward Framework for Partnerships and S Corporations</u>

Special rules apply to partnerships and S corporations. For one, the business interest limitation is calculated at the entity level for both of these types of entities, and the allowable deduction for interest under the new rule is included in the owners’ non-separately stated taxable income or loss. To prevent the double counting of income at the owner level, the owners of a partnership or S corporation ignore their share of the entity’s tax items for purposes of applying the limitation to the owner. The owners then increase their share of the adjusted taxable income of the entity by their respective shares of the “excess taxable income[3]” of the entity (i.e., the owners’ share of the additional interest expense that the entity could have deducted under the new rule).

<u>Special Partnership Carryforward and Basis Adjustment Rules</u>

With respect to carryforwards for partnerships, but not S corporations, Code Section 163(j) provides that business interest in excess of the deduction limitation (i.e., “excess business interest”) is allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership (rather than being treated as business interest paid or accrued by the partnership in the following tax year). Like the general carryforward rule

(discussed above), this rule does not impose any time restrictions on how far into the future carryforwards are permitted. The partner may deduct his or her share of the partnership's excess business interest in future years, but only against excess taxable income allocated to the partner arising out of the partnership's activities giving rise to the excess business interest carryforward.

There are also corresponding basis adjustments with unusual timing issues. When excess business interest is allocated to a partner, the partner's outside basis in the partnership interest is reduced (but not below zero) by the amount allocated. This is the case, even though the carryforward does not give rise to a deduction in the year of the basis adjustment. The partner's deduction of the interest carryforward in a future year does not, however, cause a basis adjustment. Upon a disposition of the partnership interest, the partner must increase his or her outside basis immediately before the disposition by the amount of any excess business interest that previously led to a basis reduction under the foregoing rule, but which has not yet been deducted by the partner. This adjustment brings the partner's basis back to the level it would have been had it not been reduced in excess of the amount of business interest deductions.

As noted above, these carryforward and basis adjustment rules do not apply to S corporations. Interestingly, they apply to nonrecognition dispositions of partnership interests.

Silence on Dispositions

The carryforward rules are silent on what happens when a partner or shareholder terminates his or her interest in the entity before utilizing the full amount of her excess business interest carried forward. Presumably it remains a personal tax attribute, and he or she can continue to deduct it after the termination; though we welcome additional guidance from Treasury. Meanwhile, affected partners and shareholders considering termination should take note of this uncertainty in their plans.

Exemptions and Carve-Outs

There is an exemption to the business interest limitation for qualifying "small businesses," that is, taxpayers whose annual gross receipts average less than $25 million. The average is calculated based on earnings in the three tax years prior to the current year, so some taxpayers may need to reassess whether they qualify annually. If a business has average annual gross receipts of less than $25 million, it will not be subject to the new Code Section 163(j) limitation.

The business interest limitation applies only to interest paid in carrying on a qualifying trade or business. The term "trade or business" is not specifically defined for this purpose; rather, Code Section 163(j) simply contains a list of what activities do not constitute a qualifying trade or business. For example, performing services as an employee does not constitute a trade or

business. Hopefully, the impending Treasury Regulations will shed more light on the term "trade or business."

Real property and farming businesses can opt out of the new limitation if they use the Alternative Depreciation System (ADS) to depreciate certain property used in their businesses.

Also, certain business activities related to utilities are excluded from the new Code Section 163 (j) limitation, including the sale of electrical energy, water, or sewage disposal services; gas or steam by a local distribution system; or transporting gas or steam by a pipeline.

The Good, The Bad and The Ugly

New Code Section 163(j) brings taxpayers the good, bad and the ugly. The **good** is that taxpayers still may deduct (albeit limited) interest arising from a trade or business. The **bad** is that taxpayers are now more limited in the deductibility of the interest incurred in their trade or business, and that limitation further reduces the deduction in tax years 2022 and later due to the change from an EBITDA-like to an EBIT-like approach in defining "adjusted taxable income." The **ugly** is the potential unintended consequences of the interplay between Section 163(j) and other Code Sections. For example, for tax years beginning in 2022, if a taxpayer takes advantage of new Code Section 168(k) (before it phases out), and receives 100 percent immediate expensing (first year depreciation) resulting from qualified capital purchases, its adjusted taxable income for purposes of applying Code Section 163(j) will be lower (because the amount of the Code Section 168(k) expense is not added back to adjusted taxable income under the EBIT-like approach) and the corresponding interest deduction ceiling will be lower. While that result seems logical, it may be unexpected. Careful attention is required.

Highly leveraged taxpayers (other than auto dealers) may wish to reduce their debt loads or change their capital structure to decrease their debt and increase their equity so that they are not affected (or not affected to as great an extent) by the limitation. In a low interest rate environment, the 30 percent limitation may not have as great an impact, but if interest rates begin to rise, highly leveraged businesses with variable-rate debt obligations may be significantly impacted.

Similarly, taxpayers expecting to make large capital investments may wish to do so in the near future, so they can take advantage of the depreciation add-backs under the definition of "adjusted taxable income" that exists prior to 2022. For example, a taxpayer can now purchase a $100,000 of business equipment and take advantage of an increased $100,000 depreciation add-back due to the allowed immediate-expensing under Code Section 168(k), thus resulting in a $30,000 single-year increase to the business interest limitation under Code Section 163(j). However, after 2022, a taxpayer making the same capital investment would not get the benefit of the increased interest deduction limitation arising out of the depreciation deduction.

CONCLUSION

In *Hamlet*, Polonius cautioned never to borrow or lend, “for loan oft loses both itself and friend.” Those are not the only potential downsides to borrowing and lending: poor tax planning and compliance can lead to problems with the IRS. Nonetheless, both borrowing and lending can create opportunities if done right. Were Polonius to receive a brief synopsis of the TCJA, he might instead caution modern audiences never to borrow or lend without first consulting their tax advisor.

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[1] Deduction = Adjusted taxable income of $300,000 x 30 percent.

[2] Deduction = Adjusted taxable income of $100,000 x 30 percent.

[3] “Excess taxable income” is defined as the amount which bears the same ratio to the entity’s adjusted taxable income as:

- (i) the excess (if any) of:
  - (I) 30 percent of the entity’s adjusted taxable income, over
  - (II) the amount (if any) by which the entity’s business interest, reduced by floor plan financing interest, exceeds the business interest income of the entity, bears to
- (ii) 30 percent of the entity’s adjusted taxable income.

Tags: Adjusted Taxable Income, business deductions, Business interest, Business Interest Deduction, carryforwards, Carve-outs, Decoding the Tax Cuts and Jobs Act, deductions, Depreciation, Internal Revenue Code, Internal Revenue Service, IRC §163(j), IRS, limitations, Tax Cuts and Jobs Act, Tax Exemption