BUSINESS DEDUCTIONS

¶510 Limitation on Deduction of Business Interest

NEW LAW EXPLAINED

Limitation on deduction of business interest for all taxpayers.—The deduction of interest paid or accrued on a debt incurred in a trade or business is limited regardless of the form the taxpayer's business is organized (i.e., corporation, partnership, sole proprietorship, etc.) effective for tax years beginning after December 31, 2017 (Code Sec. 163(j), as amended by the Tax Cuts and Jobs Act). An exception to the limitation is provided for a small business with average gross receipts of $25 million or less. Any interest not deductible generally may be carried forward indefinitely to succeeding tax years, subject to certain restrictions for partnerships and S corporations.

COMMENT

The limitation on the deduction of business interest, along with the reduction of income tax rates for corporation (¶305) and the business income deduction for passthrough entities (¶330), helps to reduce the differences in marginal tax rates based on different sources of financing and in the choice of business entities.

Limitation on business interest. The deduction for business interest for any taxpayer is limited in any tax year to the sum of:

- business interest income of the taxpayer for the tax year;
- 30 percent of the taxpayer's adjusted taxable income for the year, including any increases in adjusted taxable income as a result of a distributive share in a partnership or S corporation (discussed below), but not below zero; and
- floor plan financing interest of the taxpayer for the tax year (Code Sec. 163(j)(1), as added by the 2017 Tax Cuts Act).

COMMENT

The practical effect of the rule is to limit the deduction of net interest expenses to 30 percent of the taxpayer's adjusted taxable income. The deduction for business interest and floor plan financing interest is permitted to full extent of business interest income and floor plan financing interest. If the taxpayer has any interest expenses that exceed these amounts, then the deduction is limited to 30 percent of adjusted taxable income.

Business interest. Business interest for purposes of the limitation means any interest paid or accrued on debt properly allocable to a trade or business of the taxpayer (Code Sec. 163(j)(5), as added by the 2017 Tax Cuts Act). It does not include any investment interest. Business interest income is the amount of interest includible in the taxpayer's gross income for the tax year that is properly allocable to a trade or business (Code Sec. 163(j)(6), as added by the 2017 Tax Cuts Act). It does not include any investment income. Investment interest and investment income in this context has the same meaning as for the limitation on the deduction of interest by taxpayers other than corporations.

COMMENT

Investment interest is interest allocable to property that produces interest, dividends, annuities, royalties, gains, or losses not derived in the ordinary course of a trade or business. It also includes interest in a trade or business activity that is not a passive activity and in which the taxpayer does not materially participate. Investment income is the gross income derived from property held for investment purposes or from its disposition (Code Sec. 163(d)).

Adjusted taxable income. The adjusted taxable income of a taxpayer for purposes of the limitation is the taxpayer's regular taxable income computed without regard to:

- any item of income, gain, deduction, or loss that is not properly allocable to a trade or business;
- any business interest or business interest income;
- the amount of any net operating loss (NOL) deduction;
- the 23-percent deduction for qualified business income of a passthrough entity under Code Sec. 199A (see ¶330); and
- in tax years beginning before January 1, 2022, and allowable deduction for depreciation, amortization, or depletion (Code Sec. 163(j)(8), as added by the 2017 Tax Cuts Act).

COMMENT

The IRS is authorized to provide other adjustments to the computation of adjusted taxable income as it deems necessary.

Floor plan financing indebtedness. Floor plan financing interest is interest paid or accrued on debt use to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory (Code Sec. 163(j)(9), as added by the 2017 Tax Cuts Act). A motor vehicle for this purpose includes any self-propelled vehicle designed for transporting people or property on a public street, highway, or road, as well as a boat, and farm machinery or equipment

COMMENT

Any property used in a trade or business that has had floor plan financing indebtedness is not qualified property (¶410) eligible for the additional first-year depreciation deduction (bonus depreciation) if the floor plan financing interest to the debt is taken into account for purposes of the business interest deduction limitation (Code Sec. 168(k)(9), as added by the 2017 Tax Cuts Act).

Trade or business. A trade or business for purposes of calculating the business interest deduction limitation does not include the performance of services as an employee (Code Sec. 163(j)(7)(A)(i), as added by the 2017 Tax Cuts Act). Thus, wages of an employee are not included as part of the taxpayer's adjusted taxable income.

A taxpayer may also elect to exclude from the limitation any real property trade or business as defined under the passive activity rules (Code Sec. 163(j)(7)(A)(ii) and (B), as added by the 2017 Tax Cuts Act). An electing real property trade or business is any real estate development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Thus, interest expenses paid or accrued in the electing real property trade or business is not business interest subject to the limitation. The election is made at a time and manner as provided by the IRS. Once made, the election is irrevocable.

COMMENT

Under the passive activity rules, the way in which a taxpayer otherwise groups activities does not control the determination of the taxpayer's real property trades or businesses (Reg. §1.469-9(d)).

COMMENT

If a taxpayer elects to exclude a real property trade or business from the business interest limitation, then the business must use the alternative depreciation system (ADS) for certain property (Code Secs. 163(j)(10)(A) and 168(g)(1)(F), as added by the 2017 Tax Cuts Act). This includes any nonresidential real property, residential rental property, and qualified improvement property (¶405) held by the electing real property trade or business (Code Sec. 168(g)(8), as added by the 2017 Tax Cuts Act).

Similarly, a taxpayer may elect to exclude from the limitation any farming business as defined under the uniform capitalization rules, as well as any trade or business of a specified agricultural or horticultural cooperative that makes the election (Code Sec. 163(j)(7)(A)(iii) and (C), as added by the 2017 Tax Cuts Act). An electing farming business is any trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. It also includes a trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (an evergreen tree that is more than six years old at the time it is severed from the roots is not an ornamental tree). Interest expenses paid or accrued in a an electing farming business is not business interest subject to the limitation. The election is made at a time and manner as provided by the IRS. Once made, the election is irrevocable.

COMMENT

If a taxpayer elects to exclude a farming business from the business interest limitation, then the business must use the alternative depreciation system (ADS) for any property with a recovery period of 10 years or more (Code Secs. 163(j)(10)(B) and 168(g)(1)(G), as added by the 2017 Tax Cuts Act).

A trade or business for purposes of the limitation does not include the furnishing or sale of a public utility if the rates for the utility are established or approved by a State, political subdivision of a State, agency or instrumentality of the United States, public service or public utility commission, or governing or ratemaking body of an elective cooperative (Code Sec. 163(j)(7)(A)(iv), as added by the 2017 Tax Cuts Act). A regulated public utility includes the trade or business of furnishing or sale of: (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline.

COMMENT

Any property primarily used the trade or business of a regulated utility and electric cooperative as described above is not qualified property (¶410) eligible for the additional first-year depreciation deduction (bonus depreciation) (Code Sec. 168(k)(9), as added the 2017 Tax Cuts Act).

COMMENT

The limitation on the deduction of business interest is intended to apply after the application of other limitations on interest. For example, the Code Sec. 163(j) limitation applies to interest that is required to be deferred if paid on an original issue discount (OID) high-yield obligation. The business interest limitation also applies after application of the capitalization rules (House Committee Report for the Tax Cuts and Jobs Act (P.L. 115-97) (H.R. Rep. No. 115-409).

Small business exception. The limitation on the deduction of business interest does not apply to any taxpayer that meets the $25 million gross receipts test for a corporation or partnership under Code Sec. 448(c) to use the cash method of accounting after 2017 (Code Sec. 163(j)(3), as added by the 2017 Tax Cuts Act). A taxpayer meets the small business test for the tax year if its average annual gross receipts for the three tax years ending with the prior tax year do not exceed $25 million, adjusted for inflation after 2018 (¶570). In the case of a taxpayer that is not a corporation or partnership, the gross receipts test is applied in the same manner as if the taxpayer were a corporation or partner. The small business exception is not available to tax shelter.

Carryforward of disallowed business interest. Any business interest not allowed as a deduction for the tax year under these rules may be carried forward and treated as business interest paid or accrued in the succeeding tax year (Code Sec. 163(j)(2), as added by the 2017 Tax Cuts Act). The interest may be carried forward indefinitely, subject to certain restrictions for partnerships and S corporations (discussed below).

In the case of a nontaxable acquisition or liquidation of a corporation under Code Sec. 381, the acquiring corporation generally succeeds to any carryover of disallowed business interest to tax years ending after the date of distribution or transfer (Code Sec. 381(c)(20), as added by the 2017 Tax Cuts Act). Similarly, the amount of any pre-change loss of a loss corporation (i.e., target corporation) that may be used to offset post-change taxable income of an acquiring corporation includes the carryover of disallowed business interest to the tax year ending with the ownership change or in which the change date occurs (Code Sec. 382(d)(3), as added by the 2017 Tax Cuts Act). A loss corporation for this purpose includes any corporation with carryforwards of disallowed business interest deductions (Code Sec. 382(k)(1), as amended by the 2017 Tax Cuts Act).

Application to partnerships and S corporations. In the case of a partnership or S corporation, the limitation on the deduction of business interest is applied at the entity level. Any deduction for business interest is taken into account in determining the non-separately stated taxable income or loss of the partnership or S corporation (Code Sec. 163(j)(4)(A)(i) and (D), as added by the 2017 Tax Cuts Act). While any business interest not deductible generally may be carried forward indefinitely to succeeding tax years, restrictions apply for partnerships and S corporations (discussed below).

The adjusted taxable income of each partner or shareholder is determined without regard to the partner's or shareholder's distributive share of any item of income, gain, deduction, or loss of the partnership or S corporation (Code Sec. 163(j)(4)(A)(ii)(I) and (D), as added by the 2017 Tax Cuts Act). This prevents doubled counting of the same dollars used in the adjusted taxable income of the entity generating addition interest deductions passed through to the partners or shareholders.

EXAMPLE 1

The ABC partnership is owned equally by XYZ, Inc. and an individual. ABC generates $200 of noninterest during the tax year, but its only expense is $60 of business interest. Its deduction for business interest is limited to $60 (30 percent of its adjusted taxable income of $200). ABC deducts $60 of business interest and reports ordinary business income of $140.

XYZ's distributive share of ordinary business income of ABC is $70. It has no taxable income from its other operations and $25 of business interest expenses. XYZ's adjusted taxable income for the year is computed without regard to the $70 distributive share of the non-separately stated income of ABC. As a result, XYZ has adjusted taxable income of $0 and its deduction for business interest is limited to $0 (30 percent of adjusted taxable income of $0). The $25 of business interest expenses may not be deducted for the tax year, but may be carried forward for up to five years.

In the absence of the double counting rule, XYZ's adjusted taxable income for the year would include the $70 distributive share of the non-separately stated income of ABC. Its deduction for business interest would be limited to $21 (30 percent of adjusted taxable income of $70), resulting in a disallowance of only $4. Thus, XYZ's share of ABC's adjusted taxable income ($100) would generate $51 of interest deduction ($21 deduction for XYZ, plus $30 from distributive share of ABCs' deduction). If XYZ were a passthrough entity rather than a C corporation, additional deductions could be available at each tier.

If a partnership or S corporation has an excess taxable income for purposes of the deduction limit, then the excess is passed through to the partners or shareholders. Specifically, the adjusted taxable income of each partner or shareholder is increased by the partner's or shareholder's distributive share of the entity's excess taxable income (Code Sec. 163(j)(4)(A)(ii)(II) and (D), as added by the 2017 Tax Cuts Act). A partner's or shareholder's distributive share of partnership excess taxable income is determined in the same manner as the partner's or shareholder's distributive share of non-separately stated taxable income or loss of the entity.

The excess taxable income of a partnership or S corporation is a percentage of the entity's adjusted taxable income for the year (Code Sec. 163(j)(4)(C) and (D), as added by the 2017 Tax Cuts Act). The percentage is:

- 30 percent of the entity's adjusted taxable income, over its net excess business interest (the excess of business interest of the entity, reduced by floor plan financing interest, over business interest income; over
- 30 percent of the entity's adjusted taxable income.

This addition to a partner's or shareholder's adjusted taxable income, allows them to deduct more interest than they may have paid or incurred during the year, to the extent the entity could have deducted more business interest.

EXAMPLE 2

Assume the same facts as in Example 1 above, except that the ABC partnership has only $40 of business interest for the tax year. Its limit on its interest deduction is $60 for the year. Thus, the excess amount for ABC is $20 ($60 - $40). The excess taxable income for ABC is $66.67 (($20/$60) × $200) and XYZ's distributive share is $33.33. XYZ's deduction for business interest is limited to 30 percent of the sum of its adjusted taxable income plus its distributive share of the excess taxable income from ABC partnership is $10 (30 percent × ($0 + $33.33). As a result of the rule, XYZ may deduct $10 of business interest and has an interest deduction disallowance of $15.

Carryforwards for partnerships and S corporations. Unlike other taxpayers, any disallowed interest of a partnership or S corporation is not carried forward to the succeeding tax year. Instead, the disallowed interest of the entity is treated as excess business interest that is allocated to each partner or shareholder in the same manner as any non-separately state taxable income or loss (Code Sec. 163(j)(4)(B)(i) and (D), as added by the 2017 Tax Cuts Act).

The allocated excess business interest for the current tax year is treated by the partner or shareholder as business interest paid or accrued by the partner or shareholder in the next succeeding year. In other words, the allocated excess business interest is carried forward to next succeeding tax year by the partner or shareholder but only to the extent the partner or shareholder is allocated excess taxable income from the entity in the succeeding year (Code Sec. 163(j)(4)(B)(ii)(I) and (D), as added by the 2017 Tax Cuts Act). Excess taxable income allocated to a partner or shareholder for any tax year must be used against excess business interest from the entity from all tax years before it may be used against any other business interest.

If the partner or shareholder does not have enough excess taxable income from the entity to offset the carried forward excess business interest, then the interest must continue to be carried forward to succeeding tax years (Code Sec. 163(j)(4)(B)(ii)(II) and (D), as added by the 2017 Tax Cuts Act). In all subsequent tax years, the excess business interest carried forward by the partner or shareholder is treated as paid or accrued in the next subsequent tax year that may only be used against excess taxable income allocated by the entity to the partner or shareholder for that tax year.

The adjusted basis of a partner's or shareholder's interest in the entity is reduced (but not below zero) by the amount of excess business interest allocated by the entity to the partner or shareholder (Code Sec. 163(4)(B)(iii)(I) and (D), as added by the 2017 Tax Cuts Act). However, if the partner or shareholder sells or otherwise disposes of the interest in the partnership or S corporation, then their adjusted basis is increased immediately before the disposition by the excess (if any) of:

- the amount of the basis reduction due to the excess business interest allocated by the entity to the partner or shareholder, over

- any portion of the excess business interest allocated to the partner or shareholder which has previously been treated as interest paid or accrued by the partner (Code Sec. 163(4)(B)(iii)(I) and (D), as added by the 2017 Tax Cuts Act).

A disposition for purposes of an increase in the adjusted basis of a partnership or S corporation interest includes any transactions in which gain is not recognized in whole or part (including the death of the partner of shareholder). Also, no deduction is allowed to the transferor or transferee for any excess business interest that increases the adjusted basis in the entity.

Effective date. The amendments made by this section generally apply to tax years beginning after December 31, 2017 (Act Sec. 13301(c) of the Tax Cuts and Jobs Act).