



Limitation on Deduction of Business Interest Expense

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The 2017 tax act signed into law on December 22, 2017 imposes a broad limit on the deductibility of business interest expense for tax years beginning in 2018 and later, which may result in increased tax liability for corporations and investors in pass-through businesses that finance acquisitions with debt.

For purposes of the limitation on the deduction of business interest expense, “interest” also includes substitute interest payments, debt issuance costs, loan commitment fees, certain amounts that affect the economic cost of funds or yield of a borrowing or an interest-generating asset, and certain amounts predominantly associated with the time value of money.

If the business interest limitation applies to any of your businesses, then the amount of business interest expense that you may deduct is limited to the sum of: (1) 30% of adjusted taxable income; plus (2) 100% of

business interest income; plus (3) 100% of floor plan financing interest.

For tax years beginning in 2018 through 2021, adjusted taxable income (ATI) is computed by starting with your taxable income for the tax year (disregarding the business interest limitation), and then adding to it and subtracting from it the following amounts:

Add to Taxable Income:

- business interest expense;
- net operating loss deduction;
- deduction for qualified business income;
- depreciation, amortization, or depletion deduction;
- capital loss carrybacks or carryovers;

and

• any deduction or loss not properly allocable to a non-excepted trade or business.

Subtract from Taxable Income:

- business interest income;
- floor plan financing interest expense;

- the lesser of (i) gain realized on sale or disposition of property or (ii) deductions for depreciation, amortization or depletion taken for such property during a tax year beginning after 2017 (and similar adjustments for sales or dispositions of property held by a partnership or member of a consolidated group upon the sale or other disposition of the partnership interest or stock of the member); and
- any income or gain that is not properly allocable to a non-excepted trade or business.

For tax years beginning in 2022 and later, deductions for depreciation, amortization, or depletion are not taken into account in computing ATI.

Special rules and other adjustments apply to certain types of taxpayers when computing ATI.

Business interest expense does not include investment interest expense. However, all interest income and all interest expense of a C corporation (including, in certain cases, members of a consolidated group of corporations, REITs, and RICs) is treated as business interest income and business interest expense, unless the interest income or interest expense is allocable to an “excepted trade or business” (defined below). For example, investment interest expense that is passed through by a partnership to a C corporation partner generally would be considered business interest expense.

The business interest limitation generally applies to all taxpayers that have business interest expense. However, a small business

taxpayer that meets the “gross receipts test” is exempt from the limitation. A business meets the gross receipts test if it is not a tax shelter and it has average annual gross receipts of \$25 million or less for the three previous tax years. The \$25 million amount is adjusted for inflation. Please note that “tax shelter” is defined broadly for this purpose, and includes any partnership or S corporation that allocates more than 35% of its losses for the year to limited partners or limited entrepreneurs.

The business interest limitation generally applies at the entity level to all business debt incurred, including debt incurred before 2018.

Interest that is allocable to an “excepted trade or business” is not treated as business interest.

Excepted trades and businesses are those in the trade or business of providing services as an employee, certain regulated utility trades or businesses, certain real property trades or businesses that make an irrevocable election to be excepted from the business interest limitation, and certain farming businesses that make an irrevocable election to be excepted from the business interest limitation.

For those businesses electing to be excepted from the business interest expense limitation, making the election involves a tradeoff: a real property business or farming business that makes the election must use the Alternative Depreciation System to depreciate certain types of property, which requires straight-line depreciation over a

longer depreciable recovery period compared to depreciation under the General Depreciation System.

If you are engaged in both an excepted trade or business and a non-excepted trade or business, interest expense that is allocable to an excepted trade or business is not subject to the business interest limitation, and the amount of your items of income, gain, deduction, or loss, including interest income that is allocable to an excepted trade or business, is excluded in determining the business interest limitation. Therefore, you must allocate your tax items between excepted and non-excepted trades and businesses to determine the limitation.

Business interest expense not allowed as a deduction for a tax year is treated as a business expense paid or accrued in the next tax year, and can be carried forward indefinitely. Disallowed business interest expense carryforwards are subject to limitation in change-of-ownership situations.

Special rules regarding the carryover of disallowed business interest apply to partnerships and S corporations. For partnerships, any business interest expense that is not allowed as a deduction is passed through to the partners, and can be deducted by the partners only to the extent that there is excess taxable income from that specific partnership to absorb the deduction. For S

corporations, disallowed business interest expense is carried over to the next tax year of the S corporation and is treated as interest expense paid or accrued by the S corporation in that year.

The business interest limitation applies at the consolidated return level, and a consolidated group has a single limitation. In calculating the limitation, a consolidated group's business interest expense and business interest income is, respectively, the sum of its members' business interest expense and business interest income.

The business interest limitation applies to a foreign corporation that is a controlled foreign corporation (CFC), generally in the same manner as it applies to a domestic C corporation. If a CFC is a partner in a partnership, the limitation applies to the partnership in the same manner as if the CFC were a domestic C corporation.

The business interest limitation rules are complex and can significantly impact your tax liability. We suggest that you meet with us as soon as possible to discuss strategies to minimize the impact of the limitation, including determining whether your business qualifies to make an election to be excepted from the limitation, whether making the election is advisable in your situation, and if so, what steps we need to take to make the election.

This article contains general information only. It is not tax advice and it should not be used as a basis for any business or tax decision. You should consult with a qualified professional before taking any action that may affect your business or you personally.

