Accountant

What the new Tax Cuts and Jobs Act means for business interest deduction

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The Tax Cuts and Jobs Act signed by the President on December 22, 2017 made a significant change in Code Sec. 163(j) for disqualified business interest paid or accrued. Before January 1, 2018, business interest expense deduction limitation generally was applied to businesses with loans from foreign related parties, such as a parent corporation or related subsidiary. Disqualified interest for this purpose included interest paid or accrued to related parties when no Federal income tax was imposed on the related party receiving the interest.

Under the new law, the deduction allowed for business interest for any tax year can't exceed the sum of (1) taxpayer's business interest income (2) 30% of the taxpayer's adjusted taxable income (3) taxpayer's floor plan financing interest. Section 163(j) (2) as amended by the new law, provides that the amount of any business interest not allowed as a deduction for any taxable year as a result of the limitation is treated as business interest paid or accrued in the next taxable year. The new law removes from code sections 163(j)(6)(C) and 163(j)(9)(b) that treated an affiliated group as one taxpayer and which authorized the super-affiliation rules. No equivalent provisions are included in Section 163(j), as amended.

An example of the limitation: Corporation X has $100,000 of adjusted taxable income, $3,000 of business interest income and $20,000 business interest expense. Corporation X can deduct all $20,000 of its business interest expense as 30% of its adjusted taxable income exceeds the business interest expense.

Assume the same circumstances as above except that adjusted taxable income is $50,000. Corporation X interest deduction will be limited to $18,000. ($50,000 x 30% = $15,000 + 3,000 of business interest income). The remaining $2,000 is carried forward into the next year as interest expense.

The new law also has provisions to prevent double-dipping. This could occur when a partnership is a partner in another business. The business cannot use its share of the partnership income in its adjusted taxable income in the calculation of the interest expense limitation. Similar rules will apply to any S-corporation and its shareholders.

The business interest limitation applies at the taxpayer level. For an affiliated group of corporations that file a consolidated return, it applies at the consolidated tax return filing level. The Treasury Department and IRS anticipate that future regulations will not include a general rule treating an affiliated group that does not file a consolidated return as a signal taxpayer for purposes of section 163(j).

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The limitation in section 163(j) applies to all taxpayers, except for certain taxpayers that meet the gross receipts test. Businesses that meet the average gross receipts of less than $25 million under Code Sec 448(c) for the prior three years meet the exception. Code Sec 448(c) has a provision that related entities (50% or greater common ownership) including partnerships (LLCs) and S-corporations will need to aggregate receipts for purposes of this test.

Adjusted taxable income is computed without regard to any income or loss not properly allocable to a trade or business, any business interest expense or business interest income and the amount of any net operating loss deduction. Before 2022, adjusted taxable income also excludes deductions for depreciation and amortization.

Taxpayers with disqualified interest disallowed under prior section 163(j) for last taxable year beginning before January 1, 2018, may carry such interest forward as business interest to the taxpayer's first taxable year beginning after December 31, 2017. This business interest carried forward will be subject to potential disallowance under the new provisions in the same manner as any other business interest otherwise paid or accrued.

In the case of a C-corporation, all interest paid or accrued by the corporation on indebtedness will be business interest expense and all interest on indebtedness held that is includible in gross income will be business interest income within the meaning of Section 163(j).

Real property trades or businesses may elect not to be subject to the business interest limitation deduction, providing the business uses the ADS method of depreciation (40 years-commercial/30 years-residential). The use of the ADS method of depreciation means that bonus depreciation and Section 179 expensing are not available. The election is irrevocable. The change to the ADS system may require a change of accounting method that will require recapture of previously taken excess depreciation.

Partnerships (LLCs) and S-corporations are subject to this code section. Additional regulations and guidance from the Internal Revenue Service will be forthcoming.

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