

## ALERT: IRS sheds light on new limit on business interest expense deductions

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The Tax Cuts and Jobs Act (TCJA) imposes a limit on deductions for business interest for taxable years beginning in 2018. The limit, like other aspects of the law, has raised some questions for taxpayers. In response, the IRS has issued temporary guidance in Notice 2018-28 that taxpayers can rely on until it releases regulations. While the guidance provides some valuable information, it also leaves some questions unanswered.

Prior to the TCJA, most taxpayers were unaware of the interest limitation because it only applied to corporations in very limited circumstances. As discussed below, the new law could now result in a limitation on the interest deduction for more business taxpayers.

### New law limit

For tax years beginning after 2017, the TCJA amended Section 163(j) of the Internal Revenue Code (IRC). Under the amended rules, the deduction for business interest incurred by both corporate and noncorporate taxpayers is limited to the sum of:

- + Business interest income for the taxable year
- + 30 percent of the taxpayer's **adjusted taxable income** for the tax year
- + Taxpayer's floor plan financing interest paid by vehicle dealers for the tax year

**Adjusted taxable income:** taxable income without gain or loss on investments, business interest expense or income, net operating loss deduction, the 20 percent qualified business income deduction, or depreciation, amortization or depletion. The adjustment for depreciation, amortization and depletion is only through 2021.

The limit applies to all taxpayers, except those with average annual gross receipts of \$25 million or less, real estate or farming businesses that elect to exempt themselves (see below for how the election works), and certain regulated utilities. Certain aggregation rules apply to related entities for purposes of the \$25 million gross receipts exemption.

The amended rules allow for the indefinite carryforward of any business interest not deducted because of the limit. Excess limit, however, cannot be carried forward.

### Example of how the limitation will work:

	Prior law	New law
<b>Gross receipts</b>	<b>\$1000</b>	<b>\$1000</b>
<b>Interest Income</b>	<b>\$50</b>	<b>\$50</b>
<b>Cost of Goods Sold</b>	<b>(\$700)</b>	<b>(\$700)</b>
<b>Interest Expense</b>	<b>(\$200)</b>	<b>(\$200)</b>
<b>Depreciation</b>	<b>(\$100)</b>	<b>(\$100)</b>
<b>Taxable income before interest limitation</b>	<b>\$50</b>	<b>\$50</b>
<b>Add back net interest expense</b>		<b>\$150</b>

<b>Add back depreciation</b>		<b>\$100</b>
<b>Adjusted taxable income</b>		<b>\$300</b>
<b>Multiply by 30 percent</b>		<b>\$90</b>
<b>Business interest limitation</b>	<b>\$0</b>	<b>\$90</b>

In this example, only \$90 of net interest expense can be deducted instead of \$150, resulting in a \$60 disallowance. The \$60 disallowance can be carried forward to future years indefinitely; however, it would be included in interest expense and could be limited again in future years.

### C-corporation business interest income and expense

The IRS announced it will issue regulations clarifying that, for purposes of Section 163(j) only, all interest paid or accrued on a C corporation's debt is business interest. All interest on debt held by a C corporation and includable in its gross income is business interest income.

In addition, the regulations will address the proper treatment of interest paid, accrued or includable in gross income by a noncorporate entity (a partnership, for example) in which the C corporation holds an interest. And the regulations will clarify that the disallowance and carryforward of a deduction for a C corporation's business interest expense won't affect whether and when such an expense reduces the corporation's earnings and profits.

### Treatment of consolidated groups

For groups of affiliated corporations that file a consolidated tax return, forthcoming regulations will clarify that the business interest deduction limit applies at the group level. For example, a consolidated group's taxable income for purposes of calculating its adjusted taxable income will be its consolidated taxable income. Intercompany obligations (debt between affiliated corporations) won't count when determining the amount of the limitation.

The regulations also will address several other issues related to the application of the limit to consolidated groups. These include the allocation of the limit among group members, the treatment of disallowed interest deduction carryforwards when a member leaves the group and the treatment of a new group member's carryforwards. The regulations aren't expected to treat an affiliated group that doesn't file a consolidated tax return as a single taxpayer for purposes of the interest expense deduction limit.

### Pass-through entities

The annual limitation on the deduction of interest expense will be applied at the entity level. The IRS intends to issue regulations that provide that a partner cannot include the partner's share of the partnership's business interest income for the tax year except to the extent of the excess of the partnership's business interest income over the partnership's business interest expense. A partner will not be able to include the partner's share of the partnership's floor plan financing interest in determining the partner's business interest deduction in order to prevent double counting of the floor plan interest.

Similar rules will apply to S corporations and their shareholders. One difference between partnerships and S corporations that was not addressed in the IRS guidance, but is included in the revised tax code is as follows:

- **Partnerships:** interest disallowed under these rules reduces a partner's basis in the partnership when the interest is incurred even if it is not yet deductible.

- **S corporation:** shareholder does not reduce basis in the S corporation stock until the interest is deducted.

### Electing to be exempt from the interest expense deduction limit

As previously mentioned, real estate and farm businesses can elect to be exempt from the Section 163(j) interest expense deduction limit. At first glance, making the election might seem like an easy decision — but the election, which is irrevocable, could provide an even lower deduction.

Businesses that make the election must use the alternative depreciation system (ADS) for **certain property** used in the business, regardless of when the property was placed in service. ADS depreciation is over longer periods, so an electing taxpayer's annual depreciation deductions are reduced if the election is made. Electing businesses also can't claim first-year bonus depreciation.

**Certain property:** generally defined as real or farm property with a recovery period of 10 years or more

Businesses should weigh the advantage of avoiding the interest expense deduction limit by making the election against the detriment of slower depreciation deductions if the election is made.

### Next steps

This new limitation could have a significant impact on tax liability, even on a conservatively-financed business that is in years of low profitability. Action should be taken now to determine the potential impact on your business.

The IRS has requested comments on the rules outlined in its interim guidance. It also expects to issue regulations providing additional guidance on issues not yet covered and is taking comments through the end of May on which issues those regulations should address. We will provide more information as new details become available.

For more information on these changes, please contact your AGH tax advisor or AGH tax senior vice president Shawn Sullivan at 316.291.4110 or [Shawn.Sullivan@aghlc.com](mailto:Shawn.Sullivan@aghlc.com).

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