The New Limited Interest Deduction: Good For Business?

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Along with the new year came sweeping changes to the Internal Revenue Code, in the form of the Tax Cuts and Jobs Act, P.L.115-97. Among other things, the new law purports to lower taxes and simplify the IRC. Lowering the corporate tax rate to 21 percent and allowing a 20 percent deduction for qualified business income to pass-through entities such as partnerships certainly seem like good ways to meet these objectives. The new limitation on the deductibility of business interest, however, seems contrary to this objective and, as we discuss below, isn't so simple at all.

TCJA amends Code Section 163(j), commonly known as the earnings stripping rule, which formerly disallowed a corporation to deduct interest on certain indebtedness. Under the old rule, all other businesses — for example, partnerships — were generally able to fully deduct any business interest paid or accrued.

Now, however, if any business — including partnerships and every type of corporation — has business interest in excess of its business interest income, the new Code Section 163(j) broadly limits the deductibility of business interest to 30 percent of the adjusted taxable income.

This new deduction limit will certainly cause most businesses to pause and consider whether debt financing is the best option for them. Some businesses may be more inclined to explore the option of financing with preferred equity. Others may be incentivized to place more property in service before 2022 to benefit from the new rule's allowance of a greater base for business interest deductibility before then.

The overall impact of the new limit on how public and private transactions will be structured in the coming months and years remains to be seen, but the impact will clearly be meaningful.

What is Adjusted Taxable Income?

The adjusted taxable income is a key component of the new Code Section 163(j) deduction limits, and is defined as the taxable income of a business without taking into consideration the following:

- items of income, gain, deduction or loss that are not properly allocable to a trade or business,
- business interest or business interest income,
- any net operating loss deduction,
- any qualified business income deduction under the new Code Section 199A and
- for the years before Jan. 1, 2022, depreciation, amortization or depletion.

In other words, the adjusted taxable income of a business before Jan. 1, 2022, is roughly equal to a business' earnings before interest, taxes, depreciation and amortization, and after Jan. 1, 2022, a business' earnings before interest and taxes.

The New Rule May Not Apply if…

The applicability of the new Code Section 163(j) is relatively simple, except perhaps when it's not. A small business with less than $25 million average annual gross receipts for the three taxable years preceding the applicable taxable year is exempt from the business interest deduction limitation. Simple enough.

However, Code Section 163(j) applies only to interest paid or accrued on indebtedness properly allocable to a "trade or business," which for purposes of Code Section 163(j) specifically excludes performing services as an employee, an electing real property trade or business, an electing farming business or the trade or business of furnishing certain regulated public utilities. The interest of these types of businesses is not allocable to a "trade or business" under Code Section 163(j) and therefore is not subject to the new business interest deduction limitation.

Many businesses in the real estate industry may determine it is in their best interest to take advantage of the option to not have Code Section 163(j) apply to them by choosing to be an electing real property trade or business. Under the Code, an electing real property trade or business must be any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.

The Joint Explanatory Statement of the Committee of Conference on TCJA states that a real property trade or business conducted by a corporation or a real estate investment trust, as well as a trade or business that operates and manages a lodging facility, is intended to qualify as an electing real property trade or business.

An electing real property trade or business may elect to not be subject to the limitation set forth in Code Section 163(j) in such manner as prescribed by the Secretary of the U.S. Treasury. The election is irrevocable, and any such electing real property trade or business must use the alternative depreciation system to depreciate its nonresidential real property, residential rental property and qualified improvement property, thereby increasing the depreciable lives of such property.

Carryforward Provisions not Necessarily Straightforward

Generally, if there is business interest in excess of 30 percent of a business' adjusted taxable income, it may be carried forward indefinitely, and it is treated as paid or accrued in the subsequent taxable years.

Partnerships, however, are subject to a special carryforward rule. For partnerships, the limitation on the deductibility of business interest is applied at the partnership level. The excess business interest, if any, then flows through to the partner.

The partner may not take its distributive share of any income, gain, deduction or loss from the partnership in determining such partner's own adjusted taxable income. This is intended to prevent double counting, which would allow the partner of such partnership to deduct more business interest than allowed.

Here's an example: Assume that Partnership AB has $100 of adjusted taxable income and $50 of business interest. Partner C has a 50 percent interest in Partnership AB. Partnership AB may deduct $30 of business interest (30% x $100), and has excess business interest of $20 ($50 - $30), $10 of which is allocated to Partner C. Let's also assume that Partner C's own adjusted taxable income (without regard to its distributive share from Partnership AB) is zero.

Therefore, Partner C may not deduct any of the excess business interest. However, if Partner C was able to include the $35 allocated to it from Partnership AB (($100 - $30 = $70) x 50%), Partner C would be able to deduct the $10 of excess business interest allocated to it (30% x $35 = $10.50), which would double-count that adjusted taxable income of Partnership AB.

If excess business interest is allocated to a partner, such excess business interest is carried forward by such partner and is treated as paid or accrued by the partner in the subsequent taxable years. The excess business interest must first be applied against any excess taxable income distributed to such partner by the partnership that generated the excess business interest. Once all excess business interest for such taxable year and the preceding taxable years has been treated as paid or accrued, the excess taxable income distributed to the partner may be applied against other business interest.

The basis adjustment rules are an added layer of complexity surrounding the treatment of partnerships under Code Section 163(j). If a partner is allocated excess business interest by a partnership, such partner's basis in the partnership is reduced — but not below zero — by the amount of such excess business interest. Any interest that is carried forward and treated as paid or accrued in a subsequent taxable year does not reduce the partner's basis in the partnership.

Upon disposition of the partnership interest, the basis of the partnership interest is increased immediately before the disposition by the amount of the excess, if any, of the amount of the basis reduction over the portion of the excess business interest allocated to the partner that has been treated as paid or accrued by the partner.

The special carryforward rules and the basis adjustment rules applicable to partnerships do not apply to S corporations. Although a shareholder of an S corporation may not take its distributive share of such S corporation's income, gain, deduction or loss into account when determining its own adjusted taxable income, the excess business interest of the S corporation is carried forward at the S corporation level, and therefore the basis adjustment rules do not apply to shareholders of S corporations.

The Path Forward

Time will tell how this new limit on the deductibility of business interest will interplay with the lowered corporate tax rate and the 20 percent deduction for qualified business income of pass-through entities, among other things. What was intended to spur economic growth may in fact inhibit certain types of transactions.

On the other hand, new ways of structuring transactions may become more common — and perhaps more beneficial — for many types of businesses. One thing is for sure: The changes to the tax code are not as simple as they seem.

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