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Tax Reform Alert: Business Interest Expense Limitation

The Tax Cuts and Jobs Act made significant changes to individual and corporate taxation by generally lowering tax rates and widening tax brackets. In addition, certain deductions were curtailed. One of those deductions having new limitations in 2018 is interest expense, which this article will define as “net business interest (NBI).”

(This is a very complex area of the new tax law, what follows is subject to change pending further guidance).

Definition of Net Business Interest

Net business interest generally is trade or business interest (excludes investment interest), less business interest income (interest income cannot be tax-exempt).

For example, trade or business interest would include interest related to equipment notes, mortgage notes, subordinated debt, lines of credit (excluding certain floor plan financing), and interest paid to acquire S corporation shares or partnership units. The provisions apply to all loans of the taxpayer, not just 2018 borrowings (there are no exceptions for pre-2018 debt).

Floor plan financing is not considered business interest for purposes of this limitation (defined as interest paid on debt secured by motor vehicles, boats, or farm equipment held for sale or lease).

Business interest income would exclude investment income but would appear to include finance charges to customers on past due accounts receivable.

Limit for Net Business Interest

NBI is limited to 30% of Adjusted Taxable Income (ATI) and applies to any business interest of any taxpayer (regardless of form). For S corporations or partnerships, the limitation is applied at the entity level. For tax years 2018 through 2021, ATI is generally taxable income:

1. Plus business interest expense (includes floor plan interest expense)
2. Less business interest income
3. Less nontrade or business income (investment income, capital gains, etc.)
4. Plus any Section 199A deduction
5. Plus any net operating loss deduction
6. Plus depreciation, depletion, or amortization (only applicable through 2021)

For years beyond 2021, depreciation, depletion, and amortization are no longer allowed as an addback to compute ATI. This makes the limitation more stringent for years beginning in 2022 as adjusted taxable income will be lower.

Any disallowed interest can be carried forward indefinitely (more details provided later in this article). It is unclear whether this test is applied just once at the consolidated return level for C corporations.

Small Business Exception

The NBI limitation does not apply to a taxpayer with less than \$25 million of average annual gross receipts for the three preceding tax years. Special related party aggregation rules apply.

The small business exception cannot be used for an entity that is a tax shelter. The definition of a tax shelter is not entirely clear, but it most likely includes any entity that generates a loss which is owned more than 35% by passive investors (includes partnerships and S corporations). Therefore, if an entity is considered a tax shelter, the interest expense limitations would apply even though the entity's revenue is under \$25 million.

Specific Industries Have Option to Elect Out

The following types of business can make a one-time irrevocable election to not be subject to the interest limitation rules: (1) an electing real property trade or business, (2) an electing farming business, and (3) certain regulated public utilities.

An electing real property trade or business has been defined as a real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. More guidance is needed here, in particular, the definition of "real property" for the types of businesses that may qualify. The Committee report indicates that the operation or management of a lodging facility is intended to qualify.

An electing farming business means the trade or business of farming and includes the operation of a nursery or sod farm or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.

The election requires the taxpayer to use the "alternative depreciation system" (ADS) which generally has longer recovery periods, requires the use of the straight-line method and does not allow the use of "bonus" depreciation for the new "qualified improvement property" category under the Act. Note: tangible personal property is not required to be depreciated using ADS, so a taxpayer can still utilize bonus depreciation for those assets (key for farming).

For real estate property, the ADS life is 20 years (vs. 15 years) for leasehold improvements, 30 years (vs. 27.5 years) for residential property, and 40 years (vs. 39 years) for nonresidential property. The residential property life was lowered to 30 years under the Act, therefore it is not clear if the 30-year ADS life applies only to property acquired in 2018, or to all such property owned.

Special Reporting Requirements for S Corporation and Partnerships

Partnerships will need to report to their partners whether they have excess business interest (interest expense that is not able to be deducted at the partnership level) or excess business income (the capacity to deduct additional interest expense).

Example 1: Excess business interest: adjusted taxable income is \$100, and net business interest expense is \$40; there would be \$10 of excess business interest expense.

Computation: the interest limitation is \$30 ($\$100 \times 30\%$), therefore \$10 ($\$40 \text{ interest} - \30 limit) is considered excess business interest.

Example 2: Excess business income: adjusted taxable income is \$100 and net business interest is \$20; there would be \$33 of excess business income. Computation: the interest limitation is the same \$30 ($\$100 \times 30\%$). Therefore, an extra \$10 ($\$30 \text{ limit} - \20 interest) of interest could have been deducted had it been incurred. This translates to \$33 ($\$10 \div 30\%$) of excess business income.

In contrast, S corporations will only be required to report to its shareholders excess business income in the same manner as Example 2 above. Any excess business interest (Example 1) will be retained at the S corporation level and is not reported to its shareholders.

Carryover Rules

Excess Business Income Carryover Rule (S corporations & Partnerships)

If a partner or S corporation shareholder has excess business income for a year (Example 2), the owner is permitted to utilize its share of such excess in computing its business interest limitation for use against such owner's income from other sources (after first utilizing any carried over excess business interest against such excess under the carryover rule described below).

Therefore, it appears that any excess business income (after utilizing any prior year excess business interest) can be used to support a deduction for interest incurred at the individual taxpayer level. Potentially then, interest incurred on debt to acquire an ownership interest, or interest on a separate wholly-owned trade or business rental property of a taxpayer could be offset with the excess business income. It does not appear that the excess business income could be used to offset interest incurred of another partnership or S corporation.

Excess Business Interest Carryover Rule (Partnerships Only)

As mentioned above, interest expense in excess of the limitation (Example 1) is allocated by the partnership out to its partners (it is not retained at the entity level). Each partner carries over its excess business interest and may utilize it in a subsequent year to offset such partner's distributive share of the partnership's unused business income limitation for such year. Excess business interest of a partner may not be offset by taxable income from other sources.

Self-Charged Interest

The Act does not mention self-charged interest, where an equity owner has loaned money to a business. The interest paid to the owner would presumably be subject to the same limitations as other interest. Further guidance would be needed in order to treat self-charged interest any differently.

Trades or Businesses Owned Directly by Taxpayer

It appears that businesses of an individual taxpayer which are not owned through a corporation or partnership would be able to be aggregated for purposes of the interest limitation. Therefore, a taxpayer who operates a sole proprietorship (reporting interest expense on Schedule C) and a trade or business rental property (reporting interest expense on Schedule E) could aggregate those two businesses in determining any business interest limitation. Adjusted Taxable Income is only computed once at the taxpayer level in this case.

In contrast, if such businesses were owned in an S corporation and/or a partnership entity, the two businesses would not be able to be aggregated. In effect, partnership or S corporation businesses are treated as silos for purposes of this limitation and cannot offset each other.

Summary

Taxpayers that rely on significant debt financing and exceed the \$25 million revenue threshold will need to be very aware of the business interest limitation for the 2018 tax year. Certain smaller business that meet the definition of a tax shelter are not exempt. There are several more complications to this interest limitation that are unable to be discussed in an article of this length including uncertainties around tiered entities. Please contact our office for more information.