

Business Interest Expense Deduction Limitation – I.R.C. Section 163(j)

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Today's Agenda

I.R.C. Section 163(j) as Revised by the TCJA

The Small Business Exception & Aggregation

Electing Real Property Trade or Business

The Proposed Regulations



I.R.C. Section 163(j) as Revised by the TCJA

- THE BASICS
- SPECIAL RULES



Business Interest Expense Deduction

The business interest deduction for a tax year cannot exceed:

- The taxpayer's business interest income for the tax year; plus
- 30% of the taxpayer's adjusted taxable income for the tax year which cannot be less than zero; plus
- The taxpayer's floor plan financing interest for the tax year.



Business Interest Expense Deduction

- Any excess interest that is disallowed is carried forward
- Applies at taxpayer level for all taxpayers with business interest expense (other than exempt small businesses)
- Calculated on Form 8990



Business Interest

- Interest paid or accrued on indebtedness allocated to a trade or business
- Not investment interest



Trade or Business

- Does not include:
 - The trade or business of performing services as an employee;
 - Any electing real property trade or business;
 - Any electing farming business; or
 - The trade or business of furnishing or sale of
 - Electrical energy, water, or sewage disposal systems;
 - Gas or steam through local distribution system; or
 - Transportation of gas or steam by pipeline



Adjusted Taxable Income

Similar to EBITDA

Taxable income computed without regard to:

- Non-business income & expense
- Business interest expense
- Business interest income
- NOLs
- QBI
- Depreciation & amortization (only for taxable years beginning before January 1, 2020)



Business Interest Expense Deduction Example

In 2019, Corporation A has \$110,000 of adjusted taxable income, \$8,000 of business interest income and \$60,000 of business interest expense. It has no floor financing interest.



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- **Business Interest Income = \$8,000**
- **30% of Adjusted Table Income = \$33,000**



Business Interest Expense Deduction Example

In 2019, Corporation A has \$110,000 of adjusted taxable income, \$8,000 of business interest income and \$60,000 of business interest expense. It has no floor financing interest.

- Business Interest Income = \$8,000
- 30% of Adjusted Table Income = \$33,000
- **Total Deductible Business Interest Expense = \$41,000**
- **Business Interest Expense Carried Forward = \$19,000**



Special Rules – Partnerships

- Determined at the partnership level
- Disallowed Business Interest Expense passed out to partners as excess business interest (a separately stated item)
- Excess business interest is carried forward indefinitely on the partner's return
- Excess business interest can **ONLY** be utilized against excess taxable income from partnership that created the excess business interest



Special Rules – Partnerships

- Partner's adjusted basis in partnership interest reduced (but not below zero) by excess business interest allocated to partner
- Disposition of partnership interest
 - Adjusted basis of partner increased immediately before disposition by amount of excess basis reduction over portion of excess business interest allocated to partner that was treated as business interest paid by partner in subsequent year
 - Applies to nonrecognition transfer of partnership interest (including by reason of death)



Special Rules – S Corporations

- Determined at the S corporation level
- Disallowed Business Interest Expense carried forward at S corporation level



The Small Business Exception & Aggregation

- THE EXCEPTION IN GENERAL
- THE AGGREGATION RULES



Small Business Exception

- Business meets the gross receipts test in I.R.C. Section 448(c)
 - Business is not a tax shelter (as defined in I.R.C Section 448(a)(3)); and
 - Business has average annual gross receipts of \$25 million or less in the previous three years
- For tax years 2019 forward, the \$25 million will be adjusted for inflation
- Taxpayers that are not corporations or partnerships, calculate gross receipts test in same manner as if taxpayer were a corporation or partnership



What is a Tax Shelter?

- I.R.C. Section 461(i)(3):
 - Partnerships where the interest are offered via securities registration (state or federal)
 - Syndications defined in I.R.C. Section 1256(e)(3)(B)
 - I.R.C. Section 662(d)(2)(C)(ii) – partnerships where the significant purpose is to avoid or evade taxes



What is a Syndication?

- I.R.C. Section 1256(e)(3)(B):
 - More than 35% of the losses in a taxable year are allocable to limited partners or limited entrepreneurs.
 - Year by Year determination



What is a Syndication?

- I.R.C. Section 1256(e)(3)(B):
 - More than 35% of the losses in a taxable year are allocable to limited partners or limited entrepreneurs.
 - Year by Year determination
 - **Active Exception:**
 - **Partners that participate at all times during the year in the management of company.**
 - **An Estate of a person who had been active for at least five years.**
 - **A person who has been active in management at some point for at least five years even if not currently active.**



Aggregation

- Gross receipts of entities under common control must be aggregated
 - I.R.C. Section 1563 – Every business being aggregated is a corporation (controlled group of corporations)
 - I.R.C. Section 414(m) – One of the businesses being aggregated either provides services to a related personal service business or provides management services to another business (services being provided between entities)
 - I.R.C. Section 52(b) – Every other situation (majority of situations)



What is common control?

- See Treas. Reg. Section 1.52-1
 - Parent-Subsidiary Groups – Treas. Reg. Section 1.52-1(c)
 - Brother-Sister Groups – Treas. Reg. Section 1.52-1(d)

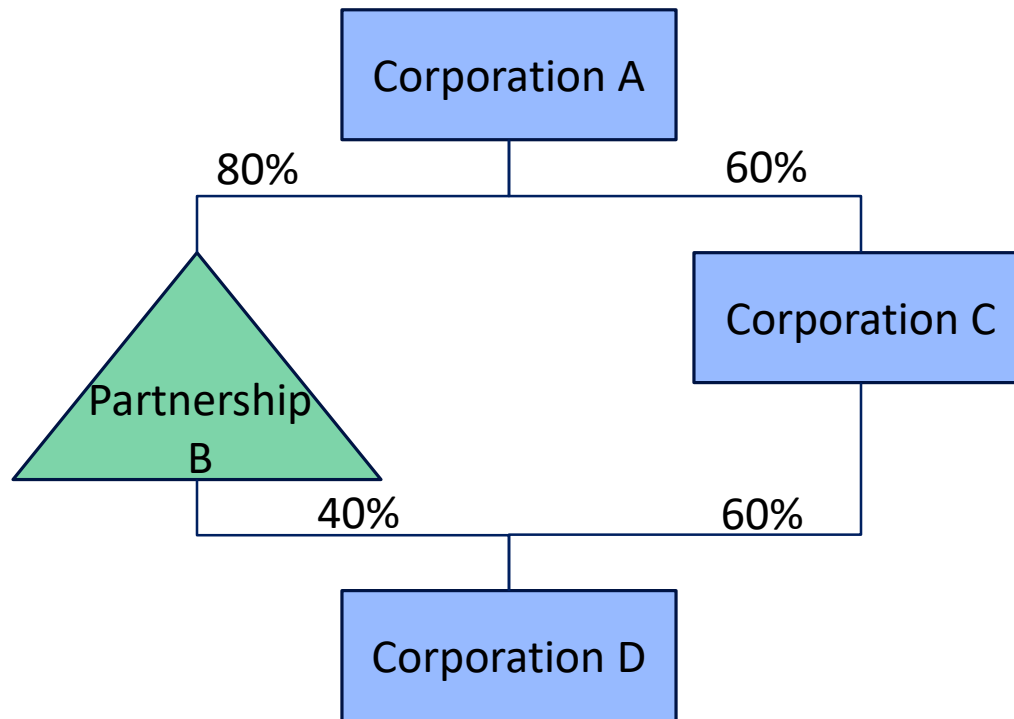


Parent-Subsidiary Groups

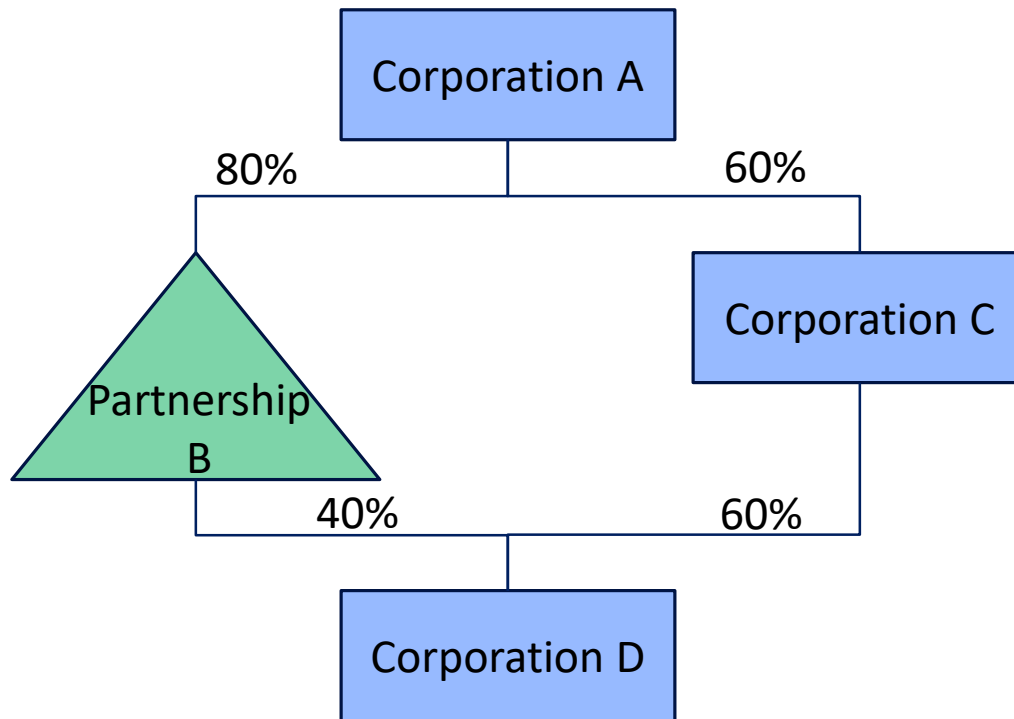
- Common control if parent organization directly or indirectly owns a **controlling interest** in the organization
- Organization means a sole proprietorship, partnership, trust, estate or corporation
- Parent's controlling interest:
 - Corporation – owning more than 50% of total combined voting power of all classes of voting stock or more than 50% of total value of all classes of stock
 - Partnership – owning more than 50% of profit interest or capital interest
 - Trust or Estate – owning more than 50% of actuarial interest
 - Sole Proprietorship – owning the sole proprietorship



Parent-Subsidiary Groups Example

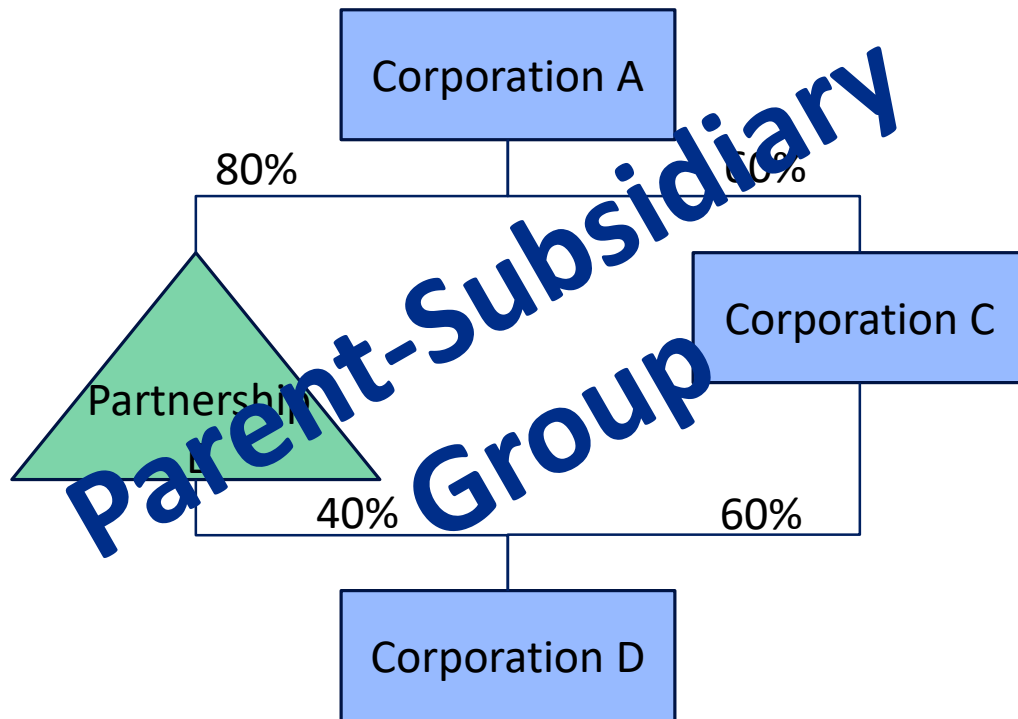


Parent-Subsidiary Groups Example



- Corporation A directly owns more than 50% of Partnership B and Corporation C
- Corporation A indirectly owns more than 50% of Corporation D

Parent-Subsidiary Groups Example



- Corporation A directly owns more than 50% of Partnership B and Corporation C
- Corporation A indirectly owns more than 50% of Corporation D

Brother-Sister Groups

- Same five or fewer persons own a **controlling interest** in each organization
- Those same five or fewer owners counted for determining a controlling interest must also have **effective control** of each organization
- Determined by considering the lowest amount owned in each organization



Brother-Sister Groups

- **Controlling interest:**
 - Corporation – owning at least 80% of total combined voting power of all classes of voting stock or at least 80% of total value of all classes of stock
 - Partnership – owning at least 80% of profit interest or capital interest
 - Trust or Estate – owning at least 80% of actuarial interest
 - Sole Proprietorship – owning the sole proprietorship

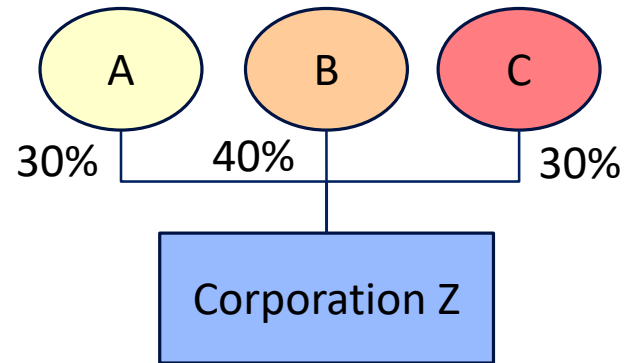
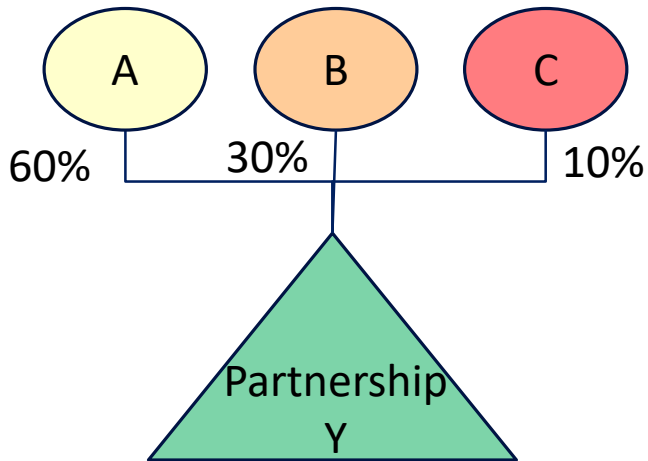


Brother-Sister Groups

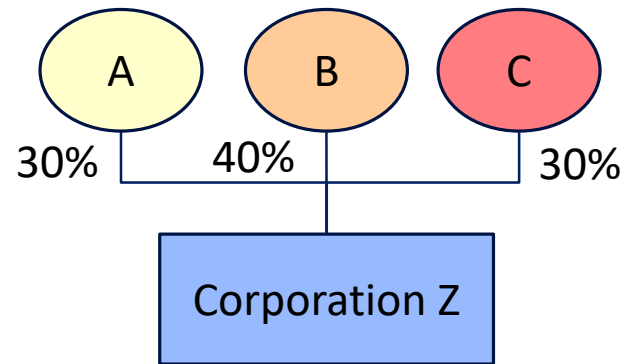
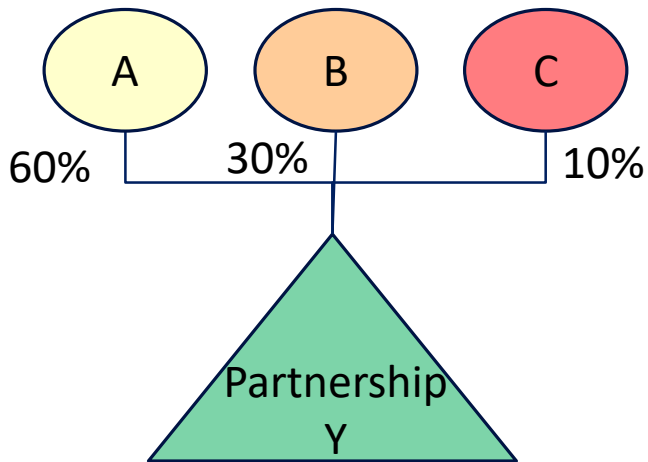
- **Effective Control:**
 - Corporation – owning more than 50% of total combined voting power of all classes of voting stock or more than 50% of total value of all classes of stock
 - Partnership – owning more than 50% of profit interest or capital interest
 - Trust or Estate – owning more than 50% of actuarial interest
 - Sole Proprietorship – owning the sole proprietorship



Brother-Sister Groups Example



Brother-Sister Groups Example

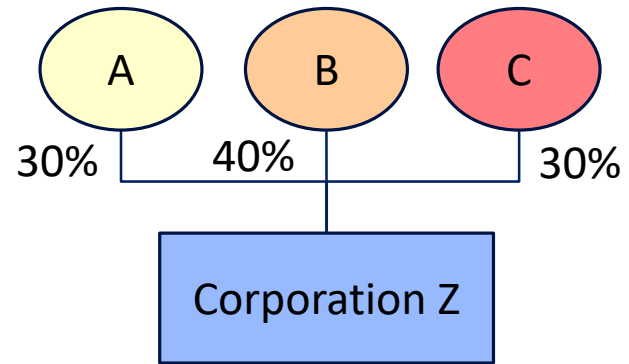
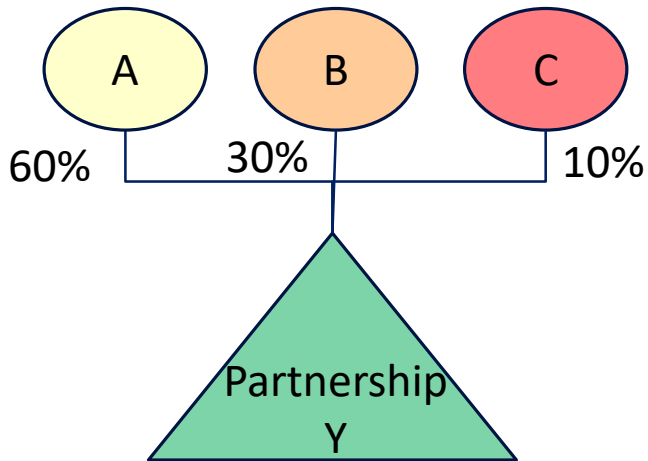


80% Test

	Partnership Y	Corporation Z
A	60%	30%
B	30%	40%
C	10%	30%
Total	100%	100%



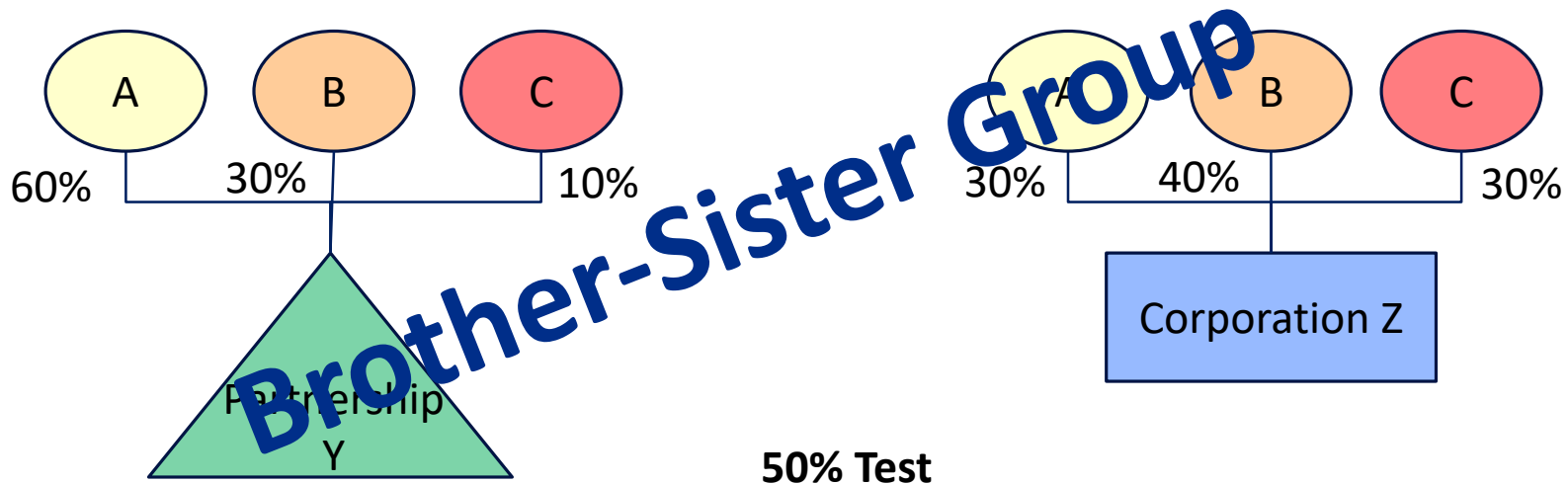
Brother-Sister Groups Example



50% Test

	Partnership Y	Corporation Z	Lowest Owned
A	60%	30%	30%
B	30%	40%	30%
C	10%	30%	10%
Total			70%

Brother-Sister Groups Example

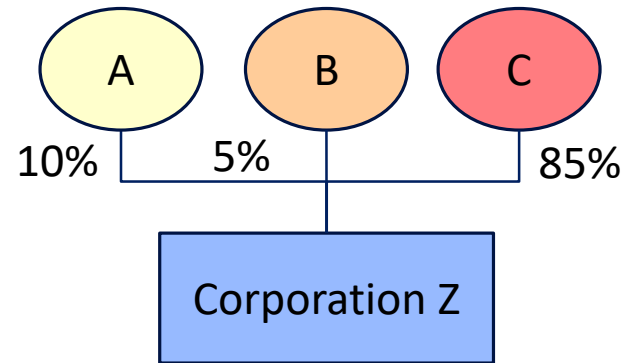
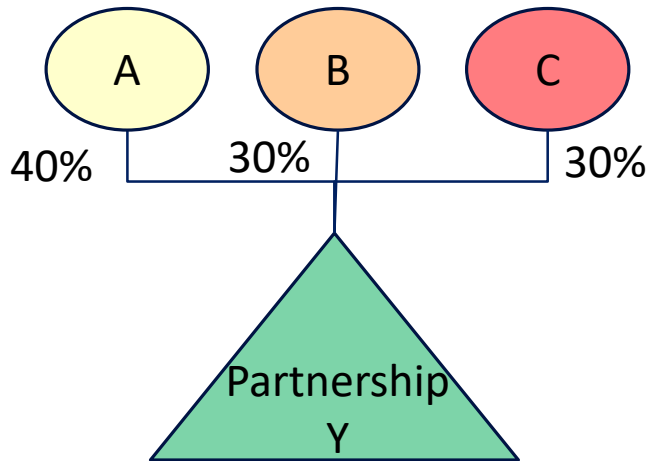


50% Test

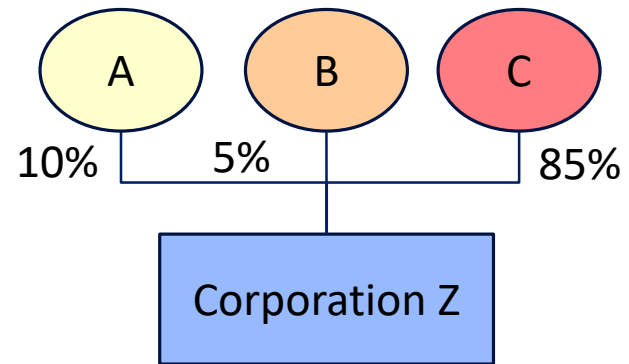
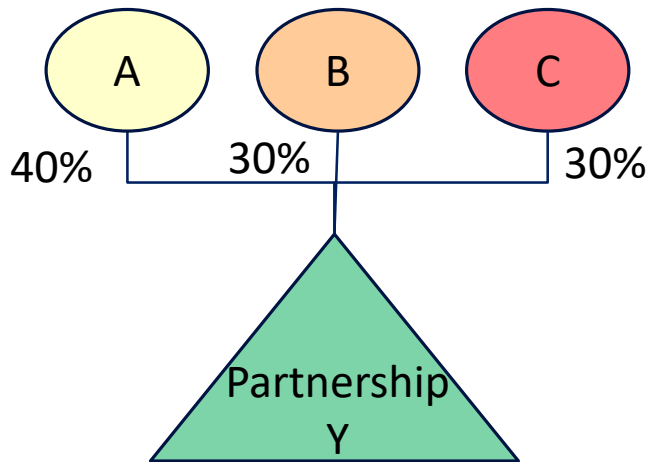
	Partnership Y	Corporation Z	Lowest Owned
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C	10%	30%	10%
Total			70%



Brother-Sister Groups Example



Brother-Sister Groups Example

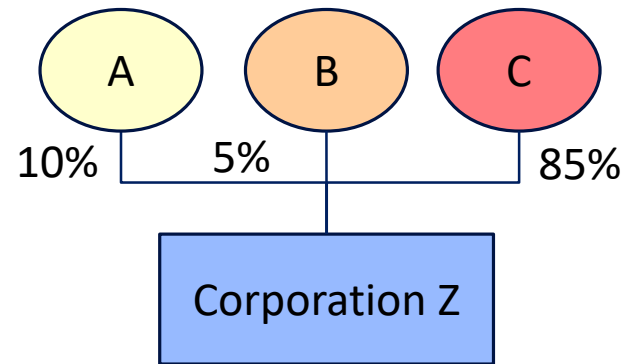
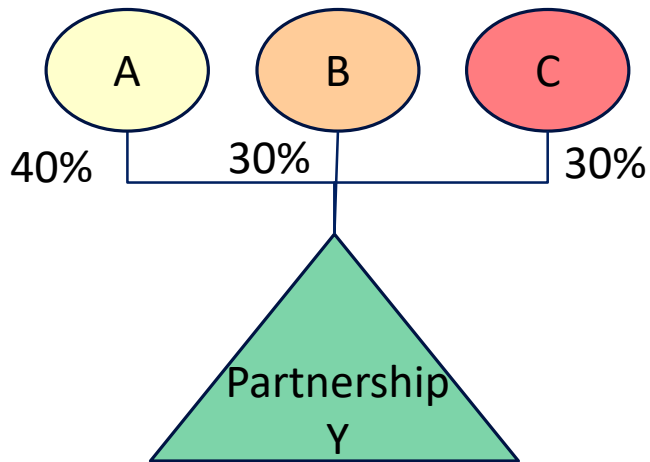


80% Test

	Partnership Y	Corporation Z
A	40%	10%
B	30%	5%
C	30%	85%
Total	100%	100%



Brother-Sister Groups Example

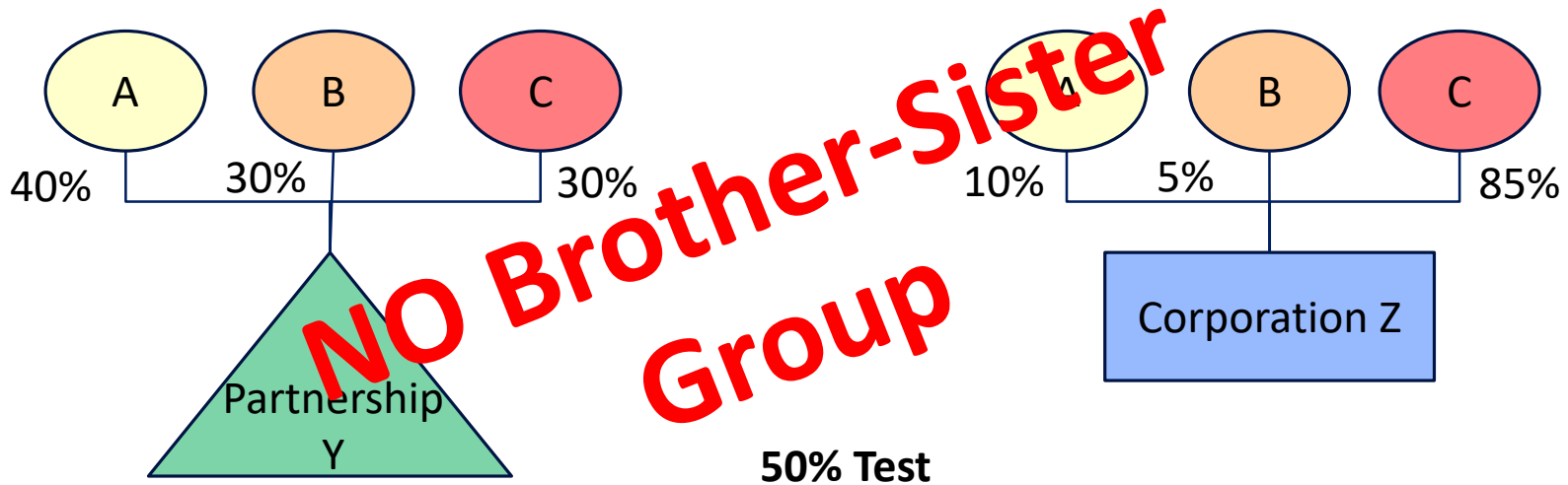


50% Test

	Partnership Y	Corporation Z	Lowest Owned
A	40%	10%	10%
B	30%	5%	5%
C	30%	85%	30%
Total			45%



Brother-Sister Groups Example



	Partnership Y	Corporation Z	Lowest Owned
A	40%	10%	10%
B	30%	5%	5%
C	30%	85%	30%
Total			45%



Attribution Rules

- Only attribution rules that apply to both Parent-Subsidiary Groups and Brother-Sister Groups is Treas. Reg. Section 1.414(c)-4(b)(1)
- If taxpayer has an option to acquire any outstanding interest in an organization then interest is considered owned by such person for the aggregation calculation



Electing Real Property Trade or Business

- EFFECT OF ELECTING OUT
- HOW TO ELECT OUT



Real Property Trade or Business

- Can irrevocably elect out of the Business Interest Expense Limitation
- A real property trade or business includes real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental operation, management, leasing or brokerage trade or business (See I.R.C. Section 469(c)(7))



What Does This Mean?

- Required to use Alternative Depreciation system (ADS) to depreciate residential real property, non-residential real property and qualified improvement property
 - Nonresidential property – 40 years
 - Residential rental property – 30 years
 - Qualified improvement property – 40 years (20 years)
- **NO bonus depreciation** on assets depreciated under ADS



ADS – Treatment of Existing Property

- Revenue Procedure 2019-8
 - Switch to ADS is **NOT** a change in accounting method, but merely a “**change in use**”
 - Depreciation deductions beginning in the year of change are determined as though the property had been originally placed in service by the taxpayer with the longer recovery period and/or the slower depreciation method (See Treas. Reg. Section 1.168(i)-4(d))
 - Business takes remaining tax basis in asset and depreciates it straight-line over remaining life of the asset.
 - Pre-2018 residential property required to switch to ADS must use 40 year life that was in place prior to 2018, rather than the new 30-year life



How to Elect Out

- Prop. Treas. Reg. Section 1.163(j)-9
 - Attach a statement to timely filed federal income tax return (including extensions) for year of election
 - Statement must include:
 - Taxpayer's name, address and social security number or EIN;
 - Description of the electing trade or business, including the principal business activity code; and
 - Statement that the taxpayer is making an election as a real property trade or business under I.R.C. Section 163(j)(7)(B)
 - Partnership election must be made on partnership return and is specific to that partnership



Termination of Election Out

- The election automatically terminates if the taxpayer ceases to engage in the electing trade or business
 - Taxpayer sells or transfers substantially all of the assets of the electing trade or business to non-related party
- The election automatically terminates if the taxpayer terminates its existence for Federal income taxes (unless the termination is due to selling/transferring substantially all of the assets to a related party or in a nonrecognition transaction)



The Proposed Regulations

- GENERAL COMPUTATION RULES
- PARTNERSHIP & S CORPORATION RULES



The Proposed Regulations

- 1.163(j)-1 – Definitions
- 1.163(j)-2 – General computation rules
- 1.163(j)-3 – Ordering rules
- 1.163(j)-4 – C corporation and tax exempt corporation rules
- 1.163(j)-5 – C corporation carryforward rules
- 1.163(j)-6 – Partnership and S corporation rules
- 1.163(j)-7 – Application to foreign corporations
- 1.163(j)-8 – Foreign persons with effectively connected income rules
- 1.163(j)-9 – Elections for excepted trades or businesses & REITs safe harbor
- 1.163(j)-10 – Non-excepted and excepted trades or businesses allocation
- Section 1.163(j)-11 – Transition rules



The Proposed Regulations

- 1.163(j)-1 – Definitions
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- Section 1.163(j)-11 – Transition rules



Prop. Treas. Reg. Section 1.163-2 – General Computation Rules

- Small Business Exception
 - Annual determination
 - Exempt entity
 - Each partner includes a share of the partnership's gross receipts based on partner's distributed share (determined under I.R.C. Section 704)
 - Each shareholder includes a pro rata share of the S corporation's gross receipts
 - Taxpayers satisfying the Small Business Exception unable to Elect Out as Electing Real Property Trade or Business



Prop. Treas. Reg.

Section 1.163-6 – Partnership & S Corporation Rules

- If partnership or S corporation is subject to I.R.C. Section 163(j) then limitation applied at partnership or S corporation level
- If the partnership's business interest expense is less than or equal to the partnership's Business Interest Expense Deduction, then business interest expense loses its character as business interest expense at the partner level for the partner's I.R.C. Section 163(j) calculation
 - Not subject to further limitations
- Excess business interest expense retains its character as business interest expense at the partner and S corporation shareholder-level
- If partnership has excess taxable income, partner may include its share as partner's own ATI to determine partner's I.R.C. Section 163(j) calculation



Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules

- Generally business interest expense and excess items allocated based on partnership interest owned
- If partnership has special allocations or I.R.C Section 704(c) then **11 step process** under the Proposed Regulations for allocating business interest expense and excess items



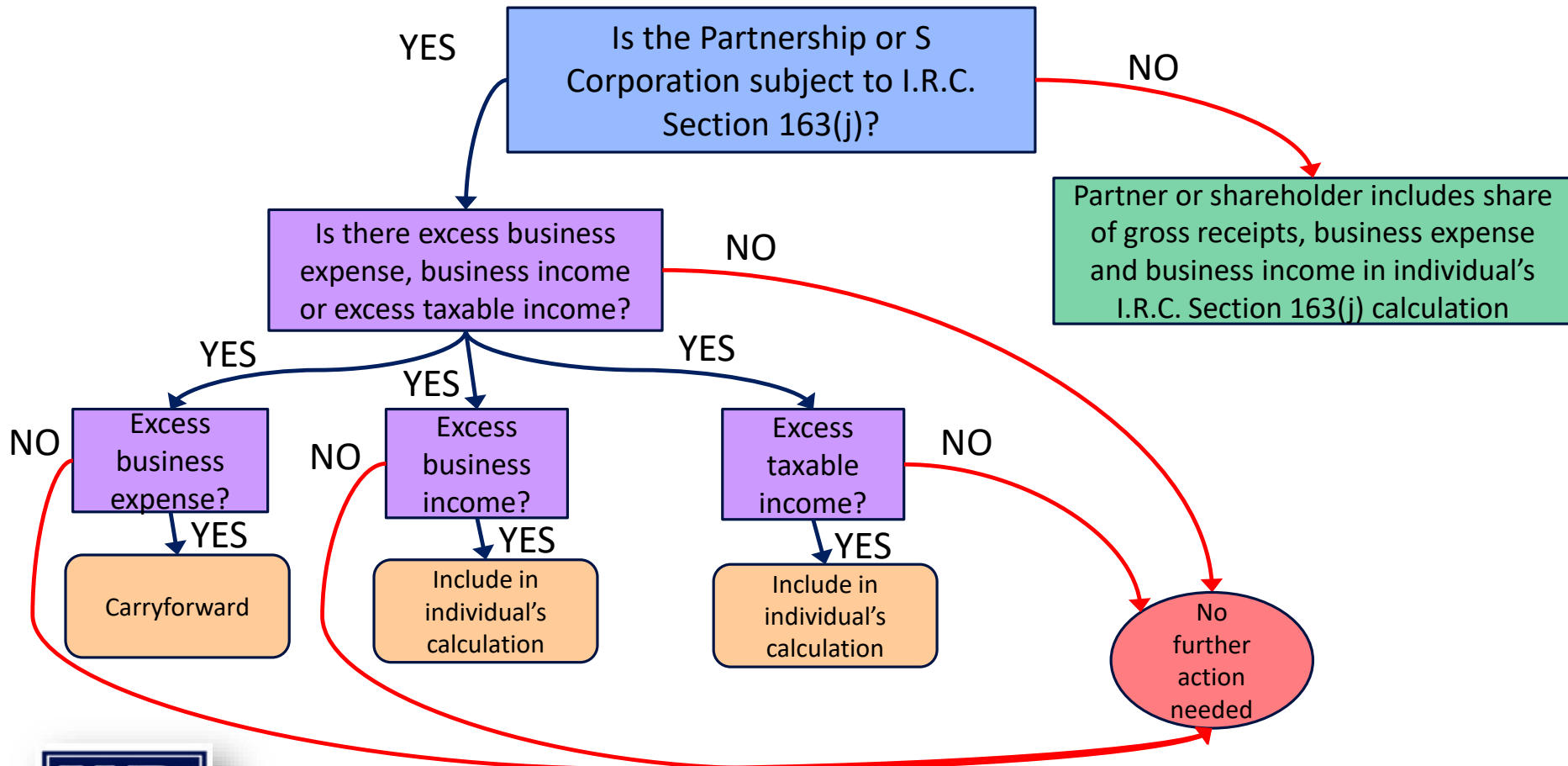
Prop. Treas. Reg.

Section 1.163-6 – Partnership & S Corporation Rules

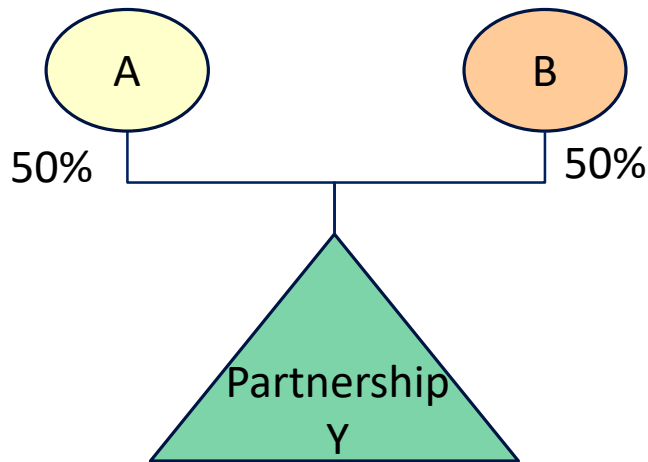
- Exempt Entities
 - Business interest expense retains character and is allocated (with gross receipts) to partner or S corporation shareholder
 - Determine if partner or shareholder is subject to an individual Business Interest Expenses Deduction calculation
- Excepted Trade or Businesses
 - Business interest expense and gross receipts are excluded from partner or shareholder's individual Business Interest Expenses Deduction calculation



Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules



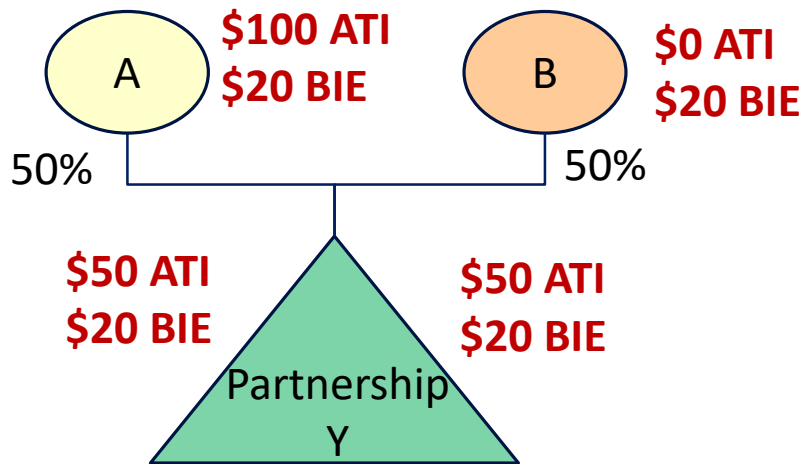
Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules Example



- Partnership Y has \$100 of ATI and \$40 of Business Interest Expense
- A has \$100 ATI and \$20 of Business Interest Expense for its sole proprietorship
- B has \$0 of ATI and \$20 of Business Interest Expense from its sole proprietorship
- Partnership Y, A and B are all subject to I.R.C. Section 163(j)



Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules Example

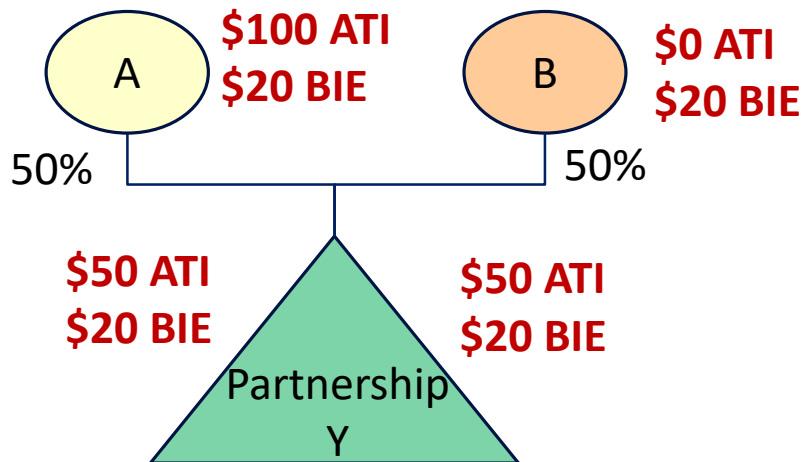


Partnership Level Calculation

- Partnership Y's Business Interest Expense Deduction is \$30 (30% of \$100 ATI)
- Partnership Y has \$30 of deductible Business Interest Expense and \$10 of Excess Business Expense
- A and B each have \$15 of deductible Business Interest Expense from Y and \$5 of Excess Business Expense to carryforward



Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules Example

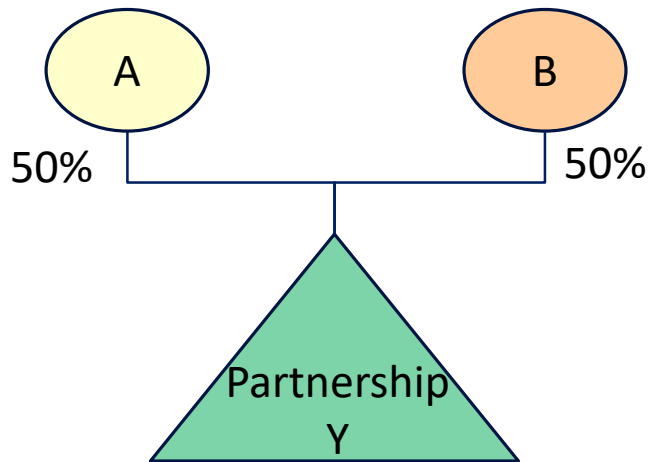


Partner Level Calculation

- A's Interest Expense Deduction is \$30 (30% of \$100 ATI)
- A may deduct all \$20 of its Business Interest Expense
- B's Interest Expense Deduction is \$0 (30% of \$0 ATI)
- B must carryforward all \$20 of its Business Interest Expense



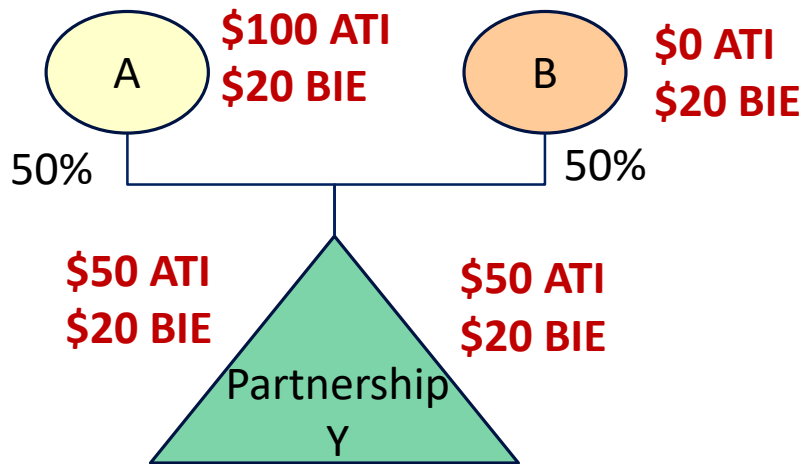
Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules Example



- Partnership Y has \$100 of ATI and \$40 of Business Interest Expense
- A has \$100 ATI and \$20 of Business Interest Expense for its sole proprietorship
- B has \$0 of ATI and \$20 of Business Interest Expense from its sole proprietorship
- Partnership Y is an exempt entity
- A and B are all subject to I.R.C. Section 163(j)



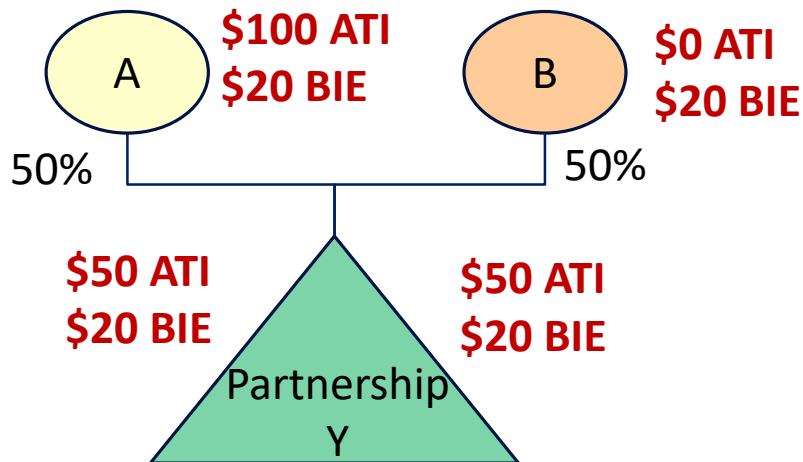
Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules Example



- **No Partnership level calculation**
- Partnership Y is an exempt entity
- A and B each receive \$50 ATI and \$20 Business Interest Expense from Partnership Y to include in their respective calculations



Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules Example

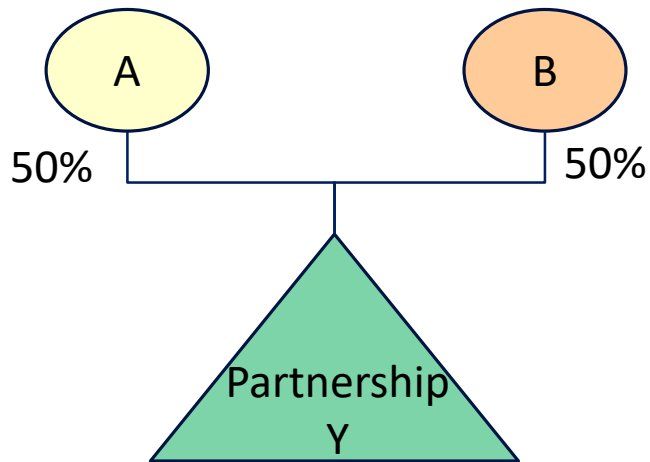


Partner Level Calculation

- A's Interest Expense Deduction is \$45 (30% of \$150 ATI)
- A may deduct all \$40 of its Business Interest Expense
- B's Interest Expense Deduction is \$15 (30% of \$50 ATI)
- B may deduct \$15 of its Business Interest Expense and must carryforward \$25 of its Business Interest Expense



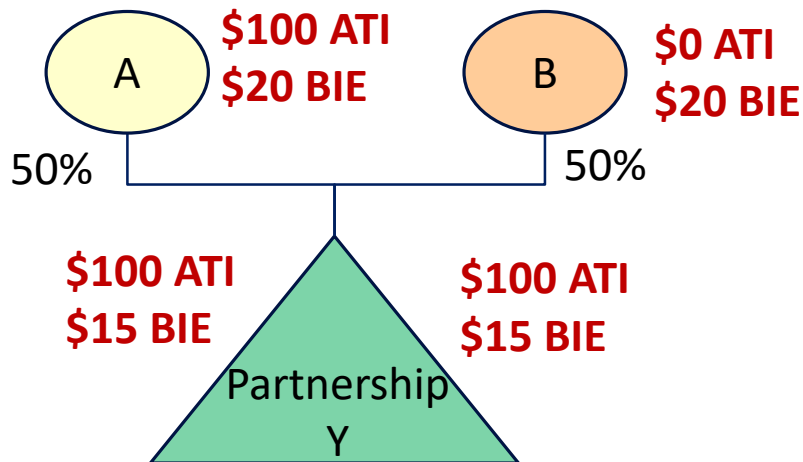
Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules Example



- Partnership Y has \$200 of ATI and \$30 of Business Interest Expense
- A has \$100 ATI and \$20 Business Interest Expense for its sole proprietorship
- B has \$0 of ATI and \$20 of Business Interest Expense from its sole proprietorship
- Partnership Y, A and B are all subject to I.R.C. Section 163(j)



Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules Example

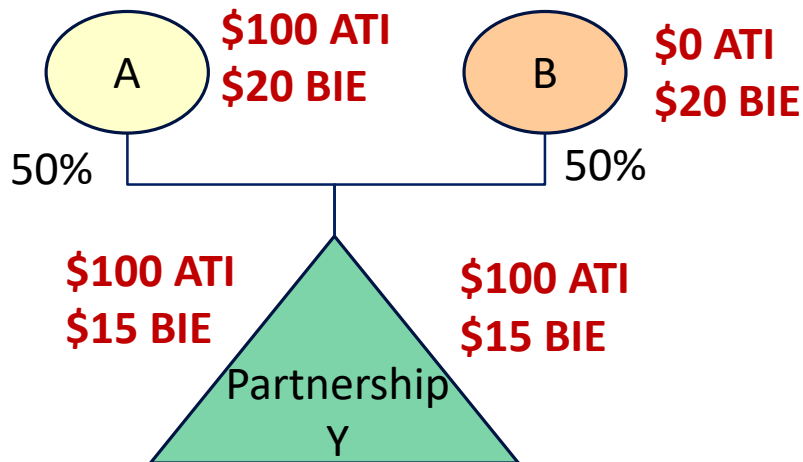


Partnership Level Calculation

- Partnership Y's Business Interest Expense Deduction is \$60 (30% of \$200 ATI)
- Partnership Y has \$30 of deductible Business Interest Expense
- A and B each have \$15 of deductible Business Interest Expense from Y and \$50 of Excess ATI



Prop. Treas. Reg. Section 1.163-6 – Partnership & S Corporation Rules Example



Partner Level Calculation

- A's Interest Expense Deduction is \$45 (30% of \$150 ATI)
- A may deduct all \$20 of its Business Interest Expense
- B's Interest Expense Deduction is \$15 (30% of \$50 ATI)
- B may deduct \$15 of its Business Interest Expense and carryforward \$5 of its Business Interest Expense



QUESTIONS?

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