This article is the fourth in a series of articles examining major changes from the **Tax Cuts and Jobs Act** of 2017 and looks to the provisions addressing the deductibility of business interest expense.

Interest-ING Changes Further Restrict Deduction of Debt Financing Costs

By **TIM THOMASSON** and **DON CARPENTER**

The optimal mix of debt and equity in a business's capital structure is one of the most critical financial decisions made by management. The tax deductibility of interest expense versus the non-deductibility of dividends has long been a significant advantage of debt.

Well-publicized business provisions of the new tax law included the reduction in the corporate tax rate to 21 percent, a partial move towards a territorial system for international operations and the implementation of a partial deduction for business income from certain flow-through entities. Congress needed revenue offsets to lower the potential negative impact on the deficit that these three provisions are projected to have. One mechanism Congress is using to provide offsets is new limitations on the deduction available for business interest expense. In contrast to prior interest expense limitations that focused almost exclusively on related party debt, Congress is making no distinction between debt amongst affiliated parties and third-party debt.

A Brief History

Concrete limitations on the deduction of various types of non-business interest expense have existed in the Internal Revenue Code (IRC) for many years. For example, Congress has provided very objective and mechanical limitations for deducting interest on mortgages, which have been modified somewhat in the new act. The IRC also limits the deduction for interest paid on student loans to taxpayers under certain income thresholds. Likewise, interest expense on loans used to buy investment assets by individuals has been limited to the investment income derived from those assets. And interest expense on personal debt and on loans to finance tax-exempt income is disallowed entirely.

But limitations on the deductibility of interest expense on business loans has been far more subjective. Congress originally attempted to address this issue with IRC Section 385, in which the Internal Revenue Service (IRS) was given legislative authority to issue regulations classifying certain shareholder-corporation relationships as equity rather than debt. Initial regulations issued under IRC Section 385 were largely ineffective and much of the analysis as to whether an instrument should be classified as debt or equity was based on a variety of factors in case law.

In 2016, the IRS issued revised regulations under IRC Section 385. These regulations were narrower in scope and attempted to curtail inappropriate erosion of the U.S tax base by foreign shareholders of U.S. corporations. Congress did provide more concrete restrictions on the deductibility of interest expense to related parties through two additional provisions. First, IRC Section 267 requires that interest expense to a related party is only deductible

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when actually paid, even for an accrual method obligor. Second, IRC Section 163(j), prior to the modifications we are discussing in this article, limited the deduction of interest expense owed to foreign related parties to a percentage of the taxpayer's cash flow.

All of these provisions focused primarily on debt between related parties, with a particular focus on foreign lenders and in the case of IRC Section 385, introduced a level of subjectivity that made enforcement very difficult. In the new act, Congress amended IRC Section 163(j) to provide a broader, more mechanical limitation on the deduction of business interest expense.

What Changed

Before delving deeper into the specific aspects of the new limitations on the deductibility of business interest expense, let's examine an overview of the new framework of IRC Section 163(j):

- For tax years beginning after December 31, 2017, the deduction for business interest expense will be limited to the sum of (1) business interest income and (2) 30 percent of adjusted taxable income (ATI). A special provision excludes floor plan financing interest from this limitation.
- Business interest expense is any interest paid or accrued on indebtedness allocable to a trade or business activity regardless of the type of legal entity conducting the trade or business. The new law specifically excludes investment interest expense from this definition.
- For tax years beginning before January 1, 2022, ATI is determined by reducing taxable income by business interest income and increasing it by business interest expense, any net operating loss (NOL) deduction, the new pass-through deduction and cost recovery items (depreciation, depletion and amortization).
- For tax years beginning on or after January 1, 2022, the cost recovery items are not added back in determining ATI.
- A taxpayer can carry forward any disallowed interest expense indefinitely. Such carryforward is treated as additional business interest expense in subsequent taxable years.
- The limitation is calculated at the business entity level, including partnerships and S corporations. Complex rules exist for the interaction of the interest limitation at the pass-through entity and owner levels and the impact of any disallowed interest on the owner's tax basis in the entity.
- This limitation does not apply to taxpayers with average annual gross receipts in the three previous tax years of $25 million or less. In addition, farming and real property businesses that elect to depreciate assets using the Alternative Depreciation System (ADS) are also exempt, as are certain regulated public utilities.
- Unlike the old IRC Section 163(j) limitation, there is no debt to equity safe harbor and any excess limitation capacity does not carry forward to subsequent years, nor can disallowed business interest expense be carried back.

With this overview in mind, we will examine the individual components of the new limitation.

The Basic Calculation

Calculating the Limitation

Under newly revised IRC Section 163(j), the limitation for deductible business interest expense is the sum of (1) business interest income and (2) 30 percent of ATI. In no event can ATI be less than zero. To better understand these two components, let's consider the following example.

Debtor Inc., a calendar year corporation that is not eligible for any exclusion from the new interest expense limitation, has $20 million of taxable income in 2018, before deducting business interest expense of $1 million. Taxable income includes the following items related to this limitation: (1) business interest income of $3 million, (2) tax depreciation of $15 million and (3) a NOL carryover from 2017 of $5 million.

Since Debtor Inc.'s business interest income exceeds its business interest expense, there is no disallowed interest expense in 2018. Debtor can deduct all of its business interest expense of $1 million.

However, assume that business interest expense is $10 million instead of $1 million. All of the other facts remain the same. In this case, Debtor Inc.'s business interest expense exceeds business interest income, so a calculation of ATI is necessary:

Taxable Income before interest expense	$20,000,000
Add: Depreciation	15,000,000
Add: NOL carryover	5,000,000
Less: Business interest income	(3,000,000)
Adjusted Taxable Income (ATI)	$37,000,000
30% of ATI	$11,100,000

In this example, Debtor once again can deduct all of its business interest expense. The limitation is the sum of (1) $3 million of business interest income and (2) $11.1 million, representing 30 percent of ATI. Thus, Debtor Inc. has the ability to deduct up to $14.1 million of business interest expense, which exceeds its business interest expense of $10 million by $4.1 million. Unlike the old IRC Section 163(j) rules, there is no carryforward of this excess limitation, nor can Debtor Inc. carry back to 2018 any future disallowed business interest expense.

If in the previous example, Debtor had a taxable loss of ($4 million) before deducting business interest expense of $10 million, the company's ATI would be:

Taxable income before interest expense	($4,000,000)
Add: Depreciation	15,000,000
Add: NOL carryover	-0-
Less: Business Interest Income	(3,000,000)
Adjusted Taxable Income	$8,000,000
30% of ATI	$2,400,000

In this example, Debtor Inc. can deduct only $5.4 million of its business interest expense, equal to the sum of (1) $3 million of business interest income and (2) 30 percent of ATI or $2.4 million.

We will discuss the treatment of the disallowed interest expense of $4.6 million further below.

ATI Cannot be Less Than Zero

As noted above, IRC Section 163(j) specifically states that ATI cannot be less than zero. This provision is beneficial to the taxpayer since otherwise negative ATI would reduce any business interest income. It is also important in the context of partner/partnership limitation calculations discussed later.

Assume the same facts as the previous example, except that Debtor has a taxable loss of ($100 million) prior to deducting business interest expense. After making the same adjustments, ATI would be a loss of ($88 million). The rules limit this amount to zero. In this scenario, Debtor can deduct business interest expense of $3 million, the amount of business interest income.

Taxpayers Can Carry Forward Disallowed Business Interest Expense Indefinitely

In a previous example, IRC Section 163(j) resulted in the disallowance of $4.6 million of Debtor Inc.'s business interest expense. However, the law allows Debtor to carry forward the $4.6 million of disallowed interest expense indefinitely. This carryforward is treated as additional business interest expense in subsequent years until utilized. Debtor Inc. would test for deductibility each year using the same limitation formula discussed above.

Let's assume that Debtor Inc.'s operations improve in 2019, when it has taxable income (before interest expense) of $50 million. Once again, assume taxable income includes business interest income of $3 million and depreciation of $15 million, but there is no longer a NOL carryover. Also, Debtor Inc. accrued business interest expense of $10 million, similar to 2018. This amount is not included in taxable income as we have not calculated Debtor's allowable deduction.

Debtor's ATI would be:

Taxable income before interest expense	$ 50,000,000
Add: Depreciation	15,000,000
Less: Business interest income	(3,000,000)
Adjusted Taxable Income	$ 62,000,000
30% of ATI	$18,600,000

Debtor has the limitation capacity to deduct interest expense of $21.6 million, equal to the sum of (1) $3 million of business interest income and (2) 30 percent of ATI or $18.6 million. Accordingly, Debtor will deduct all $10 million of the interest accrued in 2019 and its $4.6 million carryforward from 2018.

As Usual, Partnerships Complicate the Picture!

For an entity that is not a taxpayer, a partnership often creates very complex issues and sometimes even opportunities in many areas of tax compliance. In the context of the business interest expense limitation, this paradox applies.

Interest Limitation Calculated at the Entity Level

Initially, the application of the new tax law appears fairly straightforward in the context of a partnership. As we noted above, the limitation itself is calculated at the entity level. And this remains true for partnerships even though they are flow-through entities. Interest expense that can be deducted at the partnership level after application of the limitation does not have to be tested again at the partner level.

Let's use Leverage Ltd., a partnership for tax purposes, as an example. Assume in 2018 that Leverage Ltd. has ATI of $50 million after adding back $9 million of depreciation. The partnership has no business interest income, but does have $20 million of business interest expense. Leverage Ltd. can deduct $15 million of its business interest expense or 30 percent of ATI (as there is no business interest income). Accordingly, Leverage reports taxable income of $26 million, which is ATI of $50 million less depreciation of $9 million and deductible business interest expense of $15 million.

Debtor Inc. is a 50 percent partner in Leverage Ltd. Accordingly, Debtor will be allocated $13 million of partnership taxable income from Leverage. Debtor's allocable share of deductible business interest expense from Leverage is not separately stated from ordinary income and does not have to be tested again with Debtor Inc. Further below, we will discuss the treatment of Leverage Ltd.'s disallowed business interest expense of $5 million.

No Double-Counting of Partnership ATI

Now things start to get more complicated when dealing with partnerships. The revised IRC Section 163(j) prevents a partner from double-counting its share of partnership ATI when determining the deductibility of business interest expense directly paid or accrued by a partner. Assume that Debtor Inc. has no business interest income and ATI of $0 exclusive of its share of activity from Leverage Ltd. Debtor accrued $4 million of business interest expense directly. Although Debtor Inc. will include its $13 million allocable share of ordinary income from Leverage in its taxable income, such amount is excluded from Debtor's ATI. So, Debtor's ATI remains at zero and the corporation cannot deduct any of its business interest expense of $4 million.

However, Excess ATI from a Partnership Can Help!

The rules are not all punitive. Partnership ATI attributable to excess limitation at the partnership level is allocated to each partner for purposes of applying the partner's limitation for any business interest expense incurred directly by such partner.

Let's revise our example involving Leverage Ltd. by increasing its ATI from $50 million to $100 million. Leverage's business interest expense limitation is now $30 million or 30 percent of ATI. Leverage can deduct all $20 million of its business interest expense. The partnership has $10 million of excess limitation. Leverage Ltd.'s ATI attributable to this excess limitation is $33 million, calculated as $10 million excess limitation/$30 million total limitation times $100 million of ATI. Debtor Inc. can include its 50 percent share of this amount in its ATI. In our example, Debtor Inc. has zero ATI from its own operations and $4 million of business interest expense. Debtor can increase its ATI to $16.5 million, its 50 percent share of Leverage's ATI attributable to excess limitation. This will allow Debtor, Inc. to deduct all of its business interest expense incurred directly as it now has a limitation of $4,950,000 (30 percent of the $16.5 million excess ATI it received from Leverage Ltd.).

In determining excess ATI at the partnership, interest expense

is first offset against interest income. The remaining interest expense reduces the 30 percent of ATI to determine excess ATI. If the ordering were reversed, the partner would receive less excess ATI and business interest income would not be utilized in the calculation.

Disallowed Interest Expense of a Partnership Carried Forward by the Partners, Not the Partnership

In our initial example involving Leverage Ltd., the partnership has $5 million of disallowed interest expense. Instead of carrying disallowed interest expense forward, the law requires that the partnership allocate to each partner its share of the disallowed amount, based on the partner's allocable share of non-separately stated income. In subsequent years, the partner can deduct its share of the disqualified interest expense to the extent it is allocated any excess limitation from the partnership.

Therefore, Leverage Ltd. must report, on Debtor Inc.'s Schedule K-1, Debtor's $2.5 million share of disallowed interest expense, or 50 percent of $5 million. In subsequent years, Debtor Inc. can deduct the $2.5 million interest expense against any ATI attributable to excess limitation allocated to it from Leverage Ltd. Note that Debtor Inc. can only deduct this disqualified interest against future excess limitation from Leverage Ltd., not from any other partnership or its own ATI.

Disallowed interest expense of a partnership is allocated to each partner, who then carries such amount forward.

The specific language in IRC Section 163(j) regarding ATI attributable to excess limitation from a partnership is somewhat confusing. The language suggests that the partner can deduct the disallowed interest expense carryover to the extent it is allocated excess ATI from a partnership. Presumably, the intention is that the interest can be deducted against 30 percent of such amount, although this is not clear in the language. Hopefully, future guidance from the IRS will clarify this.

How does the disallowed interest expense impact Debtor's tax basis in Leverage Ltd.? IRC Section 163(j) requires Debtor to reduce its tax basis in Leverage by $2.5 million in 2018, even though Debtor, Inc. will not benefit from this disallowed interest expense until future years, if at all. This could impact the amount of losses Debtor can recognize from Leverage Ltd. in future years. If Debtor subsequently disposes of its investment in Leverage prior to utilizing this carryforward amount, it can increase its tax basis in Leverage immediately before the disposition by any unused portion.

A Final Word on Partnerships

A corporation, through the use of subsidiaries, has the ability to operate a business through a partnership while effectively maintaining 100 percent ownership. IRC Section 163(j) does not distinguish between partnerships held by unrelated partners and wholly owned partnerships. This presents planning opportunities with regard to placement of debt. Absent guidance from the IRS, the operating rules of Section 163(j) indicate the following:

- If the ATI limitation at the partnership equals or exceeds interest expense, there is no incentive to move debt to the partner. Any excess ATI is not wasted, but is allocated to the partners. The consolidated group rules discussed below make the allocation between partners of no consequence.
- If interest expense within a partnership exceeds the limitation, the corporation should consider restructuring the debt to place at least a portion of the balance at the partner level if the partner has excess limitation.
- If neither the partner nor partnership has excess limitation, the placement of debt at the partnership level should not exceed the limitation since disallowed interest expense at the partnership level can only be utilized against excess limitation from the partnership that is later allocated to the partners. But disallowed interest expense at the partner level can be utilized with excess limitation of the partner or excess limitation allocated to the partner from the partnership in future years.
- Corporations should consider restructuring wholly owned partnerships to increase ATI in partnerships with debt. Splitting a partnership into two partnerships might allow for greater capacity to utilize interest expense.

For example, if a partnership contains one profitable facility (A) and one unprofitable one (B), separating the facilities into two separate entities would increase the limitation for A. And the ATI of B cannot be less than zero, so there is no reduction in the ATI of the partners.

Application to Other Pass-Through Entities

With one exception, the partnership limitation provisions apply to S corporations. The limitation is still calculated at the S corporation level. To the extent ATI is used by the S corporation to deduct business interest expense, it cannot be included in the shareholder's ATI to offset interest expense from other sources. Also, similar to a partnership, a shareholder can use its allocable share of excess limitation from an S corporation. Where the two pass-through entities differ is with regards to disallowed interest expense. As we discussed above, disallowed interest expense of a partnership is allocated to each partner, who then carries such amount forward. Disallowed interest remains with an S corporation, which carries it forward until it has sufficient limitation to deduct it.

There is no mention of entities treated as sole proprietorships (e.g., default classification of single member LLCs) in IRC Section 163(j), although presumably business interest expense in these entities would be subject to the same limitation. The law does refer to ATI excluding the new special pass-through deduction, which would only apply to individuals.

In addition, IRC Section 163(j) specifically excludes services of an employee from the definition of a trade or business, implying that other activities by an individual could be subject to the limitation. Also, investment interest income and expense are specifically excluded from the definitions of business interest income and business interest expense, respectively. Investment interest income and expense is a concept unique to individuals from a tax perspective. Practically though, the small business exception applicable when average gross receipts for the three previous years does not exceed $25 million would eliminate most sole proprietorships from this limitation.

Going Forward

Future IRS Guidance

Taxpayers and their advisors are anticipating additional guidance from the IRS with regards to the limitation on business interest expense. In March 2018, the IRS issued Notice 2018-18. In this notice, the IRS indicated that future regulations will clarify that:

- All of the taxable interest income and otherwise deductible interest expense of a corporation will be considered business interest income and expense for purposes of the revised IRC Section 163(j). A corporation does not have investment interest income or expense for purposes of this limitation.
- The limitation will apply on a consolidated basis for corporations filing a consolidated tax return. However, the limitation will be computed separately for members of an affiliated group not filing a consolidated tax return.
- Interest expense disallowed in prior years under the old IRC Section 163(j) can be carried forward to 2018 and treated as business interest expense paid in 2018. This interest will be subject to the new limitation.
- Guidance in regulations will be issued addressing the interaction between the new limitation and the new base erosion avoidance tax for interest paid to related parties disallowed under the older IRC Section 163(j) and carried forward to 2018.
- Disallowed interest under IRC Section 163(j) will still reduce a corporation's earnings and profits.
- The new law specifically states that ATI from a partnership cannot be double-counted by a partner to deduct additional business interest expense at the partner level. Although IRC Section 163(j) is silent with regards to a partner's allocable share of business interest income from a partnership, the regulations will clarify that a partner cannot double count this income either.

Proactive Planning is Necessary

Businesses will certainly need to model taxable income and interest expense to determine the likelihood of a potential disallowance of a tax deduction for all or part of its business interest expense going forward. For many businesses, such analysis will show that no disallowance is expected. However, for leveraged taxpayers, especially ones in cyclical industries, a disallowance may be a possibility.

This could drive decisions on whether to finance operations with debt or equity. And if partnerships or unconsolidated groups are involved, the placement of debt within an organization could be critical. There are other issues for taxpayers to consider.

Capital Expenditures and Depreciation Elections

For capital-intensive businesses, the limitation becomes more severe for tax years beginning after January 1, 2022 when ATI is no longer increased by depreciation, depletion or amortization. While focusing on this change may be premature given Congress' history of modifying tax law to accommodate the bonus depreciation rules, as 2022 approaches, taxpayers should be prepared to analyze both (1) the timing of capital expenditure decisions (especially between 2021 and 2022) and (2) the potential

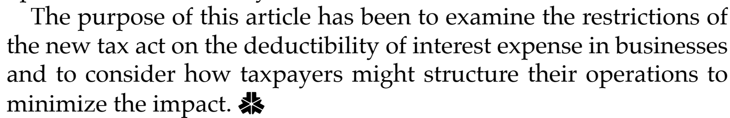
election of ADS depreciation instead of MACRS.

While depreciation is a timing issue and disallowed interest expense can be carried forward indefinitely, leveraged companies with substantial capital needs likely will not see large swings in either depreciation expense or interest expense. Accordingly, taking the maximum depreciation deduction may indirectly result in a limitation of interest expense that becomes indefinite in timing.

Financial Reporting Implications

We will make a final note regarding financial reporting. Businesses that prepare financial statements, especially those prepared under generally accepted accounting principles, will need to consider any financial reporting implications of disallowed interest expense. Since disallowed interest expense can be carried forward indefinitely, it will result in a deferred tax asset.

However, a taxpayer would then need to assess if it was more likely than not that some or all of the deferred tax asset would not be realized, thus requiring a valuation allowance. The modeling for this analysis will be complicated as it needs to encompass several factors, including (1) future operating income, (2) a reliable forecast of future debt levels and associated interest expense, (3) anticipated business interest income, (4) estimated capital expenditures and (5) available options for cost recovery.



The purpose of this article has been to examine the restrictions of the new tax act on the deductibility of interest expense in businesses and to consider how taxpayers might structure their operations to minimize the impact.

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