Six Things to Know About the New Interest Expense Limitation

Article
01.25.2018

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Last month, President Trump signed into law the much publicized Tax Cut and Jobs Act. In part of our ongoing series discussing the changes made by the Act, the following answers six common questions regarding the new Section 163(j) limitation on interest. This new limitation will be unfavorable for most taxpayers, and was part of the trade-off for the Act lowering tax rates.

1. What interest is subject to this limitation?

This limitation applies to interest expense incurred by a taxpayer in its trade or business. It does not apply to personal or investment interest expense, each of which is subject to other restrictions on deductibility.

2. What is the limitation?

A taxpayer is now limited in the amount of net business interest that it can deduct in a year to 30% of adjusted taxable income. This limitation is on net interest income, so the limitation only applies to the extent that interest expense exceeds interest income. Additionally, interest on floor plan financing is not subject to this limitation and is fully deductible.

3. Are all businesses subject to this limitation?

No. Small businesses (those with no more than $25 million in average annual gross receipts for the prior 3 tax years) are not subject to the limitation. In addition, certain businesses such as real estate or farming businesses may elect out of this rule. As discussed in last week's eblast, real estate businesses that elect out of the limitation are required to use the less favorable alternate depreciation system.

4. How is adjusted taxable income computed for purposes of this limitation?

Adjusted taxable income is equal to a taxpayer's taxable income without taking into account (i) business interest or business interest income, (ii) net operating losses, (iii) the qualified business income deduction (previously discussed here), and (iv) for tax years 2018 through 2021, deductions for amortization or depreciation deductions. More simply, taxable income is similar to EBITDA for tax years 2018 through 2021, and EDIT for tax years beginning after 2021.

5. What happens to the excess interest?

Any interest expense that is disallowed because of the 30% limitation is carried forward to the next taxable year. The excess interest expense can be carried forward indefinitely.

6. How is the limitation applied in the case of partnerships?

The limitation is applied at the partnership level. To the extent that interest is not deductible at the partnership level, the carryforward of the excess interest expense is a partner level item. The partner can only use an interest expense carryforward to offset taxable income of the partnership that generated the carryforward, and cannot use it against any other sources of taxable income. For example, if ABC Partnership has $100 of interest expense that is disallowed under Section 163(j), then 30% partner Bob will have a $30 interest expense carryforward. In the future, Bob can only apply that carryforward to offset taxable income from ABC Partnership. In the next year, if Bob has $100 of income from other sources but no taxable income from ABC Partnership, the $30 interest expense carryforward cannot be used and must continue to be carried forward. This article is informational only. You should consult an attorney before acting or failing to act. The law may change rapidly and no warranty is given. LOWNDES DISCLAIMS ALL IMPLIED WARRANTIES AND WITHOUT LIMITATION, ANY WARRANTY OF FITNESS FOR A PARTICULAR PURPOSE. ALL ARTICLES ARE PROVIDED AS IS AND WITH ALL FAULTS. Consult a Lowndes attorney if you wish to establish an attorney/client relationship.