Federal Tax Alert

Provided by the National Tax Office

December 2018

Ten things you need to know now about the new interest expense limitation

The Tax Cuts and Jobs Act imposed a limitation on the deduction of business interest expense starting in 2018. Generally, this rule limits interest deductions to an amount equal to business interest income plus 30 percent of adjusted taxable income. The Treasury Department and IRS recently released proposed regulations on this limitation, which included both expected guidance and a few surprises. As taxpayers are looking toward their fourth-quarter 2018 estimated tax payments and other tax planning, here are the top 10 things you need to know about the interest expense limitation.

Adjusted taxable income and the inventory penalty. One of the core elements of the business interest expense limitation is calculated by multiplying 30 percent times the adjusted taxable income (ATI) of the taxpayer. ATI begins with taxable income and is then adjusted by adding back several items, including net interest expense, net operating losses, depreciation, amortization, and depletion. However, the proposed regulations indicate that any depreciation, amortization, or depletion that's included in the cost of goods sold won't be added back. This interpretation is particularly harmful for manufacturing businesses where most depreciation is included in the cost of goods sold, but may also harm retailers, distributors, and other businesses with inventory. Since most capital expenditures are now eligible for 100 percent bonus depreciation and taxable income will be depressed compared to book income, even profitable businesses may encounter a greater interest limitation than otherwise expected.

Expansive definition of interest expense. The proposed regulations take a very broad view of what is considered interest expense for the purposes of this limitation. This begins with items ordinarily viewed as interest expense, such as stated interest on a loan and original issue discount. However, the proposed regulations also include items that haven't historically been treated as interest, such as debt issuance costs, payments on interest rate swaps and other derivatives, lender commitment fees, guaranteed payments for the use of capital, and other similar items. The inclusion of these additional items will cause many more taxpayers to be subject to this limitation.

Small businesses. Businesses with average gross receipts of less than $25 million over the past three years aren't subject to the interest expense limitation. This provides a welcome break to small businesses. However, entities with common ownership must combine their gross receipts to determine whether they're exempt as small taxpayers. This can be a time-consuming and costly analysis, where there are multiple related-party entities with a variety of owners. Additionally, taxpayers who generate taxable losses and allocate more than 35 percent of those losses to limited partners or passive investors aren't considered small businesses even if their gross receipts are less than $25 million.

Real estate businesses and related-party restrictions. Real estate trades or businesses are eligible to elect out of the interest limitation rules but, as a trade-off, must use slower depreciation methods on real property assets and cannot utilize 100 percent bonus depreciation on those real property assets. This slower depreciation must also be applied to assets placed in service in prior years. Since many real estate businesses are highly leveraged, this election is favorable in many circumstances. However, the proposed regulations restrict real estate businesses that lease 80 percent or more of their property to related operating businesses (so called "self-rental") from making this election. These self-rental real estate businesses will then be fully subject to the interest limitation rules unless they can qualify as a small business. This new anti-abuse rule is expected to impact many existing related-party rental arrangements, including those that weren't created to circumvent the new business interest expense limitation.

Partnership and S corporation complications. The interest limitation is determined at the entity level for partnerships and S corporations but the mechanics of each calculation is different. The excess interest expense is carried forward at the entity level for S corporations, but for partnership, that excess is tiered up to the first level of partners. Each partnership and S corporation must also flow through various other information that their owners must use to determine their own interest limitation calculations. Additionally, the allocation of certain attributes is subject to a complex 11-step determination process for partnerships. The treatment of multitiered partnerships is not yet addressed by the regulations. In short, flow-through entities, especially partnerships, and their owners will need to spend more time to address the business interest limitations.

Application to C corporations. Corporations calculate their interest expense limitation and retain all related attributes at the corporate level. In a prior notice, the Treasury Department and IRS announced that consolidated groups of corporations would determine their interest expense limitation on an aggregate basis. The proposed regulations follow these expectations and provide further clarifications regarding the treatment of attributes related to the interest expense limitation within corporations. For consolidated groups, these rules largely follow existing rules relating to ownership changes, including separate return limitation years, allocations among group members, and Section 382 limitations.

Self-charged interest. If the owner of a business loans money to the business, the owner recognizes interest income while the business recognizes interest expense. When this occurs in a pass-through business, it can be particularly troublesome if the business isn't permitted to fully deduct that interest expense but the owner still must recognize the interest income. The preamble to proposed regulations indicated that the Treasury Department and IRS intend to write rules to prevent this result and requested comments as to how they should operate. The language in the preamble should give taxpayers in this situation some comfort that they'll be able to match their interest income and deductions, but the exact nature of these rules may not be known for some time.

Floor plan financing. Dealers and lessors of motor vehicles, boats, and farm machinery or equipment aren't subject to the interest limitation rules on their debt that is used in acquiring their inventory held for sale or lease. However, as a trade-off, these taxpayers are also ineligible for 100 percent bonus depreciation. While some dealers would be in a better tax position if they were permitted to claim bonus depreciation and be subjected to the interest limitations, these rules are not elective.

Foreign businesses. The proposed regulations include a considerable number of rules for both U.S. businesses with foreign operations and foreign businesses operating in the United States. Most importantly, controlled foreign corporations are subjected to the interest limitation rules but with a number of modifications.

Entities with multiple trades or businesses. The proposed regulations contemplate that some business entities will have more than one trade or business. In such cases, it would be possible to have one business that's subject to the interest expense limitation while the other business isn't subject to the limitation (an excepted trade or business). For this purpose, an excepted trade or business would include an electing real property trade or business, an electing farming business, or a regulated utility trade or business. The entity must allocate interest income, interest expense, and other tax attributes among the different trades or businesses based on rules outlined in the proposed regulations.

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