What to Know About New Limitations on the Deduction of Business Interest

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Overview

The Tax Cuts and Jobs Act, passed on Dec. 22, 2017, makes sweeping modifications to the Internal Revenue Code, including a much lower corporate tax rate, changes to credits and deductions, and a move to a territorial system for corporations that have overseas earnings. One of the major provisions of the Act changes the deductibility of business interest expense.

For years, companies have been incentivized to borrow, not only by extraordinarily low interest rates, but also by the full deductibility of interest expense. The new law is seen as a crackdown on excessive debt. Those most impacted will be highly leveraged companies.

Business Interest Limitation

Effective for taxable years beginning after Dec. 31, 2017, the deduction for business interest expense is limited to the sum of business interest income plus 30% of the adjusted taxable income of the taxpayer for the taxable year, plus the floor plan financing interest (essentially interest incurred on debt to finance motor vehicles held in inventory for sale or lease).

The limitation applies on a taxpayer level. For affiliated corporations that file a consolidated return, it applies at the consolidated tax return filing level. In the case of any partnership, the limitation applies at the partnership level. Additionally, special rules apply to the determination of adjusted taxable income of each partner of the partnership to prevent double counting.

For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization or depletion. Additionally, because the law repeals the domestic production deduction (§199) effective Dec. 31, 2017, adjusted taxable income is computed without regard to such deduction.

Any interest disallowed as a deduction may be carried forward indefinitely.

At the taxpayer's election, the limitation will not apply to real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business to be treated as a trade or business for purposes of the limitation. Additionally, special rules and elections are available for certain regulated public utilities or electric cooperatives, farming businesses, and specified agricultural or horticultural cooperatives.

Small Business Exemption

It is important to note that an exemption is available for certain small-business taxpayers that meet a $25 million gross receipts test. This exemption allows taxpayers with annual gross receipts that do not exceed $25 million for the three prior taxable-year period to be exempt from the limitation on interest deductibility.

How does the limitation work?

To see how the business interest expense limitation works, let's consider the following examples.

Example 1

ABC Co. has taxable income of $150,000. Included in that amount is $10,000 of interest income, $100,000 of interest expense, $120,000 of depreciation and $10,000 of amortization. The adjusted taxable income and limitation is computed as follows:

$150,000 (taxable income) – $10,000 (interest income) + $100,000 (interest expense) + $120,000 (depreciation) + $10,000 (amortization) = $370,000 (adjusted taxable income).

When multiplied by 30%, the preliminary limitation is $111,000. The total limitation is $111,000 plus interest income of $10,000, or $121,000. Because interest expense of $100,000 is less than the limitation, the entire interest expense is deductible.

Example 2

Consider the same facts as above, except taxable income is now $50,000.

The adjusted taxable income is computed as follows:

$50,000 (taxable income) – $10,000 (interest income) + $100,000 (interest expense) + $120,000 (depreciation) + $10,000 (amortization) = $270,000 (adjusted taxable income).

When multiplied by 30%, the preliminary limitation is $81,000. The total limitation is $81,000 plus interest income of $10,000, or $91,000. Because of the limitation, ABC Co. can only deduct $91,000 of interest expense.

The disallowed interest expense of $9,000 is then carried forward indefinitely.

Considerations

The business interest limitation will require additional modeling when considering the financial structure of many merger and acquisition transactions. The limitation may also encourage multinational taxpayers to locate debt offshore. Marginally profitable businesses with high leverage should carefully assess their capital structure and consider repaying existing debt. Moreover, for pass-through entities, the interest expense limitation is determined at the entity level. Therefore, individual partners can only include partnership income to offset their direct interest expense to the extent it has been allocated taxable income in excess of the limitation at the entity level.

Questions? To determine how the changes in business interest deductions affect your business, or for other **federal tax planning issues**, please contact Michael R. Milazzo, CPA, or Stella I. Metz, CPA, at 813-288-8826 or email **Michael** or **Stella**.