

Overview of Limitation on Deduction of Business Interest: Section 163(j)



**Prepared by the Staff of the Joint Committee on Taxation
March 2019**

Overview

- ❑ Public Law 115-97 (the “Act”) added new section 163(j) to the Internal Revenue Code (the “Code”).
- ❑ This new rule generally limits the amount of a taxpayer’s business interest deduction to the sum of:
 - The taxpayer’s business interest income;
 - 30% of the taxpayer’s adjusted taxable income; and
 - The floor plan financing interest of the taxpayer.
- ❑ Any business interest expense in excess of this threshold is carried forward to the following year.
- ❑ The limitation generally does not apply to small businesses (other than tax shelters), regulated public utilities, and electing farming or real property trades or businesses.

Background

Background: Interest Deduction Generally

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- Taxpayers are generally allowed to deduct interest paid or accrued within the taxable year on indebtedness.
 - The Code does not define “interest.”
 - The Supreme Court has defined interest as “compensation for the use or forbearance of money.”
Deputy v. Du Pont, 308 U.S. 488, 498 (1940).

Background: Interest Deduction Generally

- Section 163 contains numerous exceptions to and limitations on a taxpayer's ability to deduct interest, for example:
 - For taxpayers other than corporations, the deduction for interest on indebtedness allocable to investment property is limited to the taxpayer's net investment income for the taxable year;
 - Personal interest (generally, interest on indebtedness not properly allocable to a trade or business or investment property) is generally not deductible, but there are important exceptions.
 - For example, some interest on indebtedness secured by a qualified residence (mortgage interest) and some interest on student loans may be deductible.

Background: Prior-Law Section 163(j)

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- Prior-law section 163(j) limited a corporation's interest deduction in circumstances that indicated the corporation was paying interest to related parties to reduce U.S. taxable income.
 - Generally, the rule applied to a corporation with a high debt-to-equity ratio making large interest payments (relative to adjusted taxable income) to related parties not subject to U.S. tax (e.g., a foreign affiliate).
 - Adjusted taxable income for purposes of prior-law section 163(j) was defined to roughly approximate earnings before interest, tax, depreciation, or amortization ("EBITDA").
 - Because of its focus on reductions in the U.S. tax base, this rule was often referred to as addressing "earnings stripping."

Background: From Prior-Law to Present-Law

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- Section 13301 of the Act replaced prior-law section 163(j) with present-law section 163(j), which has broader application. The new rule:
 - Applies to business interest expense of all taxpayers (not just corporations) regardless of debt-to-equity ratio and regardless of status of the lender (*i.e.*, related or unrelated);
 - Retains old section 163(j)'s focus on the relationship between interest payments and an adjusted taxable income; and
 - Addresses debt financing generally, and does not focus primarily on scenarios reflecting the potential for earnings stripping.

Present Law

Present-Law Section 163(j)

- ❑ For any taxpayer, the amount allowed as a deduction for business interest for the taxable year is limited to the sum of:
 - The business interest income of the taxpayer for the taxable year;
 - 30% of the adjusted taxable income of the taxpayer for the taxable year; and
 - The floor plan financing interest of the taxpayer for the taxable year.
- ❑ By including business interest income in the calculation, the rule operates to limit deduction only of net business interest expense.

Present-Law Section 163(j)

- The limitation applies at the taxpayer level.
 - For example, the limitation applies at the consolidated tax return filing level, because the consolidated group is a single taxpayer.
 - For partnerships and S corporations, the limitation applies at the entity level.
- Any business interest not allowed as a deduction for any year may be carried forward indefinitely.
 - There is a special carryforward rule for partnerships.

Defined Terms: Business Interest and Business Interest Income

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- ❑ **Business interest** means any interest paid or accrued on indebtedness properly allocable to a trade or business.
- ❑ **Business interest income** means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business.

Defined Terms: Adjusted Taxable Income

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- **Adjusted taxable income** (“ATI”) means the taxable income of the taxpayer computed without regard to:
 - Any item of income, gain, deduction, or loss that is not properly allocable to a trade or business;
 - Any business interest or business interest income;
 - The amount of any net operating loss deduction;
 - The amount of any deduction allowed under section 199A; and (definition continues on next slide)

Defined Terms: Adjusted Taxable Income (cont.)

- For taxable years beginning before January 1, 2022, ATI is computed **without** regard to any deduction allowable for depreciation, amortization, or depletion.
 - This definition of ATI generally corresponds with the financial accounting concept of EBITDA.
- For taxable years beginning on or after January 1, 2022, ATI is computed **with** regard to deductions for depreciation, amortization, and depletion.
 - This definition of ATI generally corresponds with the financial accounting concept of earnings before interest and taxes, or EBIT.
 - As a result, for taxpayers with such deductions, the limitation becomes more stringent in taxable years beginning on or after January 1, 2022.

Defined Terms: Floor Plan Financing

- **Floor plan financing interest** means interest paid or accrued on floor plan financing indebtedness.
 - **Floor plan financing indebtedness** means indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired.
 - **Motor vehicle** means a motor vehicle that is:
 - Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road;
 - A boat; or
 - Farm machinery or equipment.
 - Once a taxpayer takes floor plan financing interest into account in calculating its business interest limitation, the taxpayer may not claim bonus depreciation under section 168(k) for property placed in service during such year and subsequent years.
 - The taxpayer can choose not to take floor plan financing into account in computing its business interest limitation, in which case the taxpayer may claim bonus depreciation (if floor plan financing was not taken into account in a prior year).

Carryforward Rules

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- ❑ For taxpayers other than partnerships, the amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year.
 - The business interest carried forward is added to any business interest in the succeeding year and then subjected to the limitation for that year.
 - For corporations, this carryforward is subject to limitation by section 382.
- ❑ Partnerships have a special carryforward rule (discussed in more detail below) requiring any business interest in excess of the partnership's limitation to be allocated to partners in the same manner as the partner's distributive share of partnership interest expense.

Application to Passthrough Entities

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- For partnerships and S corporations (together, “passthroughs”), the limitation applies at the entity level.
 - The amount of business interest paid or incurred by a passthrough that may be deducted is determined by the business interest income, adjusted taxable income, and floor plan financing interest of the passthrough for the taxable year.
 - In this respect, the limitation treats passthroughs as entities rather than aggregates of their owners.

Passthroughs: Anti-double-counting rules

- ❑ Anti-double-counting rules provide that any business interest income, adjusted taxable income, or floor plan financing interest that gives rise to additional business interest deduction at the passthrough level does not also increase any passthrough owner's business interest limitation.
- ❑ These rules also allow business interest income and adjusted taxable income that does not give rise to additional business interest deduction at the passthrough level to increase owners' limitations.
- ❑ Without these rules, items of business interest income, adjusted taxable income, or floor plan financing interest of the passthrough might be viewed as generating additional deduction as the items are passed through to the owners.

Passthroughs: Allocation of Excess Items under Anti-Double-Counting Rules

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- The passthrough rules require allocations of section 163(j) items (*i.e.*, allowed and disallowed business interest of the passthrough, excess business interest income of the passthrough, and excess taxable income of the passthrough) consistent with the allocations of the economic items associated with those section 163(j) items.

Passthroughs: Allocation of Excess Items under Anti-Double-Counting Rules

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- Generally, with respect to partnerships, the anti-double-counting rules require that:
 - Allowed business interest (*i.e.*, business interest of the passthrough that does not exceed the passthrough's business interest limitation) and disallowed business interest (*i.e.*, business interest of the passthrough in excess of the passthrough's business interest limitation) are allocated in the same manner as passthrough interest expense, taking into account the partners' distributive shares of items generating limitation;
 - Excess business interest income (*i.e.*, business interest income of the passthrough in excess of what was necessary for the passthrough to deduct business interest) is allocated in the same manner as passthrough interest income, taking into account the partners' distributive shares of allowed business interest; and
 - Excess taxable income ("ETI") (*i.e.*, adjusted taxable income in excess of what was necessary for the passthrough to deduct business interest) is allocated in the same manner as items comprising adjusted taxable income of the partnership, taking into account the partners' distributive shares of allowed business interest and excess business interest income under the anti-double-counting rules.

Passthroughs: Carryforwards of Disallowed Business Interest of a Partnership

- If a partner in a partnership is allocated disallowed business interest, that amount carries forward at the partner level until the next subsequent year that excess business interest income or ETI are allocated to the partner by the partnership.
 - In a subsequent taxable year, the partner's share of the partnership's disallowed business interest is treated as business interest paid by the partner to the extent of the partner's distributive share of excess business interest income and ETI of the partnership in such year.
 - This rule limits the deductibility of the partner-level carryforward based on the activities of the partnership that gave rise to that carryforward.

Passthroughs: Using Carryforwards in Future Years

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- When disallowed business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of any such allocation.
- In a future year, if the partner deducts the disallowed business interest, the deduction does not affect the partner's basis in its partnership interest.
- If the partner disposes of its partnership interest, the partner's basis is increased by any disallowed business interest that has been allocated to the partner and reduced the partner's basis but has not been deducted.

Effect of the Special Carryforward Rule for Partnerships

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- Two examples in the appendix to this presentation illustrate three summary points about the way the special partnership carryforward rule works as currently drafted and interpreted by Treasury:
 - In the current year (*i.e.*, without regard to carryovers), the ability to deduct partnership business interest is limited by partnership business interest income, partnership ATI, and partnership floor plan financing;
 - Any interest that is not deductible in the current year does not carry forward at the partnership level, but rather is allocated to the partners, where future potential deductions depend on future amounts allocated from the partnership that generated the carryforward; and
 - A partner's ability to deduct a carryforward in the future may depend not only on business interest income allocated to the partner by the partnership that generated the carryforward, but also on other activities of the partner or entities the partner owns.
- While not inconsistent with the wording of the statute, this third point is inconsistent with the intended function of the partnership carryforward rule as described on pages 177 – 178 of JCT's *General Explanation of Public Law 115-97* ([JCS-1-18](#)).

Exceptions: Small Business and Employees

- ❑ **Certain small businesses.**—Section 163(j) does not apply to any taxpayer (other than a tax shelter) for which the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed \$25 million.
- ❑ **Employees.**—The trade or business of performing services as an employee is not treated as a trade or business for purposes of section 163(j).

Exceptions: Utilities

- **Certain regulated utilities.**—The trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by
 - A State or political subdivision thereof,
 - Any agency or instrumentality of the United States,
 - A public service or public utility commission or other similar body of a State or any political subdivision thereof, or
 - The governing or ratemaking body of an electric cooperative,is not treated as a trade or business for purposes of section 163(j).
- Any property primarily used by such utilities is not eligible for bonus depreciation under section 168(k).

Exceptions: Elections

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- Elections:
 - **Electing real property trade or business.**—Any electing real property trade or business as defined in section 469(c)(7)(C) (see next slide) is not treated as a trade or business for purposes of section 163(j).
 - **Electing farming business.**—Any electing farming business is not treated as a trade or business for purposes of section 163(j). A farming business is:
 - A farming business as defined in section 263A(e)(4) (see next slide); or
 - A trade or business of a specified agricultural or horticultural cooperative (as defined in section 199A(g)(4)).
- Effect of an election:
 - An electing real property trade or business is required to use the alternative depreciation system (“ADS,” a slower system of cost recovery than might otherwise be available) to depreciate any of its nonresidential real property, residential rental property, qualified improvement property, qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant property.
 - An electing farming business is required to use ADS to depreciate any property with a recovery period of 10 years or more.

Exceptions: Elections

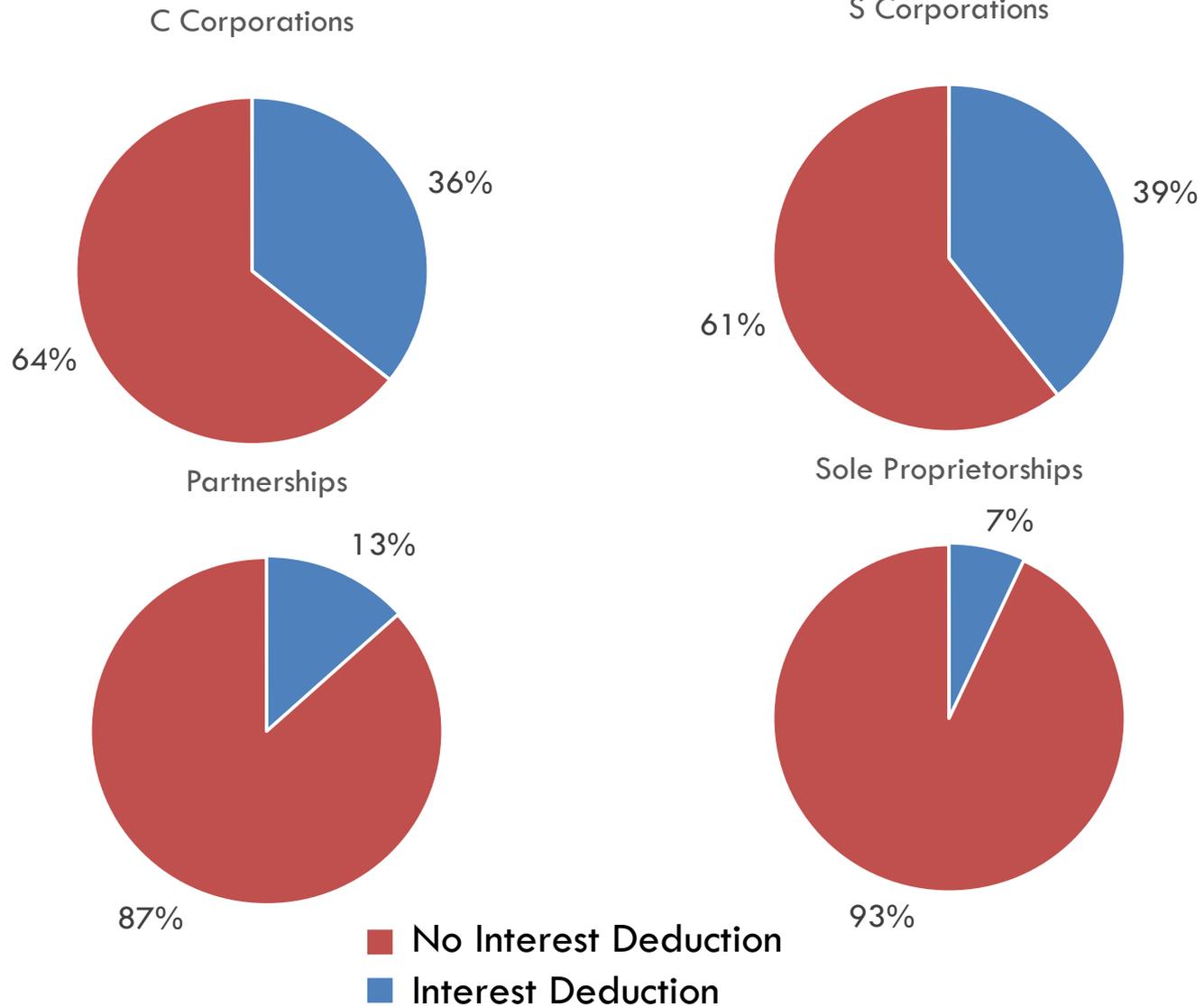
- ❑ Real property trade or business as defined in section 469(c)(7)(C): any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.
- ❑ Farming business as defined in section 263A(e)(4): the trade or business of farming, including the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (other than Christmas trees).
 - Treasury Regulation section 1.263A-4(a)(4) further defines a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity.
 - Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals.
 - A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products.
 - A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer.

Effective Date

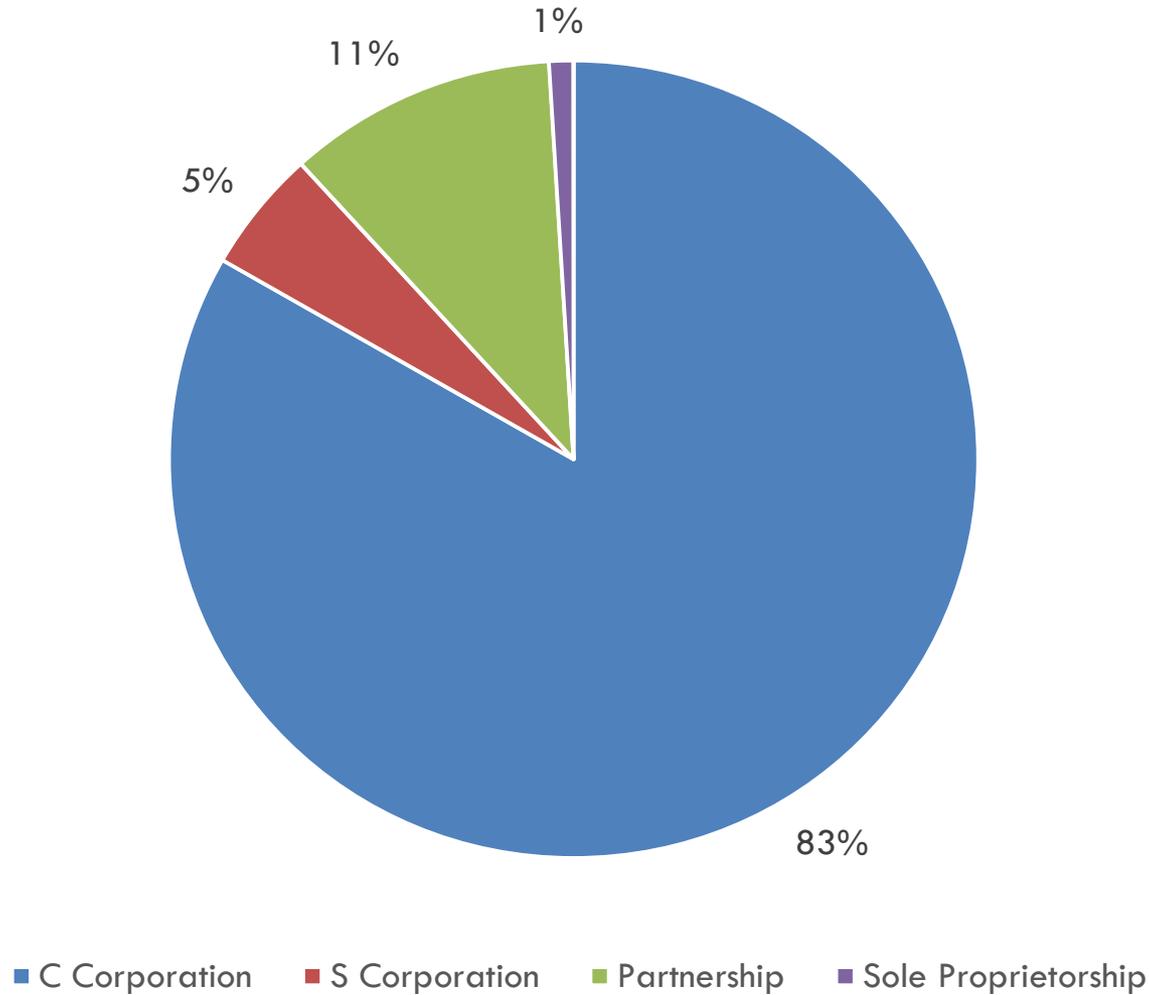
- ❑ Applies to taxable years beginning after December 31, 2017.
- ❑ Business interest expense that was disqualified under old section 163(j) for the last taxable year beginning before January 1, 2018, is carried forward and treated as business interest paid or accrued in the first taxable year beginning after December 31, 2017 and subject to new section 163(j).

Data

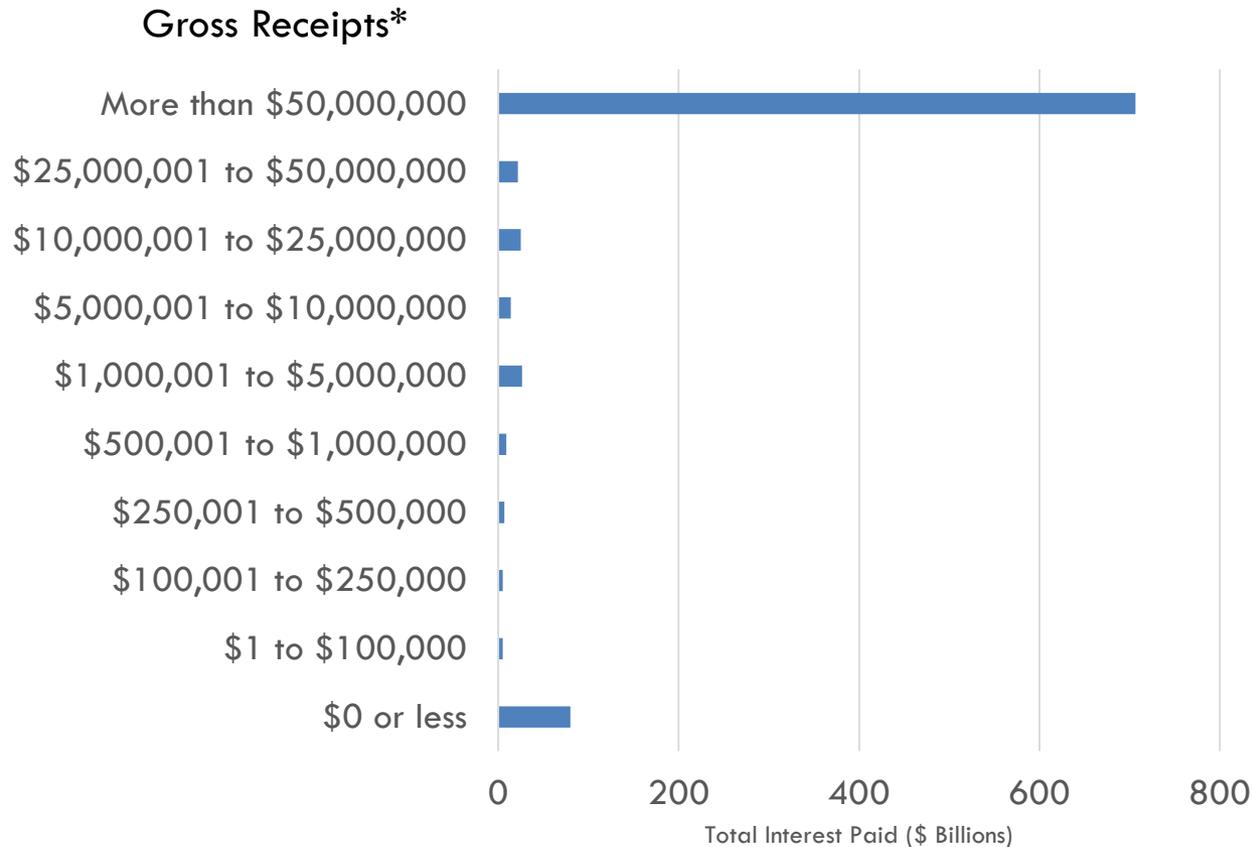
Share of Entities with Interest Deductions by Type, Tax Year 2016



Share of Total Interest Deductions by Entity Type, Tax Year 2016

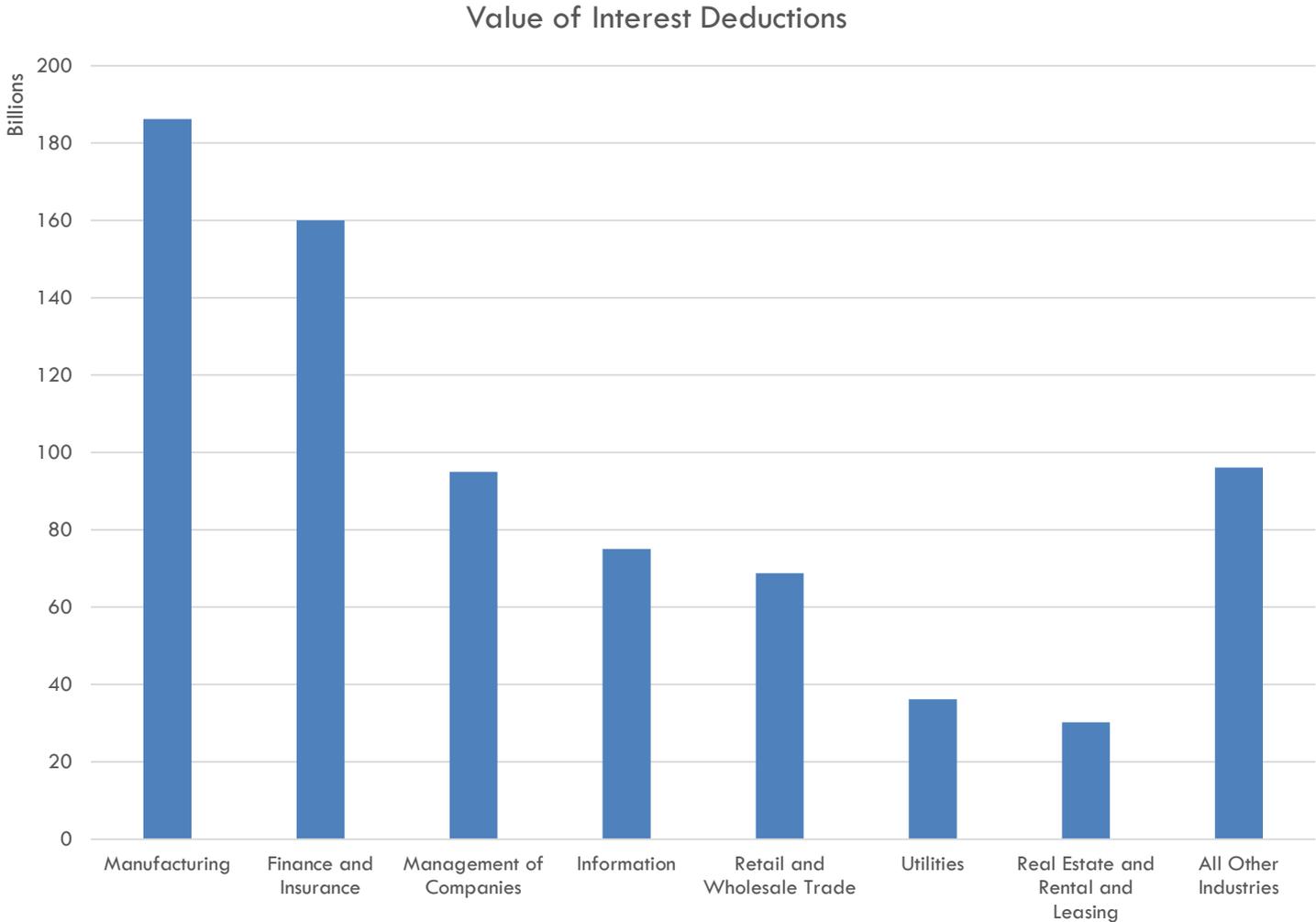


Dollar Value of Interest Deductions by Entity Size, Tax Year 2016 (All Entity Types)



* Gross Receipts generally excludes dividends, interest, rents, royalties, and gains, even if they are a part of operating income

C Corporation Interest Deductions by Industry, Tax Year 2016



Additional Resources

- ❑ Joint Committee on Taxation, *General Explanation of Public Law 115-97* ([JCS-1-18](#)), December 2018, pp. 172-179
- ❑ [REG-106089-18](#) (proposed regulations interpreting section 163(j))
- ❑ [Rev. Proc. 2018-59](#) (IRS revenue procedure treating certain infrastructure business as real property trades or businesses for purposes of section 163(j))

Appendix

Partnership Carryforward Examples

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- Assume a taxpayer, XYZ Corp, that:
 - Is not eligible for any of the exceptions to application of section 163(j);
 - Is a C corporation that is a partner in in two partnerships, Alpha and Bravo, both of which have one other partner with whom XYZ Corp shares all income and expenses equally, and neither of which have floor plan financing indebtedness; and
 - Has no income, expenses, etc. other than those allocated by Alpha and Bravo.

Partnership Carryforward Example 1

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□ Year 1 Facts:

■ Alpha

- \$40m of business interest
- No business interest income
- \$200m of ATI

■ Bravo

- \$200m of business interest
- No business interest income
- \$250m of ATI

- XYZ Corp has no income, expenses, etc. other than those allocated by Alpha and Bravo.

Partnership Carryforward Example 1

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□ Year 1 analysis: Alpha

- Alpha's interest limitation is \$60m: the sum of its business interest income of zero and 30% of its \$200m of ATI.
- The \$60m limitation exceeds Alpha's business interest of \$40m, so none of Alpha's current year business interest is disallowed as a deduction by section 163(j)(1).
 - XYZ Corp is allocated \$20m of Alpha deductible business interest.
- Alpha's ETI is the amount which bears the same ratio to Alpha's ATI as (1) the excess of (a) 30% of Alpha's ATI (\$60) over (b) the amount by which Alpha's business interest exceeds its business interest income (\$40), bears to (2) 30% of Alpha's ATI.
 - $(\$60m - \$40m) / \$60m = 1/3$.
 - $1/3 \times \$200m = \$66.7m$ ETI, \$33.3m of which is allocated to XYZ Corp.

Partnership Carryforward Example 1

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□ Year 1 analysis: Bravo

- Bravo's interest limitation is \$75m: the sum of its business interest income of zero and 30% of its \$250m of ATI.
- The \$75m limitation is less than Bravo's business interest of \$200m, so \$75m of Bravo's current year business interest is allowed as a deduction by section 163(j)(1), and \$125m is disallowed and treated as disallowed business interest.
 - XYZ Corp is allocated \$37.5m of Bravo deductible business interest and \$62.5m of disallowed business interest.
- Bravo has no ETI.

Partnership Carryforward Example 1

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□ Year 1 analysis: XYZ Corp

- Amounts allocated to XYZ Corp by Alpha and Bravo:
 - From Alpha: \$20m deductible business interest, \$33.3m ETI
 - From Bravo: \$37.5m deductible business interest, \$62.5m disallowed business interest
- XYZ Corp has no other income, expenses, etc.
- XYZ Corp's ATI is \$33.3m: the sum of zero ATI from XYZ Corp's activities viewed in isolation and \$33.3m ETI from Alpha.
- XYZ Corp has no business interest in year 1.
 - The disallowed business interest allocated by Bravo is not treated as business interest of XYZ Corp in Year 1, and therefore is not deductible using XYZ Corp's ATI.
- XYZ Corp year 1 results:
 - \$57.5m deductible interest (\$20m from Alpha and \$37.5m from Bravo)
 - \$62.5m disallowed business interest carryforward attributable to Bravo
 - \$33.3m of unused ATI does not carry forward

Partnership Carryforward Example 1

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- Year 2 facts:
 - Alpha
 - \$9m of business interest
 - No business interest income
 - \$150m of ATI
 - Bravo
 - No business interest
 - No business interest income
 - \$150m of ATI
 - XYZ Corp has no income, expenses, etc. other than those allocated by Alpha and Bravo, and has a \$62.5m carryover of Bravo's year 1 disallowed business interest.

Partnership Carryforward Example 1

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□ Year 2 analysis: Alpha

- Alpha's interest limitation is \$45m: the sum of its business interest income of zero and 30% of its \$150m of ATI.
- The \$45m limitation exceeds Alpha's business interest of \$9m, so none of Alpha's current year business interest is disallowed as a deduction by section 163(j)(1).
 - XYZ Corp is allocated \$4.5m of Alpha deductible business interest.
- Alpha's ETI is the amount which bears the same ratio to Alpha's ATI as (1) the excess of (a) 30% of Alpha's ATI (\$45) over (b) the amount by which Alpha's business interest exceeds its business interest income (\$9), bears to (2) 30% of Alpha's ATI.
 - $(\$45m - \$9m) / \$45m = 4/5$.
 - $4/5 \times \$150m = \$120m$ ETI, \$60m of which is allocated to XYZ Corp.

Partnership Carryforward Example 1

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- Year 2 analysis: Bravo
 - Bravo's interest limitation is \$45m: the sum of its business interest income of zero and 30% of its \$150m of ATI.
 - Bravo has no business interest, so all \$150m of Bravo's ATI is ETI.
 - XYZ Corp is allocated \$75m of Bravo's ETI.

Partnership Carryforward Example 1

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- Year 2 analysis: XYZ Corp
 - Amounts allocated to XYZ Corp by Alpha and Bravo:
 - From Alpha: \$4.5m deductible business interest, \$60m ETI
 - From Bravo: \$75m ETI
 - XYZ Corp has no other income, expenses, etc., but has a \$62.5m carryover of Bravo's year 1 disallowed business interest.
 - \$62.5m business interest is treated as paid or accrued by XYZ Corp: the amount of disallowed business interest carryover from Bravo's year 1 activities that does not exceed the sum of ETI and excess business interest income allocated to XYZ Corp by Bravo in the current year (\$75m).
 - XYZ Corp's ATI is \$135m: the sum of zero ATI from XYZ Corp's activities viewed in isolation, \$60m ETI from Alpha, and \$75m ETI from Bravo.
 - XYZ Corp's interest limitation is \$40.5m: the sum of its business interest income of zero and 30% of its ATI of \$135m.
 - The \$40.5m limitation is less than Bravo's business interest of \$62.5m, so \$40.5m of Bravo's current year business interest is allowed as a deduction by section 163(j)(1), and \$22m is treated as a carryforward of XYZ Corp business interest.
 - XYZ Corp year 2 results:
 - \$45m deductible interest (\$4.5m from Alpha and \$40.5m from XYZ Corp)
 - \$22m carryforward to year 3

Partnership Carryforward Example 2

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- ❑ Year 1 facts: Same as in example 1.
- ❑ Year 2 Facts:
 - Alpha
 - No business interest
 - No business interest income
 - No ATI
 - Bravo
 - No business interest
 - No business interest income
 - \$120m of ATI
 - XYZ Corp has no income, expenses, etc. other than those allocated by Alpha and Bravo, and has a \$62.5m carryover of Bravo's year 1 disallowed business interest.

Partnership Carryforward Example 2

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- Year 2 analysis: Alpha and Bravo
 - Alpha has no business interest, no business interest income, and no ATI, and therefore nothing to analyze under section 163(j).
 - Bravo's interest limitation is \$36m: the sum of its business interest income of zero and 30% of its \$120m of ATI.
 - Bravo has no business interest, so all \$120m of Bravo's ATI is ETL.
 - XYZ Corp is allocated \$60m of Bravo's ETL.

Partnership Carryforward Example 2

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□ Year 2 analysis: XYZ Corp

- Amounts allocated to XYZ Corp by Alpha and Bravo:
 - From Bravo: \$60m ETI
- XYZ Corp has no other income, expenses, etc., but has a \$62.5m carryover of Bravo's year 1 disallowed business interest.
- \$60m business interest is treated as paid or accrued by XYZ Corp: the amount of disallowed business interest carryover from Bravo's year 1 activities that does not exceed the sum of ETI and excess business interest income allocated to XYZ Corp by Bravo in the current year (\$60m).
 - The remaining \$2.5m continues to be treated as a carryforward of disallowed business interest attributable to Bravo in succeeding years until Bravo allocates sufficient ETI or excess business interest income to XYZ Corp.
- XYZ Corp's ATI is \$60m: the sum of zero ATI from XYZ Corp's activities viewed in isolation, zero ETI from Alpha, and \$60m ETI from Bravo.
- XYZ Corp's interest limitation is \$18m: the sum of its business interest income of zero and 30% of its ATI of \$60m.
- The \$18m limitation is less than Bravo's business interest of \$60m, So \$18m of Bravo's current year business interest is allowed as a deduction by section 163(j)(1), and \$42m is disallowed and treated as a carryforward of XYZ Corp business interest.
- XYZ Corp year 2 results:
 - \$18m deductible interest (from XYZ)
 - \$42m carryforward to year 3
 - \$2.5m disallowed business interest carryforward attributable to Bravo