

## **PART IV—BUSINESS-RELATED EXCLUSIONS AND DEDUCTIONS**

### **A. Limitation on Deduction for Interest (sec. 13301 of the Act and sec. 163(j) of the Code)**

#### ***Prior Law***

##### ***Interest deduction***

Interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations.<sup>857</sup>

Interest is generally deducted by a taxpayer as it is paid or accrued, depending on the taxpayer's method of accounting. For all taxpayers, if an obligation is issued with original issue discount ("OID"), a deduction for interest is allowable over the life of the obligation on a yield to maturity basis.<sup>858</sup> Generally, OID arises where interest on a debt instrument is not calculated based on a qualified rate and required to be paid at least annually.

##### ***Investment interest expense***

In the case of a taxpayer other than a corporation, the deduction for interest on indebtedness that is allocable to property held for investment ("investment interest") is limited to the taxpayer's net investment income for the taxable year.<sup>859</sup> Disallowed investment interest is carried forward to the next taxable year.

Net investment income is investment income net of investment expenses. Investment income generally consists of gross income from property held for investment, and investment expense includes all deductions directly connected with the production of investment income (e.g., deductions for investment management fees) other than deductions for interest.

The two-percent floor on miscellaneous itemized deductions allows taxpayers to deduct investment expenses connected with investment income only to the extent such deductions exceed two percent of the taxpayer's adjusted gross income.<sup>860</sup> Miscellaneous

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<sup>857</sup> Sec. 163(a). In addition to the limitations discussed herein, other limitations include: denial of the deduction for the disqualified portion of the original issue discount on an applicable high yield discount obligation (sec. 163(e)(5)), denial of deduction for interest on certain obligations not in registered form (sec. 163(f)), reduction of the deduction for interest on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 (sec. 163(g)), disallowance of deduction for personal interest (sec. 163(h)), disallowance of deduction for interest on debt with respect to certain life insurance contracts (sec. 264), and disallowance of deduction for interest relating to tax-exempt income (sec. 265). Interest may also be subject to capitalization. See, e.g., sections 263A(f) and 461(g).

<sup>858</sup> Sec. 163(e). But see section 267 (dealing in part with interest paid to a related or foreign party).

<sup>859</sup> Sec. 163(d).

<sup>860</sup> Sec. 67(a). For a discussion of changes made to the deduction of miscellaneous itemized deductions by the Act, see the description of section 11045 of the Act (Suspension of Miscellaneous Itemized Deductions).

itemized deductions<sup>861</sup> that are not investment expenses are disallowed first before any investment expenses are disallowed.<sup>862</sup>

### ***Earnings stripping***

Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: (1) the payor's debt-to-equity ratio exceeds 1.5 to 1.0, and (2) the payor's net interest expense exceeds the sum of 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion) plus any excess limitation carryforward (defined below).<sup>863</sup> Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest;<sup>864</sup> (2) unrelated parties in certain instances in which a related party guarantees the debt; and (3) a real estate investment trust ("REIT") by a taxable REIT subsidiary of that trust.<sup>865</sup> The amount disallowed may not exceed the amount by which the corporation's net interest expense exceeds 50 percent of the corporation's adjusted taxable income.<sup>866</sup> Interest amounts disallowed under these rules can be carried forward indefinitely.<sup>867</sup> In addition, any excess limitation (*i.e.*, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years (the "excess limitation carryforward").<sup>868</sup>

### ***Explanation of Provision***

#### ***In general***

In the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of (1) business interest income of the taxpayer for the taxable year, (2) 30 percent of the adjusted taxable income of the taxpayer for the taxable year (not less than zero), and (3) the floor plan financing interest of the taxpayer for the taxable year. The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely. The limitation applies at the taxpayer level (but see a special carryforward rule for partnerships, described below). In the case of a group of affiliated corporations that file a consolidated re-

<sup>861</sup> Miscellaneous itemized deductions include itemized deductions of individuals other than certain specific itemized deductions. Sec. 67(b). Miscellaneous itemized deductions generally include, for example, investment management fees and certain employee business expenses, but specifically do not include, for example, interest, taxes, casualty and theft losses, charitable contributions, medical expenses, or other listed itemized deductions.

<sup>862</sup> H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-154, Sept. 18, 1986 (Conf. Rep.) ("In computing the amount of expenses that exceed the 2-percent floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.")

<sup>863</sup> Secs. 163(j)(2)(A), (2)(B) and (6)(A). For a brief description of the legislative background of section 163(j), see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, pp. 21-23.

<sup>864</sup> If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed by the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

<sup>865</sup> Sec. 163(j)(3).

<sup>866</sup> Sec. 163(j)(1)(A).

<sup>867</sup> Sec. 163(j)(1)(B).

<sup>868</sup> Sec. 163(j)(2)(B)(ii).

turn, the limitation applies at the consolidated tax return filing level.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the Code is interest for purposes of the provision. 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. Business interest does not include investment interest, and business interest income does not include investment income, within the meaning of section 163(d).<sup>869</sup>

Adjusted taxable income means the taxable income of the taxpayer computed without regard to: (1) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) the amount of any deduction allowed under section 199A.<sup>870</sup> Additionally, for taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to any deduction allowable for depreciation, amortization, or depletion.<sup>871</sup> For taxable years beginning after December 31, 2021, adjusted taxable income is computed with regard to deductions allowable for depreciation, amortization, or depletion. The Secretary may provide for other adjustments to the computation of adjusted taxable income.

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.<sup>872</sup> A motor vehicle means a motor vehicle that is: (1) any self-propelled vehicle designed for transporting person or property on a public street, highway, or road; (2) a boat; or (3) farm machinery or equipment.

By including business interest income and floor plan financing interest in the limitation, the rule operates to allow (1) business interest up to the amount of business interest income and (2) floor plan financing interest to be fully deductible. That is, a deduction for business interest is permitted to the full extent of business interest income and any floor plan financing interest.<sup>873</sup> The deduc-

<sup>869</sup> Section 163(d) applies in the case of a taxpayer other than a corporation; a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision. For example, in the case of an insurance company that for regulatory (*i.e.*, statutory accounting) purposes has both underwriting income and expense and investment interest income and expense, any interest income is business interest income and any interest expense is business interest for purposes of section 163(j).

<sup>870</sup> For a discussion of section 199A, see the description of section 11011 of the Act (Deduction for Qualified Business Income) and the Appendix.

<sup>871</sup> Any deduction allowable for depreciation, amortization, or depletion includes any deduction allowable for any amount treated as depreciation, amortization, or depletion.

<sup>872</sup> Property that is held exclusively for lease is not inventory, but rather property used in a trade or business under section 1221(a)(2). Property simultaneously held for sale or lease is treated as inventory until such time as it first becomes leased, at which point it is no longer treated as inventory. See, *e.g.*, Notice 2013-13, 2013-12 I.R.B. 659, March 18, 2013.

<sup>873</sup> Note, however, that if the taxpayer takes floor plan financing interest into account to increase the taxpayer's interest limitation under section 163(j) for a taxable year, property placed in service by the taxpayer during such year and subsequent taxable years is not eligible for the additional first-year depreciation deduction under section 168(k), as modified by the Act. For a

tion for any remaining business interest is limited to 30 percent of adjusted taxable income.

It is generally intended that, similar to prior law, section 163(j) apply after the application of provisions that subject interest to deferral, capitalization, or other limitation. Thus, as with prior-law section 163(j), the provision applies to interest deductions that are deferred, for example under section 163(e) or section 267(a)(3)(B), in the taxable year to which such deductions are deferred.<sup>874</sup> Also as with prior-law section 163(j), the provision applies after section 263A is applied to capitalize interest<sup>875</sup> and after, for example, section 265 or section 279 is applied to disallow any interest deduction.<sup>876</sup> However, the provision applies before the application of sections 465 and 469 (again, similar to prior-law section 163(j)(7)).

### ***Carryforward of disallowed business interest***

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. Business interest may be carried forward indefinitely. The provision contains rules (described below) intended to prevent trafficking in carryforwards, and it is intended that the provision be administered consistent with that intent.

With respect to corporations, any carryforward of disallowed business interest of the corporation is an item taken into account in the case of certain corporate acquisitions described in section 381 and is subject to limitation under section 382.

### ***Application to passthrough entities***<sup>877</sup>

#### ***In general***

In the case of any partnership, the limitation is applied at the partnership level. To prevent double counting, there are special rules for the determination of the business interest income and adjusted taxable income of each partner of the partnership. Similarly, to allow for additional interest deduction by a partner in the case of an excess amount of either business interest income of the partnership or adjusted taxable income of the partnership, special rules apply. Similar rules apply with respect to any S corporation and its shareholders. Additionally, there is a special rule for carryforward of disallowed partnership interest that applies only to partnerships.

#### ***Double counting rule***

The business interest income and adjusted taxable income of each partner (or shareholder, as the case may be) is determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of the partnership. In the absence of such rules, items of business interest income or adjusted taxable income of a partnership might be viewed as generating additional

discussion of changes made to section 168(k) by the Act, including an example of the interaction of sections 168(k) and 163(j) with regard to taxpayers with floor plan financing interest, see the description of section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

<sup>874</sup> See, e.g., Prop. Treas. Reg. sec. 1.163(j)-7(b)(2) under prior section 163(j).

<sup>875</sup> See, e.g., Treas. Reg. sec. 1.263A-9(g)(1)(i).

<sup>876</sup> See, e.g., Prop. Treas. Reg. sec. 1.163(j)-7(b)(1) under prior section 163(j).

<sup>877</sup> Technical corrections may be necessary to achieve the provision's application to pass-through entities as described herein.

interest deductions as the items are passed through to the partners.

*Example 1.*—ABC is a partnership owned 50–50 by XYZ Corporation and an individual. ABC generates \$200 of noninterest income. Its only expense is \$60 of business interest. Under the provision the deduction for business interest is limited to 30 percent of adjusted taxable income, that is, 30 percent \* \$200 = \$60. ABC deducts \$60 of business interest and reports ordinary business income of \$140. XYZ Corporation's distributive share of the ordinary business income of ABC is \$70. XYZ Corporation has net taxable income of zero from its other operations, none of which is attributable to business interest income, and without regard to its business interest. XYZ Corporation has business interest of \$25. In the absence of any special rule, the \$70 of taxable income from its interest in ABC might permit the deduction of up to an additional \$21 of interest (30 percent \* \$70 = \$21), resulting in a deduction disallowance of \$4. That is, XYZ Corporation's \$100 share of ABC's adjusted taxable income would generate \$51 of interest deductions (*i.e.*, XYZ Corporation's \$30 share of ABC's interest deduction plus XYZ Corporation's interest deduction of \$21). If XYZ Corporation were instead a passthrough entity, additional deductions might be available at each tier.

The double counting rule provides that XYZ Corporation has adjusted taxable income computed without regard to the \$70 distributive share of the income of ABC. As a result, XYZ Corporation has adjusted taxable income of \$0. XYZ Corporation's deduction for business interest is limited to 30 percent \* \$0 = \$0, resulting in a deduction disallowance of \$25.

#### *Additional deduction limit*

For purposes of determining the allowable interest deduction of a partner in a partnership, the partner's business interest deduction limitation calculated under the provision is increased to reflect the partner's distributive share of any business interest income or adjusted taxable income of the partnership that was not used to generate a business interest deduction at the partnership level. Specifically, in the absence of disallowed business interest attributable to the partnership (see discussion of the partnership carryforward rule, below), the partner's business interest deduction limitation is increased by the sum of the partner's distributive share of the partnership's excess business interest income and 30 percent of the partnership's excess taxable income. Excess business interest income with respect to any partnership is the excess of the business interest income of the partnership over the business interest, reduced by floor plan financing interest,<sup>878</sup> of the partnership. Excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as (1) the excess (if any) of (a) 30 percent of the adjusted taxable income of the partnership over (b) the amount (if any) by which the business interest of the partnership, reduced by

<sup>878</sup>To the extent the partnership takes floor plan financing interest into account to increase the amount of interest permitted to be deducted under section 163(j)(1).

floor plan financing interest,<sup>879</sup> exceeds the business interest income of the partnership bears to (2) 30 percent of the adjusted taxable income of the partnership. These rules allow a partner of a partnership to deduct additional business interest that the partner may have paid or incurred to the extent the partnership could have deducted more business interest.

*Example 2.*—The facts are the same as in Example 1 except ABC has only \$40 of business interest. As in Example 1, ABC has a limit on its business interest deduction of \$60. The excess taxable income for ABC is \$66.67 ( $\$20/\$60 * \$200$ ). XYZ Corporation's distributive share of the excess taxable income from ABC is \$33.33. XYZ Corporation's deduction for business interest is limited to 30 percent of its adjusted taxable income plus its distributive share of the excess taxable income from ABC ( $30 \text{ percent} * (\$0 + \$33.33) = \$10$ ). As a result of the excess taxable income, XYZ Corporation may deduct \$10 of business interest and has a business interest deduction disallowance of \$15 ( $\$25 - \$10$ ).

#### *Carryforward rule*

In the case of a partnership, the general entity-level carryforward rule does not apply. Instead, any business interest that is not allowed as a deduction to the partnership for the taxable year (referred to as "disallowed business interest") is allocated to the partners. Each partner may deduct its share of the partnership's disallowed business interest in any future year, but only to the extent of the partner's distributive share of excess business interest income and 30 percent of the partner's distributive share of excess taxable income of the partnership the activities of which gave rise to the disallowed business interest carryforward. Any amount that is not allowed as a deduction is carried forward. For example, if a partner's disallowed business interest from a prior year of Partnership X is \$100, and in the current year the partner is allocated \$100 of excess taxable income and \$10 of excess business interest income from X and has \$200 of adjusted taxable income from other sources, the partner may only deduct \$40 of the disallowed business interest in the current year ( $\$10 \text{ excess business interest income} + (30 \text{ percent} * \$100 \text{ excess taxable income})$ ). The remaining \$60 of disallowed business interest is carried forward to the subsequent year. To prevent double counting, any deduction by the partner of disallowed business interest requires a corresponding reduction in the partner's distributive share of current-year excess business interest income and excess taxable income used to determine the partner's current-year interest limitation.

Additionally, 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 such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a subsequent year for disallowed business interest does not reduce the partner's basis in its partnership interest. In the event the

<sup>879</sup> Again, to the extent the partnership takes floor plan financing interest into account to increase the amount of interest permitted to be deducted under section 163(j)(1).

partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of disallowed business interest that has been deducted by the partner against excess business interest income or excess taxable income of the same partnership.<sup>880</sup>

This special carryforward rule does not apply to S corporations and their shareholders.

### **Exceptions**

The limitation does not apply to any taxpayer (other than a tax shelter prohibited from using the cash method under section 448(a)(3)) that meets the \$25 million gross receipts test of section 448(c) (*i.e.*, if the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed \$25 million).<sup>881</sup> Aggregation rules apply to determine the amount of a taxpayer's gross receipts under the \$25 million gross receipts test.

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation.<sup>882</sup> As a result, for example, the wages of an employee are not counted in the adjusted taxable income of the taxpayer for purposes of determining the limitation.

At the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (*i.e.*, any electing real property trade or business) is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.<sup>883</sup> Similarly, at the taxpayer's election, any farming business<sup>884</sup> or

<sup>880</sup> The special rule for dispositions also applies to transfers of a partnership interest (including by reason of death) in transactions in which gain is not recognized in whole or in part. No deduction is allowed to the transferor or transferee for any disallowed business interest resulting in a basis increase under this rule.

<sup>881</sup> In the case of a sole proprietorship, the \$25 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership. For a discussion of changes made to section 448 by the Act, see the description of section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

<sup>882</sup> The trade or business of performing services as an employee is also mentioned in section 62(a)(1), among other places, and has the same meaning here as there.

<sup>883</sup> Congress intends that any such real property trade or business, including such a trade or business conducted by a corporation or REIT, be included. Because this description of a real property trade or business refers only to the section 469(c)(7)(C) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference. It is further intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility, including a lodging facility that provides some supplemental services, such as an assisted living facility. In addition, an electing real property trade or business is required to use the alternative depreciation system ("ADS") 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. See the description of section 13204 of the Act (Applicable Recovery Period for Real Property).

<sup>884</sup> As defined in section 263A(e)(4) (*i.e.*, farming business means the trade or business of farming and includes 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 evergreen trees that are more than six years old at the time they are severed from their roots)). Treas. Reg. sec. 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

any business engaged in the trade or business of a specified agricultural or horticultural cooperative,<sup>885</sup> is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to any such trade or business.<sup>886</sup>

The limitation does not apply to certain regulated public utilities. Specifically, 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<sup>887</sup> or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative is not treated as a trade or business for purposes of the limitation, and thus any interest paid or accrued on indebtedness properly allocable to such trades or businesses is not business interest.<sup>888</sup>

The Treasury Department and IRS have issued published guidance addressing this provision.<sup>889</sup>

### *Effective Date*

The provision applies to taxable years beginning after December 31, 2017. Congress intends that taxpayers with disqualified interest disallowed under prior-law section 163(j)(1)(A) for the last taxable year beginning before January 1, 2018, may carry such interest forward as business interest to the taxpayer's first taxable year beginning after December 31, 2017, and that such business interest carried forward will be subject to potential disallowance under the provision in the same manner as any other business interest otherwise paid or accrued in a taxable year beginning after December 31, 2017.

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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. See Treas. Reg. sec. 1.263A-4(a)(4)(i) and (ii). 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. See Treas. Reg. sec. 1.263A-4(a)(4)(i).

<sup>885</sup> As defined in section 199A(g)(4).

<sup>886</sup> An electing farming business is required to use ADS to depreciate any property with a recovery period of 10 years or more. See the description of section 13205 of the Act (Use of Alternative Depreciation System for Electing Farming Businesses).

<sup>887</sup> The term "State" includes the District of Columbia. See sec. 7701(a)(10) ("The term 'State' shall be construed to include the District of Columbia where such construction is necessary to carry out provisions of this title").

<sup>888</sup> Note, however, that any property primarily used by a regulated public utility trade or business with a depreciable interest in the property is not eligible for the additional first-year depreciation deduction by such utility business under section 168(k), as modified by the Act. For a discussion of changes made to section 168(k) by the Act, see the description of section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

<sup>889</sup> REG-106089-18, November 26, 2018, available at <https://www.irs.gov/pub/irs-drop/REG-106089-18-NPRM.pdf>; Rev. Proc. 2018-59, 2018-50 I.R.B. (Nov. 26, 2018); Notice 2018-28, 2018-16 IRB 492 (Apr. 2, 2018).