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A Deep Dive Into New Limitations on Loss and Business Interest Reveals Complexity, Uncertainty, and Need for Correction

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The 2017 tax act[1] made a multitude of changes to the Internal Revenue Code, many of which significantly affect the rate at which business income is taxed and the manner in which it is computed.[2] This article provides a detailed analysis of two of those changes — the new limitation on excess business losses in §461(l) and the new limitation on the deductibility of business interest in §163(j). Not surprisingly, an in-depth review of these provisions in the context of examples and real numbers reveal significant complexity, possible errors in drafting, and the need for additional guidance.

TEMPORARY LIMITATION ON EXCESS BUSINESS LOSSES

For taxable years beginning after December 31, 2017, and before January 1, 2026, taxpayers other than C corporations are subject to a new limitation on their ability to deduct business loss. The 2017 tax act added §461(l) to the Code, which provides that a taxpayer other than a C corporation is not allowed to deduct "excess business loss."[3] Instead, the taxpayer carries forward excess business loss and treats the losses carried forward as part of its net operating loss (NOL) carryforward in succeeding taxable years.[4]

For purposes of this new limitation, excess business loss is defined as the excess (if any) of the taxpayer's aggregate deductions for the taxable year that are attributable to the taxpayer's trades or businesses (without regard to the limitation on excess business loss) over the sum of (1) the taxpayer's aggregate gross income or gain attributable to such trades or businesses, plus (2) $250,000 ($500,000 in the case of a joint return).[5] So, an overall net business loss is deductible only to the extent of $250,000 ($500,000 in the case of a joint return). These amounts are indexed for inflation after 2018.[6] Any amount over the threshold is considered an "excess business loss" and is not deductible in the current taxable year. The excess business loss limitation is applied after the passive loss rules.[7]

In the case of a partnership or S corporation, the excess business loss limitation is applied at the partner or shareholder level, which means that a partner or shareholder will take into account its allocable share of entity income, loss, gain, and deduction for any taxable year from trades or businesses attributable to

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[1] Pub. L. No. 115-97.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified.

[3] §461(l)(1)(B), *as added by* the 2017 tax act, §11012.

[4] §461(l)(2), *as added by* the 2017 tax act, §11012.

[5] §461(l)(3)(A), *as added by* the 2017 tax act, §11012.

[6] §461(l)(3)(B), *as added by* the 2017 tax act, §11012.

[7] §461(l)(6), *as added by* the 2017 tax act, §11012. Contrast this with the excess farm loss provision under suspended §461(j), which applied *before* application of the §469 passive loss rules. *See* §461(l)(1)(A), suspending the application of §469(j)(7) for taxable years beginning after December 31, 2017, and before January 1, 2016.

the partnership or S corporation.[8] For an S corporation shareholder, ''allocable'' refers to the shareholder's pro rata share of S corporation items.[9] Section 461(l) provides that a partner or S corporation shareholder takes into account its allocable share of partnership or S corporation items in applying the excess business loss limitation to the taxable year of the partner or shareholder with or within which the taxable year of the partnership or S corporation ends.[10]

Example (1) — General Application

Assume that A, an individual unmarried taxpayer, owns a 25% interest in an LLC taxed as a partnership. A is a member-manager of the LLC. In Year One, A's distributive share of net loss from the LLC is $600,000. Assume that A's deduction of its distributive share of loss is not limited by the adjusted basis limitation rules of §704(d) or the at-risk rules of §465. Section 469 does not limit the deductibility of the loss because A is active in the LLC business. Pursuant to §461(l), A is able to deduct only $250,000 of the Year One loss. The remaining $350,000 is carried forward as an NOL under §172.

Observation: The fact that this new loss limitation applies to active business losses is a significant departure from previous rules pursuant to which a taxpayer could deduct active business losses against nonbusiness income (as long as the other loss deduction limitations (e.g., basis, at-risk) did not apply). In fact, in the context of certain types of startup companies, an active investor's return on investment in the early years of the venture was based, in part, on the investor's ability to utilize active losses from the business against other income. The excess business loss limitation will drastically reduce the value of these early-year losses.

Planning Opportunity: The existence of this new limitation coupled with the fact that the corporate rate under the 2017 tax act is 21% may, in certain circumstances, lead to the conclusion that doing business as a C corporation is a better alternative from a tax perspective. As an example, assume that a startup technology company expects to generate significant losses in the early years of its existence and the business plan envisions a sale of the company a few years down the road (once the business begins to turn a profit). Consideration should be given to operating as a C corporation, especially if the owners can utilize the §1202 gain exclusion for qualified small business stock to eliminate all or a substantial portion of gain on the ultimate sale of the business. There are many factors to consider in the context of choice of entity and many of the provisions in the 2017 tax act could affect this determination.

Example (2) — Interaction with Passive Loss Rules

Assume that Partner A, an individual, unmarried taxpayer, owns a 25% limited partnership interest in Partnership ABCD. Partner A does not materially participate in the activities of the partnership. In Year One, Partner A's allocable share of net partnership loss is $600,000. Assume that Partner A's deduction of its distributive share of partnership losses is not limited by the adjusted basis limitation rules of §704(d) or the at-risk rules of §465. The loss is, however, a passive loss and is subject to the limitations in §469. A's ability to deduct the $600,000 loss is dependent upon whether A has passive income from another activity to offset the loss. If A has no passive income, the entire $600,000 deduction is disallowed under §469 and A has a passive loss carryover of $600,000. There is no need to apply the excess business loss limitation because §469 has disallowed the loss deduction in its entirety.

What if A has $300,000 of passive income from a separate trade or business? In this case, §469 would allow A to deduct $300,000 of the loss from Partnership ABCD. It does not appear that A has an excess business loss because, after application of §469, A's aggregate deductions for the taxable year that are attributable to the taxpayer's trades or businesses (without regard to the limitation on excess business loss) ($300,000) does not exceed the sum of (1) the taxpayer's aggregate gross income or gain attributable to such trades or businesses ($300,000) plus (2) $250,000. A would have a $300,000 passive loss carryover.

What if A has $600,000 of passive income from a separate trade or business? In this case, §469 would allow A to deduct the entire $600,000 loss from Partnership ABCD. Again, it does not appear that A has an excess business loss because, after application of §469, A's aggregate deductions for the taxable year which are attributable to the taxpayer's trades or businesses (without regard to the limitation on excess business loss) ($600,000) does not exceed the sum of (1) the taxpayer's aggregate gross income or gain attributable to such trades or businesses ($600,000) plus (2) $250,000.

What if A has no other trade or business activities but has a §212 activity for the production of income and has $300,000 of passive income from that activity? Section 469 allows passive losses to offset passive income from §212 activities. So, in this instance, §469 would allow A to deduct $300,000 of the passive loss from partnership ABCD against the $300,000 of passive income from the §212 activity.

[8] §461(l)(4), *as added by* the 2017 tax act, §11012.

[9] §461(l)(4)(B), *as added by* the 2017 tax act, §11012.

[10] §461(l)(4)(B), *as added by* the 2017 tax act, §11012.

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However, the excess business loss calculation refers only to "trades or businesses," so A would have an excess business loss of $50,000 under §461(l) — the excess of A's aggregate deductions for the taxable year that are attributable to the taxpayer's trades or businesses (without regard to the limitation on excess business loss) ($300,000) over the sum of (1) the taxpayer's aggregate gross income or gain attributable to such trades or businesses ($0) plus (2) $250,000. In this case, it appears that §461(l) would limit A's deduction to $250,000. The $50,000 excess business loss would be carried forward and become part of A's §172 NOL in the following taxable year. A would also have a $300,000 passive loss carryover. Although the statute is not entirely clear as to whether this is the correct result in this circumstance, a literal reading of the statutory language does lead to a different result depending upon whether passive income is attributable to a trade or business or a §212 activity. Query whether this result was intended.

Note that if, during the taxable year, a taxpayer disposes of his entire interest in any passive activity, §469 generally allows the taxpayer to utilize suspended passive losses against nonpassive income. The suspended passive losses are treated as active losses once the disposition occurs. However, it appears that the §461(l) limitation applies to limit the use of those losses.

As stated above, a nondeductible excess business loss is treated as an NOL carryforward to the next taxable year pursuant to the rules in §172. Section 461(l) specifically references §172 as applicable to the carryforward of excess business loss, which means that any limitation in §172 on the deductibility of an NOL carryforward would apply. The 2017 tax act amended §172 to provide that, for losses arising in taxable years beginning after December 31, 2017, NOLs are deductible only to the extent of 80% of taxable income, determined without regard to the NOL deduction.[11]

Observation: It appears that the excess business loss limitation is a "one and done" provision in that it applies to a loss once, in the current taxable year. To the extent a loss is disallowed under §461(l) in the current tax year, it is carried forward and, in subsequent years, its deductibility should no longer be affected by the application of §461(l). The §172 limitations will apply, but §461(l) should not. Although this is not explicitly stated in the statutory language, it appears to be the result based on the treatment of the carryforward as a §172 NOL.

Observation: An excess business loss carryforward is more advantageous than a suspended passive loss because a taxpayer is only able to use the passive loss carryover against passive income (or gain from disposition of the activity) whereas an excess business loss carryforward, as part of the taxpayer's NOL, is deductible against all taxable income.

Observation: The excess business loss provision limits losses for all pass-through entities which, for purposes of current deductibility, mitigates the partnership advantage of including partnership level debt in a partner's outside basis. Depending on the actual numbers, losses disallowed to S corporation shareholders because they lack sufficient basis may now be disallowed to partners (regardless of adjusted basis) under the excess business loss rule. However, there is still a distinct advantage to the fact that partners are allowed to include their allocable share of partnership debt in basis. The loss disallowed to an S corporation shareholder due to the basis limitation is suspended and cannot be used until and unless the shareholder's basis increases. In the partnership context, the loss disallowed under §461(l) is added to the NOL and can be used against taxable income in succeeding taxable years, subject to the limitation that NOL carryforwards are deductible only to the extent of 80% of taxable income (computed without regard to the NOL).

Section 461(l)(5) provides the Treasury Secretary with authority to prescribe additional reporting requirements to carry out the purpose of the excess business loss limitation.

LIMITATION ON THE DEDUCTION OF BUSINESS INTEREST EXPENSE

Computation of the Limit on Deductibility

For taxable years beginning after December 31, 2017, §163(j)[12] limits a taxpayer's deduction of business interest to business interest income plus 30% of adjusted taxable income plus floor plan financing interest.[13] Thus, putting floor plan financing aside,[14] net business interest expense is deductible only to the extent of 30% of adjusted taxable income. Disallowed business interest is carried forward and treated as business interest paid or accrued in the succeeding taxable year.[15]

Note: Existing indebtedness is not grandfathered. That is, this new limitation on the deduction of inter-

[11] §172(a), *as amended by* the 2017 tax act, §13302(a).

[12] *As amended* by the 2017 tax act, §13301(a).

[13] §163(j)(1), *as amended by* the 2017 tax act, §13301(a).

[14] For additional discussion of floor plan financing, see below.

[15] §163(j)(2), *as amended by* the 2017 tax act, §13301(a). The 2017 tax act added disallowed business interest under §163(j) that has been carried over to taxable years ending after the date of distribution or transfer to the list of carryover items in §381(c).

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est applies to business interest on all existing indebtedness as well as debt incurred after the effective date of the 2017 tax act.

Section 163(j) applies to all taxpayers and applies regardless of whether the interest is paid to a related party.[16] Section 163(j)(5) defines ''business interest'' as any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest does not include investment interest (as defined in §163(d)).[17]

Note: The §163(d) rules regarding investment interest apply to taxpayers other than corporations. A corporation does not have investment interest or investment income within the meaning of that section. Thus, the references in §163(j)(5) and §163(j)(6) to investment interest and investment income do not apply to a corporation. Interest income and interest expense of a corporation is properly allocable to a trade or business, unless that trade or business is otherwise explicitly excluded from the application of §163(j). The Report of the Committee on Ways and Means House of Representatives on H.R. 1 makes this clear.[18]

Observation: It remains to be seen whether and the extent to which the IRS will try to re-characterize payments as ''business interest'' in order to subject those payments to this new limitation on deductibility.

Business interest income is the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business.[19] Business interest income does not include investment income (as defined in §163(d)).[20]

For purposes of §163(j), ''adjusted taxable income'' is equal to 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 under §172; (4) the amount of any deduction allowed under §199A; and (5) *for taxable years beginning before January 1, 2022*, any deduction allowable for depreciation, amortization, or depletion.[21] Thus, for taxable years beginning before January 1, 2022, adjusted taxable income will be higher (and, therefore, more business interest will be deductible) because taxable income is not reduced by depreciation, amortization, and depletion. However, beginning in 2022, those deductions will reduce adjusted taxable income (and, therefore, reduce the amount of deductible business interest).

Note: There has been some question as to how the §163(j) limitation will apply to a consolidated group. On January 25, 2018, at a District of Columbia Bar Community of Taxation event, Brenda Zent, special adviser, Treasury Office of International Tax Counsel, stated that Treasury intends to issue guidance stating that §163(j) will apply on a consolidated basis and taxpayers will not be able to elect to apply it any other way.

Planning Point: Although this limitation may not apply to a large universe of taxpayers due to the combination of the small business exception (discussed below) and the fact that it only applies to significantly leveraged businesses, the taxpayers to whom it does apply may be significantly affected by the loss of the full deduction for business interest. There is little doubt that taxpayers will try to find ways to avoid this new limitation. As an example, in some cases, it may be possible to use preferred equity in a partnership as a substitute for certain types of debt (particularly subordinated debt). As an alternative to debt, a partnership (or partnership subsidiary) may be able to issue preferred equity with a fixed return which, if properly structured, would be similar to debt but without the limitation on deductibility. The return distributed to the preferred equity holders would reduce the amount of income available to distribute to other equity owners, which would leave them in the same position they would be in if the entity paid deductible interest in that same amount. There are certainly other factors that must be considered such that this ''fix'' would not always work, but it will be worth considering in some instances.

EXCEPTIONS TO APPLICATION OF OVERALL LIMITATION

Floor Plan Financing

A taxpayer is allowed to fully deduct floor plan financing interest.[22] Floor plan financing interest is defined as interest paid or accrued on floor plan financ-

§381(c)(20), *as added by* the 2017 tax act, §13301(b)(1). In addition, for purposes of §382, the term ''pre-change loss'' includes a carryover of business interest disallowed under §163(j) under rules similar to those in §382(d)(1). §382(d)(3), *as added by* the 2017 tax act, §13301(b)(2).

[16] Contrast this with the new excess business loss provision, which does not apply to C corporations, and the §163(j) limitation prior to amendment by the 2017 tax act, which only applied to corporations.

[17] §163(j)(5), *as amended by* the 2017 tax act, §13301(a).

[18] Rep. of the Committee on Ways and Means House of Representatives on H.R. 1, fn. 444.

[19] §163(j)(6), *as amended by* the 2017 tax act, §13301(a).

[20] §163(j)(6), *as amended by* the 2017 tax act, §13301(a).

[21] §163(j)(8), *as amended by* the 2017 tax act, §13301(a). The statute grants authority to the Treasury Secretary to provide for additional adjustments to taxable income.

[22] §163(j)(1)(C), *as amended by* the 2017 tax act, §13301(a).

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ing indebtedness.[23] Floor plan financing indebtedness is defined as indebtedness that a taxpayer uses to finance acquisition of ''motor vehicles'' held for sale or lease as long as the indebtedness is secured by the inventory acquired.[24] A ''motor vehicle'' includes any of the following:[25]

- A self-propelled vehicle designed for transporting persons or property on a public street, highway or road;
- A boat; and/or
- Farm machinery or equipment.

Note that for purposes of the §168(k) bonus depreciation provisions, any property used in a trade or business that has had floor plan financing indebtedness with interest taken into account under §163(j)(1)(C) is not considered ''qualified property.''[26]

Certain Small Businesses

The §163(j) overall limitation on the deduction of business interest does not apply to a taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under §448(a)(3)) if the average annual gross receipts for the three-year annual period ending with the prior tax year is $25 million or less.[27] If an entity (or trade or business) has not been in existence for this entire three-year period, this test can be applied on the basis of the period during which the entity (or trade or business) has been in existence.[28]

Trade or Business of Performing Services as an Employee

As discussed above, the §163(j) limitation applies to the deduction of ''business interest,'' which is defined as interest paid on indebtedness allocable to a ''trade or business.'' For purposes of this definition, a ''trade or business'' does not include the trade or business of performing services as an employee.[29]

Electing Real Property Trade or Business

The §163(j) definition of a trade or business does not include an ''electing real property trade or business.''[30] An ''electing real property trade or business'' is defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business that makes an election not to apply §163(j).[31] Once the election is made, it is irrevocable.[32]

If a real property trade or business elects not to apply the §163(j) business interest limitation, that business is required to depreciate its nonresidential real property, residential rental property, and qualified improvement property using the alternative depreciation system (ADS).[33] For property placed in service after December 31, 2017, the ADS recovery period for nonresidential real property is 40 years; the ADS recovery period for residential rental property is 30 years; and the ADS recovery period for qualified improvement property is 20 years.[34] In addition, a real property trade or business that makes this election will not be able to take advantage of bonus depreciation under §168(k).[35]

Electing Farming Business

The §163(j) definition of a trade or business does not include an ''electing farming business.''[36] An ''electing farming business'' includes a farming business that makes the election not to apply §163(j).[37] A farming business is defined in §263A(e)(4) as a trade or business of farming, and specifically includes the trade or business of operating a nursery or sod farm, and the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees. The term ''electing farming business'' also includes any trade or business of a specified agricultural or horticultural cooperative (as defined in §199A(g)(2)) with respect to which the cooperative makes an election not to apply §163(j).[38]

If a farming business elects not to apply the §163(j) business interest limitation, that business is required to depreciate any property with a recovery period of

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[23] §163(j)(9)(A), *as amended by* the 2017 tax act, §13301(a).

[24] §163(j)(9)(B), *as amended by* the 2017 tax act, §13301(a).

[25] §163(j)(9)(C), *as amended by* the 2017 tax act, §13301(a).

[26] §168(k)(9)(A), *as added by* the 2017 tax act, §13201(d).

[27] §163(j)(3), *as amended by* the 2017 tax act, §13301(a). Section 163(j)(3) references the gross receipts test in §448(c), which was also amended by the 2017 tax act. The 2017 tax act increased the $5 million threshold in §448(c) to $25.

[28] §448(c)(3)(A).

[29] §163(j)(7)(A)(i), *as amended by* the 2017 tax act, §13301(a).

[30] §163(j)(7)(A)(ii), *as amended by* the 2017 tax act, §13301(a).

[31] §163(j)(7)(B), *as amended by* the 2017 tax act, §13301(a).

[32] §163(j)(7)(B), *as amended by* the 2017 tax act, §13301(a).

[33] §168(g)(1)(F), §168(g)(8), *as added by* the 2017 tax act, §13204.

[34] §168(g)(2)(C), *as added by* the 2017 tax act, §13204(a)(3)(C).

[35] §168(k)(9)(A), *as added by* the 2017 tax act, §13201(d). This section provides that ''qualified property,'' for purposes of §168(k), does not include property primarily used in a trade or business described in §163(j)(7)(A), which includes an electing real property trade or business.

[36] §163(j)(7)(A)(iii), *as amended by* the 2017 tax act, §13301(a).

[37] §163(j)(7)(C)(i), *as amended by* the 2017 tax act, §13301(a).

[38] §163(j)(7)(C)(ii), *as amended by* the 2017 tax act, §13301(a).

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10 years or more using the alternative depreciation system (ADS).[39] In addition, a real property trade or business that makes this election will not be able to take advantage of bonus depreciation under §168(k).[40]

Certain Public Regulated Utilities

The §163(j) definition of a trade or business does not include the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services; gas or steam through a local distribution system; or transportation of gas or steam by pipeline as long as the relevant rates have been established or approved by a state 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 rate making body of an electric cooperative.[41]

Application to Partnerships and S Corporations

Application at Entity Level

Section 163(j) is applied at the partnership or S corporation level.[42] Any deduction for business interest is taken into account in determining the nonseparately stated taxable income or loss of the partnership.[43] What this essentially means is that the limitation is calculated separately for each partnership or S corporation in which a taxpayer is a partner or shareholder. In some cases, this rule results in a smaller deduction than the partner or shareholder would have been able to claim if the limitation were applied to aggregate business interest at the partner or shareholder level.

Partner/Shareholder Computation of Adjusted Taxable Income

Although §163(j) is applied at the partnership or S corporation level with respect to entity level indebtedness, it is also applied at the partner or shareholder level if that partner or shareholder has other business interest. In that case, the partner or shareholder needs to compute its own adjusted taxable income in order to apply §163(j) to its other business interest. In computing its own adjusted taxable income, the partner or shareholder does not include its distributive share of any items of income, gain, deduction, or loss of the partnership or S corporation.[44] However, adjusted taxable income does include the partner or shareholder's distributive share of ''excess taxable income.''[45] A partner's distributive share of excess taxable income is determined in the same manner as the partner's distributive share of nonseparately stated taxable income or loss of the partnership.[46] In other words, a partner cannot include excess taxable income in adjusted taxable income until all of the partner's excess business interest from that same partnership, for all taxable years, is treated as paid or accrued.[47]

Excess Taxable Income

''Excess taxable income'' (ETI) is a new concept introduced by the 2017 tax act that is equal to the amount (if any) of the partnership's (or S corporation's) adjusted taxable income (ATI) (as computed for purposes of §163(j)) that bears the same ratio to the partnership's (or S corporation's) total ATI as the unused amount of the 30% of ATI limitation bears to 30% of ATI. The unused amount of the 30% of ATI limitation is the amount by which 30% of ATI exceeds the partnership's or S corporation's net business interest expense. The statutory language, written as a ratio, is as follows:

$$\frac{\text{ETI}}{\text{ATI}} = \frac{\text{(30\% of ATI) minus net business interest expense}}{\text{30\% of ATI}}$$

Put another way, ETI is computed by multiplying ATI by a fraction, the numerator of which is the unused portion of the 30% of ATI limitation and the denominator of which is 30% of ATI, as follows:

$$\text{ETI} = \text{ATI} \times \frac{\text{unused portion of 30\% of ATI limitation}}{\text{30\% of ATI}}$$

> ***Example:***
> S corporation WXYZ has four equal shareholders and is subject to the §163(j) limitation. Assume the following in Year One:
> S corporation's ATI computed under §163(j)(8): $30 million
> Business Interest: $3 million
> 30% of ATI = $9 million [The S corporation could deduct up to $9 million of business

[39] §168(g)(1)(G), *as amended by* the 2017 tax act, §13205.

[40] §168(k)(9)(A), *as added by* the 2017 tax act, §13201(d). This section provides that ''qualified property,'' for purposes of §168(k), does not include property primarily used in a trade or business described in §163(j)(7)(A), which includes an electing real property trade or business.

[41] §163(j)(7)(A)(iv), *as amended by* the 2017 tax act, §13301(a).

[42] §163(j)(4)(A)(i), *as amended by* the 2017 tax act, §13301(a).

[43] §163(j)(4)(A)(i), *as amended by* the 2017 tax act, §13301(a).

[44] §163(j)(4)(A)(ii)(I), *as amended by* the 2017 tax act, §13301(a).

[45] §163(j)(4)(A)(ii)(II), *as amended by* the 2017 tax act, §13301(a).

[46] §163(j)(4)(A)(ii)(II), *as amended by* the 2017 tax act, §13301(a).

[47] §163(j)(4)(B)(ii)(II), *as amended by* the 2017 tax act, §13301(a).

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interest under §163(j). However, the S corporation has only paid $3 million of business interest, which means that there is ETI to be allocated to the S corporation shareholders.]

30% of ATI minus net business interest expense = $6 million

$6 million is 66.6% of $9 million

So, 66.6% of ATI ($30 million) is ETI = $20 million

Each shareholder is allocated $5 million of ETI, which the shareholder can include in its computation of its own adjusted taxable income for purposes of applying the §163(j) limitation to other business interest.

Special Rules Applicable to Partnerships

Partner Carryforward of Excess Business Interest

For partnerships with excess business interest (nondeductible because it exceeds the §163(j) limit), that excess is *not* carried forward at the partnership level.[48] Instead, the excess business interest is allocated to the partners.[49] Excess business interest is allocated in the same manner as nonseparately stated partnership taxable income or loss.[50] The *partners* carry forward that excess and it is treated as paid or accrued by the partners in succeeding taxable years but only to the extent of ETI (if any) allocated to the partners from that same partnership.[51]

The rules discussed in this section and below, regarding the excess business interest carryforward at the partner level, do not apply to S corporations.[52]

Example (1):

Partnership ABCD has four equal partners and is subject to the §163(j) limitation.

Assume the following in Year One:

Partnership's ATI computed under §163(j)(8) = $32 million

Partnership's Business Interest Income = $2 million

Partnership's Business Interest Expense = $8 million

The partnership is able to deduct the entire $8 million of business interest (because it does not exceed $2 million (business interest income) plus $9.6 million (30% of ATI))

— What is the percentage of the 30% limitation ($9.6 million) that exceeds the partnership's net business interest expense ($6 million)?

Answer = 37.5% (($9.6 million – $6 million)/$9.6 million)

Thus, 37.5% of the partnership's ATI is considered ETI and is allocated to the partners. ETI is $12 million ($32 million × .375). There is $3 million of ETI allocated to each partner in Year 1. If the partners pay or accrue business interest directly (outside of the partnership), they will need to compute the limitation at the partner level as well. When they compute their own ATI, they cannot include their distributive share of income, gain, deduction, or loss from Partnership ABCD but they can include their distributive share of ETI.

Example (2):

Assume the facts in Example (1) above for Year One — each partner's distributive share of ETI for Year One was $3 million.

Assume the following in Year Two:

Partnership's ATI computed under §163(j)(8) = $32 million

Partnership's Business Interest Income = $2 million

Partnership's Business Interest Expense = $12 million

— The partnership is not able to deduct the entire $12 million of business interest (because it exceeds $2 million (interest income) plus $9.6 million (30% of ATI)) — so $400,000 is nondeductible ''excess business interest'' which will be allocated to the partners.

— Each partner is allocated $100,000 of excess business interest and each partner carries forward that excess interest and can deduct it when and to the extent that Partnership ABCD allocates ETI to the partners. [Note also that each partner reduces its adjusted basis in its partnership interest by its distributive share of excess business interest, regardless of whether the partner is able to deduct that interest in that year. The effect on basis is discussed further below.]

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[48] §163(j)(4)(B)(i)(I), *as amended by* the 2017 tax act, §13301(a).

[49] §163(j)(4)(B)(i)(II), *as amended by* the 2017 tax act, §13301(a).

[50] §163(j)(4)(B)(i)(II), *as amended by* the 2017 tax act, §13301(a).

[51] §163(j)(4)(B)(ii)(I), *as amended by* the 2017 tax act, §13301(a).

[52] §163(j)(4)(D), *as amended by* the 2017 tax act, §13301(a). Section 163(j)(4)(D) specifically states that rules similar to those found in §163(j)(4)(A) and §163(j)(4)(C) apply to S corporations. Thus, the rules in §163(j)(4)(B) (special rules for carryforwards) do not.

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Observation: Even though, in Example (2), the partners had ETI in Year 1, the statute does not contemplate allowing the partners to use that ETI to treat the excess business interest allocated to them in Year 2 as paid or accrued. There is no mechanism to carry the excess business interest *back* or carry the ETI *forward*.

Observation: Even if one or more of the partners in Example (2) have an interest in another partnership that happens to have ETI for Year 2, it does not appear that the partners are able to deduct the excess business interest from Partnership ABCD against the ETI from the other entity — the statute clearly states that the excess business interest is ''treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income *from such partnership* [emphasis added].''[53]

The statutory language governing excess business interest and ETI for partners is problematic and does not seem to lead to the right result. First, the statute provides that ''excess business interest shall be treated as business interest *paid or accrued by the partner* in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only *to the extent of such excess taxable income* [emphasis added].''[54] Second, any portion remaining (excess business interest that has not been treated as paid or accrued under the previous rule), shall be ''treated as business interest paid or accrued in succeeding taxable years,'' to the extent of ETI in those succeeding years.[55] The problem with this language is that it ignores the fact that interest that is treated as paid or accrued by the partner is *not* the same as interest that is deductible by the partner because that interest should be subjected to the §163(j) limitation (similar to the manner in which a carryforward at the corporate level will be subjected to the limitation in succeeding years). If excess business interest is treated as paid or accrued *to the extent of excess taxable income* and only the remaining portion (if any) continues to be carried forward and treated as paid or accrued in future years, then the carryforward is reduced by the amount treated as paid or accrued, not the amount actually deducted (which should be limited to 30% of ETI).

Consider, for example, a partner whose distributive share of excess business interest in Year One is $1 million and whose distributive share of ETI in Year Two is $1.5 million. The statutory language would treat the entire $1 million excess business interest as paid or accrued by the partner in Year Two. But then what? There is only $1.5 million of ETI from the partnership. The partner should only be able to deduct $450,000 of the excess business interest (30% of ETI). What happens to the remaining $550,000? The statute does not contemplate continuing to carry this forward, but that is not the right result. In addition, the language in §163(j)(4)(B)(ii)(II)(flush language) further complicates the analysis. It provides that ''excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account [for purposes of the 30% of ATI limit] with respect to *any business interest other than excess business interest* from the partnership until all such excess business interest for such taxable year and all preceding taxable years has been treated as paid or accrued [emphasis added].'' In this example, all excess business interest has, in fact, been treated as paid or accrued (even though it has not all been deductible), which seems to mean according to this statutory provision that some amount of the ETI is available for the partner to include in its ATI when determining whether other business interest can be deducted. Again, this does not make economic sense when there is not sufficient ETI to fully deduct the excess business interest from the partnership.

The statutory approach is also problematic in the context of the basis rules, as discussed more fully below. A partner's basis is reduced by its distributive share of excess business interest. However, upon a disposition of the interest, the partner is able to increase its basis, immediately before the disposition, by the ''amount by which the allocated excess business interest amounts (that have previously reduced basis) exceed the excess business interest that has been *treated as paid or accrued by the partner* [emphasis added].''[56] Again, because the amount treated as paid or accrued is not the same as the amount actually deducted, this provision does not accomplish its goal of eliminating the basis reduction for amounts that the partner has never been able to deduct.

How should the statute approach excess business interest and ETI to solve these issues? It seems that there is a relatively simple fix. Section 163(j)(4)(B)(i) should read as follows: ''such excess business interest shall be treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, **but only to the extent of *30% of* such excess taxable income**.'' Going back to the

[53] §163(j)(4)(B)(ii)(I), *as amended by* the 2017 tax act, §13301(a).

[54] §163(j)(4)(B)(ii)(I), *as amended by* the 2017 tax act, §13301(a).

[55] §163(j)(4)(B)(ii)(I), *as amended by* the 2017 tax act, §13301(a).

[56] §163(j)(4)(B)(iii)(II), *as amended by* the 2017 tax act, §13301(a).

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example of the partner with $1 million of excess business interest carryforward from Year 1 and $1.5 million of ETI in Year 2, this rule would treat $450,000 of the $1 million excess business interest carryforward as paid or accrued by the partner in Year 2. The partner would determine the deductibility of that $450,000 against the $1.5 million of ETI, 30% of which is $450,000. The remaining $550,000 of excess business interest would be carried forward until there was additional ETI from the partnership. There would be no ETI in Year 2 to take into account for any other business interest of the partner because not all of the $1 million excess business interest has been treated as paid or accrued. In addition, if the partner disposed of its partnership interest at the beginning of Year 3, the application of §163(j)(4)(B)(iii)(II) would lead to the right result because basis would be increased by $550,000 (the amount by which the allocated excess business interest amounts ($1 million) exceed the excess business interest that has been treated as paid or accrued by the partner ($450,000). Again, if, instead, the amount treated as paid or accrued had been $1 million (which is the way the statute currently reads), there would be NO increase in basis, which leaves the partner recognizing an inappropriate amount of gain.

Observation: Although there does seem to be an easy fix to the statutory language, it is not what the statute currently provides for. It does seem that this was an oversight but it is not entirely clear. It is also unclear whether the IRS could provide for this result in regulations or whether legislative change is necessary.

Effect on Basis

As stated above, excess business interest allocated to a partner reduces that partner's adjusted basis in its partnership interest (but not below zero) in the year of allocation (even though the interest does not give rise to a deduction for the partner in that year).[57] If, in a later taxable year, a partner has a distributive share of excess taxable income and, therefore, some portion (or all) of a previous excess business interest carryforward is treated as paid or accrued by the partner in that year, there is no effect on basis.

If a partner disposes of a partnership interest and the basis has been reduced due to excess business interest, the partner's basis is increased, immediately before the disposition, by the amount by which the allocated excess business interest amounts (that have previously reduced basis) exceed the excess business interest that has been treated as paid or accrued by the partner.[58]

As discussed above, the way in which the statute is currently written is problematic because the amounts treated as paid or accrued are not equal to the amounts that the partner is actually able to deduct. The following Example illustrates the issue.

> ***Example:*** Assume the following:
>
> Partner A's adjusted basis in its partnership interest at the end of Year One, prior to taking into consideration excess business interest = $10 million
>
> Partner A's distributive share of excess business interest in Year One is $3 million. Partner A's adjusted basis in its partnership interest is reduced to $7 million.
>
> Year Two: Partner A's distributive share of excess taxable income is $1 million. Pursuant to the statutory language, $1 million of the $3 million excess business interest carryforward is treated as paid or accrued by Partner A in Year Two. There is no effect on basis. Note that once A applies §163(j) to that $1 million of business interest treated as paid or accrued, only $300,000 is actually deductible (because there is only $1 million ETI).
>
> Year Three: Partner A sells its partnership interest. Immediately before the sale, A increases its adjusted basis in its partnership interest by $2 million (the amount of excess business interest that has not been treated as paid or accrued by A). Thus, for purposes of the sale, A's adjusted basis in its partnership interest is $9 million. Note, however, that A has only deducted $300,000. As discussed in the section above, what should happen here is that the amount of excess business interest treated as paid or accrued in Year 2 should be equal to 30% of the ETI ($300,000) and the increase in basis should, therefore, be $2.7 million to give A an adjusted basis in its partnership interest of $9.7 million.

These rules also apply to transfers in which gain is not recognized in whole or in part (including transfers by reason of death).[59] Section 163(j) specifically provides that no deduction is allowed to the transferor or transferee for any excess business interest resulting in

[57] §163(j)(4)(B)(iii)(I), *as amended by* the 2017 tax act, §13301(a).

[58] §163(j)(4)(B)(iii)(II), *as amended by* the 2017 tax act, §13301(a).

[59] §163(j)(4)(B)(iii)(II), *as amended by* the 2017 tax act, §13301(a).

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a basis increase under these rules.[60]

[60] §163(j)(4)(B)(iii)(II), *as amended by* the 2017 tax act, §13301(a).

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