Daily Tax Report®

February 12, 2018

Bloomberg BNA

Interest

A Deep Dive Into the New Business Interest Limitation Reveals Need for Correction

Lisa Starczewski and Bruce Booken of Buchanan, Ingersoll & Rooney analyze one portion of the new limitation on the deductibility of business interest in tax code Section 163(j), conclude that the provisions related to application of this new limitation to partnerships do not operate as intended, and suggest a “fix” to the statutory language.

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The 2017 tax act (Pub. L. No. 115-97) made a multitude of changes to the tax code, many of which significantly affect the rate at which business income is taxed and the manner in which it is computed. This article provides a detailed analysis of one portion of the new limitation on the deductibility of business interest in tax code Section 163(j) and concludes that the provisions related to application of this new limitation to partnerships do not operate as intended. The authors suggest a “fix” to the statutory language.

For taxable years beginning after Dec. 31, 2017, Section 163(j), as amended by the 2017 tax act, limits a taxpayer's deduction of business interest to business interest income plus 30 percent of adjusted taxable income plus floor plan financing interest. [Section 163(j)(1)] Thus, putting floor plan financing aside, net business interest expense is deductible only to the extent of 30 percent of adjusted taxable income. The limitation applies to all taxpayers, although there are exceptions applicable to small businesses, electing real property trades or businesses, electing farming businesses, and certain publicly regulated utilities.

This article focuses on the rules in Section 163(j)(4) regarding how this limitation is applied to an entity taxed as a partnership.

1. Application at Entity Level

Section 163(j) is applied at the partnership level. Any deduction for business interest is taken into account in determining the non-separately stated taxable income or loss of the partnership. [Section 163(j)(4)(A)(i)] What this essentially means is that the limitation is calculated separately for each partnership in which a taxpayer is a partner. In some cases, this rule results in a smaller deduction than the partner would have been able to claim if the limitation were applied to aggregate business interest at the partner level.

2. Partner Computation of Adjusted Taxable Income

Although Section 163(j) is applied at the partnership level with respect to entity level indebtedness, it is also applied at the partner level if that partner or shareholder has other business interest. In that case, the partner needs to compute its own adjusted taxable income in order to apply Section 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. [Section 163(j)(4)(A)(ii)(I)] However, adjusted taxable income does include the partner or shareholder's distributive share of "excess taxable income." [Section 163(j)(4)(A)(ii)(II)] 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. However, 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. [Section 163(j)(4)(B)(ii)(II)]

3. 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 adjusted taxable income (ATI) (as computed for purposes of Section 163(j)) that bears the same ratio to the partnership's total ATI as the unused amount of the 30 percent of ATI limitation bears to 30 percent of ATI. [Section 163(j)(4)(C)] The unused amount of the 30 percent of ATI limitation is the amount by which 30 percent of ATI exceeds the partnership's net business interest expense. The statutory language, written as a ratio, is as follows:

ETI ÷ ATI = ((30% of ATI) minus net business interest expense) / 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 percent of ATI limitation and the denominator of which is 30 percent of ATI, as follows:

ETI = ATI x (unused portion of 30% of ATI limitation / 30% of ATI)

Example:

Partnership ABCD has 4 equal partners and is subject to the Section 163(j) limitation. Assume the following in Year One:

Partnership's Adjusted Taxable Income (ATI) computed under Section 163(j)(8): $30,000,000

Business Interest: $3,000,000

30% of ATI = $9,000,000 [The partnership could deduct up to $9,000,000 of business interest under Section 163(j). However, the partnership has only paid $3,000,000 of business interest, which means that there is excess taxable income (ETI) to be allocated to the partners.]

30% of ATI minus net business interest expense = $6,000,000

$6,000,000 is what percentage of $9,000,000? = 66.6%

So, 66.6% of ATI ($30,000,000) is ETI = $20,000,000

Each partner is allocated $5,000,000 of excess taxable income.

4. Partner Carryforward of Excess Business Interest

For partnerships with excess business interest (nondeductible because it exceeds the Section 163(j) limit), that excess is not carried forward at the partnership level. [Section 163(j)(4)(B)(i)(I)] Instead, the excess business interest is allocated to the partners. [Section 163(j)(4)(B)(i)(II)] Excess business interest is allocated in the same manner as nonseparately stated partnership taxable income or loss. 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 "excess taxable income" (if any) allocated to the partners from that same partnership. [Section 163(j)(4)(B)(ii)(I)]

Example (1):

Partnership ABCD has 4 equal partners and is subject to the Section 163(j) limitation.

Assume the following in Year One:

Partnership's adjusted taxable income (ATI) computed under Section 163(j)(8) = $32,000,000

Partnership's Business Interest Income = $2,000,000

Partnership's Business Interest Expense = $8,000,000

– The partnership is able to deduct the entire $8,000,000 of business interest (because it does not exceed $2,000,000 (business interest income) plus $9,600,000 (30% of ATI))

– What is the percentage of the 30% limitation ($9,600,000) that exceeds the partnership's net business interest expense ($6,000,000)? Answer = 37.5% (($9,600,000 - $6,000,000)/$9,600,000)

Thus, 37.5% of the partnership's ATI is considered "excess taxable income" and is allocated to the partners. Excess taxable income is $12,000,000 ($32,000,000 x .375). There is $3,000,000 of excess taxable income 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 "adjusted taxable income," they cannot include their distributive share of income, gain, deduction or loss from Partnership ABCD but they can include their distributive share of "excess taxable income."

Example (2):

Assume the facts in Example (1) above for Year One – each partner's distributive share of excess taxable income for Year One was $3,000,000.

Assume the following in Year Two:

Partnership's ATI computed under Section 163(j)(8) = $32,000,000

Partnership's Business Interest Income = $2,000,000

Partnership's Business Interest Expense = $12,000,000

– The partnership is not able to deduct the entire $12,000,000 of business interest (because it exceeds $2,000,000 (interest income) plus $9,600,000 (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 excess taxable income to the partners. [Note also that the 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.]

Observation: Even though, in Example (2), the partners had excess taxable income in Year 1, the statute does not contemplate allowing the partners to use that excess taxable income 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 excess taxable income forward.

Observation: Even if one or more of the partners in Example (2) have an interest in another partnership that happens to have excess taxable income for Year 2, it does not appear that the partners are able to deduct the excess business interest from Partnership ABCD against the excess taxable income 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]." [Section 163(j)(4)(B)(ii)(I)]

The statutory language governing excess business interest and excess taxable income 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]." [Section 163(j)(4)(B)(ii)(I)] 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 excess taxable income in those succeeding years. [Section 163(j)(4)(B)(ii)(I)] 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 Section 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 percent of excess taxable income).

Consider, for example, a partner whose distributive share of excess business interest in Year One is $1 million and whose distributive share of excess taxable income 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 excess taxable income from the partnership. The partner should only be able to deduct $450,000 of the excess business interest (30 percent of excess taxable income). 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 Section 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 percent 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.” 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 excess taxable income is available for the partner to include in its adjusted taxable income when determining whether other business interest can be deducted. Again, this does not make economic sense when there is not sufficient excess taxable income 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].” [Section 163(j)(4)(B)(iii)(II)] 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 excess taxable income 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 example of the partner with $1 million of excess business interest carryforward from Year 1 and $1.5 million of excess taxable income 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 excess taxable income, 30 percent of which is $450,000. The remaining $550,000 of excess business interest would be carried forward until there was additional excess taxable income from the partnership. There would be no excess taxable income 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 Section 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.

5. 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). [Section 163(j)(4)(B)(iii)(I)] 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. [Section 163(j)(4)(B)(iii)(II)]

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 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 = $10,000,000.

Partner A 's distributive share of excess business interest in Year One is $3,000,000. Partner A's adjusted basis in its partnership interest is reduced to $7,000,000.

Year Two: Partner A's distributive share of excess taxable income is $1,000,000. Pursuant to the statutory language, $1,000,000 of the $3,000,000 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 Section 163(j) to that $1,000,000 of business interest treated as paid or accrued, only $300,000 is actually deductible (because there is only $1,000,000 excess taxable income).

Year Three: Partner A sells its partnership interest. Immediately before the sale, A increases its adjusted basis in its partnership interest by $2,000,000 (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 $9,000,000. 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 excess taxable income ($300,000) and the increase in basis should, therefore, be $2,700,000 to give A an adjusted basis in its partnership interest of $9,700,000.