DUGAN, SCOTTI & ZOCH, P.A.

Certified Public Accountants

161 McKINLEY STREET • P.O. BOX 576 • CLOSTER, NJ 07624

PHONE: (201) 767-6270 • FAX: (201) 767-0920

www.dszcpa.com

Abstract: To provide tax relief to businesses suffering during the COVID-19 pandemic, the CARES Act temporarily relaxes the limitation on deductions for business interest expense. This article explains the rules that had gone into effect under the TCJA and the favorable changes under the CARES Act.

Relaxed limit on business interest deductions

To provide tax relief to businesses suffering during the COVID-19 pandemic, the Coronavirus Aid, Relief, and Economic Security (CARES) Act temporarily relaxes the limitation on deductions for business interest expense. Here's the story.

TCJA created new limitation

Before the Tax Cuts and Jobs Act (TCJA), some corporations were subject to the so-called "earnings stripping" rules. Those rules attempted to limit deductions by U.S. corporations for interest paid to related foreign entities that weren't subject to U.S. income tax. Other taxpayers could generally fully deduct business interest expense (subject to other tax-law restrictions, such as the passive loss rules and the at-risk rules).

The TCJA shifted the business interest deduction playing field. For tax years beginning in 2018 and beyond, it limited a taxpayer's deduction for business interest expense for the year to the sum of:

- Business interest income,
- 30% of adjusted taxable income (ATI), and
- Floor plan financing interest expense paid by certain vehicle dealers.

Business interest expense is defined as interest on debt that's properly allocable to a trade or business. However, the term trade or business doesn't include the following excepted activities:

- Performing services as an employee,
- Electing real property businesses,
- Electing farming businesses, and
- Selling electrical energy, water, sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, if the rates are established by a specified governing body.

Interest expense that's disallowed under the limitation rules is carried forward to future tax years indefinitely and treated as business interest expense incurred in the carry-forward year.

Small business exception

Many businesses are exempt from the interest expense limitation rules under what we'll call the small business exception. Under this exception, a taxpayer (other than a tax shelter) is exempt from the limitation if the taxpayer's average annual gross receipts are $25 million or less for the three-tax-year period ending with the preceding tax year. Businesses that have fluctuating annual gross receipts may qualify for the small business exception for some years but not for others — depending on the average annual receipts amount for the preceding three-tax-year period.

For example, if your business has three good years, it may be subject to the interest expense limitation rules for the following year. But if your business has a bad year, it may qualify for the small business exception for the following year. If average annual receipts are typically over the $25 million threshold, but not by much, judicious planning may allow you to qualify for the small business exception for at least some years.

Special rules for partnerships and S corporations

The interest expense deduction limitation rules get more complicated for businesses operating as partnerships, limited liability companies (LLCs) treated as partnerships for tax purposes and S corporations.

Basically, the limitation is calculated at both the entity level and at the owner level. Special rules prevent double counting of income when calculating an owner's ATI for purposes of applying the limitation rules at the owner level.

IRS proposed regs set forth the special rules for applying the business interest expense limitation to partnerships and S corporations and their owners. The rules are complex and present significant compliance challenges.

Favorable CARES Act changes

The CARES Act generally allows businesses, unless they elect otherwise, to increase the interest expense deduction limitation to 50% of ATI for tax years beginning in 2019 or 2020. Businesses can also elect to use 2019 ATI to calculate the 2020 ATI limitation, which can allow for a larger deduction if 2020 ATI is less, which may be the case for many businesses.

For partnerships (including LLCs treated as partnerships for tax purposes), the 30% of ATI limitation remains in place for tax years beginning in 2019 but is 50% for 2020. Disallowed partnership business interest expense from a partnership's 2019 tax year is allocated to partners and carried over to their 2020 tax years.

Unless a partner elects otherwise, 50% of carried-over partnership business interest expense from 2019 is deductible in the partner's 2020 tax year without regard to the business interest expense limitation rules. The remaining 50% is subject to the normal limitation rules, calculated at the partner level, for carried-over partnership business interest expense. Like other businesses, partnerships can elect to use 2019 ATI to calculate the 2020 ATI limitation.

Help is available

As you can see, the business interest expense limitation rules are complicated. The temporarily relaxed limitations can allow affected businesses to reduce their federal tax liabilities for 2019 and 2020. However, for partnerships and partners, limitation rules are relaxed only for 2020. Your tax advisor can help your business take advantage of the relaxed rules for business interest expense deductions and benefit from other tax relief measures made available by the CARES Act.

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