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Abstract: The Tax Cuts and Jobs Act introduced a variety of tax benefits for businesses. At the same time, the act placed limits on several tax breaks, including the amount of interest expense a business may deduct. This article takes a closer look at the business interest limit and possible exemptions and opt-outs.

The TCJA limit on interest expense deductions

Does it affect your business?

The Tax Cuts and Jobs Act (TCJA) introduced a variety of tax benefits for businesses. Among other things, it slashed corporate income tax rates, temporarily reduced individual rates and established a new 20% deduction for certain pass-through income. At the same time, the act placed limits on several tax breaks, including the amount of interest expense a business may deduct.

“Small” businesses are exempt

Before you worry about the mechanics of the business interest limit, you should determine whether you qualify for the small business exemption. Businesses whose average annual gross receipts for the preceding three years are \$25 million or less aren't subject to the limit and, with a few rare exceptions, may deduct all their business interest expense.

Keep in mind that some related businesses must combine their gross receipts for purposes of the \$25 million test. So, you can't avoid the limit by splitting a larger business into separate entities.

How it works

If your gross receipts exceed the \$25 million threshold, then under the TCJA your annual deduction for business interest expense is limited to the sum of:

1. Your business interest income,
2. 30% of your adjusted taxable income, and
3. Your floor-plan financing interest (for dealers in some motor vehicles, boats and farm equipment).

Put another way, aside from floor-plan financing, your net interest expense — that is, interest expense less interest income — is deductible up to 30% of adjusted taxable income. Note: The limit doesn't apply to *investment* interest.

Your adjusted taxable income is your taxable income without regard to:

- Nonbusiness income,
- Business interest expense or income,
- The amount of any net operating loss deduction,
- The 20% pass-through deduction, and
- Depreciation, amortization or depletion.

The last adjustment expires at the end of 2021. In other words, beginning in 2022, adjusted taxable income will be reduced by the amount of depreciation, amortization and depletion, limiting business interest deductions even further.

Disallowed interest expense may be carried forward indefinitely and deducted in subsequent years, subject to the same limits.

Real property and farming businesses may opt out

Some real property businesses — including development, construction, management, leasing and brokerage — may elect not to apply the business interest limit. The trade-off is that these businesses must forgo 100% bonus depreciation and depreciate specific assets over longer periods.

Once made, the election is irrevocable. A similar election is available for farming businesses.

What about pass-through entities?

A complete discussion of the application of the business interest limit to pass-through entities is beyond the scope of this article. But in general, the limit applies at the entity level.

For a partnership, any interest above the limit is passed through to the partners and carried forward until it can be offset against “excess taxable income” allocated to the partners. Excess taxable income is essentially partnership income in each year that’s sufficient to support interest deductions beyond the partnership’s actual interest expense for that year.

For an S corporation, excess interest is carried over at the entity level until the corporation generates sufficient income to absorb it.

Next steps to take

If your average annual gross receipts exceed \$25 million, estimate the impact of the business interest limit on your tax bill. If it’s significant, consider strategies for softening the blow, such as shifting from debt to equity financing. If you have a real property or farming business, weigh the costs and benefits of opting out of the interest limit.

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