A Few Reasons Why S Corporation Owners & Shareholders Should be "Interested" in New Section 163(j) Interest Expense Limitations

The Tax Cuts and Jobs Act (TCJA) amended a number of long standing Internal Revenue Code provisions including Section 163(j).[1] Congress intended new Section 163(j) to be a significant revenue raiser for the government as it expressly limits the ability of sole proprietors, C corporations, S corporations, utility trades, farming businesses and partnerships to deduct previously allowed business interest expenses. It is important for those structuring entities and transactions to consider this provision's impact and reach when advising clients with heavy business interest exposure. The following provides a survey of the major statutory changes with a focus on how Section 163(j) relates to S Corporations.

I. *New Section 163(j) - An Overview.*

Effective December 31, 2017, Section 13301(a) of the TCJA amended Section 163(j) by removing prior paragraphs 163(j)(1)-(9), and imposing new paragraphs 163(j)(1)-(10). For tax years beginning after December 31, 2017, new Section 163(j) limits the amount of business interest expense that may be deducted in the current taxable year.

Under the new Section 163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of the following three items: (1) the taxpayer's business interest income for the taxable year; (2) 30% of the taxpayer's adjusted taxable income (better known as ATI) for the taxable year, and (3) the taxpayer's floor plan financing interest expense for the taxable year (hereinafter collectively referred to as ATI). Any disallowed interest deduction carries forward indefinitely. The interest limitation generally applies to all taxpayers, unless they meet one of two exceptions. [2]

The first exception applies to "small" businesses that satisfy the gross receipts test of Section 488(c). S Corporations with $25 million or less of average gross receipts over the past three years may deduct an unlimited about of business interest expense.[3] For example, assume a business has gross receipts of $20 million in 2015, $25 million in 2016 and $30 million in 2017. Under new Section 163(j), the prior three-year average gross receipts equal $25 million. Thus, the business' average gross receipts for the prior three-year period does not exceed $25 million

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[1] *See* Income Tax Regulations (26 CFR part 1) under Section 163(j) of the Internal Revenue Code (Code), REG – 106089, & 83 Fed. Reg. 67490-67610 (12/28/2018).

[2] Under the old version of section 163(j) the test was satisfied if the payor's debt to equity ratio exceeded 1.5 to 1.0 (defined in the Code and Regs as the safe harbor ratio), or if the payor's net interest expense exceed 50% of the businesses adjusted taxable income. Disqualified interest under the old section included interest paid to related parties where no income tax was imposed with respect to the interest, interest to unrelated parties where the related party guaranteed the debt, or certain transactions involving a taxable subsidiary of a real estate investment trust (REIT).

[3] It is important to note this represents a significant increase from the old version of 448(c) which limited this threshold to $5 Million.

and the business is considered a small business for purposes of Section 448(c) and may deduct an unlimited amount of business interest expense.

The second exception is for certain trades or businesses listed in Section 163(j)(7). These include trades or businesses of providing services as an employee, real property trades or businesses, farming businesses and regulated utility businesses (an "excepted trade or business"). An S corporation or partnership that conducts an excepted trade or business does not apply the Section 163(j) limitation to its business interest expense.[4]

II. *S Corporations and the Interplay with Partnership Provisions*.

A. *Partnerships*.

Section 163(j)(4)(D) expressly provides that subparagraphs (j)(4)(A) & (C)[5] apply to S corporations. Section 163(j)(4) provides special rules for applying Section 163(j) in the case of partnerships and S corporations. Section 163(j)(4)(A) requires that the limitation on the deduction for business interest expense be applied at the partnership level based upon the ATI of the partnership. Any business interest properly deducted by the partnership after the application of Section 163(j) passes through to the partners as part of their ordinary business income or loss.[6] In addition, any business interest that cannot be deducted on account of Section 163(j) ("excess business interest") passes through to the partners and may be deducted in subsequent years, but only against excess taxable income attributable to that particular partnership. Excess taxable income reflects the partnership's excess capacity to deduct additional business interest under the Section 163(j) limit.[7] A partner's individual ATI for purposes of claiming business interest deductions from other sources will be increased by his or her share of the excess taxable income of the partnership. The Treasury Department did tax practitioners few favors when it issued its proposed regulations under new Section 163(j), at least with respect to partnerships. These exceptionally dense regulations create an elaborate eleven-step process for allocating the excess taxable income of a partnership among its partners.[8] This allocation occurs outside of the rules of Section 704(b) and does not impact the capital accounts of the respective partners. The Treasury Department worried that taxpayers would use the same source of income twice in applying the Section 163(j) limit, which would increase the amount of business interest that may be deducted by the partner from other sources.

B. ***S Corporations.***

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[4] *See* Prop. Reg. §1.163(j)-6(m)(2).

[5] These sections tend to confuse most commentators since they specifically use the terms "Partner" and "Partnership" in each of these definitions. It's important to use when discussing the tax changes to clients & IRS examiners using the catchall language of Section 163(j)(4)(D) which states these same rules be applied to "S corporations" and "S corporation shareholders."

[6] Box 1 of IRS Form K-1.

[7] *See* IRC §163(j)(4)(c). A partnership's "excess taxable income" is the amount that bears the same ratio to the partnership's adjusted taxable income as: the excess (if any) of 30% of the partnership's adjusted taxable income over the amount (if any) by which the partnership's business interest, reduced by any floor plan financing interest, exceeds its business interest income, bears to 30% of the partnership's adjusted taxable income

[8] *See* Prop. Reg. §1.163(j)-6.

Like partnerships, the Section §163(j) limitation applies at the entity (corporate) level. As such, to apply the limitation an S corporation must first compute its ATI and determine if it exceeds the corporation's business interest expense. The proposed regulations issued under Section 163(j) take a substantially more direct approach in articulating the application of Section 163(j) to S corporations.[9] Practitioners will appreciate the simplicity of these rules in comparison to their partnership counterparts. Prop Reg. Section 1.163(j)-6(l) states that the Section 163(j) limit is applied at the corporate level using the corporation's ATI. Deductible business interest expense after the application of this limit is taken into account in determining the non-separately stated taxable income or loss of the S corporation. Thus, an S corporation determines its allowable deduction for business interest expense for its taxable year and the allowable interest deduction is reflected in the amount reported in Box 1 of the corporation's Schedule K-1 (ordinary business income or loss). Note, however, that any income allocated to the shareholder on his or her K-1 cannot be used to compute his or her ATI in determining the deductibility of business interest from other sources, though gain from the sale of S corporation stock may be used for such purpose in certain circumstances.[10] Unlike partnerships, however, an S corporation retains its disallowed interest expense deduction. Instead of pushing this interest out to its shareholders as is done with partnerships, an S corporation adds the interest to the business interest paid or accrued by the corporation in the following year and applies Section 163(j) to the resulting aggregate amount of interest.[11]

If an S corporation's ATI is greater than its business interest expenses, the corporation's excess taxable income (and excess business interest income) will pass through to the shareholders (and thus increase the amount of business interest from other sources that may be deducted by the shareholder). Since partner-level adjustments are not applicable to S corporation shareholders, the ATI of an S Corporation would generally be determined in accordance with Prop. Reg. Section 1.163(j)-1(b)(1) without additional modifications.

The proposed regulations also expressly explain that the small business exception for taxpayers with less than $25 million in gross receipts applies at the corporate level.[12] These exempted S corporations simply do not apply the Section 163(j) limitation. The business interest expense allocated to a shareholder of an exempt S corporation, however, will be subject to the Section 163(j) limit at the shareholder level.[13] Thankfully, however, the shareholder may include his or her allocable share of the S corporation's income or loss in calculating his or her ATI.

III. ***Conclusion.***

While IRC §163(j) applies to corporations and partnerships at the entity level, practitioners should be aware of how the applicable operational rules for these entities differ. The simplicity of the S corporation rules may render S corporation's comparatively more attractive

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[9] *See* Prop. Reg. §1.163(j)-6(l).
[10] Prop. Reg. §1.163(j)-6(l)(4)(ii).
[11] *See* IRC §163(j)(4)(D), which does not apply carryforward and basis adjustment rules of IRC §163(j)(4)(B) to S corporations.
[12] *See* Prop. Reg. §163(j)-2, -6(m), Rev. Proc. 2018-40.
[13] The regulations explain that the exempt corporation does not include its deductible interest in its non-separately stated income or loss. *See* Prop. Reg. §1.163(j)-6(m).

for practitioners advising on choice of entity planning for businesses with gross receipts in excess of $25 million, or not otherwise exempt from Section 163(j).