

Mann Report

<https://www.mannpublications.com/mannreport/2020/11/16/what-investors-need-to-know-about-the-section-163j-limitation-on-deducting-interest-expense/>

What Investors Need to Know About the Section 163(j) Limitation on Deducting Interest Expense

Rachel Lawent

November 16, 2020

As a result of the Tax Cuts and Jobs Act (TCJA) of 2017, businesses and investors incurring interest expense face a new limitation in tax years beginning after 2017 that restricts the amount of interest expense they can deduct. The newly created section 163(j) of the Internal Revenue Code stipulates that, for most taxpayers, the maximum amount that may be deducted for interest expense is 30% of the taxpayer's Adjusted Taxable Income.

Adjusted Taxable Income is defined as taxable income with certain items added back, including interest expense, depreciation and amortization. Businesses with significant loans or mortgages faced the potential of being caught by this limitation for the first time when they filed their 2018 tax returns.

Investors in pass-through businesses who are affected by this limitation may have found new items related to section 163(j) reported on their 2018 and 2019 partnership or S-corporation K-1s. The items being reported should fall into one of the following categories:

K-1 reports excess taxable income (ETI) or excess business interest expense (EBIE). Businesses that are subject to section 163(j) must file Form 8990, the IRS form where the 30% limitation is calculated. If total interest expense exceeds the 30% limitation, the excess is excess business interest expense (EBIE) and is separately stated on the tax return. If interest expense is lower than this threshold amount, the business instead has excess taxable income (ETI). EBIE is not deductible; therefore, it is suspended and carried forward until a future year when there is sufficient ETI to absorb the prior-year EBIE.

For partnerships, the interest deduction limitation is determined at the investor level instead of at the entity level. A partner receiving a K-1 reporting EBIE will have to wait until a future year when that same K-1 reports ETI to be able to deduct carryforward EBIE on the investor's return. In contrast, for S corporations, the carryforward of excess interest happens at the entity level. If there is EBIE, it is not reported on the K-1s. The interest will be deducted by the S corporation and will be part of taxable income in a future year when the 30% limitation permits it.

Both partnerships and S corporations will report an owner's share of ETI, if any exists. As mentioned above, a partner needs ETI to be able to deduct EBIE from the same partnership from a previous year. Additionally, the owners of pass-throughs reporting ETI will use the ETI allocated to them as part of their own 8990 calculation if they have other business interest expense.

K-1 includes a footnote stating that it is not subject to section 163(j) and reporting the investor's share of gross receipts, adjusted taxable income (ATI), business interest expense, and/or business interest income. Certain businesses are exempt from the section 163(j) limitation on interest expense. If a business is a "small business," defined as one having gross receipts from the last 3 years averaging less than \$26 million, all of its interest expense is deductible, and it is not required to calculate or report ETI or EBIE to its owners. In July 2020, the IRS provided clarification that business interest expense of a small business is not subject to retesting at the investor's level to determine that the investor also meets the definition of a small business. Prior to this clarification, it was thought that investors needed to use the gross receipts, ATI and interest expense of small businesses that they owned to redetermine whether they were subject to the 163(j) limitation at their level. The July 2020 IRS issuance of these new regulations occurred after many 2019 K-1s had been issued. So, many investors likely saw these disclosures on 2018 and 2019 K-1s, even though they no longer need to do anything with this information.

K-1 includes a footnote stating that the entity has made the real property trade or business election and there are no 163(j) items to report. A real estate business that does not meet the definition of a small business can elect to be a real property trade or business and be exempt from the 163(j) limitation. A real estate business that makes this election can deduct all of its interest expense, with the tradeoff being that it is required to use an alternative depreciation method over a longer period for certain assets. Depending on the size of the mortgage and the type of assets being depreciated, the real property election may or may not produce the lowest taxable income, so a business must analyze this tradeoff carefully before making the election. Once the business makes this election, it is irrevocable and applies to all future years. If a K-1 discloses that this election was made, there is no action required on the investor's individual tax return relating to the income from that K-1 for section 163(j).

K-1 includes a footnote stating that the entity is not subject to the limitation or no 163(j) items are reported. There is one more reason that a K-1 may have no 163(j) items to disclose. The deduction that is limited is specifically for business interest expense, meaning interest expense of a "trade or business." While the term "trade or business" does not have a black and white definition in the Internal Revenue Code, there are a variety of factors to consider in determining whether its activities constitute a trade or business or whether they are investment activities. If the entity's activities do not consist of a trade or business, it is not considered to have business interest expense. Thus its interest expenses (if any) are not limited, and it would not have any ETI or EBIE. Ideally, the K-1 will disclose this fact so that the investor knows there is no action needed on the investor's tax return. But this disclosure is not required. Thus, if the K-1 makes no mention of any 163(j) items, the entity is most likely not subject to the limitation. However, if the investor thinks the entity should be subject to the limitation, it may be worth inquiring with the company whether any disclosures were inadvertently omitted.

The TCJA added complexity for owners of businesses that have interest expense with the addition of Internal Revenue Code Section 163(j). Be sure to take note of any 163(j) items disclosed on K-1s that you receive to make sure you are taking all deductions to which you are entitled.

Rachel Lawent, CPA, is a manager in the Boston office of Marcum LLP and a member of the firm's Real Estate Group. She can be reached at rachel.lawent@marcumllp.com.

