EFFECTIVE TAX PLANNING SURROUNDING THE SECTION 163(J) INTEREST LIMITATION AND THE SMALL BUSINESS EXCEPTION

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Navigating U.S. tax law can feel like a Herculean task, particularly for small businesses and taxpayers in the real estate industry. The Tax Cuts and Jobs Act in 2017 made this task even more complex due to Section 163(j) — a provision that restricts the amount of business interest taxpayers can deduct. Opportunities and exceptions do present themselves, but navigating these waters demands strategic planning, particularly as the rules changed after December 31, 2021.

Under the provisions of Section 163(j), the deduction for business interest expense is generally limited to the sum of:

1. Business interest income
2. 30% of the taxpayer's adjusted taxable income (ATI) and
3. Floor plan financing interest.

Real Estate Industry Exceptions

Two exceptions to Section 163(j) specific for the real estate industry's taxpayers enable them to avoid the business interest limitation:

1. The taxpayer qualifies as a small business under Code Section 448(c).
2. A taxpayer meets the requirements as a Real Property Trade or Business under Code Section 469(c)(7)(C) and elects out of Section 163(j) as described in Code Section 163(j)(7)(B).

Computing Adjusted Taxable Income (ATI)

For tax years beginning before January 1, 2022, the computation of ATI was:

1. Tentative taxable income
2. Subtract interest income
3. Add back interest expense
4. Add back depreciation and amortization.

For tax years beginning after December 31, 2021, taxpayers can no longer add back depreciation and amortization in determining ATI. This change has resulted in many more taxpayers being impacted by Section 163(j).

Net Income vs. Net Loss

Taxpayers who would typically meet the definition of a small business but are considered a tax shelter or a syndicate can not use the small business exemption. In some cases, real estate entities could flip from net income to net losses due to items like depreciation or vacancy. In such cases, strategies such as electing out of bonus depreciation or utilizing specific tax regulations may alleviate the application of Section 163(j). This could include using elections based on the prior year's income or filing Form 8990 for temporary relief.

Opting for Form 8990 and Limiting Interest

If the taxpayer does not qualify as a small business for the current tax year but expects to qualify in a succeeding tax year, the second option would be to file Form 8990 and limit the interest for the year. The interest that was limited would be treated as paid or accrued in the succeeding tax year. If all else fails, a taxpayer that qualifies as a real property trade or business can election out of Section 163(j) by making the election out under Code Section 163(j)(7)(B).