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New Proposed Regulations under the TCJA 2017 Business Interest Deduction Limitation

-by Robert P. Achenbach, Jr.

The IRS has issued proposed amendments to the regulations under I.R.C. § 163(j), as amended by the Tax Cut and Jobs Act of 2017 (TCJA 2017).[1] The TCJA 2017 amended I.R.C. § 163(j) by removing prior I.R.C. § 163(j)(1) through (9) and adding I.R.C. § 163(j)(1) through (10). The provisions of I.R.C. § 163(j) as amended by the TCJA 2017 are effective for tax years beginning after December 31, 2017.

Prior Law

I.R.C. § 163(j), prior to the amendment by the TCJA 2017, disallowed a deduction for "disqualified interest" paid or accrued by a corporation in a taxable year if two threshold tests were satisfied – (1) the payor's debt-to-equity ratio exceeded 1.5 to 1.0 and (2) the payor's net interest expense exceeded 50 percent of its adjusted taxable income, i.e., generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under old I.R.C. § 199, depreciation, amortization, and depletion. Disqualified interest under the prior I.R.C. § 163(j) included interest paid or accrued to (1) related parties when no federal income tax was imposed with respect to such interest; (2) unrelated parties in certain instances in which a related party guaranteed the debt; or (3) a real estate investment trust (REIT) by a taxable REIT subsidiary of that REIT. Interest amounts disallowed for any taxable year under the prior I.R.C. § 163(j) were treated as interest paid or accrued in the succeeding taxable year and could be carried forward indefinitely. In addition, any excess limitation, namely, the excess of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense, could be carried forward three years. The IRS had issued proposed regulations under the prior I.R.C. § 163(j)[2] which are withdrawn under the new proposed regulations.

Changes in 2017

For tax years beginning after December 31, 2017, I.R.C. § 163(j) generally limits the amount of business interest expense that can be deducted in a taxable year. Under I.R.C. § 163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of (1) the taxpayer's business interest income for the taxable year; (2) 30 percent of the taxpayer's adjusted taxable income (ATI) for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year. The limitation applies to all taxpayers,[3] except for certain small businesses that meet the gross receipts test in I.R.C. § 448(c)[4] and certain trades or businesses listed in I.R.C. § 163(j)(7).[5]

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The proposed regulations contain an anti-avoidance rule which allows the IRS to disregard or recharacterize arrangements ("to the extent necessary to carry out the purposes of section 163(j)")[6] designed to avoid the interest limitation, such as the creation of multiple entities such that each meets the small business gross receipts test.

I.R.C. § 163(j)(2) provides that the amount of any business interest not allowed as a deduction for any taxable year as a result of the limitation under I.R.C. § 163(j)(1) is carried forward and treated as business interest paid or accrued in the next taxable year but does not provide for the carryforward of any excess limitation, as allowed under prior law.

Definitions

"Business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business[7] but does not include investment interest.[8] The proposed regulations define "interest" as ". . . an amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of section 1275(a) and § 1.1275–1(d), and not treated as stock under § 1.385–3, or an amount that is treated as interest under other provisions of the Internal Revenue Code (Code) or the regulations thereunder."[9]

"Business interest income," includes interest includible in gross income that is properly allocable to a trade or business.[10]

"Adjusted taxable income" (ATI) is defined as the taxable income of the taxpayer without regard to the following: items not properly allocable to a trade or business; business interest and business interest income; net operating loss deductions; and deductions for qualified business income under I.R.C. § 199A.[11] ATI also generally excludes deductions for depreciation, amortization, and depletion with respect to taxable years beginning before January 1, 2022.[12]

"Floor plan financing interest" is defined as interest paid or accrued on "floor plan financing indebtedness" for motor vehicles held for sale.[13]

The proposed regulations provide several examples illustrating the business interest deduction limitation, including the following:

> **Example**: During its taxable year ending December 31, 2019, the taxpayer, a sole proprietorship, has ATI of $100,000. The taxpayer has business interest expense of $50,000, which includes $10,000 of floor plan financing interest expense, and business interest income of $20,000. The taxpayer's Section 163(j) limitation is $60,000, which is the sum of its business interest income ($20,000), plus 30 percent of its ATI ($100,000 × .30 = $30,000), plus its floor plan financing interest expense ($10,000). See Prop. Treas. § 1.163(j)–2(b). Because the taxpayer's business interest expense ($50,000) does not exceed the taxpayer's Section 163(j) limitation ($60,000), the taxpayer can deduct all $50,000 of its business interest expense for the 2019 taxable year.

Electing Out of Business Interest Deduction Limitation

Farming businesses[14] and electing real property businesses electing to be excepted from the business interest limitation must use the alternative depreciation system (ADS), rather than the general depreciation system for certain types of property.[15]

Form 8990

The IRS has published the final version of Form 8990, *Limitation on Business Interest Expense Under Section 163(j)*, to be used to figure the amount of business interest expense a taxpayer can deduct and the amount to carry forward to the next year. The instructions are also available but are still in draft form.

ENDNOTES

[1] Pub. L. No. 115–97, § 13301, 131 Stat. 2117 (2017). The proposed regulations are published at 83 Fed. Reg. 67490 (Dec. 28, 2018).

[2] 56 Fed. Reg. 27907 (June 18, 1991).

[3] The Conference Report states that ''[i]n the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.'' H. Rept. 115–466, at 386 (2017).

[4] I.R.C. § 163(j)(3) provides that the limitation under I.R.C. § 163(j)(1) does not apply to a taxpayer, other than a tax shelter as defined in I.R.C. § 448(a)(3), with average annual gross receipts of $25 million or less, determined under I.R.C. § 448(c) (including any adjustment for inflation under I.R.C. § 448(c)(4)). For taxpayers other than corporations or partnerships, I.R.C. § 163(j)(3) provides that the gross receipts test is determined for purposes of I.R.C. § 163(j) as if the taxpayer were a corporation or partnership.

[5] I.R.C. § 163(j)(7): "TRADE OR BUSINESS.—For purposes of this subsection—

(A) IN GENERAL .—The term 'trade or business' shall not include—

(i) the trade or business of performing services as an employee,

(ii) any electing real property trade or business,

(iii) any electing farming business, or

(iv) the trade or business of the furnishing or sale of—

(I) electrical energy, water, or sewage disposal services,

(II) gas or steam through a local distribution system, or

(III) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative."

[6] Prop. Treas. Reg. § 1.163(j)-2(h).

[7] See I.R.C. § 163(j)(7) (trade or business); Prop. Treas. § 1.163(j)-1(b)(38) (trade or business as defined in I.R.C. § 162).

[8] The legislative history states that ''a corporation has neither investment interest nor investment income within the meaning of I.R.C. § 163(d). Thus, interest income and interest expense of

a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision." H. Rept. 115–466, at 386, fn. 688 (2017).

[9] Prop. Treas. § 1.163(j)-1(b)(20). The proposed regulations provide several examples which include original issue discounts, deferred payments treated as interest under I.R.C. § 483, amounts treated as interest under an I.R.C. § 467 rental agreement and redeemable ground rent treated as interest under I.R.C. § 163.

[10] See I.R.C. § 163(j)(7) (trade or business).

[11] I.R.C. § 163(j)(8). See Prop. Treas. § 1.163(j)-1(b)(1).

[12] See Prop. Treas. § 1.163(j)-1(b)(1)(i)(D), (E). See also Prop. Treas. § 1.163(j)-1(b)(1)(iii) (depreciation, amortization, or depletion expense that is capitalized to inventory under I.R.C. § 263A is not a depreciation, amortization, or depletion deduction.

[13] I.R.C. § 163(j)(9). These provisions allow taxpayers incurring interest expense for the purpose of securing an inventory of motor vehicles, which includes farm machinery and equipment, held for sale or lease to deduct the full expense without regard to the limitation under I.R.C. § 163(j)(1).

[14] See Prop. Treas. § 1.163(j)-1(b)(1)(i) (farming business is defined as in I.R.C. § 263A(e)(4) or Treas. Reg. § 1.263A–4(a)(4) and "as any trade or business of a specified agricultural or horticultural cooperative, as defined in I.R.C. § 199A(g)(4)."

[15] I.R.C. § 163(j)(10). The required use of ADS results in the inability of these electing trades or businesses to use the additional (bonus) first-year depreciation deduction under I.R.C. § 168(k) for those types of property.

CASES, REGULATIONS AND STATUTES

BANKRUPTCY

GENERAL

DISCHARGE. The debtors, husband and wife, filed for Chapter 11 bankruptcy and their partnership filed a separate Chapter 11 case. The debtors engaged primarily in soybean crop farming and sought court approval for an operating loan to provide for farming inputs and advance rental fees. As part of their loan application with a new creditor, the debtors submitted a list of land they intended to plant and harvest with the proceeds of the loan. The list totaled 8300 acres; however, a good number of the leases were not secured at the time of the loan application or the court hearing on the post-petition financing. In fact, the debtors lost several leases and farmed only 4900 acres with the loan proceeds. The debtors defaulted on the loan and the creditor sought a ruling that the loan deficiency was nondischargeable under Section 523(a)(2)(A) & (B) and (a)(6) for money obtained under false pretenses and false representations in the loan application. Section 523(a)(2)(B) provides that "(a) A discharge under section 727, 1141, 1228(a), or 1328(b) of this title does not discharge an individual debtor from any debt— . . . (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by— . . . (B) use of a statement in writing— (i) that is materially false; (ii) respecting the debtor's or an insider's financial condition; (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive." The debtors argued that the leasing list was not part of the loan application because it was not attached to the application and was merely a projection of the possible leases. The court found, however, that it was irrelevant how the list was presented but it was important only that the list was presented to the creditor during the loan process. In addition, the court found that the list did not contain any language or other indication that the list was only prospective leases. The debtors admitted that the list was constructed from the prior year's leases but failed to explain why the list contained additional leased land. In addition, the court found that several of the prior leases had been terminated by the lessors prior to the bankruptcy request for approval of the loan and that the debtors knew those leases would not be renewed. The court held that the list of leases and proposed total planting acres satisfied the first requirement of Section 523(a)(2)(B) that the debtors submitted a written statement respecting the debtors' financial condition in that the total acres to be planted directly impacted the expected income from farming. As to the second element of Section 523(a)(2)(B), the court found that the leasing list was materially false in that (1) the leases were not executed at the time the list was made, (2) the debtors planted almost 50 percent less acreage and (3) the actual planted acreage matched the prior year's leased acreage. On the third factor, the court used five factors to indicate whether a creditor reasonably relied on a debtor's loan documents: (1) whether the creditor had a close personal relationship or friendship with the debtor; (2) whether there had been previous business dealings with the debtor that gave rise to a relationship of trust; (3) whether the debt was incurred for personal or commercial reasons; (4) whether there were any "red flags" that would have alerted an ordinarily prudent lender to the possibility that the representations relied upon were not accurate; and (5) whether even minimal investigation would have revealed the inaccuracy of the debtor's representations. The court found that nothing in the leasing list indicated that it was incorrect or incomplete and that the debtors had testified in the bankruptcy proceeding that they would be farming over 8,000 acres; thus, the creditor reasonably relied on the debtors' written and oral statements. The fourth element involves the debtors' intent in providing the false information. The court noted that the intent to deceive can be determined by showing that the debtors either intended to deceive or acted with gross negligence in submitting the false documents. Unless the debtors admit to the intent to deceive a creditor, the debtors' intent must be determined through