



Basic questions and answers about the limitation on the deduction for business interest expense

Below are answers to some basic questions about the limitation on the deduction for business interest expense, also known as the “section 163(j) limitation.” Prior to the 2017 Tax Cuts and Jobs Act (TCJA), section 163(j) of the Internal Revenue Code applied only to certain interest paid or accrued by corporations. However, the TCJA significantly changed the section 163(j) limitation. These questions and answers address the section 163(j) limitation after amendment by the TCJA.

General

Q1. What is the section 163(j) limitation on the deduction for business interest expense?

A1. Generally, taxpayers can deduct interest expense paid or accrued in the taxable year. However, if section 163(j) applies, the amount of deductible business interest expense in a taxable year cannot exceed the sum of:

1. the taxpayer’s business interest income for the year;
2. 30% of the taxpayer’s adjusted taxable income (ATI) for the year; and
3. the taxpayer’s floor plan financing interest expense for the year.

Q2. Who is subject to the section 163(j) limitation?

A2. For tax years beginning after 2017, the limitation applies to all taxpayers who have business interest expense, other than certain small businesses that meet the gross receipts test in section 448(c) (“exempt small business”) (see Q/A 3-4). The limitation does not apply to certain excepted trades or businesses (see Q/A 5-6).

Q3. What is the gross receipts test for purposes of the section 163(j) limitation?

A3. A business generally meets the gross receipts test of section 448(c) when it is not a tax shelter (as defined in section 448(a)(3)) and has average annual gross receipts of \$25 million or less in the previous three years. For tax year 2019 and subsequent years, the \$25 million amount will be adjusted for inflation.

Q4. Although my average annual gross receipts for years 2015-2017 were more than \$25 million, my gross receipts in 2018 decreased enough to lower my average annual

gross receipts for years 2016-2018 to below \$25 million. Will I be subject to the section 163(j) limitation when I file for the 2019 tax year?

A4. No. Although you are subject to the section 163(j) limitation for the 2018 tax year, the limitation does not apply to you for the 2019 tax year. Any amount of business interest expense that was disallowed in 2018 due to the limitation is carried forward to 2019 and will no longer be subject to the limitation in 2019. Therefore, you do not need to compute the section 163(j) limitation for the 2019 taxable year.

EXCEPTED TRADES OR BUSINESSES

Q5. Which businesses qualify as an excepted trade or business?

A5. The following are excepted trades or businesses:

1. The trade or business of providing services as an employee;
2. Certain real property trades or businesses that elect to be excepted;
3. Certain farming businesses that elect to be excepted; and
4. Certain regulated utility trades or businesses.

Q6. How does an eligible real property trade or business or farming business elect to be an excepted trade or business?

A6. An eligible real property trade or business or farming business may elect to be an excepted trade or business by following the procedures outlined in §1.163(j)-9 of the proposed regulations, including the requirement to attach a statement to a timely filed federal income tax return (including any extensions) for the year of election. See also [Revenue Procedure 2018-59](#). An exempt small business is not permitted to make an election to be an excepted trade or business because that taxpayer is already not subject to the section 163(j) limitation. Once made, the election is generally irrevocable and binding on the trade or business for all succeeding years. See §1.163(j)-9 of the proposed regulations for certain circumstances where the election may no longer apply. The statement must include the following information:

1. The taxpayer's name, address, and social security number or employer identification number;
2. A description of the electing trade or business, including the principal business activity code; and
3. A statement that the taxpayer is making an election as a real property trade or business (under section 163(j)(7)(B) or as a farming business (under section 163(j)(7)(C)), as applicable.

After 2018, the time and manner for making an election may be updated in forms, publications, or other guidance.

Q7. Are there any consequences I should be aware of in making an election to be an excepted trade or business?

A7. Yes. If you make an election to be an excepted real property trade or business, the following assets that you hold in the electing real property trade or business must be depreciated using the alternative depreciation system (ADS), and are not eligible for a bonus depreciation deduction under section 168(k):

1. Nonresidential real property;
2. Residential rental property; and

3. Qualified improvement property.

If you make an election to be an electing farming business, any property with a recovery period of 10 years or more that you hold in the electing farming business must be depreciated using ADS, and such property is not eligible for a bonus depreciation deduction under section 168(k).

DETERMINING THE SECTION 163(j) LIMITATION AMOUNT

Q8. What is considered interest for purposes of section 163(j)?

A8. Interest is any amount that is paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement or that is treated as interest under the Internal Revenue Code or the regulations thereunder. Interest also includes certain amounts that are closely related to interest such as substitute interest payments, debt issuance costs, loan commitment fees, and certain amounts that affect the economic cost of funds or yield of a borrowing or an interest-generating asset. Under an anti-abuse rule, certain amounts predominantly associated with the time value of money also may be treated as interest expense for purposes of section 163(j). Section 1.163(j)-1(b)(20) of the proposed regulations provides additional information on what constitutes interest under section 163(j).

Q9. What is business interest expense?

A9. Business interest expense is any interest expense that is properly allocable to a trade or business. Floor plan financing interest expense is also business interest expense. See Q/A 8, above, for what is considered interest. See Q/A 14, below, if you have interest expense that is allocable to both an excepted trade or business and a non-excepted trade or business.

Q10. What is business interest income?

A10. Business interest income is interest income that is includable in gross income and properly allocable to a trade or business. See Q/A 8, above, for what is considered interest. See Q/A 14, below, if you have interest income that is allocable to both an excepted trade or business and a non-excepted trade or business.

Q11. How do I calculate ATI?

A11. ATI is calculated by taking the taxable income for the taxable year as if section 163(j) does not limit any interest deduction, and then adding and subtracting from it certain amounts for the taxable year:

Additions: business interest expense; net operating loss deduction; deduction for qualified business income under section 199A; depreciation, amortization, or depletion deduction; capital loss carrybacks or carryovers; and any deduction or loss not properly allocable to a non-excepted trade or business.

Subtractions: business interest income; floor plan financing interest expense; the lesser of (i) gain realized on sale or disposition of property or (ii) deductions for depreciation, amortization or depletion taken for such property during a tax year beginning after 2017 (and similar adjustments for sales or dispositions of property held by a partnership or member of a consolidated group upon the sale or other disposition of the partnership interest or stock of the member); and any income or gain that is not properly allocable to a non-excepted trade or business.

For taxable years beginning after 2021, deductions for depreciation, amortization, or depletion are not taken

into account in calculating ATI.

Certain other adjustments apply for some types of taxpayers. See §1.163(j)-1(b)(1) of the proposed regulations.

Q12. What is floor plan financing interest expense?

A12. Floor plan financing interest expense is interest paid or accrued on floor plan financing indebtedness. Floor plan financing indebtedness is indebtedness that is used to finance the acquisition of motor vehicles held for sale or lease, and that is secured by the acquired inventory. For example, if you own an automobile dealership and paid interest on a loan that is secured by the dealership's office equipment, then such interest is not a floor plan financing interest expense.

Q13. What happens to business interest expense that I cannot deduct in the current year because of the section 163(j) limitation?

A13. The amount of business interest expense disallowed as a deduction in the current year under section 163(j) is carried forward to the next taxable year (a "disallowed business interest expense carryforward"). Your disallowed business interest expense carryforward may be limited in the next taxable year if the section 163(j) limitation continues to apply to you. Special rules apply to partnerships and S Corporations (see Q/A 15).

Q14. If I'm engaged in both an excepted trade or business and a non-excepted trade or business, how do I determine the section 163(j) limitation?

A14. Your interest expense that is properly allocable to an excepted trade or business is not subject to the section 163(j) limitation. Similarly, the amount of your items of income, gain, deduction, or loss, including interest income that is properly allocable to an excepted trade or business, is excluded in determining the section 163(j) limitation. Therefore, you should allocate tax items between excepted and non-excepted trades or businesses in order to determine the section 163(j) limitation.

Section 1.163(j)-10 of the proposed regulations provides special rules for allocating various tax items. You must generally compare your basis in the assets you use in your excepted trades or businesses and your basis in the assets you use in your non-excepted trades or businesses to determine what portion of interest expense and interest income to allocate to your excepted trades or businesses. In limited cases, tracing of interest expense paid on certain nonrecourse debt may be available.

Q15. How does the section 163(j) limitation apply to partnerships and S corporations?

A15. The section 163(j) limitation is applied at the partnership level. As provided in Q/A 1, the amount of deductible business interest expense in a taxable year cannot exceed the sum of the partnership's business interest income, 30% of the partnership's ATI, and the partnership's floor plan financing interest expense. Business interest expense that may be deducted upon application of the section 163(j) limitation is taken into account in determining the non-separately stated taxable income or loss of the partnership. Any business interest expense of the partnership that is disallowed upon application of the section 163(j) limitation is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. This amount is called excess business interest expense.

A partner carries forward its share of excess business interest expense. In a succeeding taxable year, a partner may treat its excess business interest expense as business interest expense paid or accrued by the partner to the extent the partner is allocated excess taxable income or excess business interest income from the same partnership. Excess taxable income is the amount of ATI of the partnership that was in excess of what it needed to deduct its business interest expense, and excess business interest income is the amount by which business interest income exceeded business interest expense at the partnership level. Excess taxable income is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. An allocation of excess taxable income to a partner increases the partner's ATI. Similarly, an allocation of excess business interest income to a partner increases the partner's business interest income. Once excess business interest expense is treated as business interest expense paid or accrued by the partner, such business interest expense is subject to the partner's section 163(j) limitation, if any (see Q/A 1).

S corporations apply the section 163(j) limitation at the S corporation level. Any business interest expense of the S corporation that is disallowed upon application of the section 163(j) limitation is not allocated to its shareholders, but is instead carried over at the S corporation level to its succeeding taxable years. An S corporation allocates any excess taxable income and excess business interest income to its shareholders on a pro-rata basis.

Section 1.163(j)-6 of the proposed regulations provides special rules and defined terms relating to the application of section 163(j) to partnerships and S corporations.

Q16. How does the section 163(j) limitation apply to a consolidated group of corporations?

A16. The section 163(j) limitation applies at the consolidated return level, and a consolidated group has a single limitation. In calculating the limitation, a consolidated group's business interest expense and business interest income is, respectively, the sum of its members' business interest expense and business interest income. The consolidated group should calculate its ATI using the group's taxable income as determined under § 1.1502-11 without regard to any carryforwards or disallowances under section 163(j).

Q17. Does the section 163(j) limitation apply to foreign corporations and their shareholders?

A17. Yes, the section 163(j) limitation applies to a foreign corporation that is a controlled foreign corporation (CFC) within the meaning of section 957 (applying only if the foreign corporation has at least one United States shareholder that owns at least 10 percent of the vote or value of the foreign corporation, directly or indirectly, within the meaning of section 958(a)). Generally, section 163(j) applies to a CFC in the same manner as those rules apply to a domestic C corporation. If a CFC is a partner in a partnership, the section 163(j) limitation applies to the partnership in the same manner as if the CFC were a domestic C corporation. Section 1.163(j)-7 of the proposed regulations provides rules for determining the amount of ATI and calculating the limitation for CFCs.

In addition, under §1.163(j)-8 of the proposed regulations, a foreign corporation that is engaged in a United States trade or business, may also be subject to section 163(j). In the case of foreign corporations engaged in a U.S. trade or business, the proposed regulations coordinate the application of section 163(j) with the rules limiting U.S. taxation to only that income effectively connected with that U.S. trade or business.