Business Interest Deduction Limitation and S Corporations

By William E. Sigler, Esq.

For tax years beginning after December 31, 2017, Section 163(j) of the Internal Revenue Code limits the deduction of business interest to business interest income, plus 30 percent of adjusted taxable income, plus floor plan financing. Any net business interest expense in excess of 30 percent of adjusted taxable income is non-deductible, although it may be carried forward and treated as business interest paid or accrued in the following taxable year.

Definitions

Business interest means any interest paid or accrued on indebtedness allocable to a trade or business. It does not include investment interest. Adjusted taxable income means taxable income computed without regard to the following:

- Income, gain, deduction or loss not allocable to a trade or business;
- Business interest or business interest income;
- Net operating loss deductions;
- Section 199A deductions; and
- For tax years beginning prior to January 1, 2022, any deductions for depreciation, amortization or depletion.

Exceptions

There are several exceptions to the business interest deduction limitation, including the following:

1. Taxpayers whose average annual gross receipts for the three-year period ending with the prior tax year is $25 million or less;
2. Interest allocable to an electing real property trade or business; and
3. Interest allocable to an electing farming business.

The $25 million gross receipts exception does not apply to a taxpayer that is

classified as a tax shelter. An S corporation could be classified as a tax shelter if more than 35 percent of its losses during the taxable year are allocable to limited partners or “limited entrepreneurs” not actively participating in the business. However, even if an S corporation does not qualify for the $25 million gross receipts exception because it has shareholders who are not actively participating in the business, each individual shareholder may nonetheless qualify for the exception.

S Corporation Rules

The business interest deduction limitation for a partnership is applied at the partnership level. The partnership then passes through to the partners any disallowed business interest for the year and the carryforward rules are applied at the partner level. However, these partner-level carryforward rules do not apply to S corporations and their shareholders. Instead, the carryforward of disallowed business interest expense occurs at the S corporation level. Thus, if an S corporation has a disallowed business interest expense carryforward for a year, that expense would be carried forward to subsequent years at the S corporation level.

Other Rules

The proposed regulations require S corporation shareholders to include the proceeds from the disposition of S corporation stock in the selling shareholders individually computed adjusted taxable income. They reserve for the future issuance of regulations the treatment of business interest expense and corresponding business interest income arising from lending transactions between an S corporation and its shareholders.

Under the passive loss rules, business interest expense from an S corporation continues to be treated as interest derived from a trade or business in the hands of the shareholder, even if the shareholder does not materially participate in the S corporation’s trade or business. The proposed regulations clarify that the business interest limitation applies before the application of the excess business loss rules, the at-risk rules, and the passive loss rules.

It is not entirely clear how Section 382 applies to the carryover attributes at the S corporation level. Section 382 was enacted to prevent corporations from trafficking in NOLs and sets forth limitations on the use of NOLs and other tax attributes

when a corporation undergoes an “ownership change.” It appears from the preamble to the proposed regulations that Treasury believes Section 382 applies to corporate-level business interest suspended at the S corporation level.

A qualified subchapter S subsidiary or “Qsub” has no separate existence apart from its S corporation parent for federal tax purposes. If a corporation’s QSub election terminates and any disallowed business interest expense carryforward is attributable to the activities of the QSub, the proposed regulations treat the disallowed business interest expense carryforward as a business interest carryforward of the parent S corporation, not the terminated subsidiary.

Further Comments

If you have any questions, or if we may be of any assistance with respect to your business planning needs, please do not hesitate to contact us.