Tax Cuts and Jobs Act

Restrictions on the Deduction of Business Interest

Background

Borrowing to do acquisitions has been a popular way to boost the return on cash invested. The key risk was that the return on assets was higher than the cost of borrowing to make leverage work. Now there is a potential downside from excessive leverage in the form of lost interest deductions.

Debt incurred to buy assets can produce deductible interest in the following situations.

- Debt incurred to purchase or improve a personal residence currently qualified up to $1,000,000. The deduction is taken on Schedule A.

  For changes in process, see "Withdrawal of Tax Subsidies for Residential Real Estate."

- Interest on debt incurred to purchase assets that generate portfolio income is deductible to the extent of net investment income. Any excess is carried forward. The deduction is generally taken on Schedule A.

  Net investment income is interest, non-qualified dividends, annuity income, and short-term capital gains, less investment expenses.

- Debt used to purchase assets used in a trade or business produces business interest.

  The interest deduction is taken where business income is reported on tax returns. On individual returns this can be on Schedule C (self-employment income), Schedule E (rental income), and Schedule F (farm income). Business interest can also be reported on partnership, trust, and corporate income tax returns.

  To date the only limitation on the deduction of business interest has been where business losses are limited by the passive loss rules or by the at risk limitations.

New limitation on business interest deductions

Both the House and Senate versions of the Tax Cuts and Jobs Act limit business interest deductions to 30% of Adjusted Taxable Income.

Adjusted Taxable Income is defined as taxable income computed without regard to—

- Non-business income and deductions,
- Business interest income,
- Business interest deductions,
- Net operating loss deductions, and
- Depreciation, amortization, and depletion deductions.

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Real property businesses and certain utilities are exempted. Small businesses meeting the requirements for using cash basis accounting are also exempted. (The current test is having average gross receipts less than $5 million during the prior 3 years. The House bill increases this to $25 million. The Senate version has an increase to $15 million.)

Interest disallowed under this limitation can be carried forward 5 years. Deductions are used on a first-in, first-out basis. It appears that carryforward deductions are lost if not used within 5 years.

Observations:

- The availability of financing with deductible debt affects asset pricing.

- This has the effect of limiting borrowing when acquiring assets.

Here is a simple calculation of the maximum leverage that will allow for deductible debt.

Return on assets	6%
Cost of debt	4%
30% of income	1.8% of assets (30% * 6%)
Borrowing limit	45% of assets (1.8%/4%)

- Here is yet another deduction carryforward calculation that can be added to the myriad of others currently in place.

- The tax bill is trying to encourage business investment by allowing immediate expensing of asset purchases. Factoring expensing of asset acquisitions into the limitation on business interest expense would be counterproductive.

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