boyum
barenscheer
CPAs AND BUSINESS ADVISORS

How does the deduction for interest limitation work with the new tax law?

The Tax Cut and Jobs Act created a limitation on deductible interest expense. Interest paid is generally deductible but subject to a number of limitations. The new rules limit the deduction to the sum of:

1. The taxpayer's business interest income for the year.
2. 30% of the taxpayer's adjusted taxable income* for the tax year, plus
3. The taxpayer's floor plan financing for the year

*Note that in the event of "loss" the 30% limitation cannot be less than zero.

Let's define "Adjusted Taxable Income". It means the taxpayer's taxable income, computed without regard to:

1. Any item of income, gain, deduction, or loss that isn't properly allocable to a trade or business
2. Any business interest expense or business interest income.
3. The amount of any net operating loss (NOL) deduction
4. The amount of any qualified business income (QBI) deduction allowed which was added by the Tax Cuts and Jobs Act
5. For tax years beginning before Jan. 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

To illustrate:

In year 2018, Corporation X has taxable income of $83,000 which included a depreciation deduction of $15,000, interest expense deduction of $40,000, NOL of $5,000, QBI deduction of $10,000 and $1,000 of interest income, $2,000 of dividend income.
Adjusted taxable income is computed as follows:

Taxable income	$83,000
Add:	
Depreciation	15,000
Interest expense	40,000
Net operating loss	5,000
Qualified business deduction	10,000
Subtract:	
Interest income	(1,000)
Dividend income	(2,000)
Adjusted taxable income	$150,000

X can deduct all $40,000 of its business interest expense, because that's less than the sum of its $1,000 of business interest income plus 30% of its adjusted taxable income (30% × $150,000 = $45,000).

Let's modify the scenario to trigger the limitation.
Assume the same fact pattern as the illustration above except interest expense was $90,000 (as opposed to $40,000 in the earlier example).

Adjusted taxable income is computed as follows:

Taxable income	$83,000
Add:	
Depreciation	15,000
Interest expense	90,000
Net operating loss	5,000
Qualified business deduction	10,000
Subtract:	
Interest income	(1,000)
Dividend income	(2,000)
Adjusted taxable income	$200,000

Under this example, X is limited on how much interest expense it can deduct. The deduction is limited to the sum of interest income ($1,000) plus of 30% adjusted taxable income ($60,000) which equals $61,000. X would be able to deduct $61,000 of interest expense and the excess interest of $29,000 would be disallowed in the current year and carried over indefinitely. X's current year taxable income would increase by $29,000 from $83,000 to $112,000.

The law includes a provision for the following exceptions to the limitation:

Small business exemption: the limitation does not apply to taxpayer's with less than $25 million average gross receipts for the three-tax-year period ending with the prior year.

Electing real property trade or business: the limitation does not apply to real estate professionals (as defined under the passive loss rules) and real trades or businesses (i.e. real property development, construction, rental, management, etc.) that elect longer depreciation lives provided under the alternative depreciation system (ADS).

Electing farming business: the limitation does not apply to farming businesses and agricultural or horticultural cooperatives that elect longer depreciation lives provided by the ADS

Contact: John Csargo, CPA, MBT, CFP® at jcsargo@myboyum.com or 952.858.5553