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Background

Section 163(j), Limitation On Business Interest, was amended by the 2017 TCJA and by the CARES Act. For tax years beginning after December 31, 2017, business interest expense deductions are generally limited to the sum of:

- the taxpayer's business interest income;
- 30 percent (or 50 percent, as applicable – see below) of the taxpayer's adjusted taxable income “ATI”; and
- the taxpayer's floor plan financing interest expense.

A taxpayer can avoid the business interest limitation by either:

- Qualifying for the small business exemption or
- Making the real property trade or business election

A taxpayer who is subject to the business interest expense limitation, uses Form 8990,Limitation on Business Interest Expense Under Section 163(j), to calculate and report their deduction and the amount of disallowed business interest expense to carry forward to the next tax year.

Small Businesses Exemption

A business (other than a tax shelter which is defined below) is considered a small taxpayer if it’s average gross receipts for the immediately preceding three years do not exceed $26 million (in 2020 and 2019). If the taxpayer’s average gross receipts are less than $26 million, they are considered a small taxpayer and are not subject to the business interest expense limitation.
A taxpayer that is considered a “tax shelter” won’t qualify as a small taxpayer, regardless of its gross receipts. For this purpose, a tax shelter is defined, in part, as a partnership or other entity if more than 35 % of its losses are allocable to limited partners.(A person who actively participates in the management of the enterprise, or whose relative actively participates in the management or who actively participated for at least five years is not considered a limited partner for this purpose). Therefore, if a partnership is considered a tax shelter in any year because more than 35% of the losses in that year are allocable to limited partners it is subject to the business interest expense limitation regardless of its gross receipts.
In addition, there are aggregation rules that must be applied to determine whether the gross receipts test under the small business exemption is met. These include a parent-subsidiary controlled group, brother-sister controlled group, or a combined group of corporations, etc.

Real Property Trades or Businesses Election

As mentioned above, taxpayers who are considered to be in a “real property trade or business” can make an election (which is irrevocable and discussed in

more detail below) to avoid having the business interest limitation rules apply. A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental operation, management, leasing, or brokerage trade or business. Generally the same activities used for purposes of determining whether a taxpayer is a real estate professional under the passive activity loss rules.

Although the business interest expense limitation does not apply to a taxpayer who makes this election, a taxpayer who makes the election is not eligible to depreciate certain capital expenditures under the modified accelerated cost recovery system (MACRS) and must instead use the alternative depreciation system (ADS). If the election is made, non-residential real property is depreciated under 40 years vs. 39 years, residential real property is depreciated under 30 years vs. 27.50 years and the first-year bonus depreciation is not allowed.

It is important to note that taxpayers who make the election and therefore are not allowed bonus depreciation can still perform Cost Segregation Studies and benefit from them. The ineligibility for bonus depreciation does not apply to assets typically reclassified from a Cost Segregation Study, such as personal property or land improvements.

The IRS has provided guidelines for businesses in a rental real estate activity that are uncertain whether their activity rises to the level of a Section 162 trade or business to make a protective election to be an electing real property trade or business.

IRS Guidance in Rev. Proc. 2020-22 for Real Property Trades or Business Election

As mentioned above, the real property trade or business election once made is normally irrevocable. However, there was a provision in the CARES Act that retroactively made qualified improvement property (QIP) eligible for 100 % bonus depreciation, essentially a write-off of the improvement. QIP is defined as certain qualifying improvements made to an interior portion of a nonresidential building (e.g., tenant improvements) that is placed in service after the date the building is first placed in service. As result, the IRS issued Rev. Proc. 2020-22 which allowed businesses that previously made the real property trade or business election and, as result were not eligible for bonus depreciation (QIP is depreciated over 20 years under ADS), the opportunity to withdraw that election.

Rev. Proc. 2020-22 allows eligible businesses that made the electing real property trade or business election for their tax years beginning in 2018, 2019, or 2020 to withdraw their election out of the Section 163(j) limit on business interest expense. This can be especially beneficial to certain real property trades or businesses that elected out of IRC Sec. 163(j) before QIP was eligible for bonus depreciation.

Rev. Proc. 2020-22 also allows businesses that filed returns for their 2018, 2019, or 2020 tax year without making the election out of the business interest expense limit to make a late election by filing an amended return. In the case of a partnership that is subject to the centralized partnership audit regime (a BBA partnership), an administrative adjustment request (AAR) would be filed instead.

Changes that Affect the 2019 and 2020 Tax Years

Generally, partners who have excess business interest expense allocated from a partnership can only treat that amount as paid when and to the extent that they are allocated excess taxable income from that partnership in a future year. However, the CARES Act provides that, for their first year beginning in 2020, partners can treat 50% of any excess business interest expense passed to them from a partnership for 2019 tax year as business interest expense that is paid in the partner's 2020 tax year and not subject to the Section 163(j) limit. The remaining 50% excess business interest expense is treated under the normal rules.

Partners can elect out of treating 50% of the excess business interest expense passed through by the partnership in 2019 as paid or accrued in 2020 (the

50% rule) by timely filing (including extensions) their tax return or an amended return or an AAR, as applicable, for the 2020 tax year and not applying the 50% rule. Partners can make this election separately for each partnership interest they own.

50 percent ATI limitation for taxable years beginning in 2020.

As stated in the "Background section" at beginning of this memo part of the business interest expense deduction limit calculation is:

- 30 percent (or 50 percent, as applicable) of the taxpayer's adjusted taxable income "ATI"

The applicable % for the ATI limitation is 30 percent, however for the partnership's taxable year beginning in 2020, the 30 percent is substituted with 50 percent. A taxpayer may elect out of the 50 percent ATI limitation rule.

Small business exemption met in a later year w/ disallowed business interest expense

If a taxpayer has disallowed business interest expense carried forward to a taxable year in which they meet the small business exemption, then the general rule of IRC Sec. 163(j) does not apply to the deduction in that year and to all of the disallowed business interest expense carryforward.
The same rules apply if a partner is allocated excess business interest expense from a partnership and, in a succeeding taxable year, such partnership is considered a small business exempt entity.