

## **C. Cost Recovery, etc.**

### **1. Limitation on deduction for interest**

#### **Present Law**

##### **Interest deduction**

Interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations.<sup>181</sup>

Interest is generally deducted by a taxpayer as it is paid or accrued, depending on the taxpayer's method of accounting. For all taxpayers, if an obligation is issued with original issue discount ("OID"), a deduction for interest is allowable over the life of the obligation on a yield to maturity basis.<sup>182</sup> Generally, OID arises where interest on a debt instrument is not calculated based on a qualified rate and required to be paid at least annually.

##### **Investment interest expense**

In the case of a taxpayer other than a corporation, the deduction for interest on indebtedness that is allocable to property held for investment ("investment interest") is limited to the taxpayer's net investment income for the taxable year.<sup>183</sup> Disallowed investment interest is carried forward to the next taxable year.

Net investment income is investment income net of investment expenses. Investment income generally consists of gross income from property held for investment, and investment expense includes all deductions directly connected with the production of investment income (*e.g.*, deductions for investment management fees) other than deductions for interest. Investment income includes only so much of the taxpayer's net capital gain and qualified dividend income as the taxpayer elects to take into account as investment income.

The two-percent floor on miscellaneous itemized deductions allows taxpayers to deduct investment expenses connected with investment income only to the extent such deductions

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<sup>181</sup> Sec. 163(a). In addition to the limitations discussed herein, other limitations include: denial of the deduction for the disqualified portion of the original issue discount on an applicable high yield discount obligation (sec. 163(e)(5)), denial of deduction for interest on certain obligations not in registered form (sec. 163(f)), reduction of the deduction for interest on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 (sec. 163(g)), disallowance of deduction for personal interest (sec. 163(h)), disallowance of deduction for interest on debt with respect to certain life insurance contracts (sec. 264), and disallowance of deduction for interest relating to tax-exempt income (sec. 265). Interest may also be subject to capitalization. See, *e.g.*, sections 263A(f) and 461(g).

<sup>182</sup> Sec. 163(e). But see section 267 (dealing in part with interest paid to a related or foreign party).

<sup>183</sup> Sec. 163(d).

exceed two percent of the taxpayer's adjusted gross income ("AGI").<sup>184</sup> Miscellaneous itemized deductions<sup>185</sup> that are not investment expenses are disallowed first before any investment expenses are disallowed.<sup>186</sup>

For purposes of the investment interest limitation, debt is allocated under a tracing approach to expenditures in accordance with the use of the debt proceeds, and interest on the debt is allocated in the same manner.<sup>187</sup> Thus, generally, the disallowance of a deduction for investment interest depends on the individual's use of the proceeds of the debt. For example, if an individual pledges corporate stock held for investment as security for a loan and uses the debt proceeds to purchase a car for personal use, interest expense on the debt is allocated to the personal expenditure to purchase the car and is treated as nondeductible personal interest rather than investment interest.

### **Earnings stripping**

Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1.0 (the safe harbor ratio) and the payor's net interest expense exceeds 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest;<sup>188</sup> (2) unrelated parties in certain instances in which a related party guarantees the debt; or (3) to a real estate investment trust ("REIT") by a taxable REIT subsidiary of that trust.<sup>189</sup> Interest amounts disallowed under these rules can be carried forward indefinitely.<sup>190</sup> In addition, any

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<sup>184</sup> Sec. 67(a).

<sup>185</sup> Miscellaneous itemized deductions include itemized deductions of individuals other than certain specific itemized deductions. Sec. 67(b). Miscellaneous itemized deductions generally include, for example, investment management fees and certain employee business expenses, but specifically do not include, for example, interest, taxes, casualty and theft losses, charitable contributions, medical expenses, or other listed itemized deductions.

<sup>186</sup> H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-154, Sept. 18, 1986 (Conf. Rep.) ("In computing the amount of expenses that exceed the 2-percent floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.").

<sup>187</sup> Temp. Treas. Reg. sec. 1.163-8T(c).

<sup>188</sup> If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed by the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

<sup>189</sup> Sec. 163(j)(3).

<sup>190</sup> Sec. 163(j)(1)(B).

excess limitation (*i.e.*, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.<sup>191</sup>

## **Description of Proposal**

### **In general**

In the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year. The amount of any interest not allowed as a deduction for any taxable year may be carried forward indefinitely. The limitation applies at the taxpayer level. In the case of a group of affiliated corporations that file a consolidated return, it applies at the consolidated tax return filing level.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the Internal Revenue Code is interest for purposes of the proposal. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment income, within the meaning of section 163(d).

By including business interest income in the limitation, the rule operates to limit the deduction for net interest expense to 30 percent of adjusted taxable income. That is, a deduction for business interest is permitted to the full extent of business interest income. To the extent that business interest exceeds business interest income, the deduction for the net interest expense is limited to 30 percent of adjusted taxable income.

Adjusted taxable income means the taxable income of the taxpayer computed without regard to: (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the 17.4 percent deduction for certain pass-through income;<sup>192</sup> and (4) the amount of any net operating loss deduction. The Secretary may provide other adjustments to the computation of adjusted taxable income.

### **Application to pass-through entities**

#### **In general**

In the case of any partnership, the limitation is applied at the partnership level. Any deduction for business interest is taken into account in determining the nonseparately stated taxable income or loss of the partnership.<sup>193</sup> To prevent double counting, special rules are

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<sup>191</sup> Sec. 163(j)(2)(B)(ii).

<sup>192</sup> See section I.B.1. of this document (Allow 17.4 percent deduction to certain pass-through income).

<sup>193</sup> This amount is the "Ordinary business income or loss" reflected on Form 1065 (U.S. Return of Partnership Income). The partner's distributive share is reflected in Box 1 of Schedule K-1 (Form 1065).

provided for the determination of the adjusted taxable income of each partner of the partnership. Similarly, to allow for additional interest deduction by a partner in the case of an excess amount of unused adjusted taxable income limitation of the partnership, special rules apply. Similar rules apply with respect to any S corporation and its shareholders.

#### Double counting rule

The adjusted taxable income of each partner (or shareholder, as the case may be) is determined without regard to such partner's distributive share of the nonseparately stated income or loss of such partnership. In the absence of such a rule, the same dollars of adjusted taxable income of a partnership could generate additional interest deductions as the income is passed through to the partners.

Example 1.—ABC is a partnership owned 50-50 by XYZ Corporation and an individual. ABC generates \$200 of noninterest income. Its only expense is \$60 of business interest. Under the proposal the deduction for business interest is limited to 30 percent of adjusted taxable income, that is,  $30 \text{ percent} \times \$200 = \$60$ . ABC deducts \$60 of business interest and reports ordinary business income of \$140. XYZ's distributive share of the ordinary business income of ABC is \$70. XYZ has net taxable income of zero from its other operations, none of which is attributable to interest income and without regard to its business interest expense. XYZ has business interest expense of \$25. In the absence of a double counting rule, the \$70 of taxable income from XYZ's distributive share of ABC's income would permit XYZ to deduct up to an additional \$21 of interest ( $30 \text{ percent} \times \$70 = \$21$ ), and XYZ's \$100 share of ABC's adjusted taxable income would generate \$51 of interest deductions, well in excess of the intended 30% limitation. If XYZ were a pass-through entity rather than a corporation, additional deductions might be available to its partners as well, and so on.

The double counting rule prevents this result by providing that XYZ has adjusted taxable income computed without regard to the \$70 distributive share of the nonseparately stated income of ABC. As a result it has adjusted taxable income of \$0. XYZ's deduction for business interest is limited to  $30 \text{ percent} \times \$0 = \$0$ , resulting in a deduction disallowance of \$25.

#### Additional deduction limit

The limit on the amount allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess taxable income. The excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership exceeds the business interest income of the partnership bears to 30 percent of the adjusted taxable income of the partnership. This allows a partner of a partnership to deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. The proposal requires that excess taxable income be allocated in the same manner as nonseparately stated income and loss.

Example 2.—The facts are the same as in Example 1 except ABC has only \$40 of business interest. As in Example 1, ABC has a limit on its interest deduction of \$60. The excess of this

limit over the business interest of the partnership is  $\$60 - \$40 = \$20$ . The excess taxable income for ABC is  $\$20 / \$60 * \$200 = \$66.67$ . XYZ's distributive share of the excess taxable income from ABC partnership is  $\$33.33$ . XYZ's deduction for business interest is limited to 30 percent of the sum of its adjusted taxable income plus its distributive share of the excess taxable income from ABC partnership (30 percent \*  $(\$0 + \$33.33) = \$10$ ). As a result of the rule, XYZ may deduct  $\$10$  of business interest and has an interest deduction disallowance of  $\$15$ .

### **Carryforward of disallowed business interest**

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely. With respect to the limitation on deduction of interest by domestic corporations which are United States shareholders that are members of worldwide affiliated groups with excess domestic indebtedness,<sup>194</sup> whichever rule imposes the lower limitation on the deduction of interest with respect to the taxable year (and therefore the greatest amount of interest to be carried forward) governs.

Any carryforward of disallowed interest is an item taken into account in the case of certain corporate acquisitions described in section 381 and is subject to limitation under section 382.

### **Exceptions**

The limitation does not apply to any taxpayer that meets the \$15 million gross receipts test of section 448(c), that is, if the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed \$15 million.<sup>195</sup>

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation. As a result, for example, the wages of an employee are not counted in the adjusted taxable income of the taxpayer for purposes of determining the limitation.

At the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.

The limitation also does not apply to certain regulated public utilities. Specifically, the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been

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<sup>194</sup> See section IV.D.1. of this document (Denial of deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic indebtedness).

<sup>195</sup> See section III.B.2. of this document (Modifications of gross receipts test for use of cash method of accounting by corporations and partnerships). In the case of a sole proprietorship, the \$15 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership.

established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof is not treated as a trade or business for purposes of the limitation.

### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2017.

## **2. Temporary 100-percent expensing for certain business assets**

### **Present Law**

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.<sup>196</sup> Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period,<sup>197</sup> and convention.<sup>198</sup>

### **Bonus depreciation**

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property acquired and placed in service before January 1, 2020 (January 1, 2021, for longer production period property<sup>199</sup> and certain aircraft<sup>200</sup>).<sup>201</sup> The 50-percent allowance is phased down for property placed in service after December 31, 2017 (after December 31, 2018 for longer production period property and certain aircraft). The bonus depreciation percentage rates are as follows.

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<sup>196</sup> See secs. 263(a) and 167. However, where property is not used exclusively in a taxpayer’s business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.*, section 280A.

<sup>197</sup> The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. Exercising authority granted by Congress, the Secretary issued Rev. Proc. 87-56, 1987-2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Rev. Proc. 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary’s authority to modify the class lives of depreciable property. Rev. Proc. 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

<sup>198</sup> Sec. 168.

<sup>199</sup> As defined in section 168(k)(2)(B).

<sup>200</sup> As defined in section 168(k)(2)(C).

<sup>201</sup> Sec. 168(k). The additional first-year depreciation deduction is generally subject to the rules regarding whether a cost must be capitalized under section 263A.