5x5 series: Insights and actions

Navigating Interest Expense Limitations Under IRC Section 163(j)

IRC section 163(j) imposes limits on the deductibility of business interest expense. For taxpayers experiencing, or expected to experience, significant interest expense limitations under IRC section 163(j), it is important for taxpayers to understand the basic statutory and regulatory framework of section 163(j). Within that framework, taxpayers may identify the drivers of their interest expense limitations and consider tax elections and changes to their capital structure and/or business model to mitigate the impact of IRC section 163(j).

5 insights you should know

1. The limitation for business interest expense ("BIE") under IRC section 163(j) is formulaic and equals the excess of the sum of the taxpayer's (i) business interest income ("BII"); plus (ii) thirty percent (30%) of adjusted taxable income ("ATI"; plus (iii) floor plan financing interest expense.
2. The limitation is determined at the entity level with special rules for consolidated groups, partnerships and controlled foreign corporations (CFCs). Certain taxpayers and businesses are exempt from the limitation.
3. Disallowed BIE is carried forward indefinitely, but such carryforwards may continue to grow, effectively creating an indefinite deferral of BIE deductions. Rising interest rates and a more restrictive measure of ATI have exacerbated the limitation for many taxpayers with higher levels of leverage.
4. The regulations under IRC section 163(j) contain both a general anti-avoidance rule and specific anti-avoidance rule relating to the definition of interest.
5. The ability to deduct interest for state tax can vary greatly due to application of the section 163(j) on a separate company basis in many jurisdictions, where interest expense is borne by a member of the group without sufficient ATI.

5 actions to take now

1. **Analyze whether IRC section 163(j) is limiting interest expense deductions:** Consider both the current year impacts and projections for future years, including the value of the deferred interest expense as a tax attribute.
2. **Review the treatment of various items:** Consider whether items treated as interest expense may instead be deductible as ordinary and necessary business expenses, such as debt issuance costs.
3. **Evaluate approaches for managing interest expense limitations:** Identify the drivers of the interest expense limitation and opportunities to reduce interest expense, capitalize interest, increase BII, or increase ATI through tax elections, changes to capital structure and or modifying business operations.
4. **Start tax modelling:** Tax elections, changes to the capital structure and modifications to business operations likely impact the computation of other tax items, so modelling the federal, state and U.S. international tax implications is essential
5. **Review the company's domestic debt profile:** Evaluate whether the company's intercompany and third-party debt structure is efficient in jurisdictions which do not impose tax on a consolidated basis. Sf

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