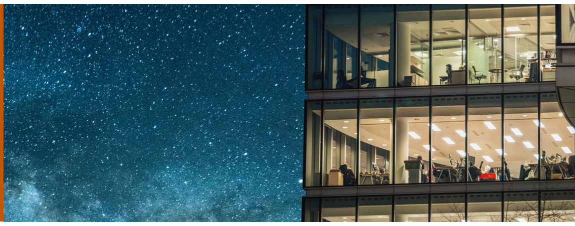

JO Knows Business Interest Limitation Changes

FEBRUARY 3, 2022 | BY: THE REAL ESTATE TEAM

Starting back on January 1, 2018, the Tax Cuts and Job Act ("TCJA") implemented a new limitation on the deductibility of business interest. The limitation applies to every form of business including C corporations, S corporations, partnerships and individual sole proprietors. If the limitation applies, the interest deduction is limited to 30% of adjusted taxable income. The calculation for adjusted taxable income is done with certain addbacks for the first few years which then drop from the calculation for the 2022 tax year, significantly reducing the amount of deductible interest.

There are two relevant exceptions to this limitation. The first is that small businesses with average gross receipts of less than $26 million over the past three years are not subject to the limitation, unless they are considered a tax shelter. The $26 million threshold is adjusted for inflation and contains related party rules when calculating the gross receipts that would trigger the limitation. The second exception is an election allowed for businesses that are in the business of renting, developing, constructing, leasing, managing or acquiring real property among other things. If a taxpayer makes the real property trade or business election, the business would need to follow the alternative depreciation system ("ADS") which will slow down depreciation deductions. The biggest drop in depreciation would apply to commercial real estate, because, bonus depreciation on qualified improvement property would not be available. Taxpayers should carefully consider making this election since it is irrevocable.

Unless you qualify for one of these exceptions, you will be subject to the interest expense limitation. The calculation of the limitation is based on the business's adjusted taxable income. For years prior to 2022, adjusted taxable income was calculated by taking taxable income and adding back interest expense, depreciation and amortization (effectively net operating income).

Big Changes

Starting for tax years beginning on January 1, 2022, the addback for depreciation and amortization goes away in the calculation of adjusted taxable income. This is a major change and will limit a significant amount of interest that previously was not subject to the limitation. Here is an example of how this limitation changes and the effects starting in 2022.

	Prior to 1/1/22	Post 1/1/22
Taxable income prior to interest limitation	20,000	20,000
Addbacks:		
Interest expense	40,000	40,000
Depreciation	80,000	–
Amortization	5,000	–
Adjusted taxable income (ATI)	145,000	60,000
Interest limitation (30% of ATI)	43,500	18,000
Current year interest	40,000	40,000
Interest limited	–	22,000
Taxable income after interest limitation	**20,000**	**42,000**

As you can see, the removal of the depreciation and amortization addbacks from the calculation of adjusted taxable income can have major effects on the interest limitation for your entity. We can help you review the effects of this change on your business and suggest options to consider to maximize the deductibility of interest and depreciation going forward. If you would like to stay in front of tax law changes and avoid tax surprises, we would love to chat with you. To learn more about Johnson O'Connor's Real Estate services, click **here**.

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