

Life After Tax Reform

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I am often reminded of my summer after law school as I prepared for my L.I.M. program at NYU. Congress passed a sweeping “tax reform,” the much heralded Tax Reform Act of 1986. I questioned my decision to take on another year of school and expense. Fortunately, shortly thereafter the NYU graduate tax program sent incoming students a letter making the case that tax reform is not synonymous with tax simplification. They were certainly correct.

A recent example is the amendment to Section 163(j), the interest stripping rule. Under prior law, interest incurred by a corporation on related party cross border debt (and certain other debt) was limited. The TCJA, though, expanded the scope to all business interest. Accordingly, (1) certain high earning individuals are now subject to the interest stripping rules; and (2) the interest limitation applies to interest on all debt.

Business interest is limited to 30% of the taxpayer's EBITDA computed using tax accounting rules. Starting in 2022, the limitation is 30% of the taxpayer's EBIT computed using tax accounting rules. Any disallowed interest under this rule is carried forward to future years indefinitely subject to the same rules.

Another new feature of the amended interest stripping rules is its application to partnerships. The interest stripping limitation applies at the partnership level, such that a partnership's interest deduction is limited to 30% of partnership EBITDA regardless of the income of the partner.

This rule is specifically harsh in intragroup partnerships where the debt is also funded by members of the same group, as is common. The partnership's interest deduction might be limited by these new rules, while the lending group member must take into income the full amount of the interest accrued on the debt.

Accordingly, it is important for companies that are partners in partnerships to take the following steps:

- Model the expected interest expense and the deductibility under revised Section 163(j).
- Consider paying down debt from the partnership to group members if interest is expected to be limited.
- Consider having the partners rather than the partnership incur third party debt so that the interest limitation will be based on the entire group's income rather than the partnership's alone.

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