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While There's Still Time: 2019 Year-End Tips and Tax Planning Strategies for Individuals

As we head into the last quarter of the year there are several action items that individual taxpayers may want to consider before year-end.

While some of these ideas are specific to the current year and some are more long-term planning, all seek to accomplish the goal of optimizing one's overall tax position.

Make the Most of Retirement Contributions

Contributions to retirement accounts are a type of *above-the-line deduction*, which lowers your tax bill by reducing the amount of your gross income subject to tax.

These types of deductions are important because they can be claimed without itemizing your deductions. 401(k) plans and individual retirement accounts (IRAs) are effective tax savings vehicles, but are subject to contribution limits and annual income thresholds. If your annual income is below the applicable threshold, you can deduct on your 2019 tax return all or part of your contribution to a traditional IRA made on or before April 15, 2020.

Consider a back-door Roth IRA conversion

In both traditional and Roth IRAs, investments grow tax free. Roth IRAs offer the additional benefit of tax-free withdrawals without required minimum distributions (RMDs) to the contributor. Roth IRAs are however only available to those who do not exceed specified annual income limits ($203,000 for married filing jointly and $137,000 for single filers). A way around this is to contribute to a traditional IRA, which has no similar income limit, and then convert it to a Roth IRA. As part of the conversion process, any amounts representing pre-tax or deductible contributions would be taxed. But no tax would be imposed on post-tax or nondeductible contributions, as those amounts represent basis in the IRA. It should however be noted that taxpayers must consider all existing traditional IRAs for purposes of these basis rules, which require aggregating the fair market value and basis of all the accounts in determining the tax impact of the conversion of a single account.

Minimize tax by using IRAs to make charitable contributions

Each year a taxpayer may direct up to $100,000 in RMDs to a qualified charity. If certain requirements are met, the otherwise taxable RMDs would be excluded from gross income. IRS has established rules to ensure qualified charitable distributions are executed properly so it is important to consult your tax advisor. To prevent double dipping of tax benefits, only amounts representing nondeductible contributions are eligible for qualified charitable distribution treatment.

Strategically Stacking

Choose between itemizing your deductions and the standard deduction

Because of the higher standard deduction under the new tax law, the benefit of some deductions can be minimized, if not eliminated altogether. For example, a married taxpayer filing jointly who donated $10,000 to a qualified charity in 2019 would still be better off taking the $24,400 standard deduction.

Maximize deductible expenses by *stacking* qualified expenses in specific years to exceed the standard deduction amount

Instead of donating $10,000 to a charity over five years, consider donating $50,000 in year one and itemizing deductions and then take the standard deduction in years two through five. The additional $25,600 in deductions would save a taxpayer subject to the highest marginal tax rate of 37% nearly $9,500.

Capital Ideas for Minimizing or Avoiding Capital Gains

Use capital losses to offset capital gains

Harvesting losses is a tried and true method of reducing gains. If you sold shares of stock for a $100,000 profit this year and sold other shares of stock at a $25,000 loss, you would pay tax on capital gains of $75,000. If your losses exceed your gains in 2019, you can deduct the difference up to $3,000 in capital losses and carry any unused balance to subsequent tax years. For example, if you have a $12,000 capital loss, you can deduct $3,000 in the current year and claim an additional deduction of $3,000 a year for the next three years.

Minimize or avoid capital gains tax by investing in Qualified Opportunity Zone Funds

This new investment vehicle that was enacted under the Tax Cuts and Jobs Act allows investors to defer, reduce and in some cases eliminate capital gains depending on how long the funds are invested. It is important to work with a tax advisor when exploring this option to avoid running afoul of complex and strict qualification rules.

Maximize the Benefit of Current Estate and Gift Tax Exemptions and Gift Exclusions

Reduce the value of your estate

In 2019 the lifetime gift, estate and generation-skipping (GST) tax exemption is $11.4 million. This means that an individual can either give away or die with assets totaling this amount (and double for spouses) without paying transfer tax. By using the GST exemption in conjunction with the gift/estate exemption, those assets can go to grandchildren and lower generations while avoiding all transfer tax as well. However, under current law this exclusion is scheduled to revert back to pre-2018 amounts in 2026 (approx. $5.75 million).

In addition, recognized as the annual exclusion, cash gifts up to $15,000 per year ($30,000 for married couples) in 2019 can be made to as many people as you choose without triggering gift tax or using any of the $11.4 million lifetime gift exemption amount. Further, you can provide an unlimited amount for qualified tuition or medical expenses. At a 40% federal transfer tax rate, depending on the size of a taxpayer’s estate, it is advantageous to use some or all of these exemptions and exclusions. The real benefit of gifting now is not only that the asset is removed from the estate, but the appreciation on that asset is removed from the estate as well.

The Takeaway

There are several actions you can take now to lower your tax bill for 2019 and implement beneficial planning strategies for the future. Maximizing retirement contributions, formulating an effective plan for making charitable donations and minimizing capital gains are all components of a thorough review process. It is also important to put plans in place to support future generations. While the approaches to achieving these goals are as varied as the outcomes sought to be accomplished, maximizing tax efficiencies should always be part of the equation. As the saying goes, plan early and plan often!

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All in the Family: Kress Gift Tax Case Gives Business Owners Reason to Cheer

In Kress v. United States, a U.S. District Court accepted the taxpayer's valuation for lifetime gifts of minority interests in stock in an operating business organized as an S corporation.

This is a positive decision for business taxpayers because the court allowed income taxes to be considered in the valuation of a pass-through entity, which produced a lower, and more accurate, value than if income taxes were ignored in the valuation process.

The court also accepted IRS's argument that the transfer restrictions on the transfer of the company's stock contained in its bylaws should be disregarded in determining the value of the gifts. The Internal Revenue Code allows IRS to disregard these restrictions unless the taxpayer can show that certain exceptions are satisfied, and the taxpayers could not do so.

Background

James and Julie Kress (Taxpayers) were shareholders in a family-owned S corporation, Green Bay Packaging (GBP), which manufactured packaging and other related products. GBP employed approximately 3,400 people throughout the country and the Kress family held approximately 90% of the outstanding stock. The other 10% was held by employees and directors.

The bylaws for GBP contained various restrictions that limited the ability of family members to sell their stock. The restrictions required that members of the Kress family transfer their shares, whether by gift, bequest, or sale, only to other members of the Kress family. Taxpayers maintained that the restrictions ensure that the family will retain control of the corporation, minimize the risk of disruption of its affairs by a dissident shareholder, ensure confidentiality of corporate affairs and that all sales of GBP minority stock will be to qualified subchapter S shareholders.

In 2007, 2008, and 2009, Taxpayers each made gifts of some of their shares in the corporation to their children and grandchildren and paid over $2 million in gift taxes. Upon audit, IRS assessed additional tax after concluding that the shares were incorrectly valued. After paying the assessment, the Taxpayers filed suit in the U.S. District Court.

Tax Affecting Method

At trial, four different appraisers entered reports into evidence regarding the value of the stock. Two of the appraisals supported the Taxpayers' valuation of their stock and the other two supported IRS. One of the appraisals that supported the Taxpayers' value was submitted by an appraiser who had a history of working with the family. His report was submitted with the gift tax returns. Both the report submitted with the gift tax returns and the report submitted by an IRS-retained appraiser used the *tax affected* method as part of the analysis to arrive at a per share value of the stock. *Tax affecting* attempts to account for the S corporation shareholder's tax burden in determining the value of the business, even though no entity-level tax exists. The adjustment accounts for the fact that while a pass-through entity does not pay tax, the entity's earnings are passed through to the owners who must include their pro-rata share of earnings as income on their personal income tax returns.

Prior to the Tax Court decision in *Gross v. Commissioner* in 1999, earnings for S corporations were routinely *tax affected* for valuation purposes. In *Gross*, the taxpayers gifted S corporation stock to their children. The S corporation annually distributed substantially all of its net earnings and, therefore, its shares were valued using the discounted cash-flow method. The shares were then discounted for lack of marketability and cost-of-equity capital. The Tax Court agreed that the discounted cash-flow method was appropriate to value future cash flows, but refused to reduce the earnings by corporate taxes that would have been paid had a buyer terminated the S election.

Some practitioners believe that not allowing *tax affecting* results in an over-valuation of S corporation stock. Since *Gross*, several other cases have held that the value of S corporations should not be determined by *tax affecting* the earnings of the corporation. In light of the *Gross* decision and the other subsequent cases, it is surprising that the expert employed by IRS applied the *tax affecting* method as part of the analysis to determine the value of GBP stock.

After analyzing the reports, the court concluded that the report submitted with the gift tax returns to be the most reliable. The court reached its conclusion noting that the appraiser had a long history valuing the company stock.

Restrictions on Stock

Another significant aspect of the ruling was the court's acceptance of IRS's argument that the restrictions placed on the family's stock in the GBP bylaws should be disregarded when determining the fair market value of the lifetime gifts. In certain circumstances, the Internal Revenue Code allows IRS to ignore restrictions in bylaws when valuing an entity. However, any restriction that (1) is *a bona fide business arrangement*, (2) is not a device to transfer the property to members of the *decedent's* family for less than full and adequate consideration in money or money's worth; and (3) includes terms that are comparable to similar arrangements entered into by persons in an arm's length transaction shall be considered when valuing the property. For the third requirement, Taxpayers failed to produce any evidence that the restrictions in the bylaws were comparable to those entered into by other unrelated parties. Although the court acknowledged that restrictions like those in GBP's bylaws were common. Interestingly, the court found that the second requirement, commonly known as the *device test*, only applies to situations involving testamentary transfers because the statute referred to *decedents*.

The Takeaway

The court's acceptance of the *tax affecting* valuation method represents a victory for owners of pass-through entities, who have had to contend for nearly two decades with IRS's *non-tax affecting* approach. By essentially treating these pass-throughs and their owners like tax-exempt entities, many practitioners believe this approach results in inflated valuations. It is also significant that the court determined that the *device test* only applied to testamentary transfers.

While the *Kress* decision was issued by a District Court, the Tax Court also recently opined on *tax affecting* in the valuation of a pass-through entity in *Estate of Aaron Jones*, T.C. Memo 2019-101. The Tax Court drew an important distinction and emphasized the need for appraisers that use the *tax affecting* method to provide justification for doing so. According to the Tax Court, the question is not *whether* to take the tax benefits inuring to a pass-through entity into account but rather *how*.

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Sweetening the Deal: The Value of Research Tax Credits in a Merger or Acquisition

Congress enacted Internal Revenue Code Secs. 382 and 383 to prevent companies from acquiring targets for the express purpose of using their net operating losses (NOLs) and tax credits.

Section 382 limits the use of a target's pre-acquisition NOL carryforward to an amount equal to the product of the fair market value (FMV) of the target's stock (prior to the transaction and subject to certain adjustments) and the long-term tax-exempt rate. Similarly, Sec. 383 limits use of a target's pre-acquisition General Business Credits (including the federal research credit) to the difference in taxable income that is computed with and without the Sec. 382 limitation in place. In many transactions, these tandem limitations significantly impair the value of a target's federal research credit carryforwards. However, it is a mistake to assume that acquired research credits have little or no value. Understanding when a target's research credits are available to the target's purchaser can sweeten the deal for any M&A transaction.

Low vs. High Section 382 and Section 383 Limitations

The limit on a purchaser's use of a target's pre-acquisition NOL carryforward is the FMV of the acquired business's stock multiplied by the long-term tax-exempt rate. If the equity value of the target is low relative to the value of its pre-acquisition tax attributes, the respective Sec. 382 and Sec. 383 limitations will significantly impair the post-acquisition value of its NOL and credit carryforward balances as the amount of attributes that can be used each year may be small and certain attributes may expire unused due to carryover limitations.

If the equity value of the acquired business is high, the annual limitation on the use of the target's pre-acquisition losses and credits may also be a large number, so that the target's full NOL and credit carryforward balances may be fully absorbed in a few years after the transaction. Consider the following scenarios, and the impact of the Sec. 382 and Sec. 383 limitations on the relative value of a target's NOL and tax credit carryforward attributes.

Scenario 1: Large NOLs and Credit Carryforwards, Low Value Target

Target's Pre-acquisition NOL	2,000,000	(a)	Post-Acquisition Taxable Income	50,000	(f)
Target's Pre-acquisition Credits	500,000	(b)	Regular Tax liability (no NOL) at 21% rate	10,500	(g) = (f) x 21%
Target Equity Value	1,000,000	(c)	Post-Acquisition Taxable Income	50,000	(f)
Long-term Tax-exempt Rate	5.00%	(d)	382 NOL Limitation Deduction	(50,000)	(h) = Min((e),(a))
			Post-Acquisition Taxable Income	-	(i) = (f) + (h)
382 Limitation	50,000	(e) = (c) x (d)	Tax liabity with 382 Limit at 21%	-	(j) = (i) x 21%
			Unused 382 Limitation	-	(k) = (e) + (h)
			Modified Tax Liability	-	(l) = ((i) - (k)) x 21%
			Available 383 Limitation	-	(m) = (j) - (l)
Years to absorb full pre-acquisition NOL			40.00 (a)/(e)		

As you can see in Scenario 1, the Target's attributes are severely impaired by the annual Sec. 382 limitation. Pre-2018 NOLs have a 20-year carryover period but due to the small annual Sec. 382 limitation, the $2,000,000 of pre-acquisition NOLs wouldn't be fully absorbed for 40 years. As a result, the majority of the NOLs will expire before utilization and because the Sec. 382 limitation is applied before any credits under Sec. 383, none of the credits can be utilized.

Scenario 2: Small NOLs and Credit Carryforwards, High Value Target

Target's Pre-acquisition NOL	2,000,000	(a)	Post-Acquisition Taxable Income	50,000,000	(f)
Target's Pre-acquisition Credits	500,000	(b)	Regular Tax liability (no NOL) at 21% rate	10,500,000	(g) = (f) x 21%
Target Equity Value	10,000,000	(c)	Post-Acquisition Taxable Income	50,000,000	(f)
Long-term Tax-exempt Rate	5.00%	(d)	382 NOL Limitation Deduction	(500,000)	(h) = Min((e),(a))
			Post-Acquisition Taxable Income	49,500,000	(i) = (f) + (h)
382 Limitation	500,000	(e) = (c) x (d)	Tax liabity with 382 Limit at 21%	10,395,000	(j) = (i) x 21%
			Unused 382 Limitation	-	(k) = (e) + (h)
			Modified Tax Liability	10,395,000	(l) = ((i) - (k)) x 21%
			Available 383 Limitation	-	(m) = (j) - (l)
Years to absorb full pre-acquisition NOL			4.00 (a)/(e)		

As you can see in Scenario 2, the Target's NOL attributes can be fully utilized within four years assuming annual post-acquisition taxable income of at least $500,000. Beginning in year five, the Target's credits would be available for utilization and could be fully utilized within 5 years as illustrated below.

Year 5 Remaining Attributes					
Target's Pre-acquisition NOL	-	(a)	Year 5 Post-Acquisition Taxable Income	50,000,000	(f)
Target's Pre-acquisition Credits	500,000	(b)	Regular Tax liability (no NOL) at 21% rate	10,500,000	(g) = (f) x 21%
Target Equity Value	10,000,000	(c)	Post-Acquisition Taxable Income	50,000,000	(f)
Long-term Tax-exempt Rate	5.00%	(d)	382 NOL Limitation Deduction	-	(h) = Min((e),(a))
			Post-Acquisition Taxable Income	50,000,000	(i) = (f) + (h)
382 Limitation	500,000	(e) = (c) x (d)	Tax liabity with 382 Limit at 21%	10,500,000	(j) = (i) x 21%
			Unused 382 Limitation	500,000	(k) = (e) + (h)
			Modified Tax Liability	10,395,000	(l) = ((i) - (k)) x 21%
			Available 383 Limitation	105,000	(m) = (j) - (l)
Additional years to absorb full pre-acquisition Credits			4.76	(b)/((e) x 21%)	

In summary, all the pre-acquisition NOLs would be available within four years and all the pre-acquisition credits would be available within nine years under Scenario 2. None of the Target's pre-acquisition tax attributes would be lost in this scenario.

As the above scenarios illustrate, Sec. 382 and Sec. 383 limitations do not always significantly impair the value of a target's tax attributes. Valuation of a target should always include an analysis of how soon the purchasers will be able to absorb the target's NOLs and tax credit carryforward balances.

Target's Addition to Current Qualified Research Expenses

Even if a target's historical attributes are severely impaired by Sec. 382 and Sec. 383 limitations, a target's potential to add qualified research expenses (QRE) to the purchaser's post-acquisition expenses can add value to an acquisition, especially where it is expected that the incremental spend on the target's research and development (R&D) activities will increase in the post-acquisition period. Section 41(f) generally requires that the purchaser of a target that conducted QRE must adjust its base period to add the historical QRE of the target to its own base period QRE to ensure that the credit eligible spend in the post-acquisition period is measured in relation to the full history of the pre-acquisition activities that preceded the post-acquisition QRE. If the target's historical spend is lower than the post-acquisition R&D spend, then the purchaser's incremental increase in QRE will be greater, resulting in a larger post-acquisition federal (and most state) research credits.

Understanding the historical R&D spend of a target sounds like a straight-forward exercise if an entire entity is being acquired, but if a purchaser is acquiring a division or just a portion of another company's trade or business, identifying the historical R&D expenses may be a complex exercise. Purchasers are advised to request a "section 41(f) letter" from the seller, if the historical books and records of the target are part of another company's financial statements. The section 41(f) letter should identify all historical QRE associated with the target that the buyer will need to properly adjust its base calculation for the post-acquisition tax years in order to maximize current and future research credits.

Target's Payroll Credits Outside Section 383 Limitations

Businesses with less than $5 million in gross receipts and less than a five-year history of receiving gross receipts (Qualified Small Businesses) can elect to apply up to $250,000 of their federal research credit as an offset to the employer's quarterly Federal Insurance Contributions Act (FICA) payroll tax liability. The election is made on the income tax return filed during the current year (generally the prior tax year's return), and the benefit is claimed on the quarterly payroll tax return for the first full quarter after the income tax return is filed. The election can be made for up to five tax years, resulting in a maximum benefit of $1.25 million. Any credit in excess of the employer's payroll tax obligation carries forward to subsequent quarters to offset the company's future FICA tax liability. There is no expiration of the payroll credit carryforward. It will continue to offset FICA tax liabilities until it is fully depleted.

Qualified Small Businesses are frequently the targets of M&A activity. A purchaser's standard due diligence should include an inquiry into the target's Sec. 383 limitation, and the purchaser's ability to utilize the target's research credit carryforward. If a Qualified Small Business has a payroll credit carryforward, the seller should point out to the purchaser that the payroll credit is not subject to Sec. 383 limitations. Section 383 only applies to the General Business Credits that are enumerated in Sec. 38. The election to apply the research credit to FICA payroll tax liabilities removes the credit from the list of General Business Credits and reclassifies it as a credit against payroll tax under Sec. 3111(f). There is no Sec. 383 equivalent limitation on payroll credits, so the buyer of a Qualified Small Business will acquire the carryforward balance of any unused payroll tax credits and may use the attribute to offset its own FICA payroll tax liability for quarters following the acquisition. Even when a target is subject to a significant Sec. 383 limitation, payroll tax credits can continue to provide immediate cash tax value.

The Takeaway

A buyer and target company's research credits are often overlooked in the context of mergers and acquisitions because of the presumption that Secs. 382 and 383 will limit their value. Understanding the special rules applicable to computing the research tax credit in a merger or acquisition and then analyzing the potential target's history of development activities and the nature of the research credits it has claimed can uncover hidden value in the calculation of the purchaser's post-acquisition research tax credits.

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Part I: The Business Interest Expense Limitation When Investing in Partnerships

Prior to the Tax Cuts and Jobs Act, a taxpayer could deduct trade or business interest expense with few limitations.

There were restrictions when interest was paid to a related party, and of course there were basis, at-risk, and passive activity limitations that generally apply to all deductions, but most taxpayers could still derive a tax benefit from a large interest expense deduction resulting in an ordinary business loss. Under new section Internal Revenue Code Sec. 163(j) however, the deduction of business interest expense is subject to several new restrictions imposed on most taxpayers that conduct a trade or business in any form, whether as an individual, a corporation, through a partnership, or multiple partnerships or business entities.

Calculating the Limitation

Conceptually, the biggest change under Sec. 163(j) is that it is truly an entity-level calculation, and in many ways disregards the concept of aggregation familiar to many taxpayers. An individual, for instance, may own two separate partnerships engaged in a trade or business in which she is a material participant. If Partnership A is struggling and operating at a loss and Partnership B is booming and generating large amounts of taxable income, in general the individual can use the loss allocated to her from A to offset the gain allocated to her from B. As long as basis, at-risk, or active vs. passive activity issues do not come into play, a taxpayer can aggregate the gains and losses. That is no longer the case when it comes to business interest expense. If A operates at a loss, its business interest expense is subject to limitation even if B has more than enough income to absorb the expense.

Business interest expense (BIE) is now limited to the sum of (1) business interest income (BII), (2) 30% of adjusted business taxable income (ATI), and (3) the amount of the business's floor plan financing. BII is a specific item, such as interest income from making loans. Interest income derived from bank balances, even if the account is owned by an operating business, is still considered investment income. Investment income can be used by the ultimate taxpayer to deduct investment interest expense, but it is specifically excluded from the BIE limitation. Floor plan financing is similarly specific, and only applies to loans secured by the acquisition of motor vehicles held as inventory for sale or lease. To the extent a taxpayer has either, though, BIE may be deducted dollar for dollar.

ATI is calculated beginning with the overall taxable income or loss by the particular taxpayer subject to the limitation. Any deduction for BIE is added back, and any income for BII is subtracted, since they are separately accounted for in the calculation. Next, any items of gain or loss that are not from a trade or business are subtracted or added back, respectively. That includes any income or expenses treated as investments. Then, to the extent that there is depreciation, amortization, or depletion from a trade or business, that is added back as well (for tax years beginning before 2022). If they are added back, though, any associated depreciation or amortization recapture upon sale is subtracted from ATI. Finally, certain tax attributes are also added back, such as Sec. 172 net operating loss deductions and Sec. 199A qualified business income deductions. A taxpayer does not need to balance the use of those attributes with the prospect of limiting their BIE.

As an example, an individual has gross income of $30 (in millions) from a trade or business, and has $10 of expenses, $11 of depreciation and $8 of BIE associated with that business. Additionally, the individual has investments generating $13 of dividends and $2 of investment interest expense. The taxpayer's overall taxable income before application of Sec. 163(j) is $12. To derive ATI, add back the $8 of BIE and $11 of depreciation, subtract the $13 of investment income and add back the $2 of investment expenses. The result is ATI of $20, the business income less the business expenses. A taxpayer can deduct interest expense up to 30% of ATI, or $6. Since the taxpayer has $8 of BIE, $6 will be deductible, and $2 will be limited. In the following charts, numbers are shown in millions.

Taxable Income Before Sec. 163(j)		**Adjusted Taxable Income (ATI)**	
Gross Income from Trade or Business (T/B)	30	Taxable Income Before Sec. 163(j)	12
		Plus: T/B BIE	8
T/B Expenses	(10)	Plus: T/B Depreciation	11
T/B Depreciation	(11)	Less: Dividend Investment Income	(13)
T/B BIE	(8)	Plus: Investment Interest Expense	2
		Adjusted Taxable Income (ATI)	20
Dividend Investment Income	13		
Investment Interest Expense	(2)	30% of ATI Limitation	6
Taxable Income Before Sec. 163(j)	12	**Limitation**	
		Total BIE	8
		Deductible BIE	6
		Disallowed BIE	2

Investment in Partnerships

There is an additional piece to calculating ATI, and that is the effect of partnership income received from a Schedule K-1. Since Sec. 163(j) is an entity-level calculation, if a taxpayer receives income on a K-1, except for certain small businesses (to be discussed in the next issue of *For The Record*), that income should have been subject to its own limitation under Sec. 163(j) at the partnership level. If it was, the taxpayer does not need to subject that income to an additional limitation. As a result, any net income derived from a K-1 is subtracted from the taxpayer's ATI, and any net losses are added back.

Further, the taxpayer may be able to derive a tax benefit from the underlying partnership. If a partnership is subject to the Sec. 163(j) limitation, has business income and does not have a BIE limitation, it may have what is defined as excess business taxable income (EBTI) or excess business interest income (EBII). To the extent that a partnership has business income and does not use it to deduct BIE of its own, it can pass the excess up to its partners. The partner can then use that excess against its own BIE. EBII from a K-1 is added to a taxpayer's own BII, and EBTI from a K-1 increases the taxpayer's ATI.

It is important to note that the tax attributes for EBTI and EBII can only move up in tiered partnerships—never laterally, and never down. For instance, Taxpayer A owns an interest in Partnerships X and Y. X has limited BIE and Y has EBTI. A cannot use the EBTI from Y to deduct the BIE from X. If A personally has BIE, she can use Y's EBTI to help deduct her personal BIE, but it cannot be used for deductions in one of A's other partnership investments.

Limited Interest Expense

Perhaps the most complicated aspect of the new law is what happens to the BIE once it is limited. Defined as excess business interest expense (EBIE), the amount becomes nondeductible in the current year and is carried forward to future years. It can only be deducted if, in a future year, the same activity that generated the EBIE in the first place now generates EBII or EBTI. Taxpayer A above, for instance, has EBIE reported to her from her interest in Partnership X. That EBIE will not be deductible in 2018 and will be carried forward to 2019. The only way for A to eventually receive a tax benefit and deduct the EBIE will be if X itself generates EBII or EBTI in 2019 or beyond and reports it on A's K-1.

Despite EBIE being currently nondeductible, A is still required to reduce her basis in X to the extent of her allocation of current year EBIE. Even though it is a carryforward and potentially deductible in the future, basis is reduced immediately. That may lead to basis limitations in other areas, such as the inability to take future losses because of at-risk limitations, or the recognition of gain on a distribution in excess of basis. To the extent that the taxpayer disposes of the investment before getting a tax benefit for the carryforward, the carryforward disappears and is added back to the basis of the investment for purposes of calculating gain or loss on disposition.

Section 163(j) not only potentially reduces the benefits of business interest expense, but also adds significant complication for businesses and individuals in accounting for its tax impact. It is critical that taxpayers and their advisors understand these new rules and if, and how, it applies to their business. There are additional considerations for small business taxpayers and multi-tier partnerships, which will be discussed in more detail in a subsequent *For the Record* newsletter article.

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