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Proposed Regulations May Devalue Certain Loss Corporations

Net operating losses (NOLs) are valuable corporate assets that can generally be used to offset future profits.

In corporate acquisition transactions, buyers may ascribe value to NOLs as business assets, counting on the ability to offset tax on future profits to enhance expected after-tax rates of return. Proposed regulations issued recently under Internal Revenue Code Section 382 could significantly reduce the value of these attributes when a corporate ownership change occurs in the future.

Background

Section 382 imposes limits on the amount of NOLs available to offset future profits after there is a greater than 50% increase in ownership by 5% shareholders over a specified period (three years). Section 382 was enacted in 1986 in response to transactions that were viewed as “trafficking in NOLs.” Despite 30 plus years since enactment and hundreds of pages of regulations, IRS and Treasury continue to issue guidance, introducing additional complexity and uncertainty in certain areas.

Section 382 applies to all loss corporations, including corporations with NOLs, credits, capital losses, or other deductible carryforwards (e.g., Sec. 163(j) carry forwards) following an *ownership change*. An ownership change may be obvious, as in the case of a 100% acquisition of stock, or it may be less obvious if it involves increases in ownership by a number of 5% shareholders.

The computation of the annual Sec. 382 NOL limitation following an ownership change is complex, but generally it is the product of the value of the loss corporation immediately before the ownership change and IRS tax-exempt interest rate (currently 1.59%, December 2019). Consequently, a corporation valued at $20 million undergoing an ownership change today would have an annual limitation of $318,000 on its NOLs generated prior to the ownership change date. This means its NOL utilization is limited to $318,000 per tax year until the pre-change NOLs are utilized or expire unused (generally, under the Tax Cuts and Jobs Act (TCJA) post-2017 NOLs do not expire). At a 21% corporate tax rate, this results in approximately $66,780 of annual tax savings.

In situations where the loss corporation has a net unrealized built-in gain (NUBIG) in its assets, the annual limitation may be increased for recognized built-in-gains (RBIG), where assets with a fair market value greater than tax basis as of the ownership change date are disposed of within five years following the ownership change. Similar rules apply to situations where the loss corporation has a net unrealized built-in loss (NUBIL) in its assets (i.e., assets have a fair market value lower than tax basis and any recognized built-in losses (RBIL) are subject to the Sec. 382 limitation).

Historically, the measurement and composition of NUBIG, NUBIL, RBIG, and RBIL was a source of controversy. In response, IRS issued Notice 2003-65, providing methodologies for how to measure NUBIG, NUBIL, RBIG, and RBIL. One methodology, the *Section 338 Approach*, allows an increase in the annual limitation for the first five years following an ownership change with respect to NUBIG corporations. This increase is computed through a hypothetical asset purchase as of the ownership change date under the principles of Sec. 338, measuring hypothetical increases in depreciation and amortization deductions on the corporation's assets. This hypothetical increase in cost recovery deductions is treated as RBIG, even though the underlying assets may not be disposed of during the five-year period.

Any increase to RBIG under the Section 338 Approach is taxpayer favorable. Continuing the prior example, assume that the loss corporation has a NUBIG and $15,000,000 of the $20,000,000 value is attributable to intangible assets that have no tax basis (i.e., were created by the corporation, not acquired). Under the Section 338 Approach, the intangibles would hypothetically be amortizable over 15 years at $1 million per year. Therefore, the corporation's annual limitation would be increased by $1 million each year for the first five years following the ownership change, resulting in a total annual limitation during that period of $1,318,000 (compared to $318,000) and annual tax savings of $276,780 (compared to $66,780). Consequently, the Section 338 Approach provides significant value by increasing the available NOL to offset future profits.

Proposed Section 382(h) Guidance

On September 9, 2019, the Treasury Department issued proposed regulations under Sec. 382(h), which would bring significant changes to existing guidance that taxpayers have relied upon for over a decade, and negatively impact the Sec. 382 computation for many corporations going forward. Under the proposed regulations, for changes of ownership after the regulations are finalized, the Section 338 Approach would no longer be available, generally leaving only gains recognized as RBIG to increase the annual limitation. Since few corporations dispose of assets such as goodwill following an ownership change, the proposed regulations could create significant economic disadvantages for those companies that are acquiring loss corporations and loss corporations undergoing creeping ownership changes. In addition, the proposed regulations would significantly expand the definition of RBILs, particularly with respect to deductions attributable to contingent liabilities, making Sec. 382 more onerous for NUBIL corporations.

Many commentators view the proposed changes as inappropriate as well as unfair with respect to transactions that may be in progress. Some are calling for transition rules for transactions under letter of intent (or similar) when the proposed regulations were released but will close and trigger ownership changes after the finalization. In response to taxpayer comments, Treasury recently issued a statement indicating a transition rule will be added to the proposed regulations but offered no specificity on what it will look like or how broadly it might apply to pending transactions.

The Takeaway

Any loss corporation that may be acquired, that is anticipating shifts in ownership, or has undertaken multiple rounds of equity financing could be negatively impacted if a change in ownership occurs after finalization of the proposed regulations. The resulting devaluation of NOLs could impact operating cash-flow, and diminish value paid by purchasers regarding these attributes. As a result, loss corporations raising equity capital or shifting ownership might consider accelerating transactions or other actions that would trigger an ownership change now, prior to the finalization of the proposed regulations. Buyers should be very wary of this change in the calculation of the Sec. 382 limitation and understand its impact on the value of the transaction.

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Effective Risk Mitigation Strategies – Avoiding Estate Tax Return Audits

Estate tax return audits can be expensive and time-consuming. The best way to reduce or avoid costs is to plan ahead.

The focus of this article is specific targets of estate tax return audits and the effective risk mitigation strategies that can be employed during a decedent's life and in the preparation of an estate tax return to reduce that risk.

There are some basics mistakes and internal inconsistencies that can be easy to avoid and prevent larger headaches in the event of an estate tax audit. The following is a non-inclusive list:

1. Has the estate tax return been filed without all necessary attachments and documents?

2. Does the Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, contain inadequate descriptions of reported assets?
3. Have all required questions been answered sufficiently?
4. Have all prior gifts been reported, and gift tax returns attached to the estate tax return?
5. Has the decedent's last will and testament bequeathed certain specific property which is not properly reported on the Form 706?
6. Has a deduction for real estate taxes been taken on Schedule K of the 706 but no real estate been reported as an asset?
7. Neatness counts! Is the return organized properly with all necessary attachments in good order?

Again, these are just some of the straight-forward mistakes that can needlessly either trigger an audit or create time-consuming issues with an estate-tax examiner. The next group of issues are more technical and complex:

1. Have formation documents been timely created and filed?

> The formation of an FLP typically involves the following steps. First, the entity is created under state law by drafting and filing all necessary documents. The entity is then funded with assets. From there, typically the grantor transfers interest in the entity via gifts or sales to their heirs or trusts for their heirs, often at a discount. The entity is then operated according to the agreement. These steps should be taken thoughtfully, following this order and allowing for time in between each step. This process is critical when trying to withstand an IRS challenge during an audit.

2. Have business and accounting requirements been satisfied?

> The FLP should be careful to maintain proper accounting books and records. The partners should hold regular meetings and keep detailed minutes. All necessary partnership and gift tax returns should be filed, showing correct ownership, capital accounts, distributions, profits accounts, schedules K-1, etc.

3. Was the FLP funded with personal items of the decedent resulting in their inability to pay for personal expenses?

> The grantor should retain substantial assets outside of the FLP. More specifically, following the transfer of a decedent's assets to an FLP, they must be able to meet their financial obligations without using the transferred funds. If distributions from the FLP are required to meet the basic living expenses of the decedent, IRS would likely assert that all FLP interests are includable in the decedent's estate. Further, a business plan should exist with a method for the FLP expenses to be paid separate from any personal expenses that might arise.

4. Has a legitimate nontax purpose for the entity been documented?

> Tax court decisions have provided several legitimate nontax purposes for the creation of FLPs and LLCs. These include (1) centralized control of family investments, (2) reduced expenses associated with family wealth, (3) educating the next generation regarding management of family investment assets, (4) protecting family assets, (5) consolidating investments with a single investment advisor, and (6) creating a common ownership of assets for efficient management to meet minimum investment requirements. The intent of any

created family entity should include most if not all these goals. In addition, during the lifetime of the entity, there should be evidence showing actions were taken to meet these goals.

5. Does the FLP agreement allow for unilateral powers for the manager?

When drafting an FLP agreement primary areas of concern are restrictions on transfer, withdrawal and distributions rights, and management powers. To reduce the likelihood IRS could sustain estate tax inclusion of the interest, the decedent's control should be limited.

6. Have there been distributions which could negatively impact the discounts?

One of the drivers in establishing an entity discount is a lack of liquidity. In other words, the inability of a partner to benefit from the entities cash flow reduces the value of the partnership interest. If there are frequent distributions (other than perhaps tax distributions), IRS may be successful in reducing a discount on that basis.

7. Was the value of the interest in the estate reported and substantiated through a qualified appraisal?

Knowing it is likely IRS will challenge any discounts taken on family entity interests, it is critical that value be determined via a qualified appraisal. Having the appraisal will make it that much more difficult for IRS to disregard the reported value and challenge the economic factors that give rise to a discount. While having the appraisal in no way guarantees a value will go unchanged on an audit, it does allow for more negotiating power during an audit.

8. Was the entity dissolved shortly have the death of the decedent? Were FLP assets used to pay for death-related expenses?

If an entity is liquidated soon after the decedent's death, absent some compelling non-tax reason for that liquidation, IRS will likely try to argue the entity was designed only for tax reasons. Generally, it is a good idea for there not to be any transactions with the entity until after any potential audit period is over.

Since these can be more complex matters, there are several different potential issues that can arise with respect to each of the above considerations. There is however one area that commands specific attention because of the focus given to it by IRS: the family limited partnership. Family limited partnerships (FLPs) and limited liability companies (LLCs) are primary targets of IRS estate tax return audits. Specifically, because of the discounts associated with these interests, for years IRS has attacked both the validity and amounts of these discounts, as well as asserted estate tax inclusion of interests gifted during life. While they have not always been successful in challenging these entities, advisors should be aware that IRS is likely to scrutinize such interests reported on an estate tax return. Knowing this, practitioners would be wise to review the relevant case law, which provides many factors to consider and questions to ask when determining if the use of an FLP or LLC will increase the likelihood of triggering an IRS estate tax return audit.

The Takeaway

An estate tax audit may be unavoidable as IRS typically reviews most taxable estates. However, the scope and expense related to that audit can be dramatically reduced. While the above points are only some of the issues that can come up in an examination, taking these considerations into account both during planning and in preparation of the estate tax return can pay off in withstanding IRS challenges.

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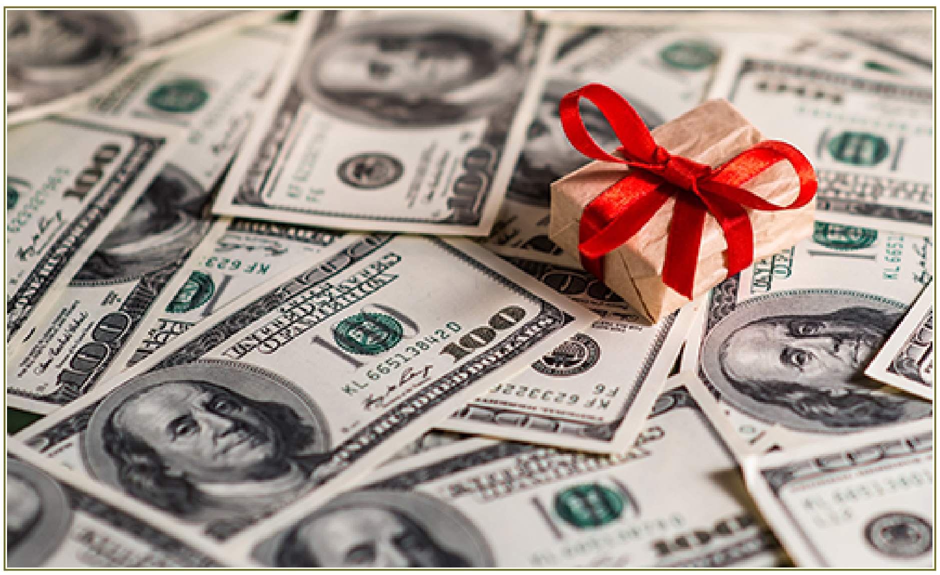
Foreigners Still Don’t Get an Estate and Gift Tax Break



IRS recently announced an additional increase in the lifetime estate and gift tax exemption, up from the $11,400,000 2019 amount to $11,580,000 for the 2020 tax year.

Despite these increases however, the exemption for non-U.S. persons who die owning U.S. assets remains at the paltry $60,000 level. In general, it remains a surprise to many U.S. assets investors that the U.S. can apply the estate and gift tax at all to foreign persons. This (largely understandable) lack of knowledge of the rules combined with the low level of exemption means planning is a necessity.

Non-U.S. Person for Purposes of the Gift and Estate Tax

A non-U.S. person for purposes of the gift and estate tax is a non-U.S. citizen who is not domiciled in the U.S. at the time of gift or bequest. Domicile is a subjective term based on a long-term intent to remain in the U.S. While this standard can be relatively clear when applied to a foreign person with little or no ties to the U.S., it can create confusion in such cases as a green card holder residing outside of the U.S. or a visa holder living in the U.S. for a period.

What is Subject to Tax?

Broadly speaking, U.S.-situated assets are subject to tax. However, different rules apply to gifts versus estate bequests. The general rule is that estate tax applies to all U.S.-situated assets, except for securities that generate portfolio interest, non-business bank accounts and life insurance proceeds. For gift tax purposes, intangible assets including most securities are not subject to gift tax.

How Does the Tax Apply?

As stated above, the lifetime exemption for a non-citizen, non-domiciled person is $60,000. Gifts of U.S. assets that take place in the U.S. that are in excess of the annual exclusion of $15,000 will reduce the lifetime exemption and if exceeded will be taxed at rates up to 40%. Upon death, the fair market value of U.S.-situated assets exceeding the remaining exemption are taxable at the same rates. Transfers to a U.S. citizen spouse from a non-U.S. citizen spouse will be eligible for the unlimited marital deduction. Although treaties may exempt certain intangible assets from tax or provide a higher exemption, they are limited in numbers and their application. Currently, only 17 estate and gift tax treaties exist and almost all are with European countries.

Estate Tax Return

Many executors or heirs are further surprised that the decedent's U.S. assets will be effectively tied up until IRS determines that all tax obligations have been met and issues a transfer certificate permitting the custodian to release the assets. To get the certificate, the estate executor must file an Estate Tax Return (Form 706-NA) within nine months (not including extensions) of the date of death with information on their worldwide assets. Once filed, it can take several months if not years to resolve these matters, depending on the complexity of the estate assets. During this period, the estate may also find itself having to file a U.S. income tax return to report U.S. source income generated on the assets.

Planning Ahead

For a non-U.S. citizen, the first issue is to determine domicile status as best as possible. Once determined, several options can provide adequate protection. For example, holding assets through a non-U.S. entity; using an irrevocable trust; or hedging the risk with life insurance. Any strategy should factor in the circumstances of the respective family members, long-term goals and potential income tax considerations. As with any plan, early implementation is key.

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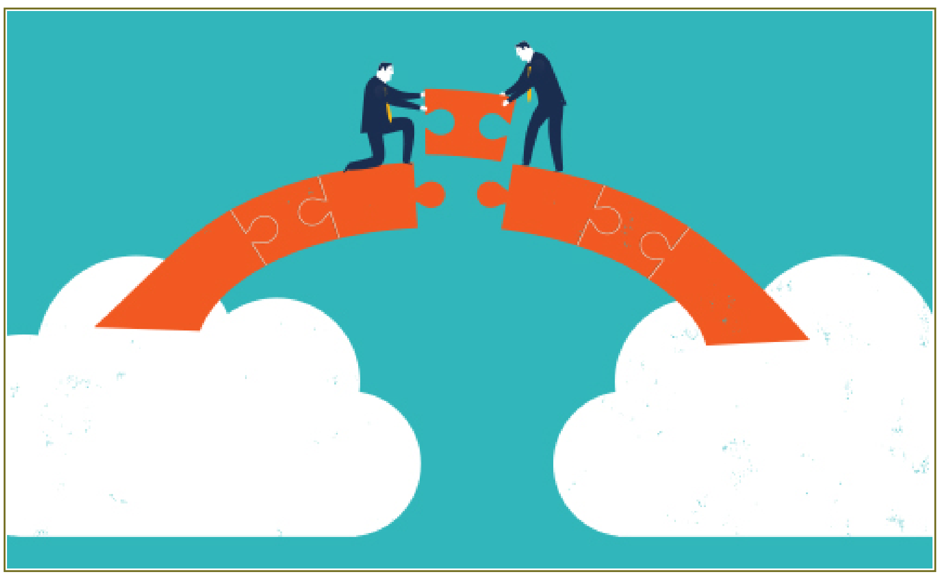
U.S. Federal Tax Treatment of Digital Content and Cloud Transactions – A Moving Target?



Treasury and IRS proposed regulations addressing the federal income tax treatment of cloud and digital content transactions for the first time.

The proposed regulations specify how cloud and digital content transactions should be classified and sourced, which is used to determine whether such transactions are treated as effectively connected income subject to U.S. taxation. Questions arising from the proposed regulations include how general sourcing rules specifically apply to cloud and digital content transactions and whether it is legally permissible for the U.S. to determine the taxable situs of digital content based on the location where it is downloaded.

There are currently no U.S. laws that specifically address the tax treatment of digital content accessed through the cloud. To remedy this lack of guidance, Treasury and IRS released proposed regulations in August that would provide the first update to a rule adopted in 1998 addressing the tax treatment of computer programs. While adopting a policy on the tax treatment of cloud transactions is an important step forward, the proposed regulations raise significant policy and compliance questions for both U.S. and foreign taxpayers.

The bulk of the proposed regulations address whether a cloud transaction should be classified and sourced as either (1) a lease of computer hardware, digital content or similar resources, or (2) a provision of services. Cloud transactions generally involve access to property or use of property, instead of a sale, exchange, or license of property. As a result, the transactions would typically be classified as either a lease of property or provision of services.

How cloud transactions are classified is important because it dictates the taxing jurisdiction to which the revenue from the transaction is sourced and subject to tax. The Internal Revenue Code generally sources rents and royalties to where the leased or licensed property is used. Services are generally sourced to where the services are performed. The source of sales of inventory may depend on where title passes.

For foreign taxpayers conducting transactions with U.S. customers, the source and classification of cloud and digital content transactions may impact whether income from such transactions is treated as *effectively connected income* subject to U.S. taxation. It may also trigger withholding requirements for U.S.-based digital platforms that sell items created by foreign individuals or businesses.

For example, assume a U.S.-based company operating a website offering users a selection of designs to be applied to t-shirts or coffee mugs obtains its designs from artists in other countries. To protect itself from claims arising from the content of the designs, the company does not purchase the designs. Instead, it pays the artist a royalty. For each sale, the U.S. company would be required to withhold 30% of the royalty paid to the artist.

One aspect of Treasury and IRS's proposed regulations that has produced uncertainty is that they stop short of explaining how or if the general sourcing rules would apply to cloud transactions. It is possible that Treasury and IRS may consider proposals emerging from other countries to source cloud transactions based on the location of servers, where the services are consumed or some combination of factors. Proponents of these measures say that such a levy is needed because their country's tax regimes are geared toward imposing tax on businesses with buildings, equipment and employees within their borders. These tax systems are not equipped to deal with cloud transactions and therefore allow digital behemoths such as Facebook or Google, which are able to maintain a virtual presence, to escape paying their fair share of taxes, proponents argue.

But opponents of this approach point out that the current law in most countries dictate that a business have a *permanent establishment* within a country's borders before it can become subject to the nation's income tax. Among the standard criteria used in most countries for permanent establishment are that the company has a fixed place of business, address, bank account or other physical presence within the country's borders.

Another aspect of the proposed regulations that has raised questions are the sourcing rules for copyrighted articles, such as digital books, music, or movies sold through an electronic medium. The proposed regulations would deem these sales to occur at the location of the download or installation onto the end-user's device.

Sale Occurs at Location of Download

Under the proposed rule, a company that is based in France that sells video games on a digital platform and has no buildings, equipment, employees or other physical presence in the U.S. would be subject to U.S. federal income tax on sales of video games downloaded within the U.S. The French company would then need to determine whether they are engaged in a U.S. trade or business and therefore taxable on U.S.-sourced sales income.

The proposed tax treatment of these transactions contravenes the guiding U.S. law established in this area. Since the 1940s, the situs of a taxable transaction is where the production took place. The principle was established in the seminal case of *Piedras Negras Broadcasting Co. v. Commissioner*, 127 F.2d 260 (5th Cir. 1942). In the facts of that case, a Mexican radio station broadcasted from Mexico (with its broadcasting facilities and other property in Mexico). The station's programming was targeted at U.S. listeners and 95% of the station's income came from U.S. advertisers. The radio station met with advertisers and received mail in the U.S. The court ruled that the source of the income is the situs of the income-producing service.

The repeated use in the statute of the words "within" and "without," the court found, suggests that sourcing determinations are based on a physical presence, with some tangible and visible activity. The court reasoned that if income is produced by the transmission of electromagnetic waves that cover a radius of several thousand miles, free of control or regulation by the sender from the moment of generation, the source of that income is the act of transmission. All of the radio station's broadcasting facilities were situated outside of the U.S. and all of the service it rendered in connection with its business were performed in Mexico. As a result, the court concluded that the advertising revenues were not subject to U.S. tax because the transactions were deemed to have occurred in Mexico.

The proposed rule would also likely bring compliance headaches to businesses operating digital platforms. Instead of sourcing income based on the location where the product was produced, they would be required to track the locations of each download.

Demise of Physical Presence Standard at State Level

While physical presence has long been the standard for federal income tax purposes, it recently met its demise in the state tax arena. For more than 50 years, U.S. Supreme Court precedent required that a seller have property, employees or some other physical connection to a state before the state could require the seller to collect and remit sales tax. As internet commerce grew, several states enacted statutes asserting the right to impose tax on out-of-state sellers solely based on their level of economic activity within the state's borders. One of these states was South Dakota, which enacted a statute requiring an out-of-state seller to collect sales tax on a prospective basis if the seller (1) had gross revenue from the sales of taxable goods and services in South Dakota exceeding $100,000; or (2) sold taxable goods and services for delivery in South Dakota in 200 or more separate transactions.

In 2018, the U.S. Supreme Court in *South Dakota v. Wayfair* upheld the South Dakota law against a taxpayer's claim that it was unconstitutional because it lacked a physical presence requirement. The court found that the statute did not violate the Interstate Commerce Clause of the U.S. Constitution. Since *Wayfair* was decided many states have adopted statutes similar to South Dakota's for sales tax. In addition, several jurisdictions are considering a similar standard for income tax.

The Takeaway

The bulk of the regulations proposed by Treasury and IRS address whether a cloud transaction should be classified and sourced as either a lease or a provision of services. However, the proposal stops short of providing guidance on how the general sourcing rules should specifically apply to cloud transactions. Another problematic aspect of the proposal is that it fixes the situs of a sale of a copyrighted article, such as an electronic book, song or movie to the location where the download took place. This policy would contravene a long-standing U.S. policy of determining the source of income based on a physical presence or location where the production took place. If adopted, the rule would create compliance challenges for digital companies who would be required to move away from sourcing income based on where the product is produced and toward tracking each location where the product is downloaded or consumed. While controversial, the proposed rule is consistent with tax policies emerging in Europe and adopted by most states in the U.S., but it is unclear what the final result will be. As the U.S. and other countries try to update their tax laws to match current technologies and business practices, uncertainty may be the only thing that is guaranteed.

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Business Interest Limitation Relief: Electing Real Property Trade or Business

The Tax Cuts and Jobs Act of 2017 (TCJA) amended Internal Revenue Code Sec. 163(j) to include new rules that potentially limit the ability to deduct business interest expense.

These new rules are in effect for tax years beginning after December 31, 2017. With limited exception, this potential limitation applies to all taxpayers. In general, a taxpayer's business interest expense is now limited to the sum of (1) business interest income, (2) 30% of Adjusted Taxable Income (ATI), and (3) the taxpayer's floor plan financing interest.

For most taxpayers, ATI is calculated by taking taxable income before any limitations imposed under Sec. 163(j), and adding back business interest expense, depreciation expense, and amortization expense. There are several other adjustments that are beyond the scope of this article. We examined in greater detail these calculations in a previous volume of For The Record. For tax years beginning after 2021, depreciation and amortization expense are not added back in the calculation of ATI. This will increase the potential for a business interest limitation under Sec. 163(j). To the extent business interest expense is limited, a carryover is permitted to future years. Any carryover amount is subject to the same potential limitations described above.

Exception for Electing Real Property Trade or Business

Fortunately, there is a potential exception to Sec. 163(j) that benefits Real Property Trades or Businesses (RPTB) known as an electing RPTB. An electing RPTB is any trade or business described in Sec. 469(c)(7)(C) that makes a binding election under Sec. 163(j)(7)(B). Section 469(c)(7)(C) includes real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business. This definition includes trades or businesses that involve operating or managing a lodging facility.

The election under Sec. 163(j)(7)(B) to be an electing RPTB that is excluded from the business interest limitation is made by attaching a statement to the taxpayer's timely filed original income tax return, including extensions. A taxpayer can incorporate multiple trade or business elections on a single statement. This election is irrevocable and applies to the tax year in which it is made and all subsequent tax years. An election made by a partnership doesn't apply to trades or businesses conducted by a partner outside the partnership. This election terminates if the taxpayer no longer participates in the electing trade or business. In order to terminate, the taxpayer must sell or transfer substantially all the assets of the electing trade or business to a non-related party. IRS has included anti-abuse rules that prevent a taxpayer from attempting to terminate the election through a transfer with the intent of re-acquiring the assets in a similar trade or business.

An electing RPTB is required to use the alternative depreciation system (ADS) to depreciate its non-residential real property, residential rental property and qualified improvement property. Under ADS, assets are depreciated straight-line over a longer recovery period than the general depreciation system (GDS). Currently, the ADS recovery period for non-residential real property is 40 years as compared to 39 years under GDS and the ADS recovery period for residential rental property is 30 years as compared to 27.5 years under GDS. Any newly acquired property that is required to be depreciated under the ADS system is not eligible for the bonus depreciation deduction under Sec. 168(k).

The change to ADS is considered a change in use as described in Sec. 168(i)(5) and not a change in accounting method. For property placed in service before the election year, the remaining tax basis in the asset is depreciated straight-line over the remaining life of the asset as if it had originally been placed in service with the longer ADS life. For existing property, the additional first-year bonus depreciation deduction allowable under Sec. 168(k) for that property is not recalculated.

IRS has included anti-abuse rules preventing certain RPTBs from taking advantage of this exception. A trade or business isn't eligible to be an electing RPTB if at least 80% of the real property's fair market value is leased to a trade or business under common control. Common control occurs when 50% of the direct and indirect ownership interests in both trades or businesses are held by related parties as described in Sec. 267(b) and Sec. 707(b). These anti-abuse rules do not apply to real estate investment trusts (REITs) that lease qualified lodging facilities and qualified health care properties to a taxable REIT subsidiary.

Example: Newly Acquired Property

A taxpayer operates a single rental real estate business. The taxpayer placed a commercial office building into service on January 1, 2018 that has a cost basis of $6,500,000. In 2018, the taxpayer has taxable income of $50,000, which includes business interest expense of $150,000 and GDS depreciation expense of $159,965. Under Sec. 163(j) limitations, the business interest expense for 2018 is limited to only $107,990, making the taxpayer's taxable income for 2018 $92,010.

Taxable Income	50,000
Add: Business Interest Expense	150,000
Add: Depreciation Expense	159,965
Adjusted Taxable Income	359,965
30% Limitation	107,990
Disallowed Business Interest Expense	42,010
2018 Taxable Income	**92,010**

If the taxpayer elects to be an electing RPTB in 2018, the business interest expense would no longer be limited. However, the depreciation expense for the year would be slightly lower since the building must be depreciated using ADS. The ADS depreciation expense for the year is $155,740. In this situation, the taxpayer's taxable income for 2018 is $54,225.

Taxable Income (Pre-Depreciation Expense)	209,965
ADS Depreciation Expense	(155,740)
2018 Taxable Income	**54,225**

By making the election, the taxpayer can reduce taxable income by $37,785.

The Takeaway

The TCJA significantly complicated the business interest limitation. Taxpayers who have RPTBs with business interest limitations should consult with their tax advisors about the benefits of making this election.

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