Manufacturers Beware: The Impact of Stricter 163(j) Deductibility Amid Rising Interest Rates

Nov 17, 2023

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Blogs
Tax Law Defined™ Blog

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The Tax Cuts and Jobs Act of 2017 (TCJA) introduced significant changes to the deduction of business interest expenses under Section 163(j) of the Internal Revenue Code.[1] Since 2022, these changes have been further amplified in ways that disproportionately affect manufacturers due to their capital-intensive investments, as well as many other businesses that rely on debt financing along with associated interest expense deductions.

History

In 2017, the TCJA expanded the scope of Section 163(j) to encompass all businesses, with certain exemptions.[2] The maximum deduction allowed for business interest became restricted to the *sum* of:

- The taxpayer's business interest income for the tax year;
- 30% of the taxpayer's adjusted taxable income (ATI) for the tax year; [3] and
- Floor plan financing interest expenses.

ATI is a modified calculation of taxable income involving the exclusion of specific items such as income or loss that cannot be attributed to a trade or business, business interest income, business interest expense (excluding disallowed carryforwards), net operating loss deductions, and deductions related to qualified business income, among others.

Before 2022, ATI closely resembled the concept of EBITDA (earnings before interest, taxes, depreciation, and amortization). This was because Section 163(j) provided that depreciation, amortization, or depletion expenses capitalized to inventory before January 1, 2022, are "added back" to taxable income regardless of their later recovery through cost of goods sold. However, the transition to

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2022 marked a notable shift in ATI as the "add-back" no longer applied after January 1, 2022, making the ATI more aligned with EBIT (earnings before interest and taxes).[4]

Impact and Industry Concern

The shift from EBITDA to EBIT as the basis for ATI and the Section 163(j) interest expense deduction significantly impacts taxpayers operating in the manufacturing, distribution, and other inventory-focused sectors who effectively operated with an EBITDA-based calculation. Moreover, this change also impacts those taxpayers making capital expenditures with a useful life of more than one year, as the inability to include depreciation and amortization in the calculation reduces the amount of deductible interest.

According to a recent analysis conducted by Ernst & Young and commissioned by the National Association of Manufacturers (NAM), this change predominantly affects industries such as manufacturing, information, transportation, and mining, accounting for approximately 77% of the disallowed interest expense.

One striking finding from the NAM analysis is that the impact of the stricter Section 163(j) limitation has almost doubled in the past year due to the continuous rise in interest rates resulting in a higher cost of capital and reduction in investment. The data indicates that restricting manufacturers' ability to deduct interest on debt-financed investments may potentially cost the U.S. economy up to 867,000 jobs, $58 billion in employee compensation, and $108 billion in GDP (before market adjustments), making a strong case for policy changes.[5]

Planning Ahead

Given the more stringent Section 163(j) interest expense deduction limitation, businesses should proactively plan for the implications of the rise of interest rates in their year-end planning meetings, especially if they operate in industries heavily reliant on interest deductions. Similarly, organizations that depend on debt for capital expenditures or inventory purchases should consider alternative financing options such as preferred equity to reduce their reliance

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on interest deductions.

There are exemptions for small businesses, real property, and/or farming under Section 163(j), and companies should evaluate whether they qualify for an exemption. . Companies should also assess the size of their interest expenses and consider recharacterizing interest to other expense categories, such as research and development, construction, or acquisition of property.

In conclusion, the stricter interest deductibility limitation introduced in 2022 has far-reaching implications for the manufacturing industry and the broader economy. If you would like to gain deeper insights into how the Section 163(j) interest expense deduction limitation might affect your business and explore potential tax planning strategies, we encourage you to reach out to the authors of this article or connect with any member of Frost Brown Todd's Tax Practice Group.

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[1] Any references to "Code" or "Section" shall mean that section of the Internal Revenue Code of 1986, as amended.

[2] Exemptions include small businesses with average annual gross receipts for three prior years that do not exceed $29 million (for 2023), activities not classified as a trade or business, electing real property trade or business entities, and electing farming businesses that use the alternative depreciation system for certain property types. These exemptions are subject to their own respective requirements.

[3] Notably, the 30% ATI limitation temporarily increased to 50% for the 2019 and 2020 tax years under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, only to revert to the 30% limitation for the 2021 tax year.

[4] I.R.C. Section 163(j)(8)(A)(iv).

[5] While there have been initiatives, such as the proposed Build in America Act (H.R. 3938), aimed at reinstating the EBITDA regime for calculating ATI and offering retroactive relief until 2026, as of the date of this article, no initiatives have been enacted under law.

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