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The OBBBA Changes the Capitalized Interest Rules Under §163(j)

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Sam Pollack, a partner in Baker McKenzie's Chicago office, reviews the three major changes to §163(j) in the One Big Beautiful Bill Act.

The One Big Beautiful Bill Act ("Act") makes three major changes to the interest deduction limitation provision of §163(j). Pub. L. No. 119-21, §70303, §70341 (July 4, 2025), applicable to taxable years beginning after December 31, 2024. This article reviews the three changes and then focuses on the new rule for capitalized interest.

As background, §163(j) was enacted as part of the Tax Cuts and Jobs Act of 2017, and generally limits a taxpayer's deduction from business interest expense to 30% of the taxpayer's adjusted taxable income (ATI). This article refers to the amount of business interest that a taxpayer is permitted to deduct under §163(j) as its "§163(j) Limitation." For pre-2022 taxable years, ATI was computed in a manner similar to earnings before interest, tax, depreciation and amortization (i.e., EBITDA). However, §163(j) included a built-in provision that, for years beginning after December 31, 2021, included depreciation and amortization in the ATI computation, thereby reducing taxpayers' ATI and §163(j) Limitation.

Furthermore, when enacted, §163(j) was silent with regard to the treatment of inclusions from a US shareholder's controlled foreign corporations (CFCs) and whether those inclusions ("CFC Inclusions") counted to increase ATI. Treasury determined that CFC Inclusions are not generally included in ATI, but

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permitted US shareholders making a "CFC Group" election to include CFC Inclusions in ATI to the extent of the CFC Group's excess §163(j) Limitation.

Two of the Act's three major changes relate to the computation of ATI. First, benefiting taxpayers, the ATI computation permanently excludes depreciation and amortization. Second, harming taxpayers, the Act expressly excludes CFC Inclusions from ATI. That is, making a CFC Group election no longer gives a US shareholder access to its CFCs' excess §163(j) Limitation. The focus of this article, however, is on the third major change to §163(j): the change to the treatment of capitalized interest expenditures.

In general, prior to the Act, a taxpayer could gain access to some relief from §163(j) by capitalizing interest expenditures and, later, reducing taxable income in a manner not subject to §163(j). For example, interest capitalized into inventory could be benefited as COGS, and interest capitalized into the basis of business property could be benefited as depreciation / amortization deductions. The Act limits a taxpayer's ability to gain such relief from §163(j) by subjecting capitalized interest to §163(j).

The Act generally treats capitalized interest as interest expense for the purpose of applying §163(j). Thus, for example, if in 2026 a taxpayer has: (i) a §163(j) Limitation of $100x; (ii) $70x of interest expense, and (iii) $50x of capitalized interest, §163(j) applies to the taxpayer for 2026 because total capitalized interest and interest expense exceed $100x.

Applying §163(j) to both interest expense and capitalized interest, the statute's limitation first applies to disallow the taxpayer's deduction for interest expense and then applies to reduce capitalization of interest. Thus, in the example above, the taxpayer's deduction from interest expense is reduced from $70x to $50x and the taxpayer's capitalized interest remains at $50x.

Consider an alternative scenario, when, in 2026 a taxpayer has: (i) a §163(j) Limitation of $100x, (ii) $10x of interest expense, and (iii) $150x of capitalized interest. In this scenario, the taxpayer's $10x of interest expense is disallowed and $50x of the taxpayer's interest expenditure is not permitted to be capitalized. What happens to the $50x of interest expenditure that the taxpayer is not permitted to capitalize (or deduct)? That amount is carried forward and treated, for carryforward purposes, as an interest expense. In this regard, there are certain instances in which §163(j) may actually accelerate a taxpayer's deductions from interest. Returning to the example above, assume that capitalized interest is capitalized into property that amortizes ratably over a period of ten years. Assume further that, in 2027, the taxpayer has no interest expense or capitalized interest, and the same §163(j) Limitation ($100x). If §163(j) did not exist, in 2026, the taxpayer would have (at most) $25x of deductions from interest ($10x of interest expense and $15x from amortization of capitalized interest), and, in 2027, the taxpayer would have $15x of deductions (all from amortization of capitalized interest). Under amended §163(j), however, in 2026, the taxpayer has $10x of deductions from interest ($0 of interest expense and $10x from amortization of capitalized interest), and, in 2027, the taxpayer has $60x of deductions ($0 from interest expense, $10 from amortization of capitalized interest, and $50x as a §163(j) carryforward treated as interest expense). Treasury may seek to alter this outcome in regulations, but such regulations would appear to run right up against relatively clear directions from the statute.

As much fun as this provision has been, we come back down to earth with the last operative rule relating to capitalized interest. This change kicks out interest capitalized under §263(g) and §263A(f) from the definition of "business interest." In other words, so long as interest is capitalized under those provisions, §163(j) does not apply to such capitalized interest. Thus, for example, if a taxpayer is required to capitalize an interest expenditure into inventory under §263A(f), such capitalized interest is not subject to §163(j). As a result, the capitalized interest rule focuses, for the most part, on interest capitalized under §263(a) (e.g., overhead costs related to the acquisition or production of tangible property) and §266 (interest that a taxpayer elects to capitalize as a carrying charge with respect to property).

As a parting thought to ponder, consider a situation in which a taxpayer has: (i) $100x of interest expense paid to related foreign persons, (ii) $100x of capitalized interest from payments to unrelated parties, and (iii) a §163(j) Limitation of $100x. As discussed above, in this scenario, the $100x of interest expense (paid to foreign related persons) is disallowed, and the $100x of capitalized interest is capitalized. For BEAT (§59A) purposes, in a subsequent year, when the $100x of §163(j) carryforward from the disallowed interest expense is allowed as a deduction, is there a base erosion tax benefit of $100x or of $0?

On one hand, the taxpayer actually deducts $100x of interest expense relating to a payment made to related foreign persons. On the other hand, §59A(c)(3) says "in the case of a taxpayer to which §163(j) applies for the taxable year, the reduction in the amount of interest for which a deduction is allowed by reason of such subsection shall be treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to such related parties." Under the Act, §163(j) applies to the $200x of interest paid by the taxpayer, reducing the amount of interest for which a deduction is allowed (withing the meaning of §163(j)(1)) from $200x to $100x. For BEAT purposes, the $100x reduction is allocated to interest paid to persons who are not related parties. Thus, even though the actual interest expense with respect to which a deduction is disallowed by §163(j) is an expense from interest paid to related foreign persons, §59A(c)(3) would appear to allocate the disallowance (for BEAT purposes) to the interest paid to unrelated parties. Under this interpretation, for BEAT purposes, the §163(j) carryforward would appear to be a carryforward of interest paid to an unrelated party that does not give rise to a base erosion tax benefit.

Relevant to this consideration, the Act directs Treasury to "issue such regulations or guidance as may be necessary or appropriate to carry out the purposes of [§163(j)], including regulations or guidance to determine which business interest is taken into account under [§163(j) and §59A(c)(3)]." It is unclear what exactly Treasury is being directed to do, and it will be interesting to track the commentary that surely will be authored in the coming months that will seek to parse this Congressional instruction to Treasury.

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