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New Limitation on Business Interest Deductibility

In this article Jon Brose Tax Partner at Seward & Kissel, LLP, New York and Brett Cotler, Tax Associate at Seward & Kissel, LLP, New York share their views on new limitations for business interest deductibility for hedge fund managers.

The Tax Cuts and Jobs Act of 2017[1] (the "Tax Act") limits the deductibility of business interest paid by US businesses. This change in law will impact businesses that rely on debt-financing and that have three-year average gross receipts in excess of $25 million. This business interest limitation may impact M&A, private equity and other potential tax planning opportunities.

Under current law, certain highly leveraged corporations may not deduct interest expense that is "disqualified interest" (the "earnings stripping rules").[2] Congress enacted the earnings stripping rules to curb businesses' excessive use of debt in their capital structures. The Tax Act replaces the earnings stripping rules with new rules governing business interest expense deductibility.[3]

The business interest limitation applies to both corporate and non-corporate taxpayers. Where a partnership has business interest expense, the determination of whether such interest is subject to the business interest limitation is made at the partnership level.[4]

Business interest expense will be deductible only to the extent of business interest income plus 30% of "adjusted taxable income".[5] Adjusted taxable income is taxable income computed without regard to non-business income and without regard to certain deductions; this provision is intended to get to EBITDA.[6] Business interest expense means interest that is not "investment interest"[7] and is paid or accrued on debt properly allocable to a trade or business.[8] Similarly, business interest income means interest income that is not "investment income"[9] and that is properly allocable to a trade or business.[10]

For these purposes, a trade or business will not include, among several others, certain electing real estate businesses and regulated public utilities, which includes certain midstream oil and gas pipeline companies.[11] Therefore, these businesses would not be subject to the business interest limitation and may continue to offer debt-financing opportunities to investors.

While several types of business will not be subject to the business interest limitation, there may be fewer debt-financed M&A transactions since the cost of such debt-financing may be greater than under current law because of the disallowed interest expense deductions. In addition to more equity in deals, there may also be more transactions that utilize financial products that are economically equivalent to debt but give rise to deductible non-interest payments.

In addition to impacting M&A activity, the business interest limitation may increase the overall effective tax rate applicable to certain "leveraged blocker" structures used in private equity. However, private equity may continue to utilize leverage blockers structures because the lost benefit from the interest deductions by the blocker may be offset by the corporate income tax rate reduction.

Lastly, companies with excessive debt should discuss tax planning strategies with their tax advisers. Strategies worth consideration include increasing business interest income by converting non-interest bearing assets into interest bearing assets. This will increase the interest limitation and allow greater amounts of business interest deductions. Conversely, companies may be able to restructure their own debt into financial instruments that give rise to non-interest expense, which would not be subject to the business interest limitation. Either strategy, if available, can lessen the impact of the business interest limitation.

1 An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, H.R. 1.
2 I.R.C. § 163(j). Under I.R.C. § 163(j)(3), disqualified interest includes interest that is paid or accrued by the taxpayer to certain related persons if no tax is imposed on such interest payments and interest paid or accrued by a taxable REIT subsidiary to the parent REIT. In addition, disqualified interest includes interest paid to a person that is not a related person if there is a disqualified guarantee of such debt and no gross basis tax with respect to such interest payments is not subject to U.S. federal income taxation. Unless an exception applies, a disqualified guarantee means a guarantee by a related person by a related person that is exempt from U.S. federal income taxation or is a non-U.S. person.
3 § 13301 of the Tax Act.
4 I.R.C. § 163(j)(4) as amended by §13301(a) of the Tax Act.
5 The limitation on deductibility of business interest expense also takes into account any floor plan financing interest of the taxpayer.
6 I.R.C. § 163(j)(8) as amended by §13301(a) of the Tax Act. Adjusted taxable income means the taxpayer's taxable income without taking into account (i) items of income, gain, deduction, or loss that are not properly allocable to a trade or business, (ii) any business interest or business interest income, (iii) NOLs, (iv) the amount of any deduction allowed under Section 199A, and (v) in the case of tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion. The IRS may propose regulations to exclude other items of income, gain, deduction or loss for purposes of computing adjusted taxable income.
7 I.R.C. § 163(d)(3). Investment interest is any interest that is paid or accrued on any debt that is properly allocable to property held for investment.
8 I.R.C. § 163(j)(5) as amended by §13301(a) of the Tax Act.
9 I.R.C. §163(d)(4).
10 I.R.C. § 163(j)(6) as amended by §13301(a) of the Tax Act.
11 I.R.C. § 163(j)(7) as amended by §13301(a) of the Tax Act.

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