Tax Cuts and Jobs Act
New Limitation on Interest Expense Deduction

On December 20, 2017, both houses of Congress passed the Tax Cuts and Jobs Act (H.R. 1). The bill is expected to be signed into law by President Trump in the coming days.

Among the extensive changes to U.S. federal income taxation contained in the legislation is a new limitation on the deductibility of net business interest expense that exceeds 30% of a taxpayer's "adjusted taxable income." The new limitation, which will replace the existing "earnings stripping" rules of Section 163(j) of the Internal Revenue Code, generally applies to all debt incurred by a taxpayer, including third-party debt. In this regard, the new limitation is far more sweeping than the existing earnings stripping rules, which generally apply only to related-party debt and certain third-party debt guaranteed by foreign affiliates of the taxpayer.

The new limitation generally applies to corporations and partnerships with respect to taxable years beginning after December 31, 2017, with no grandfathering for existing debt. Any interest expense disallowed under the limitation may be carried forward indefinitely.

I. Overview of New Limitation

1. Net business interest expense. The 30% limitation applies only to *net* business interest expense, i.e., the excess of business interest expense over business interest income. For taxpayers such as banks that generally earn business interest income in excess of business interest expense, the limitation is unlikely to have a meaningful impact.

2. Adjusted taxable income. The limitation is based on "adjusted taxable income." For taxable years beginning before January 1, 2022, "adjusted taxable income" will be roughly equivalent to a taxpayer's EBITDA.[1] For subsequent taxable years, "adjusted taxable income" will no longer include an add-back for depreciation and amortization. Thus, absent a further change in law before 2022, the new limitation may become much more severe in 2022.

3. Partnerships. The limitation for partnerships is applied at the partnership level. To the extent that the partnership's business interest expense is less than the limit, the partners may be entitled to use the excess limitation in determining their allowable deduction for their separate, non-partnership interest expense.

4. Exceptions. Real property businesses may elect out of the limitation. In addition, the limitation does not apply to small businesses with average gross receipts of $25 million or less, or to regulated public utilities. The limitation also does not apply to interest on certain indebtedness used to finance the acquisition of motor vehicles held for sale or lease.

[1] "Adjusted taxable income" is taxable income of the taxpayer computed without regard to (i) items of income, gain, deduction, or loss not properly allocable to a trade or business, (ii) business interest expense or business interest income, (iii) any net operating loss deduction, (iv) any deduction allowed under Section 199A for qualified business income of pass-through businesses, and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.

II. Observations

1. Anticipated impact of new limitation. It is too soon to predict the impact of the new rule on LBOs and other financing transactions. Although the new rule may result in a significant disallowance of interest expense, the impact of such disallowance may be relatively muted to the extent that we remain in a low interest rate environment.

2. Multinational groups. In establishing the capital structure of a multinational group, it might be more efficient to incur debt at non-U.S. members of the group where a larger tax deduction would be available under the laws of a non-U.S. jurisdiction compared to the tax deduction available for U.S. tax purposes. Other provisions of the tax reform legislation that would reduce the effective U.S. tax rate of corporate taxpayers, such as the reduction of the U.S. corporate income tax rate to 21% and the allowance of the immediate deduction of the cost of tangible property, would further reduce the value of an interest expense deduction in the United States.

3. Debt v. equity financing. In cases where the new limitation would defer all or a significant portion of a taxpayer's interest expense, the use of preferred equity might be more efficient than debt financing. In making that evaluation, the tax profile of the expected lenders/holders would need to be considered, including whether dividends on preferred equity would attract withholding tax.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Craig M. Horowitz at 212.701.3856 or chorowitz@cahill.com; or Aliza R. Levine at 212.701.3524 or alevine@cahill.com.