Chapman and Cutler LLP

Chapman Client Alert

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The Proposed Limitations on Deduction of Interest Could Change Funding Choices

The recently released "Unified Framework for Fixing Our Broken Tax Code" includes a proposed limitation on the deductibility of interest expense by corporations. Although this framework does not provide details as to the nature or scope of the proposed limitations, any such limitations will potentially affect the balance in preferences between debt and equity funding.

The current legislative outlook of this proposal is uncertain, but the proposed limitation of the corporate interest deduction has now been raised multiple times.

Current Preference for Capitalization with Debt

Currently, interest is generally deductible by a business in the calculation of its taxable income. However, the Code imposes various limitations on deductibility, such as when the interest is paid to a related non-U.S. person, if a guarantee is made by an exempt or non-U.S. person, or if interest is paid by a taxable REIT subsidiary to the REIT. Separately, interest may be recharacterized as non-deductible dividends to the extent the accrual rate of the original issue discount exceeds certain levels (or if the debt instrument is recharacterized as equity under general tax principles). In addition, deductions for interest paid to a related person are generally limited to the amount of interest that an unrelated person would have charged.

Assuming that interest is not subject to these or other limitations or recharacterizations, under current law interest expense would reduce the taxable income of the debtor corporation. Other than in the case of tax-exempt or non-U.S. lenders, the interest is generally included in the taxable income of the lender. In contrast, under current law dividends are not deductible (other than for certain specialized entities such as REITs and RICs). This distinction means that, from the borrower's perspective, there is currently a tax incentive to borrow rather than raise capital through equity contributions (assuming both were demanding the same rate of return). If equity demands a higher rate of return, the cost of equity increases by the incremental amount of non-deductible cash distributions. Current law allows U.S. corporations a partial or complete exclusion of most dividends from taxable income.

The Proposal

There are few details about the current proposal, but the details available indicate that the corporate interest deduction would be limited and the immediate deduction of most capital expenditures would be permitted for at least five years. This latter change would accelerate deductions into the year of expenditure. Currently, after bonus depreciation, capital expenditures generally are recovered over the life of the property.

The proposal does not indicate whether expenses that are economically interest equivalents will be treated as interest and subject to the limitation.

Planning Ahead

Looking forward, these proposals, if enacted, would change the analysis for both capital users and capital providers. Capital users would need to do an economic cost comparison of comparable debt and equity financing. In addition, financing that is similar to borrowing but is not treated as indebtedness for tax purposes, such as operating leases and, in the case of financing of securities, total return swaps and other derivatives, may have a more favorable after-tax cost than the equivalent debt. Capital providers would need to put greater emphasis on their own tax analysis and non-tax factors in determining which method of financing is most appropriate. U.S. capital providers may prefer dividends to interest and derivatives income, and non-U.S. capital providers may prefer interest and derivatives income to dividends.

Indeed, the finance market will almost certainly adjust to this change in the U.S. tax treatment of interest. Lenders will offer, and debtors will seek, financing structures that do not have an economic rationale under the existing tax laws. These structures will take advantage of tax laws in foreign jurisdictions which continue to allow interest as a deduction in calculating taxable income.

For More Information

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