COVID-19: LIMITATIONS ON INTEREST DEDUCTIBILITY BEFORE AND AFTER THE CARES ACT

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The Coronavirus Aid, Relief and Economic Security Act (the CARES Act), enacted on 27 March 2020 included a number of tax measures designed to address liquidity concerns for businesses. Some revisions directly unwound or temporarily limited revenue provisions originally included as offsets to the cost of implementing significant tax reform at the end of 2017 in the Tax Cuts and Jobs Act (the TCJA). Many of these provisions have retroactive effect.

Income tax can have a significant impact on the most fundamental of fundraising questions: whether to raise capital through debt or equity. Changes to the deductibility of interest in the TCJA changed the decision making process for many issuers and, while the CARES Act may provide a temporary reprieve for certain issuers, it did not address some limitations that may be more likely to apply (and often overlooked by taxpayers) in a low-interest rate, high-risk environment. This alert introduces how the Section 163(j) interest deduction limitations based on “adjusted taxable income” apply following the CARES Act and how certain historical interest deduction limitations left unchanged by the CARES Act may become more relevant in the marketplace.

THE SECTION 163(J) LIMITATION

TCJA Implementation

Prior to the TCJA, taxpayers were generally entitled to deduct business interest expense without regard to their income. Following the TCJA, a taxpayer’s business interest expense deductions were limited to the sum of: (1) the taxpayer’s business interest income and (2) 30 percent of the taxpayer’s “adjusted taxable income” for the taxable year (the Section 163(j) limitation). For this purpose, “adjusted taxable income” is defined to be taxable income without regard to interest, net operating loss deductions, and, for taxable years beginning before January 2022, any deductions for depreciation, amortization, or depletion. While each of these items is computed using federal income tax accounting methods, “adjusted taxable income” can generally be thought of, for taxable years beginning before 2022, as a tax equivalent to the financial accounting concept of earnings before interest, taxes, depreciation, and amortization, or “EBITDA.”

For taxable years beginning on or after 1 January 2022, the elimination of the add-backs for depreciation, amortization, and depletion, functionally a tax equivalent to the financial accounting concept of earnings before interest and taxes, or “EBIT,” may significantly bring down a taxpayer’s limitation. While regulations implementing the Section 163(j) limitation have not been finalized, proposed regulations provide certain structuring opportunities...
in connection with acquisitive transactions that may not limit certain of these add-backs on or after 1 January 2022.

Certain businesses are exempt from the application of the Section 163(j) limitation. These include certain real property businesses, farming businesses, and regulated utility businesses.⁵

The Section 163(j) limitation did not operate to eliminate any excess deductions for business interest expense and, therefore, any interest expense deductions disallowed by the limitation are carried forward indefinitely.⁶

CARES Act Modifications

The CARES Act significantly, but temporarily, modified the application of the Section 163(j) limitation. The resulting operation of the Section 163(j) limitation is a complex matrix of default rules, modifications by election, and alternative application depending on the tax classification of the issuer. In general terms:

- For taxable years beginning in 2019 and 2020,⁷ the new default rule takes into account 50 percent, rather than 30 percent, of the taxpayer's adjusted taxable income,⁸ unless the taxpayer elects otherwise; and
- For taxable years beginning in 2020, the default application of the Section 163(j) limitation takes into account the taxpayer's adjusted taxable income for the current year, but a taxpayer (including a partnership) can elect to calculate its Section 163(j) limitation using its prior taxable year's adjusted taxable income.⁹

Implications

A significant component of the application of the Section 163(j) limitation is the adjusted taxable income of the taxpayer, which component will directly relate to a taxpayer's earnings. In periods of stagnant or decreasing earnings, the Section 163(j) limitation may become more relevant for taxpayers, in particular for taxable years beginning on or after 1 January 2022, in which case a taxpayer cannot add back depreciation, amortization, and depletion when calculating the limitation.

It is possible that the increased limitation creates or increases a taxpayer's net operating loss for a taxable year beginning in 2019 or 2020. In those circumstances, what would have otherwise been an interest expense carryforward becomes a net operating loss that, under the CARES Act, may be carried back up to five years and result in early liquidity through tax refunds.

LIMITATIONS ON HIGH-YIELD DEBT, CORPORATE ACQUISITION DEBT, AND EQUITY-LINKED DEBT

AHYDO

The “applicable high yield discount obligation,” or “AHYDO,” rules limit the deductibility of interest expense on certain instruments that do not provide for current-pay interest. Where the AHYDO rules apply, they have two impacts: first, disallowing interest deductions attributable to yield on the instrument in excess of the “applicable federal rate” plus six percentage points and, second, deferring deductions for the balance of the interest accruals on the applicable instrument until actually paid.¹¹

The AHYDO rules apply to an instrument that: (1) is issued by a corporation,¹² (2) has a term to maturity of more than five years,¹³ (3) has a yield to maturity that is five percentage points or more in excess of the relevant applicable federal rate in effect on the issue date,¹⁴ and (4) that has “significant original issue discount.”¹⁵
or not a debt instrument has “significant original issue discount” is a complex question, but generally considers whether, at the closing of any accrual period after the fifth anniversary of the issue date, the aggregate accrued (and unpaid) yield on the debt instrument is in excess of the yield on the instrument in its first year.

Importantly, for purposes of determining whether an instrument has “significant original issue discount,” any payment made in the form of additional debt instruments (or added as additional principal amount of the existing debt) is assumed made only when such additional debt instrument is required to be paid in cash or property other than additional debt.16 As a result, instruments that are payable-in-kind implicate the AHYDO rules.

AHYDO Implications

The AHYDO rules were unchanged by the CARES Act.

In a low interest-rate environment, a debt instrument with an interest rate in excess of the applicable federal rate plus five percentage points may not immediately come to mind as an equity-like high-yield instrument potentially subject to interest deferral and disallowance. For example, the applicable federal rate for a seven-year debt instrument issued in May of 2020 is 0.58 percent.17 Further, in an environment where borrowers are considering options to manage liquidity needs, the pressure for alternative payment mechanics may increase the prevalence of payable-in-kind debt.

The most common practices to limit the application of the AHYDO rules to a debt instrument generally utilize limitations on the maturity of the instrument or mandatory prepayments. The AHYDO catch-up mechanic utilizes one or more prepayments on the debt such that, as of any testing date following the fifth anniversary of the issue date of the instrument, there have been sufficient cash payments on the debt such that the aggregate accrued but unpaid yield following such payment does not exceed the instrument’s first-year yield.

Where a subordinated debt instrument of an issuer could be subject to the AHYDO rules, a senior lender’s willingness to permit mandatory payments on junior debt impacts an issuer’s ability to avoid “significant original issue discount.” Similarly, the maturity date on a subordinated debt instrument is often intentionally set to follow the maturity date of more senior debt (usually by six months or more). Therefore, there may be instances where an issuer and a junior lender are unable to solve an AHYDO problem without bringing other stakeholders to the table. In a difficult economic climate, senior lenders may be less willing to permit AHYDO payments or may propose (additional) default or financial covenant tests for AHYDO payments. As a result, identifying AHYDO issues early can be critical to reaching an optimal result.

Corporate Acquisition Indebtedness

Interest on certain “corporate acquisition indebtedness” issued by a corporation in excess of $5 million per year is disallowed.18 For this purpose, “corporate acquisition indebtedness” is debt that is:

- Issued to provide consideration for the acquisition of either stock of another corporation, or pursuant to a plan of acquisition, at least two-thirds (by value) of another corporation’s business assets;19
- Either subordinated to the issuer’s trade creditors generally or “expressly subordinated” to any substantial amount of unsecured indebtedness;20
- Either convertible directly into stock of the issuer or part of an investment unit that includes an option to acquire stock of the issuer;21 and
- Issued by a corporation that, as of the last day of the taxable year in which the tested debt is issued, has a debt-to-equity ratio exceeding 2:1 or does not have projected earnings that exceed three times the annual interest to be paid or incurred.\(^{22}\)

Special rules apply to tax-deferred acquisition transactions, refinancings, foreign targets, and issuers that are members of an affiliated group of corporations.

**Corporate Acquisition Indebtedness Implications**

The corporate acquisition indebtedness rules of Section 279 were unchanged by the CARES Act.

Often, parties are not aware of the corporate acquisition indebtedness rules because of their limited applicability. However, the application of these rules can often be mitigated by mechanical changes that, with thoughtful design, do not meaningfully change the economics to the parties. For example, where equity upside can make financing more attractive, the outright issuance of common stock as part of an investment unit, rather than adding a convertibility feature or including a warrant, can be determinative for the application of this limitation.

**Equity-Linked Debt**

Section 163(l) disallows interest with respect to a “disqualified debt instrument” issued by a corporation.\(^{23}\) For this purpose, a “disqualified debt instrument” is debt payable in equity of the issuer or a related party or equity held by the issuer or a related party in another person.\(^{24}\) An instrument is considered to be “payable in equity” if:

- A substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into, such equity,
- A substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of such equity, or
- The instrument is part of an arrangement that is reasonably expected to result in a transaction described in (1) or (2) above.\(^{25}\)

**Equity-Linked Debt Implications**

The disqualified debt instrument rules of Section 163(l) were unchanged by the CARES Act.

Where borrower liquidity is a concern, alternative payment mechanics may involve the optional use of equity to satisfy debt. Importantly, this limitation on deductions for interest on a disqualified debt instrument does not require that the holder of the instrument have some sort of equity-based return.\(^{26}\) For example, an instrument is payable in equity where it can be satisfied with a variable amount of stock having a value equal to the principal or interest due. An instrument is also payable in equity where it is payable in a fixed amount of shares of stock. In the former scenario, the creditor has no upside potential.\(^{27}\)

No regulations addressing interpretive issues in this context have been issued. As a result, where alternative payment mechanics on a debt instrument involve the use of equity-linked payments, borrowers that are sensitive to the deductibility of interest should consult a tax advisor.

**FOOTNOTES**

\(^{1}\) Section references herein are to the Internal Revenue Code of 1986, as amended (the Code), and the treasury
regulations promulgated thereunder.

2 Certain “earnings stripping” limitations applied under former Section 163(j) for debt issued to, or guaranteed by, foreign affiliates.

3 Section 163(j)(1). Special rules beyond the scope of this alert apply to “floor plan financing indebtedness.”

4 Section 163(j)(8).

5 Section 163(j)(7). If a business is entitled to, and does, elect out of the application of the Section 163(j) limitation, that business is required to use certain less-favorable methods to depreciate its business property.

6 Section 163(j)(2). Complex rules apply to any disallowed interest expense carried forward, in particular for disallowed interest expense incurred by a partnership.

7 For taxpayers that are partnerships, this rule only applies for taxable years beginning in 2020. Section 163(j)(10)(A)(ii). Further, unless they elect otherwise, partners in partnerships that were allocated excess business interest expense for a taxable year that began in 2019 can deduct 50 percent of that excess in their first taxable year beginning in 2020 without taking into account their personal Section 163(j) limitation. Section 163(j)(10)(A)(ii)(II).

8 Section 163(j)(10)(A).

9 Section 163(j)(10)(B)(i). A special rule applies to prorate the prior taxable year's adjusted taxable income where the taxable year beginning in 2020 is a short taxable year. Section 163(j)(10)(B)(ii).

10 The Internal Revenue Service publishes the applicable federal rates each month. Section 1274(d)(1)(B). Instruments with a term over three years but not over nine years are subject to the federal mid-term rate. Section 1274(d)(1)(A). Instruments with a term over nine years are subject to the federal long-term rate. Id.

11 Section 163(e)(5).

12 Section 163(e)(5)(A). This limitation is subject to certain anti-abuse rules. Section 163(i)(5)(B).

13 Section 163(i)(1)(A).

14 Section 163(i)(1)(B).

15 Section 163(i)(1)(C).

16 Section 163(i)(3)(B). A payment in issuer stock is also not a payment for this purpose, and certain related party debt instruments and stock are also excluded from consideration as “property” for this purpose.


18 Section 279(a). The $5 million ceiling is reduced by interest deductions with respect to indebtedness incurred with the requisite acquisition intent but that is not corporate acquisition indebtedness. Section 279(a)(2).

19 Section 279(b)(1).

20 Section 279(b)(2). Express subordination includes subordination with respect to unsecured indebtedness that may be subsequently issued.

21 Section 279(b)(3). Note that this convertibility threshold is not met where an investment unit consists of a debt
instrument and a direct stock issuance.

22 Section 279(b)(4). The computation of the debt-equity ratio and the projected earnings is specially determined for purposes of Section 279 and beyond the scope of this alert.

23 Section 163(i)(1).

24 Section 163(i)(2). For this purpose, a related party is one specified in Section 267(b) or 707(b), which relationships are beyond the scope of this alert.

25 Section 163(i)(3).

26 An equity-based return would generally be within the scope of (2) above.

27 The creditor does retain downside equity risk in that there are circumstances where no number of shares could satisfy the outstanding principal and accrued interest, e.g., where the stock is worthless.

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