



Limits on Business Interest Deductions Under the Coronavirus Aid, Relief, and Economic Security (CARES) Act

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Thin capitalization rules, broadly, limit the amount of debt that can generate deductible interest for the purpose of calculating taxable income. Limits on the tax deduction for business interest restrictions have been relaxed by the [Coronavirus Aid, Relief, and Economic Security \(CARES\) Act](#) (H.R. 748, as amended) providing economic stimulus and relief for taxpayers due to the expected slowdown of the economy because of the coronavirus pandemic. These restrictions, also referred to by their Internal Revenue Code Section 163(j), were expanded by the 2017 tax revision, P.L. 115-97.

Changes in P.L. 115-97, Popularly Known as the “Tax Cuts and Jobs Act (TCJA)”

Restrictions on net interest deductions were significantly tightened in the 2017 tax legislation. Taken as a whole, the tax revision was a tax cut, although a number of provisions were enacted to limit certain deductions, among them the restrictions on interest deductions.

Rules Prior to TCJA

Prior to the TCJA, the [thin capitalization](#) rules were narrowly focused and limited. They applied only to corporations and only to interest paid to related parties. Their objective was largely to limit [earnings stripping by multinational corporations](#) that located debt in the United States. Even so, the rules could be viewed as relatively liberal. They applied only to firms whose debt to equity ratio exceeded 1.5 to 1. Interest deductions were limited to 50% of earnings before interest, taxes, depreciation, amortization, and depletion (EBITDA). Disallowed deductions could be carried forward for three years.

Proposals to further restrict the thin capitalization rules had been made for some time to address [corporate inversions](#), in which firms shifted their headquarters to a foreign country in order to reduce profits in the United States, in some cases by earnings stripping through locating debt in the United States.

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Changes in TCJA

The TCJA tightened the limit on net interest deductions by eliminating a safe harbor for debt-to-equity ratios at 1.5 to 1 and below and by reducing the interest deduction cap to 30%. The TCJA also changed the income measure to income before interest and taxes (EBIT), which defined a narrower measure of income and thus imposed a further limit on interest deductions, although this change was not scheduled to take place until 2022. These changes became part of a host of [changes that affected the international tax regime](#).

The restrictions were also broadened to shift the focus toward borrowing in general by applying the rules to all interest, not just related party interest, and by increasing the coverage to all businesses, not just corporations.

Certain businesses were exempt from the changes. Smaller businesses with less than an average of \$25 million in gross receipts in the past three years were excluded. (This exclusion aggregated businesses under common control.) Certain regulated utilities are exempt. Real estate businesses can elect out of the interest restriction by adopting longer depreciation periods: 30 years rather than 27.5 years for residential structures and 40 years rather than 39 years for nonresidential structures. Farm businesses can also elect out by using longer depreciation periods (generally 15 years or 20 years rather than 10 years) and slower methods for certain assets (structures, land improvements, and certain trees and vines). Interest used to finance inventory for motor vehicles is exempt, although the exemption does not apply to vehicles that are not self-propelled, an exclusion that has raised some concerns about [non-self-propelled trailers and campers](#).

Any unused interest deductions can be carried forward indefinitely.

The change made by the TCJA was estimated to raise \$18 billion in its first full fiscal year (FY2019), and \$20 billion in FY2020. The revenue gain was projected to increase to \$30 billion after the change from EBITDA to EBIT was fully reflected, in FY2023.

Reasons for Change

In the [House Report](#) on the legislation, the reason given for the expanded restrictions was to reduce the differentials between debt and equity finance (debt-financed investments are more favorably treated). The extension to all forms of business organizations was made to reduce differentials arising from choice of entity form. The exclusion for smaller businesses was provided because these businesses, even if heavily leveraged, are not as likely to have as big an effect on the economy in times of financial distress and because they have less access to public equity markets. This rationale suggests a concern about excessive leveraging making firms more prone to failure. The exclusions for certain industries were in recognition that these industries have special characteristics.

Temporarily Relaxing the Interest Restrictions in the CARES Act

The CARES Act increases the limit on interest deductions from 30% to 50% for 2019 and 2020. It also allows firms to use 2019 incomes for the 2020 limitation. The expected downturn in the economy would make the effect of the interest restriction more widely felt, as firms' profits fell, leading to a smaller base to calculate the interest cap in 2020. The increased deduction will increase liquidity for firms that have or take on more debt and firms subject to the interest cap would find borrowing, which might be needed to meet basic business needs as revenues fell, less costly. [Guidance](#) has been issued on making elections or

opting out of certain prior elections. A [survey of manufacturers](#) indicated that 3.7% of firms had taken advantage of the increased limit on interest deductions.

The provision is [estimated to cost \\$13.4 billion](#) for the two-year period.

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