What is the Limitation on the Deduction for Interest Expense?

Center Forward Basics

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Overview

When the Tax Cuts and Jobs Act (TCJA) passed in 2017, it included new limitations on the tax deduction for interest expense for businesses. The legislation capped the deduction at 30 percent of adjusted taxable income; previously there was no cap. Starting in 2022, the base on which the amount of interest that can be deducted is determined will be smaller and the interest limitation will be more restrictive. This change affects many industries including manufacturing, information technology, entertainment, and hospitality. This Basic will explain the interest expense deduction and future implications as it's set to change at the end of the year.

What is the Limitation on the Deduction for Interest Expense?

Currently, the tax deduction for interest expense is limited to 30 percent of adjusted taxable income (ATI). ATI is currently an EBITDA based limitation, meaning it is computed **without** regard to any deduction allowable for depreciation, amortization, or depletion. For tax years after December 31, 2021, the adjusted taxable income is computed **after** any deduction allowable for depreciation amortization, or depletion, an EBIT-based limitation. This change means that the amount of interest that can be deducted from taxable income will be smaller and the interest limitation will be more restrictive. Further, Congress is considering imposing an additional global ratio limitation on top of the 30 percent limitation.

Impact of this Change

The change to an EBIT-based interest deduction limitation has many implications including increasing the after-tax cost of capital, specifically penalizing U.S. taxpayers such as manufacturers investing in their facilities. This increase in the cost of capital is likely to reduce investments, which will then result in slower economic growth and lower average labor productivity.

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Center Forward brings together members of Congress, not-for profits, academic experts, trade associations, corporations and unions to find common ground. Our mission: to give centrist allies the information they need to craft common sense solutions, and provide those allies the support they need to turn those ideas into results.

In order to meet our challenges we need to put aside the partisan bickering that has gridlocked Washington and come together to find common sense solutions.

For more information, please visit www.center-forward.org

Key Facts

- EBITDA - Earnings before interest, taxes, depreciation, and amortization. It is a measure of a company's overall financial performance.
- EBIT - Earnings before interest and taxes. It is an indicator of a company's profitability.

While the Joint Committee on Taxation estimated that the EBITDA-based limitation on interest expense deduction would raise $10 billion less per year than the EBIT-based limitation, this change also hurts U.S. companies and taxpayers. The COVID-19 pandemic has devastated and impacted many industries including entertainment, transportation, restaurants, and manufacturing. Now, companies in these industries will have to pay an additional incremental tax. The sectors with the largest percentage increases in incremental tax liability are accommodation and food services (3,462.3 percent), mining (2,839.8 percent), and transportation and warehousing (2,531.1 percent). The limitation on the deduction increases the after-tax cost of capital for taxpayers who have net interest expense exceeding 30 percent of adjusted taxable income. Additionally, these limitations to the deduction for interest expense result in companies potentially having increased tax

liability as their income declines. The change from an EBITDA-based interest limitation to an EBIT-based interest limitation would hurt U.S. global competitiveness and imposition of a global ratio test would hurt U.S. global competitiveness even more. The United States would be the only advanced economy in the world with this system, contrary to OECD and EU taxing principles.

Links to Other Resources

- Bloomberg Tax and Accounting - Business Interest Expense Limitation
- Investopedia - Interest Deduction
- Progressive Policy Institute - Constructing an Effective Manufacturing Policy
- Tax Foundation - Interest Deductibility - Issues and Reforms