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INSIGHT: Interest Expense Limitation to Trigger Changes in Financing Private Equity Deals

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Businesses typically chafe at expense limitations, and many taxpayers, especially private equity (PE) firms, are quickly learning that the rules governing the deductibility of interest expenses have recently become much more complicated and, potentially, a trap for the unwary.

Historically, business interest expenses have generally been deductible. However, following the modifications to tax code Section 163(j) as part of the 2017 Tax Cuts and Jobs Act (TCJA), there are new limitations on their deductibility. PE owners need to understand these new federal (and state) income tax rules when structuring debt, and they should model how the borrower's interest expense (and, potentially, lender's interest income) will be treated during the expected life of the debt.

Due to Section 163(j)'s complexity, this article does not discuss the treatment of small businesses, eligible real property trades or businesses, or other special classifications within Section 163(j), but rather will summarize the general rules especially as such rules apply to PE firms.

In effect, interest expense is now limited to 30% of a taxpayer's "Adjusted Taxable Income" (ATI). ATI is comparable to EBITDA (earnings before interest, taxes, depreciation, and amortization), but taxes are deducted. PE firms need to consider this limitation in their deals, as interest expense exceeding this 30% limitation is not currently deductible. Section 163(j) also contains a provision whereby, beginning in 2022, depreciation and amortization are removed from the definition of ATI. ATI would then be comparable to EBIT (earnings before interest and taxes), but taxes are still deducted. This will result in many more taxpayers being impacted by this rule. We will use the terms "EBIT" and "EBITDA" throughout this article for simplicity, but note that for many businesses there will be nuances because, as described above, income taxes are not added back for ATI purposes.

Given the above basic outline of the Section 163(j) limitation, what should PE funds and portfolio companies do? Of course, every situation is different. In the middle market, the average amount of debt at portfolio companies is about six times EBITDA. We see many businesses in the range of three-and-a-half to four times EBIDTA. In the lower middle market, however, many PE firms have portfolio companies with higher debt to equity ratios. The challenge is that with the new Section 163(j) rules, while PE firms may wish to push more debt to portfolio companies, the debt may not result in currently deductible interest expense to the portfolio company, but may result in currently taxable income to the lender.

From a mergers and acquisitions standpoint, the market is expensive, with high valuations. To make a deal work, PE firms target an internal rate of return for the fund, which translates into targeted returns for each portfolio company. A PE firm typically has a "magic number" regarding the amount of equity and debt it wants to place on each portfolio company. With the Section 163(j) rules, a PE firm is potentially limited in the debt amount it can attribute and still reach its targeted returns. Yet, the more equity the PE firm puts into each deal, the harder it is to achieve those returns.

When businesses with lower EBITDA combine with PE firms that place a lot of debt on each company, something has to give. Going forward, PE firms have three options:

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1. Being unable to pay the multiples they are paying for these businesses today
2. Increasing the equity they place in each deal, which could significantly impact the returns for that investment
3. Considering alternative financing instruments that fall outside the scope of Section 163(j)

Illustrating the Change

Let's take an example. A typical middle-market business has $20 million of EBITDA, and the PE firm is paying the multiple of 10 times EBITDA, or $200 million, for that business. Historically, the equity to the total enterprise value has been 30% to 50%. The PE firm puts 40%, or $80 million, in equity in the deal, so it still needs $120 million. To get to a deal, the PE fund will generate that $120 million by raising debt or other types of securities. It is paying 10 times EBITDA for the business and will have six times leverage, which is about the average in the market.

Let's say the PE firm can get a blended total cost of debt of 10%, meaning it is paying $12 million of interest expense annually on that $120 million. Assume there is no business interest income. Based on the new Section 163(j) rules, the portfolio company will be able to deduct interest expense of $6 million (30% of its $20 million of EBITDA). Previously, it could have deducted $12 million. So, it will have $6 million more of taxable income than it would have had before Section 163(j) was changed. The PE firm would want to consider how to reduce the target's interest expense so that it can deduct the full amount of such expense in the year incurred.

Explore Creative Instruments

The alternative financing instruments mentioned previously include sale-leaseback transactions. If a PE firm owns a business with a substantial amount of mortgaged property, those properties are of course carrying additional debt. Rather than letting that debt sit on the balance sheet and paying interest on those mortgages, some firms have sold the properties and leased them back, reducing their total interest cost.

Other financing instruments include some type of preferred stock for example, convertible securities or other instruments that involve cash payments or payments in kind that would not be classified as debt instruments under general income tax principles and Section 163(j).

Looking Ahead

If interest rates climb and debt becomes more expensive, PE firms using floating rate debt or financing tied to the London Interbank Offered Rate or the U.S. Treasury may see negative consequences on the investment's overall economics because of Section 163(j). This could lead to the need to refinance, review the capital structure, and/or identify opportunities to reduce the interest expense limitation within that capital structure.

Even though final regulations have not been released, PE firms and portfolio companies can take certain actions now. They should understand that Section 163(j) is more restrictive after 2022. That means that they need to think carefully before entering a transaction if they have considerable capital expenditures, equipment, depreciation, or amortization; have made acquisitions and have significant goodwill on the balance sheet; or have any investment in which EBITDA is substantially higher than EBIT. When modeling a transaction past 2022, portfolio companies should ensure that they consider each of these factors, because they could materially impact the business's bottom line and returns.

It's also important to research alternative financing vehicles and talk to financial institutions about ways to structure transactions or restructure debt. Another essential step is conducting strong due diligence on targets at an early stage. If PE firms are going out to the market to acquire businesses and raise financing based on adjusted EBITDA, they should be certain that those EBITDA adjustments are highly achievable and that any interest expense limitations are considered.

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