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Will the U.S. end tax deductibility for corporate debt interest?

Introduction

When it comes to corporate tax reform, the headlines have mostly been focused on the House Republicans' plan to tax imports into the United States while exempting U.S. exports. But another proposal which has received much less media attention could also significantly impact financial markets: eliminating or limiting the deductibility of interest paid on corporate debt. A provision that has been on the books since 1918.

Where do President Trump and House Republicans stand on this issue?

While their proposals differ, they are both broadly in favour of at least placing limits on the deductibility of corporate debt interest.

Under President Trump's plan, businesses would have the choice either to deduct the cost of debt interest or to write off capital expenditures immediately. Currently, a company can only gradually deduct capital expenditures from their U.S. taxable income over the lifetime of the investment. Trump has supported limiting this option to the manufacturing sector. He has also at one time favoured placing a "reasonable cap" on interest expenses rather than completely eliminating the deduction.[1]

In contrast, the House Republicans' plan would make it mandatory for most sectors to replace the deductibility of debt interest in exchange for being able to immediately write-off new capital expenditures.[2]

In both cases, the impact would be cushioned by a cut in the headline corporate tax rate from 35% to either 15% or 20%.

What happens if any of these proposals get approved?

While there is no doubt that these proposals will face significant opposition, it is important to note that even if they are adopted only in part, their impact could be quite significant. Among other things:

- Corporations would be incentivized to rely less on debt and more on equity financing
- The spread between investment and junk bond yields could widen
- Companies that must spend heavily on capital investment to increase revenues would benefit the most

It is likely any changes to the tax code would only apply to new debt issues. Under this scenario, a rush to market new bond issues could be expected before the new rules came into effect. **Exemptions could be made for certain sectors that rely heavily on debt financing, such as real estate and banking.**

Finally, it is important to note that regardless of whether any proposal regarding interest deductibility is adopted, President Trump's pledge to cut taxes, increase military spending, invest more in infrastructure and not cut entitlements means the market for U.S. government debt should continue to grow.

Some analysts feel that if the U.S. government goes through with this reform, American companies will simply respond by borrowing in other countries where interest on corporate debt is still tax deductible. While this is a possibility, it should be noted that certain countries have taken measures to limit this deductibility. Germany, Italy, Portugal and Spain have already placed caps on such deductions. In the UK, these deductions will be limited to 30% of earnings before interest, taxes, depreciation and amortization as of April 2017.[3]

[1] "Tax reforms threaten U.S. bond market," Reuters, February 3, 2017
[2] "Private Equity Eyes Tax and Financial Reform in the Trump Era," Bloomberg, January, 19, 2017
[3] "Private equity frets as Congress eyes interest cost deduction," The Financial Times, January 24, 2017

How easy will it be for Trump and the Republican Party to pass a tax bill?

For the first time since 2007, Republicans have control of both the executive and legislative branches of government. The Republicans hold 52 seats in the Senate against 48 for the Democrats. As for the House, the Republicans outnumber Democrats 239 to 219. While this constitutes a slim majority, particularly in the Senate, it still leaves Republicans well positioned to pass major pieces of legislation that enjoy broad support within the party.

For a bill to become law, it must be approved by the two houses of Congress and signed by the President. Traditionally, the minority party in the Senate has resorted to filibustering in order to obstruct the passage of legislation.

Filibustering is a process whereby the opponents of a measure require the other side to obtain a supermajority of 60 votes for a bill to pass in the Senate. However, spending and taxation bills (via a process called reconciliation) cannot be filibustered.

It is important to note, though, that using reconciliation to get a spending bill passed in the Senate by simple majority vote entails a drawback. If the bill is deemed to result in a significant increase in the federal deficit 10 years down the road, it will expire if not renewed. This is known as the "Byrd Rule". Under this scenario, Trump's tax cuts would have to be renewed in a decade's time or they would expire.

Conclusion

The intense focus on the border adjustment tax, fears over protectionism and the many controversies (i.e., immigration and Russia) dogging the new Trump administration means that many analysts have not fully grasped the potential impact of eliminating or limiting the tax deductibility of corporate debt interest.

While we can expect strong opposition to this proposal, the fact that both House Republicans and President Trump are broadly in agreement on at least limiting this deduction raises the odds of seeing some version of the measure incorporated in a future tax bill. Exemptions could be provided for certain sectors that rely heavily on debt financing, such as real estate and banking.

Two factors increase the chances some form of tax reform will be introduced:

- The difficulty of repealing and replacing Obamacare without provoking a political backlash will encourage Republicans to focus first on tax reform.
- The widespread view among Republicans that their control of all the federal branches of government is a rare opportunity that should not be wasted. The last time this occurred was during the presidency of George W. Bush (2003-2007). Before that, it was during the presidency of Herbert Hoover (1929-1931).

What remains to be seen is which proposal will ultimately be most prevalent in the tax bill: Trump's more modest plan to limit the deduction of interest paid on debt, or the House Republican's more comprehensive proposal to eliminate the deduction altogether from many sectors.

Angelo Katsoras

Geopolitical Briefing

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD, Public Sector Research and Strategy
warren.lovely@nbc.ca