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Tax Changes to Compound Pressures for Highly-Levered US Corporates

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Fitch Ratings-New York/Chicago-27 January 2023: Higher US corporate taxes will compound the effects of rising borrowing costs, slower US economic growth and sustained, high inflation on speculative-grade credit profiles, Fitch Ratings says. Larger, highly-levered issuers in capital intensive industries, such as diversified industrials, aerospace & defense and transportation, along with those with high R&D expense have the highest relative risk exposure.

The increase in taxes stem from tax law changes relating to capex, R&D and the effective interest deductibility changes under the 2017 Tax Cut and Jobs Act (TCJA) and implementation of the 2022 Inflation Reduction Act (IRA). Key provisions of TCJA have, or are set to lapse in whole, or part, this year.

The TCJA placed limitations on business interest deductibility for most corporations, limiting the allowable amount to 30% of taxable income (i.e. section 163 (j)). However, the effects of this limitation were effectively deferred for most companies due to the ability to deduct depreciation and amortization (D&A) expense when calculating adjusted taxable income (ATI). With the D&A deduction falling away in 2022, the amount of allowable business interest deduction is effectively capped at 30% of EBIT.

Issuers in capital intensive industries with high equipment spending needs will be meaningfully affected by the changing tax laws. Starting in the 2023 tax year, companies are no longer permitted to fully expense equipment in the year purchased. The "depreciation bonus" provision in the TCJA begins to sunset, with the allowable amount dropping to 80% this year and phasing out completely by 2026.

Companies with high R&D expenses in their cost structures began facing higher taxes in 2022. The TCJA did away with the ability for companies to deduct 100% of R&D expenses in the year incurred, but the change did not take effect until 2022. Companies are now required to spread R&D expensing for tax purposes over a multi-year period (five for domestic spending and 15 for international).

The elimination and reduction of key tax benefits under the TCJA are not the only tax headwinds US leveraged finance issuers may face this year. One of the most notable tax changes in IRA is a 15% corporate alternative minimum tax (CAMT). Companies will incur CAMT if their average adjusted financial statement income (AFSI) for the prior three years exceeds the $1 billion threshold, and no other exclusions apply. With the rolling three-year average look back income test for computing AFSI, companies subject to the CAMT that experience a sharp decline in profits may continue to incur CAMT treatment during a period of weaker profitability and cash flows.

We view larger, speculative-grade issuers as facing greater exposure to the IRA's CAMT than those that are smaller and less likely to meet the AFSI test. Certain small businesses are exempt from TCJA's rule 163(j) related to business interest deductibility. The exemption is primarily for those that meet the gross receipts test of having average annual gross receipts of $25 million or less, during the previous three years, adjusted annually for inflation. (The amount was $27 million in 2022.) Despite these factors, smaller issuers are likely to have a tougher time adapting to the depreciation bonus changes than larger issuers, given their relative scale and need to invest to remain competitive.

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