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Congress allows a larger deduction for project-level interest expense

By Forrest Milder

The recent coronavirus legislation (the CARES Act) contains a wide variety of loan and grant programs, as well as a handful of very technical changes to the Internal Revenue Code. We wanted to highlight one of those changes that can be relevant to renewable energy investing—the provision that raises the cap on business interest deductions.

Here's the background: In 2017, the Tax Cut and Jobs Act inserted a cap on a business's ability to deduct interest expense to 30% of the business's income.

For example, assume a solar project has $20M of entity level debt, and $1M of interest expense in 2020. Assume it also has $2.5M of "adjusted income" (that's its income after adding back depreciation deductions and before the interest expense) for 2020, resulting in a cap of $750,000 of 2020 interest expense that can be used currently (30% times $2.5M). Because our business had $1M of interest expense, but a $750,000 cap, there's an excess of $250,000 that must be carried forward to be used a few years later. I say a few years later because income and annual interest expense will probably continue at about the same level for the near future, meaning that the computation may generate another $250,000 of carried forward interest next year as well. Indeed, under the rules, depreciation will cease being a favorable adjuster in 2022. At a 21% tax rate, this deferred $250,000 of interest expense is worth the time value of about $52,000 of actual cash that might be deferred by five years or more. And a similar amount the next year, and so on. Of course, all of this depends on the actual math for the particular project.

Here's the change just made by the CARES Act: It increases the 30% cap on business interest, for one year only, 2020, to 50% of adjusted gross income.

Let's return to our example. Under the new law, the interest cap is 50% of $2.5M, or $1.125M, meaning that ALL $1M of the 2020 interest is currently deductible, and nothing is carried forward. At a 21% tax rate, this added deduction is worth about $52,000, remembering that the effect is actually reduced on account of the time value of money concept that we discussed above.

We'll conclude by noting that this change in the Code hasn't gotten that much attention. So, if you have project-level debt in your project, make sure that the new cap has been addressed in your projections!

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