"Disinterested?' - The Short-Term Effects of the TCJA Interest Expense Limitations on Corporate Financing

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The Tax Cuts and Jobs Act of 2017 (hereafter, “the TCJA”) was the most extensive overhaul of the Internal Revenue Code since the Tax Reform Act of 1986. In this paper, we examine firms’ immediate financing response to changes in the Section 163(j) provision limiting the deduction of business interest expense (hereafter, “the interest limitation”) due to the TCJA. Across our full sample, the only impact we find is that of an increase in dividends. However, since the interest limitation affected firms differentially, by exploiting the differences we find that the limitation has a significant impact on the mode of external financing by causing affected firms to switch from debt to equity financing.

Additionally, we find that the interest limitation is also associated with a decrease in affected firms’ dividend payouts and capital expenditures. Furthermore, exploiting a provision that significantly lowered the tax penalty for firms repatriating foreign earnings that had previously been designated ‘permanently reinvested income’, we find that firms subject to the repatriation tax reduced equity issuance, and increased stock repurchases in the four quarters immediately after the TCJA.

We use a difference-in-difference model to test the research hypotheses. The challenge in researching the effects of the TCJA is while the TCJA is exogenous it is also extensive, because it simultaneously changes several tax provisions. Therefore, we control for other provisions of the TCJA that are most likely to affect the corporation’s decision to finance with debt after the tax reform in our regressions.

We identify treatment and control companies based on their pre-TCJA financing activities, and firms that frequently used debt as a tax shield pre-TCJA are classified as the treatment group. Our sample excludes companies in regulated or subsidized industries like agriculture, utilities, finance, and insurance. Additionally, we run our regressions using quarterly financials.

The research extends the existing literature the effect of tax on firm debt. Modigliani (1982) shows that the value of leverage is tied to the market’s perception of its tax saving characteristics; Givoly et al (1992) examine companies’ responses to the 1986 Tax Reform and conclude that a company’s tax rate affects its leverage decision. MacKie-Mason (1990) also finds that the use of debt financing is positively associated with the effective marginal tax rate, while Graham (1996) asserts that the interest expense deduction causes high-tax rate companies to issue more debt than their low-tax rate counterparts.

Since the TCJA marked the first time in a century since the interest expense deduction had been restricted, this paper is the first, as far as we know, to detail how a company’s financing structure changes as a result of the interest limitation. It also contributes to the literature by showing the changes in equity financing as a result of the interest limitation.