

M&A Tax Talk

Section 266 tax planning in M&A transactions

Introduction

A confluence of several factors has contributed to companies having generated large business interest expense limitation carryforwards under section 163(j). The rise in interest rates in recent years, combined with uncertainty in macroeconomic conditions, have resulted in a slowdown in deal activity since the Covid era. As a result, private equity firms are more commonly holding on to their investments longer than the typical 3-5 year holding period. Many companies have also had to refinance existing debt nearing maturity with new debt with less favorable rates.

Furthermore, the Tax Cuts and Jobs Act (TCJA) provisions have resulted in companies having to compute adjusted taxable income (ATI) for purposes of computing their section 163(j) business interest expense limitation based on tax EBIT (not EBITDA) for tax years 2022 through 2024. Note that ATI will be based on tax EBITDA starting in tax year 2025 as a result of the enactment of The One Big Beautiful Bill Act (OBBBA). However, even if deductible, taxpayers should consider the impact of business interest expense deductions on other provisions such as foreign derived intangible income (FDII), foreign tax credit utilization, and base erosion

and anti-abuse tax (BEAT). OBBBA also contains modifications to some of these provisions as discussed later in this article.

Companies should explore the potential consequences of capitalizing interest expense under the provisions of section 266. This article will focus on the requirements and potential benefits of this specific provision. As described in more detail below, time is of the essence as certain provisions in the OBBBA may mitigate some of the potential benefits in the future.

What is section 266 and how does it apply?

The direct predecessor to section 266 was enacted by the Revenue Act of 1942 as section 24(a)(7) of the Internal Revenue Code of 1939 and section 266, adopting the same language with no substantive modifications, was codified in 1954. Section 266 and corresponding regulations permit taxpayers to capitalize taxes and other carrying charges, including interest expense, into the basis of certain assets.

Section 266 is an annual election made with the US federal income tax return, and allows for the capitalization of interest into the basis of the following types of property:

- Unimproved or unproductive real property;
- Real property being developed or improved;
- Personal property; or
- Other property

While the section 266 regulations only provide examples with respect to certain types of tangible property (e.g., fixed assets), if section 266 is applied broadly to personal property as defined elsewhere in the code, regulations, and other authorities, additional examples of interest capitalization would include inventory, software and contract assets as illustrated in examples #2 and #3 below:

- **Example #1:** A taxpayer obtains a loan to purchase machinery for use in its factory. The taxpayer may capitalize the interest into the machinery up to the later of the date of installation or when the machinery is first put in use.
- **Example #2:** A taxpayer has a manufacturing facility and obtained

a loan from a third-party to fund the purchase of raw materials. These raw materials will be used in the production of the inventory. In this example, the interest can be traced to the production of the inventory and thus may be capitalized into inventory.

- **Example #3:** A private equity firm acquires a software company using both sponsor cash and third-party debt financing. A portion of the acquisition debt is used to fund expenses incurred by the portfolio company related to software development and facilitation of customer contracts. As such, a portion of the interest expense that can be traced to the costs incurred may be capitalized into software development costs and contract facilitation/origination costs. See *Private Equity Insights* for additional discussion.

In order to capitalize interest expense into personal property, the section 266 regulations require that the corresponding debt be traced to the applicable asset. This is done on a factual basis and is based upon the debt agreement. In cases where debt is used to fund multiple activities, Treas. Reg. section 1.266-1(e) permits a reasonable allocation based on the facts and circumstances of the taxpayer.

Once interest is capitalized into the basis of qualifying property, it takes on the attributes of that property and is recovered accordingly under US tax principles. For example, interest capitalized into tangible assets is recovered via depreciation and interest expense capitalized with respect to inventory is recovered as cost of goods sold (COGS). This character change applies for all US tax purposes and can impact calculations such as the section 163(j) limitation and section 861 expense apportionment, among others.

Section 266 tax implications and considerations - Under current law (prior to enactment of the new tax provisions under the OBBBA)

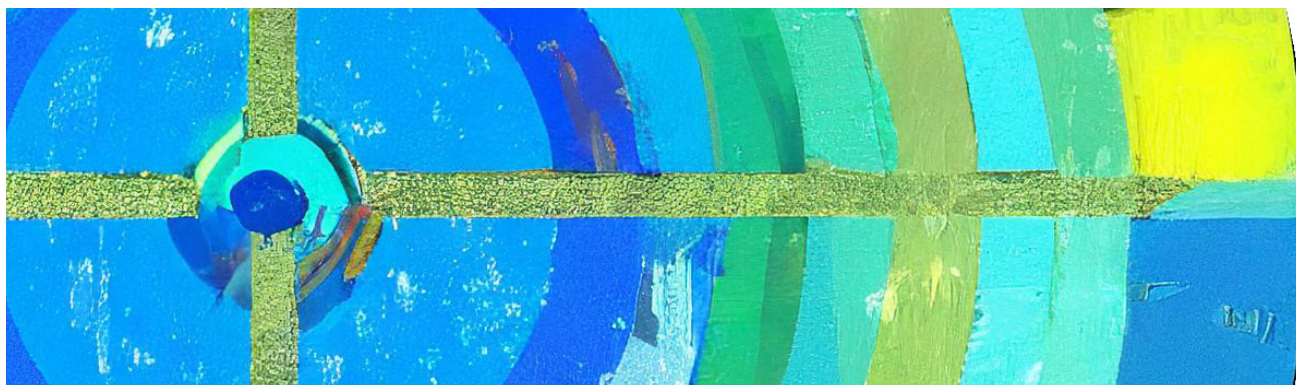
The capitalization of interest expense into qualified property under section 266 may provide benefits with respect to the following:

Section 163(j) – Business interest deduction limitation

- **Implication:** To the extent interest expense amounts are capitalized, the capitalized amount would be removed from the total business interest expense when computing the section 163(j) interest expense limitation. Further, if a taxpayer has a section 163(j) carryforward from prior years, by capitalizing current year interest, the taxpayer may be able to utilize the carryforward earlier than anticipated.
- **Considerations:** If a taxpayer is unable to deduct all or a portion of their interest expense in the US due to limitation constraints, the capitalization of interest expense into qualifying property would reduce the amount of interest expense subject to the section 163(j) computation. This has the effect of decreasing a taxpayer's taxable income as the capitalized interest is then recognized as a deduction not subject to that limitation. This will often create reduction in a taxpayer's tax liability in the year of capitalization and/or future years.
- **Example:** Assume a taxpayer with \$150 of current year interest expense and \$10 of disallowed interest carryforward capitalizes 20% of its current year interest expense into inventory and recovers the full amount through COGS in the current year.

	Status Quo	Capitalized Interest
US Interest Expense	150.00	150.00
Capitalized Interest Expense to Inventory (20%)	-	30.00
Revised US Interest Expense	150.00	120.00

	Status Quo	Capitalized Interest
Current Year Interest Expense	150.00	120.00
Prior Year Section 163(j) Carryforward Balance	10.00	10.00
Pre-163(j) Taxable Income	300.00	300.00
Add Back: Current Year Interest Expense	150.00	120.00
Adjusted Taxable Income	450.00	420.00
Applicable Percentage	30%	30%
Limitation Amount	135.00	126.00
Current Year Interest Expense	150.00	120.00
Prior Year Carryforwards	10.00	10.00
Total Interest Expense Subject to Limitation	160.00	130.00
Deductible Current Year Interest Expense	135.00	126.00
Total Interest Expense Carryforward	25.00	4.00
Additional COGS Deducted in Current Year	-	30.00
Total Net Deductions in Current Year	135.00	156.00

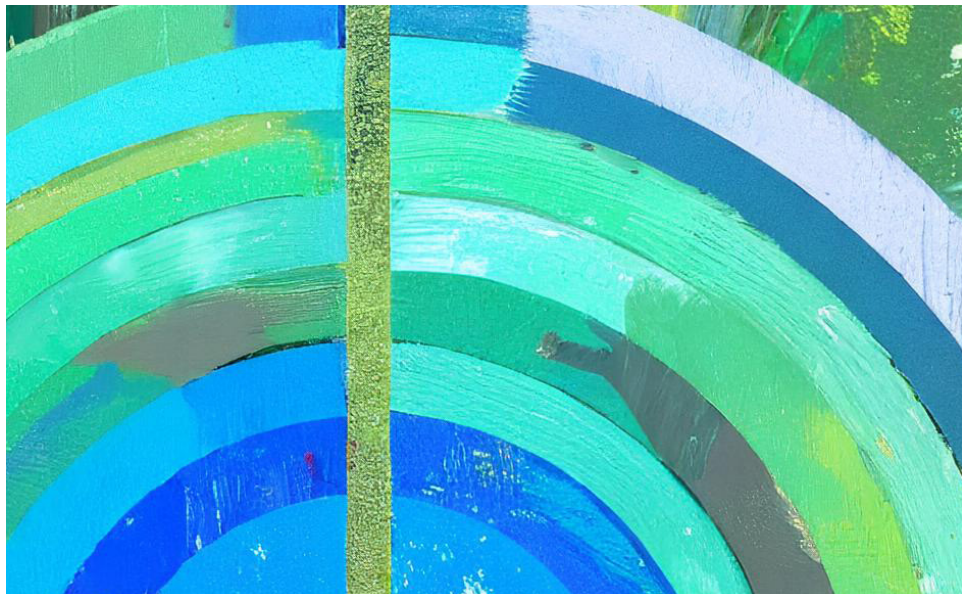


Section 861 – Foreign tax credit allocation and apportionment of deductions

- Implication:** To the extent interest expense amounts are capitalized into qualifying property, the recovery of such costs takes on the character of that property. As such, the resulting deductions are apportioned differently for section 861 purposes. The capitalized interest would be removed from the total interest expense allocated against foreign-derived deduction eligible income (FDDEI) and the various foreign source income baskets (e.g., general, passive, GILTI). The amounts would then be apportioned in alignment with the rules governing their character. Generally, this results in none of that amount being apportioned to foreign source income baskets which can increase utilization of foreign tax credits in those baskets. Similarly, this recharacterization often decreases the expense apportioned to FDDEI and thus increases a taxpayer's FDII deduction. Modeling is of course required to fully vet the impact of such recharacterization on all elements of the US tax profile.
- Considerations:** If a taxpayer is limited in the ability to utilize foreign tax credits due to interest expense apportionment to foreign source income basket(s), recharacterizing such interest expense by capitalizing it into qualifying property may allow for additional foreign tax credits to be utilized in such basket(s).
- Example:** In the following illustrative example, assume a taxpayer with \$200 of current year interest expense, capitalizes 30% of its current year interest expense, thus reducing interest expense allocated to foreign source income basket and increasing FTCs utilized.

	Status Quo	Capitalized Interest
US Interest Expense	200.00	200.00
Capitalized Interest Expense (30%)	-	60.00
Revised US Interest Expense	200.00	140.00

Foreign Source Income: General	Status Quo	Capitalized Interest
Net Income (Before Expenses)	200.00	200.00
Interest Expense Allocation (18%)	36.00	25.20
Other Expenses	5.00	5.00
Net Foreign Source Income	159.00	169.80
FTC Limitation (at 21%)	33.39	35.66
Current Year Taxes	36.00	36.00
Excess Limitation / (Credit)	(2.61)	(0.34)
Incremental FTC Utilization		(2.27)



BEAT

- **Implication:** To the extent taxpayers have interest expense paid to foreign affiliates, such interest amounts are generally subject to BEAT. However, certain exemptions exist with respect to the treatment of payments to foreign affiliates being deemed base erosion tax benefits. For example, amounts recovered through COGS are statutorily exempt from BEAT. To the extent interest expense is capitalized into inventory, the capitalized amount would be removed as a base erosion tax benefit in the year capitalized and remains exempt from BEAT as it is then recovered through COGS. A similar opportunity exists for capitalization of interest into other types of assets including self-constructed property and created intangibles.
- **Considerations:** If a taxpayer makes interest payments to foreign affiliates and is expecting a potential BEAT liability, capitalization of interest expense into certain types of property may exempt such amounts from BEAT. This can: (1) reduce the numerator of the BEAT safe harbor calculation which may allow taxpayers to meet that safe harbor requirement and be exempt from BEAT; and (2) if the safe harbor is still exceeded, it will reduce the net BEAT tax liability and could reduce it to the point where a taxpayer is out of BEAT. Further, for taxpayers who are close to BEAT but not paying BEAT, capitalizing base erosion interest can provide additional capacity for other planning such as increasing foreign tax credit utilization that, otherwise, may trigger a BEAT liability.

Impact of The OBBBA on Section 163(j) and Section 266 planning

The OBBBA permanently reinstates the addback of depreciation and amortization for purposes of calculating ATI for the section 163(j) limitation (i.e., ATI is calculated based on EBITDA) for tax years beginning after December 31, 2024.

The OBBBA also provides that the section 163(j) interest limitation applies to interest expense regardless of whether the taxpayer would deduct or capitalize that interest under an interest capitalization provision (except for interest capitalized under section 263(g) or 263A(f)). As such, for tax years beginning **after** December 31, 2025, the potential section 163(j) benefits of capitalizing interest expense under section 266 may no longer be applicable for taxpayers.

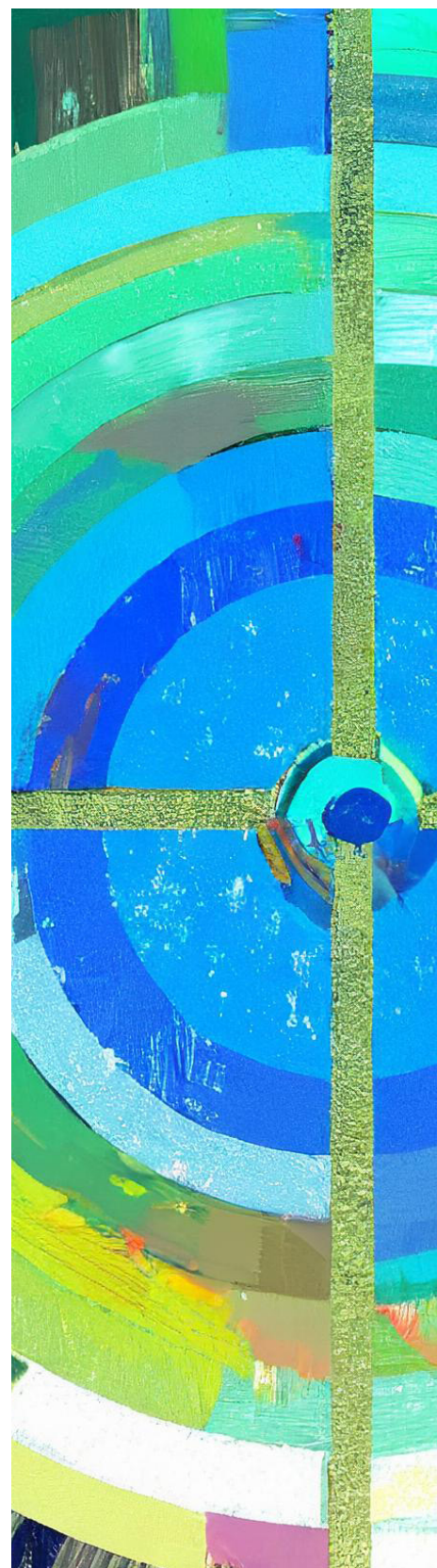
The OBBBA also changed the apportionment rules for interest and R&E expenditures with respect to FDDEI and Net CFC Tested Income ("NCTI" f/k/a GILTI), resulting in those expenditures being reallocated back to US residual (i.e. non-FDDEI) income for tax years beginning **after** December 31, 2025. While there may still be benefits to capitalizing interest for other foreign source income baskets (e.g. general, branch), capitalization under section 266 will generally no longer have the same favorable impact on FDDEI and NCTI foreign tax credit calculations for years beginning after December 31, 2025.

Further, while capitalizing interest under section 266 now comes after the application of the section 163(j) limit starting in tax years beginning after December 31, 2025, such elections may still be valuable to recharacterize the portion of deductible interest paid to foreign affiliates from a BEAT standpoint.

It is imperative to consider section 266 planning opportunities now for tax year 2025 (or for fiscal years ending in 2025 and 2026) before the above-mentioned provisions under the OBBBA go into effect for tax year 2026, as well as consider the remaining planning considerations for 2026 and beyond.

Private Equity insights

In private equity M&A transactions, the acquisition debt often sits in a newly formed entity in the buyer acquisition structure and the qualified property, as



defined under section 266, often sits within operating entities in the target structure. As such, interest expense is incurred at a different entity than where the company incurs expenditures with respect to qualified property.

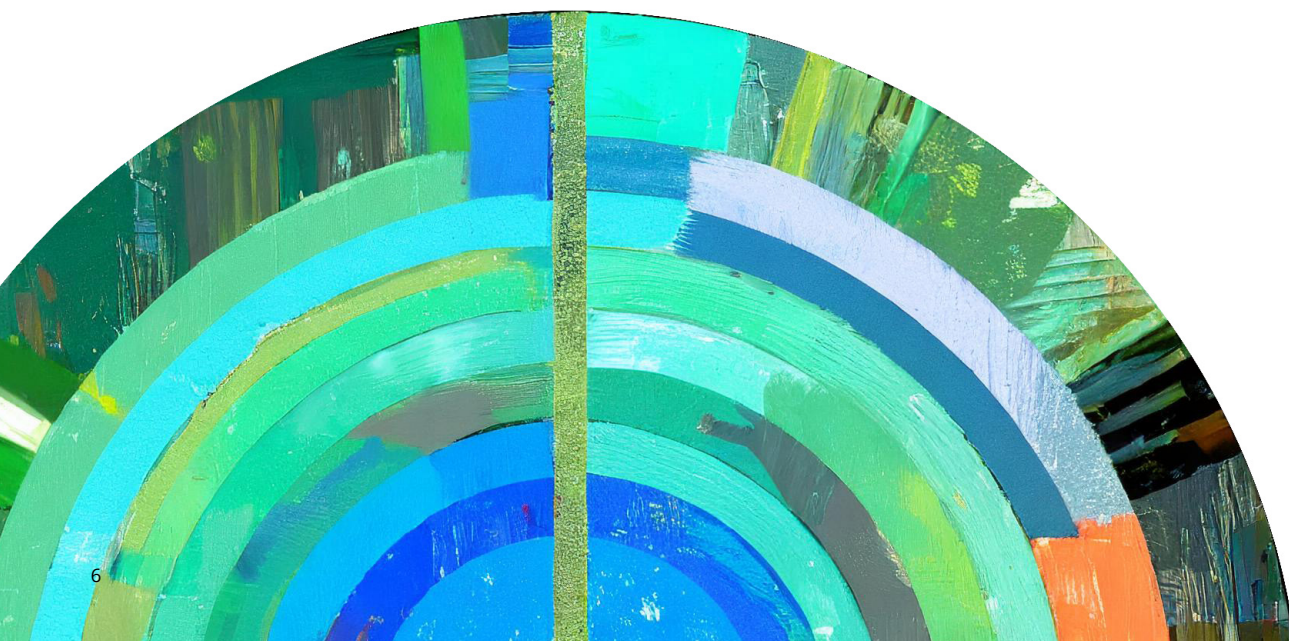
Although the 266 regulations do not contemplate related party fact patterns, taxpayers should consider other authorities for how Congress, Treasury and the IRS have viewed similar situations. One such authority, Notice 88-99, addresses interest expense capitalization under section 263A(f) in a related party context. The Notice outlines the “Deferred Asset Method,” which provides that to the extent the entity that incurs the expenditures for qualified property does not have sufficient interest expense to capitalize but the owner(s) of the entity do have debt and interest, the taxpayer would look up the chain of ownership to an entity with sufficient interest expense to meet the amount required to be capitalized under section 263A(f).

Such interest is then capitalized by the related party using the expenditures incurred for the qualifying property at the related party as a proxy. The capitalized interest at the ownership level then retains the same character as the underlying qualified property in the lower-tier entity (i.e., if capitalized to fixed assets the capitalized interest expense is depreciated or amortized using the same method, life and convention as the underlying qualified property in the lower-tier entity). Under this approach, the amount of interest capitalized by the related party is the same amount that would have been capitalized by the lower-tier entity (the producer) had it incurred the debt itself with respect to the qualified property production.

While there are other considerations in assessing the Deferred Asset Method in the context of section 266, taxpayers in a typical private equity structure with interest expense incurred in a different related party entity than entities with the qualifying property expenditures should assess the viability of applying this methodology.

Conclusion

After the closing of an M&A transaction, taxpayers should assess the overall tax and debt profile of the company on an integrated perspective and consider whether an opportunity exists to recharacterize interest expense under section 266. There is a small window to identify potential opportunities prior to the enactment of the new section 163(j) ordering rules under the OBBBA starting in tax year 2026. Taxpayers and their advisors should develop cash tax projections of annual interest expense, the section 163(j) limitation and carryforward balance as well as other relevant implications such as foreign tax credits and BEAT. Cash flow modeling is crucial in determining whether an opportunity exists to utilize the current disallowed interest expense carryforward balance and/or capitalize that interest expense into qualified property. As the section 266 election is made with the US federal income tax return (including extensions), now is the time to review the potential benefits as taxpayers prepare for the 2025 tax return and provision calculations (or are preparing their fiscal year 2025 tax returns and look forward to fiscal year 2026 provision calculations and tax returns).



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