BUILD COALITION

Businesses United for Interest and Loan Deductibility

The Importance of Interest Deductibility to Businesses and the Economy

January 2014

Executive Summary

The stated goals of tax reform are to boost the U.S. economy, increase investment, create more jobs, and foster innovation. With a cumbersome, outdated, and bloated tax code, reform has the potential to provide a significant boost to the U.S. economy. However, focusing solely on lowering rates may lead to harmful policy outcomes. This primer outlines interest deductibility (ID), its importance to businesses and the economy, and the negative effects of any limits on interest deductibility. Key takeaways include:

- **Interest expense is a cost of doing business that has been fully deductible from taxable income since the start of the modern tax code in 1921.** Interest deductibility is used by businesses of all sizes, in all industries, and of all legal forms. It is not a tax expenditure, a loophole, or designed to boost a special interest.
- **A new tax targeting interest will raise the cost of capital for companies.** On its own, this policy will reduce investment in the United States and lower economic growth.
- **Limiting interest deductibility to "pay for" tax reform reduces long-run growth by $33 billion in today's economy and hits all industries and all states with two-thirds of the effect felt in the first decade.** The increase in the cost of investment from limiting interest deductibility more than offsets the combined benefits of lower tax rates and efficiency gains from more equal tax treatment of debt and equity.
- **Concerns about asymmetric treatment of debt and equity financing in the tax code do not justify limiting interest deductibility for several reasons.**
    - **Tax penalties on equity and tax exemptions at the lender level are the root causes of the asymmetric treatment of debt and equity financing.** As an ordinary cost of doing business, interest expense is rightfully deductible, while interest income is generally taxed.
    - **At the same time, there is no evidence that interest deductibility has led to an overleveraged corporate sector.** In fact, limits on interest deductibility could lead to financial instability.
    - **Equity and debt financing are not functional equivalents.** The two forms of financing serve distinct purposes for businesses and are not substitutes. Therefore, different tax treatments are warranted.
- **Limiting interest deductibility does not support the goals of tax reform**. It reduces economic growth, lowers investment, and makes the U.S. a global outlier in tax policy.

What Is Interest Deductibility?

What Is Interest Deductibility?

Interest deductibility refers to the ability of businesses to deduct the interest paid on debt from their taxable income.

For example, if a business owner wants to build a factory, they might raise capital by issuing corporate bonds or taking out a loan to finance the investment.

Interest on the loan or bond is a cost of doing business. Therefore, the interest paid is deductible from taxable income.

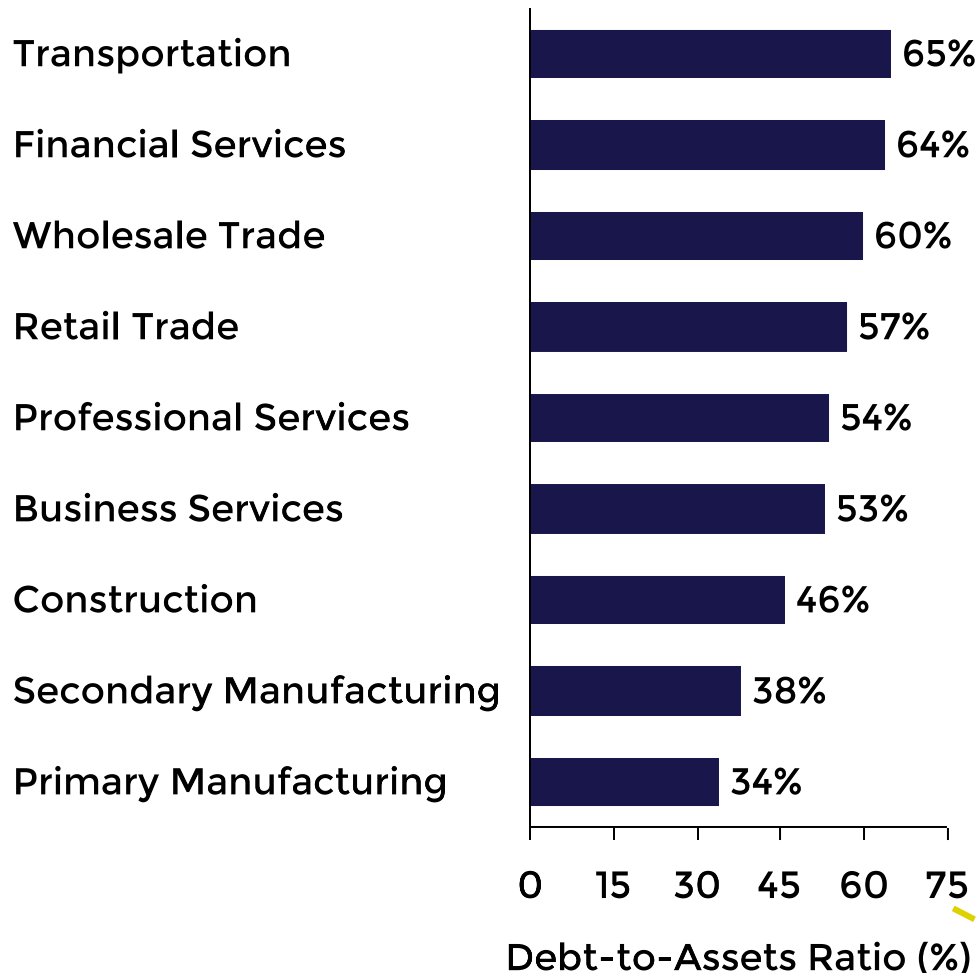
Three Facts About Interest Deductibility

1. **Debt financing and interest deductibility are normal parts of all businesses' operations.** Businesses of all sizes, in all industries, and of all legal forms use debt financing to make growth-enhancing investments.

2. **Interest deductibility is not a tax expenditure or special interest provision.** Both U.S. Treasury and the Joint Committee of Taxation recognize interest deductibility as a normal tax provision, not an expenditure.

3. **Interest deductibility has been a core component of the modern tax code since its inception.** Since 1921, the income tax code has maintained 100 percent interest deductibility.

Interest Deductibility Is Used By Virtually All Businesses, Regardless Of Size Or Industry



While all businesses use debt financing, limits on interest deductibility would adversely affect some types of businesses more than others, namely:

- **Capital-Intensive Businesses**: Limiting interest deductibility raises capital costs and will impact capital-intensive industries more than others.
- **Small Businesses**: Four out of five small businesses use debt financing. In addition, 75 percent of start-ups use some sort of debt financing at inception.
- **Minority and Female-Owned Small Businesses**: Within small businesses, minority and female-owned businesses are more dependent on bank loans for financing.

Source: Rebel Cole, "Why Businesses Use Debt – And How Debt Benefits Businesses," *BUILD Coalition*, June 2013

Limiting Interest Deductibility Does Not Support The Goals Of Tax Reform

The goals of tax reform…

- **Boost Economic Growth**: "On both sides of the aisle, I believe there is basic agreement that a reformed tax code should encourage long-run economic growth for the United States." Sen. Tom Carper
- **Increase Business Investment**: "The truth of the matter is we know that we need to do entitlement reform and tax reform. We need it for competitiveness and we know it on a bipartisan basis. It's time to do it, and it's time to unleash the investment that I think will follow." Sec. Jack Lew
- **Improve Competeiveness**: "We need, for economic growth and international competeiveness, to reform our tax system." Rep. Paul Ryan

…are not supported by limiting ID

- **Lower Economic Growth**: Limiting interest deductibility reduces long-run economic growth by $33 billion. It reduces output in all 50 states and in all industries, according to the latest EY research.
- **Reduced Business Investment**: Limiting interest deductibility increases the marginal effective tax rate on new corporate investment. This will deter investment, reduce capital stock, and lower long-run economic growth in the United States.
- **International Outlier**: Our major trading partners generally allow for full interest deductibility. An across-the-board limitation to ID would be detrimental to U.S. competitiveness.

Source: EY, "Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses," *BUILD*, 7/13

Limiting The Ability To Deduct Interest Will Raise The Cost Of Capital For Businesses

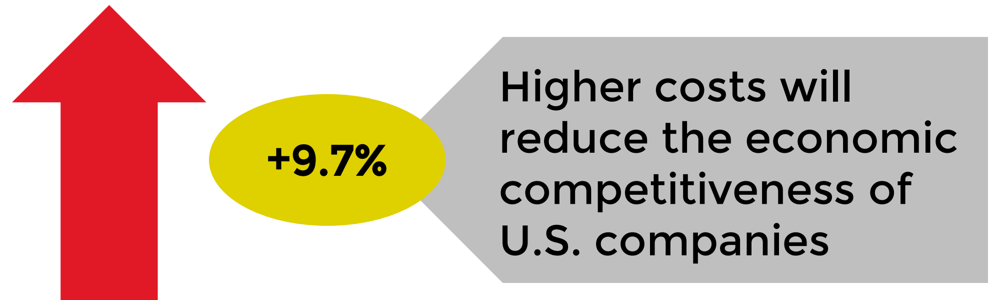
Higher Capital Costs

Limiting interest deductibility will increase the marginal effective tax rate (METR) of new business investment, even with a lower statutory tax rate.

A higher METR implies that the needed return on new investment must rise to cover the cost of higher taxes.

The higher costs will result in less investment in the United States, reduced capital stock, and lower economic growth.

Impact Of Limiting ID On METR Of New Corporate Investment



Source: Drs. Robert Carroll and Thomas Neubig, "Business Tax Reform And The Treatment Of Debt," EY, 5/12

Even If Revenue From Limiting ID Is Used To Lower Rates, Long-Run Growth Is Still Reduced

Overview of EY Research

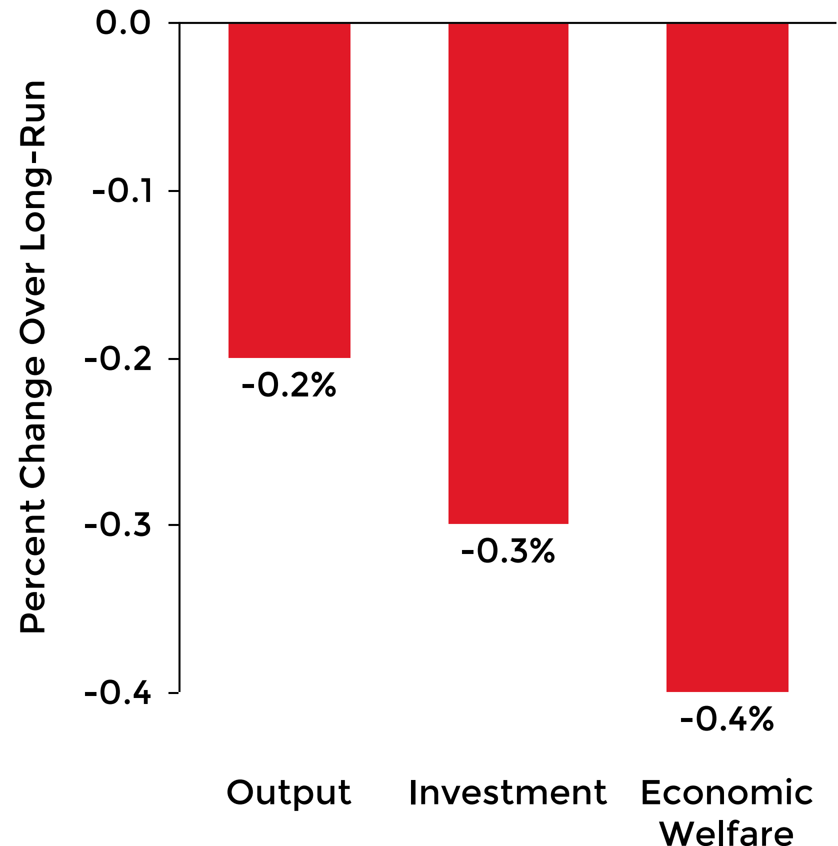
EY examined the impact of limiting the deductibility of corporate interest to its noninflationary component to finance a revenue neutral 1.5 percent reduction in the corporate income tax rate.

Why does this policy hurt economic growth?

The increase in the cost of investment from limiting interest deductibility more than offsets the combined benefits of lower tax rates and efficiency gains from more equal tax treatment of debt and equity.

In total, EY finds that limiting interest deductibility to finance lower rates results in:

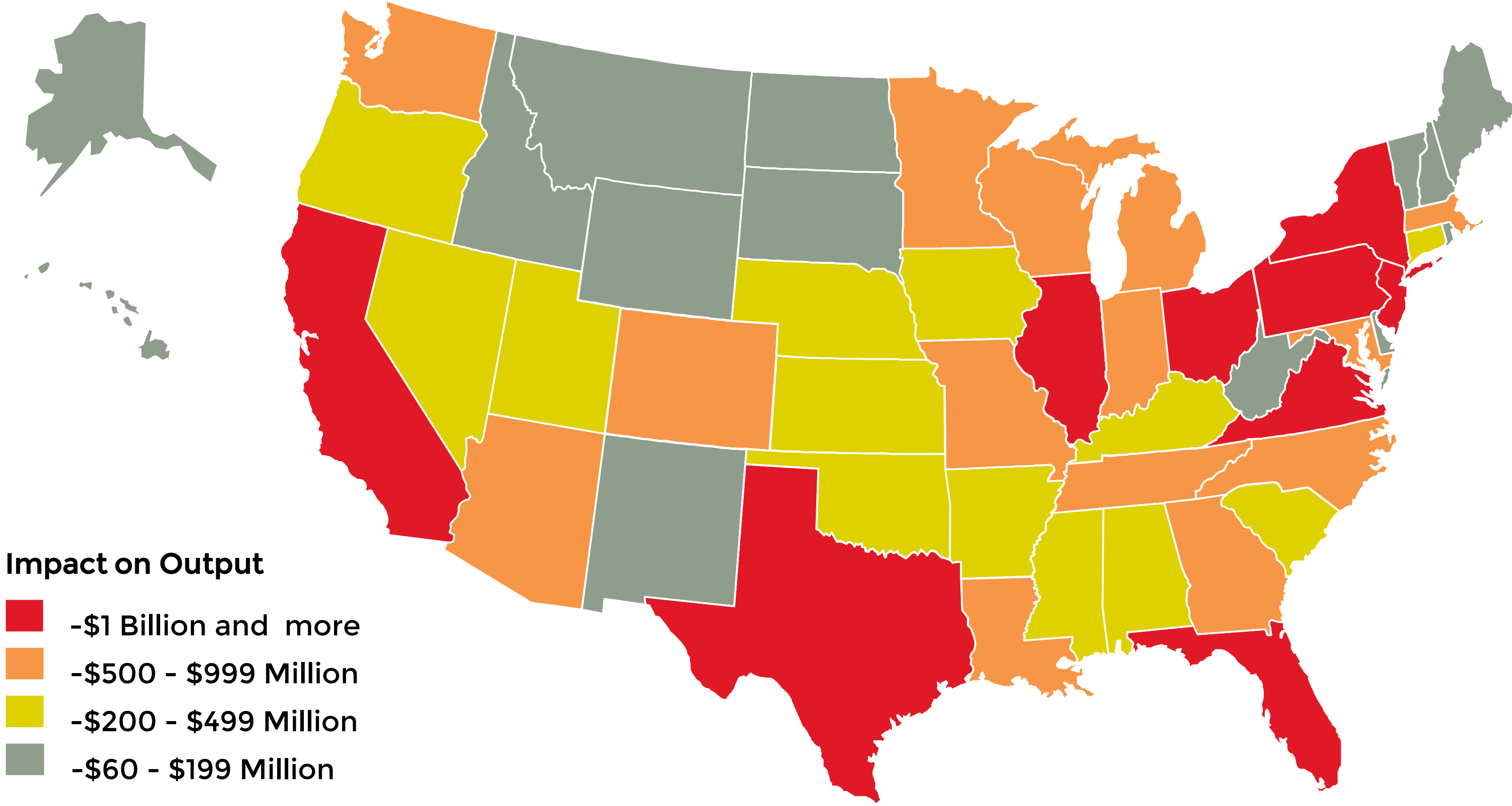
- GDP to fall by an estimated 0.2 percent in the long-run, or $33.6 billion in today's economy;
- Investment to fall by an estimated 0.3 percent, or $6 billion in today's economy, and;
- Economic welfare, measured by the value of household consumption and leisure, to fall by an estimated 0.4 percent.



Source: EY, "Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses," *BUILD*, 7/13

Limiting Interest Deductibility Will Reduce Growth By $33 Billion In Today's Economy In Long-Run*

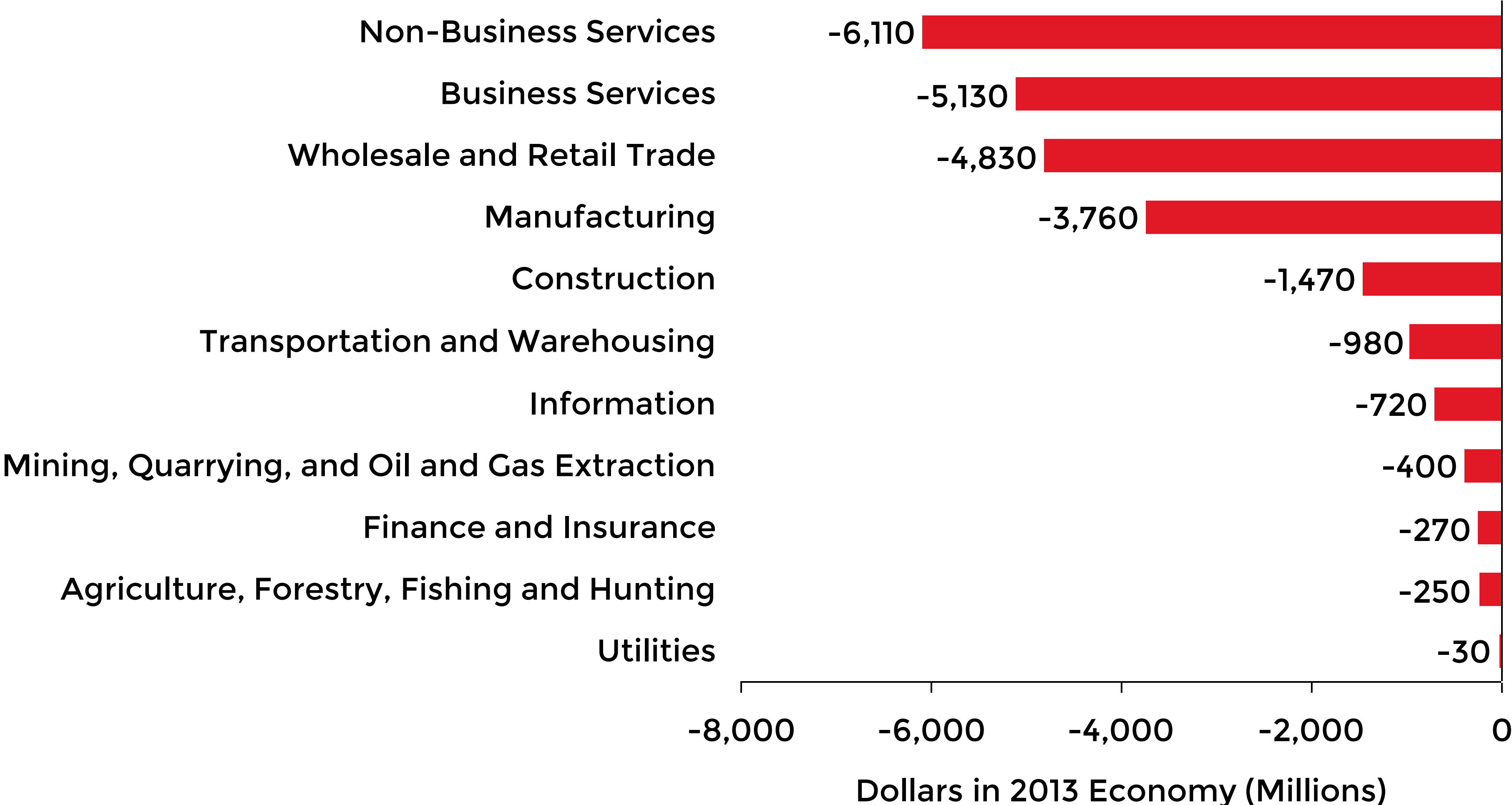
Reduction In State-Level Growth Over Long-Run In 2013 Dollars



Source: EY, "Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses," *BUILD*, 7/13

*Two-thirds to three-fourths of long-run effect is felt in the first 10 years

Limiting Interest Deductibility Reduces Growth In All Industries



Source: EY, "Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses," *BUILD*, 7/13

The Tax Code's Asymmetric Treatment Of External Financing Options Does Not Justify Limiting ID

This concern does not justify limiting interest deductibility because...

Interest deductibility is not a root cause of asymmetric treatment in tax code

- **Interest expense is taxed appropriately.** As a cost of doing business, interest expense is deductible, however interest income is generally taxed.
- **The root causes are the tax penalty on equity financing and tax preferences for certain types of debt at the lender level**, as well as accelerated depreciation.
- **Reform that lowers rates will reduce the value of the deduction, decreasing the effects of asymmetries** in the code without limiting interest deductibility.

Leverage has not been a problem for businesses or the economy

- **Corporate leverage was not a contributing factor to the financial crisis.** In fact, corporate leverage decreased significantly in the decades before the crisis.
- **There is no evidence that interest deductibility drives increases in leverage** according to research by Duke Professor John Graham.
- **Limits on interest deductibility decrease financial stability and add to risk,** contrary to conventional opinion.

While the "debt is bad" narrative has an intuitive appeal, this argument does not justify limiting interest deductibility.

Asymmetric Treatment Of Debt And Equity Is Driven By Other Features Of The Tax Code

Current Tax Treatment Of Interest Is Appropriate

While interest expenses paid by borrowers are deductible, interest income received by lenders is generally included in taxable income.

Therefore, interest is subjected to one level of tax under graduated individual income tax rates, which is the same as other ordinary business expenses, such as utilities and office space rent.

Asymmetric Treatment Of Debt And Equity Financing Is Driven By Other Features Of The Tax Code

Double Taxation Of Equity Financing: Equity-financed investments are subject to the corporate tax and then to taxes on dividends or capital gains. This double tax penalizes equity-financed investments.

Tax-Exempt Investments At Lender Level: Policymakers have chosen to reduce taxes on specific forms of interest income- such as debt held within retirement savings accounts and debt held by nonprofit organizations to support their activities.

Corporate Leverage Did Not Contribute To The Financial Crisis

Non-Financial Corporate Leverage

While displaying some cyclicality, nonfinancial leverage fell during 20 years leading up to the crisis

100 Years Of Evidence
Research by Nobelist Merton Miller and Duke Professor John Graham have found no connection between interest deductibility and corporate leverage over the past century.

Leverage Not A Problem
Furthermore, by a host of measures, corporations are not overleveraged. Leverage has fallen over the past several decades.

For example, according to James Zeitler, the median ratio of net debt to assets for public firms fell 75 percent from 1975 to 2010.

Sources: John Graham, Mark Leary, And Michael Roberts, "A Century Of Capital Structure: The Leveraging Of Corporate America," *NBER*, 8/9/14 , Merton Miller, "Debt And Taxes," *Journal Of Finance*, 5/1977 , St. Louis Federal Reserve, Mihir Desai, "Remarks At U.S. House Committee On Way And Means And Senate Committee On Finance," 7/13/11

Moreover, Other Factors Reinforce The Notion That 100% Interest Deductibility Should Be Maintained

Factor	Description
Reform Itself Will Reduce Tax Code Asymmetries	By enacting pro-growth tax reform and lowering rates, policymakers reduce the value of the deduction and the effects of the asymmetric treatment of equity and debt financing in the tax code.
Limiting ID Will Cause Other Distortions	According to independent research, companies are likely to use more costly and less efficient financing techniques to avoid the adverse effects of limits on deductibility. Also, equity and debt financing are not functional equivalents. Debt financing prevents shareholder dilution and creates a steady, disciplined stream of payments. These differences warrant different tax treatments for each form of financing.
Limiting ID Will Increase Financial Instability	St. Louis Federal Reserve researchers found that limiting interest deductibility will increase financial instability. From their conclusion: "…contrary to conventional wisdom, we find that eliminating interest deductibility results in an increase in the default frequency and average credit spreads. The intuition for this lies in the fact that this policy change makes external financing more costly, which results in riskier firms and higher credit spreads."

Source: Brent Glover, Joao Gomes & Amir Yaron, Corporate Taxes, Leverage, and Businesses Cycles, *St. Louis Fed*, July 2011)

Conclusion: Limiting Interest Deductibility Does Not Support The Goals of Tax Reform

The Goal Of Tax Reform Is Boosting The U.S. Economy

"While we are from different political parties, we agree that America's tax code is broken. That is why we have been working together as the chairmen of Congress's two-tax writing committees to make it fairer for families and spark a more prosperous economy...[Tax reform] has to be about the people we serve, about boosting the economy, about creating jobs in Montana, Michigan and across America."

- Sen. Max Baucus and Rep. Dave Camp

Does "paying for" tax reform with a new tax targeting interest support the goals of tax reform?

The research says, "No."

Tax reform efforts should seek to maintain 100 percent interest deductibility to ensure reform meets the goal of boosting economic growth

For More Information:

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Appendix I: State-By-State Impacts

See state-by-state impacts here.

Industry breakdown here.

National fact sheet here.

Full EY infographic here.

Limiting Corporate Interest Deductibility Will Reduce Long-Run GDP By $1.1 Billion In Ohio

Industry Impact - Change In GDP*

Long-Run Impact of Limiting
te Interest Deductibility**

DP	-$1.1B
ita ange	-$95
nsation	-$170M

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Limiting Corporate Interest Deductibility Will Reduce Long-Run GDP By $880 Million In Michigan

Industry Impact - Change In GDP*

Long-Run Impact of Limiting
te Interest Deductibility**

DP	-$880M
ita ange	-$89
nsation	-$130M

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Limiting Corporate Interest Deductibility Will Reduce Long-Run GDP By $980 Million In North Carolina

Industry Impact - Change In GDP*

Long-Run Impact of Limiting
te Interest Deductibility**

DP	-$980M
ita ange	-$100
nsation	-$140M

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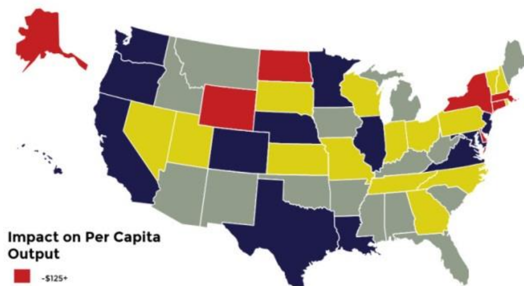
Per Capita GDP Drops In All 50 States With Limits On Interest Deductibility Over Long-Run

Reduction In State-Level GDP Over Long-Run* in 2013 Dollars Per Capita



Ten States Most Impacted

1. Alaska
2. Delaware
3. Wyoming
4. Connecticut
5. Massachusetts
6. North Dakota
7. New York
8. New Jersey
9. Virginia
10. Maryland

*Two-thirds of long-run impact are felt in the first 10 years.
Source: "Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses, EY, July 2013.

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Appendix II: Cited And Other Relevant Research

- EY, "Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses," *BUILD*, 7/13
- Rebel Cole, "Why Businesses Use Debt – And How Debt Benefits Businesses," *BUILD Coalition*, June 2013
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