BUILD
COALITION

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September 18, 2017

The Honorable Orrin Hatch
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

RE: Senate Finance Committee Hearing On Business Tax Reform (September 19, 2017) And The Preservation Of Full Interest Deductibility

Dear Chairman Hatch, Ranking Member Wyden, and Members of the Committee:

The Businesses United for Interest and Loan Deductibility (BUILD) Coalition is submitting this letter to reiterate our support for maintaining full interest deductibility in tax reform. We applaud the Committee's thoughtful approach to making tax reform a legislative priority, and we support its commitment to simplifying the code, creating a system that treats all taxpayers equally, and fostering sustained economic growth in today's competitive global marketplace.

The BUILD Coalition's members represent critical industries throughout the American economy, including agriculture, manufacturing, real estate, retail, and telecommunications. We believe that any measures to spur long-term, sustainable U.S. economic growth should ensure companies retain the necessary access to affordable capital for undertaking new investments, expanding operations, and creating more jobs.

Therefore, as the Committee determines which of the various elements of the tax code should remain or be reformed to encourage stronger growth, we'd like to reinforce the importance of preserving the full deductibility of interest on borrowing for all U.S. businesses. To create a tax structure that fulfills America's maximum growth potential, Congress must avoid any limitation to, or elimination of, interest deductibility.

Our experience managing the daily operations of our respective businesses compels us to relay the real-world implications of eliminating or limiting interest deductibility. It is also essential that we dispel misconceptions regarding this key part of our tax code, including the inaccurate notions that limiting interest deductibility to finance a lower tax rate for businesses would result in economic growth, that the interest expense deduction distorts financing decisions, that interest deductibility can be replaced by immediate expensing of capital expenditures, and that interest deductibility encourages excessive risk in the economy.

The deductibility of business interest expense is a well-established, growth-promoting component of the tax code. Interest expense is a normal cost of doing business. The deduction for interest is necessary to measure income properly and has been present in the tax code since the implementation of the modern income tax structure roughly a century ago. Failure to maintain interest deductibility will overstate a business' taxable income and result in over-taxation. By guaranteeing businesses will not be taxed on the cost of accessing capital, interest deductibility affords us the correct tax treatment and encourages us to continue to invest in growing our businesses and creating more jobs.

Also, a study by Ernst & Young (EY) finds that limiting interest deductibility to help fund a lower corporate tax rate would negatively impact economic growth in the long-run.[1] More specifically, EY found that a 25 percent across-the-board limitation on corporate interest expenses can be used to fund an approximate 1.5 percentage-point reduction in the corporate income tax rate. EY's research found that this trade-off would raise the cost of capital and result in a decline in long-run GDP of 0.2 percent, with the majority of this effect occurring in the first 10 years.

In other words, proposals that call for placing limits on interest deductibility in order to achieve a lower tax rate for businesses run counter to the Committee's stated goal of achieving pro-growth tax reform.

Beyond economic models, the practical implications of limiting or eliminating interest deductibility for businesses throughout the U.S. economy raise major cause for concern. As our member organizations prove, businesses of all sizes borrow in order to finance expansions or meet obligations and the ability to deduct interest expense gives business owners the certainty to make critical operating decisions. For many firms, access to credit is essential for working capital, and many of these companies use debt to weather shifts in demand.

Our nation's debt capital markets are the most liquid and efficient in the world. Banks supply the credit that is in turn the life blood of American businesses of all sizes and types—the businesses that provide the core growth in our economy.

The impact would be particularly harsh for startups, small businesses, and other private companies, which do not have ready access to alternative sources of financing. In fact, research has found that 75 percent of startups and 80 percent of small businesses rely on debt financing.[2] In addition to these small businesses, medium and large enterprises also turn to debt financing in large part because of its efficiency and relative speed to market compared to equity financing. Borrowing allows these businesses to respond quickly to market demands and capitalize on new opportunities, whether through revolving lines of credit, bonds, or bank loans. Without access to affordable credit, companies of all sizes will struggle to create jobs and grow the economy.

Proponents of eliminating interest deductibility argue that the tax code favors debt over equity, and that this encourages companies to take on more leverage. And yet, research by economists from Duke University, University of Pennsylvania, and Washington University in St. Louis,[3] as well as findings by Nobel Prize-winning economist Merton Miller,[4] show that the tax code has little to no impact on companies' leverage ratios. Harvard University finance professor Mihir Desai confirmed the findings of these earlier studies, noting that the non-financial sector is "remarkably underlevered by historical standards."[5] We believe this is because corporate decisions regarding the level of debt to assume are impacted by numerous non-tax market forces, such as analysts, rating agencies, regulators, investors, and lenders.

[1] EY's Quantitative Economics and Statistics (QUEST) Group. "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.

[2] Cole, Rebel A. "Why Businesses Use Debt – And How Debt Benefits Businesses." June 2013.

[3] Graham, John R., Mark T. Leary, And Michael R. Roberts. "A Century Of Capital Structure: The Leveraging Of Corporate America." June 2014.

[4] Miller, Merton. "Debt And Taxes." *Journal Of Finance*. May 1977.

[5] Desai, Mihir. "Testimony of Mihir A. Desai." United States Senate Committee On Finance And The United States Committee On Ways And Means. July 2011.

Moreover, the argument that equity and debt financing are similar is a fallacy. Debt and equity do not serve identical purposes and are not interchangeable forms of financing. There are a variety of non-tax reasons that businesses like ours choose debt over equity when raising capital. Thus, their differing tax treatment is appropriate.

For one thing, many businesses do not have access to equity markets, making debt their only option to start and grow enterprises that in turn create new jobs. In contrast to the dilutive effects of equity, borrowing allows owners to access capital without diluting control of their business. Debt is also a cheaper financing solution than equity because it is more secure for investors, who charge a premium for the risks associated with equity. Therefore, on both sides of the equation, debt and equity play separate and distinct roles in capital formation.

To the extent that policymakers would like to incentivize equity financing, the answer is to reduce or eliminate the tax on dividends, not to punish and restrict debt financing by removing or limiting interest deductibility. Any purported debt bias would also be significantly reduced by lowering the corporate tax rate.

In addition, proposals to offer 100 percent expensing in place of interest deductibility miss the mark. Such proposals fail to account for the real-life implications of what such a trade-off means for businesses, namely that full and immediate capital expensing is not an acceptable alternative for interest deductibility. Immediate expensing is a timing difference, while interest deductibility has a permanent impact and helps ensure income is properly measured.

A recent analysis by Goldman Sachs Economics Research predicts that proposals to eliminate interest deductibility in favor of 100 percent expensing "would raise the user cost of capital and reduce investment in the longer run." While 100 percent expensing might boost cash flows in the near term by pulling forward depreciation schedules, "after the first year, however, the impact on cash flow would begin to decline and eventually turn negative," the Goldman Sachs study warns.[6]

These harmful effects would not be cancelled out by lower rates, either. As University of Pennsylvania professor Chris Sanchirico has explained, even proposals to lower the tax rate would "not temper" the harmful effects of the proposed trade-off between interest deductibility and expensing.[7] As businesses that make these financing decisions every day, we know firsthand that you can't expense what you can't afford.

Lastly, some have claimed that debt inherently creates risk in the economy and that steps should be taken to discourage too much borrowing by businesses. This is by no means a given. In fact, a study published by the St. Louis Federal Reserve's Brent Glover, Joao F. Gomes, and Amir Yaron finds that limiting interest deductibility would actually *increase* volatility throughout the economy by raising the overall cost of accessing capital. The authors understand that limiting or eliminating the deduction for business interest expense would push firms to intentionally cap their size and rely more on operating leverage, making them more susceptible to default.

Glover, Gomes, and Yaron conclude: "Contrary to conventional wisdom, we find that eliminating interest deductibility results in an increase in the default frequency and average credit spreads. The

[6] Mericle, David and Daan Struyven. "U.S. Daily: Corporate Tax Reform: Trading Interest Deductibility for Full Capex Expensing." Goldman Sachs Economic Research. November 2016.
[7] Sanchirico, Chris William. "Expensing and Interest in the GOP Blueprint: Good Deal? Good Idea?" *Tax Notes*. April 2017

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."[8]

All of the arguments against interest deductibility also ignore the distributional impact of limiting interest deductibility. According to a report by the Small Business Administration (SBA), woman- and minority-owned small businesses typically have less access to equity markets compared to other businesses. Thus, woman- and minority-owned small businesses turn to bank loans, as well as alternative lending methods. By limiting interest deductibility, policymakers would further increase the existing financial burdens that woman and minority business owners face when trying to raise capital for investments.[9]

These are just the immediate dangers. Numerous policy proposals would also suffer if interest deductibility is limited. For example, President Donald Trump has announced his desire for a $1 trillion infrastructure investment plan based in large part on public-private partnerships. Congressional leaders have discussed similar proposals, which also feature a heavy emphasis on the private sector. Of course, limiting or eliminating the deductibility of interest expense would undermine these plans by increasing the cost of capital and making such investments less feasible for the private sector.

Finally, limiting interest deductibility would directly undermine "America-First" goals for tax reform. America's capital markets are second to none, giving the U.S. a major advantage over other nations in attracting businesses and investment. Without the ability to deduct interest expenses, these businesses would look overseas for their credit needs, weakening U.S. credit markets and hindering job growth.

As the Committee investigates ways to promote stronger economic growth and faster job creation through tax reform, it must maintain provisions in the tax code that help achieve these goals. Interest deductibility is one of these provisions, and has been since the creation of the modern tax code.

While the BUILD Coalition fully supports the Committee's goal of achieving pro-growth tax reform, any proposal that places limitations on interest deductibility will harm these efforts. We strongly encourage the Committee, in any proposed tax legislation, to maintain the full deductibility of business interest expense as it exists under current law. By doing so, policymakers will give the U.S. economy the opportunity to achieve its full growth potential.

Sincerely,

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[8] Glover, Brent, Joao F. Gomes, and Amir Yarons. "Corporate Taxes, Leverage, and Business Cycles." St. Louis Fed. July 2011

[9] Robb, Alicia. "Access to Capital among Young Firms, Minority-owned Firms, Women-owned Firms, and High-tech Firms." *U.S. Small Business Administration*. April 2013.