



The Daily Dish

Expensing Investment and Interest Deductibility

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Eakinomics: Expensing Investment and Interest Deductibility

The [border adjustment](#) feature of the House [Blueprint](#) dominated the tax reform discussion since the start of the year. Looking forward, there are other features in the Blueprint that will figure prominently in the debate. Among them are the immediate expensing of investment (i.e., deductibility of 100 percent of the purchase price in the year of investment) and the disallowance of the deductibility of interest costs. How should one think about those things?

My basic reflex is to prefer symmetric treatment of debt- and equity-financed investments. In the context of business tax reform, this usually takes the form of disallowing the deduction of interest expenses, thereby matching the non-deductible treatment of dividends. Of course, one could allow the deductibility of both; if so then the overall tax on capital investment will be entirely determined by the individual income tax treatment.

When deductible interest is combined with expensing of investment (or even accelerated depreciation), it can produce negative effective tax rates. To see this, consider a 100 percent debt-financed investment of \$1,000 that yields the market rate of return - 10 percent. So if you borrowed \$1,000 and made the investment, in the future you could sell \$100 of output and the original capital asset for \$1,000. You'd have a net rate of return of 10 percent - matching the market. Put differently, you'd have just enough cash flow - \$1,100 - to pay the principal and interest on the borrowing. This is a break-even (but not more) opportunity.

Now consider taxes. Suppose the tax rate is 20 percent, investments are expensed, and there is no interest deductibility. When you make the investment, you run a tax loss of \$1,000. If you carry the tax loss forward with interest, it is just enough to offset the future

cash flow of \$1,100. Taxable income and tax liability are zero. Because the project earns the normal rate of return - it is a break-even project - it yields no taxes. (Notice that if it had an above-market return, it would incur a tax.)

Now, allow interest deductibility. In this example, the future taxable cash flow would no longer be zero. There would be an additional deduction of \$100, taxable cash flow would be -\$100. Other things being the same, deductibility has generated a negative tax rate. This seems undesirable.

Intuitively, expensing is a tax benefit worth \$200 in this example. If you invest it at the normal return, you will have \$220 in the future - exactly the amount needed to pay the tax on the future cash flow of \$1,100. The tax benefit alleviates all taxes on the market rate of return. Adding additional tax benefits - interest deductibility - pushes the tax rate into negative territory.

Firms currently have interest deductibility, and there is a great push for expensing. Unfortunately, providing the latter means eliminating the former if tax reform is to achieve a level playing field in capital investments