The Daily Dish

Groundhog Day, Interest Deductibility Edition

DOUGLAS HOLTZ-EAKIN, PATRICK HEFFLINGER | JUNE 26, 2017

Last week the Department of Education announced that their Regulatory Reform Task Force identified 150 regulations that are subject to a review. The department will next decide whether they should be repealed, modified or kept. The task force directed each office to offer their recommendations by June 30th. The task force was formed following President Trump's regulatory modernization directive issued in February, and the directive was aimed at reducing and eliminating overly burdensome regulations.

On Thursday the U.S. Copyright office announced their support for consumers' "right to repair." The Copyright office stated they believe companies have abused section 1201 of the Digital Millennium Copyrights Act to prevent consumers from going outside the manufacturer of their devices to have their devices repaired. The office stated that they believe that Congress should pass legislation "outside of the Copyright Act" to prohibit companies from preventing consumers from repairing products which they have purchased.

Eakinomics: Groundhog Day, Interest Deductibility Edition

Remember border adjustment; the notion that all goods sold in the U.S. should have a level tax playing field and that multinationals should not be able to easily cheat on their taxes? In the blink of an eye it got a new name — the border adjustment tax — and an undeserved reputation as a threat to America's consumers. Why? A narrow sliver of the business community decided that tax reform should have only good news for them — a lower rate, better investment incentives, and continued reliance on cheap overseas labor.

Get ready for round two: the deductibility of business interest costs. To review, if a business raises new equity capital to make an investment, it can't deduct the dividends from its taxes. In contrast, if the business borrows exactly the same amount of money, it is permitted to deduct the subsequent interest payments. On the face of it, this seems odd. Shouldn't finance be driven by whether debt or equity is cheaper and more efficient? Why should the tax code have an opinion on how someone finances their business?

Nevertheless, interest deductibility has been in the tax code since its inception and the prospect of eliminating interest deductibility is on the table. This would produce neutral treatment of finance, more efficient use of capital, likely lead to less leverage and reduced financial fragility and ….. is lined up as the next attack on tax reform. The Wall Street Journal notes "That means the effective marginal tax rate on equity-financed corporate investments is 34.5%, according to a report released by the Treasury Department this year in the waning days of the Obama administration. The corresponding rate for debt-financed investment is negative 5%. That subsidy for corporate debt 'potentially creates a large tax-induced distortion in business decision making,' the report says."

Let's focus on the key fact: debt-financed investment has a negative tax rate. It makes no sense to subsidize interest through the tax code, but it makes a lot of sense to wage a political war to save such a handout. Get ready for the attack ads.

The cold arithmetic of tax reform is simple. Broadening the base, whether it is eliminating the deductibility of interest ($1.5 trillion) or border adjusting a tax ($1 trillion), is necessary to transform the tax system to a territorial base, introduce immediate expensing of investments, lower the corporate rate and still raise the same revenue. These are the components that will benefit all by improving incentives to invest, innovate, hire, and grow in America. The political question is whether narrowly-interested minorities will be permitted to scuttle tax reform to the detriment of the broad populace.