Insight

Interest Expenses and Tax Reform

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The goal of any fundamental corporate tax reform should be to improve the attractiveness of the United States as a location for investments in human, technological, and physical capital (i.e. "competitiveness") and eliminate to the extent practical economic distortions introduced by the tax code. Much time and effort has been expended on the merits of eliminating "loopholes" and the benefits of a lower rate. However, there has been less focus on the asymmetric tax treatment of debt and equity. Perhaps surprisingly, one route to making the U.S. more internationally competitive may include *eliminating* the deductibility of interest expenses.

At present, corporate interest expenses are a deductible expense, while dividends and returns to equity are not. This introduces a significant disparity between the tax treatment of debt and equity financing. Indeed, debt financing exposes firms to a marginal effective tax rate of -2.2 percent, compared to 39.7 percent on equity financing, according to a study from the Department of the Treasury. This disparity considerably distorts corporate finance decisions and firm capital structure, with a fairly clear bias towards debt.

For a practical example consider a business that needs to raise $10 million to finance a new operation. It can raise it by issuing corporate debt or otherwise borrowing the needed funds, or it can finance the new project with equity by issuing new stock or investing retained earnings. In the first case, the interest paid on the $10 million in debt is tax deductible, which contributes to the low effective tax rate of -2.2 percent on the investment returns. In contrast, the dividend payments associated with equity finance are not deductible, leading to the higher effective rate of 39.7 percent on returns to the equity investment. The result is an incentive for greater leverage and an increased possibility of bankruptcy. In the wake of the recent financial crisis, reforming tax policies that subsidize leverage over equity would seem wise.

A recent analysis by the IMF also notes that "debt bias has acquired more urgency in light of the economic crisis." While this bias is not viewed as a major cause of the financial crisis, in the IMF's view, it could have made it worse. There also appears to be little legal or economic rationale for the tax disparity between debt and equity, according to the IMF's literature review. On a pure policy basis, it would seem the disparate tax treatment has little justification.

Notice that really fixing the tax treatment of debt and equity finance requires also leveling the playing field when taxing individuals. At present, interest and dividend earnings are fully taxable, while long-term capital gains are taxed at a preferential rate. If interest expenses were no longer deductible at the corporate level, then individual tax reform would also be required to have the overall tax burdens level across all forms of finance.

Notice that in addition to better incentives for financial policy, eliminating deductibility would raise revenue. In the context of any revenue-neutral tax reform, reforming or eliminating this tax policy could be used for rate reduction – the other goal of tax reform.

The final decision is the level at which to equalize the taxation of the various forms of investment finance: at zero, at the ordinary income tax rate, or in between. The IMF and the Treasury have studied various policy reforms to address this issue, and each policy approach has its relative strengths and weaknesses. Broadly, the reforms seek to reduce or eliminate the disparity by either raising the effective tax rate on debt financing or lowering it on equity financing.

At one end of the spectrum is reform that taxes comprehensive income, including the return to saving and investment. This requires measuring income correctly. One approach that has been proposed is by Senators Wyden and Gregg. Their tax reform included an approach that would limit the deductibility of interest by essentially indexing it for inflation (by using a fractional measurement of inflation relative to a long run average). This was also advanced in a 1984 analysis by the Treasury in the lead-up to the 1986 tax reform. While it is a more modest approach to addressing the disparate treatment of debt and equity, it does have some merit. Nominal interest necessarily includes inflation, which also has the effect of reducing the value of the principal amount borrowed. By isolating the real interest rate, this approach addresses the effective overstatement of the cost of borrowing for tax purposes. The details in the legislation also deal with concerns of complexity with a system that would rely on interest adjustments for every associated transaction.

At the other end of the spectrum is pro-growth reform that taxes aggregate consumption, and exempts the return to saving and investment. In this case, eliminating interest deductibility should be paired with full expensing of investment outlays and non-taxation of corporate interest, dividends, or capital gains in individual tax reform. Unlike an income tax, this reform means that saving and investment are taxed only once – when profits are received – because of the expensing of investment.

Comprehensive tax reform is an imperative for the United States. Developing a strategy for reform will dictate how loophole-closing can correctly address the tax treatment of