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Interest Deductibility – Issues and Reforms

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Key Findings:

- Overall, the U.S. federal income tax system is intended to include deductions for interest paid and taxation on interest received. However, a substantial portion of interest received is untaxed.
- The combination of deductions for interest paid and untaxed interest income results in a substantial gap in the income tax, amounting to as much as 33 percent of all corporate debt.
- Interest deductibility is also a key feature of many profit-shifting arrangements, where multinational corporations borrow in order to reduce U.S. taxable income against the high U.S. corporate income tax rate.
- The net subsidy for leverage created by interest deductibility may contribute to financial crises because unexpected defaults on debts often lead to a macroeconomic cascade of troubled financial assets.
- Several reforms have sought to limit interest deductibility in recent years, and these reforms should be taken seriously.
- Tax provisions should be evaluated on the basis of opportunity cost; limiting interest deductibility is a better idea to raise revenue than many other options.

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Introduction

One major unresolved question in tax policy is the appropriate treatment for interest payments. Interest payments exist in a sort of in-between area for tax policy: interest involves money changing hands, but it creates no net increase in national income. Some tax systems attempt to track interest payments as they change hands and adjust tax burdens based on those interest payments. Other tax systems take a shortcut and acknowledge that on net, every interest payment has matching interest received elsewhere, and therefore, one can simplify the code by ignoring interest entirely.

There are principled arguments for both approaches. For example, the argument for deducting interest paid and taxing interest received goes something like this: When money changes hands in the form of interest, an income tax would ideally want to follow the money until it reaches its final owner. Interest is income, after all, as most individuals understand it, and it makes sense to include all sources of income in one's income tax liability. This is, at least in theory, the design for the U.S. income tax.

For an alternative tax system, one could note that all interest payments and interest receipts cancel out, and therefore exclude both interest receipts and interest payments. This approach has its virtues as well, especially its relative simplicity. This is the design for a number of approaches to business taxation worldwide.

These two approaches are not the only ones possible, but they are the two systems in which tax revenue is invariant to the amount of borrowing in the economy. Most tax systems, at least by their original intent, choose one of these two options for interest treatment. However, it is worth mentioning two other potential systems. A system that taxed interest received but did not allow an equal deduction for interest paid would be a net tax on leverage. A system that allowed a deduction for interest paid but did not have an equal tax on interest received would be a net subsidy for leverage.

While the U.S. income tax system is intended to match deductions for interest paid with taxes on interest received, in practice it is a convoluted mix of the systems described above. As a result, it hemorrhages tax revenue, distorts business decisions, and potentially even contributes to financial crises. This paper will address the deficiencies in current law treatment of interest, and discuss potential reforms, including options presented by the Congressional Budget Office (CBO) and the Better Way plan proposed by U.S. House Republicans.

Current Policy is a Mix of Several Systems

Under the current U.S. income tax system, most interest paid is deductible, and interest received is usually taxable. The ideal, one might imagine, is to tally up everyone's income, with interest receipts counting as positive income and interest payments to others counting as negative income. Once everyone's income is determined, that income is subject to the income tax at progressive rates. In practice, though, the U.S. income tax system doesn't always follow this ideal with respect to interest.

For example, interest paid is only sometimes deductible. While businesses can almost always deduct interest, individual income tax filers are often not able to do so. For example, they can deduct mortgage interest, but this option has value only if the standard deduction isn't a superior alternative. Even when they do choose to itemize, the cost of the foregone standard deduction may reduce the value of the mortgage interest deduction to the taxpayer. Furthermore, many consumer loans, such as car loans or credit card loans, are not deductible.[1]

Interest received is also not always taxable. While individuals and institutions both typically pay taxes on interest in many circumstances, there are several exceptions. Interest from municipal bonds is tax-free, making them a popular investment choice for wealthy individuals. Many private institutions, such as university endowments, are exempt from income taxes, allowing them to receive interest tax-free. Individuals who take advantage of defined-benefit pensions, 401(k) plans, or Individual Retirement Accounts, are also able to lend without paying taxes immediately on interest receipts.

Overall, the U.S. federal income tax adheres to no consistent principle on interest payments.

Interest Deductions Create a Hole in the Income Tax

The possibility of deductible interest payments without matching taxable interest income is a kind of dead zone for the income tax. Imagine a borrower with positive taxable income, and a lender who, for whatever reason, does not pay tax. These two taxpayers can collaborate to make the borrower's taxable income vanish into thin air. This is a form of financial engineering enabled by current policy. The Congressional Budget Office (CBO) explained it this way in a 2014 report:[2]

By law, businesses have been able to deduct all of their interest expenses. For the purposes of federal revenues, that deduction is partly offset by the tax that lenders must pay on the interest they receive from borrowers. If the interest is received within a tax-favored retirement plan, however, it effectively escapes taxation.

1 Internal Revenue Service, Topic 505 – Interest Expense, Retrieved February 15 2017, https://www.irs.gov/taxtopics/tc505.html.

2 Congressional Budget Office, "Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options," December 18, 2014. https://www.cbo.gov/publication/49817.

This is a substantial flaw in the U.S. income tax, and one that the CBO has quantified on more than one occasion. The findings are that this dead zone is massive; the CBO finds that it accounts for one-third of all corporate interest income in the country. As a result, the CBO finds that the effective tax rate on capital income for C corporations is actually negative:

TABLE 1.

Effective Tax Rates on Capital Income Under 2014 Law (CBO)

	Percent
Overall	**18**
Business	**29**
C corporations	31
Equity-financed	38
Debt-financed	-6
Pass-through entities	27
Equity-financed	30
Debt-financed	8
Owner-Occupied Housing	**-2**
Equity-financed	-3
Debt-financed	1

Source: Congressional Budget Office

Debt-financed corporate capital has an effective rate of negative 6 percent, 44 percentage points lower than the rate on equity-financed corporate capital. It is the only kind of business capital that has a negative tax rate at the federal level, and it is the only kind of capital that has a negative tax rate overall.[3]

Negative taxes can be a concern for two reasons; the first of these is incentives, the second is revenue. If a negative tax rate applies to the marginal decision maker, some debt-financed investments are actually inefficient; they wouldn't be built if not for the tax code. This would be concerning if true, but it seems unlikely. The CBO's calculation of a negative tax rate, however, uses an average rate for lenders, not a marginal one. Tax-exempt lenders are a minority of lenders, and often there are limits to how much capital can be placed into tax-exempt organizations. Overall, the idea of firms building inefficient investments merely for a relatively small tax benefit seems unlikely.

However, the question of negative taxes' impact on revenue is a larger concern. The latest estimates by the Federal Reserve show that there is $8.4 trillion of outstanding corporate debt in the economy, and that nonfinancial corporations paid $453 billion of interest in 2015.[4]

The privileged treatment of interest in the tax code, then, comes at substantial costs. Even simply

3 The CBO notes that owner-occupied housing has a negative tax rate at the federal level only because of the deduction for state and local property taxes. These property taxes, of course, give owner-occupied housing a positive tax burden overall after including state and local taxes in the calculation.

4 Board of Governors of the Federal Reserve System, *Financial Accounts of the United States, Fourth Quarter 2016*, March 9, 2017. https://www.federalreserve.gov/releases/z1/Current/z1.pdf.

returning the tax rate on corporate debt-financed capital to zero (much less a positive number) would save the federal government about $27 billion per year in a steady state.[5]

It is worth mentioning that, as the CBO analysis shows, pass-through entities are less of a problem than corporations. They tend to be smaller and don't have access to as many credit markets, and are therefore less likely to end up with a negative effective rate. The CBO notes that substantially less of their debt is held in tax-free accounts—only about 14 percent, relative to the 33 percent for corporate debt.

Nontaxable entities are the largest source of negative taxes on interest, and are therefore the main focus of the CBO's argument, but it is worth noting that even if interest were consistently taxable in theory—even if nonprofits and retirement accounts were abolished—there would still be no guarantee that lenders would pay as high a tax rate as borrowers. Progressive rate schedules and a variety of different business forms make it highly likely that at least some interest recipients pay taxes at lower rates than the ones against which borrowers deduct.

Simply put, there is no way for a system to make interest payments deductible under a progressive income tax and entirely avoid this problem.

Interest Deductions Enable Profit Shifting

Interest deductions can be a headache for international tax systems. The same general strategies that apply to domestic interest transactions also apply to international ones; that is, if a borrower has a high tax rate and a lender has a low tax rate, then the deductions for interest paid will be more valuable than the tax paid on interest received.

Use of strategy contributes to a phenomenon known as profit shifting, in which multinational corporate income shows up more abundantly in low-tax jurisdictions than in high-tax jurisdictions. Multinational corporations have an incentive to report their income this way because it reduces their tax burden.

Interest deductibility enables a number of different strategies for profit shifting, but the main idea of most of these strategies is that corporations borrow most heavily in high-tax jurisdictions, wiping out their taxable income in those jurisdictions.[6],[7] One academic estimate suggests that 10 percent higher local tax rates were associated with 2.8 percent higher debt/asset ratios.[8] In other words, the higher the tax rate, the more the taxable income decreases due to interest deductions.

Cross-border debt transactions are one of the trickiest subjects to address for international tax

5 Author's calculations using the CBO and Federal Reserve data.

6 Dirk Schindler, Jarle Møen, Guttorm Schjelderup, and Julia Tropina, "International Debt Shifting: Do Multinationals Shift Internal or External Debt?" Beiträge zur Jahrestagung des Vereins für Socialpolitik 2013, March 5 2012. https://www.econstor.eu/bitstream/10419/79749/1/VfS_2013_pid_317.pdf.

7 Luc Laeven, Gaëtan Nicodème, and Harry Huizinga, "Capital Structure and International Debt Shifting," IMF Working Paper, No. 07/39, pp. 1-37, March 4 2007. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=967880.

8 Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "A Multinational Perspective on Capital Structure Choice and Internal Capital Markets," *The Journal of Finance*, Vol. 59, pp. 2451–2487, December 2004. http://onlinelibrary.wiley.com/wol1/doi/10.1111/j.1540-6261.2004.00706.x/full.

systems. They have been the focus of both the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Project[9] as well as the U.S. Department of Treasury's Section 385 regulations.[10]

Allowing interest deductions but avoiding profit shifting by multinational corporations is a difficult task that requires an enormous amount of thought, regulation, and administrative resources.

Interest Deductions Distort Business Financing Decisions

As the CBO's calculations above show, the tax rate on debt-financed investment is much lower than the tax rate on equity-financed investment for both corporate and pass-through entities. This creates an incentive for businesses to pay for new investments by taking on debt rather than issuing new shares or retaining existing earnings.

Robert Pozen and Lucas Goodman describe the divergence between the rates on debt and equity finance succinctly:

> The tax code generally favors debt over equity because interest on debt is deductible against corporate tax while returns to equity (in the form of dividends or share appreciation) are not. As a result, equity-financed corporate investment typically faces two layers of tax (at the corporate level and again at the shareholder level), while debt-financed investment faces only shareholder-level tax.[11]

Under such a system, it makes sense to convert equity to debt for tax reasons. Sujeet Indap at *Financial Times* notes that "two common textbook methods for valuing companies show that executives can boost value simply by replacing their firm's equity with debt."[12] The change in financial structure ends up creating shareholder value at the taxpayers' expense by replacing nondeductible financing with deductible financing. Indap concludes that one "cannot justify the serious consequences of uneven treatment of capital sources."

Proponents of interest deductibility often argue that debt and equity instruments are separate financial markets, and separate treatment can be justified. There is some truth to this: bondholders and shareholders often have separate needs or preferences, and choose different assets for those reasons. For example, a pension fund typically has a predictable stream of liabilities in the future. A pension fund can become far more stable if it matches that predictable stream of liabilities with the predictable interest payments from a bond. On the other hand, an individual investor more interested

9 OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD Publishing, Paris, December 22, 2016. http://www.oecd.org/tax/beps/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2016-update-9789264268333-en.htm.

10 Richard Rubin, "Treasury Announces Final Regulations on Earnings Stripping," *The Wall Street Journal*, October 13, 2016. https://www.wsj.com/articles/treasury-announces-final-regulations-on-earnings-stripping-1476392428.

11 Lucas W. Goodman and Robert Pozen, "Capping the Deductibility of Corporate Interest Expense," Tax Notes, Vol. 137, 2012. https://ssrn.com/abstract=2190966.

12 Sujeet Indap, "Private equity frets as Congress eyes interest cost deduction," *Financial Times*, January 25, 2017. https://www.ft.com/content/5d02b33e-e1d0-11e6-9645-c9357a75844a.

in high returns may prefer equities.

Ultimately, debt and equity instruments both represent claims on a firm's resources granted to savers in exchange for their money. As Goodman and Pozen put it:

> The similarities of debt and equity capital far outweigh their differences. At their most basic level, both debt and equity represent funds that individuals contribute to a corporation in the hope that they receive a return on their investment in the future. Although debt holders have a more senior and more limited claim on corporate earnings than do shareholders, interest expense serves a similar function to an equity return in that both constitute a return to invested capital. Thus, we find no strong policy rationale supporting the very favorable treatment of interest expense relative to that of returns to equity.[13]

The differences in risk and in bankruptcy claims between debt and equity are relevant distinctions for investors; however, it is far from clear that these distinctions should be relevant to the Internal Revenue Service.

Interest Deductions Can Contribute to Macroeconomic Instability

This paper so far has focused on the relationship between investors and tax collectors. One might get the impression that debt-equity bias is an obscure issue that only affects a small group of people. However, the use of leverage in corporate finance has macroeconomic implications as well, because of the relationship among debt finance, bankruptcy, and the business cycle.

Use of debt finance rather than equity finance is a risk for firms. Debt is a promise to return a fixed amount of money. Firms go bankrupt when they cannot meet the demands of their creditors. The more a firm borrows, the more it owes in interest, and if it cannot pay interest, bondholders can make claims on the firm's physical assets to get their money back. In contrast, equity is much more flexible; during downturns, equity simply accepts a loss of shareholder value. It may not accept that loss happily, but it accepts it nonetheless, and there is no immediate threat to the health of the firm. Firms with more leverage are more likely to find themselves underwater with their inflexible lenders, and therefore more likely to go under permanently.

Many bankruptcies are idiosyncratic; if one particular firm goes bankrupt, it is typically not a concern for people who don't work there, or for people who invest in very broad portfolios. But some bankruptcies are systemic, and lead to a cascade of bankruptcies and the beginning of a recession.

It's easy to imagine this scenario: one firm goes bankrupt, and it cannot fully repay its creditors. As a result, some of those creditors go bankrupt and cannot repay their creditors, and so on. As debt instruments around the economy begin to fail, investors "flee to safety," putting their money into cash

13 Goodman and Pozen (2012), above.

and the safest bonds. As demand for cash increases, it becomes more valuable relative to goods and services. In other words, the currency deflates. People with goods and services to trade, or workers, find it harder to exchange their labor for money, and the unemployment rate rises. It is easy to imagine this scenario in part because it happened in the last ten years, in a bankruptcy cascade that started with leveraged homeowners in 2007 and 2008.

Since the 2008 recession, the role of interest deductions in promoting leverage—and potentially, financial instability—has come into focus. In recent years, a variety of economists have expressed worries about interest deductibility in this context.[14,15,16]

Recent Tax Proposals Have Sought to Limit or Eliminate Interest Deductibility

One common tradeoff in recent tax proposals has been to curb interest deductions in favor of lower overall rates on businesses. Goodman and Pozen proposed this in their 2012 paper, and a similar provision was included as an option in the CBO's 2014 report on taxing capital income. It also is featured in the Better Way plan proposed by House Speaker Paul Ryan (R-WI)[17] and in a number of tax plans proposed during the 2016 presidential campaign.

The proposals have taken a variety of approaches. The Goodman and Pozen proposal only allows businesses to deduct a certain percentage of their interest. Given that interest is only sometimes taxed at the lender level, it makes some sense to make interest payments only partially deductible at the borrower level. Goodman and Pozen were able to propose a substantial reduction in corporate rates due to the revenue raised by the limitation.

Another approach might be to remove interest from the tax code entirely; rather than aiming for an ideal system of interest deductions and interest taxes, one could have the tax code simply ignore interest. One benefit of this approach is that it does not create a tax burden on debt-financed capital. Sen. Marco Rubio (R-FL) proposed precisely this during his 2016 presidential campaign: eliminating deductibility of business interest paid, but eliminating tax on interest received. Tax Policy Center, which uses similar calculations to the CBO on effective marginal tax rates, found that Rubio's plan would increase the tax on debt-financed corporate capital overall, returning it from negative 6 percent to about 0 percent.[18]

The Rubio approach seems almost too good to be true; it raises tax revenue, it reduces administrative costs, and it still results in a zero percent burden on marginal debt-financed corporate capital. However, it was true nonetheless—by starting from a baseline of negative taxes, many things that seem impossible really are attainable.

14 Goodman and Pozen (2012) above.

15 Noah Smith, "Forget the Border Levy. Here's the Really Big GOP Tax Idea," *Bloomberg View*, March 6, 2017. https://www.bloomberg.com/view/articles/2017-03-06/forget-the-border-levy-here-s-the-really-big-gop-tax-idea.

16 The Economist, "The great distortion," May 16 2015. http://www.economist.com/news/leaders/21651213-subsidies-make-borrowing-irresistible-need-be-phased-out-great-distortion.

17 Kyle Pomerleau, "Details and Analysis of the 2016 House Republican Tax Reform Plan," Tax Foundation Fiscal Fact No. 516, July 5, 2016.

18 Elaine Maag, Roberton Williams, Jeff Rohaly, and Jim Nunns, "An Analysis of Marco Rubio's Tax Plan," Tax Policy Center, February 11, 2016. http://www.taxpolicycenter.org/publications/analysis-marco-rubios-tax-plan/full.

Finally, the approach of the Better Way plan currently advocated by House Republicans is a less-ambitious version of the Rubio approach; like the Rubio plan, it eliminates deductibility of business interest paid, but it only reduces taxes on interest income, rather than eliminating them. A Tax Policy Center analysis found that this would increase the tax burden on corporate debt-financed capital to about 10 percent.[19] While this adds to the cost of additional investment in the economy, the plan had a number of other provisions designed to reduce burdens on investment in other ways. Critically, the plan allows for the expensing of structures, such as buildings. Since buildings are one of the assets that most frequently uses debt finance, the plan gives in addition to taking away.

One critical question for reforms of interest deductibility is how to handle financial institutions that regularly lend and borrow. Typically, reforms like the Better Way plan have allowed financial institutions to retain their current-law tax treatment; when an institution both lends and borrows, one can be certain that the interest deductions and the interest income are counted at the same overall tax rate, meaning there is no distortion to remove.

Conclusion

It is easy to make arguments for interest deductibility. If interest is income (and by most popular definitions, it is), then interest payments are negative income and it makes sense to deduct them. If debt finance contributes to investments that boost productivity and wages (and it does), then adding a tax burden to debt finance will harm economic growth.

But it is also quite possible to make arguments against interest deductibility, and a number of strong arguments have been made over the years. Interest deductibility creates holes in the tax base, both domestically and internationally. It distorts corporate investment strategies and increases the returns to financial engineering. And it contributes to a potentially dangerous macroeconomic environment of overleveraging.

Relatively few tax breaks as large as the business interest deduction are so ambiguous in their benefits to the private sector. There is no doubt that eliminating or reducing the deduction for interest would create a political backlash, and even genuine economic harm. But revenue-raising provisions are always unpopular, and virtually always create harm; the question is whether a partial or total loss of interest deductibility would be more or less painful than other means of raising revenue.

In the current political environment, both the congressional majority and the president want to lower tax rates. However, spending cuts do not appear to be a substantial possibility. The president has pledged not to reduce entitlement spending. Furthermore, he has proposed a budget with increased military spending. On top of this, even with no legislative changes, the CBO's 2017 budget outlook projects that debt will rise from 77 percent of GDP to 150 percent by 2047.[20]

19 Leonard E. Burman, James R. Nunns, Benjamin R. Page, Jeffrey Rohaly, and Joseph Rosenberg, "An Analysis of the House GOP Tax Plan," Tax Policy Center, April 5, 2017. http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan-0/full.

20 Congressional Budget Office, *The 2017 Long-Term Budget Outlook*, March 30, 2017, https://www.cbo.gov/publication/52480.

Given the priority of tax rate reductions and this fiscal outlook, it makes sense for lawmakers to look for trade-offs within the tax code; not every tax cut must be offset by equivalent base broadening or tax increases, but perhaps some should.

If lawmakers are looking for base-broadening measures, then the federal tax code's system for debt finance—a mess of inconsistent and revenue-losing provisions—is a good place to start.