

# MERCATUS ON POLICY

## The Role of the Interest Deduction in the Corporate Tax Code

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### **UNDER THE US CORPORATE TAX CODE, DEBT AND**

equity investments are treated unequally. The government provides a limited deduction for interest payments on debt, but double-taxes equity investment at both the corporate and shareholder levels. Such a tax structure can create a negative effective tax rate to a borrower and incentivize debt-financed investment.

The new tax law, the Tax Cuts and Jobs Act of 2017 (TCJA), is aimed at increasing economic growth through reforming the corporate tax code. To further spur corporate investment, the TCJA cuts the top statutory corporate rate from 35 percent to 21 percent. It also includes allowances for full and immediate expensing of capital investments. Alongside these major changes, the TCJA also places limitations on the previously existing interest deduction. It allows for interest expense deductions of up to 30 percent of adjusted taxable income, or earnings before interest, depreciation, amortization, and taxes. While there are arguments for the inclusion of interest deductibility in the tax code, there are many problems with such inclusion as well, and the interaction of the deduction with the recently passed tax legislation could have troubling consequences. The deductibility of interest creates potential for a negative tax rate for the borrower. Any further reforms to the corporate income tax system should remove the deductibility of interest to further pay for the reduction in the corporate tax rate that was enacted in the TCJA, or to pay for additional reforms.

### **INTEREST DEDUCTIBILITY IN PRACTICE**

#### Tax Neutrality

The most prevalent argument in favor of the interest deduction is that it keeps the tax code neutral with regard to investment. Neutrality refers to the notion that taxes should not affect the decision-making

processes of businesses or individuals. Maintaining neutrality should always be one of the most important considerations when reforming the tax code. According to research by the Heritage Foundation, without other changes in the tax code, the elimination of the interest deduction would violate tax neutrality by raising the cost of capital and thus discouraging investment.<sup>1</sup>

The Heritage report clarifies that the deduction is not a subsidy for investment, but rather it ensures that the tax code does not discourage investment in the first place. Critics often claim that the interest deduction should be removed because it incentivizes debt financing over equity financing.<sup>2</sup> While debt currently enjoys a tax advantage over equity, destroying neutrality is hardly the way to retain fairness between financing options. The real problem lies with equity financing being double-taxed—once as revenue at the corporate level and again as dividends when paid to shareholders. If removing the debt financing advantage is the goal, then changes should be made to the treatment of equity, not debt. However, introducing major tax reforms including rate cuts and expensing creates entirely new tax investment implications and should change the current way the interest deduction is viewed.

#### The Value of the Deduction and Profit Shifting

There is little debate among tax scholars as to whether the deductibility of interest affects corporate structure and investment practices.<sup>3</sup>

In general practice, when corporate tax rates are higher and alternative methods of financing are not shielded from taxes, it is expected that corporations will engage in more borrowing and debt financing due to the presence of the interest deduction. Simply put, the value of the interest deduction is directly related to the effective tax rate: as tax rates rise, the value of the interest deduction rises as well.

An Internal Revenue Service (IRS) study by economist George Contos confirmed this logic. The IRS research found that large firms in the 1990s used debt to finance investments 1.4 percent more than small

firms in the same time period, a differential that has rapidly decreased since 1950.<sup>4</sup> Contos attributes this to the lower tax rates faced by small firms, and in particular the shrinking gap in the tax rates between firms of various sizes. Debt financing levels decrease with lower tax rates and increase with higher rates, a response that is easily observed in profit shifting.

Multinational corporations are more inclined to borrow in jurisdictions with high corporate tax rates to help lower their taxable income. The end result is multinational corporations reporting higher levels of income in jurisdictions with lower taxes. The presence of the interest deduction incentivizes deficit financing and reduces tax revenue collected by high-tax jurisdictions, such as the United States.

#### Potential Domestic Exploitation

The current US tax code allows a deduction for interest paid but requires that most interest received is taxable. Such a distinction is where the debt financing advantage arises, as it is not doubly taxed like equity. However, not all received interest is taxable. Important exceptions in the tax code allow some interest to escape taxation completely.

The Congressional Budget Office (CBO) finds that if interest payments to the lender are nontaxable, as in the case of a loan owed to a retirement plan or the case of an endowment to a university, the interest never gets taxed.<sup>5</sup> The perverse incentives are abundant. Nothing stops corporations from purposely arranging interest payments in this way. CBO finds that this immense loophole is responsible for nearly one-third of corporate income in the United States. This is a large reason why the current effective tax rate for some debt-financed investment is negative, and it has major repercussions on tax revenue.<sup>6</sup>

#### Negative Tax Rates

Using debt to finance investment under the pre-2018 tax code had an effective tax rate of negative 6 percent for C corporations.<sup>7</sup> Under such a regime, the presence of inflation, accelerated depreciation, and

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the excluded interest payments turn what should be a tax rate of zero into a negative tax rate. Negative rates can actually cause inefficiency in investment practices, allowing some firms to finance projects that would not pay off without the current tax structure. According to research by the Tax Foundation, another main concern with the prevalence of negative tax rates stems from lost revenue.<sup>8</sup>

Outstanding nonfinancial corporate debt currently totals \$8.7 trillion, with debt growth averaging 3.9 percent in 2017. The present debt growth rate is currently below the 4.3 percent average from the past 10 years, though a big fourth quarter report could continue the recent upward trend.<sup>9</sup> Additionally, non-financial corporations paid over \$445 billion in interest in 2016.<sup>10</sup> With these numbers generally climbing from year to year, the Tax Foundation predicts that even just increasing the effective tax rate on debt-financed investment to zero, holding all else constant, would add around \$27 billion per year to the federal government's tax revenue.<sup>11</sup>

### A Look at the Interest Deduction in Light of Tax Reforms

After examining the effects of interest deductibility in the old tax code, it is now possible to examine how reforms similar to those passed in the TCJA might affect financing decisions between equity and debt.

In a 2014 report, CBO tested various reform options and how they would interact with one another. When examining the results of a 10-point reduction in the effective tax rate, CBO found that it would create greater equality between debt and equity financing, even removing the negative rate on debt financing.

The reduction in value of the interest deduction as overall rates fall is expected. In addition, the same CBO report examines the effects of allowing full and immediate expensing with all other deductions held in place. Besides moving the overall effective tax rate to near zero, it would decrease the effective tax rate on debt-financed investments to negative 61 percent, creating the potential for huge revenue losses and inefficiencies. Implementing a lower statutory rate, allowing expensing, and making equity investment at the shareholder level through dividends and capital gains deductible at once would somewhat raise the effective rate on debt financing, but would still retain a large amount of negativity. In response, CBO estimates that capping interest deductions at 65 percent of interest payments for C corporations and 67 percent for pass-through entities would get the debt-financed effective tax rate to zero.<sup>12</sup>

Similarly, Robert Pozen and Lucas Goodman, publishing in *Tax Notes*, find that lowering the statutory tax rate by the same 10 percentage points would have caused a reduction of \$648 billion in tax revenue from 2000 to 2009. Despite reduction in tax revenue, Pozen and Goodman estimated that a partial cap on interest deductibility would have more than made up for the revenue loss. Additionally, by implementing a cap for nonfinancial corporations of 65 percent and a cap for financial corporations of 79 percent, Pozen and Goodman were able to offset \$651 billion in revenue over the same period, all else constant.<sup>13</sup>

These reports demonstrate that combining strict interest deductibility and expensing potentially does more harm than good. To avoid negative rates and revenue losses, either deductibility or expensing must be removed or relaxed.

## POLICY RECOMMENDATIONS

If the goal of the TCJA was to create economic growth through the promotion of investment, cutting the statutory rate and allowing for full expensing was the correct path to take. But given that both of those major changes took place, there is no longer any reason to keep the interest payment deduction. In fact, it will be beneficial to remove it.

It is an unavoidable truth that cutting the statutory corporate tax rate and allowing firms to deduct capital expenditures in full from their taxable income will reduce tax revenue. Earlier reports indicated that partially capping the percentage of interest payments that can be deducted from income would help recoup some, if not all, of the lost revenue from such proposals. If the deduction were completely removed, or at least capped, it could go a long way toward paying for not only the rate reduction to 21 percent, but also the capital expensing provision.

Removing the tax deduction of interest paid raises concerns over tax neutrality, though these concerns are easily addressed. For example, from a tax neutrality standpoint, if interest is taxable to the lender, then interest should be deductible by the borrower. However, if the deduction for interest by the borrower is removed, then the interest received by the lender should not be taxable. Tax neutrality is achieved by not taxing interest received and disallowing a deduction for interest paid, but further economic efficiency is gained by this treatment of interest because the tax bias for debt financing is removed.

Despite the ability of capped interest deductions to make up for lost revenue and the deduction of lender-received interest payments to maintain neutrality, it may be simpler still to have the tax code ignore interest altogether. In 2016, Senator Marco Rubio proposed a tax plan that included the elimination of the interest deduction and the removal of the tax on interest received, a plan that effectively removes interest from the tax code entirely. In an analysis of this tax proposal, the Tax Policy Center determined that such a plan would move the effective tax rate on debt-financed investment from negative 6 percent

to roughly zero.<sup>14</sup> A policy reform effort to eliminate negative rates and recoup revenue can also simplify the tax code.

Continuing to keep the interest deduction in place now that the TCJA has lowered the corporate tax rate and allows for full expensing is a perilous practice. Allowing for strong negative tax rates on debt financing could lead to greater inefficient investing and huge losses of revenue. With lower statutory corporate tax rates and full expensing now part of the new tax law, further changes to the corporate income tax code should include elimination of deductibility of interest as a fiscally responsible measure.

## NOTES

1. Curtis Dubay, "The Proper Tax Treatment of Interest" (Backgrounder No. 2868, Heritage Foundation, Washington, DC, February 14, 2014).
2. "The Great Distortion," *Economist*, May 16, 2015. This article is merely one example of many in recent years challenging the tax code bias toward debt, not only in the United States, but around the world.
3. Franco Modigliani and Merton H. Miller were the first to recognize the effect of interest deductibility on corporate structure and investment in their 1958 seminal work. See Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," *American Economic Review* 48, no. 3 (1958): 261-97.
4. George Contos, *An Essay on the Effects of Taxation on the Corporate Financial Policy* (Washington, DC: Internal Revenue Service, 2005), 106.
5. Congressional Budget Office, *Taxing Capital Income: Effective Marginal Tax Rates under 2014 Law and Selected Policy Options*, 2014, 24.
6. Congressional Budget Office, *Taxing Capital Income*.
7. A "C corporation" is a business term that is used to distinguish one type of business structure from others. Profits of a C corporation are taxed separately from its owners under subchapter C of the Internal Revenue Code. Tax is levied first at the corporate level and then again at the individual level when profits are distributed as dividends, interest, or capital gains. In an S corporation, the profits are passed on to the shareholders and taxed solely at the individual level on personal income tax returns. See Congressional Budget Office, *Taxing Capital Income*, 2.
8. Alan Cole, "Interest Deductibility – Issues and Reforms" (Fiscal Fact No. 548, Tax Foundation, Washington, DC, May 4, 2017).
9. Calculated from Board of Governors of the Federal Reserve System, *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts—Third Quarter 2017*, December 7, 2017, 5-7.
10. Board of Governors of the Federal Reserve System, *Financial Accounts of the United States*, 156.

11. Alan Cole, "Interest Deductibility – Issues and Reforms."
12. Congressional Budget Office, *Taxing Capital Income*, 19.
13. Robert Pozen and Lucas W. Goodman, "Capping the Deductibility of Corporate Interest Expense," *Tax Notes* 137 (2012): 1207–23.
14. Elaine Maag, Robertson Williams, Jeff Rohaly, and Jim Nunns, *An Analysis of Marco Rubio's Tax Plan* (Tax Policy Center, Washington, DC, 2016).

### About the Authors

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