Do No Harm: Keep Corporate Interest Fully Deductible

By Jonathan Talisman


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Talisman argues that recent proposals to impose across-the-board limits on the deductibility of corporate interest should be rejected. Interest is an ordinary and necessary cost of doing business. Disallowing all or a portion of a corporation's interest deduction will overstate its economic income, and increase the effective tax rates for capital intensive businesses well above the top statutory corporate rate. By raising the cost of capital, the proposed limits will impede corporate investment and will add distortions as corporations seek other financing alternatives. Moreover, the proposed limits undermine the core purposes of corporate tax reform by making the U.S. system less consistent and competitive with other countries.

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I. Overview

There appears to be widespread agreement among policymakers that the Internal Revenue Code should be reformed by lowering tax rates and broadening the tax base. However, as proposals have surfaced, it has become increasingly clear that it may be difficult to achieve desired goals merely by closing loopholes or eliminating or reforming tax expenditures. Tax reform proponents have begun a search outside the box to find other potential sources of revenue to offset the cost of corporate tax reform. In conducting that search, policymakers must be careful to avoid tax reform efforts that do more harm than good — that is, revenue proposals that will reduce fairness and impede investment and growth.

A case in point is the suggestion by the Obama administration, some policymakers, and pundits that limits be imposed on the deductibility of corporate interest.[1] They argue that the imposition of those limits will raise revenue and reduce economic distortions caused by the different tax treatment of corporate debt and equity. However, for the reasons described below, this so-called debt bias does not warrant arbitrary limitations on the deductibility of corporate interest. Those proposals should be rejected.

First, the current treatment of interest is appropriate and is not distortive. Interest on debt incurred in a trade or business is an ordinary and necessary cost of doing business and should remain fully deductible in measuring taxable income, just as it is for financial accounting purposes. Disallowing the deduction for interest on a corporation's debt will overstate a corporation's economic income and result in overtaxation.[2] That is why the deduction for corporate interest has never been, nor should it be, viewed as a tax expenditure.

While both debt and equity are sources of corporate capital, the two serve distinct purposes, and warrant separate analysis and tax treatment. The

[1] *See, e.g.*, the White House and Treasury, "The President's Framework for Business Tax Reform," at 12 (Feb. 2012) (President's Framework); S. 727, "The Bipartisan Tax Fairness and Simplification Act of 2011," section 211 (Wyden-Coats reform plan); Robert C. Pozen and Lucas W. Goodman, "Capping the Deductibility of Corporate Interest Expense," *Tax Notes*, Dec. 10, 2012, p. 1207; Martin A. Sullivan, "Treat Corporate Interest Deductions Like Any Tax Expenditure," *Tax Notes*, Aug. 6, 2012, p. 631; Calvin H. Johnson, "Corporate Meltdowns and the Deduction of Credit-Risk Interest," *Tax Notes*, May 2, 2011, p. 513.

[2] As explained below, that problem is exacerbated for financial institutions if the limitation is based on gross interest expense, rather than net interest expense.

corporate tax was originally intended as a proxy tax to ensure that corporate equity holders would not defer tax merely by having the corporation retain its earnings.[3] The same issue does not exist regarding debt.

Second, current economic research suggests that any relationship between corporate debt bias and overleveraging or company financial distress is overstated. Moreover, it is clear that the recent formulations of corporate tax reform to lower the corporate rate and broaden the base will significantly mitigate any existing bias, without the need for arbitrary limits imposed on the interest deduction.

Finally, and most importantly, the proposed limitations on the deductions for corporate debt will impede investment by raising the cost of capital, and they will create or exacerbate other significant distortions. A recent EY study found that ''the Wyden-Coats tax plan to limit the interest deduction to its non-inflationary component would have a significant negative effect on the cost of investing.''[4]

Small or closely held businesses will be especially harmed because they do not have ready access to different sources of capital. By increasing hurdle rates for new corporate investments, the proposed limitations will encourage shifts in investments from the corporate to the noncorporate sector of our economy and from capital-intensive businesses to the services sector. To avoid those adverse effects, corporations will likely shift to other techniques that will allow them to fully deduct their financing costs. And efforts to limit those will only add further distortions, complexity, and inefficiency to our tax system.

The proposed limitations will make our tax system an outlier relative to our major trading partners. That would undermine a major purpose of corporate tax reform — to bring our system closer to international norms and improve its competitiveness. Also, as proponents for a limitation readily admit, the real culprit for any debt bias is the double-level tax on C corporations leading to the conclusion that ''it would be far better to eliminate double taxation than to expand it through an elimination of interest deductions.''[5]

[3]*See infra* text accompanying note 30.

[4]Robert Carroll and Thomas Neubig, ''Business Tax Reform and the Tax Treatment of Debt: Revenue Neutral Rate Reduction Financed by an Across-the-Board Interest Deduction Limit Would Deter Investment,'' at i, EY (May 2012) (Carroll and Neubig).

[5]Sullivan, *supra* note 1, at 632.

II. Discussion

A. Current Tax Treatment Is Appropriate

1. Business interest expenses are a cost of deriving income and should be deductible to measure economic income properly. The federal income tax is a tax on profit, not on gross receipts. Consequently, a deduction for interest expenses incurred in a trade or business has been provided since the inception of the modern income tax[6] and is now generally allowed under section 163.[7] Even absent section 163, interest relating to a trade or business presumably would be deductible as an ordinary and necessary expense.

In its 1977 seminal report *Blueprints for Basic Tax Reform*, Treasury explains why business interest should be deductible in determining income under a Haig-Simons comprehensive income tax[8]:

> Income may be viewed as the sum of consumption and change in net worth in a given time period. Although income is thus defined conceptually in terms of uses of resources, it is not practical to measure an individual's annual income by adding up all of his individual purchases of consumer goods and the change of value of all the items on his balance sheet. Rather the measurement of income is accomplished by using the accounting notion that the sum of receipts from all sources within a given time period must equal the sum of all uses. To compute income, it is necessary simply to subtract from sources expenditures that represent neither consumption nor additions to net worth. These expenditures include the cost of operating a business (payment of salaries, rent, interest, etc.).[9]

Thus, to properly measure income under Haig-Simons, business interest expenses generally must be subtracted from the taxpayer's base made up of the sum of income from all sources.

[6]The Revenue Act of 1921, ch. 136.

[7]By contrast, a deduction for personal interest is generally disallowed other than for interest on some home mortgages and student loan indebtedness. The deduction for corporate interest can be limited in cases ''in which interest cost can be traced to exempt income, or when what is being called debt is really equity, or if related-party loans are used to shift income out of high-tax jurisdictions.'' *See* Sullivan, *supra* note 1, at 631; *see, e.g.*, sections 163(e)(5), 163(j), and 265.

[8]See Robert M. Haig, ''The Concept of Income — Economic and Legal Aspects,'' in *The Federal Income Tax* 1, 7 (1921), reprinted in *Am. Econ. Ass'n, Readings in the Economics of Taxation* 54 (Richard A. Musgrave and Carl Shoup, eds. 1959); Simons, *Personal Income Taxation* 50 (1938).

[9]Treasury, ''Blueprints for Basic Tax Reform,'' Jan. 17, 1977, at 3.

Still, some recent tax reform proposals call for a limitation on the deductibility of corporate interest. For example, the President's Economic Recovery Advisory Board suggested that "one option would be to limit the deductibility of net interest to 90 percent of expense in excess of $5 million per year."[10] According to the advisory board, the proposal to limit the deduction for corporate interest would allow approximately a 0.7 percent reduction in the corporate rate. Robert Pozen is even more aggressive in his tax reform proposal. He proposes a 35 percent haircut (21 percent for financial institutions) on corporate interest deductibility. He claims that by itself would allow a corporate rate reduction to 25 percent.[11] Finally, in the Bipartisan Tax Fairness and Simplification Act, Sen. Ron Wyden, D-Ore., and Sen. Dan Coats, R-Ind., have proposed that the inflationary component of interest paid be disallowed as a deduction for corporations.[12] That is tantamount to a 25 percent haircut on interest deductibility, according to a study by EY.[13]

Failure to provide a full deduction for corporate interest will overstate a corporation's economic income and result in overtaxation. For example, assume Acme Corp. wants to buy an income-producing asset that costs $1 million; there is an expected 12 percent return. Assume further that the cheapest financing available to purchase the asset is for Acme to borrow $900,000 at 10 percent annual interest. After one year, the asset is sold for what Acme paid for it, and the loan is paid off with the sales proceeds. Acme's gross income equals $120,000 ($1 million x 12 percent). However, Acme's net economic income (that is, the equity return or accretion of wealth for Acme's shareholders) equals $30,000 ($120,000 - $90,000) because interest is owed on the loan, which is deducted to derive net profit. If the interest deduction is disallowed in whole or in part, Acme's taxable income will be overstated and Acme will be overtaxed. In fact, assuming a 35 percent interest disallowance, as proposed by Pozen, and an aspirational top corporate tax rate of 25 percent, the tax owed of $15,375 (25 percent x $61,500)[14] will be more than 50 percent of the economic profit on the venture, and 1.5 times what is owed under current law. And that is before taking into account any second-level tax on dividends or capital gains.

Table 1. Calculating Net Economic Income and Taxable Income

	Without Tax Reform: Full Interest Deductibility and 35% Tax Rate	With Pozen Tax Reform: 35% Limit on Interest Deductibility and 25% Tax Rate
Investment proceeds	$120,000	$120,000
Interest expense	($90,000)	($90,000)
Net economic income	$30,000	$30,000
Deductible interest expense	($90,000)	($58,500)
Taxable income	$30,000	$61,500
Tax liability	$10,500	$15,375

2. The corporate interest deduction is an ordinary business expense, not a tax expenditure. Historically and recently, base-broadening tax reform efforts have focused on reducing tax expenditures to offset reductions in tax rates. For example, in the Tax Reform Act of 1986, Congress broadened the base of tax revenue by eliminating or restricting tax expenditures and closing loopholes — not by restricting ordinary and necessary business expenses. In December 2010 Erskine Bowles and Alan Simpson, co-chairs of President Obama's Deficit Commission, proposed the "Zero Plan," which would have eliminated most tax expenditures and used the savings primarily to lower tax rates.[15] Most recently, in a letter to other senators, Finance Committee Chair Max Baucus, D-Mont., and ranking

[10]The President's Economic Recovery Advisory Board (PERAB), "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," at 73 (Aug. 2010).

[11]*See* Pozen, *supra* note 1, at 1209. Pozen's deduction limit is only 3.5 times greater than the PERAB proposal yet he claims a rate reduction nearly 15 times greater. Possible explanations for that difference are that Pozen's proposed limitation applies to the first dollar of interest and to gross interest expense, as opposed to net interest expense (see discussion of the problems that causes below). The PERAB estimate probably reflects behavioral effects too. It is important to note that neither proposal provides any grandfathering for preexisting debt and thus any claimed rate reduction is before any potential transition relief.

[12]Wyden-Coats reform plan, *supra* note 1, section 211. Other than for revenue purposes, it is not clear as a policy matter why the inflationary component of interest expense should be disallowed to the borrower if the inflationary component of interest income is taxable to the lender.

[13]Carroll and Neubig, *supra* note 4, at 6. The Joint Committee on Taxation staff estimates that would raise $162.7 billion over 10 years, which would allow for a corporate rate reduction of 1.5 percentage points, according to the EY report. *Id.* at 10. Again, it is hard to reconcile Pozen's projected 10 percentage point rate reduction for his proposal with the JCT staff estimate.

[14]$61,500 = $120,000 gross income less $58,500 limited interest expense deduction. As suggested in footnotes 11 and 13, it is not clear that Pozen's proposal actually can achieve, by itself, a top corporate tax rate of 25 percent.

[15]The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," at 29 (Dec. 2010).

minority member Orrin G. Hatch, R-Utah, have adopted a similar ''blank slate'' approach to tax reform, saying they intend to eliminate tax expenditures unless they meet one of three tests, and asking their colleagues to help them identify the ones that should be retained.[16]

In an effort to produce additional savings to lower rates further, some tax reform proponents have attempted to characterize the deductibility of corporate interest as an additional tax expenditure.[17] The problem with that proposed characterization is that corporate interest expense has never been, nor should it be, viewed as a tax expenditure. As described above, it is a necessary deduction to measure economic income properly. Accordingly, the deductibility of business interest was left unchanged in the Tax Reform Act of 1986, when restrictions were placed on the deductibility of personal interest (which was viewed as a tax expenditure), and in the Zero Plan.

Stanley Surrey, then Treasury assistant secretary for tax policy, first coined the term ''tax expenditures'' in 1967. His view was that there are two types of tax provisions. Some structural provisions are ''necessary to implement a normal income tax. . . . These provisions compose the revenue-raising aspects of the tax.''[18] Then, there are those that are special preferences; ''departures from the normal tax structure and designed to favor a particular industry, activity, or class of persons.''[19] Surrey labeled that second category tax expenditures because they provide government assistance through the tax system. He hoped that by identifying tax expenditures, the same level of scrutiny would be applied to those provisions as to the appropriations process.[20]

Treasury's 1968 annual financial report included the first tax expenditure analysis, conducted under Surrey's leadership. Consistent with his principles, the report identified ''the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax.''[21] In that analysis, the deduction for corporate interest expense was not treated as a tax expenditure, while the deductions for consumer interest and home mortgage interest expense were. Although unclear in the report, Surrey later said that the normative baseline for the report was a Haig-Simons ''economic definition of income,'' and thus the report's determination of tax expenditures was generally based on items that deviated from that definition.[22]

That tax expenditure analysis was codified by the Congressional Budget and Impoundment Act of 1974 (the Budget Act).[23] The Budget Act requires the Congressional Budget Office and Treasury to publish annually a list of tax expenditures and the amount of revenue associated with each item.[24] The Budget Act defines tax expenditures as ''those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.''[25] Because the staff of the Joint Committee on Taxation is responsible for revenue analysis, ''CBO has always relied on the JCT staff for the production of its annual tax expenditure publication.''[26] Neither the JCT staff nor Treasury has ever listed the deduction for corporate interest expense as a tax expenditure.[27]

3. Contrary to proponents' claims, debt and equity serve different purposes that warrant different treatment in measuring corporate income. Proponents for limiting the corporate interest deduction argue that debt and equity serve similar purposes and should not receive different tax treatment. According to them, ''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. . . . Thus, we find no strong policy rationale supporting the very favorable treatment of interest expense relative to that of returns to

[16]Baucus and Hatch, ''Next Steps on Tax Reform'' (June 27, 2013).

[17]*See* Sullivan, *supra* note 1, at 632-633. Sullivan argues that the corporate interest deduction reduces neutrality by favoring debt over corporate equity; however, he later admits that, other than revenue constraints, corporate integration is a ''far better'' answer. He does not address the effects of the generally worse treatment of interest at the personal level, which professor Merton Miller argued offset any benefit at the corporate level. *See infra* text accompanying note 51.

[18]Surrey and Paul R. McDaniel, *Tax Expenditures*, Harvard University Press: 1985, at 3 (Tax Expenditures).

[19]*Id.*

[20]*See id.* at 32.

[21]Treasury, ''Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968,'' Government Printing Office 1969, at 327.

[22]*Tax Expenditures*, *supra* note 18, at 3.

[23]For a brief discussion of the history of the Budget Act, see Patrick Heck and John Godfrey, ''Treasure or Trash: Sorting Tax Expenditures in Tax Reform,'' *Tax Notes*, Mar. 28, 2011, p. 1565.

[24]P.L. 93-344, sections 202(f)(1)(B) and 601.

[25]P.L. 93-344, section 3(a)(3).

[26]JCT, ''A Reconsideration of Tax Expenditure Analysis,'' JCX-37-08, at 22 (May 12, 2008).

[27]By contrast, the home mortgage interest deduction has been listed as a tax expenditure because the ''implicit rental income from the home . . . is not subject to tax.'' *See* Senate Budget Committee, ''Tax Expenditures,'' S. Prt. 102-119, Nov. 1992, at 187.

equity."[28] That argument ignores essential differences between debt and equity and neglects to take into account the purpose of the corporate income tax.

There are several nontax reasons why corporations and other businesses may choose to use debt rather than equity to raise needed investment capital. The issuance of debt is non-dilutive for the shareholders. By using debt to raise capital, they are able to raise funds without relinquishing control rights or their share of the business's residual profits. Further, because it is a less risky investment, debt is generally much cheaper to issue than additional equity. Debt holders will typically accept a lesser return on their capital because their investment and its return are often secured and have priority of repayment in the case of bankruptcy. Moreover, the cost of debt is often fixed and determinable in advance, while the return on new equity is less predictable. Debt must be repaid by a certain date, while equity capital represents the going concern value of the enterprise. It is easier to obtain debt capital to meet unforeseen business needs than it is to raise equity in the capital markets, which even if available may require the company to incur expensive underwriting costs. As discussed more fully below, debt may be even more essential for small businesses, which do not have access to public capital markets. Finally, debt in a corporate capital structure can help maintain organizational efficiency by enforcing payments of cash flow. Debt helps "to motivate managers to disgorge [free cash flow] rather than investing it at below the cost of capital or wasting it on organization inefficiencies."[29]

Thus, while they are both forms of capital available for corporate investment, the differences indicate that debt and equity are not substitutes for each other from either investors' or the corporation's standpoint. Most notably, shareholders own the company, while creditors do not. Shareholders have the right to control corporate decision-making and are entitled to the residual profits and going concern value of the venture.

It is the latter point that caused the differentiation of debt and equity in the origins of the corporate income tax. The corporate tax was initially intended as "a substitute or 'proxy' for taxing corporate shareholders directly."[30] It was viewed as necessary to reach shareholders' intangible wealth and prevent them from avoiding tax by keeping profits at the corporate level.

In 1894, when the first tax on U.S. corporate income was adopted, the House initially passed a dividends tax and an undistributed profits tax, which was a direct tax on corporations.[31] The undistributed profits tax was proposed to prevent shareholders from avoiding taxation "by causing their corporation to refrain from issuing dividends."[32] In an effort to simplify the House bill, the Senate abandoned the House's two-pronged approach and replaced it with a single, direct tax on corporate net profits. At the time, Sen. George Graham Vest of Missouri, a member of the Finance Committee and the author of the Senate's version of the bill, explained that "instead of making the corporation a collector simply for the Government, we have endeavored to simplify the bill and, in my judgment, we have strengthened it, by putting the tax directly upon the corporation and then allowing the corporation to adjust its relations with its own stockholders as it sees fit."[33] Thus, the Senate bill was an effort to combine the House bill into one step, but it was still viewed as an effort to tax shareholder income. After becoming law, the tax was struck down in 1895 when the Supreme Court held the income tax was unconstitutional in *Pollock v. Farmer's Loan & Trust Co.*[34]

Similarly, when President Taft proposed an excise tax on corporate profits in 1909, congressional supporters stressed the need "to reach the great accumulated wealth of the country, or its earnings, engaged in corporate enterprise."[35] Thus, according to professor Steven A. Bank, the country's history evinces that the corporate income tax "was a natural progression in the quest to reach shareholder income."[36]

That rationale for the corporate tax continues to exist today. In a recent article on international tax reform, professor Reuven S. Avi-Yonah explains

[28]Pozen, *supra* note 1, at 1213.

[29]Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," Harvard Business School, at 2 (1986).

[30]Steven A. Bank, "Entity Theory as Myth in the Origins of the Corporate Income Tax," 43 *Wm. & Mary L. Rev.* 447, 452, Dec. 2001.

[31]*Id.* at 504.

[32]*Id.* at 518.

[33]*Id.* at 529, citing 26 *Cong. Rec.* 6866 (1894) (statement of former Sen. Vest).

[34]157 U.S. 429 (1895).

[35]Bank, *supra* note 30, at 532. The double taxation of corporate income arose during the Roosevelt era as a compromise to an administration proposal to impose an undistributed profits tax. There was a concern that undistributed corporate surplus was adversely affecting the economy. *See generally* Bank, "Corporate Managers, Agency Costs, and the Rise of Double Taxation," 44 *Wm. & Mary L. Rev.* 167, 192-228, Feb. 2002. As discussed above, by contrast, debt helps to encourage disgorgement of corporate cash flow. *See supra* text accompanying note 29.

[36]Bank, *supra* note 30, at 528.

that one of two reasons to continue to tax corporations is that ''if we don't, rich individuals could park their income inside corporations and obtain deferral.''[37] That same logic does not apply in the case of corporate debt holders because the corporation does not provide a deferral shield with respect to debt. Interest generally must be paid periodically. Even if it is not actually paid out, the original issue discount rules ensure that corporate debt holders are generally subject to tax currently.[38] Thus, there is no need for a corporate proxy tax for debt to prevent deferral.[39] Moreover, as described below, any corporate proxy tax imposed by disallowing interest deductions would ultimately harm corporate shareholders and possibly employees, rather than debt holders.[40]

B. Effects of Debt Bias Appear Exaggerated

1. Recent economic research suggests the relationship between interest deductibility and company financial distress is overstated. According to the Obama administration and other proponents of limiting interest deductibility, the tax preference for debt financing has adverse economic consequences. In its Framework for Business Tax Reform, the administration said, ''outsized reliance on debt financing can increase the risk of financial distress and thus raise the likelihood of bankruptcy. . . . In the broader context, a large bias towards debt financing in the corporate tax code may lead to greater aggregate leverage and the associated firm level and macroeconomic costs of debt financing.''[41]

However, bodies of economic research call into question the administration's assertions and assumptions about debt financing. For several reasons, it appears that any tax-driven bias for debt may be exaggerated and, to the extent it exists, it does not contribute significantly to overleveraging or distress.

In his presidential address to the American Finance Association, Nobel Laureate Merton Miller found paradoxically that the debt-to-asset ratio of a typical nonfinancial corporation had not changed significantly over several decades ''despite the fact that tax rates [and hence the value of interest deductions] had quintupled.''[42] Finding more than 30 years of observable behavior too hard to ignore, Miller surmised, ''the tax advantages of debt financing must be substantially less than the conventional wisdom suggests.''[43] He concluded that any corporate tax advantage for issuing debt is mitigated by the returns to debt being treated generally worse at the individual level.[44]

Duke University finance professor John R. Graham has found that there is a significant degree of conservatism in corporate debt policy. His prize-winning research shows that many firms are ''leaving money on the table'' and not borrowing at levels that would be financially optimal, given the availability of the interest deduction.[45] He suggested that an optimal capital structure would cause those firms to incur more debt, not less. That appears to refute the notion that companies are overleveraged because of the tax treatment of debt.

In testimony before the two taxwriting committees, professor Mihir Desai at Harvard University reached a similar conclusion, saying that concerns over the tax treatment of corporate debt ''in fostering the financial crisis appear unfounded.''[46] Later in his testimony, he elaborated, ''the evidence is clear. The leverage of the non-financial sector was not a contributing factor to the crisis.''[47]

Most notably, in a recent paper, finance professors Brent Glover of Carnegie Mellon Tepper School of Business and Joao F. Gomes and Amir Yaron at University of Pennsylvania's Wharton School of

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[37]Reuven S. Avi-Yonah, ''Arguments For and Against Territoriality,'' *Tax Notes*, May 13, 2013, p. 797.

[38]Under the original issue discount rules, the holder of some debt instruments must include in gross income an amount equal to the daily portions of the OID for each day on which the instrument is held. Section 1272(a)(1).

[39]As with dividend and other investment income, ''a considerable amount of interest income is not subject to tax.'' Carroll and Neubig, *supra* note 4, at 3. Generally, that is because of other policy objectives (*e.g.*, support of the nonprofit sector and encouragement of various types of savings), and tax treaty obligations. *Id.*

[40]*See infra* text accompanying note 67. The question of who bears the incidence of the corporate tax is complicated and unsettled. However, there have been several advancements in recent research that appear to indicate that most of the burden is borne by shareholders and to a lesser extent by labor. For example, according to economists at the Tax Policy Center, ''In the short-run, the burden of the tax likely sticks with shareholders. Over time, the tax will be shifted to other capital owners and labor, but for a variety of reasons, even in the long-run, most of the tax (and even all) may be borne by shareholders.'' Roseanne Altshuler et al., ''Income Taxation and Progressivity in a Global Economy,'' Tax Policy Center, May 12, 2010, at 4. *See also* Alan J. Auerbach, ''Who Bears the Corporate Tax? A Review of What We Know,'' *Tax Policy and the Economy*, MIT Press 2006.

[41]The President's Framework, *supra* note 1, at 5-6.

[42]Miller, ''Debt and Taxes,'' *The Journal of Finance* (May 1977), at 264.

[43]*Id.* at 266.

[44]For a fuller explanation, see *infra* text accompanying note 51.

[45]John R. Graham, ''Estimating the Tax Benefits of Debt,'' *Journal of Applied Corporate Finance* (Spring 2001), at 44 (his research won the Brattle Award for outstanding work in the area of corporate finance).

[46]Testimony of Mihir Desai, Professor of Law, Harvard University, before the Senate Finance Committee and the House Committee on Ways and Means, July 13, 2011, at 2.

[47]*Id.* at 5.

Business quantitatively evaluated the effects of the interest deduction on financial variables, including the amount of leverage, credit spreads, and defaults.[48] Not surprisingly, they found that removing the interest deduction lowers the incentive to finance with leverage. However, they found that "contrary to conventional wisdom . . . eliminating interest deductibility results in an increase in the default frequency and average credit spreads."[49] That is because, as explained more fully below, removing the interest deduction increases a company's external cost of capital and hence its risk. With greater risk, the probability of default is greater and credit spreads increase.

2. Tax reform will naturally mitigate any corporate debt bias. The United States and most other major countries allow a full deduction for corporate interest payments, but provide no deduction for dividends.[50] That arguably creates a tax bias for corporations to use debt rather than equity. However, there is substantial uncertainty as to the extent of that debt bias.

As discussed above, Miller noted in his speech that a personal tax advantage exists to holding equity that offsets the corporate tax advantage of issuing debt.[51] While interest is taxed currently as ordinary income at the individual level, equity returns often are deferred indefinitely and taxed at lower capital gains rates, or possibly not taxed at all if held to death.[52] Thus, investors will demand a higher pretax return on debt relative to equity — holding risk constant — to offset their higher personal tax costs on interest income received, which reduces the benefits of issuing debt at the corporate level.[53] Miller said that there could be clientele effects or losses at the corporate level that mitigate or eliminate the double taxation of equity, further reducing any debt bias.[54] Thus, he postulated that "the personal tax cost of debt was equal to the corporate tax advantage in equilibrium, and therefore there is no tax advantage to debt once you net out personal tax costs."[55] Graham and others believe that the mitigating effect of "the personal tax costs of debt" is only partial — reducing the corporate tax advantage by roughly a third.[56]

In his recent testimony before the taxwriting committees, Desai generally agreed by saying that while a pro-debt bias is feasible, current empirical evidence might indicate otherwise. He elaborated, "The U.S. corporate non-financial sector appears remarkably underleveraged by historical standards. . . . One interpretation of the current situation is that the tax system still provides a pro-debt bias but other financial frictions[57] have led to a reliance on equity capital that is unusual. An alternative interpretation would be that the tax system is neutral or pro-equity biased because of widespread corporate tax losses and the possibility that equity is more lightly taxed at the individual level than debt is."[58]

Regardless of which interpretation is right, it is clear that current formulations of tax reform will mitigate any debt bias to the extent one exists. First, lowering the corporate tax rate to recently proposed levels will, by itself, reduce the value of the corporate interest deduction by 20 percent or more.[59] It also significantly lowers the double-level tax on equity.[60] Second, to the extent that accelerated depreciation or other similar benefits are eliminated or reduced, as has been proposed in several of the major reform proposals, the concern raised by Pozen and others that there can be a negative corporate effective tax rate on debt-financed investment disappears.

Finally, it is important to note that the current treatment of interest is not the real cause of any debt bias that may exist.[61] As proponents for a limitation readily acknowledge, the real problem is the double-level tax on C corporations. *Tax Notes* chief economist Martin A. Sullivan admits, "It would be far better to eliminate double taxation than to expand it through an elimination of interest deductions."[62] However, he argues that because budget constraints make corporate integration unlikely, a limit should be imposed on interest deductions to promote "economic neutrality" with the treatment

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[48]Glover et al., "Corporate Taxes, Leverage, and Business Cycles," working paper, Aug. 2011.

[49]*Id.* at 23.

[50]*See infra* text accompanying note 80.

[51]Miller, *supra* note 42, at 267-268.

[52]*Id.* at 266, 270. (Miller noted that "by conventional folk wisdom, 10 years of tax deferral is almost as good as exemption").

[53]Graham, *supra* note 45, at 53.

[54]Miller, *supra* note 42, at 270; Desai, *supra* note 46, at 3.

[55]*See* Graham, *supra* note 46, at 53.

[56]*Id.*

[57]Various market forces will police the amount of leverage undertaken by a corporation, including lenders, investors, regulators, rating agencies, etc.

[58]Desai, *supra* note 46, at 3 (Desai cites a time series prepared by his colleague, professor Sam Hanson, showing that "the corporate sector is not highly leveraged by historic standards").

[59]*See* Carroll and Neubig, *supra* note 4, at 6.

[60]That effect on debt bias is even more significant if corporate rates are lowered further than individual rates. That assumes that tax rates on shareholder income are not changed.

[61]For a similar discussion, see Carroll and Neubig, *supra* note 4, at ii.

[62]Sullivan, *supra* note 1, at 632.

of equity, even though he admits that the extra layer of tax on equity income ''is an arbitrary tax with no solid economic justification.''[63]

Respectfully, I disagree with his conclusion that two wrongs make a right. Imposing two levels of tax on debt merely duplicates the current-law problem and leaves in place and possibly exacerbates several economic distortions caused by the double-level corporate tax. For example, it will further distort the allocation of capital between the corporate and noncorporate sector, and further encourage corporations to retain corporate earnings.[64] Moreover, the neutrality arguments fail to reflect the personal tax advantage of holding equity noted by Miller and Desai. Some countries recently have attempted to address the real problem by providing an allowance for corporate equity, that is, a deduction or other tax relief for some portion of the notional return to equity.[65]

C. Proposed Limits Will Impede Investment

1. By raising the cost of borrowing, limiting the interest deduction will ultimately harm shareholders and lower investment. Proponents for limiting the corporate interest deduction acknowledge that their proposals would increase the effective tax rate on debt-financed investment, but they assert that ''the overall cost of capital would remain roughly the same'' because equity returns would be taxed at 25 percent instead of at 35 percent.[66] This is misleading. Only corporations with no debt at all will have an effective tax rate on their equity returns of 25 percent. Capital-intensive businesses that need to borrow to grow could see their effective tax rates on equity returns grow substantially, causing them to be significant losers under those proposals. That is because a significant amount of the benefit from rate reduction financed by limiting interest deductions is going to companies that are not substantial borrowers.

According to calculations used for books and financial analysis, the pretax equity return to shareholders is the net income of the corporation determined after all expenses, including interest. Any disallowance of the deduction for interest expense means that a corporation with borrowings will pay income tax on an amount in excess of its net income. That additional tax is likely to reduce the after-tax equity return to shareholders.[67] While the statutory rate will be lower, the lower rate often will be insufficient for capital-intensive businesses to offset the tax applying to an aggregate amount that is greater than their net income. Thus, for capital-intensive businesses, the effective tax rate on their equity returns could be substantially higher than it is under present law.

Here is a simple illustration of the different effects on companies under the proposal. Assume Company A is a labor-intensive service provider and has no need to borrow for investment, while companies B and C need to borrow to make infrastructure investments to serve their customers. Company B is an average corporate borrower, while Company C is capital intensive and borrows heavily for investment. The three companies all have $10 million in pretax net income. Company B has net interest expenses of $13.2 million.[68] Company C has net interest expenses of $25 million.[69] Under current law, the three companies would have the same net income, that is, equity return, and would pay the same tax of $3.5 million (35 percent of $10 million). Under the Pozen proposal, only 65 percent of the interest deduction would be allowed.[70] Company A would continue to be taxed on $10 million, but both Company B's and Company C's taxable income and effective tax rate will increase significantly. If the tax rate is reduced to 25 percent as Pozen proposes, Company A's tax will decrease by $1 million to $2.5 million (25 percent of $10 million), but Company B's tax will increase by $155,000 to $3.655 million (25 percent of $14.62 million) and Company C's tax will increase by $1.1875 million to $4.6875 million (25 percent of $18.75 million), an effective tax rate increase of more than 10 percentage points.

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[63] *Id.*

[64] *See* Michael J. Graetz and Alvin C. Warren Jr., ''Introduction to Integrating Corporate and Individual Taxes,'' *Tax Notes*, Sept. 27, 1999, p. 1767. *See also supra* text accompanying note 29.

[65] *See* A. Klemm, ''Allowances for Corporate Equity in Practice,'' IMF Working Paper, at 8 (Nov. 2006). *See also*, Frederic Panier, Francisco Perez-Gonzalez and Pablo Villanueva, ''Capital Structure and Taxes: What Happens When You (Also) Subsidize Equity?'' May 2013 (finding that a Belgian ''notional interest deduction'' for equity increased corporate equity levels and improved equity ratios, but did not diminish non-equity liabilities).

[66] Pozen and Goodman, *supra* note 1, at 1207.

[67] *See supra* text accompanying note 40.

[68] According to the summary data in Pozen's Table 2, corporate interest deductions appear to be roughly 132 percent of corporate taxable income, on average. That was determined by dividing the total corporate interest deductions of $8,566 billion ($5,745 billion nonfinancial-sector interest + $2,821 billion financial sector interest) by the total corporate taxable income of $6,483 billion (($2,115 billion of corporate tax revenue + $154 billion of corporate credits)/corporate tax rate of 35 percent).

[69] Companies that are in highly capital-intensive businesses, such as utilities, energy, communications, and materials, will often have interest expenses that are a multiple of taxable income.

[70] That is increased to 79 percent for financial services companies. That would, however, be based on gross interest expenses. The problems with that approach for financial services companies are discussed *infra* note 89.

Table 2. Effects on Different Types of Companies

	Company A Labor Intensive Service Provider	Company B Average Corporate Borrower	Company C Capital Intensive Manufacturer
Taxable income (current law)	$10 million	$10 million	$10 million
Tax paid (current law) (35%)	$3,500,000	$3,500,000	$3,500,000
Effective tax rate (current law)	35%	35%	35%
After-tax retained earnings (current law)	$6,500,000	$6,500,000	$6,500,000
Interest expense	$0	$13,200,000	$25,000,000
Disallowed portion of interest expense (Pozen proposal)	N/A	$4,620,000	$8,750,000
Taxable income (Pozen proposal)	$10 million	$14,620,000	$18,750,000
Tax paid (Pozen proposal) (25%)	$2,500,000	$3,655,000	$4,687,500
Effective tax rate (Pozen proposal)	25%	36.55%	46.88%
After-tax retained earnings (Pozen proposal)	$7,500,000	$6,345,000	$5,312,500

The example highlights another important aspect of the proposal: The incidence of the tax increase from limiting interest deductions will be borne by shareholders and possibly employees, not by debt holders. As the example demonstrates, the proposal will significantly reduce after-tax retained earnings, that is, residual profits available for distribution or reinvestment, for capital-intensive businesses and increase the effective tax rate on equity returns. Thus, the burden of the additional tax will fall on shareholders and to some extent employees, unless the disallowance results in a reduction of overall interest rates, something that is probably not likely.

Graham confirms that analysis and explains the incidence of the interest deduction as follows:

> By financing with debt a firm reduces its tax liability, thereby reducing the portion of the pie given away to the government. As long as debtholders receive their portion of the pie, the stockholders get what's left over (because they are the residual owners of the firm). Therefore, stockholders get to pocket the tax savings that are achieved by financing with debt.[71]

Moreover, the proposed limitations will increase the cost of capital raised through debt by reducing corporate returns. Most corporations will only make a new investment if it exceeds an established ''hurdle rate,'' which typically is determined as the cost of capital plus a return to reflect the perceived risk of the investment. Thus, by raising the cost of capital, the disallowance of interest expense increases the hurdle rate for new corporate investments. That could diminish overall levels of investment in the economy and inhibit investment in essential infrastructure that other businesses rely upon to grow and compete. It could shift investments from the corporate to the noncorporate sector of our economy or from capital-intensive businesses to the service sector.

For example, according to a recent EY study, ''the Wyden-Coats tax plan to [reduce the corporate rate and] limit the interest deduction to its non-inflationary component would have a significant negative effect on the cost of investing in the United States.'' The study found that even with a concomitant change in the corporate rate, the proposed interest limitation would increase the marginal effective tax rate on new corporate investment from 31 to 33.1 percent. Thus, the study found that the ''higher overall cost of investment in the United States as compared to other nations would make the United States a less attractive place to invest,'' and ''the corporate capital stock in the United States would be smaller,''[72] ultimately hurting our productivity and living standards.

Those effects may be magnified for start-ups and other small businesses, which do not have ready access to public markets for alternative sources of capital. Recent studies have shown that 75 percent of all start-ups rely on debt financing and that 4 out of 5 small businesses use debt as a source of capital.[73] Thus, raising the cost of capital for debt financing by imposing limitations on interest deductibility is likely to impede investment and growth by the small business corporate sector and other closely held businesses.

2. Deduction limits may be avoided through other financing alternatives. It is likely that corporations will use several available techniques to avoid the adverse effects of any interest deduction limitation

[71]Graham, *supra* note 45, at 42.

[72]Carroll and Neubig, *supra* note 4, at 2.

[73]Rebel A. Cole, ''Why Businesses Use Debt — And How Debt Benefits Businesses,'' Private Equity Growth Capital Council, at 3 (2013).

should one become law.[74] Switching from debt to those other available financing techniques, however, is likely to have costs and be less efficient.

a. Leasing. The most obvious way for corporations to avoid any limitations on interest deductions would be to lease property rather than purchase it with debt financing. Anybody who has dealt with a car salesman knows that leasing serves roughly the same purpose as borrowing. They are simply alternative forms of financing.[75]

In general terms, leasing allows someone to obtain use and control of an asset without actually acquiring ownership of it. It can take many forms: short-term leases, simple long-term lease arrangements, leveraged leases, leases coupled with an option to purchase, and sale-leaseback arrangements. If the asset is leased in connection with a trade or business, the lease payments generally are fully deductible.[76] Thus, if interest deductions are limited, corporations may opt for the more tax-efficient financing structure and lease assets, instead of using debt to purchase them.[77]

Because the proposals to limit interest deductions affect only corporations,[78] any necessary borrowing to purchase assets may be shifted to individuals and passthrough entities that would then lease the assets to corporations. If the proposals are limited to net interest (see below), then corporate intermediaries likely could continue to borrow to purchase an asset and then lease it. The lessors would continue to be allowed to deduct their interest payments fully, while the corporate lessee would be able to deduct the lease payments. That would be likely to increase leveraged leases and sale-leasebacks.

b. Partnerships and other passthroughs. Another relatively straightforward way of avoiding any limits on interest deductions would be for the corporation to enter into a partnership with a financing partner. Instead of interest, the financing partner can be paid a preferred return by the partnership. That preferred return is effectively deductible to the corporation because the partnership's income would be allocated first to the financing partner in an amount equal to the preferred return.

Because the proposed interest limitations generally would apply only to C corporations, the proposals appear merely to substitute a new set of distortions for the current purported bias for corporate debt. Taxpayers would have greater incentive to move assets or make new investments in passthrough form, including limited liability companies, real estate investment trusts, and, possibly, master limited partnerships. Taxpayers that need to borrow to make capital investments are more likely to do so in passthrough form. Thus, incentives for adopting passthrough treatment would increase if the proposed corporate interest limitations are adopted.

c. Factoring and securitization. Other common financing techniques that could allow corporations to avoid any imposed limits on interest deductibility are factoring and securitizations.

Factoring is one of the oldest forms of financing and could become more widely used if the corporate limitations on interest deductibility proposals move forward. In a factoring transaction, companies can raise funds readily by assigning their receivables to a bank or other financier. In exchange, the assigning company typically receives a discounted sum without having to wait for payment from customers. The discount effectively is the same as interest paid on an advance secured by the receivables.

Structured finance transactions serve a similar purpose. In a typical securitization, an originator of various forms of debts payable (for example, receivables) sells the debts to a special purpose vehicle. The special purpose vehicle, in turn, offers interests in securities collateralized by the debts to investors on an established securities market. That type of securitization transforms an on-balance-sheet collateralized loan into an off-balance-sheet financing — in the form of a tradable bond — that likely would avoid any corporate interest limitation. One must question whether Congress wants to encourage securitizations given the recent financial crises.

A recent *Tax Notes* article suggests that factoring and securitization are already being used to avoid thin capitalization regimes in other countries. According to an expert quoted in the article, ''factoring, leasing, and off-balance-sheet-structured finance [are] alternatives to debt that would fall

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[74]As Pozen admits, his proposal does not provide a ''full regulatory structure for implementing the interest cap'' and ''there are some legitimate possibilities for avoidance that regulators must address.'' *See* Pozen and Goodman, *supra* note 1, at 1219.

[75]Most economic models predict that debt and leases act as substitutes for each other; however, in some cases, they can act as complements. *See, e.g.,* Jim Schallheim et al., ''A Test of the Substitution Between Debt and Leases Using Sale-and-Leaseback Transactions,'' at 30 (Nov. 2007).

[76]*See, however*, sections 168(h) and 467.

[77]The Japanese recently adopted earnings stripping rules that restrict interest paid to related parties, including the interest portion of any lease payments. It excludes any interest on repo transactions.

[78]*See* the President's Framework, *supra* note 1, at 10; Wyden-Coats reform plan, *supra* note 1, section 211; Pozen and Goodman, *supra* note 1, at 1210.

within the statutory limits'' to avoid Germany's thin capitalization rules.[79]

Thus, it is not clear that the interest limitation proposals would achieve the desired amounts of revenue gains unless they restricted the other financing techniques described above too. Addressing those other techniques fully would add layers of complexity and other distortions to our tax law. Further, any limitations are likely to impose additional inefficiencies and undesirable economic barriers in corporate financing.

3. Limiting corporate interest deductions would make the United States an outlier among developed countries and could inhibit long-term growth. Currently, U.S. tax policy on the deductibility of interest as an ordinary business expense is in line with most industrialized countries. Imposing an arbitrary limitation on the interest deduction would change that dramatically.

The tax systems of our major trading partners generally treat interest expenses as fully deductible if they are incurred in connection with a business.[80] Only France, in a recent change, imposes a percentage haircut on the interest deduction.[81] Some other countries, such as Germany, Italy, Spain, and Australia, impose proportionality rules to ensure that home country interest expenses are not disproportionate relative to the rest of the multinational group.[82] Several countries, including the United States, impose interest-stripping rules to limit base erosion through interest payments to foreign related parties.[83] A few countries, such as Germany and Australia, impose thin capitalization rules that apply to all interest and ''limit a borrower's ability to deduct interest on debt if the borrower's capital structure is deemed to be excessively leveraged.''[84] However, the most common rule among our major trading partners is to impose no limitation on the deductibility of unrelated-party interest expenses.[85] In fact, the United Kingdom, Canada, and Japan recently each considered and rejected imposing limitations on interest deductions because of competitiveness concerns.[86]

Thus, imposing a haircut on the deductibility of interest, as proposed as a potential offset for corporate tax reform, would make the United States an outlier among developed economies. According to Marlin Risinger, enacting rules ''that are burdensome, by reference to the benchmark of global norms . . . will increase the cost of capital of the affected [multinational corporations], which in turn will affect their competitive position by hampering their ability to fund new investment and price their output of goods and services at competitive levels.''[87] Moreover, the proposed limitations could hinder U.S. companies' ability to bid on acquisitions against foreign competitors that are fully able to deduct their interest costs.

Other potential issues that arise from a limitation on corporate interest deductibility include encouraging foreign investment by U.S. companies in countries where interest is fully deductible, placing U.S. financial companies at a disadvantage in making loans, and encouraging foreign takeovers of U.S. companies.[88] That runs counter to two purposes of corporate tax reform: to make our system more consistent with those in other countries and to make it more competitive.

D. Proposed Limits Will Have Adverse Effects

1. Determination of interest expense. At least two of the major proposed limitations to date — Wyden-Coats and Pozen — appear to be based on gross interest expenses rather than net interest expenses.[89]

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[79]Lee A. Sheppard, ''Doors to Manual: Antiabuse Rules Take Flight,'' *Tax Notes*, May 9, 2011, p. 542.

[80]By contrast, none of those countries provide a deduction for dividends.

[81]The haircut is 15 percent of net interest in 2013 and increases to 25 percent thereafter.

[82]For an excellent discussion of the proportionality rules, see Marlin Risinger, ''Limiting the Deduction for Multinational Interest Expense: The Importance of Global Norms,'' *Taxes*, Mar. 2013, at 71, 89-95.

[83]*See* section 163(j). Other countries that impose similar interest-stripping or thin capitalization restrictions on interest paid to related parties include Canada, Japan, Spain, and the United Kingdom. *See* JCT staff, ''Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income,'' JCX-33-11, at 14-45 (May 24, 2011).

[84]Edward D. Kleinbard, ''Stateless Income,'' 11 *Fla. Tax Rev.* 699, 729 (2011). For a further discussion of the German-style thin capitalization rules, see Kleinbard, ''Stateless Income's Challenge to Tax Policy,'' *Tax Notes*, Sept. 5, 2011, p. 1021. The

(Footnote continued in next column.)

discussion draft proposal of House Ways and Means Committee Chair Dave Camp, R-Mich., follows that model.

[85]*Id.* at 90. Risinger ''reviewed the relevant tax rules in 24 countries which together represent 88 percent of the total cumulative outbound foreign direct investment (excluding the United States) as of 2011. The most common rule on interest deductibility for payments to unrelated parties in those countries is 'no limitation.'''

[86]*Id.* For example, in rejecting any limitation, the Canadian government said ''now is not the right time to impose rules that could restrict access to capital for Canadian companies, especially when international tax rules in many other countries support the deductibility of interest for investments and arrangements.'' *Id.* at 93 (quoting Advisory Panel on Canada's System of International Taxation, ''Final Report: Enhancing Canada's International Tax Advantage,'' Dec. 2008).

[87]*Id.* at 80.

[88]*See* John M. Samuels, ''American Tax Isolationism,'' *Tax Notes*, June 29, 2009, p. 1593.

[89]Wyden-Coats reform plan, *supra* note 1, section 211; Pozen and Goodman, *supra* note 1, at 1210.

Thus, unlike other countries that impose thin capitalization rules[90] or France's new limitation,[91] the recent proposals fail to reflect that financial institutions are necessarily highly leveraged and that they act as intermediaries by borrowing. To be fair, Pozen at least acknowledges that issue by reducing his proposed haircut from 35 to 21 percent for financial institutions, but still bases the proposed limitation on gross interest expenses. That softens the effect of his limitation for financial firms, but, as the example below demonstrates, still is highly unfair and is driven by revenue, not policy concerns.

As the Securities Industry and Financial Markets Association notes, "For financial institutions, interest expense is the equivalent of the cost of goods sold, and imposing a limitation on gross interest expense deductibility would be akin to limiting the deduction for raw materials by a manufacturer, or on labor costs for a retailer."[92] A simple illustration comparing a financial services business to a retailer illustrates the unfairness of that approach. Assume first that a bank takes $10 million of deposits at 8 percent simple interest and lends the same money at 10 percent. At the same time, a retailer buys $10 million of goods with a 2 percent gross margin. Each would have $200,000 of economic income and would properly be taxed the same. However, as Table 3 shows, the tax results are significantly different under the interest limitation proposals. Assuming a top corporate rate of 25 percent, the retailer would owe $50,000 of tax on its $200,000 of income, whereas the bank would owe $92,000 on the same level of income. The bank's effective tax rate would be 46 percent. While clearly unfair, it also places U.S. financial institutions at a significant disadvantage in competing for business against foreign competitors. Money is the ultimate commodity. The only real differentiation is price. If U.S. financial companies are subject to a far higher effective rate on those types of transactions than their foreign competitors, they will be unable to compete for business.

Table 3

	Bank	Retailer
Economic income	$200,000	$200,000
Interest expense disallowed (Pozen proposal)	$168,000 (21% of gross interest expense of $800,000)	$0
Taxable income (Pozen proposal)	$368,000	$200,000
Tax owed at 25% (Pozen proposal)	$92,000	$50,000
Net after-tax income	$108,000	$150,000
Effective tax rate	46%	25%

2. No differentiation by types of debt. As described above, the various proposed limitations are premised at least partly on reducing the purported current bias for debt over equity. If that were the true justification, one would think the proposals' ambit would not apply to types of debt that are clearly not substitutes for equity.[93] For example, it is very difficult to argue that various forms of short-term debt, such as accounts payable, trade credit, bridge loans, credit cards, or repos, are acting in any fashion as an alternative to equity. Yet, none of the proposals to date would distinguish interest on those types of loans from interest on other borrowings. A one-size-fits-all approach seems to show that the exercise is mostly revenue — and not policy — driven.

III. Conclusion

Tax reform efforts should be driven by policy considerations. While ostensibly aimed at reducing the so-called debt bias, it is clear that proposals to impose arbitrary limits on interest deductions are driven largely by revenue needs. That would be a mistake. The current tax treatment of corporate interest is appropriate. Imposing a haircut on interest deductibility will result in overtaxation of corporations, inhibit corporate investment and growth, add economic distortions, and reduce U.S. competitiveness.

As Camp and Baucus have said, tax reform efforts should "grow and expand the economy."[94] Arbitrary limits on the deductibility of corporate interest fail by that measure and should therefore be rejected.

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[90]Germany, Italy, and Spain apply their thin cap rules only to net interest expense to limit their effect on financial institutions. Australia disallows interest on debt exceeding a debt/equity ratio of 3 to 1 for most corporations, but increases the ratio to 19 to 1 for financial services businesses.

[91]The new percentage haircut in France is imposed on net interest income as well.

[92]"SIFMA Views on Tax Reform," Apr. 15, 2013, at 7.

[93]As described above, there is a significant question as to how much most debt acts as a substitute for equity.

[94]Baucus and Camp, "Tax Reform Is Very Much Alive and Doable," *The Wall Street Journal*, Apr. 7, 2013.