BUILD COALITION

April 15, 2015

The Honorable Orrin Hatch
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable John Thune
Co-Chairman
Business Income Tax Working Group
Committee on Finance
United States Senate
511 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Ben Cardin
Co-Chairman
Business Income Tax Working Group
Committee on Finance
United States Senate
509 Hart Senate Office Building
Washington, DC 20510

RE: Keeping Interest Fully Deductible Is Crucial For Pro-Growth Tax Reform

Dear Chairman Hatch, Ranking Member Wyden, Senator Thune, and Senator Cardin,

The Businesses United for Interest and Loan Deductibility (BUILD) Coalition is submitting this letter in response to the Senate Finance Committee's invitation for public comment as the Committee and its five bipartisan Working Groups weigh options for business tax reform. We commend the Committee for investigating ways in which pro-growth tax reform can be achieved. As the Committee determines which of the various provisions of the tax code should remain or be reformed in order to encourage growth, we reinforce the necessity of preserving the full deductibility of interest on debt.

The BUILD Coalition is a group of small, mid-sized, and large businesses in all sectors of our economy including retail, technology, real estate, hospitality, construction, and finance. Our membership also includes a diverse group of trade associations, such as the Real Estate Roundtable, Equipment Leasing and Finance Association, Private Equity Growth Capital Council, Small Business and Entrepreneurship Council, and International Council of Shopping Centers. The views in this letter represent a broad swath of the U.S. economy.

Many policy makers from across the political spectrum have highlighted three primary goals of tax reform: (1) Boost long-term economic growth and investment; (2) simplify the tax code; and (3) ensure fairness in the code. Limiting interest deductibility runs directly counter to each of these goals.

According to a study by EY, a 25 percent across-the-board limitation on interest deductibility, coupled with revenue neutral reductions in statutory corporate income tax rates, would reduce long-run economic growth by $33 billion, as well as decrease outputs in all 50 states and across all industries. The same EY study also finds that limits to interest deductibility would cause investment to fall by $6 billion in today's economy.[1] The reason for this decline is that the primary benefit of limiting interest deductibility – specifically the ability to lower rates– is more than offset by the increase in cost of investment.

[1] EY's Quantitative Economics and Statistics (QUEST) group. "Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses." *EY*. July 2013.

At the same time, interest deductibility is not a loophole that needs to be eliminated or curtailed, it is an ordinary and necessary business expense for businesses of all sizes and in all sectors. Interest is simply a cost of doing business, and deducting interest expense is critical in any tax system that seeks to accurately measure income. For this reason, full interest deductibility has rightfully been in law since the start of the modern income tax code. As Karen Kerrigan, the President and CEO of the Small Business and Entrepreneurship Council, wrote in a 2013 op-ed in *The Hill*, "tax reform should tackle 'loopholes' and unnecessary deductions that litter the code, but it should not upend a legitimate business expense. Doing so could set a precedent for targeting other business expenses, which works against the fundamental fairness and certainty that entrepreneurs so desire."[2]

Not only does limiting interest deductibility run counter to the stated goals of tax reform, the supposed benefits of limiting interest deductibility vanish on closer inspection. Specifically, the notion that interest deductibility unfairly benefits certain sectors of the economy, that equity is an equal substitute for debt financing, and that limiting interest deductibility can improve financial stability all miss the mark.

Businesses use debt financing not just for acquisition costs, but also to finance day-to-day operations and fundamental business activities like meeting payroll, buying raw materials, making capital expenditures, and building new facilities that allow for expansion and job creation.

Research by Dr. Rebel Cole, a professor at DePaul University, reveals that four out of five small businesses use debt financing, while three out of four start-up companies utilize debt financing at inception.[3] In addition to small businesses, capital-intensive industries, such as transportation, retail trade, and construction, rely on debt to finance operations. Business services, professional services, retail trade, wholesale trade, finance and transportation all have a debt-to-assets ratio of more than 50 percent. For these industries, debt financing not only unlocks potential growth, it also sustains day-to-day business activities.

Those in favor of limiting interest deductibility often point to equity financing as being an equal substitute for debt financing. This is not a valid argument. Equity financing, unlike debt financing, requires a business owner to issue new shares of stock, thereby causing shareholder dilution and reducing the owner's stake in the business. Debt financing, on the other hand, requires no such relinquishing of ownership by the borrower. Additionally, debt is less risky and often comes with fixed payouts, making it less expensive and easier to raise for uncertain expenses relative to equity. Debt and equity serve different purposes.

Similarly, proponents of limiting interest deductibility claim that it may encourage excessive leverage due to the asymmetrical treatment of debt and equity by the tax code. This argument fails for several reasons.

First, there is simply no relationship between interest deductibility and nonfinancial leverage. Nobelist Merton Miller found, "When I looked into the matter in 1960 under the auspices of the Commission on Money and Credit, I found, among other things, that the debt/asset ratio of the typical nonfinancial corporation in the 1950's was little different from that of the 1920's despite the fact that tax rates had quintupled – from 10 and 11 percent in the 1920's to 52 percent in the 1950's. Such rise as did occur, moreover, seemed to be mainly a substitution of debt for preferred stock, rather than of debt for common stock."

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[2] Kerrigan, Karen. "Protecting the entrepreneurial dream." *The Hill*. June 2013.
[3] Cole, Rebel A. "Why Businesses Use Debt – And How Debt Benefits Businesses." http://buildcoalition.org/wp-content/uploads/2013/06/BUILD_WhyBusinessUseDebt_RebelCole.pdf

He concluded, "A disequilibrium that has lasted 30 years and shows no signs of disappearing is too hard for any economist to accept. And since failure to close the gap cannot convincingly be attributed to the bankruptcy costs or agency costs of debt financing, there would seem to be only one way left to turn: the tax advantages of debt financing must be substantially less than the conventional wisdom suggests."[4]

Second, according to research on corporate capital structures conducted by John Graham, Mark Leary, and Michael Roberts, leverage has not increased since the 1970s. "Since 1970, leverage has remained fairly stable, but for an increase during the 1980s that gradually reversed over the next two decades. We observe similar broad patterns when we restrict our sample to firms listed on the NYSE or only include the 500 largest firms each year, both of which mitigate a changing sample composition."[5]

Academic evidence is clear over the last half century – there is no relationship between interest deductibility and financial instability. In fact, limiting interest deductibility may actually increase financial instability.

According to research by the St. Louis Federal Reserve's Brent Glover, Joao F. Gomes, and Amir Yarons, "…contrary to conventional wisdom, we find that eliminating interest deductibility results in an increase in the default frequency and average credit spreads. The intuition for this lies in the fact that this policy change makes external financing more costly, which results in riskier firms and higher credit spreads."[6]

For those concerned about the asymmetrical treatment of debt and equity in the tax code, limiting interest deductibility is simply the wrong way to address this problem. According to research by EY, interest deductibility is not the root cause of the bias in the corporate tax system toward debt financing. Rather, "the tax bias results primarily from other aspects of the U.S. income tax system: The double tax on corporate profits raises the tax cost of equity as compared to debt financing. Thus, limiting the deductibility of interest to address the over-or-double-taxation of equity-financed investment in the corporate sector would be at cross purposes with other tax and economic policy objectives."[7]

In essence, two wrongs won't make a right when it comes to the equitable treatment of debt and equity financing. Just because equity financing is subjected to double taxation does not mean that tax reform efforts should subject debt financing to double taxation by scrapping the deductibility of interest expenses. This system of double taxation would only further complicate the tax code, running counter to the goals of tax reform.

All of these arguments also ignore the distributional impact of limiting interest deductibility. According to a report by the Small Business Administration (SBA), woman and minority-owned small businesses typically have limited access to equity markets compared to businesses with male and white owners. Thus, woman and minority-owned small businesses have to turn to bank loans, as well as alternative lending methods. By limiting interest deductibility, policymakers would further increase the existing financial burdens that woman and minority business owners face when trying to raise capital for investments.[8]

[4] Miller, Merton. "Debt And Taxes." *Journal of Finance*. May 1977.
[5] Graham, John R., Mark T. Leary, and Michael R. Roberts. "A Century of Capital Structure: The Leveraging of Corporate America." June 2014.
[6] Glover, Brent, Joao F. Gomes, and Amir Yarons. "Corporate Taxes, Leverage, and Business Cycles." *St. Louis Fed*. July 2011.
[7] Carroll, Dr. Robert and Dr. Thomas Neubig. "Business Tax Reform and the Treatment of Debt." *EY*. May 2012.
[8] Robb, Alicia. "Access to Capital among Young Firms, Minority-owned Firms, Women-owned Firms, and High-tech Firms." *U.S. Small Business Administration*. April 2013.

Lastly, a number of recent proposals that call for 100 percent expensing for businesses seek to eliminate the deductibility of interest payments. While allowing expensing of capital expenditures favors new investment generally, to do so at the expense of interest deductibility would create an unintended effect that would actually limit new investment. These proposals would only benefit those companies with capital structures that do not require borrowing to finance investments, whereas stripping interest deductibility would harm all capital-intensive companies that need to borrow before making investments. For these businesses, both large and small, doing away with interest deductibility will significantly reduce incentives to invest and subsequently grow. Accordingly, the benefits of 100 percent expensing would be offset by the negative impact of eliminating interest deductibility on new investments and overall growth.

The BUILD Coalition fully supports the Committee's goal of achieving pro-growth tax reform. However, any proposal that seeks to limit interest deductibility will not achieve this goal. Instead, such proposals will harm growth in the long run by deterring investment and reducing capital stock. We encourage the Committee, in any proposed tax legislation, to maintain the full deductibility of business interest debt as it exists under current law.

Sincerely,

The BUILD Coalition