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Key Issues in Tax Reform: The Business Interest Deduction and Capital Expensing

Two policy changes that have appeared in the recent tax reform discussions are (1) disallowing business deductions of interest payments and (2) allowing expensing of capital investments. While the discussions are typically framed in terms of trading one policy for the other policy, the analysis presented here attempts to separate the two options where possible, given that each policy change could be enacted independent of the other.

Brief Summary of Current Law

Currently, businesses are generally allowed to deduct interest costs incurred when borrowing money to finance business activities. The rules and limitations for the deduction are detailed in Section 163 of the Internal Revenue Code (IRC). Business interest has been deductible since the enactment of the modern federal income tax code in 1913. The deduction is consistent with traditional theories of income taxation which call for the deduction of expenses incurred in the generation of income.

Businesses are also allowed to claim a deduction for the cost of their investments in physical assets wearing out (i.e., depreciating). Like the interest deduction, the depreciation deduction is a feature of an income tax and has been available in some form since the enactment of the modern tax code. The general idea is that since physical assets generate income over time, the deduction of their cost should be spread out over time to match the generation of income. The Modified Accelerated Cost Recovery System (MACRS) has been used to depreciate most investments made after 1986. The intricacies of MACRS and the exceptions to it are governed by various sections of the tax code (e.g., Sections 167, 168, 179, etc.).

The current depreciation system can be understood along two dimensions. The first dimension is the length (or life) over which a business may depreciate an asset. Most equipment is depreciated over 5 to 7 years, although some may be depreciated over as short as 3 years or as long as 20 years. Residential buildings are depreciated over 27.5 years, while commercial buildings are depreciated over 39 years. Land may not be depreciated.

The second dimension is the method used to determine how much depreciation can be deducted each year. Under MACRS, the simplest method is the straight-line method which allows for equal amounts to be deducted each year over the relevant life of an asset. For example, under the straight-line method if a machine costs $1 million and has a depreciable life of 10 years, a business would be permitted to deduct $100,000 from its income each year for 10 years.

More complicated methods exist under the declining-balance approach which allows for larger depreciation deductions in the earlier years of an asset's life. Because assets are deprecated more quickly under the declining-balance method, this approach is often referred to as "accelerated" depreciation.

The tax code provides two exceptions to MACRS known as "179 expensing" and "bonus" depreciation. These exceptions allow for more generous capital cost recovery. For more information, see CRS Report R43432, *Bonus Depreciation: Economic and Budgetary Issues*, by Jane G. Gravelle; and CRS Report RL31852, *The Section 179 and Bonus Depreciation Expensing Allowances: Current Law and Issues for the 114th Congress*, by Gary Guenther.

Recent Proposals

The Unified Framework for Fixing Our Broken Tax Code, issued by the Office of the Speaker on September 27, 2017, would allow businesses to expense new investments made within at least the next five years. Structures would not be eligible for expensing. The Unified Framework also states that the deduction for net interest would be "partially limited" for C corporations, and that consideration would be given to the appropriate treatment for non-corporate businesses.

The House "Better Way" tax reform blueprint proposed prohibiting businesses from deducting net interest while simultaneously allowing them to expense the cost of investments in the year capital is purchased. Not allowing a deduction for interest while allowing full expensing is a fundamental feature of a business cash-flow tax, but not an income tax. Interest expenses could offset interest income, but could not offset non-interest income.

In the 113th Congress, former Ways and Means Chairman Dave Camp's Tax Reform Act of 2014 (H.R. 1) would have allowed businesses to continue to deduct interest, but would have slowed depreciation for most businesses by extending the time period over which the deductions were claimed and requiring the use of the straight-line method. Small businesses, however, would have been eligible for more generous depreciation than is allowed under the current system.

Budgetary and Economic Issues

Budgetary Issues

Disallowing the deduction for net interest and allowing businesses to expense their investments would have opposing revenue effects. The Joint Committee on Taxation

(JCT) would be assigned the task of providing official revenue estimates of both changes were legislation to be introduced. As of the date of this writing, only outside estimates are available.

The Tax Foundation estimates that allowing expensing would result in a revenue loss of approximately $2.2 trillion in the first decade, whereas disallowing the deduction of interest would increase revenue by $1.2 trillion, for a combined revenue loss of approximately $1 trillion. The Tax Policy Center (TPC) estimated the combined revenue effect of allowing expensing and disallowing the deduction of interest and found that the changes would result in a $1.1 trillion revenue loss over the first 10 years. However, the TPC found that the combined changes would increase revenue by $1.1 trillion in the second decade following the reform.

The reversal in revenue effects in the first and second decades following reform are due to a timing effect. The expensing of capital investment will have a large negative revenue effect in earlier years which will be offset in later years because firms will not be claiming depreciation deductions. Also, the estimates assume that interest on existing loans will still be deductible and the revenue gain will grow over time as those loans mature.

Economic Issues

Currently, the tax code tends to encourage the use of more debt than otherwise would occur because interest payments are deductible while equity earnings (e.g., dividends paid) are not. There is concern that the tax-induced preference for debt financing distorts the allocation of capital and introduces undue risk in the economy. Removing the deduction for interest would create parity in the tax treatment of debt financing and equity financing.

Disallowing the interest deduction would negatively impact businesses that rely on debt financing. There is concern that smaller business could be disproportionally impacted since they may not be able to access equity financing as easily as larger firms. There is also concern over businesses that rely on bridge loans such as farmers who must cover costs between planting and harvest, or contractors and developers who may need to finance the purchase of materials or payroll several months in advance of a project's completion. One option would be to continue to allow certain taxpayers deductions for interest, although this would reduce the revenue generated from removing the deduction. Allowing some taxpayers a deduction for interest, while denying it to others, could create administrative complexity and potentially introduce new tax-induced distortions.

If Congress chooses to modify the treatment of business interest, it will need to carefully consider how to transition to the new policy. For businesses that secured loans before the policy change, policymakers would have to decide if interest payments on debt secured before the policy change would continue to be deductible. Additionally, Congress would have to decide how to treat interest payments associated with existing debt that is refinanced after the policy change.

Allowing firms to expense their capital investment would likely stimulate investment in the short run. Fully deducting the cost of capital expenditures would reduce the marginal tax rate on investment and therefore the after tax return. Increases in the capital stock should translate into increased growth in the short run as the economy transitions under the new policy. The effect of expensing within a broader tax reform, however, is likely to be smaller than if the proposal were enacted as a stand-alone provision. Most tax reform proposals would also lower tax rates on business income, which would lessen the value of expensing.

The longer-run effect on the capital stock and economy as a result of expensing is less clear, particularly if expensing leads to increased deficits. Increased deficits may lead to higher future interest rates, or possibly higher tax rates if policymakers grow concerned over the sustainability of the deficits. A rise in interest rates or taxes could curtail or offset any positive effect expensing has on investment incentives. If the proposal is part of a larger reform package, the revenue effects of the reform, as well as tax rates set in the reform, would also influence the impact of the expensing provision.

Full expensing of capital expenditures would simplify the tax system. The current depreciation system is generally recognized to be complex, requiring companies to incur administrative costs when investing in capital equipment and structures. Since expensing would allow the full cost of an investment to be written off in the first year, this option avoids many of the complexities and costs of the current system.

As with disallowing a deduction for interest, transitioning to expensing will require careful consideration. Policymakers will have to decide if any existing capital stock is eligible for expensing after the change is enacted. If not, immediate expensing could create a disparity in the tax treatment of new and old capital, especially investments made in the year immediately preceding the change. If so, it would create tax parity in the tax treatment of new and old capital, but at an extremely high revenue cost given the size of the existing depreciable capital stock. It would also produce a windfall gain for past investments. Relatedly, there is the question of whether to allow used assets that are acquired after the policy change to be expensed.

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