May 17, 2017

The Honorable Kevin Brady  
Chairman  
Committee on Ways and Means  
United States House  
1102 Longworth House Office Building  
Washington, D.C. 20515

The Honorable Richard Neal  
Ranking Member  
Committee on Ways and Means  
United States House  
1102 Longworth House Office Building  
Washington, D.C. 20515

RE: Hearing On How Tax Reform Will Grow Our Economy And Create Jobs

Dear Chairman Brady, Ranking Member Neal, and Members of the Committee:

The Businesses United for Interest and Loan Deductibility (BUILD) Coalition is submitting this letter in anticipation of the House Ways and Means Committee’s May 18 hearing entitled “How Tax Reform Will Grow Our Economy and Create Jobs.” We commend the Committee for exploring 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 stronger growth, we want to reinforce the necessity of preserving the full deductibility of interest on debt.

The BUILD Coalition’s members represent industries throughout the economy, including agriculture, manufacturing, real estate, retail, and telecommunications. We believe that in crafting measures to catalyze economic growth in the U.S., the last thing Congress should do is make it harder for companies to access capital that can be used to make investments, expand operations, and create more jobs.

Our first-hand experience managing the daily operations of our respective businesses compels us to relay the real-world implications of eliminating or limiting interest deductibility. We also want to dispel some of the misconceptions about this key part of our tax code, including notions that interest deductibility distorts financing decisions, that equity is an equal or appropriate substitute for debt financing, and that interest deductibility can be replaced by immediate expensing of capital expenditures.

Interest deductibility is a well-established, growth-promoting component of the tax code. Interest expense is a normal cost of doing business, and by guaranteeing businesses will not be taxed on the cost of accessing capital, interest deductibility affords us the correct tax treatment that encourages us to continue to invest in growing our businesses and creating more jobs. Not surprisingly, a study by Ernst & Young (EY) finds that limiting interest deductibility to help fund a lower corporate tax rate would negatively impact economic growth in the long-run.¹

Businesses of all sizes borrow in order to finance expansions or meet obligations, and the ability to deduct the interest expense gives business owners the certainty to make such decisions with confidence. For many firms, access to credit is essential for working capital, and many of these companies use debt to weather shifts in demand.

Our debt capital markets are the most liquid and efficient in the world. Small- to medium-sized banks supply the credit that is in turn the life blood of American businesses of all sizes and types—the businesses that provide the core growth in our economy.

Research has found that 75 percent of startups and 80 percent of small businesses rely on debt financing. Without access to affordable credit, these companies, along with medium-sized and larger businesses, will struggle to create jobs and grow the economy.²

Proponents of eliminating interest deductibility sometimes argue that the tax code favors debt over equity, and that this encourages companies to take on more leverage. And yet, research by economists from Duke, University of Pennsylvania, and Washington University in St. Louis³, as well as findings by Nobel Prize-winning economist Merton Miller⁴, show that the tax code has little to no impact on companies' leverage ratios.

Moreover, the argument that equity and debt financing are similar is a fallacy. Debt and equity do not serve identical purposes and are not interchangeable forms of financing. Thus, their differing tax treatment is appropriate. There are a variety of non-tax reasons that businesses like ours choose debt over equity when raising capital. To the extent that policymakers would like to assist equity financing, the answer is to eliminate the tax on dividends, not to punish and restrict debt financing by removing or limiting interest deductibility.

For one thing, many businesses don't have access to equity markets, making debt their only option. In contrast to the dilutive effects of equity, borrowing allows owners to access capital while retaining full control of their business. Debt is also a more cost-effective financing solution than equity because it is more secure for investors, who charge a premium for the risks associated with equity. Therefore, on both sides of the equation, debt and equity play separate and distinct roles in capital formation.

In addition, proposals to offer 100 percent expensing in place of interest deductibility miss the mark. Such proposals fail to account for the real-life implications of what such a trade-off means for businesses, namely that full and immediate capital expensing is not an acceptable alternative for interest deductibility.

For starters, introducing 100 percent expensing would offer no benefit to small businesses, which are already able to expense annual capital expenditures. For larger companies, such plans would amount to Congress raising their taxes by eliminating interest deductibility and lowering them to a lesser degree, if at all, through expensing. That’s a far cry from pro-growth tax reform.

Once again, research supports these arguments. A recent Goldman Sachs Economics Research note predicts that proposals to eliminate interest deductibility in favor of 100 percent expensing "would raise the user cost of capital and reduce investment in the longer run."

While 100 percent expensing might boost cash flows in the near term by pulling forward depreciation schedules, "after the first year, however, the impact on cash flow would begin to decline and eventually turn negative," the Goldman Sachs study warns.⁵

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These harmful effects would not be cancelled out by lower rates, either. As UPenn professor Chris Sanchirico has explained, even proposals to lower the tax rate would "not temper" the harmful effects of the proposed trade-off between interest deductibility and expensing. As businesses that make these financing decisions every day, we know first-hand that you can't expense what you can't afford.

Lastly, some have claimed that debt inherently creates risk in the economy, and steps should be taken to discourage too much borrowing by businesses. This is by no means a given. In fact, a study published by the St. Louis Federal Reserve's Brent Glover, Joao F. Gomes, and Amir Yaron finds that limiting interest deductibility would actually increase volatility throughout the economy by raising the overall cost of accessing capital. The authors understand that limiting or eliminating the deduction for business interest expense would push firms to intentionally cap their size and rely more on operating leverage, making them more susceptible to default.

Glover, Gomes, and Yaron conclude: "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."

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.

These are just the immediate dangers. Numerous policy proposals would also suffer if interest deductibility is limited. For example, President Donald Trump has announced his desire for a $1 trillion infrastructure investment plan based in large part on public-private partnerships. Congressional leaders have discussed similar proposals, with anticipated leverage ratios of up to five-to-one. Of course, limiting interest deductibility would undermine these plans by increasing the cost of capital and making such investments less feasible for the private sector.

As this Committee investigates ways to promote stronger economic growth and faster job creation through tax reform, it must maintain provisions in the tax code that help achieve these goals. Interest deductibility is one of these provisions, and has been since the creation of the modern tax code a century ago.

While the BUILD Coalition fully supports the Committee's goal of achieving pro-growth tax reform, any proposal that seeks to limit interest deductibility will run counter this objective. We encourage the Committee, in any proposed tax legislation, to maintain the full deductibility of business interest expense as it exists under current law. By doing so, policymakers will give the U.S. economy the opportunity to achieve its full growth potential.

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Sincerely,

The BUILD Coalition