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Taxation of Debt and Equity: Setting the Record Straight

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The U.S. tax system treats debt financing and equity financing differently. In debt financing, a business raises money by issuing debt, usually by selling a bond. In equity financing, a business raises funds by selling a share in the business through the sale of stock.

The tax system provides a relative advantage to financing capital expenditures through debt because under current tax law, businesses can deduct their interest payments on the debt instruments, but dividend payments to shareholders are not deductible. Thus, equity is disadvantaged because it is double taxed while debt correctly faces only a single layer of taxation.

On occasion, policymakers have proposed fixing this inequity by eliminating or reducing the interest deductibility for businesses.[1] This would be the wrong policy. Instead, Congress should eliminate the double taxation on equity financing to equalize the tax treatment of the two means of raising capital.

Interest on Debt Should Not Be Taxed

There is a common misconception that allowing businesses to deduct interest payments is bad policy because it results in businesses taking on too much debt, rather than financing spending by selling shares in the business. Those who hold this view see the deduction of interest expenses as a subsidy, or an unjustified tax benefit, and therefore as conferring the preference to debt. In fact, when interest income is taxable to lenders under an income tax, which is generally the case, the deduction is neutral.

When lenders pay a tax on their interest income, they demand a higher interest rate from borrowers than they would have in the absence of that tax. In this case, the lenders are families, financial institutions, and other groups that lend to businesses. The businesses are the borrowers. Lenders demand a higher interest rate because they require a certain *after-tax* rate of return for taking the risk of lending to the businesses.[2]

Basic economics suggests that as the price of a good goes up, the quantity demand for that good falls (as long as demand is not perfectly inelastic). Therefore, a higher interest rate would, all things equal, cause businesses to forego certain investments because it would raise the cost of making them. This would reduce investment across the economy, resulting in less economic growth, fewer jobs, and lower wages.

However, the deduction of their interest expense offsets the extra interest that they pay (as long as the tax rates of lenders and borrowers are equal) and taxes fall out of the lending and borrowing decision. Investment remains what it would have been if the tax had never interfered and tax policy is neutral—the central goal of good tax policy. Properly understood this way, interest deductions are not subsidies when interest income is taxable.[3]

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Taxes can also be neutral to lending and borrowing decisions if taxes do not apply to interest income. In that case, borrowers do not raise the interest rates that they charge so there is no need for a deduction for borrowers. Similar to the situation in which interest is taxable to lenders and deductible to borrowers, tax does not affect borrowing, and total investment remains unaffected by the tax code.[4]

Equity Is Taxed Twice

Income earned by debt financing is taxed only once, at the business level, because of the interest deduction. On the other hand, income earned via equity financing faces two layers of taxation, first at the business level through the corporate tax and then at the shareholder level through dividend and capital gains taxes.

The combined rate for equity-financed income earned by a business subject to the corporate tax rate is over 50 percent at the federal level after both of these levels of taxation are taken into account.[5] Breaking this down, the double taxation imposes a penalty of a 15 percent tax on top of the 35 percent corporate tax rate. Income earned by debt financing faces only the 35 percent corporate tax rate because there is no extra layer of tax on interest.

The double tax on equity makes debt a relatively more attractive way for businesses to finance themselves, all else equal. As a result, businesses will take on more debt than they otherwise might. A neutral tax code would not have such an effect.

This is a serious problem because carrying significant amounts of debt can make businesses less stable during periods when profitability declines. Interest payments on debt are a fixed cost that businesses must pay regardless of their performance. This can be onerous and endanger a business's solvency when profits fall.

The Right Solution

The tax code tilts in favor of debt compared with equity because it handicaps equity with the second layer of tax, not because debt receives preferential treatment. Therefore, it does not make sense to equalize their tax treatment by eliminating interest deductibility for businesses. Doing so would further suppress economic growth, job creation, and wage increases.

Instead, Congress should end the double taxation of income earned through equity financing in tax reform by eliminating taxes on saving and investment, including capital gains and dividends. A consumption tax, like the traditional flat tax, the New Flat Tax, a national retail sales tax, or a hybrid of these approaches would accomplish this.[6] This would level the playing field for debt financing and equity financing in a way that would help American families by boosting economic growth.

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1. For instance, President Barack Obama proposed paring back the deduction in his framework for corporate tax reform: J. D. Foster, "Obama Corporate Tax Reform a Sugar-Coated, Harmful Tax Hike," The Daily Signal, February 22, 2012, http://dailysignal.com/2012/02/22/obama-corporate-tax-reform-a-sugar-coated-harmful-tax-hike/.
2. It is clear that lenders pass the cost of taxes on to borrowers when looking at the differing rates on tax-free municipal bonds and similarly risk-rated corporate bonds of equal duration. The difference in rate equates almost entirely to the difference in tax treatment. See Yahoo Finance, "Composite Bond Rates," http://finance.yahoo.com/bonds/composite_bond_rates (accessed September 23, 2015).
3. Curtis S. Dubay, "The Proper Tax Treatment of Interest," Heritage Foundation *Backgrounder* No. 2868, February 19, 2014, http://www.heritage.org/research/reports/2014/02/the-proper-tax-treatment-of-interest. Related to the misunderstanding about interest deductibility is the misconception that providing an interest deduction *and* allowing businesses to deduct immediately the cost of new capital purchases (expensing) would create a negative tax rate (and therefore a further subsidy) for debt financing. This idea is wrong because businesses would need to recapture income if they sell an asset. As long as they do that, there is no negative tax rate on debt financing, and taxes remain neutral when interest is deductible and expensing allowed. See J. D. Foster, "The Big Choice for Jobs and Growth: Lower Tax Rates Versus Expensing," Heritage Foundation *Backgrounder* No. 2810, June 19, 2013, http://www.heritage.org/research/reports/2013/06/the-big-choice-for-jobs-and-growth-lower-tax-rates-versus-expensing.
4. Curtis S. Dubay, "An Alternative Way to Treat Interest Properly in Tax Reform," Heritage Foundation *Issue Brief* No. 4465, September 30, 2015, http://report.heritage.org/ib4465.
5. The 35 percent federal corporate tax rate plus the 23.8 percent tax rate on dividends and capital gains, multiplied by 0.65, the remaining portion of income after the corporate tax, equals 50.5 percent.
6. Curtis S. Dubay and David R. Burton, "A Tax Reform Primer for the 2016 Presidential Candidates," Heritage Foundation *Backgrounder* No. 3009, April 7, 2015, http://www.heritage.org/research/reports/2015/04/a-tax-reform-primer-for-the-2016-presidential-candidates.