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ECONOMIC PARTIALITY AND HORIZONTAL INEQUITY: THE NEW TCJA INTEREST EXPENSE DEDUCTION LIMIT

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INTRODUCTION

The Tax Cuts and Jobs Act (TCJA), enacted on December 22, 2017, was the most significant overhaul of the tax code in several decades. Among the changes was a limit on the amount of interest expense that businesses can deduct,[1] ending the policy of full deductibility for most financing transactions[2] that had been in place for over one hundred years.[3] Businesses typically rely on a mixture of debt and equity to finance their productive assets, i.e., assets used to carry out revenue-generating business activities.[4] Businesses have no obligation to repay the amount of the equity holder's investment or make regularly scheduled payments (i.e., dividends), making equity riskier for the investor than debt is for the creditor.[5] However, the equity holder is compensated for the risk by having a right to profits, which allows them greater upside potential than debt holders who are only entitled to the amount of principal invested and interest payments.[6] Debt and equity are taxed differently; interest expense paid to debt holders is tax deductible, while dividends or gains on capital appreciation paid to equity holders are

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1. 26 U.S.C. § 163(j) (2018).
2. *See infra* Section II.D for an overview of the narrow exceptions to full deductibility that predated the TCJA.
3. Steven A. Bank, *A Historical Perspective on the Corporate Interest Deduction*, 18 CHAP. L. REV. 29, 31 (2014).
4. ZANE SWANSON, BIN SRINIDHI & ANANTH SEETHARAMAN, THE CAPITAL STRUCTURE PARADIGM 2 (2003). "Debt is a contractual arrangement between the firm and the debt holders that includes the principal, relevant interest and maturation date. Equity defines ownership where the holder has certain rights to the overall direction of the firm and the disposition of residual assets at the dissolution of the firm." *Id.*
5. *See* Will Kenton & Chris B. Murphy, *Equity*, INVESTOPEDIA, https://www.investopedia.com/terms/e/equity.asp [https://perma.cc/L3T7-39PC].
6. *See* SWANSON ET AL., *supra* note 4, at 5.

not.[7] This discrepancy has been controversial because "[t]he lower net cost of corporate capital brought about by the deductibility of interest payments has thus been thought to bias capital structures in favor of debt, supposedly resulting in an inefficient unneutrality in the tax structure."[8]

The appropriateness of preferential treatment for debt financing should be evaluated through universally accepted tax policy objectives: taxation of enrichment, horizontal equity, and economic neutrality.[9] The original Modigliani and Miller Theorem (MMT) concluded that the value of a firm and the cost of its capital are not affected by the choice of debt or equity in the absence of taxes.[10] Yet, when taxes are factored in, there is a heavy preference for debt financing caused by the deductibility of the interest expense and non-deductibility of dividend payments on equity.[11] This finding suggests that such a discrepancy in tax treatment between debt and equity financing violates horizontal equity and economic neutrality.[12] However, subsequent studies elaborating on the original MMT complicate this finding by showing that economic considerations can erode the attractiveness of business interest expense deductibility.[13]

The context in which the interest expense deduction was enacted is also relevant for evaluating its consistency with horizontal equity and economic neutrality. The deduction was not the result of a deliberate policy decision enacted after a comprehensive evaluation of its impact on tax policy.[14] Instead, it resulted from a series of negotiations and compromises that were largely reactive to the imposition of the federal income tax after the passage of the Sixteenth Amendment.[15] As such, the changes to the interest expense

7. BORIS I. BITTKER, BORIS S. EUSTICE, & WILLIAM P. STRENG, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.01[1] (2018), Westlaw.

8. Alvin C. Warren Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L. J. 1585, 1606 (1974).

9. RICHARD K. VEDDER & LOWELL E. GALLAWAY, JOINT ECON. COMM., SOME UNDERLYING PRINCIPLES OF TAX POLICY 4 (1998). Essentially, taxes should be imposed only on a taxpayer's increase in wealth by permitting costs of attaining such wealth to be deductible and such deductions should be designed so that taxpayers in the same economic position should be taxed equally and that taxpayers are do not choose economic decisions primarily on tax incentives. *See infra* Sections II.A.2 and II.A.3 for a more in-depth discussion of taxing enrichment, horizontal equity and economic neutrality.

10. *See generally* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

11. *Id.* at 294.

12. Warren, *supra* note 8.

13. SWANSON ET AL., *supra* note 4, at 8–9.

14. Bank, *supra* note 3, at 30.

15. *Id.* at 47–48.

limitation in the TCJA present a unique opportunity to conduct a policy-based review of whether the deduction itself is appropriate—an evaluation that should have occurred over a century ago.

Therefore, this Note attempts such a policy-based review of the interest expense deduction. Part I.A of this Note examines the history and application of economic neutrality and horizontal equity, i.e., the criteria under which the limitation on the interest-expense deduction should be evaluated. Part I.B of this Note explores the historical background of the interest expense deduction and the resulting consequences for business taxpayers. Part II evaluates whether the limitation on interest expense deduction is consistent with economic neutrality and horizontal equity. Part III offers two proposals based on the conclusions drawn from the analysis in Part II: the first is to reverse the limitation altogether and return to the allowance of full interest expense deductibility; however, if such a reversal is politically imprudent, then the second proposal is to permit full deductibility of disallowed deductions upon maturity of the debt.

I. HISTORY

A. Background Principles

1. Establishment of the Federal Income Tax

The history of the federal income tax began with the Sixteenth Amendment's ratification into the United States Constitution in 1913. It allows Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."[16] While Congress has had the power to impose taxes under the Constitution since the founding,[17] any direct taxes levied must be apportioned among the states according to their populations.[18] The Sixteenth Amendment "does not extend the taxing power to new or excepted subjects, but merely removes [the previously required] . . . apportionment among the States of taxes laid on income, whether it be derived from one source or another."[19] Free from the apportionment

16. U.S. CONST. amend. XVI.
17. *Id.* art. I, § 8, cl. 1.
18. *Id.* § 9, cl. 4.
19. Peck & Co. v. Lowe, 247 U.S. 165, 172–173 (1918).

requirement, Congress passed the Revenue Act of 1913, imposing a tax on net income of every U.S. citizen and every trade or business.[20]

2. Taxation of Income Net of Deductions

It is an established principle that the income tax must only be levied on the income remaining after all of a business's expenses incurred to generate the gross income have been deducted.[21] This is because taxing gross income without any deductions would be tantamount to taxing a corporation's volume of transactions.[22] This would contravene the fundamental premise that "enrichment is the best measure of the taxpayer's ability to bear the cost of government. While gross income may give some indication of a taxpayer's income status, it would obviously be arbitrary and in many instances highly unfair [for this to serve as the tax base]."[23]

3. Policy Objectives: Horizontal Equity and Economic Neutrality

Since taxes should only be levied on enrichment, Congress, with the help of the United States Department of the Treasury (Treasury) and Internal Revenue Service (IRS), must exercise judgment to determine which items are deductible so that the income remaining after such deductions best

20. Revenue Act of 1913, ch. 16, 38 Stat. 114.

21. MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 117 (Robert C. Clark et al. eds., 14th ed. 2018).

22. *Id.*

23. *See id.* For instance, it is impossible to determine whether a small-business owner who makes one million dollars in revenue for a taxable year was enriched without also examining how much the owner incurred in expenses to generate that revenue. It could very well be the case that the owner did not net any positive income and therefore there was no taxable enrichment from these business transactions. *Id.* This is however, a very simplistic example to illustrate the fundamental logic of taxing enrichment; in practice many of the largest, most profitable companies escape corporate taxes through controversial use of incentives. *Compare* Erik Sherman, *A New Report Claims Big Tech Companies Used Legal Loopholes to Avoid Over $100 Billion in Taxes. What Does That Mean for the Industry's Future?*, FORTUNE (Dec. 6, 2019), https://fortune.com/2019/12/06/big-tech-taxes-google-facebook-amazon-apple-netflix-microsoft/ [https://perma.cc/2XQH-STC7] ("Corporate taxation has been a contentious issue for a long time, with some profitable Fortune 500s paying no taxes in multiple years, again all on the legal level.") *with* Stephanie Denning, *Why Amazon Pays No Corporate Taxes*, FORBES (Feb. 22, 2019), https://www.forbes.com/sites/stephaniedenning/2019/02/22/why-amazon-pays-no-corporate-taxes/#6c2f94ef54d5 [https://perma.cc/8DLP-U7GY] ("Under a scenario where Amazon had no corporate tax breaks, it would disincentive the company from reinvesting and thus creating greater opportunity for the businesses and cities in which it operates.").

represents enrichment. Criteria must be used to assess the wisdom of such laws and regulations defining the scope of deductions.[24] Among the various criteria that have been suggested for this assessment, "only three criteria are universally accepted by experts in public finance": administrative convenience, economic neutrality, and equity.[25] Equity is defined as the "fairness in distribution of burdens of government expenditures or of economic stabilization[,] . . . [which] must be an objective of any acceptable taxing system."[26] Horizontal equity, a subcategory of equity, is defined as "imposing similar burdens on people in like circumstances."[27] Economic neutrality refers to "avoiding or minimizing distortions of normal economic incentives."[28] "Virtually any tax will distort market incentives to some extent, but some taxes are worse than others in this respect" and should be avoided.[29] A tax is administratively convenient if costs imposed on taxpayers, "such as the monies spent on tax preparation services such as H & R Block," are low and evasion of taxes is difficult.[30] Economic neutrality and horizontal equity were specifically implicated in a pair of landmark Supreme Court tax cases in the twentieth century, indicating their importance to the overall fabric of tax law.[31] While administrative convenience is also an indispensable policy consideration, the primary concern for administrability is excessive complexity,[32] which is not a

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24. *See* CHIRELSTEIN & ZELENAK, supra note 21, at 117 (explaining that to be consistent with taxing enrichment, business expenses should be deducted but personal expenditures should not be); VEDDER & GALLAWAY, *supra* note 9, at 7 (explaining that criteria for evaluating tax policy should also be applied to assessing the wisdom of deductions).
25. VEDDER & GALLAWAY, *supra* note 9, at 4.
26. WILLIAM D. ANDREWS & PETER J. WIEDENBECK, BASIC FEDERAL INCOME TAXATION 12 (Erwin Chemerinksy et al. eds., 7th ed. 2015).
27. *Id.*
28. *Id.*
29. *Id.*
30. VEDDER & GALLAWAY, *supra* note 9, at 5.
31. The Supreme Court implicitly invokes horizontal equity and economic neutrality in *Helvering v. Bruun*, 309 U.S. 461 (1940), and *Eisner v. Macomber*, 252 U.S. 189 (1920), respectively, without explicitly referencing these concepts. *Compare Bruun*, 309 U.S. at 469 (1940) (taxpayer subject to tax because his business transaction was complete, thereby shielding him from the risk of liability or possibility of profit), *with* Hewitt Realty Co. v. Commissioner, 76 F.2d 880, 883 (2d Cir. 1935) (taxpayer not subject to tax because the income was dependent on future events from the ongoing business transaction). *See Eisner*, 252 U.S. at 194–195, 216, 237 (1920) (responding to the dissent's fear that diverging tax treatment between stock dividend and cash dividend would allow business owners to escape tax, the majority held that such fears are overblown because of the dissimilar economic characteristics between stock dividends and cash dividends).
32. ANDREWS & WIEDENBECK, *supra* note 26, at 13.

significant problem in a binary issue like the deductibility of interest expenses.[33] As such, the primary focus of this Note will be on economic neutrality and horizontal equity.

In *Eisner v. Macomber*, the Supreme Court implicated economic neutrality when it decided that a corporation's issuance of stock dividends to all shareholders in proportion to their ownership of stock was a non-taxable event.[34] While the term "economic neutrality" was not explicitly used, the Court found the issuance of stock dividends to be a non-taxable event by differentiating the economic qualities of stock dividends and cash dividends.[35] In doing so, the majority essentially applied economic neutrality as a central principle underpinning its holding:

> It is said there is no difference in principle between a simple stock dividend and a case where stockholders use money received as cash dividends to purchase additional stock contemporaneously issued by the corporation. But an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend, such as the one we have under consideration, where nothing of value is taken from the company's assets and transferred to the individual ownership of the several stockholders and thereby subjected to their disposal.[36]

The majority further elaborated that the key distinction was that the recipient of a stock dividend

33. Taxpayers can create complex issues by creating "unusual instruments in an effort to exploit tax advantages of debt without being burdened by its nontax restrictions." BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 91.10.2 (2018), Westlaw. However, absent exotic financial instruments, the computation of interest expenses, particularly on conventional term loans, is straightforward.

34. *Eisner*, 252 U.S. at 191.

35. *See id.* at 217 ("We cannot accept [the] reasoning [that stock and cash dividends are the same, because doing so would be conflating] . . . a case where money is paid into the hand of the stockholder with an option to buy new shares with it, followed by acceptance of the option . . . with a case where the stockholder receives no money and has no option.").

36. *Id.* at 215.

> has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment.[37]

On the other hand, a cash dividend allows investors to disassociate themselves from the company, and by extension, the company's business risk.[38] The implication of the disparate economic risk borne by investors receiving a cash dividend and investors receiving a cash dividend is that tax treatment would not be the only consideration for whether shareholders vote for cash or stock dividends.[39] Therefore, taxing cash dividends and not stock dividends is consistent with the principle of economic neutrality, which requires business "decisions [to be] made on their economic merits and not for tax reasons."[40]

In *Helvering v. Bruun*, the Supreme Court invoked horizontal equity when it ruled that the termination of a lease agreement was a taxable event.[41] The taxpayer in *Bruun* leased a plot of his land to a tenant for ninety-nine years.[42] As part of the consideration for the lease, the tenant agreed to demolish the existing structure and build a new building on the taxpayer's land, which significantly increased the value of the land.[43] However, the tenant defaulted only eighteen years later, so the taxpayer terminated the lease and repossessed his land.[44] While "horizontal equity" was not explicitly mentioned, in parallel with *Eisner*, the Supreme Court found the termination to be a taxable event by differentiating the economic condition

37. *Id.* at 211.
38. *Cf. id.* at 208–209 ("If he desires to dissociate himself from the company he can do so only by disposing of his stock.")
39. *Id.* at 211 (stock dividends don't disassociate the shareholder from the company the way cash dividends would, thereby continuing to expose the shareholder to ongoing business risk).
40. JASON FURMAN, BROOKINGS INST., THE CONCEPT OF NEUTRALITY IN TAX POLICY (2008), https://www.brookings.edu/testimonies/the-concept-of-neutrality-in-tax-policy/ [https://perma.cc/S2PE-3WQB].
41. Helvering v. Bruun, 309 U.S. 461, 467 (1940).
42. *Id.* at 464.
43. *Id*.
44. *Id.*

of a real property free and clear of a lease—which the taxpayer had reposessed—from one still encumbered by a lease.[45] This holding implicitly implicated the principle of horizontal equity: By terminating the lease, the taxpayer in *Bruun* completed the transaction, thereby making the value of the new building on his property fully ascertainable and captured.[46] The Court distinguished the circumstances in *Bruun* from those in *Hewitt*, where the value of the property was still subject to the lease and therefore exposed to variables due to unforeseeable future events such as the property being destroyed before the lessor could take back the property from the lessee.[47] "Whether there is an increase in value is a question of fact which will vary as the circumstances vary."[48] The taxpayer in *Bruun* was not in a similar situation as the taxpayer in *Hewitt*; therefore, taxing the former and not the latter is consistent with the principle of horizontal equity, which requires that "similarly situated individuals face similar tax burdens."[49]

4. Modigliani and Miller Theorem

Given the established use of horizontal equity and economic neutrality in evaluating the appropriateness of tax laws, both criteria should be applied to tax policies involving debt and equity. This interaction between tax treatment and capital structure was the subject of studies conducted by Carnegie Mellon professors Franco Modigliani and Merton Miller beginning in 1958, resulting in the influential MMT.[50] The first study showed "theoretically that the choice of a firm's debt/equity financing mix has no impact on its firm value under certain assumptions."[51] The MMT study makes five "simplifying assumptions: (1) markets are perfect;[52] (2)

45. *Id.* at 467, 467–69 ("The circumstances of the instant case differentiate it from the . . . Hewitt case[s]. . . . Here, as a result of a business transaction, the respondent received back his land with a new building on it, which added an ascertainable amount to its value.").
46. *Id.* at 469 (holding that realization of gain can occur from the completion of a transaction, which in this case was quantified by the added value of the new building).
47. Hewitt Realty Co. v. Commissioner, 76 F.2d 880, 882–883 (2d Cir. 1935).
48. *Id.* at 883.
49. David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 43 (2006).
50. SWANSON ET AL., *supra* note 4, at 14.
51. *Id.*; *see also* Modigliani & Miller, *supra* note 10, at 269–271.
52. A perfect market is a hypothetical condition in which the following conditions are met: (1) all firms sell the same identical product, (2) no firm can influence the market price of this product, (3) market share cannot influence prices, (4) buyers have perfect information, (5) employees working for

markets are complete;[53] (3) firms can be categorized into equivalent risk classes such that the inherent business risk is the same for all firms in that class; (4) all investors have common beliefs about securities; and (5) all investors are rational."[54] The effect of taxes, growth in cash flows, and depreciation were not included in this 1958 study.[55] As such, the 1958 study assumes a very simplistic, bare-bones worldview where corporations are faced with a binary decision of whether to finance with equity or debt without any other variables that might influence their decisions.[56]

Modigliani and Miller found that the mix of debt compared to equity in a corporation's capital structure had no effect on the corporation's value or cost of capital.[57] As such, a key implication of the 1958 study is that "it does not matter how firms finance themselves in the absence of taxes. . . . [Although overly simplistic, MMT] provide[s] a conceptual foundation to build theory."[58] In 1963, Modigliani and Miller elaborated on their first study by adding the effect of corporate taxes on the economic impact of capital structure.[59] They demonstrated that, with corporate taxes, the choice of capital structure affects firm value because the deductibility of interest expenses and the non-deductibility of dividends and equity appreciation incentivizes the rational corporation to take on as much debt as possible.[60] The interest expense deduction results in a smaller tax expense, which would allow the business to retain more earnings, thereby making it more valuable than if it were financed only by equity.[61] While incorporating the

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firms are perfectly mobile, and (6) firms can enter and exit the market without bearing any entry and exit costs. Adam Hayes, *Perfect Competition*, INVESTOPEDIA, https://www.investopedia.com/terms/p/perfectcompetition.asp [https://perma.cc/6TE7-3M79] (last updated June 25, 2019)

53. A complete market is a hypothetical condition in which a stable price, at a point where market supply equals market demand, for every asset in every possible state of the world. *Complete Market*, https://stats.oecd.org/glossary/detail.asp?ID=5900 [https://perma.cc/SJ73-Q352] (last visited Jan. 1, 2020); James Chen, *Equilibrium*, INVESTOPEDIA, https://www.investopedia.com/terms/e/equilibrium.asp [https://perma.cc/6LXZ-NG2M] (last updated May 24, 2019).

54. SWANSON ET AL., *supra* note 4, at 14 (citations omitted).

55. *Id.*

56. *See id.*

57. *Id.* at 15.

58. *Id.* at 24.

59. *Id.* at 30; *see also* Franco Modigliani and Merton H. Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 53 AM. ECON. REV. 433, 438 (1963).

60. SWANSON ET AL., *supra* note 4, at 40–41.

61. *Id.* at 40.

effect of income taxes into the 1963 study without more is still simplistic, it "provides a conceptual framework to further develop firm financing decision making."[62]

Other scholars have subsequently built upon this initial conceptual framework by incorporating the effects of other costs that could have an impact on the choice of capital structure in addition to taxes.[63] One of these is the cost of bankruptcy. Studies since the 1980s have shown that there is a connection between a firm's leverage and bankruptcy costs.[64] Bankruptcy costs have been divided into three categories: (1) the direct cost of filing such as lawyers' fees, accountants' fees, trustee's compensation and other administrative expenses, (2) indirect costs from lost profits like those caused by distracted management and supplier hesitance to provide inventory, and (3) lost revenues from customers concerned about potentially deteriorating quality and credibility of warranties and services.[65] Furthermore, probability of default also has a greater impact on capital structure choice than do tax effects.[66] This is because when a corporation defaults on its debt, a chain of events, such as the acceleration of debt payments, protracted legal proceedings, and the imposition of protective covenants, will cause the

62. *Id.*
63. *Id.* at 34.
64. *Id.* at 77. *Leverage* is the colloquial term for the concept of borrowing in order to generate returns on equity in excess of what equity-only financing would generate. Adam Hayes, *Leverage*, INVESTOPEDIA, https://www.investopedia.com/terms/l/leverage.asp [https://perma.cc/BVV5-RFVZ]. Debt financing's fixed repayment obligation and fixed interest payments regardless of a company's profitability are what allows corporations to generate excess returns for their shareholders. *Id.* In a very simplistic example, compare two corporations, A and B. Assume both A and B have total capital of one hundred million dollars, and both invest in a single asset worth one hundred million dollars. Corporation A finances the entire one-hundred-million-dollar investment through equity, held among ten shareholders at ten million dollars each, while Corporation B finances using sixty million dollars of debt and forty million dollars of equity, held among ten shareholders at four million dollars each. Now assume that in five years, both A's and B's asset increases to $120 million in value, at which point A and B both sell the asset, earning proceeds of $120 million each. A's ten shareholders receive twelve million dollars each, amounting to a twenty percent return on their ten-million-dollar investment. B must first use the sixty million dollars of proceeds to repay the sixty-million-dollar debt before it can pay out the remainder to its shareholders, since all debt holders have a more senior claim than equity holders. Once the debt is repaid, sixty million dollars of profits remain to allocate among B's ten shareholders, who each receive six million dollars each. This amounts to two million dollars or a fifty percent return on each of their four-million-dollar investments. B was able to take advantage of the "leverage" created by the debt to generate higher returns for its shareholders than A despite investing in an identical asset for the exact same duration.
65. SWANSON ET AL., *supra* note 4, at 68.
66. *Id.* at 77. Default probability in this context means likelihood of failure to make required payments and not likelihood of firm liquidation. *Id.*

stock price to drop precipitously.[67] While this is not a cost in the sense of lost revenues or increased expenses to the corporation, it is a direct cost to the shareholders in the form of asset devaluation. These studies suggest that bankruptcy costs may act as a cap on the benefits of excessive leverage observed from Modigliani and Miller's 1963 study.[68] "In other words, firms should incrementally finance with debt up to the point that the marginal tax benefits equal the marginal bankruptcy costs."[69]

Another factor that exerts significant influence on a corporation's choice of capital structure is its agency costs. A corporation is not a monolith but a nexus of contractual agreements tying together various self-interested stakeholders who may have different and conflicting objectives.[70] An agency relationship of central relevance to the choice of capital structure is that between stockholders and debt holders.[71] Thus,

> [c]onflicts between the stockholders and debtholders could arise because risky projects with high expected returns, but also a higher probability of very negative returns, are asymmetrically beneficial to stockholders and costly to debtholders. Debtholders do not participate in the high positive returns and stockholders do not participate in the high negative returns because of limited liability.[72]

As a response, debt holders may try to extract higher returns on debt, or impose protective covenants, making debt overly costly, thereby shifting the capital structure more in favor of equity.[73] Agency costs essentially refute the characterization of the choice of capital structure "as a strategic decision that is taken *once* after considering all the costs and benefits from taxes, bankruptcy and so forth."[74] Instead, "capital structure decisions are

67. *Id.* Protective covenants are terms written into a loan agreement between the borrower and lender that impose restrictions on the activities of the borrower in the event of default, such as freezing all dividend payments until the corporation has enough cash to satisfy the debt payment obligations. Adam Hayes, *Covenant*, INVESTOPEDIA, https://www.investopedia.com/terms/c/covenant.asp [https://perma.cc/8U4K-DJLX].
68. SWANSON ET AL., *supra* note 4, at 81.
69. *Id.*
70. *Id.* at 94.
71. *Id.* at 95.
72. *Id.*
73. *Id.* at 95–96.
74. *Id.* at 107 (emphasis added).

dynamic and continuously changing and need to be integrated with the overall management of the firm and its various market environments."[75]

B. Early History of the Interest Expense Deduction

Horizontal equity, economic neutrality, the MMT, and the taxation of enrichment are key conceptual foundations against which the propriety of a limit on interest expense deductions should be weighed. However, the beginnings of the deduction were founded on much more pragmatic bases, some of which the Sixteenth Amendment and subsequent case law made obsolete.[76] "[A]lthough there may be appropriate arguments in favor of maintaining a full corporate interest deduction, the historical premise for the origins of the corporate income tax system is not one of them. . . . The corporate interest deduction emerged because of expedience, not tax policy per se."[77]

1. Pre-Sixteenth Amendment Debates and Interest-Deduction Limitation of 1990

The corporate interest deduction spurred significant debate when it was first proposed in 1894.[78] One concern voiced by those opposed to the interest expense deduction was that

> in the absence of an individual income tax as a backstop to the corporation tax, an interest deduction meant that "the 'bloated bondholder' . . . escapes altogether . . . . Multimillionaires like Mr. Carnegie, whose wealth is mostly in bonded investments, go free, while the owner of no more than one share of stock in any paying corporation is taxed."[79]

A corollary complaint was that "heavily bonded concerns doing business in competition with those with little or no funded debt would

75. *Id.*
76. Bank, *supra* note 3, at 31.
77. *Id.* at 30.
78. *Id.* at 31–34.
79. *Id.* at 34–35.

practically escape taxation, an obviously inequitable advantage."[80] "The concern was that because of the different treatment of debt and equity, corporations and investors would take advantage of the relative fungibility of the different instruments and evade the tax by substituting bonds for stocks."[81]

On the other hand, "[r]equiring corporations to pay interest with post-tax money, however, was also controversial."[82] Republican Senator Elkins's objection to non-deductibility of the interest expense was that disallowing an interest-expense deduction essentially fails to "distinguish between [total] capital and capital stock [i.e. equity], as some corporations raised all their capital by bond issues and had very little stock."[83] This objection is still relevant: it comments on the fundamental distinction between the characteristics of debt and of equity. Other complaints against non-deductibility were related to constitutional issues that became irrelevant after the federal government was permitted to levy non-apportioned taxes on income.[84]

As a compromise, Congress permitted "corporations to deduct interest, but [required them] to cap the amount of the deduction to an amount of bonds equal to the par value of the corporation's capital stock [i.e. equity]."[85] Theoretically, "the cap would generally limit bonded indebtedness from growing beyond its existing one-to-one status with capital stock[,] . . . [which] also reflected Congress' concern about the practice of over-leveraging."[86] The intention was for the cap to "serve as a

80. *Id.* at 35.
81. *Id.* at 38.
82. *Id.* at 36.
83. *Id.*
84. One criticism resulted from tax-free covenants that lenders imposed on borrowers. *Id.* at 37. These covenants required borrowers to reimburse lenders for any tax that the lenders had to pay. *Id.* If borrowers were not permitted to deduct the interest expenses, then they would effectively be double taxed, which can be construed as "unconstitutionally impairing a contract." *Id.* However, this problem became irrelevant after the Supreme Court held in *Old Colony Trust v. Commissioner* that the amount of any tax reimbursement is taxable as in-kind income. 279 U.S. 716, 731 (1929). In a post-*Old Colony Trust* landscape, a payment by the borrower for reimbursing the lender's tax obligation would itself be taxable as income to the lender. *Id.* The *Old Colony Trust* decision essentially set the precedent for the very expansive scope of income codified in 26 U.S.C. § 61(a). ANDREWS & WIEDENBECK, *supra* note 26, at 42.
85. Bank, *supra* note 3, at 39.
86. *Id.* at 39–40.

dividing line between legitimate and what might have been considered excessive business debt."[87]

2. Post-Sixteenth Amendment Climate

After the passage of the Sixteenth Amendment and enactment of federal income tax legislation, a concern arose about the use of a deferral shield[88] to allow shareholders to dodge, at least temporarily, the income tax.[89] The concern could have been an opportunity to explore "means of reconciling the differential tax treatment of debt and equity."[90] Nevertheless, the deductibility cap remained, but there were further attempts to convince Congress to remove it. Some argued against setting the cap according to a debt-to-equity ratio because they believed that doing so violated horizontal equity by disadvantaging real-estate corporations.[91] Real-estate corporations typically borrow mortgages constituting up to two-thirds of the value of their underlying assets, while corporations in other industries typically have smaller proportions of debt than equity in their capital structures.[92] "[L]arge corporations with millions of bonds outstanding are permitted to deduct all of the interest which they pay on their bonds, while . . . the small corporation that owns the buildings leased by the large corporations is penalized by being unable to deduct from the rents paid by the large corporations the full amount of the interest which it has been obliged to pay to its mortgagee."[93] On the other side of the debate, bond-issuer wealth "was still prominent in policy discussions."[94] "[C]orporation bonds were an important part of corporate financing at this time, with the

87. *Id.* at 40.
88. A tax deferral shield is "a reduction in taxable income for an individual or corporation achieved through claiming allowable deductions. . . [thereby allowing a taxpayer to] defer income taxes into future years. Julia Kagan, *Tax Shield Definition*, INVESTOPEDIA, https://www.investopedia.com/terms/t/taxshield.asp [https://perma.cc/XR9F-AE9M].
89. Bank, *supra* note 3, at 41.
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.* at 41–42 (internal quotation marks omitted).
94. *Id.* at 42.

gross amount of corporate bonds outstanding equaling $17.4 billion in 1913."[95]

In the years following 1913, businesses and politicians began to turn against the interest deduction cap in favor of allowing unlimited deductions.[96] The cap was seen as a relic of policy concerns that were anachronistic in a post-Sixteenth Amendment world.[97] According to railroad lawyer Alfred Thom, "[t]he present [interest expense cap] provision has apparently been taken over from the old corporation excise law without consideration of the effect of the establishment of a net income tax on individuals."[98] Representative Sherley, a Democrat from Kentucky, stated that "when you do not tax individuals but only tax corporations, you should have a particular provision touching interest payments. But now you are taxing both the corporation and the individual."[99]

Congress resisted the pressure to remove the cap but offered a concession in 1916 by permitting entities to "deduct the interest on an amount of debt equal to the paid-up capital stock and one-half the outstanding indebtedness."[100] However, when the United States entered World War I, it levied a tax on "excess profits" and "war profits" based on a definition of "invested capital" that only included equity and not debt.[101] Since debt holders were not permitted to include debt among their capital base, they would have significantly greater taxable "excess profits" than equity holders earning the same profits.[102] This resulted in further criticism that it "was inequitable since 'all funds used in business . . . are capital in the economic sense.'"[103] The House Ways and Means Committee reasoned that "[s]ince borrowed money is not allowed to be included in computing invested capital for the purpose of the war profits and excess profits tax, it seems only fair to allow as a deduction in computing net income the whole

95. *Id.* at 42–43. This is roughly equivalent to $456 billion in 2019 dollars. *See CPI Inflation Calculator,* U.S. BUREAU LAB. STAT., https://data.bls.gov/cgi-bin/cpicalc.pl?cost1=17.40&year1=191301&year2=201911 [https://perma.cc/Z35H-L56N].
96. Bank, *supra* note 3, at 43–44.
97. *Id.*
98. *Id.* at 44.
99. *Id.* at 43–44.
100. *Id.* at 45–46.
101. *Id.* at 46.
102. *See id.*
103. *Id.*

amount of the interest paid during the year."[104] This logic convinced Congress to pass the Revenue Act of 1918, which allowed "interest on corporate debt [to become] fully deductible for the first time."[105]

The corporate interest deduction was not the result of a single, comprehensive design that broadly considered tax policies.[106] Instead, it was "a pragmatic compromise between those concerned that corporations would become over-leveraged to avoid the entity-level tax and those concerned that not permitting an interest deduction would unfairly disadvantage corporations that needed such leverage."[107] The cap "was only removed when the larger issue of taxing wartime profits made the tax treatment of heavily leveraged companies more problematic."[108] While the principles of taxing enrichment, horizontal equity, and economic neutrality were evoked to justify one position or the other, the continuously changing tax laws resulted in myopic, reactive applications of these principles. Changes such as the passage of the Sixteenth Amendment and the wartime taxes distracted policymakers from conducting a more comprehensive assessment of the interest-expense deduction's merits.

> The continuing relevance to the current TCJA is evident:
> This historical context also provides perspective for modern advocates of a cap on the corporate interest deduction. For instance, Senator Wyden justifies the proposal contained in his bill with Republican Senator Dan Coats on similar grounds of over-leverage and the ease of shifting between equity and debt. According to the information statement on the bill, the cap is justified as necessary to "create[] a more even playing field between corporate debt and equity by cutting the value of inflation from a corporation's interest deduction on debt." The statement continues to note that "[c]utting the value of this tax deduction will reduce a company's financial incentive to take on debt."[109]

104. *Id.*
105. *Id.*
106. *Id.* at 47.
107. *Id.*
108. *Id.*
109. *Id.* (alterations in original).

C. Consequences of the Deductibility of Interest

The deductibility of business interest expenses remained unchanged for over one hundred years. It survived the major tax reforms of the twentieth century, including rigorous debates during the 1960s and 1970s over whether the tax base should remain enrichment-focused or be changed to a consumption focus. The IRS has the power to recharacterize an instrument as either debt or equity because of a landmark Supreme Court decision holding that transactions are taxed according to their substance rather than their form.[110] If a taxpayer's instrument is recharacterized from debt to equity, each interest payment is not deductible and the lender becomes an equity owner in the borrower.[111] This could create punitive consequences for existing shareholders.[112] Since the tax benefits of deducting interest expenses are so significant, "[t]axpayers sometimes experiment with unusual instruments in an effort to exploit tax advantages of debt without being burdened by its nontax restrictions."[113] However, the IRS "may be unwilling to accept the taxpayer's label [of an instrument as debt] as controlling. . . . [And] tax consequences of a recharacterization can be extremely unpleasant."[114]

As such, "[m]ost litigated cases on the debt vs. equity issue are concerned with obligations having all the conventional earmarks of debt, including a fixed maturity date, fixed interest payments, no voting rights, and no subordination to general creditors."[115] In *Estate of Mixon v. United States*, a landmark case, the Fifth Circuit provided the following factors to determine whether an instrument is debt or equity:

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110. *See* Gregory v. Helvering, 293 U.S. 465, 469–70 (1935).
111. STEPHEN SCHWARZ & DANIEL J. LATHROPE, FUNDAMENTALS OF CORPORATE TAXATION: CASES AND MATERIALS 122 (Robert C. Clark et al. eds., 9th ed. 2016).
112. For example, under 26 U.S.C. § 351, a shareholder can contribute property to its corporation without recognizing any gain on the property if, among other requirements, the shareholder has eighty percent of the corporation's shares and eighty percent of the voting power in the corporation (known as a "351 Transaction"). 26 U.S.C. §§ 351, 368(c) (2012). A lender that becomes an unexpected equity owner could inadvertently turn what otherwise would be a valid 351 Transaction into a taxable sale of property by the shareholder to the corporation if the lender caused the shareholder's ownership and voting power to fall below eighty percent.
113. BITTKER & LOKKEN, *supra* note 33, at 2.
114. SCHWARZ & LATHROPE, *supra* note 111.
115. BITTKER & LOKKEN, *supra* note 33, at 2.

> (1) the names given to the certificates evidencing the indebtedness; (2) The presence or absence of a fixed maturity date; (3) The source of payments; (4) The right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.[116]

Congress attempted but failed to provide specific guidance because of the uncertainties in common law arising from issues around debt or equity characterization.[117] As such, "Congress delegated the chore to the executive branch by enacting Section 385, which authorizes the Treasury to promulgate such regulations 'as may be necessary or appropriate' to determine for all tax purposes whether an interest in a corporation is to be treated as stock or debt."[118] In October 2016, the U.S. Treasury enacted 26 C.F.R. § 1.385 (385 Regulations), but these regulations only provide requirements for avoiding *per se* recharacterization into equity and do not provide insight into what factors are sufficient for debt characterization.[119] Failing the documentation requirements would automatically recharacterize an instrument into equity,[120] but meeting the requirements would not guarantee debt characterization.[121]

116. Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972).
117. SCHWARZ & LATHROPE, *supra* note 114, at 141.
118. *Id.*
119. 26 C.F.R. §§ 1.385-1 to -4T (2016) (providing annual documentation requirements to avoid automatic recharacterization of related-party debt to equity, and providing a list of forbidden transactions, such as leveraged distributions, which result in automatic recharacterization if a distribution is made within three years of a related-party debt issuance).
120. *Id.* § 1.385-2(b)(1) (2016) ("If the documentation and information . . . are not prepared and maintained . . . [the debt instrument] is treated as stock for all federal tax purposes.").
121. *Id.* § 1.385-2(a)(2) (2016) ("Compliance with this section does not establish that an interest is indebtedness; it serves only to satisfy the minimum documentation for the determination to be made under general federal tax principles."); *id.* § 1.385-1(b) (2016) ("Whether an interest in a corporation is

D. Changes to the Interest Expense Deduction in the TCJA

Limitations on the amount of deductible interest existed prior to the TCJA, but generally applied to related-party debt.[122] The purpose of such pre-TCJA restrictions in 26 U.S.C. § 163(j) was to bar "certain corporations from taking a deduction for 'disqualified interest.'"[123] Determination of "whether interest should be treated as 'disqualified interest,' primarily focused on transactions resulting in the tax-free removal of value from the U.S. tax system."[124] However, post-TCJA "the allowable deduction for business interest is capped at the sum of the business interest income of the taxpayer for the taxable year, plus 30% of the adjusted taxable income of the taxpayer for the taxable year, plus the floor-plan financing interest of the taxpayer for the taxable year."[125] Furthermore, § 163(j) now applies to commercial third-party debt, which was not the case prior to the TCJA.[126] "For the taxable years beginning before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion."[127] After December 31, 2021, "these items will be included in adjusted taxable income, which will reduce the dollar value of the adjusted taxable income on which the 30% limit is calculated."[128]

II. ANALYSIS

A. Business Risk of Debt and Equity Financing

Under the tax policy objective of taxation of enrichment, Congress, along with Treasury and the IRS, must pass laws and regulations defining

treated for purposes of the Internal Revenue Code as stock or indebtedness . . . is determined based on common law").

122. Robert E. Holo, Jasmine N. Hay & William J. Smolinski, *Not So Fast: 163(j), 245A, and Leverage in the Post-TCJA World*, 128 YALE L.J.F. 383, 384 (2018).

123. *Id.* at 385.

124. *Id.* at 385–86.

125. *Id.* at 387 (footnote omitted). "Floor plan financing interest is indebtedness relating to the acquisition of motor vehicles held for sale or lease and secured by such vehicles. 26 U.S.C. § 163(j)(9)(A) (2018). It thus is not relevant to the majority of the majority of multinationals evaluating these new rules." *Id.* at 387 n.24.

126. *Id.* at 388.

127. *Id.* at 391.

128. *Id.*

the scope of income and deductions so that the net taxable income best represents enrichment.[129] Horizontal equity and economic neutrality are two of the three universally accepted criteria for evaluating the wisdom of such laws and regulations.[130] MMT can be cited for justification for why the pre-TCJA preferential treatment of debt financing violates both horizontal equity and economic neutrality. However, the original MMT examines only the value of the firm and the cost of capital, both of which are opaque numbers that do not shed any insight into whether the interest expense deduction is consistent with horizontal equity or economic neutrality. The Supreme Court, in *Eisner* and *Bruun*, provides an insightful way to evaluate the interest expense deduction's adherence to horizontal equity and economic neutrality.[131] In *Eisner*, the majority held that "the essential and controlling fact is that every dollar of [the stockholder's] original investment, together with whatever accretions and accumulations have resulted from employment of his money . . . still remains the property of the company, and subject to business risks which may result in wiping out the entire investment."[132] Therefore, the majority reasoned, "an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend."[133] This critically undermines Justice Brandeis's assertion that dividends distributed as cash or stock "are recognized . . . to be equivalents; and that the financial results to the corporation and to the stockholders of the two methods [of distribution] are substantially the same—unless a difference results from the application of the federal Income Tax Law,"[134] because the business risk that a shareholder faces from a cash dividend is, in the majority's words, "as far removed as possible" from a stock dividend. As such, it is not appropriate to assert that "the owners of the most successful businesses in America will, as the facts in this case

129. While taxation of enrichment is itself a policy objective, it is not particularly helpful as a criteria for determining the appropriateness of tax laws and regulations because it is overly broad and easy to meet, as even a grossly economically non-neutral tax on net income will be a tax on enrichment. *See supra* Sections I.A.2 and I.A.3.

130. The third policy is administrative convenience, which although universally accepted, functions more as a backstop justification in overriding equity and neutrality concerns. VEDDER & GALLAWAY, *supra* note 9.

131. *See supra* text accompanying notes 34–49.

132. *See* Eisner v. Macomber, 252 U.S. 189, 211 (1920).

133. *Id.* at 215.

134. *Id.* at 224 (Brandeis, J. dissenting).

illustrate, be able to escape taxation on a large part of what is actually their income,"[135] because they have business risk in addition to tax advantages to take into consideration when deciding whether to issue stock or cash dividends. Therefore, it would be reasonable to infer that the majority believes the key element preserving economic neutrality between cash and stock dividends to be business risk.

In *Bruun*, the taxpayer terminated a lease after his lessee defaulted eighteen years into their ninety-nine-year contract, enabling him to recover his land—along with the building that his lessee built—eighty-one years early. The Supreme Court held that the lease termination was a taxable event because "the respondent received back his land with a new building on it, which added an ascertainable amount to its value."[136] The Court distinguished the taxpayer in *Bruun* from the taxpayer in *Hewitt Realty* because in *Hewitt*, the taxpayer's lease remained in effect, thereby subjecting him to uncertainty as to the value of his property by the time he would eventually repossess it free from the lease.[137] The Court recognized in *Bruun* that when the taxpayer's transaction was terminated, he was thereby allowed to recover his property without exposing himself to potential future risks, risks articulated in *Hewitt*, such as the destruction of his building.[138] Therefore, while not explicitly stated, it is reasonable to infer that the Supreme Court is again finding future risk to be the dispositive element in permitting disparate tax treatment between the taxpayer in *Bruun* and the taxpayer in *Hewitt*.

Since the Supreme Court relies on business risk as a dispositive factor in these tax cases, business risk would also be appropriate to evaluate whether the business interest expense deduction is consistent with horizontal equity and economic neutrality. Debt-financing transactions are riskier for the issuer but safer for the investor, while equity-financing transactions are safer for the issuer and riskier for the investor.[139] Debt transactions carry a similar level of risk to lease transactions because they both have comparable characteristics: neither furnishes any ownership

135. *Id. at* 237.
136. *See* Helvering v. Bruun, 309 U.S. 461, 469 (1940).
137. *Cf. id.* at 467 ("Circumstances of the instant case differentiate it from the . . . Hewitt case."); *supra* text accompanying notes 45–48.
138. *See Brunn*, 309 U.S. at 469; *Hewitt*, 76 F.2d at 883.
139. Karen Berman & Joe Knight, *When is Debt Good?*, HARV. BUS. REV. (July 15, 2009), https://hbr.org/2009/07/when-is-debt-good [https://perma.cc/QR2H-BST9].

interest in the borrower/lessee; they both generally involve predictable, regular payments; and default occurs if the corporation fails to meet any one of its payments.[140] On the other hand, debt financing is riskier for an issuer because the regular obligation to make interest payments to lenders could be overly burdensome if the issuer is unable to generate enough cash.[141]

B. Horizontal Equity

The interest deduction limitation will likely exacerbate horizontal inequity rather than alleviate it the way Senators Wyden and Coats believed. Since a corporation financing itself through debt and another financing itself through leases have comparable levels of risk, tax treatment of their cost of compensating their debtors or lessors should be identical. Limiting the amount of interest expense that corporations can deduct while allowing the entire lease expense or cost of goods sold to be deducted would be inconsistent with the principle of horizontal equity. On the other hand, the risk facing a corporation financed with debt is higher than that of a corporation financed with equity, so it is entirely acceptable for the tax treatment of interest expense and dividends to be different.

C. Economic Neutrality

The interest expense limit also violates economic neutrality because of the difference in risk profile between debt and financing transactions. Allowing more favorable tax treatment for corporations that rely primarily on leases compared to those that rely primarily on debt despite facing the same economic risk profile would incentivize corporations to choose the former for a non-business tax-related purpose. For example, if a corporation needs to acquire a capital asset such as equipment, it should be indifferent

140. James Chen, *Default*, INVESTOPEDIA, https://www.investopedia.com/terms/d/default2.asp [https://perma.cc/L5HU-F538]; James Chen, *Lease*, INVESTOPEDIA, https://www.investopedia.com/terms/l/lease.asp [https://perma.cc/ZQF9-X8HF]; Christina Majaski, *Debt Financing vs. Equity Financing: What's the Difference?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/05/debtcheaperthanequity.asp [https://perma.cc/RV3K-NGPQ]; *What Happens if I Default on a Commercial Lease?*, TELLUS REAL ESTATE, https://tellusre.com/landlording/what-happens-if-i-default-on-a-commercial-lease/ [https://perma.cc/6XE5-RP4S].

141. Majaski, *supra* note 140.

between borrowing a term loan to purchase the equipment or leasing it, because both options have similar economic risks. However, if leasing provides favorable tax treatment because the entire lease expense is deductible while the interest expense on debt is subject to a deductibility limitation, corporations would rationally choose to lease instead of purchase with borrowed funds, despite there being limited substantive economic difference between the two options for the corporation. Economic neutrality requires that tax laws refrain from creating distortions that motivate taxpayers to make business decisions based on tax treatment rather than economic considerations.[142]

On the other hand, equivalent tax treatment between corporations that finance through debt and those that finance through equity is not necessary for economic neutrality. As subsequent studies elaborating upon the MMT have shown, bankruptcy costs and agency costs, i.e., economic factors relating to debt and equity financing, are significant enough to dissuade companies from gravitating towards one or the other on the basis of tax treatment.[143] Furthermore, risk of default prevents corporations from financing entirely through debt despite favorable tax treatment under the full interest expense deductibility regime because debt places significantly more pressure on corporations to generate cash flow in order to service interest payments, while equity allows them to pursue longer-term investment horizons.[144] For instance, many startup companies—particularly those in the high technology and pharmaceutical industries that require significant amounts of front-end research and development expenditure but do not become profitable for many years—would choose to finance through equity because they lack the cash flow to finance their operations through debt.

III. PROPOSAL

The best remedy is to remove the interest deduction limitation entirely so that horizontal equity and economic neutrality are restored

142. ANDREWS & WIEDENBECK, *supra* note 26, at 12–13.
143. *See generally* SWANSON ET AL., *supra* note 4 (finding that other considerations such as bankruptcy concerns and agency costs dampen the benefits of deductibility of interest found from the original MMT study).
144. *Id.* at 68–69.

between debt and leases. There are no major policy drawbacks to implementing this proposal, but doing so could be politically inexpedient given that Congress would be repealing the changes to § 163(j) soon after they were passed.

A potential compromise would allow for meaningful deferral and not effective disallowance by including a disallowed interest deduction recapture provision. A problem with the current mechanics of the limitation is that while § 163(j) permits disallowed deductions to be carried forward, many corporations never operate without any debt, so any disallowed interest deduction amounts carried forward would compete with the interest expenses generated in the future taxable year for allowable deduction room. To take advantage of the deferral, the corporation must repay its existing debt with either cash on hand or equity offerings to avoid generating additional interest expenses that would consume the amount of adjusted taxable income allowed for deductibility. As such, this deduction deferral provision in substance can often function like a permanent disallowance. An amendment to § 163(j) that provides for the accumulated interest disallowed under § 163(j)(1) to be deducted in full upon maturity of the loan would be the ideal solution.

For example, assume Corporation C has an adjusted taxable income of ten million dollars in Year 1 and has a five-year term loan of one hundred million dollars at a five-percent interest rate, resulting in five million dollars of annual interest expense. According to the new § 163(j) limitation, C would only be allowed to deduct three million dollars, i.e., thirty percent of ten million dollars. As such, the remaining two million dollars of interest expense must be carried forward. Therefore, C would not be able to deduct these two million dollars for at least five years because it would incur the same five million dollars of interest expense until the term loan matures. Unless its adjusted taxable income increases to above $16.67 million (thirty percent of which is five million dollars) without incurring additional debt, it will never have enough adjusted taxable income to absorb the non-deductible interest. In fact, when the term loan matures in five years, C will have accumulated ten million dollars of non-deductible interest if its adjusted taxable income remains constant.[145] The only way C can deduct

145. While it is unlikely to assume that taxable income for a business would remain constant over five years, it is reasonable to assume that capital intensity would remain relatively constant over the growth of the company. In other words, as revenue grows, so do the capital requirements, which would generate

this amount is to become entirely equity-funded, which may not be practicable because of its business model or shareholder demands, thereby making interest on this loan effectively non-deductible in perpetuity.[146] The proposed amendment would allow C to deduct the entire ten million dollars when its term loan matures.

There are drawbacks to this interest-recapture proposal. The first is that it does not restore the economic neutrality and horizontal equity discrepancy with leases because those remain deductible as accrued. Nevertheless, it somewhat bridges the gap in treatment because deferral is preferable to effective disallowance. Another drawback is that it may encourage companies to borrow at shorter maturities so that they can claim their backlogged deductions more frequently. However, it is reasonable to assume that the market would correct for this apparent drawback; economically rational lenders offer lower interest rates for short-term debt than for long-term debt.[147] A rational third-party lender would likely notice if a borrower continues to repeatedly refinance short-term debt. Such a lender would start charging higher rates that are commensurate with those of longer maturities to compensate itself for the risk and capital lock-in of longer-term financing. Lenders often request access to a firm's financial statements during the underwriting stage and can easily detect a borrower that is employing short-term debt to finance long-term assets.[148] Since the aggressive use of short-term debt to finance assets was a significant aggravator of damage in the 2008 financial crisis, banks would be much more alert about taking on this type of risk.[149]

Furthermore, the IRS can look through the form of the transaction to the substance.[150] If a borrower continues to refinance and claim full deductions

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more interest expense for the company, thereby consuming more of the adjusted taxable income allowed for deductibility.

146. *See* text accompanying *supra* note 61 (arguing that leverage results in higher rates of return for shareholders).

147. U.S. DEP'T OF THE TREASURY, DAILY TREASURY YIELD CURVE RATES (Aug. 2, 2019), https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield [https://perma.cc/G2KR-CNGV].

148. Mary Ellen Biery, *Looking to Borrow? You May Need an Audit, Review or Compilation*, FORBES (Nov. 26, 2016), https://www.forbes.com/sites/sageworks/2016/11/26/looking-to-borrow-you-may-need-an-audit-review-or-compilation/#1e29d10946cd [https://perma.cc/3TH4-MUPC].

149. Philip E. Strahan, Liquidity Risk and Credit in the Financial Crisis, 2012–15 FED. RES. BANK S.F. ECON. LETTER (2012) https://www.frbsf.org/economic-research/publications/economic-letter/2012/may/liquidity-risk-credit-financial-crisis/ [https://perma.cc/H5QN-UQ3Z].

150. *See* Gregory v. Helvering, 293 U.S. 465, 467–71 (1935).

while paying interest rates consistent with longer-term debt, the IRS should be able to recharacterize the debt as long-term debt and disallow the excess deductions. It can also observe patterns in which taxpayers are repeatedly refinancing short-term liabilities to fund long-term assets and disallow full deductions on maturity when it identifies abusive practices. The advantage of disallowing recapture deductions over recharacterizing debt as equity is that it avoids some of the grislier effects of debt recharacterization. The lender does not suddenly acquire an ownership interest in the borrower, so other provisions of tax code that has ownership percentage requirements would remain unaffected for the issuing corporation.

CONCLUSION

The TCJA's modifications to interest-expense deductibility was likely motivated in part by the mistaken belief that tax treatment of debt and equity financing should be identical under the principles of economic neutrality and horizontal equity. Such a belief was likely supplied by MMT's conclusion that a firm's value is identical regardless of whether it finances through debt or equity without the effect of taxes.[151] What proponents of the interest-expense limitation overlooked was that the economic risk profile of debt-financing transactions is very similar to that of leases. On the other hand, debt has a very different risk profile for the issuer than that of equity financing.

Congress attempted to bridge the tax-treatment gap between debt and equity, but it did not need to be bridged. Instead, Congress created an inconsistency in tax treatment between debt and leases. Such an inconsistency creates incentives for companies to choose leases over debt independent of business reasons. This is incompatible with the established tax policy objectives of economic neutrality and horizontal equity. The ideal correction is to restore the full deductibility of the interest expense. But Congress should at least allow for a disallowed-interest recapture provision upon maturity of debt.

151. Modigliani & Miller, *supra* note 10, at 295–96.