Eric Rasmusen, [erasmuse@indiana.edu](mailto:erasmuse@indiana.edu), Armistice Day, 2021

OCT. 2021 DRAFT  **Interest Deductibility**

**David Hasen**

I like to rewrite abstracts, because I can understand the paper better then, and help the author that way too. Please don’t be offended; I rewrite my own papers this way too.

The proper tax treatment of interest expense has been a subject of disagreement since the inception of the modern income tax in the early twentieth century. On one view, the purpose of the financing transaction dictates the tax treatment, so that interest paid on borrowing used to finance consumption should be nondeductible, whereas business interest should be deductible. On another view, interest paid does not constitute a consumption item but rather a mere shift in resources and therefore should be deductible at all events, assuming the recipient includes in income the interest received. Both of these views lead to conundrums that cannot be resolved without considering the broader question of why some expenses are deductible at all. Focusing on that question, it turns out that business interest, like any other business expense, should generally be deductible as a timing or an accounting principle under an income tax. That principle does not apply to personal interest expense. Nevertheless, there may be an independent basis to permit a deduction for personal interest expense that is grounded in considerations of vertical equity. A related question arises in the business setting when loan proceeds finance the purchase of business assets that are taxed under consumption tax norms. Congress has lately sought to limit interest deductibility in this setting, but a better approach would be to apply consumption tax norms more consistently to the overall arrangement. Under consumption tax norms, business interest remains deductible but loan proceeds are includible in gross income.

Should interest expense be deductible from income for tax purposes? On one view, the purpose of the financing transaction dictates tax treatment, so business interest should be deductible, but interest paid on borrowing to finance consumption should not. On another view, interest paid is not consumption, but rather a mere shift in resources and therefore should be deductible, assuming the lender included interest received in income. Both views lead to conundrums irresolveable without considering the broader question of why some expenses are deductible at all. Focusing on that, business interest, like any other expense, should be deductible, as a timing or accounting principle under an income tax. That principle does not apply to personal interest. There may nonetheless be an independent basis for a personal interest deduction, grounded in vertical equity. A related question arises in business when loans finance the purchase of business assets taxable under consumption tax principles. Congress has lately sought to limit interest deductibility in this setting, but a better approach would be to apply consumption tax principles more consistently, so that business interest would remain deductible but loan proceeds would be part of gross income.

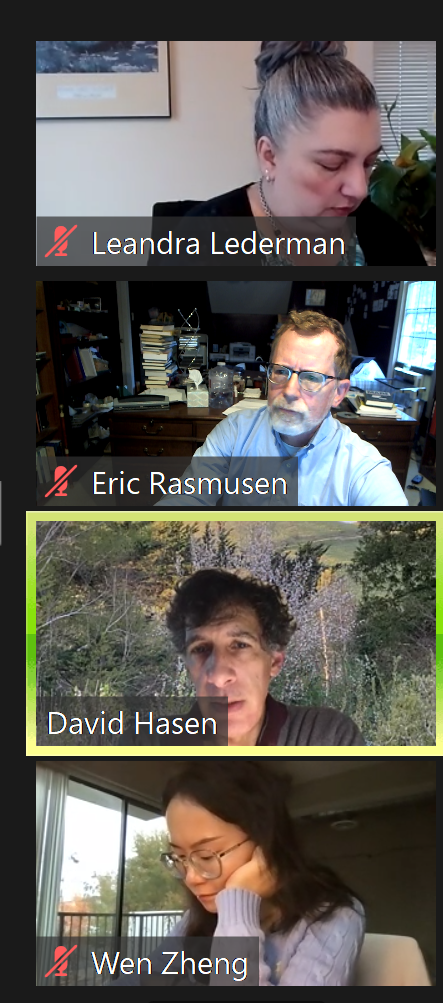
Should interest expense be deductible from income for tax purposes? On one view, the purpose of the financing transaction dictates tax treatment, so business interest should be deductible, but interest paid on borrowing to finance consumption should not. On another view, interest paid is not consumption, but rather a mere shift in resources and therefore should be deductible, assuming the lender included interest received in income. Both views lead to conundrums irresolveable without considering the broader question of why some expenses are deductible at all. Focusing on that, business interest, like any other expense, should be deductible, as a timing or accounting principle under an income tax. That principle does not apply to personal interest. There may nonetheless be an independent basis for a personal interest deduction, grounded in vertical equity. A related question arises in business when loans finance the purchase of business assets taxable under consumption tax principles. Congress has lately sought to limit interest deductibility in this setting, but a better approach would be to apply consumption tax principles more consistently, so that business interest would remain deductible but loan proceeds would be part of gross income.

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Personal interest deduction for consumption purchases, and special business interest deductions seem two quite different topics. Two papers? Maybe not.

The rationale is that maybe we can separate the financing decision from the use decision. That is standardly done in cancellation of debt situations.

The difference is that we don’t have debt covenants and dividend issuance legal rules in personal taxation, at least not as much.

If a business borrows, it does so for investment, not to issue dividends. The debt contract will prohibit using it just to issue dividends, ordinarily, since otherwise the business could just borrow a lot, issue it all as dividends, and go bankrupt (as a corproation). If the business is not incorporated, I expect there is something similar—that the borrowers cannot use the money for distributions to themselves as owner, spend the money, and declare bankrtupcy. THo I think of Tom Wolfe’s *A Man in Full*, and the insolvent developer naming his racehorse Second Draw, after teh second draw on a bank loan for his skyscrapers. Anyway, there are probably also legal rules saying that even in the absence of a contractual clause, the borrowers can’t do that (or use it to buy a house that is shielded from bankrtupcy).

If a person borrows, he often does it for immediate consumption. We don’t want to let him borrow money, go on a wild vacation, and declare bankruptcy.

Why is that reelvant to the Interest Deduction? I forget. But it at least explains why we can separate Use from Financing.

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Actually, whether it is a durable good is critical. Buying a house is an investment as well as consumption. It is like buying a house to rent out, adn then living in it yourself. Each year, you choose wehther to consume the return (live in the house) or get cash (rent it out). But you pay a lot of money in advance for consumption or cash benefits over time.

The same is true of buying a car, but it is 10 years instead of 40 years of benefit.

The same is NOT true of buying a sandwich. It is immediate consumption, not a stream over time.

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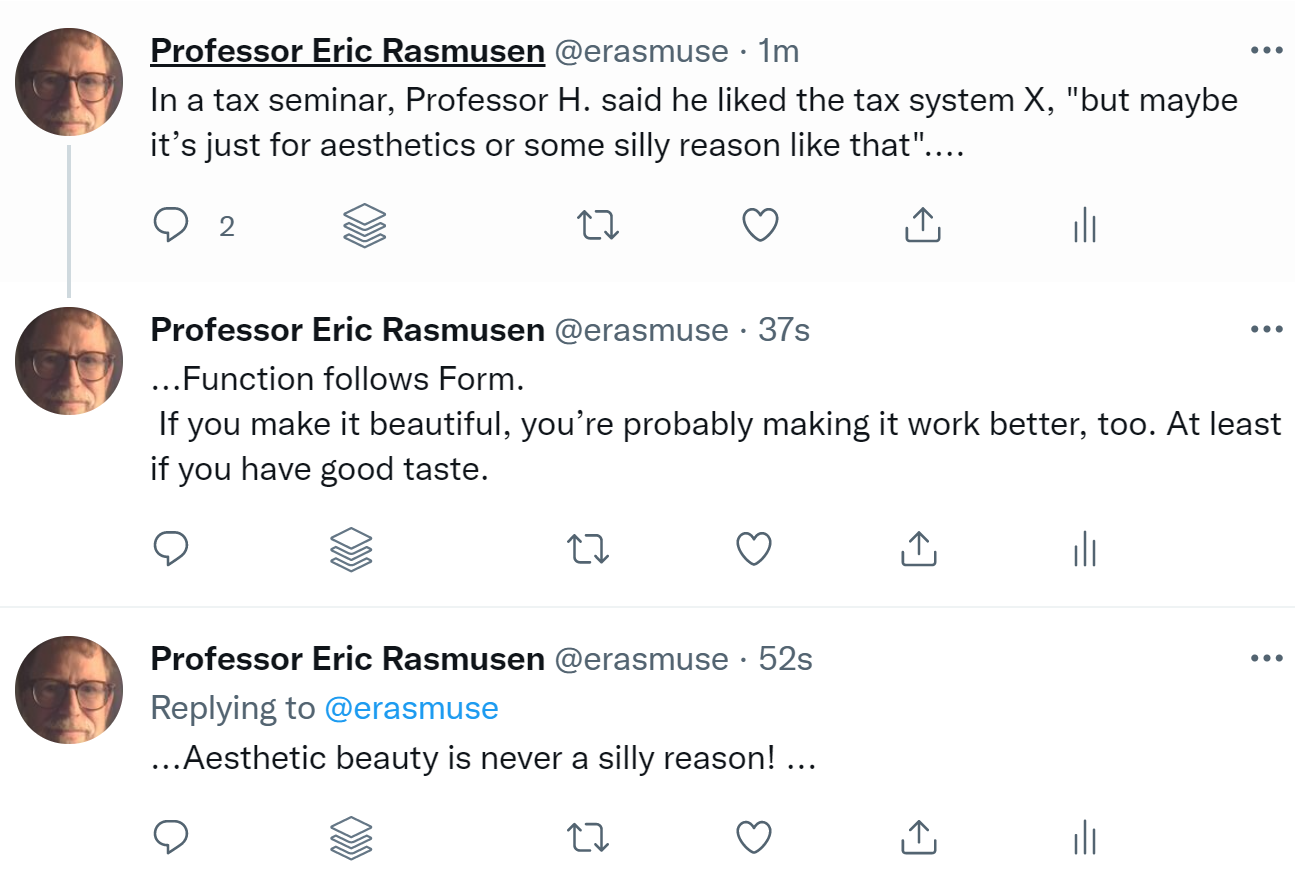
The borrower has more cash flow spent on a car, but no greater economic price, on average at least. If all borrowers were sure to repay, they’d all pay the same low interest rate.

What you buy from a loan is not JUST liquidity—you also bring the good forward in time. Money now is better than money later, liquid or not. The main value is not liquidity, but having funds earlier and thus being able to consume or invest earlier. Most obviously, if you have the money now instead of a year from now, you get 1% return from a safe investment you can make.

A case that radically illustrates that a Dollar Is Not a Dollar is the one in my amicus brief below, which tried and failed (I think) to get the Court to understand this:

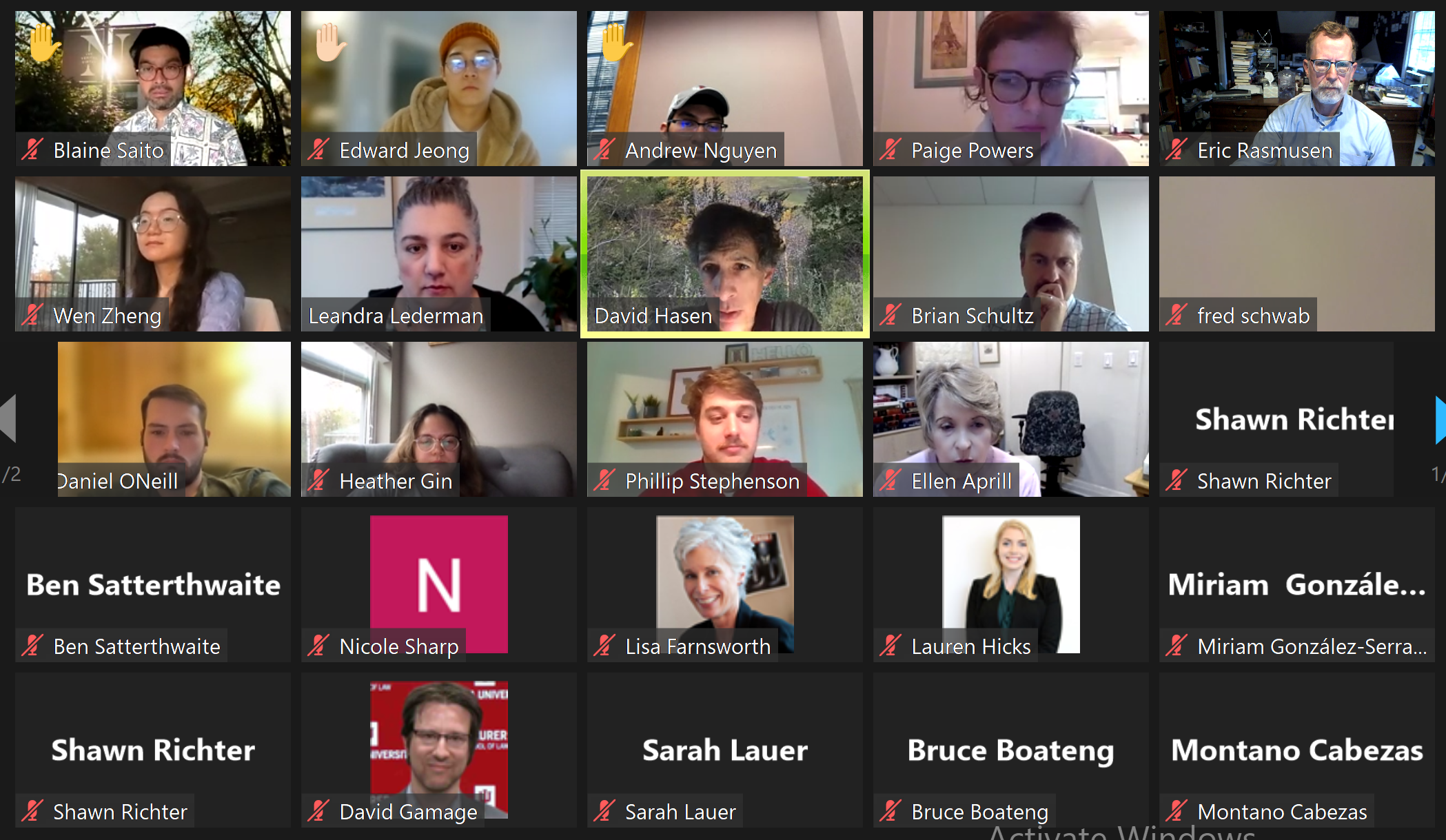
1. Eric B. Rasmusen, **"The Meaning of "Value" for Gift and Estate Tax Donee Limitation in Tax Code 26 U.S.C. § 6324(B): An Amicus Brief for Marshall v. Commissioner"** (August 12, 2013). In 1995, J. Howard Marshall II made a gift to Elaine Marshall worth some $43 million at the time of transfer. The IRS assessed gift tax against his estate, which failed to pay. In 2008 the IRS assessed gift tax of $74 million against donee Elaine Marshall, which exceeds $43 million because of the interest accumulated since 1995 but is less than the $81 million the gift would compound to at 5% per year. Does the limitation on donee liability to “the value” of the gift imposed by 26 U.S.C. § 6324(b) mean to “the original amount of the gift” or to “the value of the gift at the time of eventual tax payment”? In effect, that is the issue in Marshall v. Commissioner, which is now before the 5th Circuit. The SD Texas and the 11th Circuit went one way; the 3rd and 8th Circuits went the other way. This paper is an amicus brief for that case and, I hope, a good example of how economics can inform and simplify law. [http://ssrn.com/abstract=2261914).](https://ssrn.com/abstract=2261914)

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Leandra has the question queue listed in the chat. She also has it so that the zoom boxes of the people in the queue are in order up at the top of the page. How does she do that? Great idea.

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From Heather Gin to Everyone: 09:54 AM

Hi! My name is Heather Gin and

From Wen Zheng to Everyone: 09:54 AM

Hi, I am Wen and a 2L at Maurer.

From Lauren Hicks to Everyone: 09:54 AM

Good morning. I'm Lauren Hicks, a 2L at Maurer.

From Leandra Lederman to Everyone: 09:54 AM

Welcome, everyone! Thank you for introducing yourselves!

From Me to Everyone: 09:54 AM

Hi. I'm a retired econ professor from Indiana U., interested in tax whistleblowers in particular.

From Paige Powers to Everyone: 09:55 AM

Hi all! I'm Paige Powers, 3L JD/MBA at IU Bloomington

From Brian Schultz to Everyone: 09:55 AM

Good morning. I'm Brian Schultz with Ice Miller

From Daniel ONeill to Everyone: 09:55 AM

Good Morning, my name is Dan O’Neill and I am a third year student at Maurer.

From Leandra Lederman to Everyone: 09:55 AM

Indiana CLE is offered for this session. I will share information towards the end of the session on how to claim Indiana CLE.

From Edward Jeong to Everyone: 09:55 AM

Good morning everyone. My name is Edward Jeong, a 3L in Maurer.

From Sarah Lauer to Everyone: 09:57 AM

Good afternoon from Munich, I am Sarah Lauer, PhD Student at the Max Planck Institute for Tax Law and Public Finance.

From Blaine Saito to Everyone: 09:57 AM

Sorry for my tardiness. My name is Blaine G. Saito, Assistant Professor of Law at Northeastern University School of Law.

From Ben Satterthwaite to Everyone: 09:58 AM

Hello! I'm Ben Satterthwaite. I'm an international tax Senior at Ernst & Young and was a student of Professor Hasen at the Florida Tax LLM program a couple years ago.

From Leandra Lederman to Everyone: 10:03 AM

Thanks for introducing yourselves.

I'll keep the question queue. After Prof. Hasen's remarks, students in the Tax Policy Colloquium class will have first priority in the queue. After that, it's first come, first serve unless someone lets me know they need to leave early or have a related question or comment. Just raise your virtual "hand" to get in the queue, or, if that doesn't work, you can message me here in this chat window. Also, feel free to share links and/or long comments in the chat. I can also read questions if your mic isn't working.

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