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THE HOUSE TAX BILL: FURTHER RESTRICTIONS ON DEDUCTION OF INVESTMENT INTEREST

Under current law, investors may deduct the interest on money they borrow to purchase stock, bonds, or other property up to the amount of their investment income — whether interest or capital gains. The interest deduction reduces total taxable income, and in that sense is deductible against ordinary income subject to the 31% top tax rate even if some of the investment return is in the form of capital gains subject to a top rate of 28%. The House tax bill limits the interest deduction to the amount of investment income (interest) subject to ordinary tax rates, and excludes capital gains in computing the deduction limit. Any interest deduction in excess of that amount would have to be carried forward. (The taxpayer would have the option of treating some capital gain as ordinary income to take the interest deduction earlier.)

In the House's view, the ideal situation is one in which all lenders are taxed on the interest they receive, and borrowers may not deduct their interest payments. This is "Heads I win, tails you lose."

For example, suppose the taxpayer had $10,000 in interest expenses, $5,000 in interest income, $5,000 in capital gains, plus $50,000 in salary. Under current law, the taxpayer could deduct the full interest expense. Under the House bill, the taxpayer could only deduct $5,000 in interest expenses in the current year. He could deduct the full interest cost only if he were willing to give up the 28% tax rate on the $5,000 capital gain.

The House bill would worsen the anti-saving, anti-investment bias of the tax code, raise the cost of capital and reduce saving in the United States, and slow the growth of investment, productivity, wages, and employment.

The correct treatment of interest outlays and investment income should not be determined taxpayer by taxpayer but activity by activity. That is, the tax should not be set by looking only at a taxpayer's end of the various transactions in which he engages. Rather, each separate economic activity involving a borrower and lender should be taxed, in toto, in an appropriate way that avoids double-taxing the economic activity in which they have jointly engaged.

The economic activity in this case involves an exchange between the borrower and the lender. The borrower pays interest; the lender receives interest. If the lender is taxed on the interest, the borrower should be allowed to deduct the interest. The interest deduction of the borrower should not depend on what the borrower used the money for or whether his income took the form of capital gains, interest, or tips from a paper route. If the lender is being taxed on the interest the borrower pays, the borrower should be allowed to deduct the interest against any and all income.

The flap over limits on interest deductions, therefore, is just another case of the House looking narrowly at the borrowing taxpayer and ignoring the other side of the transaction. In the House's view, the ideal situation is one in which all lenders are taxed on the interest they receive, and borrowers may not deduct their interest payments. This is

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"Heads I win, tails you lose." People with that attitude should work in carnivals, not in government. Or is there no difference?

Current law is the result of a philosophy that seeks to tax different people at different rates according to their "ability to pay", rather than levying a uniform, non-distorting tax on all economic output to give government the use of a portion of GNP. That is, the government taxes activity according to who did it rather than according to how much the activity adds to national product. This pernicious approach to taxation severely depresses incentives to work, save, and invest. It retards investment, productivity growth, wages, and employment, injuring people at all income levels. Each of the House bill provisions regarding capital gains and interest would make this damage worse.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.