Capital Investment Tax Deduction

The Ask:

Electricity is literally the first step in the American economy. Every American uses electricity – it is baked into everything we do and is a component of every manufactured good we produce. Because of a number of factors, especially a dramatic decrease in the costs of natural gas and of renewable energy, Americans are paying less for electricity – which means more manufacturing jobs can return to the United States and reduced cost of goods and services. But, to continue to provide reliable and affordable electricity, the electric power industry needs to continue to invest in electric energy infrastructure. The industry is incredibly capital intensive – combined, electric utilities are investing over $125 billion in the U.S. economy this year alone. The investment is financed by a combination of equity and debt – generally, a balance that ensures good credit ratings and, in turn, low capital costs which translates into low electricity prices and economic growth.

Some tax reform proposals would eliminate interest deductibility, providing companies with full expensing of capital investments instead. This works for many industries, but since utilities essentially invest and build for their customers and spread, or "normalize" their investments, electricity costs are directly impacted by interest deductibility, but not from immediate expensing. In other words, eliminating interest deductibility simply increases the cost of electricity – an increase in the cost of capital is a direct pass-through. Accordingly, if interest deductibility is eliminated, there should be a carve-out for utilities that mandates utilities to deduct interest in lieu of full expensing. Exchanging expensing for continued deductibility of interest actually nets taxpayers money *and* keeps electric rates low – a rare, but very real, win-win for everyone.

The Challenge:

Congress and the Administration are working together to reform the Tax Code – in general, they want to lower rates and eliminate a number of deductions. Obviously, rewriting the Code is challenging – it's been three decades since the last major tax reform. So, although there is broad agreement on the ideal, there is not yet consensus on the details. The President and the House have both put forward proposals. The House's plan, known as the "Blueprint" is more detailed than the President's plan – there is a lot of alignment between the two plans, but also some key differences. Thus far, there are no legislative proposals, though it is presumed that the House, Senate and the Administration will put forward a plan this year.

One key difference is interest deductibility, which is often paired with full expensing. The House Blueprint, for example, proposes a trade-off between interest deductibility and the full expensing of capital, reflecting a perception that debt can lead to distortive financial decisions and that full expensing will promote increased capital investments. It is presumed that such a change would raise $1 trillion in revenue. But, not everyone agrees with the concept. Debt is clearly an essential part of business growth – not every company can or should issue equity to fund investment. And raising the cost of capital isn't necessarily stimulative – especially for capital intensive industries. Also, there's some disagreement about the efficacy of immediate expensing. Many economists dispute the notion that expensing spurs economic investment – it is, after all, just a timing issue. Because of these factors, there is no agreement yet on the best path forward. During the campaign, candidate Trump proposed providing certain taxpayers with the option of either interest deductibility or full expensing, recognizing that capital intensive industries are unique and do not necessarily benefit from full expensing. The President's most recent tax reform proposal, released on April 26, was completely silent on both interest deductibility and full expensing.

The optionality in the President's campaign proposal implicitly recognized that not all businesses and industries are equal – some are both capital intensive *and* unable to benefit from full expensing, a dynamic that simply forces certain industries to pay more for their capital without a concomitant benefit. Banks and financial institutions obviously fit into this bucket. Interestingly, electric, gas, and water utilities do as well – all invest massive amounts of money into the American economy and provide the backbone for American manufacturing, but since they essentially invest for their customers and spread, or "normalize" their investments, their customers benefit from interest deductibility but not from full expensing. Eliminating interest deductibility simply increases the cost of electricity, natural gas and water for every American.

Interest deductibility is critical to the U.S. economy because debt is essential for all businesses to finance investments to grow and manage day-to-day operations. It is a normal part of all businesses' operations. All industries, including construction, manufacturing, transportation, retail, and professional services, and all types of companies, including proprietorships, partnerships, and corporations, use debt. And importantly, according to the BUILD Coalition, research has found that 75 percent of startups and 80 percent of small businesses rely on debt financing. While capital-intensive industries use debt financing, all industries use credit to grow. {1} Debt is essential for almost all businesses to finance investments in order to expand, which in turn fuels economic growth.

Eliminating the deduction for interest will raise the cost of capital for all companies. That is, the cost to open a new plant or store, invest in new technologies, and simply manage day-to-day finances will all go up. Higher costs will reduce investment, new business formation, economic growth, and job creation. Small businesses, which create two out of every three private sector jobs in the United States and rely on debt financing, will be particularly hurt. Even if revenue from this new tax is used to finance lower tax rates, the end result is higher net costs of businesses, which would likely lead to slower economic growth. Larger companies, especially those that are publicly traded, might also be reluctant to increase spending because company executives look to other measures, such as the tax rate, in their financial statements. Theoretically, this increase will be offset by lower tax rates and by immediate expensing. In some cases, this will be true. For some companies and industries, this simply is not and cannot be true – lower corporate rates and immediate expensing will not offset an increase in the cost of capital.

How we propose it be resolved:

While the exchange of interest deductibility for full expensing may work for certain industries, it doesn't work for utilities because utilities are big infrastructure investors and, thus, big borrowers. But, more importantly, it doesn't work because utilities are rate-regulated. That is, the price of power in America is essentially set by a variety of federal and state governmental Commissions. In effect, the Commissions prescribe a rate of return on prudent investments in exchange for reliable and affordable gas, water and electricity. As such, the cost of projects is spread across all customers for the life of the project. The major variable inputs, therefore, are the cost of the commodity and the cost of capital – these two factors are direct pass-throughs to customers. So, for electric utilities, the cost of generation facilities is essentially set and is spread, or "normalized," by Commissions, and the costs of capital and of fuels, like natural gas and coal, are variable and borne directly by the consumers. In other words, the more it costs to borrow money, the more electricity costs. Consequently, utility company debt ratios are actually monitored and mandated by Commissions to ensure an optimal balance between equity and debt, which in turn ensures the lowest cost of electricity for American consumers – since utilities cannot change the balance, eliminating the interest deduction simply makes electricity more expensive. Accordingly, if interest deductibility is eliminated, there should be a carve-out for utilities that mandates utilities to deduct interest in lieu of full expensing.

Summary

Comprehensive tax reform is a top priority for investor-owned utilities this year. We support comprehensive tax reform because we believe that a simpler tax code, broader tax base, and lower tax rates will grow the economy and increase the competitiveness of the United States, support job creation in America, and benefit utility customers.

The outcome on tax reform could have a direct impact on the cost of capital to invest in energy infrastructure. That is why we believe it is essential that any tax reform legislation support investments in America's critical energy infrastructure and help keep energy bills as affordable and predictable as possible for all Americans. To accomplish this, we propose the preservation of the deductibility of interest in exchange for standard, or MACRS, expensing. Interest deductibility is critical for the utility industry as it helps to keep the cost of capital low. The rates investor-owned utilities can charge their customers and how much they can earn on investments are highly regulated, unlike those of other businesses. As a result, the full expensing of capital does not have the any stimulative economic effect for investor-owned utilities, as it might have for other industries.

Over time, the costs of a utility's investments are factored into customer bills. The loss of interest deductibility will permanently impact the cost of capital to customers, whereas expensing is simply a timing difference. Unlike other industries, full expensing will lead to less, rather than more, investment by utilities. Eliminating interest deductibility simply increases the cost of electricity because an increase in the cost of capital is a direct pass-through. To fix this, any tax reform proposal should mandates utilities to deduct interest in lieu of full expensing.

{1} Cole, Rebel A. "Why Businesses Use Debt – And How Debt Benefits Businesses." June 2013.