[JOINT COMMITTEE PRINT]

FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES

SCHEDULED FOR HEARINGS

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON JANUARY 24-26, 1989

AND THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON JANUARY 31 AND FEBRUARY 1-2, 1989

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JANUARY 18, 1989

U.S. GOVERNMENT PRINTING OFFICE

92-815 WASHINGTON : 1989 JCS-1-89

ERRATA

The following changes should be made to Federal Income Tax Aspects of Corporate Financial Structures, published by the staff of the Joint Committee on Taxation on January 18, 1989, as JCS-1-89.

(1) On page 2, the first sentence of the fifth paragraph should read as follows: Dividends paid by a corporation from its earnings are not deductible to the corporation and are subject to a tax at the individual shareholder level.

(2) On page 14, the value for the year-end balance of corporate bonds held by the Household sector should read 92.2 billion instead of 92.9 billion; the corresponding percentage of total should read 7.8 instead of 7.9.

(3) On page 44, the reference in footnote 72 to "20-year life" should read "30-year life."

(4) On page 65, the ratio of debt to equity (market) for 1966 should read 43.2 instead of 32.2.

Continued on next page.

(5) On page 67, the portion of Table IV-C which appears on that page should read as follows:

Table IV-C. Interest Coverage Ratios of Nonfinancial Corporations, 1969-1988 - Continued

Year	Ratio of Net Interest to Cash Flow[1]	Ratio of Net Interest to Capital Income Plus Economic Depreciation[2]
1975	0.15	0.14
1976	0.14	0.11
1977	0.14	0.11
1978	0.14	0.11
1979	0.14	0.13
1980	0.18	0.16
1981	0.21	0.16
1982	0.22	0.19
1983	0.18	0.15
1984	0.18	0.15
1985	0.18	0.15
1986	0.20	0.15
1987	N.A.	0.16
1988	N.A.	0.17
Averages:		
1971-75	0.13	0.14
1976-80	0.15	0.13
1981-85	0.19	0.16
1986-88	N.A.	0.16

1. Source: Ben S. Bernanke and John Y. Campbell, "Is There a Corporate Debt Crisis?" Brookings Papers on Economic Activity, No. 1, 1988, pp. 83-125.
2. Source: Division of Research and Statistics, Federal Reserve Board.

(6) On page 68, the third sentence should read as follows: Unpublished data from the Federal Reserve indicates that the (weighted) average rating on outstanding corporate bonds has steadily declined from a Standard & Poor's rating of A+ to a rating of A- during the 1978-1988 period.

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INTRODUCTION

The Senate Committee on Finance has scheduled hearings on recent trends in corporate financial restructurings and increasing corporate debt, and the relationship of these trends to the tax law. The Finance Committee hearings are scheduled for January 24-26, 1989.

The House Committee on Ways and Means has scheduled hearings on tax policy aspects of corporate mergers, acquisitions, leveraged buyouts, and recent increases in corporate debt. The Ways and Means Committee hearings are scheduled for January 31 and February 1-2, 1989.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation in connection with these hearings, discusses Federal income tax aspects of corporate financial structures (debt and equity financing), mergers and acquisitions, and leveraged buyouts. Part I of the pamphlet is background discussion of corporate restructurings that affect debt and equity and trends in corporate financial structures. Part II provides a description of present law tax rules related to corporate financing, passthrough entities, transactions involving pension plans and ESOPs, and current limitations on interest deductions. Part III presents examples of corporate transactions that increase debt or reduce equity and the tax consequences of such transactions. Part IV discusses tax and economic policy considerations related to various forms of corporate financial restructurings. Finally, Part V describes possible options relating to the tax treatment of corporate operations and discusses related policy considerations of the options.

A brief summary precedes Part I of the pamphlet.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures* (JCS-1-89), January 18, 1989.

SUMMARY

Recent Developments in Corporate Financial Transactions

In recent years, a number of transactions have occurred resulting in the replacement of corporate equity with debt. These transactions have included debt-financed acquisitions, leveraged buyouts (LBOs), use of leveraged employee stock ownership plans (ESOPs), debt-equity exchanges, stock redemptions, and extraordinary dividends.

Various corporate financing transactions during 1984–1987 have resulted in a reduction of $313.3 billion in corporate equity (other than in the financial sector). During the same period, the amount of net new corporate borrowing has increased by $613.3 billion. The ratio of debt (par) to equity (book) of nonfinancial corporations has increased from 30.3 percent in 1981 to 46.0 percent in 1987. During this period, the ratio of debt (market) to equity (market) increased from 63.0 percent to 65.3 percent. (See Table IV–B.)

Part I presents a background of corporate restructurings that affect debt and equity and describes recent trends in corporate financial structures.

Present Law Tax Rules

Under present law, corporations are subject to a corporate income tax. Corporate income is taxed at a rate of 34 percent (with lower rates for corporations with taxable income below $75,000). Certain tax deductions for preference items, such as accelerated depreciation, often result in an effective tax rate of less than 34 percent on the economic earnings of the corporation.

Dividends paid by a corporation from its earnings are not deductible to the corporation subject to a tax at the individual shareholder level. For a shareholder in the 28-percent bracket, a tax of $18.48 would be imposed if the $66 of after-tax income from $100 of corporate taxable income is distributed as a dividend. This results in a total tax of $52.48 ($34 plus $18.48) on distributed corporate earnings. If the shareholder realizes the income by selling the shares rather than receiving a dividend, the gain is taxed at the shareholder's regular tax rate.

If the corporation instead distributes its operating income to its creditors as interest, the interest is deductible by the corporation, resulting in no corporate tax on such amounts and a tax to the creditor at the creditor's normal tax rate.

Where the creditor or shareholder is tax-exempt (e.g., pension plans), no tax generally is imposed on the interest or dividend received. In the case of foreign persons, reduced (or zero) rates may apply.

Part II provides a more detailed description of present law tax rules relating to individuals, corporations, passthrough entities, ESOPs and other qualified plans, and current law limitations on interest deductions. Part III describes examples of corporate transactions that increase debt or reduce equity and the tax consequences. Part IV discusses various policy issues relating to the tax advantages of debt vs. equity, corporate restructurings and economic efficiency, risks of excessive corporate debt, use of ESOPs and other qualified plan assets, the role of interest deductions in taxing economic income, and revenue considerations.

Overview of Options

Various options could be adopted which lessen the distinction between the tax treatment of debt and equity in order to reduce the tax bias toward the issuance of debt. The double taxation of dividends could be lessened by allowing corporations to deduct dividends, or by providing a shareholder credit for corporate tax paid with respect to such dividends.

In addition, the tax treatment of debt could be made less favorable by, for example, limiting the deduction for interest on indebtedness. Possible limitations include the following: disallowing a flat percentage of all interest deductions; limiting the deduction for interest on debt in excess of a specific rate of return; limiting interest deductions based on inflation (interest indexing); disallowing interest deductions in excess of a specified percentage of income; disallowing corporate interest deductions in transactions that reduce corporate equity; and denying interest deductions in specified situations, such as acquisitions involving high risk, acquisitions involving borrowing against untaxed appreciation, or hostile acquisitions.

Other options include combining partial dividend relief and partial interest disallowance, imposing a minimum tax on corporate distributions, requiring the recognition of corporate-level gain to the extent corporate-level debt is incurred in excess of corporate-level underlying asset basis, imposing an excise tax on acquisition indebtedness, reducing specific tax incentives such as those provided to employee stock ownership plans (ESOPs), and imposing a tax on certain investment income of tax-exempt entities.

Any proposal to reduce the double taxation of dividends would more nearly conform the tax treatment of debt and equity and reduce the bias toward the issuance of debt. Previous attempts to provide dividend tax relief have met resistance because of the revenue costs, and because of lack of support from the business community. In addition, dividend relief proposals raise numerous complex issues including, for example, the treatment of corporate tax preferences, the treatment of tax-exempt and foreign shareholders, and transition issues and effective dates.

Proposals to more nearly conform the tax treatment of debt and equity by limiting interest deductions have been based on the notion that certain types of debt with high interest rates or equity features should be treated, in whole or in part, as equity. Other proposals have been based on the concept that debt issued for certain purposes (such as certain takeovers) does not serve a worthy public purpose and should be discouraged by disallowing an inter-

est deduction. Others, such as indexing, have been based on the idea of more properly measuring economic income. Many of the proposals to limit interest deductions are subject to criticism as resulting in an improper measurement of income. Also, proposals to limit interest deductions have been criticized as causing a bias in favor of foreign persons who may deduct interest in computing income in their home country. Proposals to limit interest deductions also involve difficult issues relating to transitional rules and effective dates.

Proposals to limit the benefits of ESOPs or to impose a tax on tax-exempt entities, although perhaps helpful in limiting the bias towards debt, may be viewed as limiting the benefits which Congress has granted for these entities.

Part V provides a discussion of the various tax options and related policy considerations.

I. BACKGROUND

The United States is still in the midst of a period of rapid merger activity which began several years ago.[2] As this boom in merger activity has accelerated, correspondingly major, though less well publicized, changes in the role of debt, equity and corporate distributions have occurred which has resulted in an increasing use of debt by the corporate sector. The shift away from equity toward debt finance is not solely due to leveraged buyouts nor is it a product of short-term trading of securities by market participants. Since the tax treatment of corporate debt has not changed recently, there is little evidence that the tax bias of debt over equity has led to increased takeover activity or changes in corporate financial structure. Many factors other than taxes affect financing activities and acquisitions. There are indications, however, that the tax system influences corporate merger and financing decisions and may serve as an additional incentive for debt finance.

The parallel shifts in corporate financing and merger activity have created concern for those with interests in monetary policy, the regulation of financial institutions and security markets, and antitrust and competitive policy, as well as tax policy. Some argue that the time and expense involved in corporate acquisitions divert resources and managerial energy from productive investment toward short-term goals; others claim this acquisition activity serves to redeploy corporate assets in a more efficient pattern and focuses management attention on the long-term goals of production and profitability. The changes in financing behavior cause some people to conclude that the U.S. economic system may now be more vulnerable to economic downturns and that the risk to private investors, the U.S. government, and the nation as a whole has increased. While the tax system may not be the cause for the recent changes in merger and corporate financial behavior, because the tax system does influence these decisions, it is important to identify the public policy goals that should determine the Federal government's response and the role that tax policy plays in achieving these goals. In addition, since over $94 billion in tax revenue was raised by the corporate income tax in fiscal year 1988, trends which reduce the corporate income tax base require careful scrutiny.

A. Corporate Restructurings that Affect Debt and Equity

There are a variety of transactions that affect the level of debt and equity in the corporate sector.[3] Many of these transactions in-

[2] Although "merger" is a term of art under the Internal Revenue Code, it generally will be used in this section of the pamphlet in the nontechnical sense to refer to an acquisition or takeover of one corporation by another corporation or group of investors.

[3] See Part B of this section, *infra*, for a discussion of the quantitative trends.

volve mergers and acquisitions, others do not; they all share the common trait that they may serve to reduce equity or increase debt in the corporate sector. What follows is a brief description of a few transactions and financing methods that may be of particular interest from a tax policy perspective.

Acquisitions.—Acquisitions for which the target shareholders receive cash in exchange for their shares, and in which the funding for the acquisition is provided by new debt issues or retained earnings of the acquiror, serve to reduce the level of corporate equity and generally to increase the level of debt relative to equity in the corporate sector. The acquisition process may take many forms, hostile or friendly, and may be relatively simple or involve any of the more complex maneuverings that have generated so much publicity.

Leveraged buyouts.—Leveraged buyouts are a particular form of debt-financed acquisition in which the acquiring group finances the acquisition of an existing target corporation, or a division or subsidiary of an existing company, primarily with debt secured by the assets or stock of the target corporation. Such an acquisition often produces unusually high debt to equity ratios (sometimes greater than ten to one) in the resulting company. The management of the target corporation frequently obtains a significant portion of the equity in the resulting company. The acquired corporation sometimes is taken private and, therefore, is no longer subject to the reporting requirements that apply to public corporations. It is common, however, sometimes after major asset sales or restructurings by the leveraged company, for the private company eventually to go public again, sometimes with a new infusion of equity.[3]

Leveraged ESOPs.—An employee stock ownership plan (ESOP) is a type of tax-qualified pension plan that is designed to invest primarily in the securities of the employer maintaining the plan and that can be used as a technique of corporate finance. An ESOP that borrows to acquire employer securities is referred to as a leveraged ESOP. ESOPs may be used to effect a takeover and to defend against a hostile takeover. The Code contains numerous tax incentives designed to encourage the use and establishment of ESOPs and to facilitate the acquisition of employer securities by ESOPs through leveraging. Because of these tax benefits, use of an ESOP can result in a lower cost of borrowing than would be the case if traditional debt or equity financing were used. Despite the tax advantages, ESOPs may not be attractive in all cases because the rules relating to leveraged ESOPs require that some transfer of ownership to employees occur and may place limitations on the terms of the leveraging transaction. To the extent that ESOPs make leveraging more attractive, they may increase the degree of leverage in the economy.

Debt-for-equity swaps.—A corporation may exchange new debt for existing equity in the company. This transaction increases the degree of leverage of the corporation.

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[3] For a more detailed description of leveraged buyouts, see Part III.C.2. of this pamphlet, *infra*.

[4] See Part II.C.3 of this pamphlet for a description of these benefits.

Redemptions of stock.—It has become increasingly common, particularly for large public corporations, to buy back their own shares. These repurchases of shares by the corporation will reduce outstanding equity and, particularly if financed by issues of debt, increase leverage.

Extraordinary distributions.—The quarterly or annual dividend has long been the prototypical method for distributing corporate earnings to equity investors. Sometimes a distribution amounting to a very large percentage of the value of the firm will be made to shareholders. This extraordinary distribution may be financed by debt and often is used in defensive restructurings in an attempt to avoid a takeover. The resulting corporate financial structure may be highly leveraged.

B. Trends in Corporate Financial Structure

Changes in the source and use of corporate funds

In order to invest, corporations need to retain internally generated earnings or obtain external funds in the debt and equity markets. As shown in Table I-A, the composition of this financing has changed dramatically. Although the amount of new external funds raised by nonfinancial corporations was nearly the same in 1978 as in 1987 at approximately $70 billion, the amount of net new borrowing nearly doubled to $136 billion in 1987. During the same period, funds were used to retire, on a net basis, over $75 billion of equity. Between 1978 and 1983, equity issues, net of retirements, raised an average of $3.9 billion a year in funds available for investment by the nonfinancial corporate sector. Since 1984, over $70 billion of funds (on a net basis) each year in the nonfinancial corporate sector have been used to retire existing equity. Gross retirements of corporate equity through acquisitions, leveraged buyouts, repurchases of shares and other techniques are even larger, amounting to $112 billion in 1987. Indeed, since the end of 1983, over $313 billion of net corporate equity has been retired while corporations have borrowed $613 billion.

Table I-A.—Sources of External Funds for the Nonfinancial Corporate Business Sector, 1978–1987 [1]

[Billions of dollars]

Year	Gross equity issues	Gross equity retirements	Net new equity issues (issues minus retirement)	Net new borrowing [2]	Total net funds raised in market
1978	N.A.	N.A.	−0.1	71.0	70.9
1979	N.A.	N.A.	−7.8	68.0	60.1
1980	21.1	8.2	12.9	57.8	70.7
1981	21.5	33.0	−11.5	102.1	90.7
1982	28.9	22.5	6.4	43.4	49.8
1983	40.0	16.5	23.5	54.4	77.9
1984	18.0	92.5	−74.5	170.3	95.8
1985	25.0	106.5	−81.5	132.4	50.9
1986	37.8	118.6	−80.8	173.8	93.1
1987	35.5	112.0	−76.5	136.8	60.3
Averages:					
1978–83 [3]	27.9	20.1	3.9	66.1	70.0
1984–87	29.1	107.4	−78.3	153.3	75.0

[1] Excludes farming corporations.
[2] Excludes trade debt.
[3] Equity issues and retirements are averaged over the period 1980–1983.

Source: Board of Governors of the Federal Reserve System, "Flow of Funds Accounts, Third Quarter, 1988," December 1988, and unpublished Federal Reserve data.

Funds can be disbursed from the corporate sector to shareholders in three different ways: dividends; purchases by a corporation of its own shares; or by the acquisition of shares of another corporation in exchange for cash or debt.[5] To the extent the dividend distribution, redemption, or purchase payment is made to noncorporate shareholders, all of these methods serve to reduce the amount of equity in the corporate sector. Share repurchases and cash acquisitions, however, are generally tax favored relative to dividends because they permit the shareholder to recover the basis in the stock as well as, before 1987, having been eligible for the 60 percent exclusion from tax on capital gains. In addition, the interest on any borrowing to fund these distributions will generally be deductible.

As gross retirements of equity have increased, the distribution of corporate funds through share repurchases and cash acquisitions have increased. For the sample of firms covered in Table I-B, these two methods for distributing corporate funds have grown rapidly over the last ten years, particularly after 1984. Between 1977 and 1986, dividends grew with a relatively constant pattern by about 55 percent, after adjusting for inflation. Cash acquisitions grew by 900 percent, and share repurchases expanded by over 700 percent, in terms of 1986 dollars. In 1977, dividends accounted for nearly 80 percent of cash distributions by these corporations; by 1986, they had fallen to under 40 percent.[6]

Table I-B.—Cash Distributions to Shareholders, 1977–1986

Year	Cash via acquisitions	Dividends [1]	Share repurchases
Billions of Nominal Dollars:			
1977	4.3	29.4	3.4
1978	7.2	32.8	3.5
1979	16.9	38.3	4.5
1980	13.1	42.6	4.9
1981	29.3	46.8	3.9
1982	26.2	50.9	8.1
1983	21.2	54.9	7.7
1984	64.2	60.3	27.4
1985	70.0	67.6	41.3
1986	74.5	77.1	41.5
Billions of 1986 Dollars: [2]			
1977	7.2	50.0	5.7
1978	11.4	51.9	5.6
1979	24.5	55.6	6.5
1980	17.4	56.7	6.6

[5] "Dividends" is used here in its nontechnical sense to refer distributions made with respect to holders of stock.

[6] Laurie Bagwell and John Shoven, "Cash Distributions to Shareholders: Alternatives to Dividends," *Journal of Economic Perspectives*, forthcoming. These data cover an expansive sample of most large public corporations. See Table I-B for more detail. Private tabulations by the investment banking firm of Salomon Brothers suggest that share repurchases in 1987 were significantly higher than in 1986.

Table I-B.—Cash Distributions to Shareholders, 1977-1986—Continued

Year	Cash via acquisitions	Dividends [1]	Share repurchases
1981	35.6	56.8	4.8
1982	29.9	58.1	9.2
1983	23.3	60.3	8.5
1984	68.1	63.8	29.1
1985	71.8	69.3	42.4
1986	74.5	77.1	41.5
Percentage of Total Distributions:			
1977	11.6	79.2	9.2
1978	16.6	75.4	8.0
1979	28.3	64.2	7.5
1980	21.6	70.3	8.1
1981	36.6	58.5	4.9
1982	30.8	59.7	9.5
1983	25.3	65.5	9.2
1984	42.3	39.7	18.0
1985	39.1	37.8	23.1
1986	38.6	39.9	21.5

[1] "Dividends" is used in its nontechnical sense to refer to distributions to existing shareholders without a redemption of shares.
[2] The GNP deflator was used to adjust current dollar values to constant dollar.

Source: Laurie Simon Bagwell and John Shoven, "Cash Distributions to Shareholders: Alternatives to Dividends, "*Journal of Economic Perspectives,* forthcoming. Values were compiled by the authors from 2,445 firms from the Compustat Primary, Supplementary and Tertiary Industrial Files. The sample includes most major publicly traded firms which account for the great majority of dividends in the economy.

The most publicized trend in corporate restructurings has been the growth of corporate mergers, including, particularly, leveraged buyouts. Table I-C documents the growth in number and even more rapid growth in value of mergers and leveraged buyouts. The nominal dollar value of mergers in 1987 was seven times greater than the value of mergers ten years earlier; the value of leveraged buyouts in 1987 was over ten times the value in 1981.[7] The average size of these transactions has grown accordingly. Leveraged buyouts have increased in relative importance from 4 percent of the value of all merger activity in 1981 to over 20 percent in 1987.

[7] The overall price level, as measured by the implicit GNP price deflator, less than doubled during the same period.

Table I-C.—Number and Value of Mergers and Leveraged Buyouts, 1975–1987

[Dollar values in billions of dollars]

Year	Total mergers and acquisitions		Leveraged buyouts		LBO value as a percentage of all merger value
	Number of transactions	Total dollar value	Number of transactions	Total dollar value	
1975.....	2,297	11.8	N.A.	N.A.	N.A.
1976.....	2,276	20.0	N.A.	N.A.	N.A.
1977.....	2,224	21.9	N.A.	N.A.	N.A.
1978.....	2,106	34.2	N.A.	N.A.	N.A.
1979.....	2,128	43.5	N.A.	N.A.	N.A.
1980.....	1,889	44.3	N.A.	N.A.	N.A.
1981.....	2,395	82.6	99	3.1	3.8
1982.....	2,346	53.8	164	3.5	6.5
1983.....	2,533	73.1	230	4.5	6.2
1984.....	2,543	122.2	253	18.8	15.4
1985.....	3,001	179.7	254	19.6	10.9
1986.....	3,336	173.1	331	46.4	26.8
1987.....	2,032	163.7	259	35.6	21.7

Source: Mergers from W.T. Grimm & Co., LBOs from *Mergers and Acquisitions* Magazine. Mergers information is based on announcements; total dollar value is based only on those deals where a dollar value was available. LBO information is based on completed transactions. The LBO and merger information are not exactly comparable for these and other reasons.

Table I-D.—Corporate Debt, Household Debt, and Federal Debt, as a Percentage of Gross National Product (GNP), 1967–1987

Year	Corporate debt [1] as a percent of GNP	Household debt [2] as a percent of GNP	Federal debt [3] as a percent of GNP
1967.....	32.8	46.8	34.2
1968.....	33.0	46.5	32.8
1969.....	33.6	46.6	30.0
1970.....	34.7	46.5	29.7
1971.....	34.3	46.9	29.6
1972.....	33.7	47.7	28.1
1973.....	34.4	48.1	25.7
1974.....	35.2	47.8	24.5
1975.....	33.4	46.9	27.9
1976.....	32.0	47.0	28.9
1977.....	32.1	48.9	28.8
1978.....	31.4	50.6	27.8
1979.....	30.9	52.2	26.4
1980.....	30.3	52.3	27.2
1981.....	30.3	50.7	27.2

Table I-D.—Corporate Debt, Household Debt, and Federal Debt, as a Percentage of Gross National Product (GNP), 1967-1987—Continued

Year	Corporate debt [1] as a percent of GNP	Household debt [2] as a percent of GNP	Federal debt [3] as a percent of GNP
1982	30.5	51.4	31.3
1983	30.0	53.2	34.6
1984	31.7	54.0	36.5
1985	33.2	57.6	39.9
1986	35.5	61.2	42.8
1987	36.8	62.7	43.3

[1] Corporate debt of nonfinancial corporations excluding farms.
[2] Household debt includes debt of personal trusts and nonprofit organizations.
[3] Federal debt excludes Federal debt held by Federal agency trust funds.

Source: Division of research and statistics, Federal Reserve Board.

Trends in corporate debt

The above trends would seem to imply large changes in levels of corporate debt. In fact, as Table I-D shows, since 1983 corporate debt has increased faster than gross national product and, as a percentage of GNP, is now slightly higher than its previous peak in 1974. But the pattern of change is not limited to the corporate sector alone. Indebtedness of the household sector and the Federal government has grown faster than GNP as well during this period; the ratios of debt to GNP for both of these sectors were far higher at the end of 1987 than they were in the 1970s.

Measures of the debt-equity ratio and the interest expense-to-cash flows ratio provide some support for the proposition that relative corporate debt levels are rising.[8] For example, the percentage of cash flow devoted to net interest payments by nonfinancial corporations has risen from an average of 13 percent in 1971 through 1975, to an average of 15 percent in 1976 through 1980, and to an average of 19 percent in 1981 through 1985. (See Table IV-D.)

International comparison of corporate leverage

It is difficult to draw comparisons among countries regarding the financial structure of corporations. Different legal, economic, and ownership structures affect both the measured debt-equity ratios of corporations and the implications these ratios have for tax policy and macroeconomic stability. For example, differing legal and ownership structures could actually cause a high debt-equity ratio in one country to represent a lower risk of default than that represented by a lower ratio in a different country.

Given these important caveats, there remains the impression that debt-equity ratios calculated for U.S. corporations are low compared to their counterparts in other major industrial countries.

[8] See Part IV.C below for a more extensive examination of trends in corporate debt.

A consistently calculated measure of the debt-equity ratio shows that the debt-equity ratio for the manufacturing corporate sector in the United States in 1980 was 24.6 percent compared to 26.3 percent for the United Kingdom and 76.9 percent for West Germany.[9] The debt-equity ratio for manufacturing companies in Japan, calculated in the same manner, was 66.2 percent.[10]

Ownership of corporate bonds and equities

The Federal Reserve Board balance sheets for the economy indicate that nearly 60 percent of corporate equity at the end of 1987 was held by the household sector.[11] Foreign investors, pension funds, and the life insurance sector, entities which may receive favorable Federal income tax treatment, held 31 percent of outstanding equities at the end of 1987.[12] In 1967, 82 percent of equity was held by households; 11 percent by foreign investors, pension funds, and the life insurance sector. (See Table I.E.)

The pattern of ownership for corporate bonds is completely different.[13] Only 8 percent of the outstanding bonds at the end of 1987 were held by the household sector. The life insurance sector and pension funds together held 57 percent, while foreign investors owned an additional 13 percent. In 1967, households held nearly 10 percent of outstanding corporate bonds, while foreign investors, life insurance companies, and pension funds held almost 80 percent. Thus, unlike corporate equity, the ownership of bonds is more heavily concentrated among pension funds and institutional investors.[14]

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[9] Values derived from Mervyn King and Don Fullerton, eds., *The Taxation of Income from Capital: A Comparative Study of the United States, the United Kingdom, Sweden, and West Germany*, Chicago: University of Chicago Press, 1984.

[10] John Shoven and Toshiaki Tachibanaki, "The Taxation of Income from Capital in Japan," *Government Policies Towards Industry in the U.S.A. and Japan*, Cambridge University Press, forthcoming.

[11] The household sector consists of individuals, charitable organizations, foundations, and private trusts. The Federal Reserve has estimated, for 1982 yearend, that 83 percent of equity held by the household sector was owned by individuals, and that 63 percent of corporate bonds held by the household sector was owned by individuals; the remainder was held by charitable organizations, foundations, and private trusts. Sector definitions and values obtained from "Flow of Funds Accounts: Financial Assets and Liabilities Year End, 1964-1987", Federal Reserve System, Board of Governors, 1988.

[12] The life insurance sector, as defined in the Flow of Funds accounts, includes pension funds administered by life insurance companies. Over half of the liabilities of life insurance companies are accounted by pension reserves. Omitting life insurance companies, the corporate equities held by Foreign investors and pension Funds would be 28 percent of the aggregate. (See Table I-E.)

[13] Bonds represent over a third of the credit market debt of the nonfinancial corporate sector. Liabilities are composed of bonds, bank loans and loans from other financial intermediaries, mortgages, trade debt, and other miscellaneous debt.

[14] There may be regulatory restrictions requiring some of these investors to avoid equity and to hold bonds.

Table I-E.—Holdings of Corporate Equity and Bonds, 1987

[Dollars in billions]

Sector	Year-end balance, 1987	Percent of total
Corporate equities (excluding mutual funds)	**$2,853.2**	**100.0**
Household sector [1]	1,697.8	59.5
Foreign investors	173.4	6.1
Mutual savings banks	7.0	0.2
Insurance and pension funds	782.7	27.4
Life insurance companies	83.2	2.9
Private pension funds	460.6	16.1
State and local government retirement funds	172.6	6.0
Other insurance companies	66.3	2.3
Mutual funds [2]	181.7	6.4
Brokers and dealers	10.7	0.4
Corporate bonds [3]	**1,180.9**	**100.0**
Household sector [1]	92.9	7.9
Foreign investors	157.6	13.3
Commercial banks	71.3	6.0
Savings and loans	37.6	3.2
Mutual savings banks	14.5	1.2
Insurance and pension funds	734.7	62.2
Life insurance companies	388.3	32.9
Private pension funds	157.4	13.3
State and local government retirement funds	135.2	11.4
Other insurance companies	53.9	4.6
Mutual funds [2]	54.2	4.6
Brokers and dealers	18.8	1.6

[1] The household sector consists of individuals (which include self-administered pension plans such as IRAs, Keoghs, etc.), charitable organizations, foundations, and private trusts. The Federal Reserve has estimated, for 1982 yearend, that 83 percent of equity held by the household sector was owned by individuals, and that 63 percent of corporate bonds held by the household sector was owned by individuals; the remainder was held by charitable organizations, foundations, and private trusts.

[2] The great majority of mutual fund shares are owned by the household sector.

[3] Corporate bonds include bonds issued by foreigners held by U.S. persons. Other types of debt, for example, trade debt, mortgages, and bank loans, are excluded.

Source: Board of Governors of the Federal Reserve System, "Flow Funds Accounts: Financial Assets and Liabilities Year End, 1964-87,", September 1988.

II. PRESENT LAW TAX RULES

A. Treatment of Corporations and Their Investors

Under present law, corporations and their investors are generally separate taxable entities.[14] The tax treatment of the corporation and the investor may vary depending upon whether the investor's interest in the corporation is considered debt or equity.

1. Treatment of debt versus equity at the corporate level

If a corporation earns a return on its assets and distributes that return to investors, the tax treatment of the corporation will depend on the characterization of the investors' interests in the corporation as debt or equity. Returns from corporate assets that are paid to debtholders are not taxed at the corporate level because interest payments generally are deductible for purposes of computing taxable income.[15] Conversely, returns from corporate assets that are paid out as distributions with respect to stock (e.g., dividend distributions) are subject to corporate-level tax because distributions with respect to stock generally are not deductible by a corporation.

The characterization of an investor's investment as debt or equity also affects the tax treatment of the issuing corporation if the interest is retired either at a premium or at a discount. A premium paid by a corporation to redeem stock is not deductible, whereas a premium paid to retire debt is deductible. If stock is redeemed for a price less than the issue price, the issuing corporation recognizes no income, whereas if debt is retired at a discount, the corporation recognizes income from the discharge of indebtedness.

2. Treatment of debt versus equity at the investor level

a. U.S. individuals

Individual shareholders are, in general, taxed on the return from corporate assets only when amounts are distributed with respect to their stock (e.g., dividend distributions) or when gain is realized from a sale or other disposition of their shares. Thus, individual-level tax generally is deferred to the extent management of the corporation chooses to invest earnings rather than distribute them. At present, individual shareholders are taxed at a maximum rate of 28 percent on both dividend distributions and on gains from the sale or other disposition of stock.[16]

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[14] Corporations which are taxed at the corporate level are frequently referred to as "C corporations." The tax treatment of such corporations is governed by Subchapter C of the Code.

[15] See Part II. D. of this pamphlet, *infra*, for exceptions to this general rule.

[16] This discussion ignores the additional 5-percent tax rate relating to the phaseout of the 15-percent rate and personal exemptions (sec. 1(g)).

The full amount of a dividend distribution is subject to the individual-level tax.[16] [a] Distributions with respect to stock that exceed corporate earnings and profits, and thus are not dividends, are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock and, accordingly, are taxed to the shareholder as capital gain (currently taxed at the same rate as ordinary income). In the case of a sale or other disposition of stock, a shareholder recovers basis in the stock tax-free and is subject to tax only on gain (i.e., the excess of the amount received over basis). If an individual shareholder retains stock until death, any appreciation that occurred before death will permanently escape investor-level income tax.[17]

Individual debtholders are, in general, taxed on interest received periodically as paid, on original issue discount as accrued, and on market discount upon the sale or disposition of the debt instrument. Such interest income is currently taxed at a maximum rate of 28 percent. Individual debtholders are also subject to tax at a 28-percent maximum rate on gain from the sale or other disposition of debt (i.e., the excess of the amount received over basis). If an individual debtholder retains debt until death, the appreciation that occurred before death generally will permanently escape investor-level income tax.[18]

b. U.S. corporations

Corporate shareholders, like individual shareholders, are, in general, taxed on the return from the assets of the corporation in which they own stock only when amounts are distributed with respect to their stock (e.g., dividend distributions) or when gain is realized from a sale or other disposition of their shares. Thus, tax generally is deferred to the extent management of the distributing corporation chooses to invest earnings rather than distribute them.

If corporate income is distributed as a dividend, corporate shareholders are entitled to a dividends received deduction based on the ownership of the distributing corporation by the corporate shareholder. Under present law, corporations owning less than the portfolio threshold of 20 percent of the stock of a distributing corporation (by vote and value) are entitled to a deduction equal to 70 percent of the dividends received from a domestic corporation. Corporations owning at least 20 percent of the payor's stock are entitled to an 80-percent deduction and corporations owning 80 percent or

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[16] [a] A distribution is treated as a dividend to the extent it does not exceed the current or accumulated earnings and profits of the distributing corporation.

[17] Such appreciation might give rise to Federal estate and gift tax. In many instances, however, opportunities for deferral and the rate structure under the Federal estate and gift tax may result in significantly less tax than would be imposed under the income tax. The value of stock held at death would be included in the decedent's gross estate and, if not passing to a surviving spouse or to charity, the decedent's taxable estate as well.

The extent to which such inclusion gives rise to Federal estate and gift tax depends on the value of the decedent's taxable transfers. The Federal estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent (50 percent for decedents dying after 1992) on taxable transfers over $3 million. A unified credit in effect exempts the first $600,000 from estate and gift tax. The graduated rates and unified credit are phased out for estates in excess of $10 million.

[18] As in the case of stock, such appreciation may be subject to the Federal estate and gift tax.

more may be entitled to a 100-percent deduction.[19] Because the maximum rate of tax on income received by a corporation is 34 percent,[20] the maximum rate of tax on dividends received by a corporation is generally 10.2 percent (30 percent of the amount of the dividend times 34 percent).[21]

At present, corporate shareholders are taxed at a maximum rate of 34 percent on gains from the sale or other disposition of stock (i.e., the excess of the amount realized over basis).

Corporate debtholders are, in general, taxed on interest received periodically as such interest is paid or accrued, on original issue discount as accrued, and on market discount upon the sale or disposition of the debt instrument. Such interest income is currently taxed at a maximum rate of 34 percent. Corporate debtholders are also subject to tax at a 34-percent maximum rate on gains from the sale or other disposition of the debt (i.e., the excess of the amount realized over basis).

c. Treatment of exempt organizations

Unrelated trade or business income

The Code provides tax-exempt status for a variety of entities, such as charitable organizations, social welfare organizations, labor unions, trade associations, social clubs, and qualified pension funds (secs. 501(c) and 401(a)). Tax-exempt organizations, however, generally are subject to tax on their unrelated trade or business income (secs. 511-514).[22] The unrelated business income tax ("UBIT") is imposed on gross income derived by an exempt organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both subject to certain modifications.[23] An unrelated trade or business is any trade or business the conduct of which is not substantially related (aside from the organization's need for revenues) to the organization's performance of its tax-exempt functions.

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[19] The 70 and 80-percent dividends received deductions discussed above also apply to dividends received from certain 10-percent or more owned foreign corporations to the extent the dividends are paid out of certain U.S. earnings. The 100-percent dividends received deduction also applies to certain dividends from wholly-owned foreign corporations, whose only income is effectively connected with the conduct of a U.S. trade or business.

[20] This discussion ignores the additional 5-percent tax rate relating to the phaseout of the 15 and 25-percent graduated rates for corporations (sec. 11(b)).

[21] In the case of certain "extraordinary dividends," the effective rate of tax may be as high as the maximum corporate rate of 34 percent, imposed at the time of the sale or disposition of the underlying stock (sec. 1059).

As with individual shareholders, distributions with respect to stock that exceed the distributing corporation's earnings and profits, and thus are not dividends, are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of the distributing corporation's earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock and accordingly are taxed to the shareholder as capital gain (currently taxed at the same rate as ordinary income).

[22] Certain U.S. instrumentalities created and made tax-exempt by a specific Act of Congress are not subject to the UBIT. State instrumentalities are exempt from tax on income derived from any essential governmental function (sec. 115), but certain State colleges and universities are subject to the UBIT (sec. 511(a)(2)(B)).

[23] The UBIT is generally levied at the corporate tax rates; in the case of charitable trusts, it is imposed at the individual tax rates (secs. 511(a)(1) and 511(b)).

Excluded income

Dividends.—The UBIT generally does not apply to certain types of "passive" income, such as dividends and interest, unless such income is derived from debt-financed property (explained below). Thus, if an exempt organization owns stock in a corporation, dividend payments received by the exempt organization generally are not subject to the UBIT (unless the organization's purchase of the stock was "debt-financed," as explained below), regardless of whether the corporate activities giving rise to the dividend income are related to the exempt organization's exempt functions. In addition, any gain realized from the sale or other disposition of such stock by the exempt organization generally is excluded from the UBIT.

Interest.—When an exempt organization purchases bonds issued by a taxable corporation, the interest income paid to the exempt organization (as well as any gain realized from the sale of such bonds) is excluded from the UBIT, unless the bonds were "debt-financed" by the exempt organization (explained below) or the payor corporation is a controlled subsidiary of the exempt organization.[24] Consequently, corporate income that is paid to exempt organizations holding debt may escape taxation entirely by being deductible at the level of the payor corporation and excludable from taxable income at the level of the payee exempt organization.

Partnership investments.—If an exempt organization invests in a partnership (as a limited or general partner), the exempt organization's share of income earned by the partnership retains the same character as in the hands of the partnership and thus may be subject to the UBIT.[25] For instance, if an exempt organization invests in a partnership that does not directly carry on a trade or business but merely invests in stocks or bonds of other companies, the organization's share of interest or dividend income earned by the partnership is treated as interest or dividend payments to the exempt organization, which generally are not subject to the UBIT. In contrast, if a trade or business activity directly carried on by a partnership is an unrelated trade or business with respect to the exempt organization, the exempt organization must report as income subject to the UBIT its share (whether or not distributed) of the gross income and deductions of the partnership from that unrelated trade or business.

Debt-financed property.—Although interest and dividend income paid to an exempt organization generally is excluded from the UBIT, such income is taxable to the extent derived from debt-financed property. The term "debt-financed property" means property (the use of which is not substantially related to the performance of the organization's exempt function) held to produce income with respect to which there is an acquisition indebtedness during the taxable year. For this purpose, acquisition indebtedness includes the following: debt incurred upon acquisition; debt incurred prior

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[24] Interest paid to an exempt organization by an 80-percent-owned entity is subject to the UBIT in proportion to the income of the controlled entity that would have been subject to the UBIT if derived directly by the controlling exempt organization (sec. 512(b)(13)).

[25] An exempt organization's share of the gross income of a "publicly traded partnership" (that is not otherwise treated as a corporation) is subject to the UBIT (sec. 512(c)(2)).

to the acquisition that otherwise would not have been incurred but for the acquisition; and debt incurred subsequently if the incurrence was reasonably foreseeable at the time of the acquisition.[26] The amount of gross income from an item of debt-financed property that is includible in unrelated business taxable income is limited to a percentage reflecting the degree to which such property is debt-financed.

Thus, for example, if an exempt organization borrows $75,000 in order to purchase securities costing $100,000, then the securities are debt-financed property and 75 percent of the income derived by the exempt organization from such securities (i.e., dividend or interest income, or any gain upon sale) would be subject to the UBIT. If an exempt organization is a partner in a partnership which incurs a debt in order to purchase securities, a proportionate share of the indebtedness incurred by the partnership is allocable to the exempt organization, and a portion of the exempt organization's share of partnership income is subject to the UBIT.

d. Foreign investors

General rules

In general, dividends and interest derived by nonresident alien individuals and foreign corporations from sources within the United States (other than interest paid to certain foreign persons with respect to certain portfolio debt investments) are subject to gross-basis tax (i.e., the tax is imposed on gross income without allowance of deductions) at a flat rate of 30 percent, if the interest and dividends are not "effectively connected" with the conduct of a U.S. trade or business of the recipient.[27] Interest and dividends paid by a U.S. corporation generally are treated as derived from sources within the United States.

The payor of dividends and interest to a foreign person subject to U.S. gross-basis taxation is generally obligated to withhold the amount of taxes due on the income. In addition, a corporation is obligated to withhold the tax on the gross amount of a distribution it makes with respect to its stock even in certain circumstances where it is unclear at the time of the distribution whether the distribution constitutes a dividend (rather than a return of capital or capital gain) [27 a]

Exceptions to 30-percent withholding

Interest paid to certain foreign persons with respect to certain portfolio debt instruments is wholly exempt from U.S. tax. In other cases, the U.S. tax on interest income may be reduced or eliminat-

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[26] Acquisition indebtedness does not include indebtedness necessarily incurred by an exempt organization as an inherent part of the performance of its exempt function (sec. 514(c)(4)). For example, the IRS has ruled that borrowing by a leveraged ESOP in order to purchase employer securities does not constitute acquisition indebtedness for purposes of the UBIT (Rev. Rul. 79-122, 1979-1 C.B. 204). However, income from securities purchased on margin by a qualified profit-sharing plan is unrelated debt-financed income. *See Elliot Knitwear Profit Sharing Plan v. Comm'r*, 71 T.C. 765 (1979), *aff'd*, 614 F.2d 347 (1980).

[27] If U.S. source dividend or interest income of a foreign person is effectively connected with that person's conduct of a U.S. trade or business, that income is taxed on a net basis at the same rates that would apply to a domestic person.

[27 a] Treas. Reg. 1.1441-3(b)(1); Rev. Rul. 72-87, 1972-1 C.B. 274.

ed if there is an income tax treaty between the United States and the country in which the recipient resides.[28]

Dividends from U.S. sources also may be subject to a reduced withholding tax pursuant to a treaty between the United States and the shareholder's country of residence. No U.S. treaty reduces the rate of the gross-basis tax on dividends to zero.[29]

Investment instruments that have equity features may, in some circumstances, be treated as debt. (Examples include instruments providing for payments contingent on an increase in value of an asset ("equity kickers") or on profits in excess of a stipulated amount ("net profits interest").) In such cases, characterization of the instrument as debt allows foreign holders to take advantage of the favorable tax treatment accorded interest. Some tax treaties define treaty-protected interest as income from "debt-claims . . . whether or not carrying a right to participate in the debtor's profits." (See, e.g., Article 11, paragraph 3 of the OECD's Model Double Taxation Convention on Income and Capital (1977)).

Capital gains

Investment income of foreign investors from their investments in U.S. corporate stock or any other investment assets (other than real estate) generally escapes U.S. taxation where that income is realized in the form of gains on sales of the investment assets, or distributions treated as gains for tax purposes (such as liquidating distributions). The Code also provides that in certain cases a sale by a U.S. person of stock in a foreign corporation is treated as a dividend to the extent of the foreign corporation's earnings and profits (secs. 1248 and 1291). However, there are no similar Code provisions that generally would treat gains on sales of stock of domestic corporations (whether the sales are by U.S. or foreign persons) as dividends to the extent of corporate earnings.[30]

B. Treatment of Passthrough Entities and Their Investors

Business activities may be conducted through entities that are subject to different tax rules than the two-tier tax regime applicable to C corporations. In general, owners of interests in these entities are taxed directly on an appropriate share of the entity's earnings, and the entity itself is exempt from tax. Partnerships and S corporations are examples of passthrough entities that are commonly utilized for business enterprises. Tax treatment is a factor affecting taxpayers' choice of form of business enterprise. To the extent that changes are made to the tax treatment of C corporations and their shareholders (see Part V., *infra*), the relative attractiveness of partnerships and S corporations would be affected.

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[28] Where the ultimate beneficial owner of the income resides in a country that does not have a tax treaty with the United States providing for a zero or reduced rate of withholding on U.S. source interest income of its residents, possibilities may exist for taking advantage of an existing treaty by "treaty shopping" (that is, by having the ultimate beneficial owner hold an interest in U.S. debt through a legal entity organized under the laws of the treaty country), unless prevented by anti-treaty shopping provisions in U.S. tax treaties.

[29] As in the case of treaty reductions of withholding taxes on interest, reduced rates on dividends would be effectively available to third-country residents unless precluded by anti-treaty shopping provisions.

[30] Were there such provisions in the Code, a foreign person might be subject to U.S. tax on domestic stock gains whether or not the foreign person was a treaty-country resident.

1. Partnerships

In general

Under present law, a partnership is not itself subject to Federal income taxation. Rather, each partner takes into income his distributive share of the partnership's income, gain, loss, deduction or credit (sec. 702(a)).[31]

Entity classification

Treasury regulations provide that whether a business entity is taxed as a corporation or a partnership depends on which form of enterprise the entity "more nearly" resembles. The regulations list six corporate characteristics, two of which are common to corporations and partnerships. The four that are particular to corporations are: (1) continuity of life, (2) centralization of management, (3) limited liability and (4) free transferability of interests. The regulations generally classify an entity as a partnership if it lacks any two of these four corporate characteristics, without further inquiry as to how strong or weak a particular characteristic is or further evaluation of overall corporate resemblance.

Publicly-traded partnerships (i.e., partnerships whose interests are traded on an established securities market, or are readily tradeable on a secondary market (or the substantial equivalent thereof), generally are treated as corporations (sec. 7704). An exception to this treatment is provided for publicly traded partnerships 90 percent of whose gross income constitutes passive-type income.

Whether a partnership is treated as publicly traded depends on whether its "interests" are publicly traded. Thus, many of the questions that arise in attempting to distinguish between corporate debt and corporate equity arise in similar form in this context. For example, it is unclear under present law to what degree subordination, preference, convertibility, contingency of payments of income or face amount, voting or other rights, transferability, or similar attributes of an interest in a partnership determine whether it represents partnership debt or equity.[32]

Treatment of partnership debt

A partner's distributive share of partnership loss for a taxable year is deductible only to the extent of his basis in his partnership interest (sec. 704(d)). A partner's basis for his interest equals the sum of his capital contribution plus his share, if any, of partnership liabilities. A partner's basis in his partnership interest is generally increased by an increase in his share of liabilities and decreased by a decrease in his share of them (among other factors that affect his basis) (sec. 752).[33] Characterization of funds received

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[31] Privately-offered partnerships are becoming more commonly used as investment vehicles for leveraged buyout transactions. For example, potential investors in a leveraged buyout of corporate stock may pool their financial resources in a partnership that can acquire the stock on behalf of the investors while preserving their anonymity. See "Private partnerships pick up due largely to LBO deals," *The Wall St. Journal*, November 3, 1988, p. A1.

[32] See *Hambuechen v. Commissioner*, 43 T.C. 90 (1964).

[33] By contrast, entity-level debt of other passthrough entities (for example, S corporations) is not included in the investor's basis for his interest in the entity. Similarly, debt of a C corporation is not included in the shareholder's basis for his stock or securities of the corporation.

by a partnership as a liability (rather than, for example, an equity investment in the partnership) thus can increase the basis of all partners in their partnership interests.

2. S corporations

In general

S corporations generally are treated as conduits. Taxable income of an S corporation generally is subject to a single shareholder level tax. Subchapter S was enacted to minimize the effect of Federal income tax considerations on the choice of form of business organization, by permitting the incorporation and operations of certain businesses without the incidence of corporate level tax.[34] There are significant differences between S corporations and partnerships; for example, corporate liabilities are not included in a shareholder's basis for his interest in an S corporation.

Entity classification

To be eligible to elect S corporation status, a corporation may not have more than 35 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), estates and certain trusts are permitted as shareholders. If an S corporation that was formerly a C corporation has passive income amounting to more than 25 percent of its gross receipts for 3 consecutive years, the corporation loses its S corporation status (sec. 1362(d)).[35] Despite these limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the size of such a corporation.

Treatment of debt

A shareholder's deduction for corporate losses is limited to the amount of the shareholder's adjusted basis in his stock and in the indebtedness of the corporation to such shareholder. The shareholder's basis in his stock and debt is reduced by his share of losses allowed as a deduction and, in the case of stock, by distributions, and the shareholder's basis in his stock is increased by his share of the corporation's income (sec. 1367). A shareholder does not include debt of the S corporation to third parties in the basis of his stock or debt of the corporation. To the extent a loss is not allowed due to this limitation, it generally is carried forward to the next year.

3. Other passthrough entities

Certain other types of entities are accorded passthrough treatment for tax purposes, provided they meet narrow restrictions designed to limit the type of business they conduct. For example, a real estate investment trust (REIT) is accorded conduit treatment to the extent of the amount of earnings that are distributed currently to shareholders, provided the entity meets requirements designed to assure that its assets are comprised substantially of real estate assets, and that its income is, in substantial part, realized

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[34] See S. Rept. No. 1983, 85th Cong., 2d Sess., 87 (1958).

[35] This rule is intended to prevent a regular C corporation from electing S status and converting, essentially, into a holding company, rather than liquidating and incurring tax at the shareholder level on liquidation proceeds from the period of operation as a C corporation.

from certain real estate and real estate-related sources. Conduit treatment similar to that granted to REITs is also provided to regulated investment companies (RICs). Among other requirements, the RIC must derive at least 90 percent of its ordinary income from specified sources commonly considered passive investment income, and must distribute at least 90 percent of its income to its shareholders annually. Other passthrough entities that are subject to restrictive limitations on business activity, distributions and structure include real estate mortgage investment conduits (REMICs) and cooperatives.

C. Treatment of Transactions Involving Qualified Pension Plans and Employee Stock Ownership Plans (ESOPs)

If a pension, profit-sharing, or stock bonus plan qualifies under the tax laws ("qualified pension plan"), a trust holding the plan's assets generally is exempt from Federal income tax. Furthermore, contributions to a qualified pension plan by an employer are deductible, within specified limits, in the year for which the contributions are made. The participants in the plan, however, are not taxed on plan benefits until the benefits are distributed (sec. 402(a)).

An employee stock ownership plan (ESOP) is a type of qualified pension plan that is designed to invest primarily in securities of the employer maintaining the plan and that satisfies certain specific requirements set forth in the Code and other requirements prescribed by the Secretary of the Treasury. An ESOP that borrows to acquire employer securities is referred to as a leveraged ESOP.

Certain present-law rules affect the investment of pension plan assets in leveraged buyouts and the role of pension plans and ESOPs in leveraged buyouts. These rules include (1) the special fiduciary requirements applicable to pension plans, (2) the funding requirements applicable to qualified pension plans and their impact on overfunded pension plans, and (3) the special rules relating to ESOPs.

1. Fiduciary requirements applicable to pension plans

In general

The Employee Retirement Income Security Act of 1974 (ERISA) contains rules governing the conduct of fiduciaries of employee benefit plans. ERISA has general rules relating to the standard of conduct of plan fiduciaries, and also specific rules prohibiting certain transactions between a plan and parties in interest with respect to the plan, such as a plan fiduciary. Plan participants as well as the Department of Labor may bring suit to enforce the fiduciary rules. Plan fiduciaries are personally liable under ERISA for any losses to a plan resulting from a breach of fiduciary duty. A court may also impose whatever equitable or remedial relief it deems appropriate for a violation of the fiduciary standards.

The Code does not contain extensive fiduciary rules. However, in order for a plan to be qualified under the Code, a plan is required to provide that the assets of the plan be used for the exclusive benefit of employees and their beneficiaries. In addition, the Code contains rules prohibiting transactions between a plan and disqualified

persons with respect to a plan that are similar to the prohibited transaction rules under ERISA.

Exclusive purpose rule; prudence standard

The general fiduciary standard under ERISA requires that a plan fiduciary discharge his or her duties with respect to a plan (1) solely in the interest of the plan participants and beneficiaries, (2) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable administrative expenses of the plan, (3) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, and (4) in accordance with the documents and instruments governing the plan to the extent such documents and instruments are consistent with ERISA.

The prudence requirement is the basic rule governing the standard of conduct of plan fiduciaries, and it is against this rule that actions of plan fiduciaries are generally tested. A plan fiduciary does not violate the prudence standard merely because one investment is riskier than others; rather, the prudence standard requires an evaluation of the investments of all assets in the aggregate. The prudence standard charges fiduciaries with a high degree of knowledge. This standard measures the decisions of plan fiduciaries against the decisions that would be made by experienced investment advisers. For this reason, some plan fiduciaries hire professional asset managers to invest plan assets.

Other than the prohibited transaction and self-dealing rules, described below, neither the Code nor ERISA contains specific limitations on the types of investments a pension plan may make. Thus, there is no specific prohibition on the use of pension plan assets in leveraged buyouts or other corporate transactions. However, the use of pension plan assets in a leveraged buyout could be a violation of ERISA's fiduciary rules if, for example, the investment does not satisfy the prudence standard.

The use of a leveraged ESOP in a leveraged buyout transaction or other merger or acquisition transaction may be challenged by the Department of Labor under the fiduciary rules concerning the allocation of equity to the ESOP. In some leveraged buyout transactions, the ESOP receives a disproportionately smaller equity interest than other investors in relation to amounts contributed. For example, the proposed ESOP of Scott & Fetzer Co. was barred by the Department of Labor because the employees would have received too little equity relative to their investment in the company.[36] Further, the Department of Labor may raise issues about additional dilution of the ESOP's equity interest, which has the effect of reducing the value of the interest the ESOP holds.

Diversification

ERISA also requires that plan fiduciaries diversify the investments of the plan so as to minimize the risk of large losses, unless

[36] Coffee, *Shareholders versus Managers: The Strains in the Web*, 85 *Mich. L. Rev.* 91-2 (1986).

under the circumstances it is clearly prudent not to do so. Generally, a pension plan is not permitted to invest more than 10 percent of its assets in qualifying employer real property and qualifying employer securities. Qualifying employer securities are stock or marketable obligations issued by the employer of employees covered by the plan or an affiliate of such employer.

An exception to the diversification rule permits eligible individual account plans (i.e., profit-sharing plans, stock bonus plans, or ESOPs) to acquire and hold securities of the employer and to lease property to the employer even though such investments would not otherwise be sufficiently diversified to protect the plan from large losses. That is, the exception permits such plans to hold up to 100 percent of their assets in qualifying employer real property or qualifying employer securities.

The Tax Reform Act of 1986 (the "1986 Act") added a requirement that an ESOP offer certain participants the opportunity to diversify up to 25 percent (and, in some cases, 50 percent) of the individual's account balance. The purpose of this rule is to permit employees who are nearing retirement to elect, if they so desire, to protect their retirement benefits by investing them in more diversified investments than securities of the employer.

The exemption from the 10-percent limitation on holdings of employer securities provided to ESOPs and other eligible individual account plans enables such plans to acquire a significant block of employer securities. This ability, together with the ability of ESOPs to borrow from the employer to acquire employer securities (described below), is one of the features that make it possible for ESOPs to be used in leveraged buyouts.

Prohibited transaction rules

In general

In order to prevent persons with a close relationship to a plan from using that relationship to the detriment of plan participants and beneficiaries, the Code prohibits certain transactions between a plan and a disqualified person (sec. 4975).[37] A disqualified person includes any fiduciary, a person providing services to the plan, an employer any of whose employees are covered by the plan, an employee organization any of whose members are covered by the plan, and certain persons related to such disqualified persons.

Transactions prohibited include (1) the sale or exchange, or leasing of property between the plan and a disqualified person, (2) the lending of money or other extension of credit between the plan and a disqualified person, (3) the furnishing of goods, services, or facilities between the plan and a disqualified person, or (4) the transfer to, or use by for the benefit of, a disqualified person, of any assets of the plan.

The Code imposes a two-tier excise tax on prohibited transactions. The initial level tax is equal to 5 percent of the amount in-

[37] ERISA contains prohibited transaction provisions that are very similar, although not identical to the prohibited transaction rules of the Code. In addition, ERISA prohibits the acquisition of any employer security or employer real property that is not a qualifying employer security or qualifying real property or that violates the 10-percent limitation on acquisition of such securities and property.

volved with respect to the transaction. In any case in which the initial tax is imposed and the prohibited transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed.

Exemptions from prohibited transaction rule

The Code and ERISA contain a number of statutory exemptions to the prohibited transaction rules. These rules permit the Secretary of the Treasury and the Secretary of Labor, respectively, to grant exemptions from the prohibited transaction rules on a case-by-case basis. The prohibited transaction exemption program under both the Code and ERISA generally is administered by the Secretary of Labor.[38]

The acquisition of the securities of the employer maintaining a pension plan would be a violation of the prohibited transaction rules. However, a statutory exemption permits such plans to acquire qualifying employer securities. In general, a "qualifying employer security" is stock or a marketable obligation of the employer. In order for the exemption to apply, the acquisition is required to be for adequate consideration.

Moreover, a statutory exemption to the prohibited transaction rules permits an ESOP to borrow from the employer to acquire employer securities and permits the employer to guarantee a loan to an ESOP by a third-party lender to acquire employer securities.

The prohibited transaction rules could be violated, for example, if a company becomes a takeover target of a leveraged buyout fund in which the company's pension plan assets are invested or if a group of investors joins with an ESOP in a leveraged buyout of the ESOP's sponsor. The Department of Labor has not issued guidelines for granting prohibited transaction exemptions in such cases.

Exclusive benefit rule

The Code does not have extensive rules regarding the investment of pension plan assets. The Code does require, however, that, prior to the termination of a qualified plan, no part of the assets of the plan may be used for or diverted to purposes other than for the exclusive benefit of the employees covered by the plan and their beneficiaries (sec. 401(a)(2)). This provision prohibits all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or beneficiaries covered by the plan. The acquisition of employer securities by an ESOP or other type of qualified pension plan is not considered a violation of the exclusive benefit rule even though such acquisition may benefit the employer or a new investor purchasing the employer securities.

Fiduciary standards for retirement plans maintained by State and local governments

The ERISA fiduciary standards do not apply to retirement plans maintained by State and local governments; accordingly, there are no generally applicable Federal standards for the investment of

[38] This authority was transferred to the Secretary of Labor pursuant to Reorganization Plan No. 4, which divides the administrative responsibility for enforcement of the overlapping provisions of the Code and ERISA between the Departments of Labor and Treasury.

assets of such plans. Similarly, no uniform fiduciary standards have been adopted by the States, although many States have adopted some variant of the ERISA prudence standard.

State retirement plans have been among the largest investors in leveraged buyout funds. For example, according to the January 25, 1988, issue of Pensions and Investment Age, the Washington State Investment Board is the largest pension investor in buyouts with a total of nearly $1 billion committed to such investments. Other large State and local plan investors, according to the same issue of Pensions and Investment Age, include Oregon Public Employees ($262 million), New York State and Local Retirement Systems ($218 million), Wisconsin Investment Board ($144 million), and Michigan State ($110 million). Since the publication of these statistics, it has been reported that New York Governor Cuomo has called for a freeze on leveraged buyout investments by that State's $39 billion public employee pension fund.[38]

2. Overfunded pension plans

Under a defined benefit pension plan,[39] minimum funding rules require an employer to make contributions to the plan so that an employee's retirement benefit will be fully funded upon his retirement (sec. 412). Certain factors may contribute to the overfunding of defined benefit pension plans. Under certain of the permissible funding methods, an employer's funding costs are leveled over an employee's working years even though the costs of benefits earned normally increase as the employee approaches retirement age. Thus, at any time, the plan may have assets that exceed the present value of the liabilities to employees for previously-accrued benefits.

In addition, in recent years, high rates of return on investments have contributed to substantial increases in the value of the assets held in many trusts under qualified pension plans because investments have performed better than expected when the minimum funding requirement was calculated. The excess of the return on investment over the rate of return assumed under the plan's funding method will be taken into account over time and will reduce the otherwise required funding contributions. For years before 1989, such investment gains were amortized over 15 years. Given this amortization period, it could be that a plan's assets are substantially greater than its liabilities prior to the time the amortization period has expired. For years after 1988, the amortization period has been shortened to 5 years, with the result that overfunding could decrease.

If a qualified pension plan is terminated, the rights of employees to benefits accrued up to the date of the plan termination must be nonforfeitable (sec. 411). Although a qualified pension plan must be established for the exclusive benefit of employees, present law provides that an employer is entitled to recoup excess plan assets on plan termination to the extent the plan has assets remaining after

[38] *The Wall Street Journal*, November 29, 1988, p. C-21.

[39] A defined benefit pension plan is a plan under which an employee accrues ("earns") a specified retirement benefit set forth in the plan that is not related to the amount of assets held by the plan or any account balance maintained for the employee.

all obligations to employees have been satisfied (i.e., to the extent that the plan is overfunded). The employer is required to include the recouped amounts in gross income for the year in which the amounts are received. Other deductions or credits (including loss carryovers) that the employer is entitled to claim may be used to offset the tax on this income. In addition, a nondeductible 15-percent excise tax is imposed on the amount of excess assets that revert to the employer upon termination of the overfunded pension plan (sec. 4980).

An overfunded pension plan represents a pool of assets that may make a company a target for a takeover. Conversely, this pool of assets may be used by the company to ward off a hostile takeover. In recent years, some companies with significantly overfunded pension plans have been acquired by other companies. After the acquisition, the acquiring company terminated the overfunded pension plan and used the excess assets partially to finance the takeover.

Data are not available on the extent, if any, to which the existence of excess pension plan assets has contributed to the proliferation of takeover activity.

As the financial markets have become more familiar with the existence of excess assets in companies' pension plans, the relevance of excess assets in takeovers may have diminished because the value of the excess assets is reflected in the purchase price of the company. On the other hand, an overfunded plan represents an attractive source of cash even if the value of the assets is included in the purchase price. Thus, companies with overfunded pension plans may continue to be attractive takeover targets. However, in recognition of the attractiveness of excess pension assets to potential acquirors, some companies have taken steps (such as a plan amendment providing an automatic increase in pension benefits) that are triggered in the event of a hostile takeover.

Another possibility is that a company itself will terminate an overfunded pension plan to assist its efforts to thwart a hostile takeover attempt. This can be accomplished in one of several ways. For example, the company can invest the excess assets in plant and equipment, thus making itself less attractive than if it held a large amount of liquid assets. Alternatively, the company can establish an ESOP funded with the excess assets, thereby placing employer securities in potentially more "friendly" hands.

3. Employee stock ownership plans

In general

An ESOP is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan which is designed to be invested primarily in employer securities and which may be utilized as a technique of corporate finance. Under an ESOP, employer stock is acquired for the benefit of employees. ESOPs are accorded preferential tax treatment under the Code as an incentive for corporations to finance their capital requirements or their transfers of ownership in such a way that employees have an opportunity to gain an equity interest in their employer. Thus, ESOPs are exempt from tax under the rules generally applicable to qualified pension plans, and, subject to statutory limitations, employer con-

tributions to an ESOP are tax deductible. Further, special tax rules apply to ESOPs that are not available to other types of qualified pension plans.

Under the Code and ERISA, ESOPs have the unique ability (unavailable to any other type of qualified pension plan) to borrow from the employer to acquire employer securities, or to acquire employer securities with a loan guaranteed by the employer. This feature makes ESOPs particularly attractive as a technique of corporate finance. An ESOP that borrows funds to purchase employer securities is referred to as a "leveraged" ESOP. In a leveraged ESOP, employer securities are held in a suspense account and are allocated over time as the acquisition loan is repaid.

A leveraged ESOP must meet certain requirements (secs. 409 and 4975). For example, the loan repayment and allocation formula must be pursuant to a specified schedule. In addition, leveraged ESOPs are required to pass through voting rights to plan participants with respect to employer securities allocated to their accounts. If the employer has a registration-type class of securities, then voting rights must be passed through on all issues. If the employer does not have a registration-type class of securities (e.g., in the case of privately held companies), voting rights are required to be passed through to plan participants only on certain major corporate issues, such as mergers and acquisitions. ESOPs are also required to meet certain distribution requirements. Voting rights are not required to be passed through in the case of shares of stock that have not been allocated to participant's accounts.

Under a leveraged ESOP, the employer makes contributions to repay the acquisition loan and to pay interest on the loan. An employer may deduct the full amount of any contribution to a leveraged ESOP that is used by the ESOP to pay interest on a loan to purchase employer securities and may deduct amounts used to repay loan principal in amounts up to 25 percent of payroll costs.

The Code contains other tax incentives [40] applicable to the establishment and use of ESOPs, including the following:

(1) A taxpayer owning qualified securities in an employer corporation may defer recognition of gain on the sale of the securities to an ESOP that holds at least 30 percent of the employer's securities, to the extent the taxpayer reinvests the proceeds in securities of certain domestic corporations (sec. 1042).

(2) A corporate employer may deduct dividends paid on stock held by an ESOP that are paid currently to employees or are used to repay a loan used to acquire employer securities (sec. 404(k)).

(3) A bank, insurance company, regulated investment company, or corporation actively engaged in the business of lending money may exclude from its gross income 50 percent of the interest earned with respect to any loan the proceeds of which are used by an ESOP to purchase employer securities (sec. 133).

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[40] In addition, executors eligible under Code sec. 6166 to make deferred payments of estate taxes may be relieved of liability to the extent that qualified employer securities are acquired from a decedent by an ESOP, pass from a decedent to an ESOP, or are transferred to an ESOP by the decedent's executor if the ESOP is required to pay the liability (sec. 2210(c)). Further, a deduction from the gross estate of a decedent is permitted for 50 percent of the qualified proceeds from a qualified sale of employer securities by an executor or trust to an ESOP (sec. 2057).

Role of leveraged ESOPs in corporate finance

A leveraged ESOP can be used by an employer to obtain funds for working capital or plant expansion, or as a means of financing an acquisition of the assets or stock of another corporation, including a leveraged buyout. Use of this financing technique can result in a lower cost of borrowing than would be available if conventional debt or equity financing were used. In a typical transaction, the employer enters into a contract with the ESOP to sell the ESOP a specified number of shares of its stock. The ESOP borrows the funds needed to purchase the shares from a bank or other lender and pays them over to the employer in exchange for the stock.[41] In subsequent years, the employer makes tax-deductible cash contributions to the ESOP in the amount necessary to amortize the loan principal and interest payments thereon.[42]

Because leveraged ESOPs provide a source of cash to the sponsoring corporation, they may be advantageous in a variety of situations. For example, a leveraged ESOP may be used not only to provide the company with working capital but also to finance an acquisition of the assets or stock of another corporation, including a leveraged buyout. In a typical case, a leveraged ESOP maintained by the acquiring corporation or its subsidiary borrows funds in an amount equal to the amount needed to acquire the target corporation. The proceeds of the loan are used to purchase employer securities from the employer. The employer (or the subsidiary) then uses the proceeds of the sale to purchase the stock or assets of the target company. Within statutory limits, the employer's contributions to the leveraged ESOP to enable it to amortize the loan will be deductible. In this manner, the corporation may reduce its after-tax cost of financing the acquisition.

One variation of this leveraged-ESOP financing technique is for the employer to purchase target stock, either directly or through a subsidiary, using funds borrowed from a financial institution or other lender. Once the acquisition has been completed, the newly-acquired subsidiary establishes a leveraged ESOP. The ESOP borrows money and purchases either newly issued stock of the subsidiary (or stock of the subsidiary from the acquiring corporation); the acquiring corporation then uses the proceeds of this sale to pay off the original acquisition loan. The subsidiary makes annual, deductible contributions sufficient to amortize the ESOP loan and pay interest.[43]

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[41] The lender usually requires either that the employer guarantee the loan or that the stock purchased with the loan proceeds be pledged as collateral. Because of the 50-percent interest exclusion available to the lender, it may be able to lend to the ESOP at a lower rate than it lends to its regular customers not utilizing ESOP financing techniques (or other tax-favored financing techniques).

[42] Alternatively, the employer may take out the loan itself and sell its stock to the ESOP in exchange for the ESOP's installment note. The employer will make (deductible) contributions to the ESOP in future years that will enable the ESOP to pay off the note. These payments will be used by the employer to repay its lender.

[43] If the management and shareholders of the target company cooperate in the acquisition, it is possible that a portion of the proceeds of the sale of target stock by original target shareholders would qualify for tax-free rollover under sec. 1042. Thus, the acquiring corporation and the target shareholders could agree in advance that a portion (enough to qualify the ESOP as a 30-percent shareholder) of their shares would be purchased by a leveraged ESOP established by the target and the balance by the acquiring corporation. The proceeds of the sale to the ESOP might qualify for tax-free reinvestment under sec. 1042.

Recently, leveraged ESOPs have been used in some situations to thwart hostile corporate takeover attempts. The Proctor and Gamble Company has announced plans to add $1 billion to its existing ESOP (thereby giving the ESOP a 20-percent interest in the company's common stock) in a transaction designed to provide substantial tax benefits and to offer a shield against a hostile takeover.[44] The recent establishment of the J.C. Penney Co. ESOP, in which the employees received a 24-percent interest in the company, is widely viewed as an effort to deter a hostile takeover.[45]

By selling stock to an ESOP, a company may make it difficult for a hostile bidder to acquire control, since stock held by an ESOP might be expected to vote to keep the company independent (i.e., to vote against the takeover). Management generally may use proceeds of a sale of stock to an ESOP for any corporate purpose. Moreover, a sale of stock to the ESOP will not necessarily dilute management's control of the company to the same degree as a sale to outside parties. The stock purchased by the corporation for its employees is held in a suspense account and released for allocations to employees' accounts as the acquisition loan is repaid. Prior to the time the acquisition loan is repaid and stock is allocated to employees' accounts, the shares may be voted by plan trustees on the employees' behalf in accordance with the fiduciary standards of the Employee Retirement Income Security Act of 1974. Whether or not the shares are allocated to participants' accounts, in some cases, the shares sold to the ESOP may have more limited voting rights than are granted to shareholders of public companies.

Leveraged ESOPs also have been used to accomplish leveraged buyouts by persons desiring to take a company private. An example of such a transaction is the leveraged buyout of Parsons Corporation by its ESOP. Prior to the buyout, Parsons' stock traded on the New York Stock Exchange. The ESOP originally owned a minority interest in Parsons. Parsons' management initiated the buyout plan pursuant to which the ESOP acquired all other stock of the corporation so that, according to its chairman; William E. Leonard "we could be in control of our own destiny." [45a] The $518 million transaction was fully financed by debt.

D. Limitations on Interest Deductions

In general, a deduction is allowed for all interest paid or accrued on valid indebtedness of a taxpayer. There are numerous instances, however, where the Code limits the benefit of the interest deduction. Limitations on the deductibility of interest serve several purposes. Some attempt to limit deductions in circumstances where it appears that the instrument more closely resembles equity than debt. Most of the limits, however, are imposed in cases where immediate deductibility would produce a mismatching of income and expense. In cases where the full interest deduction is not permitted under the Code, the deduction either may be disallowed, in whole or in part, or deferred, or required to be capitalized and amortized

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[44] *The New York Times*, January 12, 1989, p. D-1.
[45] *The Wall Street Journal*, December 12, 1988, p. A-1.
[45a] *The Wall Street Journal*, January 29, 1985, p. A-4.

over the depreciable life of the asset to which the interest expense relates.

The following is a brief description of some limitations on interest deductions contained in the Code.

1. Interest on certain acquisition indebtedness

A debt obligation which is issued in consideration for a corporate acquisition may have certain characteristics which make it more appropriate to treat the obligation for purposes of the deduction of interest as if it were an equity instrument rather than a debt instrument. Section 279 denies a deduction for interest on "corporate acquisition indebtedness." The limitation applies to interest in excess of $5 million per year incurred by a corporation with respect to debt obligations issued to provide consideration for the acquisition of the stock, or two-thirds of the assets, of another corporation, if each of the following conditions exists: (1) the debt is substantially subordinated; (2) the debt carries an equity participation feature (e.g., includes warrants to purchase stock of the issuer or is convertible into stock of the issuer); and (3) either the issuer is thinly capitalized (i.e., has an excessive debt-to-equity ratio) or projected annual earnings do not exceed three times annual interest costs.

2. Interest relating to tax-exempt income

In order to prevent the double benefit that would arise if the interest expense connected with earning tax-exempt income were deductible, section 265(a)(2) denies a deduction for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. The Internal Revenue Service and the courts have employed various tests to determine whether a taxpayer has incurred or continued indebtedness for the purpose of acquiring or holding tax-exempt obligations. In general, when there is a sufficient connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed.

3. Debt-financed portfolio stock

In general, a corporate shareholder can deduct 70 percent of dividends received from other corporations and 80 percent in the case of dividends received from a 20-percent-owned corporation. The purpose of the dividends received deduction is to reduce multiple corporate-level taxation of income as it flows from the corporation that earns it to the ultimate noncorporate shareholder. However, when dividends are paid on debt-financed stock, the conjunction of the dividends received deduction and the interest deduction would enable corporate taxpayers to shelter unrelated income. Therefore, section 246A generally reduces the 70 and 80-percent dividends received deduction so that the deduction is available, in effect, only with respect to dividends attributable to that portion of the stock which is not debt-financed.[46] Stock is considered to be debt-financed if the indebtedness is directly attributable to investment in the stock.

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[46] The reduction of the dividends received deduction may be viewed as a surrogate for limiting the interest deduction.

4. Personal interest, passive activity losses, and investment interest

Noncorporate taxpayers are subject to a number of interest deduction limitations. For example, personal interest is not deductible (sec. 163(h)). Deductions (including interest) from passive trade or business activities, to the extent they exceed income from all such passive activities, generally may not be deducted against other income until the taxpayer disposes of his interest in the passive activity (sec. 469). Debt-financed investment property is subject to an interest deduction limitation for the purpose of preventing noncorporate taxpayers from sheltering or reducing tax on unrelated income. Section 163(d) provides that the deduction for investment interest is limited to the amount of net investment income. Investment interest is defined to include interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.

5. Construction period interest

Section 263A requires that costs incurred in manufacturing or constructing tangible property be capitalized. In particular, interest that is paid or incurred during the production period of certain types of property, and that is allocable to the production of the property, must be capitalized. Interest is allocable to the production of property for these purposes if it is interest on debt that can be specifically traced to production expenditures. If production expenditures exceed the amount of the specifically traceable debt, then other interest expense that the taxpayer would have avoided if amounts incurred for production expenditures instead had been used to repay that debt also is treated as allocable to the production of property (the "avoided cost" method of allocating interest).

6. Allocation of interest for foreign tax credit purposes

In addition to limitations on interest deductions, rules for allocating interest between U.S. and foreign source income affect the tax benefits to be derived from interest expense. A U.S. person, or a foreign person conducting a trade or business in the United States, may claim a credit against its U.S. tax for certain income taxes paid to a foreign government. In order to prevent foreign taxes from offsetting taxes on U.S. source taxable income, however, the Code limits the credit to the amount of U.S. tax that would have been payable on the foreign source taxable income. A taxpayer thus may be able to increase its currently usable foreign tax credit to the extent it can treat gross income as foreign source gross income. Similarly, shifting the allocation of an expense (such as interest) from foreign source to U.S. source income may increase the currently usable foreign tax credit.[46a]

The Treasury has broad regulatory authority to promulgate rules governing the allocation of expenses for this purpose. In the case of

[46a] Such allocations and reallocations have no effect on tax liability, however, unless either the taxpayer has paid (or is deemed to have paid) foreign taxes in excess of the taxpayer's relevant foreign tax credit limitation, or the re-sourcing or reallocation of income and deductions results in lowering the foreign tax credit limitation below the relevant foreign income taxes paid.

interest, however, the 1986 Act contained specific guidelines that in some cases have the effect of requiring a greater allocation of interest to foreign source gross income than did prior regulations. In particular, the Code (as amended by the 1986 Act) provides that the taxable income of an affiliated group is to be determined by allocating and apportioning all interest expense as if all members of the group were a single corporation.

The interest allocation rules recognize the fungibility of money and apportion the interest expense of U.S taxpayers as described above. Thus, a substantial portion of interest expense incurred by a U.S. taxpayer that has foreign source income may not yield tax savings equal to a full 34 percent of the interest expense incurred.

7. Deduction of interest from gross income effectively connected with the conduct of a U.S. trade or business

A foreign person that earns income effectively connected with the conduct of a trade or business in the United States pays U.S. income tax, at domestic rates, on the net amount of that income. Interest and other expenses of the foreign person are deductible in arriving at U.S. taxable income, provided those expenses are connected to the taxpayer's effectively connected income. The Treasury has broad authority to promulgate rules for the allocation and apportionment of interest and other expenses for this purpose (sec. 882(c)(1)(A)). The current regulations allocate a foreign corporate taxpayer's world-wide interest expense to its U.S. trade or business on the basis of the following formula: the value of the taxpayer's U.S. effectively connected assets is multiplied by the actual debt-equity ratio of the entire corporation (or a safe harbor debt-equity ratio) times one or more average interest costs (either those incurred by the corporation as a whole within one or more "currency pools" or those incurred by the U.S. operations of the corporation).[47]

8. Allocation rules

Present law, as discussed above, contains various methods for determining whether a relationship exists between a borrowing and a targeted activity. These methods include a direct tracing between the interest expense and the activity (the "directly attributable" test in sec. 246A), semi-direct tracing (the "purchase or carry" test in sec. 163(d)), avoided cost allocation (sec. 263A) and proportional allocation (Treas. regulations under secs. 861, 864(e) and 882). There is not a uniform test for making the determination of whether there is a connection between interest expense and a particular activity.

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[47] The conference report on the Omnibus Budget Reconciliation Act of 1987 stated that the conferees expected the Treasury to take steps to amend regulations that determine which of a corporation's financial liabilities are attributable to a U.S. trade or business (which regulations include Treas. reg. sec. 1.882-5), insofar as their then-current practical effect was to permit foreign corporations to allocate excessive amounts of debt and excessive amounts of interest expense toward reducing their U.S. effectively connected income. H.R. Rep. No. 100-495, 100th Cong., 1st Sess. 984-85 (1987).

E. Distinguishing Debt from Equity

The characterization of an investment in a corporation as debt or equity for Federal income tax purposes is generally determined by the economic substance of the investor's interest in the corporation. The form of the instrument representing the investment and the taxpayer's characterization of the interest as debt or equity is not necessarily controlling. However, taxpayers have considerable latitude in structuring the terms of an instrument so that an interest in a corporation will be considered to be debt or equity, as so desired.

There is presently no definition in the Code or the regulations which can be used to determine whether an interest in a corporation constitutes debt or equity for tax purposes. Such a determination must be made under principles developed in case law. Courts have approached the issue of distinguishing debt and equity by trying to determine whether the particular investment at issue in each case more closely resembles a pure debt interest or a pure equity interest. It is generally understood that a pure debt instrument is ordinarily represented by a written, unconditional promise to pay a principal sum certain, on demand or before a fixed maturity date not unreasonably far in the future, with interest payable in all events and not later than maturity.[48] Conversely, a pure equity interest is generally understood as an investment which places the funds contributed by the investor at the risk of the enterprise, provides for a share of any future profits, and carries with it rights to control or manage the enterprise.

The determination of whether an interest constitutes debt or equity is generally made by analyzing and weighing the relevant facts and circumstances of each case.[49] Some interests in a corporation can clearly be characterized, on their face, as either debt or equity. However, other interests may have features common to both debt and equity (known as "hybrid securities"), or underlying facts and circumstances may indicate that an interest has been inappropriately characterized as debt or equity (such as when purported debt is held by the corporation's shareholders on a pro rata basis, or when debt is held in a thinly capitalized corporation).

Various courts have determined that the following features, among others, are characteristic of debt:

(1) a written unconditional promise to pay on demand or on a specific date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;

(2) a preference over, or lack of subordination to, other interests in the corporation;

(3) a relatively low corporate debt to equity ratio; [50]

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[48] *See, e.g., Farley Realty Corp.* v. *Comm'r*, 279 F.2d 701 (2d Cir. 1960), and B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 4.03 (1979).

[49] In *John Kelley Co.* v. *Comm'r*, 326 U.S. 489 (1943), the Supreme Court stated that "[t]here is no one characteristic, not even the exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."

[50] In the foreign area, the IRS has ruled that corporate obligations could be treated as debt where, among other things, the amount borrowed by the obligor did not exceed five times its

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(4) the lack of convertibility into the stock of the corporation;
(5) independence between the holdings of the stock of the corporation and the holdings of the interest in question;
(6) an intent of the parties to create a creditor-debtor relationship;
(7) principal and interest payments that are not subject to the risks of the corporation's business;
(8) the existence of security to ensure the payment of interest and principal, including sinking fund arrangements, if appropriate;
(9) the existence of rights of enforcement and default remedies;
(10) an expectation of repayment;
(11) the holder's lack of voting and management rights (except in the case of default or similar circumstances);
(12) the availability of other credit sources at similar terms;
(13) the ability to freely transfer the interest;
(14) interest payments that are not contingent on or subject to management or board of directors' discretion; and
(15) the labelling and financial statement classification of the instrument as debt.

In 1969, in response to the increased level of corporate merger activity and the increased use of debt for corporate acquisition purposes, Congress enacted Code section 279 (disallowance of interest deductions incurred to acquire certain stock or assets) [51] and section 385 (treatment of certain interests in corporations as stock or indebtedness).[52] Section 385 granted the Secretary of the Treasury the authority to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or as indebtedness for Federal income tax purposes. The regulations were to prescribe factors to be taken into account in determining, with respect to particular factual situations, whether a debtor-creditor relationship or a corporation-shareholder relationship existed. In addition, section 385 provided that the factors set forth in the regulations could include, among others, the first five of the fifteen factors listed above.

Proposed regulations under section 385 were issued on March 20, 1980, and became final on December 29 of that year. The final regulations originally had an effective date of May 1, 1981, but this date was subsequently postponed to January 1, 1982, and then to July 1, 1982. New proposed regulations were issued on December 30, 1981. However, these regulations never became effective and on July 6, 1983, all section 385 regulations were withdrawn and to date no additional regulations have been issued.[53]

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equity capital. Rev. Rul. 69-377, 1969-2 C.B. 231; Rev. Rul. 69-501, 1969-2 C.B. 233; Rev. Rul. 70-645, 1970-2 C.B. 273; Rev. Rul. 73-110, 1973-1 C.B. 454. Debt-equity ratios of up to 25 to one have been permitted in the foreign area for purposes of determining whether the issuer will be respected as a separate entity. Section 6128 of the Technical and Miscellaneous Revenue Act of 1988. However, Congress made it clear that this permitted ratio would affect only a limited class of outstanding transactions and was made to permit the affected U.S. companies to have maximum access to certain capital. It was not intended to serve as precedent for the U.S. tax treatment of other similar transactions involving tax treaties or domestic tax law. H.R. Rep. No. 795, 100th Cong., 2d Sess. 571-72 No. (1988); H.R. Rep. No. 1104 (Vol. II), 100th Cong., 2d Sess. 185-86 (1988).

[51] See Part II.D.1. of this pamphlet, *supra*, for a discussion of sec. 279.

[52] For a discussion of the background of section 385, see S. Rep. No. 552, 91st Cong., 1st Sess. 137-44 (1969).

[53] *See* T.D. 7920, 1983-2 C.B. 69 (1983).

The section 385 regulations did not succeed in the attempt to develop objective standards for distinguishing debt from equity. For example, one feature of the regulations was the development of objective safe harbor tests which, if met, would classify an interest as debt. The use of such mechanical tests would have allowed corporations to create instruments which would be considered to be debt for Federal income tax purposes, but economically had many of the characteristics of equity.[54]

F. Carrybacks of Net Operating Losses

A corporation that incurs net operating losses (NOLs) generally can carry the NOLs back 3 taxable years and forward 15 taxable years. Carrying the NOLs back against prior taxable income allows a corporation to recognize currently the benefit of those losses by obtaining a refund.

Net operating losses can be generated when a heavily debt-financed transaction such as a leveraged buyout is undertaken (due to the substantial interest deductions).[55] Limitations exist, however, with respect to the ability to carry back post-acquisition NOLs to pre-acquisition taxable years of the target corporation. These limitations generally apply where the NOLs have not been generated by the target corporation.[56] If acquisitions are structured so that these limitations do not apply (e.g., if acquisition debt is located in the target corporation as opposed to the acquiring corporation), an acquiror may be able to obtain a refund of taxes paid in previous years if interest deductions generate NOLs.

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[54] For an example of the type of interest that the proposed sec. 385 regulations would have treated as debt, see Rev. Rul. 83-98, 1983-2 C.B. 40 (1983) (describing securities known as adjustable rate convertible notes). The ruling held that the interests in question would be considered equity.

[55] If the interest deductions are so large as to create an NOL, however, a portion of the acquired business may be sold subsequently in order to reduce the debt, possibly triggering taxable gain.

[56] For example, assume a corporation acquires all of the stock of a profitable target corporation and the corporations thereafter file a consolidated return. In general, the consolidated group can carry back the group's NOLs to a pre-acquisition year of target only if those NOLs are attributable to target, e.g., if the acquisition debt that is generating the interest deductions and the NOLs is a direct obligation of target. If target had been a member (but not the parent) of another consolidated group before being acquired, the new group's post-acquisition NOLs can be carried back to prior taxable years of target's old group, but only if the NOLs are attributable to target and only to the extent of target's taxable income in the carryback year. If the acquiror subsequently merges with or liquidates target, the group may, in certain circumstances, be unable to carry back target's post-acquisition NOLs to target's pre-acquisition years.

III. EXAMPLES OF TRANSACTIONS THAT INCREASE DEBT OR REDUCE EQUITY, AND TAX CONSEQUENCES

There are various transactions which can increase the debt of a corporation or reduce its equity. The discussion below describes broad categories of these transactions and uses examples to illustrate their tax consequences. The examples assume that no restrictions on interest deductions or other tax benefits stemming from interest expenses apply.[57] In many cases, however, such limitations are applicable. For example, a taxpayer that pays foreign taxes in excess of the relevant foreign tax credit limitation (i.e., a taxpayer with excess foreign tax credits) will generally experience a net tax reduction of *less* than 34 cents on every dollar of additional interest expense; even though the interest is fully deductible, the foreign tax credit rules will apportion a fraction of each additional dollar of interest expense to foreign source gross income, further reducing the taxpayer's foreign tax credit limitation and hence its currently usable amount of foreign tax credits.

Although there are significant tax reasons which may lead a corporation to engage in these transactions, such transactions may also be motivated by reasons apart from Federal income tax considerations. For example, such transactions may be undertaken to increase the value of a corporation's stock, to enhance earnings per share calculations, to concentrate common stock holdings, to create treasury stock, as a defensive maneuver to ward off a takeover, or for other reasons.

A. Extraordinary Distributions with Respect to Stock

Description

A corporation may distribute funds to shareholders with respect to their stock. Such a distribution may be out of the accumulated cash of the corporation, or the proceeds of a sale of assets, or the corporation or the corporation may borrow funds to make the distribution.[58]

Immediate tax consequences to shareholders

A distribution with respect to stock by a profitable corporation, however financed, is generally a taxable transaction with respect to the shareholders receiving the distribution. The precise tax treatment of the distribution to shareholders depends on the exact

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[57] See part II. D. of this pamphlet, *supra*, for a discussion of some of the limitations placed on the deductibility of interest in the Code.

[58] As an alternative to borrowing funds from an outside lender and distributing the proceeds to shareholders, a corporation may issue debt (i.e., bonds) directly to its shareholders.

structure of the transaction as well as the tax attributes of the distributing corporation and its shareholders.[59]

If a distribution is made pro rata to all shareholders, the distribution will be treated as a dividend (taxed as ordinary income) to the extent that the distribution does not exceed the current or accumulated earnings and profits of the distributing corporation. The entire amount of a dividend distribution is subject to tax. Distributions in excess of earnings and profits are treated as a tax-free return of capital that reduces a shareholder's basis in the stock and distributions in excess of earnings and profits that exceed a shareholder's basis in the stock are taxed to the shareholder as capital gain (currently taxed at ordinary income rates).[60]

Alternatively, if the shareholders of the distributing corporation exchange the shares they owned before the transaction for cash and "new" shares of the distributing corporation, the transaction may be classified as a tax-free reorganization. In such case, the lesser of the cash received and the amount of gain realized on the transaction will be subject to tax. If the distribution is characterized as a dividend, that portion of the distribution not in excess of the corporation's accumulated (not current) earnings and profits will be taxed as ordinary dividend income, and the remainder as capital gain (also currently taxed as ordinary income).

As a third possibility, if new shares are not issued in the transaction but the interest of some shareholders in the distributing corporation is sufficiently reduced, those shareholders may be entitled to treat the cash distribution as received in exchange for a portion of their shares. In such case, those shareholders would be able to offset the cash received by the basis of the shares exchanged, and would be taxable only on any gain.

Immediate tax consequences to the distributing corporation

There are no immediate tax consequences to a corporation making a distribution of cash or other non-appreciated property with respect to its stock since the amount of the distribution is not deductible and there is no tax on the distribution of non-appreciated property.

Long-term tax consequences

There are future tax effects resulting from a corporation making a distribution with respect to stock.

In the case where the distribution is financed out of the corporation's earnings, the distribution reduces the total funds held by the distributing corporation. The distributed funds will thus no longer produce earnings subject to the corporate tax (assuming the distribution is made to noncorporate shareholders and is not reinvested in another corporation). All other facts being equal, the amount of tax paid by the distributing corporation will be reduced.

In the case where the distribution is financed by borrowing, there has been no reduction in the total funds of the corporation

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[59] Of course, there will be no tax imposed on those shareholders that are not subject to U. S. income tax, i.e., tax-exempt investors such as pension funds. See Parts II.A.2.c. and d. of this pamphlet, *supra*, for a fuller discussion.

[60] See Part II.A.2 of this pamphlet, *supra*.

but equity in the corporation has been replaced with debt.[61] Earnings of the corporation once available to be paid to shareholders as non-deductible dividends are instead paid to debtholders as deductible interest. As a result of the interest deduction generated by the borrowing in a sizable leveraged distribution, a corporation may have little, if any, taxable income in the years following the distribution and may claim loss carrybacks producing a refund of taxes paid prior to the distribution.[62] Because the distributing company pays little, if any, of its operating income as Federal income taxes, the portion of the distributing corporation's income that was once being paid to the Federal government may instead be redirected to increase investor (shareholder and debtholder) returns. To the extent increased investor returns are paid to taxable shareholders or debtholders, there may be an increase in investor-level taxes paid. This is illustrated by the following example.

Example III-A

Company M has annual income of $1.5 million. It has 99,000 shares of stock outstanding and no debt. Company M pays Federal income tax of $510,000 ($1.5 million times 34 percent), resulting in net after-tax income of $990,000 ($1.5 million minus $510,000). Earnings per share are $10 ($990,000 divided by 99,000 shares). The stock sells on the market at about $80 per share (or 8 times earnings).

The management of Company M announces that the company will borrow $11 million and distribute the proceeds pro rata among its shareholders. Each share will receive approximately $111, or almost 40 percent more than the price at which the stock had been trading on the market. The distribution is, in general, a taxable transaction with respect to those shareholders subject to tax.[63] Company M issues bonds for $11 million paying 12 percent interest and distributes the proceeds to shareholders.

The distribution of the operating income of Company M before and after the distribution is as follows:

	Before	After
Shareholders	$990,000	$118,800
Bondholders	0	1,320,000
Corporate income taxes	510,000	61,200
Total operating income	1,500,000	1,500,000
Earnings per share	10	1.20

[61] This transaction is sometimes called a "leveraged restructuring."

[62] Increased cash flow as a result of the reduction in the distributing corporation's Federal income tax liability might be sufficient to enable the distributing corporation to cover much of its debt service obligations with respect to the borrowed funds and retire a portion of its debt over a period of years (although the distributing corporation might also have to sell some of its assets to raise cash to assist it in paying off the loan).

[63] However, the amount of tax paid by shareholders as a result of the distribution depends on the tax attributes of Company M and its shareholders. As discussed above, the full amount of the distribution will be taxable to shareholders as a dividend only to the extent of Company M's earnings and profits.

The leveraged distribution has redistributed the income stream of Company M. The shareholders of Company M who used to get $990,000 a year in dividends now get $118,800 per year after the distribution. New bondholders receive interest of 12 percent on $11 million, or $1.32 million. This is one-third more than the entire amount of Company M's after-tax income before the distribution even though the operating income of Company M is unchanged. The shareholders of Company M receive the profit of $118,800 after the distribution (the remainder of Company M's income after taxes and interest expense.)

Note that the taxable income of Company M has been reduced from $1.5 million to $180,800 ($1.5 million minus $1.32 million) because most of the earnings of Company M are now paid to investors as deductible interest payments. The resulting reduction of corporate Federal income taxes from $510,000 to $61,200 exactly pays for the increased returns to the new bondholders and shareholders. Depending on whether the increased returns are paid to taxable bondholders and shareholders, there may be an increase in investor-level Federal income taxes paid.

After the distribution, the earnings per share of Company M are $1.20 ($118,800 divided by 99,000 shares outstanding). If the stock will sell for 8 times its earnings after the distribution, the stock price would be $9.60.[64]

Actual transactions

Holiday Corporation (the parent corporation of Holiday Inns) engaged in a pro rata extraordinary distribution of the nature described above in 1987. Holiday borrowed approximately $2.4 billion in order to finance, among other things, a special distribution of $65 per share (the shares had been trading at about $75 before announcement of the recapitalization). Notwithstanding the distribution, the shareholders retained 90 percent of their equity in the corporation. Moreover, due to the limited amount of earnings and profits of Holiday, only $20 per share was treated as a dividend.[65]

In another recent example of this type of transaction, Quantum Chemical Corp., a chemical producer, announced a $50 per share dividend distribution to its shareholders. With 22.8 million shares outstanding, the company would distribute $1.14 billion. The distribution would be financed by borrowing.[66]

B. Stock Repurchases

Description

A stock repurchase refers to a corporation redeeming (or buying back) its own shares from stockholders. A corporation may make a tender offer for a certain percentage of its shares at an announced price or a corporation may simply purchase its shares on the

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[64] Thus, although it may have appeared that most if not all of the value of the stock would be depleted as a result of the borrowing and distribution (hence the term "stub stock" to describe the stock after such a transaction), a significant portion of the value of the stock in fact remains intact because of the tax benefits that flow from the leveraged distribution.

[65] See Proxy Statement of Holiday Corporation (January 30, 1987).

[66] *The Wall Street Journal*, December 29, 1988, p. A2.

market. A corporation may fund a stock repurchase out of cash the corporation has on hand or it may borrow the funds.[67]

Tax consequences

A stock repurchase, whether financed out of cash the corporation has on hand or by borrowing, is generally a taxable transaction with respect to the redeeming shareholders. Taxable shareholders having their stock redeemed recognize any gain (i.e., the excess of the amount received over basis) or loss on the redemption of their shares.[68] There are no immediate tax consequences of a stock repurchase to the redeeming corporation.

A stock repurchase has further tax consequences to the redeeming corporation and to investors in the redeeming corporation over time. If a stock repurchase is financed with cash, the primary tax consequence is that the corporate assets of the redeeming corporation have been reduced. Corporate assets paid out to redeem shareholders' stock no longer produce earnings which are subject to the corporate income tax.[69] If the stock repurchase is financed through borrowing, the effect of the transaction is to replace the equity of the corporation with debt. Earnings of the corporation once available to be paid to shareholders as non-deductible dividends are instead paid to debtholders as deductible interest.[70] Thus, a stock redemption using borrowed funds enables the redeeming corporation to reduce its taxable income, or perhaps eliminate (or even generate current tax losses which it could carry back to obtain tax refunds).[71]

As indicated by the following example, the resulting reduction in Federal income taxes pays for increased returns to investors. To the extent increased investor returns are paid to taxable shareholders or debtholders, there may be an increase in investor-level taxes paid.

Example III-B

Consider the same facts as in Example III-A above, except that Company M announces it will repurchase up to $11 million of its shares at a redemption price of $120 per share, 50 percent more than the price at which the stock has been trading on the market. Taxable redeeming shareholders recognize gain or loss on the redemption of their shares.

At $120 per share, $11 million will purchase approximately 93 percent of Company M's outstanding shares. To finance the share

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[67] As an alternative to borrowing funds from an outside lender and using the proceeds to repurchase the stock of shareholders, a corporation may repurchase stock by issuing debt directly to redeeming shareholders. This is sometimes called a "debt-for-equity swap."

[68] Of course, there will be no tax imposed on those shareholders that are not subject to U.S. income tax on this income, i.e., certain foreign investors and tax-exempt investors such as pension funds. See Parts II.A.2.c. and d. of this pamphlet, *supra*, for a fuller discussion.

[69] As discussed in Part III.A. of this pamphlet, *supra*, this is also the result when the earnings of the distributing corporation are distributed to noncorporate shareholders in circumstances other than in connection with a stock repurchase.

[70] A leveraged stock repurchase has exactly the same tax consequences as a leveraged distribution made by a corporation with respect to its stock. See Part III.A.1. of this pamphlet, *supra*.

[71] A reduction in the redeeming corporation's Federal income tax liability could also increase its cash flow significantly. That increased cash flow might be sufficient to enable the redeeming corporation to cover most of its debt service obligations with respect to the borrowed funds and retire much of the debt over a period of years (although the redeeming company might also have to sell some of its assets to raise cash to assist it in paying off the loan).

repurchase, Company M issues bonds for $11 million paying 12 percent interest. Approximately 93 percent of Company M's outstanding shares are redeemed.

The distribution of the operating income of Company M before and after the stock repurchase is as follows:

	Before	After
Redeeming shareholders	$920,700	0
Bondholders	$0	$1,320,000
Continuing shareholders	69,300	118,800
Corporate income taxes	510,000	61,200
Total operating income	1,500,000	1,500,000
Earnings per share	10	16.20

The leveraged stock redemption has redistributed the income stream of Company M in the same way that the leveraged distribution with respect to stock redistributed the income stream, except that the continuing shareholders of Company M, rather than all the shareholders of Company M, receive the profit of $118,800. The redeeming shareholders of Company M who used to get $920,700 a year in dividends before the redemption receive no part of the income stream after the redemption. New bondholders receive interest of 12 percent a year on $11 million, or $1.32 million. This is one-third more than the entire amount of Company M's after-tax income before the stock repurchases even though the operating income of Company M is unchanged. Continuing shareholders of Company M receive the profit of $118,800 (the remainder of Company M's income after taxes and interest expense).

The taxable income of Company M has been reduced from $1.5 million to $180,000 ($1.5 million minus $1.32 million) because most of the earnings of Company M are now paid out as deductible interest payments. The resulting reduction of corporate Federal income taxes from $510,000 to $61,200 exactly pays for the increased returns to the new bondholders and the continuing shareholders. Depending on whether the increased returns are paid to taxable bondholders and shareholders, there may be an increase in investor-level Federal income taxes paid.

Note also that the earnings per share of Company M have gone up from $10 per share ($990,000 divided by 99,000 shares outstanding) before the leveraged buyout to $16.20 per share ($118,800 divided by 7,333 shares outstanding) after the leveraged buyout. If the stock will still sell for 8 times its earnings on the market after the leveraged buyout, the stock price would rise from $80 to $129.60 ($16.20 times 8).

Taxpayers have also sought similar tax results in connection with so-called "unbundled stock units." On December 5, 1988, four publicly traded companies—American Express Co., Dow Chemical Co., Pfizer Inc. and Sara Lee Corp.—announced offers to their shareholders to exchange a certain portion of their outstanding

common stock for unbundled stock units comprised of three separate securities:

(1) a 30-year deep-discount bond which will pay quarterly interest in an amount equal to the current dividend of the common stock exchanged;

(2) a share of preferred stock which will yield dividends equal to any increase in the dividend yield of the company's common stock; and

(3) an "equity appreciation certificate" which entitles the holder to acquire one share of common stock for an amount equal to the redemption value of the 30-year bond plus a share of the preferred stock. The new bond in effect would convert what had been nondeductible ordinary dividends into deductible interest payments, in addition to providing corporate deductions for an element of original issue discount.[72]

Actual transactions

Stock repurchases have become common corporate transactions. A list of the largest stock repurchases during 1988 published by *The Wall Street Journal* indicated that the largest 21 stock buyback announcements of 1988 were intended to retire almost 500 million shares of stock worth approximately $23.8 billion. Ten transactions were listed with a value in excess of $1 billion. The largest transactions listed were the following: (1) UAL Corporation buying back 35.5 million common shares with a value of $2.84 billion; (2) International Business Machines Corporation buying back 17.8 million common shares with a value of $2 billion; (3) CSX Corp. buying back 60 million shares with a value of $1.86 billion; and (4) Sears Roebuck buying back 40 million common shares with a value of $1.75 billion.[73]

C. Acquisitions Including Leveraged Buyouts

The acquisition of one corporation by another corporation may be structured in many different ways. An acquiring corporation may acquire control of the "target" corporation or it may acquire a small interest in the stock of another corporation as an investment. The acquiring corporation may finance the acquisition with debt (either by a new borrowing of the necessary funds or by keeping an old borrowing outstanding), or with its own retained earnings, or with funds contributed as new equity capital by investors.

An acquisition of the control of a target company may be a hostile or friendly transaction. It may be structured as an acquisition of the stock of the target company or an acquisition of the assets of the target company. The target company may continue to operate as an independent company in the same manner as before it was acquired, or it may be absorbed into the acquiring company or

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[72] The four companies currently plan to replace between 6.5 and 20 percent of their outstanding common stock with unbundled stock units. It has been estimated that the four corporations issuing unbundled stock units could save, in the aggregate, up to $5.9 billion in Federal income taxes over the 20-year life of the bonds. Aggregate tax savings in the first year after the exchange may be as much as $85 million, with annual tax savings steadily rising through the 30-year bond term. *New York Times*, December 7, 1988, p. D1. The Internal Revenue Service has not ruled on the tax treatment of unbundled stock units.

[73] *The Wall Street Journal*, January 3, 1989, p. 8R.

other companies owned by the acquiring company, or it may cease operations entirely and its assets be divided and sold.

1. Stock acquisitions out of retained earnings

A corporation may finance the acquisition of the stock of another corporation with internally generated funds (i.e., its retained earnings). The purchase of the stock has no tax consequences to the shareholders of the purchasing corporation. Likewise, there are no tax consequences to the acquired corporation as a result of the acquisition. The taxable shareholders of the acquired corporation recognize any gain or loss on the sale of their shares.

There are generally no immediate tax consequences to the purchasing corporation as a result of the transaction. However, the total amount of funds in corporate solution, the earnings of which are subject to a corporate-level tax, may be reduced by the amount spent for the acquisition to the extent that shares are acquired by the acquiring corporation from noncorporate shareholders. Moreover, no compensating additional corporate tax may arise when earnings of the acquired corporation are distributed to the acquiring corporation. This is because earnings of the target company which are distributed to the acquiring corporation as dividends will either be nontaxable under the consolidated return rules, or, if the corporations do not file a consolidated return, will be eligible for the dividends received deduction.[73a]

2. Debt-financed stock acquisitions including leveraged buyouts

A corporation may finance the acquisition of another corporation's stock by borrowing. The acquiring corporation may borrow using its own assets as security for the loan or it may borrow using the assets of the target company as security for the loan. In either case, debt has been substituted for equity at the corporate level. When the debt is secured by the acquired corporation's assets, the transaction is more likely to be called a "leveraged buyout."

Description

A leveraged buyout refers to a particular type of debt-financed acquisition of a "target" corporation.[74] The purchasers borrow most of the purchase price of the target company, using the assets of the target company as security for the loan. After the acquisition, the target corporation may be able to service the debt obligation out of its cash flow from operations or the purchaser may sell the assets of the target company and use the proceeds to retire the debt.

A leveraged buyout may occur in many different contexts and may be used by many different types of purchasers. The leveraged buyout, also sometimes called a bootstrap acquisition, has long been used to acquire private (i.e., closely held) corporations.[75] More

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[73a] See Part II.A.2.b. of this pamphlet for a discussion of the dividends received deduction.

[74] In what is called a "reverse leveraged buyout," public companies which had been converted to private companies in a leveraged buyout become public companies again, with their shares being sold in a public offering to shareholders.

[75] For a description of certain transactions that may be fully or partially financed by corporate borrowing, see Rev. Rul. 69-608, 1969-2 C.B. 42.

recently, leveraged buyouts have been used to acquire large public companies. A public company may be "taken private" through a leveraged buyout if the purchasers of the target public corporation are a relatively small group of investors. If the purchasers of the target corporation in a leveraged buyout include the current management of the target company, the transaction is sometimes called a "management buyout." A division or a subsidiary of a company also may be purchased through a leveraged buyout.

A leveraged buyout of a target company is usually accomplished by a debt-financed tender offer by the existing corporation for its outstanding publicly held stock, or, alternatively, by a tender offer for the target corporation's stock by a largely debt-financed shell corporation established for this purpose. The target corporation will repurchase its stock from its shareholders or the shell corporation will buy all the stock of the target corporation.[76] If a shell corporation is used, the target corporation and the shell corporation will typically merge immediately after the acquisition.

As mentioned above, most of the funds for a leveraged buyout transaction are borrowed, with the purchasers contributing only a small amount of their own funds as equity. Lenders for these transactions have been banks, investment banks, insurance companies, pension funds, and pools of investors. Debt terms reflect the degree of leverage and the loan security involved. Some of the debt incurred frequently is below investment grade, i.e., so-called "junk" bonds.

Tax consequences

A leveraged buyout is generally a taxable transaction with respect to the shareholders of the target corporation.[77] Taxable shareholders selling their stock recognize gain or loss on the sale of their shares.[78] There are no immediate tax consequences of a leveraged buyout at the corporate level since generally neither the repurchase by the target corporation of its own shares nor the purchase of the target corporation's shares by a shell corporation followed by the merger of the target and shell corporation is a taxable transactions.

The primary tax consequences of a leveraged buyout to the target corporation arise from the fact that the equity of the corporation has been replaced by debt. Income of the target corporation once paid to investors as nondeductible dividends on stock is instead paid to creditors as tax-deductible interest on debt.[79] As a result of the interest deductions generated by the borrowing in a leveraged buyout, the target corporation may have little, if any, taxable income in the years following a leveraged buyout and may

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[76] Shareholders of the target company typically receive a premium for their stock above the price at which the stock has been trading on the market.

[77] Of course, there will be no tax imposed on those shareholders that are not subject to U.S. income tax on their income, i.e., certain foreign investors and tax-exempt investors such as pension funds. See Parts II.A.2.c. and d. of this pamphlet, *supra*, for a fuller discussion.

[78] Taxable shareholders will generally recognize gain (i.e., the excess of the amount received over their basis in the stock) because acquirors typically pay a substantial premium for stock in a leveraged buyout transaction.

[79] A leveraged buyout has exactly the same tax effect as a leveraged distribution made by a corporation with respect to its stock and a leveraged stock redemption. See parts III.A.1. and III. B. of this pamphlet, *supra*.

claim loss carrybacks producing a refund of taxes paid prior to the acquisition.[80] Because the target corporation pays little, if any, of its operating income as Federal income taxes, the portion of the target corporation's income that was once being paid to the Federal government as Federal income taxes may instead be redirected to increase investor returns. However, to the extent increased investor returns are paid to taxable shareholders or holders of debt, there may be an increase in investor-level Federal income taxes paid.

Example III-C

Consider the same facts as in Example III-A. Rather than the management of Company M announcing a distribution with respect to its stock, Company M is acquired in a leveraged buyout. The acquirors pay $120 per share of stock, or 50 percent more than the price at which the stock has been trading on the market, for a total price of $11.88 million. Taxable selling shareholders recognize gain or loss on the sale of their shares.

The acquirors put up $880,000 of their own funds and raise the remaining $11 million of the purchase price by issuing notes paying 12 percent interest to be secured by the assets of Company M. The annual income of Company M after the leveraged buyout is unchanged.

The distribution of the operating income of Company M before and after the leveraged buyout is as follows:

	Before	After
Company M shareholders	$990,000	0
Bondholders	0	$1,320,000
Acquirors	0	118,800
Corporate income taxes	510,000	61,200
Total operating income	1,500,000	1,500,000

The leveraged buyout has redistributed the income stream of Company M in the same way that the leveraged distribution with respect to stock, and the leveraged stock redemption, redistributed the income stream of Company M. However, the acquirors of Company M, rather than all the shareholders (in the case of a distribution with respect to stock) or the continuing shareholders of Company M (in the case of a stock redemption) receive the profit of $118,800. Company M shareholders who before the transaction received $990,000 a year in dividends now receive no distributions. New bondholders receive interest of 12 percent on $11 million, or $1.32 million. This is one third more than the entire amount of Company M's after-tax income before the leveraged buyout, even though the operating income of Company M is the same before and after the leveraged buyout.

[80] Indeed, the target corporation may be able to service its debt obligations out of a cash flow not reduced (or reduced less) by taxes.

The taxable income of Company M has, however, been reduced from $1.5 million to $180,000 ($1.5 million minus $1.32 million) because most of the income of the company is paid out to investors as interest rather than dividends. Federal income taxes are thereby reduced from $510,000 to $61,200. Acquirors make an after-tax profit of $118,800 (pre-tax profit of $180,000 reduced by Federal income tax of $61,200), a 13.4 percent return on their $880,000 equity investment. The income tax reduction of $448,800 exactly pays for the increased returns to investors (bondholders and the acquirors) as a result of the leveraged buyout. Depending on whether the increased investor returns are paid to taxable shareholders or holders of debt, there may be an increase in investor-level Federal income taxes paid.

Actual transactions

Leveraged buyouts of public companies have greatly increased in recent years, and the amounts involved in such transactions have risen dramatically. (See the discussion in part I.B. of this pamphlet, *supra*.) The largest leveraged buyout transaction to date is the proposed acquisition of RJR Nabisco by the investment firm of Kohlberg Kravis Roberts & Co. ("KKR") for nearly $25 billion. It is expected that this acquisition will be completed by February 1989. Other large leveraged buyout transactions include the acquisition of Beatrice Companies by KKR for $6.25 billion in April 1986, and the management buyout of R. H. Macy & Co., Inc. for $3.5 billion in July 1986.

Newspaper reports indicate that out of the approximately $25 billion needed for the RJR Nabisco acquisition, more than $22.5 billion will be borrowed. Secured bank debt will account for approximately $17.5 billion of the borrowing, with most of the remainder being provided by investment banking firms. A pool of investors organized by KKR will put up $1.5 billion as an equity investment. It has been reported that KKR will contribute approximately $15 million of its own funds as equity.[81] RJR Nabisco shareholders will be paid $109 for each share of common stock. This is almost twice the price at which the stock was trading immediately prior to the announcement of the possible sale of the company.[82] It has been reported that due to increased interest deductions, RJR Nabisco could save up to $682 million annually in Federal and state income taxes and be able to seek the refund of additional amounts of taxes paid in prior years due to the carryback of net operating loses.[83] Other reports have projected the annual savings at $370 million.[84]

In the Beatrice transaction, each common shareholder received $50 per share ($40 in cash). This price of $50 per share was 45 percent higher than the market value of the stock one month prior to the announcement date of the first offer. Financing for the Bea-

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[81] *The Washington Post*, December 8, 1988, p. F1; *The Washington Post*, December 4, 1988, p. A1; *The Washington Post*, December 3, 1988, p. D1; *The Washington Post*, December 2, 1988, p. A1.

[82] *The Washington Post*, December 2, 1988, p. A1; The *Washington Post*, December 1, 1988, p. A1.

[83] See, Saunders, "How the Government Subsidizes Leveraged Takeovers," *Forbes*, November 28, 1988, p. 192.

[84] See, *The Wall Street Journal*, December 12, 1988, p. A10.

trice leveraged buyout included $6.5 billion in debt and $1.35 billion in equity capital.[84a] Four billion dollars of the debt was lent by banks and $2.5 billion came from a new issue of high yield bonds. The equity came from two sources. Six hundred million came from a buyout fund organized by KKR and subscribed to by institutional investors and $750 million came from converting existing common stock to a new issue of preferred stock.[85]

In the Macy transaction, each common share of stock outstanding received $68 in cash. This price of $68 per share was 55 percent higher than the market value of the stock one month prior to the announcement date of the first offer. On completion of the Macy leveraged buyout, the management group held 20 percent of the new company stock and an additional 20 percent was held by General Electric Co.'s credit union. Financing for the Macy leveraged buyout totalled approximately $3.7 billion.[86] Out of this amount, almost $3.2 billion was debt: $770 million was lent from banks, $1.625 billion came from new issues of high yield bonds, and $800 million came from notes secured by mortgages. The remaining $500 million of the financing consisted of $200 million of excess cash of Macy's and $300 million was equity capital contributed by the acquirors.[87]

D. Role of Overfunded Pension Plans and ESOPs in Leveraged Buyouts

1. Overfunded pension plans

In the case of a leveraged buyout, the assets in the overfunded pension plan of the target company may represent a source of capital to help finance the acquisition. An overfunded pension plan represents a pool of assets that may make a company a target for a takeover. Conversely, this pool of assets may be used by the company to ward off a hostile takeover. In recent years, some companies with significantly overfunded pension plans have been acquired by other companies. After the acquisition, the acquiring company terminated the overfunded pension plan and used the excess assets partially to finance the takeover. An overfunded plan represents an attractive source of cash even if the value of the assets are included in the purchase price.

Another possibility is that a company will itself terminate an overfunded pension plan to assist its efforts to thwart a hostile takeover attempt.

Consider the following example:

[84a] The total financing exceeded the value of the offer because the purchaser assumed Beatrice debt that it expected to refinance.

[85] Carolyn Kay Brancato and Kevin F. Winch, "Leveraged Buyouts and the Pot of Gold: Trends, Public Policy, and Case Studies," Congressional Research Service, The Library of Congress, (88-156E) (September 15, 1987) pp. 80-89 (originally published as Committee Print 100-R, by the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce) describing the facts of the Beatrice transaction.

[86] This amount is in excess of the total purchase price of $3.5 billion because funds were used to pay transaction costs and to buy out the rights of holders of Macy stock options.

[87] *Id.* at pp. 95-101, describing the facts of the Macy transaction.

Example III-D

Corporation K is a widely held public corporation. K maintains a qualified defined benefit pension plan for the exclusive benefit of its employees. The trust is currently overfunded by approximately $100 million on a termination basis. That is, if the trust is terminated, its assets would exceed the present value of the benefits accrued under the plan by K employees up to the date of plan termination. LBO Fund (L) wants to acquire K.

Under almost any form of acquisition, L, subject to some limitations, could cause K to terminate its pension plan. The termination would enable L, directly or indirectly, to obtain the $100 million. It could be used to assist L in paying for the acquisition, for general corporate purposes, or for any other purpose. While the $100 million would be included in the gross income of K upon termination of the plan, any net operating losses and loss carryovers of K could be used to offset that income. A nondeductible 15-percent excise tax would also apply to the reversion.

If K's current management wanted to prevent an acquisition, it might terminate the plan itself and make use of the proceeds. K might be a less attractive takeover candidate in that event, for it would not have $100 million in readily available cash as an inducement to a potential acquiror.

This utilization of excess pension assets is not peculiar to a leveraged buyout, but is potentially available in any takeover or merger transaction. In addition, any pool of liquid assets, not just excess pension assets, would be attractive to potential acquirors.

2. Employee stock ownership plans (ESOPs)

A leveraged ESOP can be used by an employer as a technique of finance to obtain funds for working capital or plant expansion, or as a means of financing a leveraged buyout. Use of this financing technique can result in a lower cost of borrowing than would be available if conventional debt or equity financing were used. In a typical transaction, the employer enters into a contract with the ESOP to sell the ESOP a specified number of shares of its stock. The ESOP borrows the funds needed to purchase the shares from a bank or other lender and pays them to the employer in exchange for the stock. In subsequent years, the employer makes tax-deductible cash contributions to the ESOP in the amount necessary to amortize the loan principal and interest payments thereon.

A leveraged ESOP may be used not only to provide the company with working capital but also to finance an acquisition of the stock or assets of another corporation. In a typical case, a leveraged ESOP maintained by the acquiring corporation or its subsidiary borrows funds in an amount equal to the amount needed to acquire the target corporation. The proceeds of the loan are used to purchase employer securities from the employer. The employer (or the subsidiary) then uses the proceeds of the sale to purchase the stock or assets of the target company.

One variation of this leveraged-ESOP financing technique is for the employer to purchase target stock, either directly or through a subsidiary, using funds borrowed from a financial institution or other lender. Once the acquisition has been completed, the newly

acquired subsidiary establishes a leveraged ESOP. The ESOP borrows money and purchases stock in the subsidiary from the subsidiary (or from the acquiring corporation). The acquiring corporation then uses the proceeds of this sale to pay off the original acquisition loan. The subsidiary makes annual, deductible contributions sufficient to amortize the ESOP loan and pay interest.

Recently, leveraged ESOPs have been used in some situations to thwart hostile corporate takeover attempts. Leveraged ESOPs have also been used to accomplish leveraged buyouts by persons desiring to take the company private.

The establishment of an employee stock ownership plan (ESOP) may reduce the costs of financing a leveraged buyout, as evidenced by the following example.

Example III-E

Partnership R purchases Target Company X for $3.0 billion, financed by $2.4 billion of debt and $600 million of equity capital. As part of the buyout agreement, X establishes an ESOP for its employees. X borrows $250 million from a commercial lender and secures the loan by mortgages and asset pledges. X then lends $250 million to the ESOP on substantially the same terms as the terms of X's loan from the commercial lender. The ESOP uses the loan proceeds to purchase $250 million of X's stock.

The ESOP pays off the loan with contributions made by X in subsequent years. Such contributions will equal the annual principal and interest payments required by the ESOP on the loan from X. As the ESOP makes such loan payments, X uses the payments to satisfy its repayment requirements to the commercial lender.

Under present law, the contributions of X to the ESOP, which equal the principal and interest payments on X's loan to the ESOP, generally are deductible under the rules governing deductions for contributions to qualified pension plans. Consequently, if an ESOP is established by X, X may deduct both the principal and interest payments on its loan. This result can be illustrated by comparing the following 2 cases:

Case 1.—X borrows $250 million from lender A. Only the interest on X's payments to A are deductible.

Case 2.—X establishes an ESOP, which borrows $250 million from lender A and uses the proceeds to purchase capital stock from X. X's payments to the ESOP equal the principal and interest payments on the ESOP's loan from A. X's payments are fully deductible.

In case 2, X has, in effect, borrowed $250 million from a lender and gets the benefit of a full deduction for its loan repayments. A further advantage of the use of an ESOP in the buyout of X is the special interest exclusion allowed under present law (sec. 133). The commercial lender who loans $250 million to X is entitled to exclude from gross income 50 percent of the interest it receives on the loan. Typically, this tax benefit is passed on partially to the borrower in the form of a reduced cost of borrowing (i.e., a lower interest rate on the loan).

A potential disadvantage of the use of an ESOP in this case is that the employees of X will receive an equity interest in X. As the ESOP loan is repaid, the stock of X purchased by the ESOP will be

allocated to the accounts of the ESOP participants. Thus, the ownership of the shares acquired through the ESOP ultimately will be transferred to the ESOP participants. The advantages of using the ESOP to finance a leveraged buyout or other transaction may not outweigh the disadvantage of transferring equity interests to employees.

Actual transactions

Leveraged ESOPs have been used in a variety of corporate financing transactions. For example, the Proctor and Gamble Company plans to add $1 billion (financed by debt) to its existing ESOP (thereby giving the ESOP a 20-percent interest in the company's common stock) in a transaction designed to provide substantial tax benefits and to offer a shield against a threat of hostile takeover. Similarly, the recent establishment of the J.C. Penney Company ESOP is widely viewed as an effort to deter a hostile takeover.

Leveraged ESOPs have also been used to accomplish leveraged buyouts by persons desiring to take a company private. The leveraged ESOP of Parsons Corporation accomplished such a result.

A more complete description of some of these transactions is contained in Part II.C. of this pamphlet.

IV. POLICY ISSUES

The recent wave of debt-financed mergers and acquisitions, both friendly and hostile, and the significant changes in patterns of corporate financing and distributions raise a number of public policy issues, including: (1) does the tax system encourage corporate debt financing relative to equity financing; (2) do leveraged buyouts increase economic efficiency or do they merely transfer wealth; (3) does the growth in corporate debt finance threaten macroeconomic stability; (4) does increasing leverage place additional demands on Federal guarantees of the financial system; and (5) does the role of ESOPs and tax-exempt institutions in these transactions reflect sound social policy?

A. Tax Advantage of Debt Versus Equity

The total effect of the tax system on the incentives for corporations to use debt or equity depends on the interaction between the tax treatment at the shareholder and corporate levels.

The case of no income taxes.—In a simple world without taxes or additional costs in times of financial distress, economic theory suggests that the value of a corporation, as measured by the total value of the outstanding debt and equity, would be unchanged by the degree of leverage of the firm.[88] This conclusion explicitly recognizes that debt issued by the corporation represents an ownership right to future income of the corporation in a fashion similar to that of equity. In this simple world there would be no advantage to debt or to equity and the debt-equity ratio of the firm would not affect the cost of financing investment.

Effect of corporate income tax

Tax advantages

Taxes greatly complicate this analysis. Since the interest expense on debt is deductible for computing the corporate income tax while the return to equity is not, the tax at the corporate level provides a strong incentive for debt rather than equity finance.

The advantages of debt financing can be illustrated by comparing two corporations with $1,000 of assets that are identical except for financial structure: the first is entirely equity financed; while the second is 50-percent debt financed. Both corporations earn $150 of operating income. The all-equity corporation pays $51 in corporate tax and retains or distributes $99 of after-tax income ($150 less

[88] Franco Modigliani and Merton Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, June 1958, pp. 261–297. Updated versions of this argument require only that market prices adjust so that there remain no available, unexploited arbitrage profits. *See* Stephen Ross, "Comment on the Modigliani-Miller Propositions," *Journal of Economic Perspectives*, Fall 1988, pp. 127–133, for a nontechnical discussion of this point.

$51). Thus, as shown in Table IV-A, the return on equity is 9.9 percent ($99 divided by $1,000).

Table IV-A.—Effect of Debt Financing on Returns to Equity Investment

Item	All-equity corporation	50-percent debt-financed corporation
Beginning Balance Sheet:		
Total assets	$1,000	$1,000
Debt	0	500
Shareholders' equity	1,000	500
Income Statement:		
Operating income	150	150
Interest expense	0	50
Taxable income	150	100
Income tax	51	34
Income after corporate tax	99	66
Return on Equity [1] (percent)	9.9	13.2

[1] Return on equity is computed as income after corporate tax divided by beginning shareholders' equity.

The leveraged corporation is financed by $500 of debt and $500 of stock. If the interest rate is 10 percent, then interest expense is $50 (10 percent times $500). Taxable income is $100 after deducting interest expense. The leveraged corporation is liable for $34 in corporate tax (34 percent times $100) and distributes or retains $66 of after-tax income ($100 less $34). Consequently, the return on equity is 13.2 percent ($66 divided by $500). Thus, as shown in Table IV-A, increasing the debt ratio from zero to 50 percent increases the rate of return on equity from 9.9 to 13.2 percent.

This arithmetic demonstrates that a leveraged corporation can generate a higher return on equity (net of corporate income tax) than an unleveraged company or, equivalently, that an unleveraged company needs to earn a higher profit before corporate tax to provide investors the same return net of corporate tax as could be obtained with an unleveraged company. More generally, the return on equity rises with increasing debt capitalization so long as the interest rate is less than the pre-tax rate of return on corporate assets. This suggests that the Code creates an incentive to raise the debt-equity ratio to the point where the corporate income tax (or outstanding equity) is eliminated.

Costs of financial distress

With higher levels of debt the possibility of financial distress increases, as do the expected costs to the firm which occur with such distress. These additional costs include such items as the increase in the costs of debt funds; constraints on credit, expenditure or operating decisions; and the direct costs of being in bankruptcy. These expected costs of financial distress may, at sufficiently high

debt-equity ratios, offset the corporate tax advantage to additional debt finance.

Effect of shareholder income tax

The above analysis focuses solely on the effect of interest deductibility at the corporate level. Shareholder-level income taxation may offset to some degree the corporate tax incentive for corporate debt relative to equity.

Shareholder treatment of debt and equity

The conclusion that debt is tax favored relative to equity remains unchanged if interest on corporate debt and returns on equity are taxed at the same effective rate to investors. In this case, the returns to investors on both debt and equity are reduced proportionately by the income tax; the advantage to debt presented by corporate tax deductibility remains. One noteworthy exception exists if the marginal investments on both debt and equity are effectively tax-exempt.[89] Given the previously documented importance of tax-exempt pension funds in the bond and equity markets, this case may be of some importance (See Part I.B. of this pamphlet).

Shareholder level tax treatment of equity

In general, returns to shareholders and debtholders are not taxed the same. Although dividends, like interest income, are taxed currently, equity income in other forms may reduce the effective investor-level tax on equity below that on debt. First, the firm may retain earnings and not pay dividends currently. In general, the accumulation of earnings by the firm will cause the value of the firm's shares to rise.[90] Rather than being taxed currently on corporate earnings, a shareholder will be able to defer the taxation on the value of the retained earnings reflected in the price of the stock until the shareholder sells the stock. Thus, even though the tax rates on interest, dividends, and capital gains are the same, the ability to defer the tax on returns from equity reduces the effective rate of individual tax on equity investment below that on income from interest on corporate debt.[91]

Other aspects of capital gain taxation serve to reduce further the individual income tax on equity. Since tax on capital gain is normally triggered after a voluntary recognition event (e.g., the sale of stock), the taxpayer can time the realization of capital gain income when the effective rate of tax is low. The rate of tax could be low if

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[89] Merton Miller and Myron Scholes ("Dividends and Taxes," *Journal of Financial Economics*, 1978, pp. 333-364) suggest that certain nuances of the Tax Code may render otherwise taxable investors untaxed on the margin between interest and equity. For example, if a taxpayer has investment interest expense that cannot be deducted because it exceeds current investment income to the taxpayer, any additional dividends is effectively sheltered from tax by additional interest deductions. Daniel Feenberg ("Does the Investment Interest Limitation Explain the Existence of Dividends?" *Journal of Financial Economics*, 1981) presents evidence that this argument was unlikely to be important for most individual investors. However, the reduction in the deductibility of consumer interest by the 1986 Act may increase the plausibility of this argument.

[90] Alan Auerbach ("Wealth Maximization and the Cost of Capital," *Quarterly Journal of Economics*, 1979, pp. 488-500) argues that, for mature firms, that a dollar of retained earnings will cause the value of the firm to increase by less than a dollar.

[91] Before the 1986 Act, the 60-percent capital gain exclusion caused a further reduction in the effective rate of tax on equity investment.

the taxpayer is in a low or zero tax bracket because other income is abnormally low, if other capital losses shelter the capital gain, or if changes in the tax law cause the statutory rate on capital gains to be low. Perhaps most important, the step up in the adjusted tax basis of the stock upon the death of the shareholder may permit the shareholder's heirs to avoid tax completely on capital gains. For all these reasons, the effective rate of tax on undistributed earnings may be already quite low.

Corporations can distribute their earnings to owners of equity in forms that generally result in less tax to shareholders than do dividend distributions. Share repurchases have become an important method of distributing corporate earnings to equity holders. When employed by large publicly traded firms, repurchases of the corporation's own shares permit the shareholders to treat the distribution as a sale of stock (i.e., to obtain capital gain treatment, and recover the basis in the stock without tax).[92] The remaining shareholders may benefit because they have rights to a larger fraction of the firm and may see a corresponding increase in the value of their shares.[93] Thus, less individual tax will generally be imposed on a $100 repurchase of stock than on $100 of dividends. In addition, share repurchases allow shareholders to choose whether to receive corporate distributions by choosing whether to sell or retain shares, so as to minimize tax liability.[94]

Acquisitions of the stock of one corporation for cash or property of another corporation provides a similar method for distributing corporate earnings out of corporate solution with less shareholder tax than through a dividend. The target shareholders generally treat the acquisition as a sale and recover their basis free of tax. For purposes of analyzing the individual tax effect of corporate earnings disbursements, this transaction can be thought of as equivalent to a stock merger of the target with the acquiror followed by the repurchase of the target shareholders' shares by the resulting merged firm. The result is similar to the case of a share repurchase in that cash is distributed to shareholders with less than the full dividend tax, except that two firms are involved instead of one.

Since dividends typically are subject to more tax than other methods for providing returns to shareholders, the puzzle of why firms pay dividends remains. Because dividends are paid at the discretion of the firm, it appears that firms cause their shareholders to pay more tax on equity income than is strictly necessary.[95]

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[92] Sec. 302 governs the treatment of stock redemptions and may cause some repurchases to be treated as dividends.

[93] If a dollar of repurchases by the firm reduces the value of the equity by one dollar, the remaining shareholders are no worse off; if the repurchase reduces the value by less than a dollar (perhaps because the normally higher shareholder tax on dividends is avoided) the remaining shareholders are made better off. *See*, Auerbach, *supra*.

[94] Some have proposed that the taxation of share repurchases follow the taxation of dividend distributions at the investor level. One method by which this could be done is to treat the repurchase as a pro rata dividend to all shareholders followed by a pro rata sale of shares of the selling shareholders to the remaining shareholders. *See*, Chirelstein, "Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares," 78 *Yale Law Journal* 739 (1969).

[95] The trends outlined in Part I.A demonstrate that corporations are shifting away from dividends as the predominant method for distributing income.

Until a better understanding of corporate distribution policy exists, the role of dividend taxation on equity financing decisions remain uncertain.

To summarize, although the current taxation of dividends to investors is clearly significant, there are numerous reasons why the overall individual tax on equity investments may be less than that on interest income from debt. Since the effective shareholder tax on returns from equity may be less than that on debt holdings, the shareholder tax may offset some or all of the advantage to debt at the corporate level.

Interaction of corporate and shareholder taxation

With shareholders in different income tax brackets, high tax rate taxpayers will tend to concentrate their wealth in the form of equity and low tax rate taxpayers will tend to concentrate their wealth in the form of debt. The distribution of wealth among investors with different marginal tax rates affects the demand for investments in the form of debt or equity. The interaction between the demand of investors, and the supply provided by corporations, determines the aggregate amount of corporate debt and equity in the economy.

At some aggregate mix between debt and equity, the difference in the investor-level tax on income from equity and debt may be sufficient to offset completely, at the margin, the apparent advantage of debt at the corporate level. Even if the difference in investor tax treatment of debt and equity is not sufficient to offset completely the corporate tax advantage, the advantage to debt may be less than the corporate-level tax treatment alone would provide.

Some believe that, because the top personal tax rate was reduced below the top corporate tax rate in the 1986 Act and because the share of wealth held by tax-exempt entities is substantial, the tax advantage of debt at the corporate level outweighs its disadvantages to investors.[96] They would argue that changes in tax law have provided the motive force in the drive toward higher leverage. However, given that the observed changes in corporate financial behavior began well before 1986, the changes due to the 1986 Act may be of relatively little importance in determining changes in leverage and acquisition behavior. The individual rate reductions in the Economic Recovery Tax Act of 1981, some respond, started the shift toward more debt in corporate structures and the 1986 Act merely provided another push in that direction.

Implications for policy

The analysis above suggests that any policy change designed to reduce the tax incentive for debt must consider the interaction of both corporate and shareholder taxes. For example, proposals to change the income tax rates for individuals or corporations will change the incentive for corporate debt. Likewise, proposals to

[96] Merton Miller, "The Modigliani-Miller Propositions After Thirty Years," *Journal of Economic Perspectives*, Fall 1988, pp. 99–120. Also see the discussion of corporate integration in part V.A.1 of this pamphlet, *infra*, for a numerical analysis of various possible total tax effects and the effect of the Tax Reform Act of 1986.

change the tax treatment of tax-exempt entities may alter the aggregate mix and distribution of debt and equity.

In addition, proposals to reduce the bias toward debt over equity, for example, by reducing the total tax on dividends, must confront the somewhat voluntary nature of the dividend tax. Since the payment of dividends by corporations generally is discretionary and other means exist for providing value to shareholders with less tax, corporations can affect the level of shareholder level tax incurred. Until a better understanding of the determinants of corporate distribution behavior exists, the total impact of policies designed to reduce the bias between debt and equity are uncertain.

B. Corporate Restructurings and Economic Efficiency

While the actions of those involved in leveraged buyouts and other dramatic restructurings have generated much publicity, the economic impact of the transactions is more difficult to evaluate and quantify. One thing appears clear in leveraged buyouts: the target shareholders receive a premium, often substantial, above the price of the company's shares which prevailed previously in the market.[97] The source of this increase in value is important in evaluating the social desirability of these types of corporate restructurings.

1. Sources of value in leveraged buyouts and structurings

a. Taxes

One explanation for at least part of the increase in the value of corporations involved in leveraged buyouts appears to be the reduction in future corporate taxes arising from the increased amount of deductible interest. Other sources of tax benefits include, for example, those obtained through contributions to ESOPs and increased depreciation deductions.

The evidence suggests that firms that have undergone a leveraged buyout pay very little corporate tax, at least for some period, after the buyout. The present value of the corporate tax savings may account for a substantial portion of the premium paid by the acquiror. One study of 76 management buyouts in the 1980's, estimated that the present value of corporate tax savings obtained through increased interest deductions accounted for nearly all of the buyout premium (on average) if the level of debt were maintained permanently, and over a third of the premium (on average) if the debt were repaid over an 8-year period.[98] Another study of 93 buyouts between 1982 and 1986 estimated that the median value of the corporate tax savings due to increased interest deductions ranged between 50 percent to 90 percent of the premium paid in the buyout.[99] In addition, nearly half of firms in the first and

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[97] A typical premium is more than 40 percent of the existing stock price. *See* Steven Kaplan, "Management Buyouts: Efficiency Gains or Value Transfers," Center for Research in Security Prices, Graduate School of Business, University of Chicago, Working Paper #244, 1988.

[98] Steven Kaplan, "Management Buyouts: Evidence on Taxes as a Source of Value," Center for Research in Security Prices, Graduate School of Business, University of Chicago, Working Paper #245, 1988.

[99] Katherine Schipper and Abbie Smith, "Corporate Income Tax Effects of Management Buyouts," University of Chicago, unpublished, 1988.

second full years after the buyout, in one study, paid no corporate tax, compared to less than 15 percent of the firms before the buyout.[100] Also, the average ratio of Federal taxes to a broadly defined measure of operating income was substantially less after the buyout than before. This evidence suggests that corporate tax savings may account for a large part of the observed premium paid in leveraged buyouts.

As discussed above (Part IV.A), increases in taxes at the shareholder level are likely to offset, at least in part, the reductions in taxes at the corporate level, to the extent taxes on interest payments may be greater than taxes on dividends and ongoing capital gains of the displaced equity. Also, capital gains tax may be owed by shareholders in the buyout transaction which initially may offset a portion of the value of the corporate tax savings. Both the changes in shareholder-level tax and the reductions in the corporate-level tax may be reflected in the value of the firm. Thus, disentangling the total effects of taxes on firm values may be difficult.

b. Transfers of wealth

Other sources of value may be generated in buyout transactions by transferring wealth from other stakeholders in the firm. Some argue that pre-buyout debtholders have a portion of the value of their assets taken by the acquiror and existing shareholders because the debt they hold is less creditworthy after the buyout than before. The existing bondholders in the RJR/Nabisco leveraged buyout have filed a lawsuit based on this argument.[101] However, one study found little evidence that a substantial amount of value, relative to the premium amount or the value of the debt, is transferred from old bondholders in a typical buyout.[102]

Similar arguments can be made concerning the employees of a firm. If the acquiror of a company can successfully reduce compensation to employees, then gains reflected in the premium paid to shareholders merely represent transfers from the employees.[103] Ways in which this can be done include renegotiating contracts; firing redundant layers of management; deunionizing a workplace; reneging on implicit promises to pay retiree health benefits; and by cashing out overfunded pension plans the assets of which may have gone to pay higher pensions to employees in the future.

Management buyouts, in particular, raise the possibility that managers might use detailed information about the firm in order to appropriate gains for themselves in the resulting buyout company.[104] Under this hypothesis, the market has undervalued the

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[100] Kaplan, "Management Buyouts: Evidence on Taxes as a Source of Value," *supra*.

[101] The $5 billion of RJR Nabisco bonds outstanding lost around 20% of value during the buyout battle. Metropolitan Life and other bondholders have sued the management for damages. "LBOs: Greed, Good Business—or Both?" *Fortune*, January 2, 1989, pp. 66–68.

[102] Marais, Schipper, and Smith, "Wealth Effects of Going Private on Senior Securities," Working Paper, University of Chicago, 1988. The largest effect that an announcement of a buyout on traded bonds had in their sample was a 7 percent decline in value of the bonds. In terms of the premium in a typical buyout, this would imply a maximum effect of approximately 3 percent of the premium.

[103] See Andrei Shleifer and Lawrence Summers, "Breach of Trust in Hostile Takeovers," in Alan Auerbach, ed., *Corporate Takeovers: Causes and Consequences*, Chicago: University of Chicago Press, 1988, pp. 33–56.

[104] L. Lowenstein, "No More Cozy Management Buyouts," *Harvard Business Review*, 1986, pp. 143–156.

stock of the existing firm. Management, with superior information, arranges a buyout to exploit this undervaluation, passing some of the value to existing shareholders through the takeover premium, and obtaining control of the corporate assets for less than their true value. Others suggest that, once the bid becomes public, there is very little useful information available to the management that is not available to other potential acquirors. Thus, the management is unable to appropriate the value of the firm for themselves.

c. Efficiency gains of leveraged capital structures

Managerial incentives.—Some argue that buyouts and other capital restructurings generate real efficiency gains instead of merely transferring value from the Federal Treasury or other stakeholders. One way this could occur is if the buyout more closely aligns the incentives of the managers with those of shareholders. The larger the share of equity which managers control after the buyout, the greater the financial incentive for management to act in the best interests of all shareholders. Also, because there are fewer shareholders, shareholders and the board of directors are better able to monitor the actions of management to assure that they maximize shareholder value. Under this view, leveraged buyouts provide an exceptionally effective method for aligning the interests of management with the long-term interests of the firm and its shareholders.

A related argument is that management often squanders the full value of the firm through "pet projects," inefficient investment, and management perquisites. High levels of interest payments bind the management to pay out correspondingly high levels of operating income and thereby reduce the ability of management to squander the free cash flow generated by the firm.

A highly leveraged capital structure may force management to sell off underperforming divisions to those who can operate them more efficiently or cut back on unprofitable capital or research expenditures.[105] This reasoning provides a justification for the extensive divestitures which occur after some leveraged buyouts; the existing management team or corporate structure is unable to maximize the value of existing assets and must sell them to firms which can utilize the assets more effectively. Critics of leveraged buyouts argue instead that highly leveraged firms are forced to conduct a fire sale of their more valuable assets in order to meet the interest payments to their creditors. Others argue that firms are more valuable broken apart either because management is unable to manage the various assets effectively or because the market is unable to recognize the value of the individual parts. Some leveraged buyouts, under this view, are able to recognize the full value in the corporate assets by selling off the various corporate parts.

The direct evidence on whether leveraged buyouts increase operating efficiency is limited. One study of leveraged buyouts finds increases in measures of operating income and net cash flows after

[105] Allen Jacobs ("The Agency Cost of Corporate Control: The Petroleum Industry", Massachusetts Institute of Technology, 1986) presents evidence for the application of this theory to restructurings in the petroleum industry in the early 1980s.

the leveraged buyouts.[106] In contrast, another study finds no evidence of increased profitability in acquired businesses. However, this last study is based on older data which did not include leveraged buyouts.[107]

Research and capital expenditures.—Many analysts argue that highly leveraged firms become preoccupied with meeting debt service payments and sacrifice long-term growth for short-term savings. For example, debt-laden firms may reduce their research and development and capital expenditures since such reductions have small adverse effects on current revenues and free up current cash flow for interest payments. Critics of leveraged buyouts argue that reductions in research and capital expenditures will lead to lower productivity growth in the economy. Indeed, if long-term projects provide benefits which are not appropriable to the firm, it may be socially desirable for even unprofitable projects to be retained.

Proponents argue that leveraged buyouts may increase efficiency in the corporate sector even if highly leveraged firms reduce capital and research expenditures. Leveraged buyouts channel excess cash out of mature industries with relatively few investment opportunities, via interest payments, to other sectors of the economy with more productive investment opportunities. Furthermore, expenditures on capital and research in highly leveraged companies, although perhaps at lower levels, may be more efficient. Thus, even if firms involved in leveraged buyouts reduce research and capital spending, the level and efficiency of aggregate research and investment may increase as a result of leveraged buyouts.

In general, the managers of a highly leveraged corporation may have the incentive to engage in risky investments, such as research activities, because the risk of failure will fall on the debtholders while the equity holders obtain large benefits if the project is successful. Proponents of leveraged buyouts generally contend that this incentive is lacking in a typical buyout company because the goals of creditors and shareholders are more closely aligned than with other highly leveraged corporate structures.

While there are examples of highly leveraged firms which have reduced research efforts, the evidence of the effects on the economy are less clear.[108] One study of leveraged buyouts finds reduced capital expenditures by the firms involved after a leveraged buyout.[109] A study of over 300 acquisitions (but no leveraged buyouts) concludes that the results provide "very little evidence that acquisitions cause a reduction in R&D spending. In the aggregate the firms involved in mergers were in no way different in their pre- and postmerger R&D performance from those not so involved."[110]

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[106] Kaplan, "Management Buyouts: Efficiency Gains or Values Transfers?" *supra*. All such indicators, like those for capital expenditures, are often difficult to interpret because of accounting changes and the major asset restructurings that may be involved during or after these transactions.

[107] David Ravenscraft and F.M. Scherer, *Mergers, Sell-offs, and Economic Efficiency*, Washington: Brookings Institute, 1987. The interpretation of accounting data in comparing the profitability of a business before and after an acquisition is difficult and potentially misleading.

[108] *See*, for an example, "Impact on R&D is Newest Worry About LBOs," *The Washington Post*, December 12, 1988, p. H1.

[109] Kaplan, "Management Buyouts: Efficiency Gains or Value Transfers?" *supra*.

[110] Bronwyn H. Hall, "The Effects of Takeover Activity on Corporate Research and Development," in Alan J. Auerbach, ed., *Corporate Takeovers: Causes and Consequences*, University of Chicago Press, 1988, p. 93.

None of these studies address the impact on the aggregate level or efficiency of research expenditures.

The effect of high leverage.—The arguments about managerial efficiency suggest that highly leveraged capital structures provide a tighter alignment of managerial and shareholders interests that creates efficiency gains to the firm and the economy. There appears little reason, however, for deductible interest payments to be a prerequisite for achieving these outcomes. Presumably, capital structures that obtain the same reported efficiency gains as found in a leveraged buyout could be developed using similar forms of equity, such as cumulative preferred stock, instead of debt, in order to encourage these more efficient capital structures. Nevertheless, if the efficiency gains are large, it may be desirable to permit the use of debt, even if tax deductible, to encourage these transactions.

Conversely, these same arguments suggest that, where the composition of the shareholders is not much changed or debt and equity are not concentrated in the hands of those who can provide managerial oversight, the efficiency gains for restructuring may be limited. This argument implies restructurings less extensive than those which occur in most leveraged buyouts (e.g., extraordinary distributions or share repurchases discussed in Parts III.A. and B.) may have less potential to generate efficiency gains, and any benefits to the firm are more likely to come purely from tax effects.

2. Effects on firms not directly involved in buyouts

The growth in leveraged buyouts and highly leveraged capital structures may have impacts on firms which are not actively involved in these transactions. The development of highly leveraged firms may shift the allocation of capital toward firms which can be more cheaply and easily leveraged. It is often assumed that desirable leveraged buyout candidates are stable firms with a reliable cash flow available to meet the required interest payments. As funds shift toward these firms, capital may be allocated away from riskier investments. Indeed, if debt is truly tax advantaged, then the cost of funds may be reduced for industries which can support high leverage. Less stable industries then would face a relatively higher cost of capital.

Leveraged buyouts, and other restructurings, may benefit other corporations by releasing investment funds for their use. If these restructurings occur in mature industries with few investment opportunities, they may discourage investment and research in these industries. Other, more dynamic industries would now find a greater supply of funds available for their investment projects.

The ability to use high levels of debt has made it possible for relatively small organizations and groups to bid for and acquire larger firms. This may serve to encourage the existing management of potential targets to manage more effectively in order to avoid being acquired. The existence of potential acquirors may act as a disciplining device on all management for the efficient administration of corporate assets. This argument provides that acquisitions, particularly hostile ones, or at least the potential threat of takeovers, can increase operating efficiency in the economy.

Others believe that the existence of these potential acquirors has forced management to ignore long-term goals in order to please the

short-term demands of investors. The ability of potential acquirors to borrow large sums to mount an acquisition attempt, it is argued, has forced managers to engage in unproductive defensive behavior of which the primary goal is to avoid being acquired.[111]

C. Risks of Excessive Corporate Debt

1. Implication of excessive debt for financial stability and economic growth

Overview

Increased corporate indebtedness potentially has significant implications for the financial health of investors and issuers of the debt as well as for the economy as a whole. Corporate issuers with increased indebtedness must devote larger proportions of earnings and cash flow to interest payments. If leverage ratios are high, and if sales decline or expenses increase, firms may be forced to sell assets, reduce wage costs, or reduce capital and research expenditures. If such actions are insufficient to restore liquidity, debt restructuring or bankruptcy can result. Furthermore, losses incurred by investors holding the corporate debt of troubled firms could adversely affect their own balance sheets. If bankruptcies and debt restructurings are greater than expected, the negative effects could extend beyond distressed lenders and borrowers and reduce employment, income and growth in the economy as a whole. However, increased corporate indebtedness and even increased risk are not necessarily adverse developments, and there is by no means consensus among experts about the significance of increased debt. Some consider it an impending crisis; others consider it to be just one more aspect of financial innovation; yet others consider it as ultimately improving economic efficiency.

Recent concern with rising levels of corporate debt

Like household and Federal debt, debt of nonfinancial corporate business has grown faster than gross national product in each year since 1984. The growth of corporate debt has been highlighted by the highly visible rise in takeover-related debt, even though debt used in takeovers has been a small fraction of so-called "junk" bonds, and an even smaller portion of total corporate issues.[112] Higher corporate leverage is noted by the Federal Reserve Board in both of its 1988 Monetary Reports to Congress:

> The nonfinancial corporate sector remained highly leveraged and thus potentially vulnerable to adverse changes in the economic and financial environment.[113] . . .

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[111] Gregg Jarrell, James Brickley, and Jeffrey Netter ("The Market for Corporate Control: The Empirical Evidence Since 1980," *Journal of Economic Perspectives*, Fall 1988, pp. 49-68), however, summarize evidence which suggests that defensive actions which limit the ability to be acquired without shareholder intervention reduce the value of firm.

[112] Because of differences in definitions of debt related to mergers and leveraged buyouts, estimates of the percentages of junk bonds related to mergers and leveraged buyouts vary. For 1984, estimates range from 11 to 21 percent, and for 1985, estimates range from 19 to 31 percent. The Federal Reserve Board estimates that in 1984, 41 percent of all junk bonds were related to mergers and acquisitions in some way. See Robert A. Taggert, "'Junk' Bond Market's Role In Financing Takeovers," in Alan J. Auerbach, ed. *Mergers and Acquisitions*, University of Chicago Press, 1988.

[113] Federal Reserve Board, "Monetary Policy Report to Congress," *Federal Reserve Bulletin*, Vol. 74, No. 8, August 1988, p. 531.

> [B]usinesses have added greatly to their leverage in recent years. Many companies have dramatically increased their leverage through debt-financed merger, buyout, and share retirement activity. . . . A downturn in earnings would place serious debt-servicing strains on many individual firms.[114]

Debt-equity ratios

Notwithstanding the rise in the absolute level of corporate debt, debt-equity ratios do not provide a clear indication of increased financial stress or bankruptcy risk in the corporate sector. As shown in the second column of Table IV–B, the ratio of the book value of outstanding debt to the book value of equity has increased steadily throughout the 1980s. This ratio is now at a level exceeding its previous peak in the early 1970s. However, book values of equity do not embody expectations about future profitability, and therefore do not take into account the stock market's evaluation of the corporate sector's ability to repay debt.

[114] Federal Reserve Board, "Monetary Policy Report to Congress," *Federal Reserve Bulletin*, Vol. 74, No. 3, March 1988, p. 162.

Table IV–B.—Debt-to-Equity Ratios of Nonfinancial Corporations, 1962–1988

[Percent]

End of period	Ratio of debt to equity (book) [1]	Ratio of debt to equity (market) [2]
1962	38.0	42.1
1964	40.1	37.3
1966	42.7	32.2
1968	45.2	35.4
1970	45.9	47.7
1971	45.1	46.5
1972	44.8	45.2
1973	45.7	62.6
1974	39.6	88.9
1975	36.5	69.8
1976	35.4	71.0
1977	35.9	81.5
1978	34.3	83.8
1979	32.7	72.5
1980	30.5	54.0
1981	30.3	63.0
1982	30.4	63.4
1983	31.3	56.5
1984	35.2	67.2
1985	38.5	62.5
1986	42.8	61.7
1987	46.0	65.3
1988–Q3	N.A.	69.6
Averages:		
1971–75	42.3	62.6
1976–80	33.8	72.5
1981–85	33.1	62.5
1986–88	44.4	65.5

[1] Debt is valued at book, and equity is balance sheet net worth with tangible assets valued at replacement cost. All annual values are end-of-year.

[2] The market value of debt is an estimate based on par value and ratios of market to par values of New York Stock Exchange bonds; equity value is based on market prices of outstanding shares. All annual values are end-of-year.

Source: Division of Research and Statistics, Federal Reserve Board.

Another measure of leverage is the ratio of the market value of debt to the market value of equity, shown in the third column of Table IV-B.[114a] The ratio of market-valued debt to equity has remained relatively stable because the recent increase in the market value of stock has paralleled the increase in corporate debt issuance. Such measures provide some comfort for those concerned about the increase in corporate debt, but only to the extent it is believed the stock market is a reliable predictor of future ability to repay debt.[114b]

Interest coverage ratios

A measure of corporate leverage that stresses liquidity is the ratio of interest payments to cash flow. This measure is used by bond analysts to evaluate the risk of bankruptcy. The interest coverage ratio indicates the ability of firms to meet interest payments with current cash flows. A high interest coverage ratio suggests a decreased ability to weather a downturn in sales due to a recession or a rise in costs due, for example, to an increase in interest rates. Although there is no one standard definition of an interest coverage ratio, most measures display similar trends. Two interest coverage ratios are presented in Table IV-C. Both measures indicate that current levels of interest coverage are higher than in the past, especially for a period of economic expansion with relatively low rates of interest. This may explain why, unlike in other expansions, bankruptcies and defaults are increasing.

Table IV-C.—Interest Coverage Ratios of Nonfinancial Corporations, 1969–1988

Year	Ratio of net interest to cash flow [1]	Ratio of net interest to capital income plus economic depreciation [2]
1969	0.12	0.10
1970	0.14	0.14
1971	0.13	0.13
1972	0.12	0.12
1973	0.12	0.13
1974	0.13	0.16

[114a] The particular debt-equity ratios presented in Table IV-B are representative of a wide variety of debt-equity ratios used by economists and financial analysts. One series, the market value of debt to the replacement cost of tangible capital, displays trends similar to the ratio of market-value debt to market-value equity presented in Table IV-B. Like the market-value debt-equity ratio presented in the table, this ratio peaks in the 1970s, declines in the early 1980s, and recently has returned to levels comparable to the 1970s. While neither series has achieved its previous high level, the market value of debt to the replacement cost of tangible capital is much closer to its previous peak, since growth in the replacement cost of tangible assets has not kept pace with the rise in the stock market. Market prices, when available, are indicative of firm values and may be more accurate than replacement cost estimates.

[114b] The values presented in table IV-B are end-of-period values. Given the volatility of market prices, the ratio of average debt to average equity might be more representative of the debt to equity ratio over the year.

Table IV-C.—Interest Coverage Ratios of Nonfinancial Corporations, 1969-1988—Continued

Year	Ratio of net interest to cash flow [1]	Ratio of net interest to capital income plus economic depreciation [2]
1975	0.15	0.14
1976	0.14	0.11
1977	0.14	0.11
1978	0.14	0.11
1979	0.14	0.11
1980	0.18	0.13
1981	0.21	0.16
1982	0.18	0.15
1983	0.22	0.19
1984	0.18	0.15
1985	0.18	0.15
1986	0.20	0.15
1987	N.A.	0.16
1988	N.A.	0.17
Averages:		
1971-75	0.13	0.14
1976-80	0.15	0.11
1981-85	0.19	0.15
1986-88	N.A.	0.15

[1] Source: Ben S. Bernanke and John Y. Campbell, "Is There a Corporate Debt Crisis?" *Brookings Papers on Economic Activity,* No. 1, 1988, pp. 83-125.
[2] Source: Division of Research and Statistics, Federal Reserve Board.

Credit quality

There has been a general decline in the quality of corporate credit over the last decade. Table IV-D shows that in each year from 1977 through 1988, the number of downgradings of corporate debt has exceeded upgradings. The average annual net number of downgradings during the last three (nonrecession) years of 92 exceeds the previous peak of 88 net downgradings reached during the 1982 recession. Unpublished data from the Federal Reserve indicates that the (unweighted) average rating on outstanding corporate bonds has steadily declined from a Standard & Poor's rating of A+ to a rating of A- during the 1978-1988 period.

Table IV-D.—Ratings Changes on Corporate Securities, 1976–1988

Year	Upgradings	Downgradings	Net upgradings
1976	19	35	−16
1977	30	43	−13
1978	29	34	−5
1979	31	47	−16
1980	31	69	−38
1981	41	75	−34
1982	48	136	−88
1983	56	109	−53
1984	86	94	−8
1985	72	145	−73
1986	69	176	−107
1987	66	148	−82
1988 [1]	95	183	−88

[1] Annual figures estimated from three quarters of data.

Source: Division of Research and Statistics, Federal Reserve Board.

Table IV-E shows percentages of new public issues of below-investment-grade debt to total new public issues of debt.[115] These percentages are measures of the credit quality of newly issued debt. Over the 1983-88 period, the percentage of below investment-grade issues averaged 19 percent. During the previous ten-year period, this percentage was consistently below 10 percent.[116] The percentage of low-quality bond issues has averaged 24 percent since 1986.[117]

[115] The term below-investment-grade refers to bonds that are rated BB or lower by Standard and Poor's or Ba or lower by Moody's. Such bonds are popularly known as "high-yield" or "junk" bonds.

[116] Frederick H. Jensen, "Recent Developments in Corporate Finance," *Federal Reserve Bulletin*, Vol. 72, No. 11, November 1986, p. 748.

[117] Some analysts note that bond rating standards may not be comparable over long periods.

Table IV–E.—Ratio of Below-Investment-Grade to Total New Public Offerings of Corporate Debt, 1983–1988

[In percent]

Period	Below-investment-grade to total offerings
1983	14.9
1984	20.8
1985	16.6
1986	23.8
1987	24.5
1988 [1]	23.9
1985–Q1	14.8
1985–Q2	16.2
1985–Q3	17.0
1985–Q4	17.9
1986–Q1	17.2
1986–Q2	27.9
1986–Q3	27.0
1986–Q4	23.9
1987–Q1	22.7
1987–Q2	28.9
1987–Q3	33.6
1987–Q4	13.0
1988–Q1	10.9
1988–Q2	21.4
1988–Q3	30.7
1988–Q4 [1]	41.7

[1] Preliminary, as of November 30, 1988.

Source: Division of Research and Statistics, Federal Reserve Board.

Potential bankruptcies and financial distress

These data, except for the ratios of market value of debt to the market value of equity, indicate that corporations may have greater risk of experiencing financial stress than in the past. A recent study reports results of historical simulations which show how over 600 large corporations, leveraged as they were in 1986, would have fared in the 1974-75 and 1981-82 recessions.[118] In the 1974-75 recession, stock market values plummeted. Simulations show that a similar recession would decrease the value of assets to a point that would threaten the solvency of 10 percent of the firms that did not have similar financial distress in actual 1974-75 recession. In the 1981-82 recession, stock prices remained stable but interest rates rose substantially. Simulations of this recession on over 1000 large firms show that highly leveraged firms might have more financial

[118] Ben S. Bernanke and John Y. Campbell, "Is There a Corporate Debt Crisis?" *Brookings Papers on Economic Activity*, No. 1, 1988, pp. 83-125.

difficulty than they did in the actual 1981-82 recession. In such cases, illiquidity might force firms into bankruptcy. These simulations are only suggestive, and there is some evidence that high levels of debt primarily have been incurred in leveraged buyouts in industries better able to weather business downturns.[119] However, the simulations do indicate that in the event of a recession, more corporations than usual would be unable to meet their contractual debt obligations.

The costs of bankruptcy and financial distress

An unexpectedly large number of bankruptcies could result in real costs to the economy. These costs cannot be attributed to declines in asset values since assets formerly held by the bankrupt corporations would still exist and presumably move to other productive uses. Instead, bankruptcies impose other direct and indirect costs. Direct costs are attributable to administrative and legal expenses. However, it is widely believed that these costs are only a small component of the total cost of bankruptcy. Indirect costs include difficulty in refinancing debt, cancellation of trade credit, distraction of management, and disruption in operations. Recent studies indicate that the indirect costs of financial stress and bankruptcy are significant.[120] One study reports estimates of bankruptcy costs which on average range from 11 percent to 17 percent of pre-bankruptcy stock value.[121]

Some commentators suggest that financial stress is less likely to result in bankruptcy for debt associated with leveraged buyouts since debtor-creditor relationships are less formal. It is argued that, because these corporations are no longer publicly-owned, negotiations surrounding restructuring would proceed more smoothly. Therefore, financial stress is less likely to result in direct and indirect costs of bankruptcy. Investors in risky debt may fully expect to renegotiate terms in the event of a business downturn. As one practitioner has noted: "It may be that what these institutions are now buying in leveraged buyouts is equity 'in drag'." [122] Due to these changes in institutional relationships, risks of bankruptcy may not have risen along with the increase in leverage. It is frequently maintained that substantially higher debt-equity ratios in Europe and Japan may be sustained without increased bankruptcy risk because of the close ties between lenders and debt-issuing firms.[123]

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[119] Stephen R. Waite and Martin S. Frisdan, "The Credit Quality of Leveraged Buyouts," *High Performance*, Morgan Stanley, January, 1989.

[120] See, for example, Michelle J. White, "Bankruptcy and the New Bankruptcy Code," *Journal of Finance*, Vol. 38, No. 2, May 1983, pp. 477-488; and David M. Cutler and Lawrence H. Summers, "The Cost of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation," *Rand Journal of Economics*, Vol. 19, No. 2, Summer 1988, pp. 157-172.

[121] Edward I. Altman, "A Further Empirical Investigation of the Bankruptcy Cost Question," *Journal of Finance*, Vol. 39, No. 4, September 1984, pp. 1067-1089.

[122] David Schulte et. al., "A Discussion of Corporate Restructuring," University of Rochester School of Management, Reprint Series No. MERC-R-84, 1984, p. 51.

[123] See, for example, Albert Ando and Alan Auerbach, "The Cost of Capital In the U.S. and Japan: A Comparison," University of Pennsylvania, January 1988.

2. Implications of financial instability for the Federal Government

Financial institutions

The Competitive Equality Banking Act of 1987 reaffirmed "the sense of the Congress" that deposits in federally insured deposit institutions are backed by the full faith and credit of the United States. There is little doubt that the Federal government stands behind depositors to the extent the Federal Deposit Insurance Corporation's and the Federal Savings and Loan Insurance Corporation's resources should ever be insufficient to meet their insurance obligations. To the extent takeover related loans increase the riskiness of the assets of insured banks and thrifts, the potential liability of the Federal government as the ultimate insurer of bank deposits also increases.

As the takeover-related "junk" bond market has grown, banks and thrift institutions have increased their holdings of below-investment-grade corporate bonds. This has been a significant development in commercial bank lending and, to a lesser extent, in thrift lending, but this does not necessarily pose any special risk different from the other risky lending activities.

Typically, large banks underwrite leveraged buyout loans and then syndicate major portions of leveraged buyout loans to other banks, insurance companies, and pension funds. These loans are usually collateralized and have senior status, and banks usually diversify their holdings across a large number of leveraged buyout deals. However, a few banks retain most or all of the leveraged buyout loans that they originate, and not all risk can be eliminated by diversification. A recent report by Standard and Poor's suggests that increased debt associated with buyouts and restructurings will likely lead to an increase in loan losses of commercial banks in a recession.[124] However, this bond rating agency has not downgraded the credit rating of any bank as a result of any leveraged buyout financing. In December 1988, Federal bank regulators urged caution by the banks and more scrutiny by bank examiners with regard to loans for leveraged buyouts.[125]

Compared to banks, thrifts are relatively minor participants in the leveraged buyout loan market. Data is not available on thrifts' holdings of leveraged buyout debt specifically, but only on their holdings of all below-investment-grade bonds. Even though low-quality bond holdings of thrifts have more than doubled since 1985, only a small fraction of the 3,400 FSLIC-insured institutions in the U.S. holds low-quality bonds. Although below-investment-grade bonds are only a small fraction of total assets held by FSLIC-insured institutions, the concentration of large amounts of below-in-

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[124] Andrew M. Aran, "LBOs Raise Banks' Risks," *Standard and Poor's Credit Week*, December 5, 1988, p. 21.

[125] Although increased loan loss reserves or capital might eventually be required of banks engaged in large amounts of risky takeover-related debt, restrictions on such lending by commercial banks seems unlikely. Comptroller of the Currency Robert C. Clarke has commented that "in general, the financing of highly leveraged transactions is a legitimate banking activity, as long as a bank's board of directors and management follow prudent banking principles to guard against unnecessary credit and legal risks." Clarke was quoted by Robert E. Taylor, "Agencies May Press Banks in Risky LBOs to Build Reserves, Raise Capital Levels," *Wall Street Journal*, December 16, 1988.

vestment-grade bond holdings among relatively few thrift institutions may be a potential problem.[126]

Potential assistance to large corporations

The obligations of the Federal Government are less well defined in the case of failing non-Federally insured corporations. The diverse constituencies of shareholders, creditors, suppliers, and employees of a large corporation can bring considerable pressure on the Federal Government to avert bankruptcy. Such assistance was provided to the Chrysler Corporation in the 1970's. As the size of targets for leveraged buyouts becomes increasingly large, the perceived necessity of Federal assistance, if bankruptcy occurs, also may increase. If recent increases in nonfinancial corporate leverage increase the risk of bankruptcy, potential government liabilities may have increased.

Implications of increased leverage for macroeconomic policy

Beyond any potential direct assistance provided to avert distress resulting from excess debt, the Federal Government's concern with excessive corporate debt will be manifested in its macroeconomic policy. Higher levels of corporate leverage leave the economy more vulnerable to small contractions in business activity. Recession could result in cash flows insufficient to pay interest on debt, and cause levels of bankruptcies and unemployment above those normally experienced in a downturn. This could put pressure on the Federal Reserve to increase monetary growth. If the Federal Reserve is indeed more likely to ease monetary policy as a result of increased leverage, avoidance of bankruptcies may come at the price of inflation.

D. Issues Related to the Use of Pension Plan Assets

Qualified pension plan assets typically play a role in the financing of leveraged buyout transactions in three basic ways: (1) through the use of an ESOP; (2) by using the excess assets of a defined benefit pension plan; and (3) as a general investment by the plan, such as investing in a leveraged buyout fund. Qualified plan assets can be used by both management of the target and the purchaser; for example, they can be used to finance a takeover and also can be used as part of defensive tactics to prevent a hostile takeover. The use of qualified plan assets in leveraged buyouts raises tax as well as retirement policy questions. In addition, the security of a defined benefit pension plan maintained by a company that has been involved in a leveraged buyout may be affected by the buyout.

1. Employee stock ownership plans

General tax issues

The Code contains numerous tax incentives designed to encourage the acquisition of employer securities by ESOPs, particularly if a leveraged ESOP is utilized. Those who favor the special tax bene-

[126] Robert A. Taggert, "'Junk' Bond Market's Role In Financing Takeovers," in Alan J. Auerbach, ed. *Mergers and Acquisitions*, University of Chicago Press, 1988.

fits available to ESOPs generally argue that ESOPs serve to expand capital ownership to workers. Some would also argue that worker ownership, in turn, increases worker productivity and profitability of the company. Proponents of the tax benefit for ESOPs argue that leveraging is an integral part of the transfer of ownership process, because borrowing is often the only way that an ESOP can obtain the funds to acquire a significant block of employer securities. The 1983 purchase of Weirton Steel Corporation by employees is often cited as a successful leveraged buyout by an ESOP.

The tax benefits afforded ESOPs make them particularly attractive in leveraged buyout transactions. Because both principal and interest payments on an ESOP loan are deductible, use of an ESOP can result in a lower cost of borrowing than if conventional debt were used. In addition, the partial interest exclusion under section 133 permits lenders to charge a lower interest rate to ESOPs than to other lenders, further lowering the cost of acquiring employer securities through an ESOP. Anecdotal evidence indicates that the subsidy provided by the exclusion of interest under section 133 typically results in an interest rate for ESOP loans that is 10 to 20 percent less than the rate charged with respect to other loans. This rate reduction can result in significant interest savings over the term of the loan and reduce cash flow.

The tax incentives for sales of stock to an ESOP may be used in a leveraged buyout and may also reduce acquisition costs. For example, the ability to roll over gain on the sale of stock to an ESOP (sec. 1042) creates an incentive for significant shareholders to transfer their stock to an ESOP. Part of the tax benefits available to the sellers are typically passed on to the ESOP in the form of a lower price for the shares.

The significant savings possible because of the tax benefits provided to ESOPs make ESOPs more attractive than other forms of financing. In addition, because the saving can be so attractive, the incentives may also serve to increase the overall level of leveraging.

It is not clear what percentage of leveraged buyouts involve ESOPs. However, some evidence indicates that ESOPs are used in a relatively small number of transactions. This could be true for a number of reasons. The tax savings possible through an ESOP are not likely to cause a company to establish an ESOP unless it is otherwise economically feasible to do so. In some cases, the need for tax benefits may be outweighed by the requirement that the stock is to be transferred to the employees participating in the ESOP as the ESOP is repaid. It also may be that companies that have other ways to shelter income from tax do not find ESOPs as attractive as other leveraging devices because of the transfer of ownership to employees.

The tax benefits provided for ESOPs raise the question of whether those benefits in fact accomplish the purpose for the tax benefits the expansion of stock ownership to employees. Some would argue that ESOPs do not accomplish the goal of the tax benefits, i.e., because present law does not require that ESOP participants enjoy the full benefits of stock ownership and also because the benefits of stock ownership are deferred.

For example, in a leveraged ESOP, shares are allocated to participants' accounts over time as the loan is repaid, which may take as long as 10 years. Unallocated shares are held in a suspense account. While the shares are held in the suspense account they do not have to be voted by ESOP participants and are typically voted by representatives of management. As the loan is repaid and shares are allocated, the participants will have full voting rights if the stock is publicly traded. However, ESOPs are often used by privately held companies, and in such cases participants are entitled to vote only on major corporate issues, such as mergers and acquisitions, and thus may have little opportunity to influence operation of the company.

The economic benefits of stock ownership may also be deferred in an ESOP. For example, employees generally do not have a right to receive a distribution of the employer securities until separation from service and any realization of the appreciation of the stock is deferred until the time of distribution. In addition, because the stock may be subject to vesting requirements, some participants will only receive a fraction of the shares allocated to their accounts.

The General Accounting Office (GAO) [127] reviewed ESOPs in a series of reports. Their findings were summarized in the fourth and final report. In general, the GAO found that ESOPs have broadened stock ownership among plan participants, but that the effect of ESOPs on the overall distribution of stock ownership has been limited. GAO also found that a relatively small percentage of ESOPs are leveraged, and of those that are leveraged, most used the funds to buy out existing owners. GAO also stated that ESOP ownership does not imply extensive employee control over management of a company, and found little evidence to substantiate assertions that ESOPs result in increased productivity and profitability.

As indicated by the GAO in its report, the overall impact of ESOPs is not yet clear. There is still not very much information on ESOPs. One of the reasons why the GAO may have found limited impact is that it may be that ESOPs have more of a long-term, rather than short-term, effect. In addition, the effects of recent changes in the tax incentives for ESOPs have not yet been thoroughly analyzed. These changes may have increased the establishment of ESOPs resulting in greater transfer of stock ownership to employees.

Employee equity and retirement policy issues

As discussed above (in Part II.C. of this pamphlet), the Employee Retirement Income Security Act (ERISA) requires that the ESOP receive adequate consideration for its investment and that sales of stock to an ESOP satisfy the general fiduciary rules. The Department of Labor (DOL) has authority to review ESOP transactions to determine if these requirements are satisfied, and failure to satisfy them is a violation of ERISA's fiduciary rules.

Fiduciary issues and the issue of adequate consideration can arise in a number of contexts. For example, some argue that the

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[127] *Employee Stock Ownership Plans: Little Evidence of Effects on Corporate Performance* (GAO/PEMD-88-1, October 1987).

ESOP should not receive as high a return on its investment as other investors because the employer may be obligated to repay the loan. Thus, they argue, the ESOP's interest is more in the nature of debt than equity. Or, the ESOP may have paid a premium for the stock because, immediately after the transaction, it owned a substantial portion of the company. However, it is common for other investors to receive options, with the result that the interest of the ESOP may be diluted over time, and therefore the value of the ESOP's stock will decrease. Whether or not the adequate consideration requirement is met is such a case may depend on whether the price paid by the ESOP adequately reflects the possible future dilution. The limitations placed on the terms of ESOP transactions under the adequate consideration rule and the fiduciary rules may be one reason why, despite the attractive tax benefits, the parties to a transaction may decide not to use an ESOP. These rules may require a greater portion of the equity to be transferred to employees than the parties to the transaction require.

It is often difficult to determine whether an ESOP receives adequate consideration and is in fact advantageous from the point of view of the employees in general, particularly because the ESOP may not be independently represented in the transaction. While the DOL has been involved in some cases, the DOL does not become involved in every ESOP transaction for several reasons. For example, the parties to the transaction may not ask the DOL for its opinion that the transaction meets ERISA's requirements, the transaction may not otherwise come to the attention of the DOL (e.g., by way of employees), or DOL resource limitations may preclude more extensive enforcement activity.

From a retirement policy perspective, there is also concern that the tax incentives for leveraged ESOPs encourage the establishment of ESOPs over the establishment of other types of tax-qualified retirement plans, and even encourage the conversion of pension plans into ESOPs. ERISA's diversification requirement for pension plan assets is designed to ensure that pension benefits are funded with assets the value of which is independent of the value of the employer. If an ESOP is a company's only or main retirement plan, then the goal of diversification as a means of assuring retirement security may not be accomplished. If retirement security is reduced, ultimately the social security system may be forced to provide a greater share of retirement benefits.

2. Use of excess defined benefit pension plan assets

Under present law, if a company terminates a defined benefit pension plan, any assets in excess of the assets necessary to provide for employees' accrued benefits may be returned to the employer if the plan has provided for such reversion for 5 years before the reversion. In general, any such reversion is includible in income and is subject to a 15-percent excise tax. There are no restrictions on the employer's use of the excess assets.

Because excess assets are a ready source of cash, the existence of excess assets in a defined benefit pension plan may make a company attractive as a target, and some transactions have involved the termination of a defined benefit pension plan in order to help finance the acquisition. In addition, existing management may ter-

minate the plan and recover the excess assets as part of takeover activity, for example, in order to make the company a less attractive target, or to use the funds offensively in its own takeover initiatives.

When a pension plan terminates, benefits accrued up to the date of termination are protected. The employer has to acquire annuities to provide for those benefits. The right to any future benefits, and thus whether or not employees are better or worse off following a plan termination, depends on what type of plan, if any, the employer maintains following the termination. If the employer maintains a comparable plan, then the employees may be in just as good a position after the termination as before. If, however, the employer does not adopt another plan, or establishes a less generous or a less diversified plan such as an ESOP, then the retirement security of the participants may have been impaired.

The question of what to do with excess pension assets may become less important over time. The number and amount of reversions generally has been decreasing. In addition, the Revenue Act of 1987 added a new limitation on the maximum deduction for contributions made to defined benefit pension plans which is based on the amount of benefits that must be provided on plan termination. This new limit will tend to reduce the incidence of overfunding. In addition, an excise tax is imposed on nondeductible contributions to a qualified pension plan, which further discourages excessive funding of qualified plans.

3. Investment by pension plans

The aspect of qualified plan involvement in leveraged buyouts that has received attention most recently is the participation by pension plans as an investor. Such investments generally raise two issues (1) whether such investments are too risky and therefore jeopardize the solvency of the pension plan, and (2) whether the availability of pension plan assets increases the level of leveraging.

With respect to the first issue, there is little evidence that leveraging investments are any more risky than other investments available to pension plans. Indeed, such transactions are often very profitable. As long as the ERISA fiduciary and diversification standards are met with respect to the investment, then leveraged buyout investments may present little risk of overall loss to a pension plan.

With respect to the second issue, the concern is that if too much leveraging is not beneficial to the economy, then perhaps pension plans (which have significant amounts of assets) should not be permitted to invest in leveraging transactions. Such concerns led New York Governor Cuomo to call for a freeze on leveraged buyout investments by the state's $39 billion public employee pension fund.[127a]

This issue is not a pension issue, but rather involves the broader question of whether there is an excessive level of leveraging. If so, then there are more direct ways to deal with the problem than limiting the types of investments that can be made by pension plans.

[127a] *The Wall Street Journal*, November 29, 1988, p. C-21.

4. Effect on pension plans of leveraged companies

Leveraged buyout transactions may affect the solvency of defined benefit pension plans and increase the risk to the Pension Benefit Guaranty Corporation (PBGC), which guarantees a portion of the benefits under such plans, and the risk to plan participants. First, a company that has undergone a leveraged buyout may be short on cash and therefore may have difficulty satisfying its funding obligation to the plan, with the result that the plan becomes underfunded.

If a company with an underfunded pension plan is in financial distress, the company may terminate the plan, and the PBGC pays guaranteed benefits to plan participants to the extent such benefits cannot be paid from plan assets. The PBGC attempts to recoup at least a portion of its benefit payments from the company. If a company is highly leveraged and has used the leveraging to make distributions to shareholders, then the level of assets in the company may be depleted so that there are insufficient assets to pay all creditors. In that case, the PBGC will generally not be able to recoup its benefit payments and will suffer a loss which is borne by the Federal government.

There is yet little, if any, evidence linking leveraging with underfunded defined benefit pension plans. As a result, the extent to which leveraging increases the risk to PBGC is not yet clear.

E. The Role of Interest Deductions in Taxing Economic Income

1. Theories of interest deductibility with a single level tax

Measuring economic income

An accurate measurement of an individual's economic income would provide for an appropriate deduction for real (as opposed to nominal) interest payments.[128] Real interest expense represents an appropriate measure of one of the costs of earning income or financing the consumption of individuals. In a simplified world with a single rate of tax on all economic income, there would be no need to be concerned about disallowing interest. Moreover, there would be no need to distinguish between payments which were debt or, for example, payments which reflect an equity interest in business income. This result occurs because all income is taxed identically only once to the person who receives it.

If the effective rate of tax on some forms of economic income is less than the norm, then it may not be appropriate to permit deductions for all interest. For example, if the value of consumption services provided by consumer durables (e.g., an automobile) owned by an individual is not subject to tax, then it may be inappropriate to permit a deduction for interest on debt used to obtain such assets. An example in present law is the restriction on interest deductions used to obtain income from tax-exempt bonds (Sec. 265).

The treatment of nominal versus real interest poses problems in the measurement of economic income. The deduction (inclusion) of nominal interest in an inflationary period would be appropriate

[128] More precisely, it would permit a deduction for accruals of real interest owed.

only if, at the same time, decreases in the value of the remaining principal owed (due) were recognized in income.

For example, suppose a taxpayer owed $1,000, inflation were 10 percent, and the real interest rate was 5 percent. The nominal interest rate of 15 percent would generate an annual deduction of $150. However, after one year, the value of the principal owed by such a debtor would fall in real terms by 10 percent due to inflation, so that the real liability would fall by $100 (10 percent times $1,000). If this $100 decline in the real value of the liability were simultaneously recognized as income, then the real interest cost would be $50 (5 percent times $1,000 equals $150 minus $100). As this example shows, the measurement of real interest deductions (and real interest income) would require periodic revaluations of assets and liabilities which is a theoretically sound but administratively infeasible system.

Multiple tax rates and tax arbitrage

With different effective income tax rates applying to different taxpayers, as under the current tax system, the deduction of interest becomes a problem for the integrity of the tax system. Preferences and exclusions that apply to certain activities may cause the calculated taxable income to differ from the actual economic income from such activities. Thus, some forms of investment may be effectively subject to less tax than other forms of investments. If not all economic income is taxed the same, then high effective rate taxpayers have an incentive to invest in assets which are effectively less taxed, and low-rate taxpayers, accordingly, would invest relatively more in assets which bear more tax.

Debt makes easier the process of specializing in assets with different tax characteristics by taxpayers with different tax rates. High-rate taxpayers can borrow funds and obtain ownership of greater amounts of the asset taxed less; the low-rate taxpayers would generally be willing to lend the funds required because they will pay relatively little tax on the interest income. If the high-rate taxpayers can leverage heavily enough, they may be able to obtain the same economic income as before without paying tax; the interest deductions shelter their income from the tax-preferred assets. This shifting of income inclusions to low-rate taxpayers while deductions are taken by taxpayers with higher effective marginal rates in a manner that reduces total taxes paid is known as "tax arbitrage." Thus, debt assists in tax arbitrage by easing the transfer of low effective rate assets to high-rate taxpayers.[129] Viewed in another way, if interest is deducted by taxpayers with higher marginal tax rates than those who receive the interest income, then the tax system subsidizes the creation of debt.

Tax arbitrage provides one explanation for why tax-exempt organizations (including pension funds) hold large quantities of debt while taxable individuals hold relatively more equity which tends to be subject to lower levels of tax. With a large tax-exempt sector and highly efficient tax arbitrage methods, theoretically the tax on

[129] Deduction and inclusion of nominal instead of real interest during an inflationary period aggravates this problem, because the value of the overstated deductions to high-rate taxpayers would be greater than the detriment of overstated inclusions would be to low-rate taxpayers.

all income could be eliminated; clearly, tax arbitrage does not work that efficiently in the real world. However, as this description demonstrates, tax arbitrage is a problem even without a separate corporate income tax. This problem has led to the enactment of many tax provisions that attempt to limit interest deductions on specific activities or assets that yield taxable income less than economic income. The effectiveness of these provisions vary.

The ability to engage in tax arbitrage places pressure on the definition of debt and equity. Because interest on debt is deductible currently, high-rate taxpayers have the incentive to characterize funds obtained from low-rate taxpayers as debt in order to concentrate legal ownership of tax-preferred streams of economic income in their own hands. To the extent the tax system subsidizes debt-financed activities and the subsidy is viewed as undesirable, more general restrictions on interest deductibility may be appropriate, especially for high-bracket taxpayers. In order to avoid incentives for shifting activities among different classes of taxpayers (e.g., between corporate and noncorporate business, or between owner-occupied housing and business investment), these restrictions could apply uniformly to all debt.

2. Separate corporate income taxation

The above discussion assumes that there is only one level of tax. The introduction of a separate income tax on corporations that is not perfectly integrated with the individual income tax complicates the analysis. Because the total tax on the returns to capital held by the corporation may be taxed twice (once at the corporate level and again at the individual level), there may be an incentive to avoid tax by characterizing capital contributed to the corporation as debt. Thus, the corporation has incentives similar to the high-rate taxpayer in the analysis above. If income of corporations is not effectively taxed at a high rate by both levels of tax (see the discussion in Part IV.A), then the tax incentive to displace debt with equity may not be significant.

Under one view, the corporation earns income not for the benefit of its own consumption but for the benefit of its owners. In such a case, it is not clear what the appropriate calculation of income is for the separate corporate entity or how interest should enter into it. Indeed, much of modern corporate financial analysis is based on the premise that debt and equity *both* represent ownership claims on the future earnings and assets of the corporation. Within this framework it may be more plausible to treat corporate debt just like equity and permit *no* deduction at the corporate level for interest. Yet such treatment would create additional distortions between corporate and noncorporate forms of business and among various investment activities that may be viewed as more undesirable than the problems caused by debt finance.

This same type of analysis, however, leads one to question the justification for a separate, unintegrated tax on corporate income; the corporation could be viewed as a partnership between all debt and equity holders. Some believe, however, that the large corporate enterprise often possesses significant economic resources and acts, to some degree, for its own benefit and not necessarily for the bene-

fit of its creditors or shareholders. They would argue, therefore, that a separate corporate level tax is appropriate.

F. Revenue Considerations

In the four years following 1983, domestic nonfinancial corporations have retired $313 billion of net equity while increasing net indebtedness by $613 billion.[130] This rise in corporate debt finance has contributed to the growth of corporate interest deductions. In 1985, corporate interest expense shielded almost half of corporate income (before the interest deduction) from tax, up from less than one-quarter in 1976 (see Table IV–F, below). In other words, all other things equal, if the share of corporate income shielded by interest deductions had stayed at its 1976 level, the tax base of nonfinancial corporations in 1985 would have been almost 50 percent larger (76 percent, as compared with 53 percent, of corporate income before interest).[131] In this sense, the increase in debt finance may be said to have eroded the corporate tax base.

Table IV–F.—Interest Expense of Nonfinancial Corporations, 1976–1985

Tax year	Interest expense ($, billions)	Taxable income ($, billions)	Interest as a percent of taxable income before interest
1976	52.7	166.9	24.01
1977	59.5	191.2	23.73
1978	73.5	209.6	25.96
1979	97.1	251.2	27.88
1980	125.4	222.3	36.07
1981	162.9	219.6	42.59
1982	174.0	185.2	48.44
1983	164.7	196.2	45.64
1984	188.6	231.8	44.86
1985	205.6	231.4	47.05

Source: Dept. of the Treasury, Statistics of Income, Corporation Income Tax Returns, various years.

The corporate revenue loss (if any) attributable to the growth in debt finance may, however, be offset by revenue increases from other taxpayers. For example, the holders of this debt may be subject to U.S. income tax. This would not be the case for pension funds, tax-exempt organizations, or foreign bondholders.

[130] See Table I–A in Part I.B., of this pamphlet, *Supra.*

[131] Interest expense as a percent of taxable income reflects the proportion of debt finance, as well as the level of interest rates and of income excluded from tax (as a result of tax preferences such as accelerated depreciation). The effect of tax preferences can be corrected for, at least in part, by comparing interest expense to cash flow (rather than taxable income). For nonfinancial corporations, interest expense as a share of cash flow increased from an average of 13 percent in 1971–75 to 19 percent in 1981–85. (See Table IV–C in Part IV.C.1., of this pamphlet, *supra*).

Mergers and acquisitions, leveraged buyouts, redemptions, and debt-for-equity swaps typically result in a shareholder-level tax on capital gain which otherwise might not be recognized until some time in the future, if at all. These capital gains are magnified by the increase in share value that frequently occurs during takeover contests. Of course, no tax liability on this gain would be incurred by tax-exempt or foreign shareholders.

Care must be exercised in analyzing the net revenue effect of the growth in corporate debt finance because the revenue loss attributable to interest deductions must be balanced against the revenue gain associated with interest and capital gains income. Other factors also may be relevant. For example, rising interest deductions might cause corporations to reduce tax-preferred investments (because there is less income to shelter from tax). Moreover, the bidding up of target stock may be accompanied by a decline in the share value of corporations whose characteristics (such as volatile cash flow) make them poor leveraged buyout candidates.

The recent trends in debt and equity finance also may have a number of macroeconomic effects. For example, to the extent debt-financed corporate acquisitions increase the target corporation's productivity, income tax revenues may be enhanced. As another example, the increase in corporate debt issues may boost interest rates throughout the economy.

V. POSSIBLE OPTIONS AND RELATED POLICY CONSIDERATIONS

A. Eliminate or Reduce the Distinction Between Debt and Equity by Integrating the Corporate and Individual Income Tax Systems

1. Background

The two-tier tax

Under present law, C corporations and their shareholders generally are separate taxable entities. By contrast, income from capital invested in small business corporations ("S corporations") is allocated among and taxed directly to its shareholders, regardless of whether such income is distributed, under rules that are similar to the taxation of partnership income. Under a fully integrated income tax regime, such as the S corporation rules, there is no tax detriment (or benefit) to operating in corporate form.

Table V-A shows the additional tax burden attributable to operating a business in corporate versus noncorporate form, under the 1986 and 1988 tax law. For a corporation and shareholder in the top tax brackets in 1986, the two-tier tax on $100 of distributed corporate income amounted to $73 ($46 of corporate tax plus $27 of shareholder tax on the $54 distribution). If the $100 had been earned by a partnership, the total income tax burden would have been $50; consequently, the excess tax burden from operating in corporate form was $23 in 1986 ($73 minus $50). In 1988, after the 1986 Act, the tax penalty from operating in corporate form increased to $24.48 on $100 of fully distributed income, even though the total burden of operating in either corporate or partnership form was lowered.

The excess tax burden attributable to operating in corporate form also may be determined for corporate earnings that are not distributed, under the assumption that $1 of undistributed corporate income increases share value by $1.[132] In Table V-A, the maximum and minimum shareholder taxes on this gain are determined assuming, respectively, that (1) gain is realized after 6 months, or (2) gain is deferred indefinitely or excluded at death (i.e., zero tax).

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[132] Under some models of share valuation, the stock market value of the firm may increase less than dollar for dollar of undistributed income because shareholders take into account future tax liability upon distribution or realization of gain. See David Bradford, "The Incidence and Allocation Effects of Tax on Corporate Distributions," *Journal of Public Economics*, vol. 15, no. 1, (February 1981), pp. 1-22.

Table V-A.—Example of Two-Tier Tax on Corporate Income Under 1986 and 1988 Law

[Corporation and shareholder in top income tax bracket]

Item	1986 law		1988 law	
	Income distributed	Income retained	Income distributed	Income retained
Corporation level:				
Taxable income	$100	$100	$100	$100
Income tax [1]	46	46	34	34
Dividend distribution	54	0	66	0
Shareholder level:				
Ordinary income	54	.....	66	.....
Tax on ordinary income [2]	27	.....	18.48	.....
Capital gain [3]	.....	54	.....	66
Maximum tax on gain [4]	.....	10.80	.....	18.48
Minimum tax on gain [5]	.....	0	.....	0
Total two-tier tax burden:				
Maximum tax on gain	73	56.80	52.48	52.48
Minimum tax on gain	73	46	52.48	34
Tax under full integration	50	50	28	28
Excess tax burden: [6]				
Maximum tax on gain	23	6.80	24.48	24.48
Minimum tax on gain	23	−4	24.48	6

[1] Top corporate tax bracket is 46 percent in 1986 and 34 percent after 1987.

[2] Top individual income tax bracket is 50 percent in 1986 and 28 percent after 1987 ($100 dividend exclusion available in 1986 is disregarded).

[3] Assumes share price increases by full amount of retentions.

[4] Top individual tax rate on capital gains is 20 percent in 1986 and 28 percent after 1987. The maximum tax on capital gain is computed assuming realization after 6 months.

[5] The minimum tax on capital gains is computed assuming indefinite deferral or step-up of basis at death.

[6] Difference between two-tier tax burden and single-tier tax under full integration.

If the maximum tax on capital gains applied, in 1986 the two-tier tax on $100 of undistributed corporate income amounted to $56.80, as compared to $50 per $100 of income earned by a noncorporate business (see table, above). Thus, the tax penalty for operating in corporate form was $6.80 per $100 of retained income in 1986 ($56.80 minus $50). In 1988, the excess tax liability for operating in corporate form had increased to $24.48 per $100 of retained income—an increase of $17.68 ($24.48 minus $6.80) from 1986.

If the lowest possible (i.e., zero) tax on capital gains applied, in 1986 there was a tax advantage to operating in corporate form of $4 per $100 of retained earnings ($46 of tax per $100 of undistributed corporate income as compared to $50 per $100 of noncorporate income). By 1988, the $4 tax advantage to operating in corporate form had changed to a tax disadvantage of $6 ($34 of tax per $100 of undistributed corporate income as compared to $28 per $100 of partnership income).

Criticisms of the two-tier income tax system

Advocates of integration contend that the relationship of the separate corporate and individual income taxes tends to create certain distortions in economic decisions that should be alleviated by providing some form of relief from the two-tier tax.[133] Such advocates generally contend that the tax system should seek to provide (1) neutrality between corporate and noncorporate investment, (2) neutrality between debt and equity financing at the corporate level, and (3) neutrality between retention and distribution of corporate earnings.

Corporate vs. noncorporate investment.—The two-tier tax may discourage some from deciding to carry on business in corporate form in situations where nontax considerations indicate that corporate operations would be preferable. (The S corporation rules were developed to address this concern.) The extent to which this may occur depends in large part upon where the corporate tax ultimately falls: whether it is passed on to consumers, employees, or others, or borne by the owners of the corporation's stock.

Debt vs. equity finance.—The two-tier tax in its present form tends to encourage financing corporate investment with debt rather than new equity, because deductible interest payments on corporate debt reduce corporate taxes while nondeductible dividends do not.

Accordingly, there may be an incentive for corporations to finance investment in excess of retained earnings with new debt rather than equity. To the extent that there is a bias in favor of debt financing, the risk of bankruptcy is increased for corporations, particularly those in cyclical industries.

Some investors, however, may prefer equity to debt. The corporate dividends received deduction [134] provides an incentive for a

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[133] For an analysis of the various possible effects of the two-tier tax, *see*, James Poterba and Lawrence Summers, "The Economic Effects of Dividend Taxation," Harvard Institute of Economic Research, Discussion Paper Number 1064 (May 1984); and Alvin Warren, "The Relation and Integration of Individual and Corporate Income Taxes," 94 *Harv. L. Rev.* 719, 721-738 (1981).

[134] See Part II.A.2.b., *supra*, for a description of the dividends received deduction.

corporation to invest in stock rather than debt of another corporation. In addition, an issuing corporation with tax losses, or an inability to utilize fully interest deductions for other reasons, may issue preferred stock with characteristics very similar to debt—effectively passing through some of the benefit of its losses to corporate shareholders. Foreign shareholders may prefer dividend or interest income depending on the tax treatment in their country of residence.

Retention vs. distribution of corporate income.—A further issue is whether the two-tier tax distorts decisions to retain or to distribute corporate earnings. Where shareholders are better able than the corporation to put capital to its most productive use, a tax-based disincentive to distribute earnings creates economic inefficiency.

The two-tier tax on dividend distributions can make it more desirable for a corporation to use retained earnings rather than new equity for its investments. Shareholders can find such earnings retention attractive (subject to the accumulated earnings tax and personal holding company rules) where the shareholder expects to defer tax on capital gains for a substantial period, or intends to hold stock until death (so that appreciation can be passed to his heirs free of individual income tax).

There also may be an incentive under present law to retain earnings if the corporation's effective tax rate on reinvestment is lower than the shareholder tax rate on distributed earnings.[135] By contrast, where the shareholder's tax rate is significantly lower than the corporation's effective tax rate—for example, if the shareholder is a tax-exempt entity or is a corporation entitled to a dividends received deduction—there may be a tax incentive to distribute earnings.

Under the 1988 law, the top corporate tax rate exceeds the top individual tax rate, unlike the rate structure under the 1986 law. This reversal of the tax rates and the elimination of the preferential capital gains tax rate, provided in the 1986 Act, have increased the extra tax burden of operating in corporate as compared to noncorporate form (see Table V-A). These tax changes may have created (or increased) a tax incentive to move income out of the corporate sector, particularly in industries which are unable to take advantages of tax preferences, such as accelerated depreciation.

After the 1986 Act, Congress became aware of the shifting of assets out of the corporate sector into widely-held publicly-traded partnerships (so-called "master limited partnerships") subject to a single-tier tax. To limit this potential corporate tax revenue drain, the Revenue Act of 1987 imposes a corporate level tax on certain publicly-traded partnerships.

A rationale for integration

In the 1984–1987 period, domestic nonfinancial corporations retired $313 billion of net equity, while increasing net indebtedness by $613 billion (see Table I-A). Billion dollar mergers, acquisitions, and leveraged buyouts are perhaps the most visible transactions facilitating the flow of equity out of corporate solution; however,

[135] A. Atkinson and J. Stiglitz, *Lectures on Public Economics*, Chapter 5, (1980).

equity contraction also may be accomplished by redemption, debt-for-equity swaps (including unbundled stock units), and extraordinary distributions. Many commentators have concluded that the unintegrated two-tier income tax encourages these transactions.

To the extent that corporate restructurings are influenced by tax rather than efficiency considerations, the unintegrated income tax may be causing a waste of resources. Rising corporate debt levels also may increase the risk of corporate insolvency and the associated costs of bankruptcy. Some economists have suggested that Congress amend the Code to provide partial or full integration of the income tax:

> The government needs to reconsider the double taxation of dividends (at both the corporate and individual levels), a prime reason why debt is preferred to equity by many companies. Other countries have faced this problem and have developed reasonable compromises to eliminate or greatly reduce the imbalance in tax treatment. It is time our government did so as well.[136]

Others argue that relief from the two-tier tax would require substantial tax increases to ensure revenue neutrality.[137] Thus, the economic benefits of integration (if any) would need to be weighed against the economic costs of revenue balancing taxes.

A further consideration in the decision to provide relief from double taxation is the uncertainty about the extent to which the two-tier tax in fact distorts corporate financial decisions. While income taxes generally are considered to provide a disincentive to savings and investment, there is little agreement concerning the effect of the two-tier tax on economic activity. One source of the uncertainty is the widely varying circumstances of corporations and their shareholders; such as, differing effective tax rates, need for external funds to finance investment, and ability to pass on corporate taxes to consumers or workers.[138] This uncertainty raises the possibility that measures to relieve double taxation may not have the intended results.

2. Forms of integration

There are two broad categories of integration: (1) complete integration, and (2) dividend relief. Complete integration eliminates double taxation of both dividends and retained corporate earnings. S corporations are taxed under a regime of complete integration since earnings of an S corporation, whether retained or distributed, are treated as income of the shareholders for tax purposes.

Dividend relief, unlike complete integration, reduces the double taxation on distributed earnings, with no change in the taxation of retained earnings. Dividend relief may be accomplished by reducing tax at either the corporate or shareholder level. At the corporate level, the tax burden on distributed earnings can be alleviated by means of a dividends paid deduction or a lower corporate

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[136] Henry Kaufman, *Washington Post*, (January 1, 1989), p. B4.

[137] The revenue cost of the provision included in the Treasury's 1984 tax reform proposal, which would have allowed corporations to deduct half of dividends paid to shareholders, was estimated by Treasury at $31 billion for fiscal year 1990.

[138] See Poterba and Summers, *op. cit.*

income tax on distributed versus retained income (i.e., a split-rate corporate income tax). At the shareholder level, the tax burden on dividends may be reduced by exemption or by crediting shareholders with tax paid by the corporate distributee (i.e., the imputation method).

Complete integration

Relief from the two-tier tax can be achieved by eliminating the corporate tax and including undistributed, as well as distributed, earnings in shareholders' gross income. Under this approach, a corporation's undistributed earnings would be deemed to have been distributed to and reinvested by the shareholders each year. Tax could be collected at the corporate level (in effect using the corporation as a withholding agent for shareholders), or tax could be collected solely at the shareholder level without withholding. Shareholders would be subject to income tax on their allocated earnings and would adjust basis in their shares accordingly.

In one form of this mechanism, all corporations would be treated in a manner similar to either partnerships or S corporations; this treatment would include the passing through of credits and losses as well as the character (ordinary or capital gain) and source (domestic or foreign) of income. Other versions would provide for the pass through of net income but not losses in excess of income, as is the case with real estate investment trusts.

The burden on both distributed and retained corporate earnings also could be relieved, in part, by reducing the corporate income tax rate. Reducing the corporate tax rate to zero, however, would turn corporations into the equivalent of nondeductible individual retirement accounts, since retained earnings and reinvestment income would accumulate tax free within the corporation.

Dividend relief at the corporate level

The double taxation of dividends could be alleviated at the corporate level by allowing a deduction for dividends paid to shareholders. A portion of the double tax on dividends could be eliminated by means of a partial dividends paid deduction, which reduces the corporate tax on distributed as compared to retained corporate income. In 1985, the Administration proposed a deduction of 10 percent of the dividends paid from earnings of a domestic corporation that have borne the regular corporate tax. A similar proposal was included in the House-passed version of the 1986 Act.

Dividend relief at the shareholder level

One method for relieving the tax burden on dividends at the shareholder level would be to exclude a portion of dividends from gross income.[139] This alternative has been criticized as reducing the progressivity of the income tax, since the tax benefit of exemption is greatest for shareholders in the highest tax bracket. Shareholders might be required to reduce stock basis, to the extent of tax exempt dividends, to prevent deduction of capital losses associated with untaxed dividends.

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[139] Fred W. Peel, "A Proposal for Eliminating Double Taxation of Dividends," *Tax Lawyer*, vol. 39, no. 1.

An alternative to a shareholder exemption is to give shareholders an income tax credit to reflect all or a portion of the corporate level tax paid with respect to dividends. The amount of the credit could be adjusted based on the degree to which partial relief from the two-tier tax is desired. Under such a system, shareholders who receive dividends would be required to "gross up" the dividend by the amount of the credit for corporate taxes paid, and include the grossed-up amount in income, while using the credit as an offset to their tax liability. The gross-up and credit mechanism is analogous to the credit for taxes withheld on wages under present law.

Gross-up and credit systems, also known as "imputation" systems, are used by several foreign countries including West Germany, France, Canada, and the United Kingdom. A number of these countries grant the shareholder credit only to the extent that the corporation actually has paid tax on dividends (this is accomplished by a corporate minimum tax on distributions). West Germany has a "hybrid" system, with a reduced income tax rate on distributed income at the corporate level, and a gross-up and credit at the shareholder level.

Legislative history

Congress has been concerned about the double taxation of dividends for more than 40 years, and it has tried various methods of alleviating double taxation.

In 1936, Congress enacted a split rate corporate income tax—one with a lower rate for distributed income than for retained earnings. Under this split rate system, corporate income was taxed at normal tax rates of between 8 and 15 percent, and there was a surtax on retained earnings. The intent of Congress in enacting the undistributed profits surtax appears to have been the desire to encourage dividend payouts in cases where corporations were retaining earnings to avoid the individual income tax on dividends. The rate of the undistributed profits surtax increased from 7 to 27 percent as the fraction of income paid out as dividends declined. In 1938, the surtax was repealed because Congress was concerned that it discouraged business expansion through earnings retention and created a hardship for companies which had to retain earnings because of the nature of their financial situation.

In 1954, as part of the Internal Revenue Code of 1954, Congress enacted an exclusion from adjusted gross income for $50 in dividends received by any individual. (Thus, a married couple could have received an exclusion of $100 if each spouse received at least $50 in dividends.) Also, the 1954 Code included a 4-percent tax credit for dividends in excess of the exclusion. Both of these provisions were intended to be modest starts toward the elimination of double taxation of dividends.

In 1962, President Kennedy recommended repeal of both the dividend credit and the exclusion. In the Revenue Act of 1964, Congress repealed the 4-percent dividend credit, but it doubled the maximum dividend exclusion to $100. The $100 dividend exclusion was repealed by the 1986 Act.

On February 2, 1978, Mr. Ullman (the former Chairman of the Committee on Ways and Means) proposed a refundable shareholder

credit on certain cash dividends received on corporate stock.[140] Mr. Ullman modified this proposal on March 22, 1978.[141] This proposal was not adopted by the Committee on Ways and Means.

The President's 1985 tax reform proposals included a provision which would have allowed corporations to deduct 10 percent of dividends paid, subject to certain limitations.[142] The House subsequently passed H.R. 3838 which contained a similar proposal.[143] The dividend paid deduction provision was dropped in the conference on the 1986 Act.

3. Foreign experience with dividend relief

Summary of foreign integration systems [144]

Many of our trading partners have eliminated part or all of the double tax on dividends. West Germany has eliminated all double taxation; Canada has eliminated more than half of double taxation; France and the United Kingdom have eliminated half of double taxation; and Japan has eliminated a smaller fraction of double taxation.

In West Germany, the corporate tax rate on distributed earnings is 36 percent, compared to a 56-percent rate on retained earnings. Shareholders are given a tax credit for the full 36-percent corporate tax on dividends, and they must include the credit in their taxable income.

France and the United Kingdom use a similar shareholder credit to eliminate about one-half of the double tax on dividends. Both these countries and West Germany allow the shareholder credit only to the extent that corporations have actually paid tax on the distributed income.

Canada allows its shareholders a credit of 50 percent of dividends which eliminates as much as 75 percent of double taxation. The Canadian credit is available without regard to whether the corporation actually paid corporate tax on the income.

At present, Japan has a split corporate rate of 32 percent on dividends and 42 percent on retained earnings. The recently adopted tax reform proposal will replace the split rate with a single corporate income tax rate of 37.5 percent for 1990 and beyond. Japan also allows its shareholders a credit of 10 percent of dividends, phased down to 5 percent at higher income levels.

Results of foreign integration systems

If the two-tier tax in fact contributes to a bias against new equity issues and against dividend distributions, one might expect that the adoption of partial integration systems would result in increased equity issues and dividend payments. The data, although difficult to interpret, do not appear to confirm such predictions.

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[140] Cong. Rec. 640 (Feb. 2, 1978).
[141] Cong. Rec. 2337 (March 22, 1978).
[142] The White House, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985).
[143] Section 311 of H.R. 3838 (the Tax Reform Act of 1985), passed by the House on December 17, 1985.
[144] This summary reflects foreign tax law as of 1983, as reported in Sijbren Cnossen, "Corporation Taxes in OECD Member Countries," *Bulletin for International Fiscal Documentation*, Nov. 1984, pp. 483-496.

A survey of the European experience concludes: [145]

> The experience of France, Germany and the United Kingdom with their respective tax integration schemes suggests that partial tax integration may not be an effective mechanism for increasing the rate of capital accumulation by business. In France and the United Kingdom dividend rates were not increased, and in Germany, although the dividend rate seemingly was increased, the proportion of corporate capital financed by sales of corporate stock actually decreased. It is true that in the United Kingdom potential dividend increases were held back by external factors, *i.e.*, the government's anti-inflation policy, rather than any intrinsic flaw in the imputation system itself. But the British experience indicates that a policy to increase dividends may be viewed as inflationary or, at any rate, as incompatible with an anti-inflation policy.

Given this evidence, and the extremely high debt to equity ratios reported in Japan (which has a split-rate system) and West Germany (which fully relieve the double tax on dividends), [146] adoption of dividend relief in the United States may not achieve the objectives espoused by some proponents, i.e., to reduce corporate debt to equity ratios and debt-financed acquisitions.

4. Recent legislative proposals

a. Dividends paid deduction (Administration's 1985 tax reform proposal and H.R. 3838 as passed by the House in 1985)

In general

Under the Administration's 1985 tax reform proposal, a domestic corporation would have been entitled to a deduction equal to 10 percent of the dividends paid from earnings that have borne the regular corporate tax. (The 1984 Treasury Report on tax reform was similar to the Administration proposal, except that 50 percent of dividends paid would have been eligible for the deduction.) The deduction would not have been available to corporations that are subject to pass-through tax regimes, e.g., regulated investment companies and real estate investment trusts.

Distributions that are not treated as dividends would not have been eligible for the deduction. However, distributions that are not dividends in form but are so treated for income tax purposes (e.g., certain pro rata stock redemptions) would have been eligible for the deduction. In addition, the dividends received deduction for corporations would have been changed to 90 or 100 percent, based on whether or not the payer is entitled to the dividends paid deduction (without regard to the degree of stock ownership).

Under the 1985 Administration proposal, the dividends paid deduction would have been treated like an ordinary business deduction for the purpose of determining the corporation's income tax li-

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[145] Harry G. Gourevitch, "Corporate Tax Integration: the European Experience," *Tax Lawyer*, Vol. 31, No. 1, (Fall 1977) p. 82–83.

[146] See discussion in Part I.B., above.

ability, including the liability for estimated tax payments. Net operating losses attributable to the dividends paid deduction would have been available to be carried back and forward to the extent permitted by present law.

The qualified dividend account

Dividends would have been eligible for the dividends paid deduction only to the extent that such dividends did not exceed the amount of a Qualified Dividend Account ("QDA"). Generally, the QDA consists of the amount of corporate earnings that have been subject to the corporate tax for taxable years after the effective date. Accordingly, each year a corporation would have added to its QDA its taxable income (i.e., gross income less deductible expenses), subject to certain adjustments. For this purpose, taxable income would not have included amounts on which no corporate tax was paid as a result of any available credit (including the foreign tax credit). The amount of dividends paid in a taxable year would have been deductible from the balance of the QDA as of the end of the taxable year, except to the extent that the balance in the QDA would be reduced below zero. Dividends in excess of the QDA as of the end of the taxable year in which the dividends were paid would not have been deductible. Such "excess dividends" could not be carried forward and deducted in subsequent years.

Nondividend distributions

Whenever a transaction is treated as a dividend for Federal income tax purposes, the corporation would generally have been entitled to a deduction and required to adjust the QDA to the same extent as if an actual dividend distribution were made. To be permitted to take the deduction, however, the corporation would have been required to treat the distribution as a dividend for information reporting purposes. In the case of complete liquidations, the QDA would have been eliminated.[147] In the case of redemptions and partial liquidations, the QDA would have been reduced proportionately with the amount of stock redeemed or the portion of the stock liquidated, but not in excess of the amount of redemption or liquidation proceeds distributed to shareholders.[148]

Treatment of intercorporate distributions

A corporation generally would have been taxed on only 10 percent of the dividends it receives; however, it would have increased its QDA by the full amount of any such dividends. Thus, on redistribution of that amount to its shareholders, it would in turn be entitled to the 10-percent dividends paid deduction. Where a corporate shareholder receives a dividend with respect to which no dividends paid deduction was available (because the distributing corporation did not pay any corporate tax on the distributed earnings), such shareholder would have been entitled to a 100-percent divi-

[147] The 1985 Administration proposal did not discuss whether this treatment would apply to liquidations of controlled subsidiaries qualifying for nonrecognition treatment under section 332. In this situation, a corporation's QDA could be treated as a "tax attribute" that is carried over to the shareholder corporation under section 381.

[148] This is analogous to the treatment under present law of the earnings and profits account upon redemption or partial liquidation.

dends received deduction.[149] Thus corporate earnings would have been taxed no more than once prior to distribution to noncorporate shareholders.

To implement these rules, the payer corporation would have been required to report to its corporate shareholders the amount of the dividends paid to such shareholders with respect to which a dividends paid deduction was allowed to the corporation.

Treatment of foreign corporations and shareholders

A U.S. corporation would have been entitled to the dividends paid deduction without regard to whether the dividends were paid to domestic or foreign shareholders. However, an additional withholding tax would have been imposed on dividends paid to foreign shareholders equal to the benefit received by the U.S. corporation on account of the dividends paid deduction. Initially, the additional withholding tax would not have been imposed on dividends paid to foreign shareholders entitled to the benefits of a bilateral tax treaty. However, authority would have been reserved for the Treasury Department to impose the compensatory withholding tax on dividends paid to shareholders resident in any treaty country that grants relief from a domestic two-tier tax to its national shareholders but not to U.S. shareholders.

The dividends paid deduction would have been allocated between U.S. and foreign source income in proportion to the amount of earnings in the QDA from U.S. and foreign sources.

A foreign corporation would not have been entitled to the dividends paid deduction under the 1985 Administration proposal.

H.R. 3838 as passed by the House in 1985

A 10-percent dividends paid deduction was contained in H.R. 3838 as passed by the House in 1985.[150] This provision was dropped in conference. The House bill generally followed the 1985 Administration proposal, with several modifications.

First, the House bill allowed an increase in the QDA for an amount equal to the taxable income equivalent of minimum tax liability.[151]

Second, the House bill permitted foreign corporations to take the dividends paid deduction in certain circumstances. Foreign corporations, at least 50 percent of whose income is effectively connected with a U.S. trade or business, would have been permitted to receive the dividends paid deduction. The deduction would have been available for that portion of the dividend which bears the same ratio to the dividends paid as the corporation's income effectively connected with a U.S. trade or business bears to its total income as computed for purposes of section 245(a).

Third, the House bill would have imposed a compensatory tax on dividends paid to foreign shareholders even where a treaty provided a limit on the amount of tax to which the foreign shareholder

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[149] Presumably, the QDA would not have been increased by the amount of dividends received that are eligible for the 100-percent dividends received deduction.

[150] Section 311 of H.R. 3838 (the Tax Reform Act of 1985), passed by the House on December 17, 1985.

[151] Since the top corporate tax rate in the House bill was 36 percent, the gross-up for purposes of the QDA would have been 100/36ths of the minimum tax liability.

may have been subject, unless the Secretary of the Treasury certified that: (1) such treaty prevented treaty shopping; and (2) if such country had a two-tier tax on corporate income and granted relief to national shareholders, that it also granted relief to U.S. shareholders equivalent to the dividends paid deduction.

Fourth, the House bill treated as "unrelated business income" (subject to tax under sec. 511) a portion of dividends paid to certain tax-exempt entities. This tax would have applied to organizations exempt from tax under section 501, where the organization owned 5 percent or more of the stock of the dividend-paying corporation.

Fifth, a portion of policyholder dividends paid by a mutual life insurance company would have been eligible for the 10-percent dividends paid deduction.

Sixth, the dividends paid deduction would have been phased by 1 percentage point per year over 10 years.

Finally, the dividends received deduction for dividends eligible for the 85-percent deduction under 1986 law would have been reduced to 70 percent (the deduction initially would have been reduced to 79 percent and thereafter decreased by 1 percentage point per year over 10 years). Thus, intercorporate dividends potentially would have continued to be subject to multiple corporate level tax.

b. Imputation system (1978 Ullman bill)

In general

On February 2, 1978, Mr. Ullman (the former Chairman of the Committee on Ways and Means) made a proposal to grant shareholders a refundable credit on certain cash dividends they received on corporate stock.[152] Mr. Ullman modified this proposal on March 22, 1978.[153]

Shareholder credit

Under the proposal, shareholders would have received a tax credit equal to 20 percent of their cash dividends (10 percent in 1979 and 1980, phased up by 2 percent per year). This credit, in effect, would refund to eligible shareholders a portion of the corporate income tax associated with corporate earnings from which the dividend was paid, and in that way it would eliminate a portion of the double tax on dividends.

Credits allowable would be limited to a portion of the Federal income taxes actually paid by the corporation. Whenever allowable credits would otherwise exceed this limitation, corporations would be given the choice of either paying a "shortfall" tax or of electing a lower rate of shareholder credit for their shareholders, and shareholders would be notified of the amount of the shareholder credit along with their dividend payments.

Shareholders receiving dividends would include in their gross income the amount of any cash dividend received plus the amount of their shareholder credit. They would be allowed to treat the amount of the shareholder credit as a payment against their Feder-

[152] Cong. Rec. 640 (Feb. 2, 1978).
[153] Cong. Rec. 2337 (March 22, 1978).

al income tax liability. In effect, the shareholder credit would be refundable.

Shareholder credit account

Under the proposal, each corporation would maintain a "shareholder credit account" on its books. At the close of each taxable year, a corporation would add a certain percentage of its Federal income tax liability (net of all allowable tax credits) to its shareholder credit account. The percentage would be 100 percent in 1979 and 1980, and phased down by 10 percentage points per year to 30 percent in 1987.

At the close of each taxable year, the corporation would subtract from its shareholder credit account the total amount of the shareholder credits it declared for the benefit of its shareholders for the year. Unless the corporation elected a lower rate, this would initially be 10 percent of cash dividends paid. Any amount remaining in the account after these adjustments would be accumulated and carried forward to future taxable years.

The percentage of corporate tax added to the shareholder credit account would have been greater than what was necessary to support the maximum allowable credit without the imposition of a shortfall tax (assuming all income were paid out as dividends). This was done for two reasons. First, it gave corporations time to adjust to the new integrated system. Second, it would permit corporations to integrate a small amount of tax preferences, but only if they paid some corporate tax. When fully phased in, the proposal would have permitted a corporation distributing one-half of its earnings to receive the full benefit of the proposal so long as it had an effective corporate income tax rate at least equal to 25 percent of its financial income.

Foreign tax credit

No foreign tax credit would be added to the shareholder account of U.S. corporations with respect to the foreign corporate taxes which they pay. However, the proposal contemplated that under negotiated agreements, reasonable foreign withholding taxes would be added to the shareholder credit account and be available for distribution to domestic shareholders. The amount, if any, of foreign withholding tax which would be allowed as a credit would be determined through bilateral negotiations.

Foreign shareholders

The United States would provide no shareholder credit or refund by statute for foreign shareholders in U.S. corporations. Bilateral negotiations would provide a forum for the United States to reduce its withholding tax or to grant a shareholder credit to foreign shareholders.

Shortfall tax

Under the proposal, a corporation would be required to pay a shortfall tax whenever allowable shareholder credits exceed the balance in the shareholder credit account at the end of any taxable year. The amount of the shortfall tax would equal the excess of the shareholder credits declared for the year over the balance in the

account as of the end of the year. The shortfall tax would be payable when the corporation is required to file its Federal income tax return for the year. In addition, the corporation would be required to pay any estimated shortfall tax on a quarterly basis in the same manner as the current estimated income tax.

The shortfall tax would apply to a corporation if the carryback of a net operating loss against an earlier year's taxable income resulted in a negative balance in its shareholder credit account.

Tax-exempt organizations

Under the proposal, tax exempt organizations (including pension and profit-sharing plans) would not be eligible for the shareholder credit.

Intercorporate dividends

Under the proposal, the dividends received deduction would be retained; however, corporations would not be entitled to claim the shareholder credit on dividends received from other corporations. Instead, corporate shareholders would be permitted to add to their own shareholder credit account the shareholder credit related to the dividends.

5. Issues regarding integration options

Method of granting relief

Full integration

Full integration generally is considered to be the most theoretically desirable method of providing relief from the two-tier tax, since all income earned at the corporate level would be taxed directly and currently to the shareholders, leaving none of the possible distortions described above.

However, such a system is also considered to be difficult to implement. One traditional objection to this form of relief is the concern that imposition of tax at individual rates on allocated corporate income (that is not actually distributed) may result in liquidity problems, particularly for shareholders whose marginal rates exceed the rate of tax collected at the corporate level; however, this concern has been diminished by the reduction of the top individual tax rate below the top corporate rate provided in the 1986 Act.

Considerable administrative difficulties are inherent in a system of full integration. For example, the need to allocate a corporation's tax attributes among all its shareholders (where share ownership changes and tax attribute adjustments are common), as well as the resulting need for individuals to account for potentially complex items (such as foreign tax credits, intangible drilling costs and the like), pose what many consider to be insurmountable obstacles to the general implementation of this system.[154]

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[154] A proposal for complete integration is presented in Dept. of the Treasury, *Blueprints for Basic Tax Reform*, (January 17, 1977).

Lowering corporate tax rates

Lowering corporate taxes would reduce the extent of double taxation of corporate earnings. This method of providing relief from the two-tier tax could reduce concerns about incentives for debt financing and inadequate investment in the corporate sector. However, such concerns would not be eliminated so long as the corporate tax rate exceeds zero. Moreover, the lower the corporate effective tax rate relative to the individual effective tax rate, the greater the incentive will be for a corporation to retain rather than distribute earnings. As an alternative, individual income tax rates could be raised.

Dividends paid deduction vs. shareholder credit

The dividends paid deduction (e.g., the provision passed by the House in 1985) and the shareholder credit (e.g., Mr. Ullman's 1978 proposal) generally are considered the two most feasible methods of implementing some relief from the two-tier tax and in many respects are considered economic equivalents. They operate to provide relief only with respect to distributed income. The main economic distinction between the two methods (assuming the credit is refundable) is that the dividends paid deduction initially puts cash generated by the tax relief in the hands of the corporation, while an imputation system puts the cash in the hands of the shareholders.

The 1985 Administration proposal states that the dividends paid deduction was chosen primarily because the Administration considered it somewhat easier than an imputation system to implement. A dividends paid deduction requires no additional accounting by individual recipients of dividends, though it would impose some additional accounting and reporting requirements on a corporation paying dividends. A corporate recipient of dividends also would have accounting requirements that might prove difficult to administer.

An imputation system would impose accounting and reporting requirements similar to those required for the dividends paid deduction on corporations paying and receiving dividends. It also would require individual shareholders to account for dividends differently, not simply by including them in income, but by using the gross-up and credit calculation. Nevertheless, an imputation system may offer some advantages over the dividends paid deduction if it is considered desirable to limit the relief in the case of dividends paid to certain shareholders—for example, foreign or tax-exempt shareholders. These advantages may outweigh the additional complexity of the imputation method if relief from the two-tier tax is to be implemented (see discussion below).

Dividend exclusion for individuals

A dividend exclusion can be provided for shareholders. Such an exclusion tends to benefit high-bracket taxpayers more than low-bracket taxpayers. A dividend credit system, as described above, could provide more progressive benefits. Moreover, if the dividend exclusion is limited to a dollar amount, as under prior law, it will

not encourage additional equity investment for shareholders receiving dividends in excess of the exclusion.

Treatment of tax preference items

The treatment of tax preference items, such as certain exclusions from income, credits against income tax, or tax deductions that exceed economic expense, must be examined in the context of proposals for relief from the two-tier tax on income earned by corporations. The purpose of this examination is to consider whether and to what extent preference items available to a corporation should be passed through to shareholders (reducing tax at both the corporate and shareholder levels).[155]

In general, a system of relief that passes through tax preferences not only allows the preference to reduce the tax of the corporation engaging in the activity for which the incentive is granted, but also directly or indirectly allows preference items attributable to that activity to reduce the shareholder income tax liability on distributions from the corporation.

If the purpose of granting relief from the two-tier tax is to eliminate corporate level tax entirely and to treat corporate income as earned directly by shareholders, it could be argued that all preference items of a corporation should be attributed directly to its shareholders, regardless of whether they are individuals or other corporations. Alternatively, it may be argued that any integration proposal should ensure that income arising from corporate activities is, at a minimum, subject to full tax at one level.

Any mechanism for passing through preferences to shareholders would vary depending upon the method chosen to provide relief from the two-tier tax (i.e., shareholder credit system, dividends paid deduction, etc.) and whether the preference item takes the form of an exclusion, a credit or an accelerated deduction.[156] Similarly, any mechanism for denying the passthrough of preferences to shareholders would depend on the type of system employed.[157]

If relief from the two-tier tax is granted with respect to distributed income only (as is the case with either a dividends paid deduction or a shareholder credit system), a determination must be made

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[155] See Charles McLure, *Must Corporate Income Be Taxed Twice?* Brookings Inst., 1979, pp. 92-143, for a comprehensive discussion of the treatment of tax preferences in the context of granting relief from the two-tier tax.

[156] For example, if a shareholder credit system were to pass through tax credits, the proper gross-up and credit amount would equal actual corporate income taxes paid plus allowable credits. (Credits that could not be used to reduce corporate income taxes could either be passed through to the shareholders or remain with the corporation.) To pass through excludible income or accelerated deductions, distributions in excess of the corporation's taxable income would either have to be excludible by the shareholders, or the shareholders would have to be given a larger credit. If a dividends paid deduction were chosen instead, excludible income and accelerated deductions could be passed through by excluding from the shareholder's income distributions in excess of the corporation's taxable income. Credits could be passed through by excluding from shareholders' income distributions in excess of the corporation's taxable income reduced by the amount of income, the tax on which is offset by the available credits. With either a shareholder credit system or a dividends paid deduction, where the passed-through preference is an accelerated deduction, adequate provision must be made to assure that the tax deferral that such deductions are intended to provide does not result in complete exclusion.

[157] In a shareholder credit system, the passthrough of credits, accelerated deductions, or untaxed income may be denied by limiting the gross-up and credit to actual taxes paid. Alternatively, if a uniform credit were desired, a compensatory tax could be imposed on a corporation to the extent that the credit available to its shareholders with respect to dividends paid exceeds the amount of tax paid by the corporation.

whether the distribution has been from taxed or untaxed earnings. Three different approaches are possible.

The first approach treats dividends as paid pro rata from taxed and untaxed corporate income. Thus, if a dividends paid deduction were used, for example, a corporation that has $100 of economic income but only $50 of taxable income would treat one-half (i.e., $50 divided by $100) of its dividends paid as eligible for the dividends paid deduction.

The second approach treats dividends as paid first out of income that has not been taxed and denies any dividends paid deduction unless distributions exceed a corporation's nontaxable income.

The third approach—which is the approach adopted by the Administration 1985 proposal—treats dividends as paid first out of income that has borne corporate tax. This approach might be viewed as permitting some amount of corporate tax incentives to be applied to reduce the double tax on distributions of earnings that did not bear corporate tax. To this extent, it might be seen as permitting an indirect additional benefit to all shareholders from corporate level preferences. However, this approach is significantly simpler to implement than either of the others.

Under the 1985 Administration proposal, all corporate income that was subject to tax would be added to the QDA in full even if the tax were imposed at less than the top corporate rate. This would include, for example, income taxed at marginal rates lower than the rates against which the dividends-paid deduction is taken. For example, corporate income tax may be paid in one year at a 15-percent rate, and dividends paid out of this income may give rise to a 10-percent dividends paid deduction that offsets income in the top 34-percent corporate income tax bracket.[158]

International aspects

Foreign shareholders

A significant international tax issue raised by proposals for relief from the two-tier tax on corporate income is whether such relief should be granted with respect to shares in a U.S. corporation owned by foreign shareholders and, if so, to what extent. If either denial or limitation of the relief is desired, a related issue is the manner in which the relief may be denied or limited consistent with present U.S. treaty obligations.

Denial of relief where there are foreign shareholders is arguably inconsistent, in certain cases, with the goals of avoiding some of the distortions of the two-tier tax; these distortions may arise irrespective of the nationality of the shareholder or the country that receives the shareholder level tax. On the other hand, the relief arguably is not intended to lessen the U.S. taxation of income earned by foreigners through U.S. corporations, particularly where, under an existing income tax treaty, such foreign shareholders pay little tax on dividends received from U.S. corporations. Under international norms, the primary tax jurisdiction over business income is

[158] The contrary result also could occur. If this were perceived as a problem, the benefit of a deduction arising from the distribution of income taxed at a different rate could be adjusted to reflect the amount of tax paid on such income, though this could involve complex tracing.

in the country where the operations are located. In addition, most other countries that have adopted some form of relief from a two-tier tax generally do not extend the relief to foreign shareholders unilaterally; some countries, however, provide relief for foreign shareholders through bilateral treaties.

If relief from the two-tier tax is implemented through a dividends paid deduction, such relief can be denied where there are foreign shareholders, either by denying the deduction to the corporation for dividends paid to foreign shareholders or by imposing a compensatory withholding tax (in addition to any other withholding tax) equal to the tax benefit received by the corporation on the dividends paid to foreign shareholders.

Although disallowance of the dividends paid deduction would accomplish the goal of collecting tax on income earned in the United States, it may be considered unfair and undesirable for the value of the U.S. shareholders' shares to be affected by the fact that other shareholders are foreign. Accordingly, apart from treaty considerations discussed below, a compensatory withholding method may be preferable since the benefit of the relief is, in effect, "paid back" directly by foreign shareholders rather than proportionately by all shareholders.

If an imputation system, rather than a dividends paid deduction, were used to implement the relief, the relief could be denied entirely to foreign shareholders by not permitting the gross-up and credit, or could be denied in part by not permitting a refund of any unused credit. Where the degree of relief contemplated is relatively small, however, as was true of the Administration proposal, nonrefundability may have no impact on foreign shareholders because the appropriate credit may be less than the pre-credit U.S. withholding tax on the dividend, even where such tax is reduced pursuant to a treaty.

If relief from the two-tier tax is to be denied to foreign shareholders who are entitled to a reduced rate of tax on dividends pursuant to a treaty, the method chosen to deny relief may have a bearing on whether the denial can be viewed as a violation of the treaty in question. In particular, the imposition of a compensatory withholding tax in conjunction with a dividends paid deduction might be considered a technical violation of treaties that provide a reduced withholding rate on dividends. This is so despite the fact that the compensatory withholding tax is a substitute for the collection of additional corporate tax, which would not violate these treaties. By contrast, if a shareholder credit system were adopted and the credit were denied to foreign shareholders, the same substantive result would be reached without any arguable treaty violation.

As discussed above, the 1985 Administration proposal would have imposed a compensatory withholding tax on dividends paid to foreign shareholders who are not entitled to treaty benefits but, at least initially, would not impose the additional withholding on shareholders who are entitled to treaty benefits. The proposal retained authority for the Treasury to impose the additional withholding as leverage in negotiating reciprocal relief for U.S. shareholders of foreign corporations where the foreign corporation's national shareholders are afforded relief from a two-tier tax. If Treas-

ury did not impose such withholding, this approach could have the effect of permanently lowering, without compensation, the U.S. tax on income earned by corporations to the extent such corporations have shareholders in any of the many countries that offer no relief from two-tier taxation to U.S. investors.

Foreign corporations

Under the 1985 Administration proposal, a foreign corporation would not have been entitled to the dividends paid deduction even with respect to dividends paid from earnings that were subject to U.S. tax. Certain treaties arguably may provide, however, that foreign persons (including corporations) are entitled to the same U.S. income tax treatment as a similarly situated U.S. person. Accordingly, as under the 1985 House bill, consideration could be given to extending the deduction to foreign corporations entitled to such treatment under a treaty, where dividends are paid to U.S. shareholders from earnings subject to U.S. tax. Alternatively, such a foreign corporation could be given an election to be treated as a United States corporation for all income tax purposes.[159]

Source rules

The 1985 Administration proposal indicated that the dividends paid deduction should be allocated between U.S. and foreign source income in proportion to the income out of which the dividends were paid. No method was specified for determining the income from which the dividends were paid. Where dividends paid could be attributed to more than one year, the choice can have significant practical impact. For example, if, in a year that a corporation has excess foreign tax credits, it pays dividends with respect to which it is entitled to a dividends paid deduction, the availability of the corporation's foreign tax credits may be further restricted if the dividends paid are deemed to be paid out of earnings from a year in which the corporation had a relatively high percentage of foreign source income.

Treatment of foreign tax credit

As discussed above, the 1985 Administration proposal (and House bill) generally would not have permitted a dividends paid deduction at the corporate level to the extent dividends were paid out of earnings that bore no corporate tax. The proposal treats corporate income that did bear foreign tax, but that did not bear U.S. tax due to the foreign tax credit, in the same manner as income that did not bear U.S. tax for other reasons such as accelerated depreciation or other tax preference items. Thus, income that does not bear U.S. tax due to the foreign tax credit would not have been added to the QDA.

There is controversy about whether the foreign tax credit properly should be treated in the same manner as a "preference" item. The credit is widely used by countries to reduce international double taxation. It is generally available only where foreign taxes are paid or accrued, thus reducing the amounts a corporation will

[159] See sec. 897(i).

have available for distribution. On the other hand, foreign countries that have adopted some form of relief from corporate double taxation generally do not treat foreign taxes paid by their domestic corporations as taxes paid for purposes of a shareholder credit or comparable provision.

Some may contend that the 1985 Administration proposal did not provide equal treatment for U.S. and foreign investment by U.S.-owned corporations (a violation of "capital export" neutrality), because the dividends paid deduction would have been allowed for distributions of income that had borne only U.S. tax, but not for income that had borne a comparable foreign tax. Others may contend that a U.S. tax benefit has been derived from the foreign tax credit, even though foreign taxes have also been paid. They also may contend that the U.S. should not unilaterally grant relief where other countries do not.

Treatment of tax-exempt shareholders

Where relief from the two-tier tax is granted, the treatment of shareholders who are tax-exempt raises difficult issues. Denying the relief could be viewed as inappropriately diminishing the relative advantage of tax exemption over ordinary taxable status. On the other hand, granting the relief where a shareholder is a tax-exempt entity could permit business income earned by a taxable corporation and distributed to its tax-exempt shareholders to escape tax entirely, simply because the shareholders are tax-exempt.

As one example, if a taxable corporation owned entirely by a tax-exempt entity distributed all its income, and if there were a 100 percent dividends paid deduction, the corporation would pay no tax. This result would be inconsistent with the rules that tax unrelated business income of tax-exempt entities and generally do not permit tax-exempt entities to engage in regular business activities free of tax on the business income. Although the Administration proposed only a 10 percent (rather than 100 percent) dividends paid deduction, the issue is inherent in the proposal.

If it were considered desirable to deny the relief in the case of distributions to tax-exempt shareholders, and a dividends paid deduction were chosen as the basic method of relief, the relief could be denied by treating the deductible portion of dividends paid to tax-exempt entities as unrelated business income (as under the 1985 House bill). This would require reporting of the deductible portion of dividends paid to tax exempts (similar to the reporting that would be required for dividends paid to corporations).

Such an approach would be similar to the compensatory withholding tax that the Administration proposed for certain foreign shareholders; however, the tax would not be collected by the paying corporation as a withholding agent. A withholding tax approach could be used if desired.

Another possibility would be to deny the dividends paid deduction to a corporation that is owned entirely, or to a specified extent, by tax exempt entities. Where a corporation is owned both by taxable persons as well as tax-exempt entities, however, denial of the dividends paid deduction for dividends paid to tax-exempt shareholders would impose an additional tax burden on the taxable

shareholders. If an imputation credit system were used, the credit simply could be denied (i.e., be made nonrefundable) in the case of a tax-exempt shareholder.

Transition issues

Certain issues exist relating to the one-time effects of implementing some measure of relief from the two-tier tax. One such issue is whether the relief may give a windfall to present owners of corporate equity, whose shares may become more valuable because of the lower corporate tax burden. The extent of this windfall is somewhat speculative. If present shareholders purchased their stock at a discounted price due to the double tax on dividends, adoption of dividend tax relief will be a windfall to present owners. By contrast, if the corporate tax burden is passed on to consumers or employees, its elimination would not necessarily provide a windfall to shareholders, at least in the long run. If the possibility of a windfall were perceived to be a problem, one solution would be to phase in dividend relief (as in the 1985 House bill). Another solution would be to extend the relief only to equity issued after the relief provisions generally become effective, as suggested by the 1982 ALI Reporter's study.[160]

New equity integration

To prevent windfall gains to existing shareholders and limit revenue loss, dividend tax relief could be granted only to newly issued equity (i.e., equity issued after the effective date of the provision).

New equity integration would create an incentive for corporations to convert old into new equity, unless a tax is imposed on such transactions equal to the value of dividend tax savings on new shares.

Old equity could be converted by redeeming old shares and issuing new shares. Alternatively, a corporation could make a pro rata distribution of new equity to existing shareholders, and pay all future dividends only with respect to the new shares (to take advantage of dividend tax relief). Another method for converting old equity is for the existing corporation to contribute assets to a newly-formed corporation in exchange for stock, and then to distribute this new stock to its shareholders.

Thus, new equity integration requires anti-abuse rules which deny dividend tax relief to new equity which merely replaces existing stock. Alternatively, the tax benefit of conversions could be eliminated by imposing a minimum tax on certain corporate distributions (see Part V.D.1, below).

If dividend tax relief is provided through a shareholder credit system, corporations might need to issue a separate class of stock so that shareholders would be able to differentiate between dividends paid on old as opposed to new shares. The new class of stock probably would trade at a premium over old stock as a result of the shareholder credit. This premium would transfer some or all of the benefit of the credit to the owners of old stock.

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[160] The American Law Institute, Federal Income Tax Project, Subchapter C, Proposals on Corporate Acquisitions and Dispositions (1982).

New equity integration also could be accomplished by means of a dividends paid deduction limited to new shares. In this case, new and old shares would not be differentiated from the shareholders perspective, and would be expected to trade at the same price. The benefit of the tax savings (from the dividends paid deduction) presumably would accrue to both old and new shareholders equally.

While limiting dividend tax relief to new equity has many attractive features, numerous difficult technical issues would need to be resolved. Moreover, it should be noted that none of the countries which have adopted dividend tax relief have limited such relief to newly issued equity.

B. Eliminate or Reduce the Distinction Between Debt and Equity by Limiting Interest Deductions

Interest disallowance proposals should be evaluated with reference to various policy issues. These issues include: the potential erosion of the business tax base (including but not necessarily limited to the corporate tax base); the proper measurement of economic income; the non-tax economic impact of business leverage; and whether certain specified types of transactions should be discouraged for various other non-tax economic reasons. In addition, administrability and fairness issues may be raised.

Particular interest disallowance proposals may address one or more of these issues. The proposals may be more or less comprehensive in treatment of the issues they do address. Because the proposals differ widely in the nature of the issues they address, it is necessary to determine which policy issues are considered significant in order to evaluate the desirability of any particular proposal.

The following discussion first describes a number of interest disallowance proposals and discusses the principal issues they address. The discussion then describes certain additional issues common to many of the proposals.

1. Broad interest disallowance proposals not dependent on particular types of corporate transactions

All interest deductions above a specified amount could be disallowed. There are several variations of this approach, each of which computes the amount of the disallowance based on different factors. The factors selected indicate the policy objectives of the proposals.

a. Disallow a flat percentage of all interest deductions

Under this approach, the amount of nondeductible interest would be a percentage of total interest expense. This approach principally addresses concerns about erosion of the revenue base and about the role of debt in facilitating tax arbitrage. It does not address issues of the proper measurement of income (either by trying to distinguish debt from equity, or by trying to limit interest deductions where the debt supports activities that do not produce income taxable to the entity incurring the debt). It also is not limited to any particular types of transactions that might be considered undesirable for non-tax reasons.

While revenue concerns are the main basis for this particular approach, issues arise regarding its effectiveness. For example, if the deduction denial is related only to a percentage of total interest expense, it might be possible for taxpayers in some circumstances to increase the stated interest amount beyond the amount they might have stated absent this provision, thus continuing to reap the benefit of the deduction. Present law provides certain bright-line rules designed to prevent the interest component of an obligation from being understated; but it has no comparable rules designed to prevent the overstatement of interest. Issues related to the design of such rules are addressed below in connection with other proposals.

The impact of this proposal will vary dramatically from industry to industry. For example, financial intermediaries, such as banks, may see enormous increases in taxable income, even though their loans may bear low interest rates. Likewise, this proposal will disproportionately affect activities which support high degrees of leverage, such as real estate, even though the debt involved may not be particularly risky.

b. Disallow interest deductions in excess of a specified rate of return to investors

This approach would disallow interest deductions in excess of a specified rate of return to investors. Deductions not in excess of that rate still would be permitted. The rate could be determined by reference to a rate deemed to represent that of a relatively risk-free investment (for example, the rate on comparable-term Treasury obligations issued at the time of the borrowing, or a few points above that rate). The rate could fluctuate as the reference rate fluctuates.

As with the approach described above, this approach addresses concerns about erosion of the tax base, but to the extent the rate selected reflects a measurement of "risk," this approach also might be described as an attempt to properly measure economic income. If one accepts the premise that all interest on debt is properly deductible without regard to whether the debt supports an asset that produces taxable income, and the further premise that the most fundamental basis for distinguishing debt from equity is the degree of investor risk, this approach seeks to deny a deduction for the "risk" element of stated interest on the theory it more nearly resembles a dividend distribution, while continuing to permit the non-risk portion to be fully deductible.

A primary issue with respect to this type of approach is the selection of the permitted deductible interest rate. To the extent the rate is selected in an attempt to identify excessive risk, questions may be raised regarding the accuracy of a risk analysis based solely on interest rate. On the other hand, to the extent the proposal is viewed as one of administrative convenience designed to address revenue concerns and avoid the need to distinguish between debt and equity, the accuracy of any risk analysis may be considered less important.

Non-tax policy issues also may arise. For example, even though it is arguable that a high degree of risk suggests an equity investment, and that a high interest rate suggests a high degree of risk, the practical result of such an approach may be that certain start-

up firms, or firms involved in inherently risky ventures, may be more restricted in their ability to deduct all of the interest demanded by investors than other more established or stable firms. Variations in the permitted rate might be adopted for such situations; however, arguments then may be raised that whichever taxpayers are permitted the higher deductions may obtain a competitive advantage over other ventures also involving risk, which may have implications for neutrality of the tax system in this respect.

c. Disallow interest deductions based on inflation: interest indexing

This approach would disallow a portion of interest deductions based on inflation. A corresponding portion of the recipient's interest income would be treated as nontaxable.

1984 Treasury proposal

The Treasury proposals in 1984 suggested a plan which generally would have rendered the same specified fraction of interest non-deductible and non-includable.[161] Home mortgage interest and a de minimis amount of other individual interest were exempt from these provisions. The Treasury proposal assumed a specified real pre-tax interest rate and would have calculated a percentage each year based on this assumed real rate relative to the sum of inflation and the assumed real interest rate. The allowable interest deduction (and inclusion) each year would have been calculated by multiplying nominal interest payments (and receipts) by this percentage, which would be published periodically by the tax authorities.

As a method for indexing debt, the proposal was relatively simple. Even so, it still had numerous difficulties. Because it applied a single fraction to all interest it did a poor job of coping with debt of differing risk characteristics; in particular, it made too large a percentage of interest on risky debt nondeductible and nonincludable. Also, if the fraction were applied to financial intermediaries (e.g., banks), their income could be very lightly taxed. As pointed out by Treasury at the time, even with its problems, the method was likely to provide a more appropriate measure of income than the current method of deducting and including all nominal interest.

Other proposals

Other methods of indexing may better measure real interest deductions but at the cost of increased complexity. One proposal would require the restatement of interest paid by subtracting out the inflationary component of the interest rate. For example, if one paid $100 of interest at a 10 percent nominal rate and the rate of inflation were 7 percent, then one would calculate the inflationary component of the interest paid at a 7 percent rate ($70) and subtract that amount from the interest actually paid. The difference ($30) would be the allowed amount of deductible interest. Similar calculations would be necessary for purposes of income inclusion.

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[161] Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth*, November, 1984.

This proposal, while having fewer distortions than the Treasury proposal, is significantly more complex and administratively difficult. In general, proposals designed to measure the appropriate amount of interest make a trade-off between simplicity and accuracy.

Issues generally applicable to indexing

A number of issues arise with respect to interest indexing. A principal concern is determining the amount of correction to interest expense or income that accurately reflects inflation. It may be necessary to determine a "real" interest rate prior to risk considerations. Even assuming a correct adjustment is identified, it may be necessary for administrative convenience to apply that adjustment in a relatively rough manner that does not fully account for different real interest rates over different periods of a year. It may be difficult to provide an administrable adjustment that does not involve windfalls to some taxpayers.

Indexing only interest but not other long-term arrangements may put additional pressure on the determination as to whether an instrument is properly characterized as debt. For example, depending on the relative tax situations of the parties, indexing only interest may make it more desirable for a taxpayer with a relatively high effective tax rate to hold an instrument characterized as debt rather than equity. Similarly, it may be more desirable for an arrangment to be characterized as a lending arrangement rather than a lease. To the extent parties in different tax situations recharacterized their arrangements to take advantage of tax arbitrage potential in this additional new disparity between the treatment of debt and other arrangements, there could be a corresponding revenue concern. On the other hand, it can be argued that failure to index may perpetuate a far greater revenue loss if the holders of debt instruments tend to be entities with a low effective tax rate and borrowers tend to be taxpayers with a higher effective rate who are obtaining an excessive interest deduction.

Exempting certain classes of debt, such as home mortgages, from indexing proposals may cause large tax-induced distortions of asset portfolios. Thus, excluding home mortgages would increase further the tax incentives for owner-occupied housing.

Any proposal that reduces interest inclusions and deductions to the same degree will generally reduce nominal interest rates. Because of the fall in nominal interest, the value of tax exemption to pension funds and other tax-exempt institutions will be less than it would be under a system without indexing.

d. Disallow interest deductions in excess of a specified percentage of taxable income (or earnings and profits) as computed before the deductions

This approach would limit the interest deduction by reference to taxable income (or alternatively, earnings and profits) determined prior to the deduction. For example, one version of this approach would limit the deduction to no more than 50 percent (or some other specified percentage) of the taxable income of the corporation computed without regard to the interest deduction. Such an approach was adopted in the 1986 Senate version of H.R. 3838 (the

Tax Reform Act of 1986) but was limited to situations where the lender was related to the payor corporation by at least 50-percent ownership and was a tax-exempt or foreign entity that would not pay U.S. tax on interest received from the payor corporation (Senate amendment to H.R. 3838, sec. 984 (1986)). One variation would limit the deduction to no more than 50 percent (or some other specified percentage) of the earnings and profits or the corporation computed without regard to the deduction. Another variation would apply the limitation only for minimum tax purposes.

This approach is principally addressed to revenue concerns and attempts to provide a rough but practical alternative to complex rules for distinguishing equity from debt, which assures that interest alone does not shelter taxable income to an unacceptable degree.

The limitation to a specified percentage of taxable income (or earnings and profits) might arguably be viewed as reflecting concerns about proper measurement of income, on the theory that when interest deductions alone consume a significant proportion of otherwise taxable income, this may suggest excessive risk to the lender implying an equity interest. However, this particular approach is not a targeted method of identifying situations of risk. This is because the ability to pay back indebtedness depends largely on the capacity of the debtor to generate cash flow, either from current operations or from sales of appreciated assets. Neither taxable income nor earnings and profits is an adequate measure of such capacity. For example, an entity with significant cash flow potential may have low taxable income because of other tax deductions that do not reflect economic losses (for example, accelerated depreciation), or because assets are currently held for appreciation and not for current income. The use of earnings and profits as a limitation similarly does not take account of items such as unrealized appreciation, which may be sufficient to avoid undue risk to the debtholder.

This approach also raises an issue whether it is desirable to limit interest deductions, thus increasing the effective tax rate, in times of recession or when taxable income is otherwise small due to real economic losses.

2. Disallow corporate interest deductions in transactions that reduce the corporate equity base

A corporate interest deduction could be disallowed in transactions where the underlying debt supports a reduction in the corporate equity base.[161a] This approach is directed to preservation of the corporate revenue base. The approach also can be described as one directed to the proper measurement of economic income at the corporate level. The theory is that a corporate-level interest deduction should not be permitted for a borrowing used to support a distribution that will not produce any corporate-level income but, on the contrary will reduce the corporate tax base.

Under this approach, if the borrowing supports a distribution of existing equity out of corporate solution, so that future corporate-

[161a] See footnote 172, *infra*.

level income will no longer be generated by the distributed funds, then interest deductions on the borrowing are denied. Certain distributions could be exempted from the provision (for example, "ordinary" dividends, defined in a manner intended to permit continuing distributions of regular dividends to shareholders, would not trigger interest cutbacks). However, the proposal would trigger disallowance in the case of extraordinary distributions, including large dividend distributions, stock repurchases, and acquisitions of certain stock or assets of other corporations.[162]

Under one version of the proposal, corporate interest deductions would not be limited at all if there is not a disqualifying distribution to shareholders. Under such an approach, for example, if a corporation issued an instrument characterized as debt and did not also distribute funds out of corporate solution to shareholders, no disallowance of interest would result. This version would limit its policy objective to denying interest deductions that support distributions out of corporate solution and would not attempt to reduce the distinctions between debt and equity generally, or to limit deductions to a relatively risk-free rate of return. Provisions would be necessary to prevent avoidance of the rule by first making a disqualifying distribution and subsequently borrowing to support the distribution.

Variants of the proposal could address additional objectives. For example, even if a borrowing supports bringing new funds or assets into corporate solution where the income from such funds or assets will be subject to corporate income tax, there might still be a limitation on the interest deduction, based on a "reasonable" return to investors. This approach would tend to make the treatment of debt and equity at the corporate level more equal.[163] It also could be viewed as an attempt to limit interest deductions to an amount reflecting a relatively risk-free interest rate.[164]

3. Disallow corporate interest deductions in more specified acquisition or stock purchase situations

a. Limit corporate interest deductions in the case of certain acquisitions where additional factors suggesting risk are also present

H.R. 2476 (1985), introduced by Mr. Pickle, would deny the deduction for interest payments on certain debt used for the acquisition of another corporation or the repurchase of a corporation's stock. To the extent the bill requires the existence of debt that sup-

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[162] For administrative reasons, a distinction could be made in the case of the acquisition of stock of another corporation, depending upon the amount of stock that is acquired. The interest disallowance might not be triggered if funds are used to acquire a relatively small interest in another corporation's stock; however, in such a case the dividends received deduction could be denied as a compensating mechanism.

In addition, a borrowing that supports the acquisition of a significant part of the assets of another corporation could also trigger the interest cutback, even though the payment for the assets may remain in corporate solution in the hands of the selling corporation. The proposal might trigger the interest cutback in this case because of concern that the selling corporation may liquidate and distribute the funds out of corporate solution. However, if the selling corporation agreed to pay an additional tax on a distribution of the funds, the purchasing corporation could be relieved of the interest cutback.

[163] See Part V.C.1 of this pamphlet, *infra*, for a discussion of proposal to permit a deduction for payments on new equity capital.

[164] See discussion, *supra*, of options to limit interest deductions to a specified rate.

ports a distribution out of corporate solution, it shares the policy objectives of the general proposal to disallow interest on debt that displaces corporate equity.[165] However, under the bill, interest is disallowed only if any one of four tests designed to identify risk is met; in addition the disallowance only applies if the total debt is more than $30 million (a limitation focused on revenue considerations and intended to affect only relatively large transactions). The four alternative tests indicating risk are:

(1) the instrument is subordinated to trade creditors or a substantial amount of unsecured indebtedness of the corporation;

(2) the instrument has a non-investment grade rating and that rating is at least two grades below the rating of other substantial debt of the corporation;

(3) the yield to maturity is in excess of 135 percent of the applicable Federal rate; or

(4) the total amount of the debt issue exceeds four times the net value of the assets of the corporation.

Another proposal would deny the interest deduction based solely on the corporation's debt-equity ratio, for example, if the debt-equity ratio exceeds a specified ratio (such as 4 to 1) or if it exceeds such other ratio as is established to be the predominant debt-equity ratio in a particular industry.[166]

Each of these options accepts the premise that it is appropriate to distinguish corporate-level debt from equity in order to identify deductions properly deductible against economic income of the entity (viewed as the income ultimately available for distribution to persons identified as equity holders of the corporation). The options also generally accept the premise that the degree of risk involved is the ultimate distinguishing factor between debt and equity.

These proposals have typically addressed only certain acquisition situations, although variants could be devised that would also apply to other business contexts.

The proposals recognize the Treasury Department's lack of success in its various attempts to issue regulations distinguishing corporate debt from corporate equity under section 385.[167] They attempt to tighten the present law rules that distinguish debt from equity by denying the interest deduction if certain equity-like characteristics are present.

A non-tax policy issue related to these approaches is the question whether focusing solely on risk and tightening the interest disallowance rules may have the effect of disadvantaging borrowings by companies that engage in inherently risky ventures.

Another issue is whether the proposals adequately identify degrees of risk.

A major administrative concern is whether these types of proposals can accomplish their objectives, or whether instead they will encounter the same difficulties that have prevented the issuance of regulations under section 385. A principal concern is that taxpay-

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[165] See Part V.B.2. of this pamphlet, *infra*.

[166] See, e.g., Canellos, "The Over-Leveraged Acquisition", 39 *Tax Lawyer* 91, 115-119 (1985).

[167] For a discussion of section 385 and the difficulties the Treasury Department encountered in trying to write regulations under that section, see Part II.E. of this pamphlet, *supra*.

ers will manage to avoid the particular specified bright-lines when they desire interest deductions, but will vary other aspects of their overall arrangements and continue to create equity-like interests which generate interest deductions.

b. Limit interest deductions in certain transactions where debt supports a distribution of corporate equity, unless corporate-level tax is paid on corporate asset appreciation

The House-passed version of the Omnibus Budget Reconciliation Act of 1987 (H.R. 3545, sec. 10138) would have limited interest deductions in certain debt-financed acquisitions and redemptions where appreciation on corporate assets is untaxed.

Under the 1987 House bill, interest in excess of $5 million per year would be disallowed if it is incurred by a corporation with respect to debt supporting either (1) the acquisition of 50 percent or more of the stock of another corporation or (2) the redemption by a corporation of 50 percent or more of its own stock. All acquisitions within a three-year period are aggregated in determining whether one of these 50-percent thresholds is met. The interest disallowance provision does not apply if a section 338 election has been made, thus causing the recognition of corporate-level asset appreciation.

Under the 1987 House bill, debt would be deemed to support such an acquisition if it can be directly traced to the acquisition, or if it is indirectly allocable, determined under a formula based on the ratio of the basis of the purchased stock to the basis of all the corporation's assets. However, in the case of indirectly allocable interest, the limitation on deductions terminates five years after the date of the acquisition.

Variants of this approach could be designed to apply in cases not covered by the 1987 House bill—for example, where less than 50 percent of the stock of a corporation is acquired by others, or in a stock buyback. In addition, different interest allocation rules could be adopted.

Some might view the 1987 House bill as adopting the policy premise that it is appropriate to disallow corporate-level interest deductions when borrowed funds are distributed by a corporation. In these cases, the funds will no longer produce corporate-level income. Under this approach, it is considered inappropriate to allow an interest expense that supports a corporate-level expenditure (the distribution) that does not produce corporate-level income.

However, a more fundamental aspect of this option is a belief that such borrowings and distributions frequently occur when a corporation has appreciated assets that produce a steady income stream, and that the borrowing and distribution enables the corporation to shelter its income from the appreciated assets (in effect, to shelter its recognition of the appreciation) while distributing a part or all of the value of the appreciation to shareholders. For this reason, interest deductions were not limited in the House bill if the corporation had already recognized its full corporate-level gain on appreciated assets.

Some may argue that there is no logical relationship between the denial of interest deductions and untaxed appreciation in corporate-level assets. A possible variation of this approach would not limit interest deductions at all, but rather would require recogni-

tion of corporate gain whenever corporate equity is distributed in an acquisition or redemption.[168]

The 1987 House bill was limited to cases involving an acquisition of 50 percent of the corporate stock within 3 years. It thus was directed only to cases involving a very major restructuring of corporate ownership. To the extent that either the interest disallowance or the gain recognition aspects of the House bill are considered appropriate policy objectives, the House bill limitation to 50 percent stock acquisitions limits the implementation of those objectives. Corporations could still borrow against appreciation in their assets and engage in major stock repurchases, or other substitutions of debt for equity, without limitation. A variant of the 1987 House bill approach could be devised that would apply to these situations.

c. Limit interest deductions and/or require gain recognition in the case of certain hostile acquisitions

H.R. 2995 (1987), introduced by Mr. Dorgan, and the House-passed version of the Omnibus Budget Reconciliation Act of 1987 (H.R. 3545, sec. 10144), would deny interest deductions on debt incurred or continued by a corporation to purchase 20 percent or more of the stock of another corporation in a hostile tender offer, or to purchase assets of such corporation following such a stock purchase. A hostile offer is defined as one disapproved by a majority of the independent members of the board of directors of the target corporation. H.R. 158, introduced by Mr. Dorgan in 1989, contains the same provisions. In addition to interest disallowance, these bills also would require the recognition of all corporate-level gain through a mandatory section 338 election in the case of an acquisition in which a significant portion of the stock was purchased pursuant to a hostile tender offer.

This approach would affect only transactions that involve "hostile" offers. The principal purpose is to create a tax disincentive for these transactions based on a non-tax policy assumption that corporate acquisitions that lack the consent (as defined) of the acquired corporation are detrimental to the general economy as well as to the welfare of the acquired corporation's employees and the community in which it is located. It is argued that hostile transactions are particularly distracting to management and that a hostile acquiror may be more likely to impose a high degree of leverage on a corporation than a friendly acquiror.

The tax effects of a substitution of debt for equity in "hostile" transactions are indistinguishable from those of a substitution of debt for equity in a "friendly" acquisition or even in the case of a corporation buying back its own stock. In addition to tax effects, any non-tax economic risks of a high degree of leverage can be imposed in a "friendly" leveraged buyout just as readily as in a "hostile" one. Thus, if tax consequences or risks of leverage are the policy concern, a proposal limited to hostile transactions may be too narrow.

Furthermore, there is an issue whether the definition of a "hostile" transaction under this proposal adequately identifies any par-

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[168] See the discussion of other options requiring the recognition of corporate-level gain under parts IV.B.3.c. and IV.D.2 of this pamphlet, *infra*.

ticular features that might be considered undesirable even if the policy reasons for discouraging "hostile" acquisitions are accepted. For example, an offer that is initially "hostile" might become "friendly" if the price is raised or if other features of the offer change. It is not clear that such changes (for example, a higher price) necessarily make the offer any less distracting to management or any less likely to involve significant debt at the corporate-level.

Finally, there is an issue whether the proposal may entrench existing management in circumstances when a change of management could be economically desirable.

4. Certain considerations common to all interest disallowance approaches or to specified categories of approaches

a. Distinguishing between the corporate sector and other sectors

The various proposals limiting interest deductions because of concern about the corporate tax base are of course limited to corporations that would otherwise be taxed at the corporate-level. There are issues related to when a business entity should be classified as such a corporation. Consideration should be given to the question whether denying interest deductions only in the corporate context without similar treatment in other contexts could create investment distortions.

To the extent that rules defining the tax treatment of C corporations and their investors are changed, parallel issues arise regarding tax treatment of alternative entities. For example, restrictions on the deductibility of interest on corporate debt, or changes in the corporate tax treatment of distributions on equity, could make entities other than C corporations more attractive, by comparison, as vehicles for business enterprise. At the same time, changes to the treatment of debt of partnerships or S corporations would have to take account of ramifications beyond the issue of deductibility, such as the effect of debt on basis of partners and S corporation shareholders. Similarly, changes in the tax law that would make C corporations less attractive investment vehicles for currently tax-favored investors (such as foreign persons and tax-exempt organizations) would stimulate utilization of alternative business entities. Creating a motivation to substitute partnerships and S corporations for C corporations puts pressure on entity classification rules for those organizations. Finally, proposals which would affect only tax deductions for certain business interest but leave unchanged deductions for housing interest or certain other nonbusiness interest could have some effect of shifting debt and investment to sectors such as owner-occupied housing which already are favored by the tax system.

In addition, there may be a concern that the difficulty of distinguishing debt from equity under present law permits similar economic arrangements to be taxed differently, almost at the election of the taxpayer. This gives rise to an opportunity for tax arbitrage. For example, instruments characterized as debt may tend to be issued by taxpayers with relatively high effective tax rates, while equity may tend to be held by taxpayers with relatively low effec-

tive tax rates (including those with zero tax rates, such as tax-exempt entities). Consideration should be given to limiting the tax arbitrage potential of passthrough entities, if tax arbitrage is limited in the corporate sector.

b. Situations where borrowing may occur outside U.S. taxing jurisdiction

All of the interest disallowance proposals affect only transactions in which an interest deduction is taken against U.S. taxable income. Critics of the 1987 House bill contended that the interest deduction proposals would provide an advantage to a foreign acquiror of a U.S. corporation that a U.S. acquiror did not have, as long as the foreign acquiror's interest expense was not effectively connected with a trade or business conducted by the foreign acquiror in the United States. They argued that a foreign acquiror might continue to be able deduct its interest expense against tax on foreign income in the foreign jurisdiction.

The U.S. tax system and the various foreign tax systems differ to such an extent that it has proven impossible, despite mechanisms such as tax treaties and foreign tax credits, to create rules that would completely rationalize and coordinate all the tax consequences of cross-border investments and operations. This is partly due to the inherent difficulty of legislating and regulating with specific reference to the rules of each foreign taxing jurisdiction, and partly due to the fact that each country enacts its tax law or negotiates tax treaties as an independent sovereign. Among other consequences of these realities, imperfect matching of U.S. and foreign rules may sometimes result in foreign persons receiving more or less favorable tax treatment (depending on the domestic rules under which they operate) on their U.S. income than do U.S. persons. For example, as noted above in Part II, foreign persons generally do not pay tax on gains from sales, redemptions, or liquidating distributions with respect to U.S. stock. Whether or not a foreign person has a net tax advantage over U.S. persons on their sales of U.S. stock, however, is in part a function of the tax laws and treaties of the foreign person's country of residence.

One example of a difference between U.S. and foreign tax rules involves respective rules for taxing domestic persons on their foreign income. The United States, for example, taxes domestic persons on all worldwide income, and seeks to avoid double taxation of foreign income by giving a credit for foreign taxes on foreign source income. Some countries, on the other hand, alleviate international double taxation through an "exemption system": that is, they tax their own domestic persons generally only on domestic income.

Under either a credit or exemption system, it is necessary to allocate deductions between domestic and foreign source gross income in order to determine the amount of foreign net income. Changes made to the U.S. interest allocation rules in 1986 now make it less likely than previously that a U.S. person will shelter domestic tax on *domestic* income with foreign tax credits. To the extent that the interest allocation rules of a particular foreign country may be less effective than the current U.S. rules in this regard, some may argue that U.S. taxpayers already suffer greater limitations on tax

benefits from interest expenses than do residents of that foreign country. On the other hand, if a foreign country has rules that adequately allocate interest between income from domestic and foreign sources, there may be little tax advantage to foreign acquirors even if the U.S. acquiror suffers interest disallowances.[169]

Disparities may exist between the interest allocation or deduction rules applicable in a particular foreign country and those applicable in the United States. All other things being equal, a resident of that foreign country might derive a tax advantage, relative to U.S. persons, from that disparity. However, other rules of that country may neutralize that advantage. If not, the foreign system's insufficient allocation of debt to U.S. assets or otherwise overly generous interest deduction rules would represent a subsidy provided by the foreign government for investment abroad. In effect, any advantage foreign acquirors have would come directly from the revenues of the foreign government.

In general, the U.S. tax system does not attempt to match tax incentives provided by foreign governments to their taxpayers. The number of foreign jurisdictions and the myriad of tax incentives preclude this possibility even if it were desirable. Presumably, in order for foreign governments to finance specific tax incentives, the foreign tax burden on other activities must be higher. The U.S. tax system would generally not attempt to match these higher tax burdens either.

It is also arguable that if U.S. revenue considerations are the primary policy objective, deductions against income taxable only in a foreign jurisdiction are not a concern. If, however, it is determined that any proposal restricting deductibility of interest by U.S. taxpayers must affect foreign borrowing by a foreign acquiror (in order to eliminate any competitive advantage), consideration might be given to combining or substituting additional proposals such as the excise tax or minimum distribution tax approaches discussed in the next section.

c. Interest allocation issues and other deductions

In the case of those proposals that would disallow interest deductions based on whether the borrowing supports a particular use of funds (for example, a distribution of corporate equity), it is necessary to determine what allocation method will be used to identify the troublesome borrowing.

A tracing method has limited effectiveness because money is fungible. Therefore, a corporation with sufficient assets to borrow under circumstances not directly traceable to disqualifying use (the distribution, acquisition, etc.) would not be affected by a tracing method, and would be advantaged over other corporations affected by the tracing method.

Under an avoided cost method of allocation, which is based on the concept that money is fungible, it is assumed that the corporation could have chosen to pay down its existing debt with the funds

[169] U.S. and foreign investors would achieve strict parity with regard to the treatment of interest expense if (i) the foreign allocation rules allocated debt to U.S. assets in the same way that U.S. rules allocated debt to those activities or transactions resulting in nondeductibility of allocable interest, and (ii) the foreign investor were untaxed by its home country on its U.S. investment (either because of excess foreign tax credits or home country exemption system.)

that were used for the disqualifying purpose (distribution, acquisition, etc.). Therefore, if any funds are used for that purpose instead of to pay down the debt, existing debt is in effect supporting the disqualifying use.

The 1987 House bill provision for determining when interest is incurred on debt that is "allocable" to the targeted transactions would not limit the allocation to a tracing method; but it also would not require that all indebtedness be allocated first to the equity distributed in the transaction in question. It is arguable that this method would be too limited in its application.

Transactions other than borrowings (for example, leasing arrangements) can provide deductions to a corporation or other entity. In some situations, moreover, it is arguable that the economic effect of such transactions may be similar to a borrowing. Consideration should be given to the possibility that the impact of any limitations imposed solely on interest deductions might be reduced to the extent such other transactions are unaffected.

d. Transition issues

Any attempt to impose interest disallowances will have major implications to existing debt issuers and holders. First, it would be necessary to determine whether outstanding debt will be grandfathered.[170] If there is no grandfathering rule for existing debt, large windfall wealth gains and losses will be generated in the economy. Existing financing arrangements may have been structured assuming that there would be no major change in the tax law (such as widespread debt disallowance). A proposal similar to inflation indexing, without a grandfather provision, would cause unexpected windfall reductions in taxes to creditors and increases to debtors. Although most tax changes generate similar patterns of windfall gains and losses, the prominence of interest payments in economic relations may make these wealth transfers larger and more widespread than those caused by most tax law changes.

If grandfather rules are adopted, new complexities arise. For example, if interest deductions are disallowed only with respect to debt issued after the effective date of a proposal, new companies may be disadvantaged relative to older companies which already have debt outstanding because the new company will have a higher cost of funds. In addition, it is unclear how such a rule would apply in all cases. For example, lines of credit may be established before the proposal becomes effective but borrowings under the line of credit may be made after the effective date of the proposal.

Alternatively, a grandfather rule could disallow interest on a corporation's debt that was in excess of a debt ceiling which would equal the amount of the corporation's debt on a particular date (or the average of amounts over a base period). Such a rule may be perceived as unfair since the tax treatment of otherwise similar corporations would depend upon the degree of leverage on a particular date (or over a base period). In addition, such a rule would inhibit a corporation from growing since the average and marginal

[170] The 1984 repeal of the 30-percent withholding tax on portfolio interest paid to foreigners provided that interest on debt instruments issued before the effective date would still be subject to the withholding tax.

after-tax cost of borrowing would increase with growth. A special rule could be provided for start-up corporations (that otherwise under this rule would have a debt ceiling of zero) so as not to disadvantage these corporations relative to existing corporations.

Another grandfather rule could disallow interest only on debt in excess of the debt that the corporation would have if its debt-equity ratio were the same as the ratio on a particular date (or the average ratio over a base period). Such a rule would not penalize growing corporations if equity grew with debt. However, by increasing a corporation's cost of borrowing when debt-equity rations increased above some historic level, the rule would prevent some corporations from increasing their leverage even though it might be economically efficient. This could give established corporations an advantage over new corporations.[170a]

C. Combination Interest Disallowance and Dividend Relief Options

1. Provide deductible rate of return for corporate-level equity and limit interest deductions to the same rate

This option would grant a limited corporate-level dividends paid deduction and conform the treatment of debt to that accorded equity by limiting allowable interest deductions to the same rate. The rate of return could be selected to approximate the rate an investor would demand for a relatively risk-free investment (e.g., the rate on comparable-term Treasury obligations, or a rate several points above that).[170b]

The major advantage of this proposal is that the treatment of debt and equity would be more closely aligned since the cost of all externally-raised capital generally would be deductible to the same extent. This could remove some of the importance of distinguishing debt from equity.

In addition, the proposal might alleviate pressure for the issuance of debt, and to this extent would address non-tax issues related to concern about the economic consequences of leverage. This proposal, standing alone, is not designed to address any issues related to the potential erosion of the tax base. Although the deduction with respect to debt would be limited, the new deduction for equity might offset that limit in many cases. Depending upon the rate selected and the transitional rules adopted, the total amount of available deductions might be reduced for some corporations, but might increase for others.

Moreover, the proposal does not address issues related to the reduction of the corporate tax base by debt-financed distributions or by other distributions. However, it could be combined with other proposals directed to such issues.

One issue with respect to this approach is the selection of the appropriate deductible rate.[171] The selection of the effective date of

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[170a] See the discussion of transition issues in connection with integration proposals in Part V.A.5 of this pamphlet, *supra*.

[170b] See footnote 172, *infra*.

[171] See discussion under Part V.B.1.b. of this pamphlet, *supra*.

the proposal involves additional issues. For example, granting a dividends paid deduction for capital contributed prior to the effective date of the proposal could arguably provide a windfall for such capital. Similarly, cutting back interest deductions for debt incurred prior to that debt could be viewed as undermining existing expectations.

If the deduction for equity is granted only to "new" capital, rules would have to be provided to prevent the retirement of existing capital and its reissuance as "new" capital eligible for the deduction. The minimum distributions tax proposal described below at Part V.D.1. of this pamphlet, *infra*, might provide a method of enforcing such a limitation.

Providing a deduction only for "new" capital might also raise questions whether new equity (or new corporations) might obtain some advantage over old equity (and old corporations.) Such concerns might be addressed by allowing the deduction for all capital but phasing it in slowly, or by requiring the deduction for each infusion of new capital to be phased out over some period of time.

2. Allow an investor credit for interest and dividends and deny corporate interest deduction

This option would not permit a corporation to deduct any interest. Instead, shareholders and debtholders would be allowed a credit against taxes owed as a result of their receipt of dividends and interest. The credit would be based, in some fashion, on corporate taxes paid with respect to the dividends and interest distributed by a corporation.

One advantage of this option is that the tax treatment of debt and equity would be equalized. One issue raised by this option is the effect it would have on other business entities (e.g., partnerships), depending on whether the option applied only to corporations or to a broader class of business entities. The other issues raised by this option are similar to those discussed in connection with integration proposals generally (see Part V.A. of this pamphlet, *supra*).

D. Other Options

1. Impose minimum tax on distributions

A minimum tax could be imposed on certain corporate distributions (for example, extraordinary dividends, stock redemption distributions, and amounts distributed in corporate acquisitions) to assure that the corporate revenue base is not reduced without payment of at least a minimum amount of tax.[172]

One approach would impose the tax at a rate equal to the rate on dividends received by individuals (e.g. 28 percent). The tax could be withheld from the dividend distribution by the distributing cor-

[172] A variation of this approach was suggested by Professor William D. Andrews in a *Reporter's Study on Corporate Distributions*, published as an Appendix to the American Law Institute's *Federal Income Tax Project, Subchapter C, Proposals on Corporate Acquisitions and Dispositions* (1982). The Reporter's Study made three specific proposals relating to the taxation of corporate income. The proposals would (1) provide a deduction for dividends paid on new corporate equity, (2) impose a compensatory tax on nondividend distributions, and (3) modify the tax treatment of intercorporate investment and distributions. The proposals contained in the Reporter's Study have not been adopted by the American Law Institute.

poration and a credit provided to the shareholder against any shareholder tax on the distribution.

This approach directly addresses the issue of the erosion of the corporate base by focusing on the cause of the erosion, i.e., distributions out of corporate solution. The approach recognizes that the erosion can occur whether or not debt is incurred and whether or not an acquisition transaction such as a leveraged buyout is involved. Its application to all major corporate distribution transactions would ensure that a minimum tax would in fact be collected, regardless of the nature of the distributee and of the specific tax characterization of the distribution. At the shareholder level, any bias in the tax law in favor of non-dividend distributions (treated as sales) as opposed to dividend distributions would be eliminated.

One issue related to this approach is that certain arguably unfair results may occur from the distributee's standpoint because the same tax is withheld from a distribution regardless of a shareholder's basis in the shares. In addition, the proposal would collect tax with respect to certain distributions to tax-exempt investors that are not currently taxed. This effect would be mitigated to the extent that ordinary distributions (such as ordinary dividends) might be exempted from the proposal.

It is arguable that the proposal might subject corporate income to multiple taxation if the corporation is taxed on earnings, a taxable selling shareholder is taxed on gain that is attributable to retained earnings, and the purchasing shareholder is also taxed on the distribution in redemption of his recently-acquired shares. However, such multiple taxation would be mitigated to the extent tax is deferred or eliminated either at the corporate or the shareholder level. For example, the corporation might not pay current tax on corporate earnings or appreciation that may underlie a selling shareholder's gain (because of corporate-level tax deductions that do not reflect economic losses, or because appreciation has not been recognized at the corporate level). Similarly, a selling shareholder may obtain a deferral benefit by not recognizing gain until his stock is sold. Also, such multiple taxation would not occur to the extent that the purchasing shareholder anticipates the new minimum distributions tax (or anticipated a tax on distributions under present law), and accordingly reduced the price paid to the selling shareholder.

2. Require recognition of corporate-level gain to the extent corporate-level debt is incurred in excess of corporate-level underlying asset basis

A portion of corporate-level appreciation could be recognized whenever debt is incurred in excess of underlying corporate-level asset basis. This proposal could be limited to situations where the debt supports a distribution out of corporate solution.

Under this approach, the distributing corporation is viewed as having cashed out a portion of its asset appreciation, since it has removed that value from corporate solution rather than using the funds to pay down corporate-level debt supported in part by appreciation in corporate assets. (See discussion of 1987 Act House-passed bill, as Part V.B.3.b. of this pamphlet, *supra*.). The approach addresses issues related to the erosion of the corporate revenue

base and also issues related to the measurement of economic income.

It is arguable that since the corporation is still liable for its debt, it has not obtained any advantage from the borrowing and distribution and should not be required to accelerate recognition of corporate level gain. On the other hand, to the extent corporate asset appreciation supported the borrowing, the funds have been removed from corporate solution, and the remaining corporate assets are the only source of repayment, it is arguable that the benefits of the corporate appreciation have been realized at this point.

3. Impose excise tax on acquisition indebtedness

A nondeductible excise tax at a rate that would approximate denial of a corporate level interest deduction could be imposed in the case of certain distributions where debt is involved. This tax could be designed to parallel any of the interest disallowance proposals described above that address acquisitions or other types of corporate distributions.

To the extent the tax depends upon identification of an amount of indebtedness that supports a particular type of transaction, it will involve the debt allocation issues discussed above in connection with interest disallowance proposals (see Part V.B.4.c. of this pamphlet, *supra*).

To the extent the tax is imposed only on certain types of indebtedness (for example, where the interest rate or the debt-equity ratio exceeds a certain amount), it raises the further issue whether transactions could be structured to avoid the particular limitations while varying other aspects of the transaction to produce similar economic results. (See discussion of interest disallowance proposals at Part V.B. of this pamphlet, *supra.*).

Finally, to the extent the tax is imposed only on certain types of stock purchases (for example, purchases of 50 percent of the stock of a corporation within a specified time), it will be limited in the extent to which it addresses broader questions relating to erosion of the corporate tax base or the proper matching of corporate-level deductions with income.

The principal issue such an excise tax would attempt to address is the potential concern related to interest disallowance proposals that foreign acquirors able to borrow abroad might be advantaged over U.S. acquirors. (See discussion at Part I.V.B.4.b. of this pamphlet, *supra.*). However, to the extent the excise tax is dependent upon the identification of some amount of debt supporting the acquisition, it may involve administrative issues since it may be difficult to identify the amount of foreign incurred debt supporting a U.S. acquisition. A presumption might be established that all or a specified percentage of a foreign acquiror's purchase price was debt-financed. Possibly foreign acquirors could be given an opportunity to rebut the presumption. However, it might be difficult for the Internal Revenue Service to audit any such rebuttal statements, which could require obtaining information about the entity's foreign capital structure.

4. Develop objective standards for distinguishing between debt and equity

The possibility of issuing Treasury regulations under section 385 could be revisited.[173] Such an approach could attempt to develop more objective standards for distinguishing between debt and equity. Prior attempts to develop such standards have been unsuccessful (see Parts II.E. and V.B.3, *supra*, of this pamphlet).

5. Proposals relating to employee stock ownership plans

To the extent that any proposal relating to the deductibility of interest payments in connection with leveraged buyouts is adopted, special consideration should be given to whether similar restrictions should be imposed on employer contributions to ESOPs that are used to repay loans used to acquire employer securities. The availability of the special rules for ESOP-related borrowing arguably would perpetuate an advantage of debt over equity in ESOP situations.

If the special tax incentives for leveraged ESOPS are retained, some would propose a general review of the leveraging rules relating to ESOPs to determine if the rules can be modified to better ensure that employees will benefit significantly from ESOP transactions. They argue that even if the special tax benefits for leveraged ESOPs are appropriate, changes could be made to preserve the incentives to establish ESOPs, but also provide better safeguards for employees. Examples of possible changes are modifications to the voting rules for ESOPs, or a requirement that an employer may not establish an ESOP unless it is supplemental to another tax-qualified retirement plan.

Specific options that have been proposed relating to ESOPs are discussed below.

a. Modify interest exclusion for loans to ESOPs

Reduce or eliminate interest exclusion

One option would be to eliminate or reduce the special interest exclusion for loans to ESOPs (sec. 133). Proponents of this proposal argue that, given the concern over leveraging transactions, it is appropriate to limit or eliminate tax incentives that increase the incentive to finance capital acquisitions through borrowing. In addition, some would argue that it is appropriate to limit the special tax benefits for ESOPs because there is evidence that the tax benefits do not accomplish their stated objective. Finally, some would argue that reducing the tax bias in favor of ESOPs is good retirement policy because such reduction may induce fewer companies to adopt ESOPs as opposed to other types of tax-qualified retirement plans.

Cpponents of such a proposal would argue that special tax incentives for loans to ESOPs are appropriate because borrowing may be the only way that an ESOP can obtain sufficient funds to acquire a significant block of the employer's stock. Without such benefits,

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[173] See *The Washington Post*, January 13, 1989, p. F1.

they argue, it may be difficult for the transfer of capital ownership to take place.

Excludable interest as tax preference item

H.R. 5170 (introduced by Mr. Stark in 1988) would provide that the amount excludable from income under section 133 is treated as a tax preference item. Thus, excludable interest income under section 133 would have to be taken into account in calculating the minimum tax. This proposal would reduce the tax benefits of using an ESOP in a leveraging transaction and thus could make the use of an ESOP in such a transaction less attractive. The arguments in favor and against this proposal are basically the same as those discussed under the previous proposal.

b. Require passthrough voting requirements

H.R. 5170 would amend the voting rights applicable to stock allocated to the accounts of ESOP participants by providing that each plan participant is entitled to direct how to vote the shares allocated to his or her account if (1) the employer has a registration-type class of securities, or (2) at least 35 percent of the stock of the employer sponsoring the plan (determined by vote or value) is held by an ESOP or ESOPs. Similarly, S. 2078 and S. 2291 (introduced by Senator Armstrong in 1988) would provide that the voting rights of ESOP participants must be substantially similar to the voting rights of other persons who hold the same class of securities or substantially similar securities. Under present law, if the employer does not have a registration-type class of securities, voting rights must be passed through to plan participants only in the event of any corporate merger or consolidation, recapitalization, or and similar transactions.

Proponents of such proposals argue that ESOP participants should have the full benefits of stock ownership and thus should have the same voting rights as other shareholders. Opponents of such proposals argue that they make the establishment of an ESOP less attractive in the case of non-publicly traded companies in which the management wishes to retain control of the operation of the company.

c. Impose standards for valuation of employer securities

H.R. 5171 (introduced by Mr. Stark in 1988) would require that the Securities and Exchange Commission prescribe regulations establishing standards for valuing stock in corporations in cases where the stock is not readily tradable on an established securities market, and that such standards be used in making valuations for purposes of the provisions of the Code and ERISA that relate to ESOPs. This proposal could be viewed as generally favorable to employees because it would establish independent means for determining the value of stock held by an ESOP. Some would argue that such additional rules are not necessary because the Code already requires that the value of stock that is not readily tradable in an ESOP be determined by an independent appraiser.

d. Require employee approval of the establishment of an ESOP

Several bills have been introduced that would require that a majority of the employees of an employer approve the establishment of an ESOP in order for the ESOP to be a qualified plan. H.R. 4184 (introduced by Mr. Rostenkowski in 1988) would provide that such approval is required if (1) the ESOP is proposed or agreed to by employees represented by a collective bargaining unit in a corporation with more than 1 such units, (2) at least 30 percent of the employees of the corporation are not represented by a collective bargaining unit, and (3) assets from a defined benefit plan will be transferred to the ESOP.

S. 2078 and S. 2291 would require that any ESOP is not a qualified plan unless a majority of the employees approve the establishment of the ESOP.

These proposals generally expand the influence that employees have over the establishment of an ESOP, and therefore can be viewed as favorable to employees. The establishment of an ESOP can have a direct effect on the current compensation and retirement income of employees, particularly if the ESOP replaces a defined benefit pension plan. Arguably, employees should be involved in such a decision. Requiring that the employees approve the transaction is also a measure of whether the employees significantly benefit from the ESOP.

Whether the proposals would have any effect on the rate of establishment of ESOPs is difficult to determine. In some cases, the required approval could be obtained, in which case the requirement would have no effect. Where there is no approval, there may or may not be a reduction in the number of ESOPs established; it may be that approval is eventually obtained after modifications are made to the transaction. Whether or not approval is obtained, such proposals may reduce the willingness of an employer to establish an ESOP or use an ESOP in a leveraged buyout because the need to obtain approval increases administrative burdens and may mean that the transaction is more costly or requires more time to complete.

Any of these proposals would be a significant change from present law, which permits employers (together with collective bargaining representatives, if any) to determine whether and what kinds of retirement plans should be established. Opponents of such proposals argue that an employee approval requirement is an unwarranted intrusion into the decision-making of the employer. They would argue that such employee involvement is proper only in a collective bargaining context.

e. Modify fiduciary rules

There has been some concern that the present-law rules relating to investment of pension plan assets are not sufficient to prevent risky investments, particularly given the tremendous activity in the leveraged buyout area. Thus some would argue that the rules should be reviewed, and that specific restrictions on investing in leveraged buyouts should be enacted. Some would also question whether the level of enforcement of the existing rules is sufficient,

and would argue that more specific rules regarding particular types of transactions would be easier to enforce.

On the other hand, some would argue that the general approach taken by the present-law rules is the most administrable way to regulate pension plan investments. Defining particular transactions that are impermissible investments may be difficult. Such prohibitions could be effectively meaningless if the marketplace develops new types of transactions that do not fit within the letter of the law. Some would also argue that no additional restrictions are necessary because leveraged buyout transactions do not increase the overall riskiness of pension plan funds as long as the fiduciary and diversification rules are satisfied.

Some would also argue that, even if the existing fiduciary rules are sufficient, they should be expanded to include all pension plans, particularly governmental plans. Indeed, recent reports indicate that much of the pension investment in leveraged buyouts is by public plans not subject to ERISA's fiduciary rules. Opponents of such an extension argue that state law adequately protects participants in state pension plans, and that, in any case, such an extension would be an unwarranted extension of the Federal government into state affairs.

Some would also propose limiting pension plan investment in leveraged buyouts as a means of curbing such transactions. Opponents of such proposals argue that if leveraging is a problem, it would be more appropriate to deal with the issue directly.

6. Impose unrelated business income tax in certain transactions

(1) All interest income received by a tax-exempt organization from debt that supports a leveraged buy-out or other transaction which reduces the corporate equity base could be subjected to the UBIT. This approach would ensure that there is at least one level of tax on corporate income in cases where a tax-exempt organization lends funds (which may have been accumulated with the benefit of favorable tax treatment to the organization) to a corporation and the borrowing supports a reduction in the taxable corporate revenue base.

Under this approach, if an exempt organization purchased bonds which were issued by a corporation to acquire the stock of another corporation or to finance a redemption of its own stock, then interest paid to the exempt organization (which reduces the payor corporation's tax) would be subject to the UBIT when received by the exempt organization. In contrast, interest paid to an exempt organization from borrowing that is not used to reduce the corporate tax base (e.g., the corporation uses the borrowing to purchase assets generating additional income taxable at the corporate level) would continue to be exempt from the UBIT, as would dividend payments to an exempt organization.

A variant of this proposal could provide that interest received by an exempt organization could be subject to the UBIT in certain debt-financed acquisitions and redemptions where the interest rate exceeds a specific rate or other factors exist indicating excessive risk (see Parts V.B.1.b. and V.B.3.a. of this pamphlet, *supra*).

To the extent that imposition of the UBIT on interest income was dependent upon whether indebtedness supports a particular

type of transaction, debt allocation issues (discussed at Part V.B.4.c. of this pamphlet) would arise. In addition, reporting requirements may need to be adopted so that corporations paying interest to tax-exempt organizations report to those organizations and the Internal Revenue Service whether the underlying indebtedness supports a particular type of transaction.

(2) The UBIT rules could be expanded to provide that, if an exempt organization receives an interest payment from an entity which is 50-percent or more owned or controlled by the exempt organization, then such interest income would be subject to the UBIT. Such a change would be justified by the fact that the present-law 80% threshold for determining whether an entity is "controlled" by an exempt organization is easily circumvented. Consequently, an exempt organization presently may receive tax-free part of the income from an unrelated business activity that is paid out in the form of interest from a taxable entity which it effectively controls (through at least 50-percent but less than 80-percent ownership). Adoption of a control test with a 50-percent threshold, however, would preclude what, in essence, is a parent-subsidiary group from being able to shield from taxation a portion of the earnings of a business which is unrelated to a tax-exempt function.

The proposal could further provide that, to prevent an exempt organization from circumventing the "control" test by arranging for an affiliated organization to hold ownership interests in a subsidiary entity, ownership attribution rules be adopted, and ownership interests of two or more tax-exempt organizations acting together be aggregated for purposes of determining whether interest paid by a controlled entity to an exempt organization is subject to the UBIT.

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