

**OVERVIEW OF THE TAX TREATMENT
OF CORPORATE DEBT AND EQUITY**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on May 24, 2016

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



May 20, 2016
JCX-45-16

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INTRODUCTION AND SUMMARY

Introduction

The Committee on Finance of the Senate has scheduled a public hearing on May 24, 2016, titled “Debt and Equity: Corporate Integration Considerations.” This document¹ has been prepared for that hearing by the staff of the Joint Committee on Taxation.

The first part of this document presents an overview of Federal income tax rules relating to debt and equity, and some of the statutory limitations on the tax benefits of each. The overview includes the treatment of both issuers and holders, and the treatment of each in the event of a business downturn in which the instrument becomes worthless.

The second part of this document presents data regarding nonfinancial business sector debt and equity and other business debt over several decades.

The third part of this document discusses the tax incentives created by the present-law tax treatment of debt and equity.

Summary

Business enterprises and their investors have business reasons to structure capital investment as either debt or equity. Investors may prefer varying levels of risk, and, for example, may seek different levels of priority in the event of the bankruptcy of the business. Businesses can issue interests to investors that have varying levels of control over the enterprise and degrees of participation in profitability or growth of the enterprise.

The tax law generally contains no fixed definition of debt or equity. Taxpayers have considerable flexibility to design instruments treated as either debt or equity but which blend features traditionally associated with both.

Differences in the Federal income tax treatment of debt and equity create incentives to use one or the other depending on the tax characteristics of the issuer and of the particular investor. In general, a corporate issuer is not subject to corporate tax on amounts that it deducts as interest on debt. By contrast, dividends, which are generally not deductible by the payor, come out of after-tax income of the corporation.

Debt instruments can permit the accrual of the interest deduction along with the inclusion in income by the holder at a time prior to the payment of cash. Interest income may be taxed at a higher rate to a taxable holder than the holder’s dividends or capital gains (to which lower tax rates currently apply). However, some forms of debt investments are not subject to U.S. tax or are taxed at reduced rates in the hands of a tax-exempt or foreign investor. A number of special

¹ This document may be cited as follows: Joint Committee on Taxation, *Overview of the Tax Treatment of Corporate Debt and Equity* (JCX-45-16), May 20, 2016. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

rules in the Code are designed to protect the corporate tax base by limiting the tax benefits that can be obtained from interest deductions.

To the extent that debt finances assets that produce tax-exempt or otherwise tax-favored income, the interest deduction is available to offset other income taxed at higher rates. The resulting tax arbitrage can shelter otherwise taxable income. A number of special rules in the Code are directed at limiting this effect.

In the event of financial difficulty, the discharge or restructuring of debt can cause the issuer to recognize discharge of indebtedness income or, alternatively, gain with respect to the satisfaction of nonrecourse indebtedness for less than the outstanding amount. The income tax treatment of debt discharge depends on whether the debt is recourse or nonrecourse, the nature of the borrower's assets and of the borrowing, and the circumstances of the restructuring or discharge. In a number of instances, no current income is recognized, though tax attributes such as net operating losses, credits, or the basis of assets may be reduced. By contrast, the failure to pay dividends or return an equity investment in full does not cause income or gain to be recognized by the issuer.

In classifying an instrument as debt or equity, many factors have been applied by courts. In general, a debt instrument requires a fixed obligation to pay a certain amount at a specified date. Debt instruments provide for remedies, including priorities in bankruptcy in the event of default. However, an instrument designated and respected as debt for tax purposes may have features that make it less likely to cause bankruptcy in the event of a downturn: for example, a delayed period before payment is due, the ability to miss scheduled payments over a period of time before default occurs, the ability to satisfy required payments with instruments other than cash, limits on the thin capitalization of the issuer, or ownership of the debt by equity owners who may be willing to modify its terms. Conversely, an instrument designated and respected as equity for tax purposes may have features that are more economically burdensome to the issuer, such as significantly increased dividend payment requirements after a specified period, puts and calls having the effect of requiring a cash redemption by a specified date, or provisions giving the holders certain corporate governance rights in the event scheduled payments are not made.

Equity can be beneficial for tax purposes in certain cases. Although corporate distributions and sales of corporate stock subject the holder to tax in addition to any tax paid by the corporation, reduced tax rates apply to holders with respect to such distributions or gain. Dividends on corporate equity are largely excludable by corporate holders (currently resulting in a maximum 10.5-percent tax rate under the 70-percent dividends received deduction). For individual shareholders, both dividends and capital gains on the sale of corporate stock are generally subject to a maximum 23.8-percent rate (compared to the top individual rate of 43.4 percent).² The present value of the shareholder-level tax on corporate earnings may be reduced to the extent earnings are retained and to the extent shareholders do not sell their stock.

² These 23.8- and 43.4-percent rates reflect the maximum individual rates plus the 3.8 percent tax under section 1411 on net investment income; they do not include the effect of any other tax provisions, such as the overall limitation on itemized deductions, on the effective marginal tax rate.

This second level of tax may be eliminated entirely to the extent non-dividend-paying stock is held until the death of the owner.

The treatment of an instrument for purposes of financial reporting may differ from its Federal income tax treatment. These differences may result in more favorable overall business treatment when the benefits of debt or of equity for a Federal income tax purpose are combined with the benefits of a different treatment for financial reporting purposes.

I. PRESENT LAW

A. General Rules

1. Issuer treatment of debt and equity

Interest and dividend payments

Interest paid or accrued by a business generally is deductible, subject to a number of limitations.³ By contrast, dividends or other returns to equity generally are not deductible.

Timing of interest deduction

Interest is deducted by a taxpayer as it is paid or accrued, depending on the taxpayer's method of accounting. For all taxpayers, if an obligation is issued with original issue discount ("OID"), a deduction for interest is allowable over the life of the obligation based on a yield to maturity basis.⁴ OID arises where the amount to be paid at maturity exceeds the issue price by more than a *de minimis* amount.

Principal payments and return of equity capital

Principal payments on business debt generally are not deductible. The return of capital to investors in an equity investment likewise is not deductible.

Receipt of cash upon issuance of debt or equity

The issuance of a debt or equity instrument for cash is not a taxable event to the issuer.

Basis of assets purchased with debt or equity

Purchased assets generally have a cost basis for purposes of determining depreciation or gain or loss on sale, regardless of whether the purchase was financed with debt (including nonrecourse debt) or equity.

Nonpayments on equity compared to discharge or restructuring of indebtedness

If dividends are not paid on equity, or the capital contributed by an equity holder is not returned, there is generally no taxable income, gain, or other consequence to the issuer.⁵

³ Sec. 163(a). Some of these limitations are discussed below.

⁴ Sec. 163(e). But see sec. 267 (dealing in part with interest paid to a related or foreign party).

⁵ Under certain circumstances, an additional tax at the maximum individual rate on dividends (in addition to the corporate income tax) applies to certain unreasonably accumulated income and to certain undistributed income of a closely-held corporation whose income is largely passive. Secs. 531-537 and 541-547.

The effects to the issuer if debt is modified, cancelled, or repurchased depend on the type of debt, the nature of the holder, and whether or not the debt (or property given in exchange) is traded on an established securities market. If debt is cancelled, modified, or repurchased, the borrower generally realizes income from the discharge of indebtedness. Exceptions to this income inclusion are provided for bankruptcy and insolvency, for other situations including seller financing of purchased property, qualified farm indebtedness, qualified real property business indebtedness, and contributions of debt by an equity holder. The exceptions usually require the taxpayer to reduce tax attributes, such as net operating losses, or to reduce the basis of property.⁶ If nonrecourse debt is satisfied by foreclosure on the assets securing the debt, the borrower generally realizes gain from the disposition of the assets for the amount of the debt (even if the assets are not worth that amount).⁷

Recourse indebtedness

If a taxpayer's recourse debt⁸ is discharged, the taxpayer generally recognizes income from the discharge of indebtedness at that time.⁹ A satisfaction of the debt with property worth less than the debt,¹⁰ or a repurchase of debt for less than its face amount by the taxpayer or a related party, is treated as a discharge of the taxpayer's debt to the extent of the difference between the outstanding debt and (generally) the value of the property.¹¹

A significant modification of a debt instrument is treated as the disposition of the old instrument in exchange for the new instrument.¹² Such modifications include a change in the obligor, a change in terms or interest rate, a change in principal amount, and certain modifications of security. The modification of a debt instrument can thus cause the issuer to recognize discharge of indebtedness income, measured by the difference between the adjusted issue price of the old debt and the fair market value (or other applicable issue price) of the new debt.¹³ If the debt instrument is publicly traded or is issued in exchange for property (including

⁶ Sec. 108.

⁷ *Commissioner v. Tufts*, 461 U.S. 300 (1983); *cf.*, *Crane v. Commissioner*, 331 U.S. 1 (1947).

⁸ Recourse debt is debt for which the borrower is personally liable; upon default, the lender may seek to collect against the borrower. In contrast, nonrecourse debt is debt secured only by designated collateral.

⁹ Secs. 61 and 108.

¹⁰ For example, if a creditor contributes its debt to a corporation and receives corporate stock in exchange, the corporation generally recognizes cancellation of indebtedness income to the extent the value of the stock given is less than the amount of the debt cancelled. However, if the debt was held by a person that was also a shareholder, the debt may be considered contributed in a nontaxable contribution to capital, not creating discharge of indebtedness income.

¹¹ Treas. Reg. sec. 1.61-12.

¹² Treas. Reg. sec. 1.1001-3.

¹³ The discharge of indebtedness income is taken into income at the time of the exchange. The new debt may be deemed to be issued with original issue discount (to the extent the amount payable at maturity exceeds the

other debt) that is publicly traded, then the issue price of the new debt is deemed to be the fair market value of the debt or other property that is publicly traded.¹⁴ If neither the old nor the new debt instrument is traded on an established securities market, the issue price of the new debt is generally the stated principal amount unless there is inadequate stated interest (*i.e.*, interest less than the Treasury rate for an instrument of comparable term).¹⁵ Thus, in traded situations, discharge of indebtedness income is likely to be recognized if troubled debt is modified or satisfied with other debt instruments. However, in private situations there may be no discharge of indebtedness income.

As noted above, special rules allow a taxpayer not to recognize discharge of indebtedness income if the taxpayer is in bankruptcy or is insolvent. If the discharge of indebtedness occurs in a Title 11 bankruptcy case, the full amount of any debt discharged is excluded from income. If the taxpayer is insolvent, cancellation of debt income is excludable only to the extent of the insolvency. In either case, if the tax attributes subject to reduction are insufficient to cover the amount of the discharge, there is no inclusion of debt discharge income for the excess. In the case of an entity that is taxed as a partnership, the determination of whether the discharge occurs in a Title 11 bankruptcy case, whether the taxpayer is insolvent, and the reduction of tax attributes, all occur at the partner level.

Tax attributes are generally reduced in the following order: (1) net operating losses, (2) general business credits, (3) minimum tax credits, (4) capital loss carryovers, (5) basis reduction of property, (6) passive activity loss and credit carryovers, and (7) foreign tax credit carryovers. A taxpayer may elect to apply the reduction first against the basis of depreciable property.

Nonrecourse indebtedness

Nonrecourse debt is subject to different rules than recourse debt.¹⁶ Because the taxpayer is not personally liable on the debt, there is no cancellation of indebtedness income. However, if the creditor forecloses or otherwise takes the property securing the debt, the borrower treats the transaction as a sale of the property for a price equal to the outstanding indebtedness (even if the

issue price) that the issuer can deduct, which can offset the amount of debt discharge income, but the deductions occur in the future over the period of the new debt, while the income is recognized immediately.

¹⁴ Thus, if a distressed debt instrument is modified and the transaction is treated as an exchange of the old instrument for the new one, the debtor can experience discharge of indebtedness income in the amount of the difference between the adjusted issue price of the old debt and its fair market value at the time of the modification.

¹⁵ In certain “potentially abusive” cases, the principal amount of debt given in exchange for other property (including other debt) is the fair market value of the property exchanged.

¹⁶ The distinction between recourse and nonrecourse debt may be less obvious than it would appear. Recourse debt might be issued by an entity that has limited liability and limited assets, while nonrecourse debt might be oversecured.

property securing the debt is worth less than the debt at the time of foreclosure).¹⁷ Such a transaction generally produces capital gain (rather than ordinary income) to the debtor.

Purchase money financing

If discharged debt is seller-financing for a purchase of property by the debtor, and if the debtor is not insolvent or in a bankruptcy proceeding, then instead of income from the discharge of indebtedness, the debtor-purchaser has a purchase price reduction (which reduces the basis of the property acquired).

2. Holder treatment of debt and equity

Current income and sales of interests

Taxable investors

Interest on debt is taxed to a taxable individual or corporate holder at the ordinary income tax rate of the holder (currently, up to 39.6 percent for an individual, and 35 percent for a corporation). Dividends paid by a taxable C corporation,¹⁸ are generally taxed to a taxable individual shareholder at a maximum rate of 20 percent. Such dividends are generally taxed to a C corporation shareholder at a maximum rate of 10.5 percent (or less, depending on the percentage ownership the corporate shareholder has in the issuing corporation).¹⁹ Gain on the sale of an equity interest in a C corporation or in an S corporation is generally capital gain. If the stock has been held for at least one year, such gain is generally taxable to a taxable individual shareholder at a maximum rate of 20 percent. Gain on the sale of C corporation stock is taxed to a corporate shareholder²⁰ at regular corporate rates (generally 35 percent). Gain on the sale of an equity interest in a partnership is generally also capital gain of the partner, except for amounts

¹⁷ *Commissioner v. Tufts*, 461 U.S. 300 (1983); *cf.*, *Crane v. Commissioner*, 331 U.S. 1 (1947).

¹⁸ A C corporation is defined by reference to subchapter C of the Code (tax rules relating to corporations and shareholders) and is taxable as a separate entity with no deduction for dividends or other equity distributions. For purposes of the discussion in this document, such corporations are distinguished from certain corporations that meet specific tests relating to organization, function, assets, and income types and can deduct dividends and certain other equity distributions to shareholders (*e.g.*, real estate investment trusts (“REITs”) or regulated investment companies (“RICs”)).

¹⁹ The lower rate on dividends received by a corporate shareholder results from the corporate “dividends received deduction,” which is generally 70 percent of the dividend received if the shareholder owns below 20 percent of the issuer, 80 percent of the dividend received if the shareholder owns at least 20 percent and less than 80 percent of the issuer, and 100 percent of the dividend if the shareholder owns 80 percent or more of the issuer (sec. 243). A corporation subject to the maximum 35-percent corporate tax rate and entitled to a deduction equal to 70 percent of a dividend would pay a maximum tax on the dividend of 10.5 percent (the 30 percent of the dividend that is taxable multiplied by the 35-percent tax rate).

²⁰ A C corporation is not an eligible S corporation shareholder and therefore cannot own S corporation stock.

attributable to unrealized receivables and inventory items of the partnership, which are taxable as ordinary income.²¹

Net investment income tax

An additional tax is imposed on net investment income in the case of an individual, estate, or trust.²² In the case of an individual, the tax is 3.8 percent of the lesser of net investment income²³ or the excess of modified adjusted gross income²⁴ over the threshold amount. The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case.²⁵ Thus, for taxpayers with modified adjusted gross income in excess of this threshold, the rate on certain capital gains and dividends is 23.8 percent and on interest is 43.4 percent.²⁶

Timing of inclusion

Interest is generally taxable when received or accrued. If the original issue discount rules apply, interest generally is includable in income, and thus taxable, before any cash payment is received. Dividends generally are not taxable until actually or constructively received.²⁷ In limited circumstances, however, certain preferred stock dividends may be accrued under rules similar to the rules for debt. Also, a shareholder may be treated as having received a dividend if his percentage stock ownership increases as a result of the payment of dividends to other shareholders.²⁸

²¹ Sec. 751.

²² Sec. 1411.

²³ Net investment income is the excess of (1) the sum of (a) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities, and (b) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in the active conduct of a trade or business that is not in the trade or business of trading in financial instruments or commodities, over (2) deductions properly allocable to such gross income or net gain.

²⁴ Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

²⁵ These thresholds are not indexed for inflation.

²⁶ These 23.8- and 43.4-percent rates do not include the effect of any other tax provisions, such as the overall limitation on itemized deductions, on the effective marginal tax rate.

²⁷ See Treas. Reg. secs. 1.301-1(b) and 1.451-2(b).

²⁸ Sec. 305(c). Certain situations in which some shareholders receive cash and others experience an increase in their percentage ownership can also cause both groups of shareholders to be treated as receiving a dividend under that section.

Tax-exempt investors

A tax-exempt investor (*e.g.*, a university endowment fund or a pension plan investor) is generally not taxed on investment interest, subject to certain unrelated business income tax (“UBIT”) rules for debt-financed income.²⁹ This is true whether the debt is issued by a C corporation or by any other entity.

Tax-exempt investors also are generally not subject to tax on the sale of C corporation stock, unless the stock investment is debt-financed.

Tax-exempt equity investors in a partnership are treated as engaged directly in the trade or business of the partnership. To the extent a partnership is engaged in a trade or business that is an unrelated trade or business with respect to a tax-exempt investor, the tax-exempt investor is treated as engaged in the unrelated trade or business directly, and is taxed on its distributive share of partnership income from such business accordingly.³⁰ Tax-exempt equity investors in an S corporation generally are taxed on their entire share of S corporation income or gain on the sale of the stock.³¹

Foreign investors

Debt interests in U.S. entities

Although U.S.-source interest paid to a foreign investor is generally subject to a 30-percent gross basis withholding tax, various exceptions exist in the Code and in bilateral income tax treaties.³² Interest is generally derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a noncorporate resident or a domestic corporation on a bond, note, or other interest-bearing obligation.³³ For this purpose, a noncorporate resident includes a domestic partnership which at any time during the year was

²⁹ Secs. 512 and 514. In addition, as discussed in greater detail below, interest received by an exempt organization from a 50-percent controlled subsidiary is subject to UBIT. Sec. 512(b)(13).

³⁰ Sec. 512(c).

³¹ Sec. 512(e).

³² Where a foreign investor is engaged in a U.S. trade or business, any U.S.-source interest income or U.S.-source dividend income (see “Equity interests in U.S. entities” below) derived from assets used in or held for use in the conduct of the U.S. trade or business where the activities of the trade or business were a material factor in the realization of such income are treated as effectively connected with that U.S. trade or business. Sec. 864(c)(2).

³³ Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1). However, special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions. Sec. 861(a)(1).

engaged in a U.S. trade or business.³⁴ Additionally, interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.³⁵

Statutory exceptions to this general rule apply for interest on bank deposits as well as portfolio interest. Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S.-source income but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.³⁶ Interest on deposits with foreign branches of domestic banks and savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).³⁷ Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.³⁸

Portfolio interest received by a nonresident individual or foreign corporation from sources within the United States is exempt from U.S. withholding tax.³⁹ The term “portfolio interest” means any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person. Portfolio interest, however, does not include interest received by a 10-percent shareholder,⁴⁰ certain contingent interest,⁴¹ interest received by a controlled foreign corporation from a related person,⁴² or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.⁴³

U.S.-source interest payments that do not qualify for a statutory exemption from the 30-percent withholding tax often are exempt from withholding under U.S. bilateral income tax

³⁴ Treas. Reg. sec. 1.861-2(a)(2).

³⁵ Sec. 884(f)(1).

³⁶ Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

³⁷ Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

³⁸ Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

³⁹ Secs. 871(h), 881(c). In 1984, to facilitate access to the global market for U.S. dollar-denominated debt obligations, Congress repealed the withholding tax on portfolio interest paid on debt obligations issued by U.S. persons. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

⁴⁰ Sec. 871(h)(3).

⁴¹ Sec. 871(h)(4).

⁴² Sec. 881(c)(3)(C).

⁴³ Sec. 881(c)(3)(A).

treaties. Many treaties, including, for example, those with Canada, Germany, and the United Kingdom, broadly eliminate the withholding tax on U.S.-source interest payments. The result is that large volumes of interest payments are exempt from withholding under the Code or a treaty.⁴⁴

Equity interests in U.S. entities

A foreign equity investor's receipt of U.S.-source dividend income from a U.S. domestic corporation is generally subject to a 30-percent gross basis withholding tax. Dividend income is generally sourced by reference to the payor's place of incorporation such that dividends paid by a domestic corporation are generally treated as entirely U.S.-source income.⁴⁵ As with interest, the 30-percent withholding tax on dividends received by foreign investors may be reduced or eliminated under U.S. bilateral income tax treaties. In general, the dividend withholding tax rates in treaties vary based on the percentage of stock of the dividend-paying company owned by the recipient of the dividend. Treaties typically provide lower withholding tax rates (*e.g.*, five percent) at ownership levels of 10 percent and greater. Twelve treaties, including those with Germany, Japan, and the United Kingdom, eliminate the withholding tax on dividends in circumstances in which, among other requirements, the foreign treaty resident is a company that owns at least 80 percent (in the case of Japan, 50 percent) of the U.S. corporation paying the dividend.⁴⁶

Foreign investors also are not generally subject to tax on the sale of C corporation stock.⁴⁷

In contrast, a foreign equity investor in a partnership is taxed on its distributive share of income effectively connected with the conduct of a U.S. trade or business, as if it had conducted that business directly. S corporations are not permitted to have foreign investors.

Treatment if investment becomes worthless

A taxable holder of either debt or equity held as an investment generally recognizes a capital loss if the instrument is sold to an unrelated party at a loss.⁴⁸ Capital losses can generally

⁴⁴ Of the \$293.7 billion of U.S.-source interest payments to foreign debtholders in 2013, \$165.7 billion, or 56.4 percent, was paid to recipients in countries that eliminate withholding tax by treaty. Forms 1042-S, Table 2, SOI and JCT staff calculations.

⁴⁵ Secs. 861(a)(2), 862(a)(2).

⁴⁶ These countries include Australia, Belgium, Denmark, Finland, France, Germany, Japan, Mexico, the Netherlands, New Zealand, Sweden, and the United Kingdom.

⁴⁷ Secs. 871 and 881, applicable to income not connected with a U.S. trade or business. The exemption does not apply to a foreign individual who is present in the United States for 183 days or more during the taxable year. Foreign investors may be subject to tax if the stock is a U.S. real property interest under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). Sec. 897.

⁴⁸ Up to \$50,000 of loss on certain small business company stock (\$100,000 for a couple filing a joint return) can be deducted as an ordinary loss. Sec. 1244.

offset only capital gains; however, an individual may deduct up to \$3,000 per year of capital loss against ordinary income.

A taxable holder of investment equity or debt also generally realizes a capital loss if the instrument becomes worthless. Certain other transactions, such as liquidating a subsidiary,⁴⁹ can permit recognition of a stock loss without a sale to an unrelated party.

In certain circumstances, an individual holder of debt that is not a security may take an ordinary bad debt deduction.⁵⁰

3. Acquisitions and dispositions

The Code permits certain corporate acquisitions and dispositions to occur without recognition of gain or loss, generally so long as only equity interests are received or any securities received do not exceed the amount surrendered.⁵¹ Similarly, the Code permits certain contributions and distributions of property to and from partnerships without tax if made with respect to an equity interest.⁵²

A transfer of property to a corporation or partnership in exchange for debt of the entity is generally treated as a sale of the property.⁵³ Gain or loss is recognized, except that loss may be deferred if the transfer is to a related party.⁵⁴

⁴⁹ See sec. 267(a)(1), second sentence.

⁵⁰ Sec. 166.

⁵¹ Secs. 351-368 and 1032.

⁵² Secs. 721 and 731.

⁵³ Sec. 1001. Special rules may apply if the transfer is considered part of a larger transaction such as an otherwise tax-free corporate reorganization.

⁵⁴ Secs. 267 and 707.

B. Distinguishing Between Debt and Equity

1. In general

The characterization of an instrument as debt or equity for Federal income tax purposes is generally determined by the substance of the investor's investment. An instrument's characterization depends on the terms of the instrument and all the surrounding facts and circumstances analyzed in terms of economic and practical realities. Neither the form of the instrument nor the taxpayer's characterization of the interest is necessarily determinative of the instrument's treatment for Federal income tax purposes. Nonetheless, between the extremes of instruments that are clearly debt or clearly equity, taxpayers have some latitude to structure instruments incorporating both debt- and equity-like features (commonly referred to as "hybrid securities").⁵⁵

There is currently no definition in the Code or Treasury regulations that can be used to determine whether an interest in a corporation constitutes debt or equity for tax purposes. Moreover, the IRS ordinarily does not provide individual taxpayers with guidance on whether a particular interest in a corporation is debt or equity for tax purposes because, in its view, the issue is primarily one of fact.⁵⁶

In the absence of statutory or regulatory standards, a substantial body of Federal common law is the principal source of guidance for distinguishing between debt and equity. Courts generally agree that the proper characterization of an instrument requires a facts and circumstances analysis, the primary goal of which is to determine whether, in both substance and form, an instrument represents risk capital entirely subject to the fortunes of the venture (equity),⁵⁷ or an unqualified promise to pay a sum certain on a specified date with fixed interest (debt).⁵⁸ The determination of whether an instrument constitutes debt or equity is generally made by analyzing and weighing the relevant facts and circumstances of each case.⁵⁹

⁵⁵ See *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 123 (2d Cir. 1956) (noting that "[t]he vast majority of these cases have involved 'hybrid securities' —instruments which had some of the characteristics of a conventional debt issue and some of the characteristics of a conventional equity issue.").

⁵⁶ Rev. Proc. 2016-3, sec. 4.02(1), January 4, 2016. The IRS has identified factors to weigh in determining whether a particular instrument should be treated as debt or equity. See, e.g., Notice 94-47, 1994-1 C.B. 357.

⁵⁷ See, e.g., *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943) (noting that "[t]he essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit."); and *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960); *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935) (noting that the distinction between the shareholder and the creditor is that "[t]he shareholder is an adventurer in the corporate business; he takes the risk and profits from success [while] [t]he creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives").

⁵⁸ See, e.g., *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957) (noting that debt involves "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof."); sec. 385(b)(1) ("a written unconditional

Courts have created differing (though generally similar) lists of factors⁶⁰ to distinguish debt from equity with no one factor controlling or more important than any other.⁶¹ One commentator provides a list of thirty factors, along with the Circuit courts that have considered such factors.⁶² Another commentator groups the factors discussed in the cases into four categories: (1) those involving the formal rights and remedies of the parties; (2) those bearing on the genuineness of the alleged intention to create a debtor-creditor relationship; (3) those bearing on the reasonableness or economic reality of that intention (the risk element); and (4) those which are merely rhetorical expressions of a result, having no proper evidentiary weight in themselves.⁶³

Some commonly cited factors considered, among others, are:

1. whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future;
2. whether the holder possesses the right to enforce the payment of principal and interest;
3. whether there is subordination to, or preference over, any indebtedness of the issuer, including general creditors;
4. the intent of the parties, including the name given the instrument by the parties and its treatment for nontax purposes, including financial accounting, regulatory, and rating agency purposes;

promise to pay on demand or on a specified 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"); Treas. Reg. sec. 1.165-5(a)(3) (defines security as an evidence of indebtedness to pay a fixed or determinable sum of money); and sec. 1361(c)(5)(B) (straight-debt safe harbor for subchapter S purposes).

⁵⁹ *John Kelley Co. v. Commissioner*, 326 U.S. 489 (1943) (stating "[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").

⁶⁰ See, e.g., *Fin Hay Realty Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968) (sixteen factors); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (thirteen factors); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986) (eleven factors); and *United States v. Uneco Inc.*, 532 F.2d 1204 (8th Cir. 1976) (ten factors).

⁶¹ *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969) (noting that "[t]he object of the inquiry is not to count factors, but to evaluate them"); and *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (noting that the factors are not of equal significance and that no one factor is controlling).

⁶² Nathan R. Christensen, "The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion," *University of Chicago Law Review*, 2007, pp. 1313.

⁶³ Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," *Tax Law Review*, 1971, pp. 411-412. According to a study of 126 Tax Court opinions issued from 1955 to 1987, seven factors were found to be conclusive of debt classification 97 percent of the time. Robertson, Daughtrey & Burckel, "Debt or Equity? An Empirical Analysis of Tax Court Classification During the Period 1955-1987," *Tax Notes*, 1990.

5. the issuer's debt to equity ratio;
6. whether the instrument holder is at risk of loss or has the opportunity to participate in future profits;
7. whether the instrument provides the holder with the right to participate in the management of the issuer;
8. the availability and terms of other credit sources;
9. the independence (or identity) between the holders of equity and the holders of the instrument in question;
10. whether there are requirements for collateral or other security to ensure the payment of interest and principal; and
11. the holder's expectation of repayment.

2. Regulatory authority pursuant to section 385

Section 385 authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation should be characterized as debt or equity (or as in part debt and in part equity) for Federal income tax purposes. Regulations prescribed under section 385 must set forth factors to be taken into account in determining in particular situations whether a debtor-creditor or a corporation-shareholder relationship exists.⁶⁴ These factors may include, among others, the following criteria:

1. whether there is an unconditional written promise to pay on demand or on a specified 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. whether there is subordination to or preference over any indebtedness of the corporation;
3. the corporation's debt to equity ratio;
4. whether the interest is convertible into stock of the corporation; and
5. the relationship between the holdings of stock in the corporation and holdings of the interest in question.

Section 385(c) provides that an issuer's characterization of an instrument (at the time of issuance) is binding on the issuer and any holder, but not the Secretary. However, the holder of

⁶⁴ Sec. 385(b).

an instrument may treat an instrument differently than the issuer provided the holder discloses the inconsistent treatment on his return.⁶⁵

On April 4, 2016, the Treasury promulgated proposed regulations under section 385.⁶⁶ Among other things, the regulations authorize the Commissioner to treat certain related-party interests in a corporation as part debt and part equity for Federal income tax purposes; provide rules that may treat an interest in an entity that is issued to a related party as, in whole or part, stock, if the interest is issued in a distribution or another transaction that has limited nontax effect or is issued to fund the transaction; and establish documentation requirements for certain related-party interests to be treated as debt for Federal income tax purposes.

Previously, the Treasury had promulgated more comprehensive proposed regulations under section 385 in March 1980⁶⁷ and final regulations on December 31, 1980,⁶⁸ with an effective date of April 30, 1981. The effective date was delayed twice.⁶⁹ In 1982, the Treasury promulgated proposed amendments to the regulations.⁷⁰ The effective date of the proposed amendments, and the final regulations, were again postponed.⁷¹ In 1983, the final regulations were withdrawn without ever having taken effect.⁷²

⁶⁵ For a brief description of the legislative background, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, pp. 18-19.

⁶⁶ 81 F.R. 20912. The proposed regulations were first made available for public inspection on April 4, 2016, and later published in the Federal Register on April 8, 2016.

⁶⁷ 45 F.R. 18957.

⁶⁸ 45 F.R. 86438.

⁶⁹ T.D. 7747, 45 F.R. 86438; T.D. 7774, 46 F.R. 24945; T.D. 7801, 47 F.R. 147.

⁷⁰ 47 F.R. 164.

⁷¹ T.D. 7822, 47 F.R. 28915.

⁷² T.D. 7920, 48 F.R. 50711. One commentator suggests that the regulations were not finalized because tax planners could design instruments containing all of the essential features of equity but which qualify as debt under the regulations. As an example, he noted that an instrument would be classified as debt if its debt features accounted for more than half of its value and that, as a result of this rule, hybrid instruments such as adjustable rate convertible notes began appearing that provided for guaranteed payments having a present value just greater than half of the issue price, variable payments tied to the issuer's common-stock dividends, and an option to convert these instruments into shares of the issuer's stock. Adam O. Emmerich, "Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation," *University of Chicago Law Review*, 1985, pp. 129-131.

C. Rules to Address Stripping of U.S. Corporate Tax Base in the Case of Nontaxed Holders

A taxable corporation may reduce its Federal income tax through the payment of deductible amounts such as interest, rents, royalties, premiums, or management fees to an affiliate not subject to Federal income tax. Sheltering or offsetting income otherwise subject to Federal income tax in this manner is known as “earnings stripping.” Several provisions of present law limit taxpayers’ ability to strip earnings. Following is a brief description of certain rules designed to limit the ability of corporations to strip earnings using payments of interest.

1. Earnings stripping

Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: the payor’s debt-to-equity ratio exceeds 1.5 to 1.0 (the safe harbor ratio); and the payor’s net interest expense exceeds 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest;⁷³ (2) unrelated parties in certain instances in which a related party guarantees the debt; or (3) to a REIT by a taxable REIT subsidiary of that trust.⁷⁴ Interest amounts disallowed under these rules can be carried forward indefinitely.⁷⁵ In addition, any excess limitation (*i.e.*, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor’s net interest expense) can be carried forward three years.⁷⁶

The operation of these rules is illustrated by the following example. ForCo, a corporation organized in country A, wholly owns USCo, a corporation organized in the United States. ForCo’s investment in USCo stock totals \$6.5 million. In addition, USCo has borrowed \$8 million from ForCo and \$5 million from Bank, an unrelated bank. In 2015, USCo’s first year of operations, USCo’s adjusted taxable income is \$1 million (none of which is from interest income), and it also pays \$400,000 of interest to ForCo and \$300,000 of interest to the unrelated bank. Under the U.S.-country A income tax treaty, no tax is owed to the United States on the interest payments made by USCo to ForCo.

⁷³ If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed by the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

⁷⁴ Sec. 163(j)(3).

⁷⁵ Sec. 163(j)(1)(B).

⁷⁶ Sec. 163(j)(2)(B)(ii).

- USCo has a 2 to 1 debt-to-equity ratio (total borrowings of \$13 million (\$8 million + \$5 million) and total equity of \$6.5 million), so USCo's deduction for the \$700,000 (\$400,000 + \$300,000) of interest paid may be limited.
- USCo's disqualified interest is \$400,000 (the amount of interest paid to a related party on which no Federal income tax is imposed).
- USCo's excess interest expense is \$200,000 (\$700,000 - (\$1 million x 50%)).
- Accordingly, USCo may deduct only \$500,000 (\$700,000 - \$200,000) for interest expense in 2015.

The \$200,000 of excess interest expense may be carried forward and deducted in a subsequent tax year with excess limitation.⁷⁷

2. Tax treatment of certain payments to controlling exempt organizations

Although tax-exempt organizations described under section 501(c) are generally exempt from Federal income tax,⁷⁸ such organizations may be subject to the unrelated business income tax ("UBIT")⁷⁹ on interest and other income received from the organization's controlled subsidiaries.⁸⁰ Section 512(b)(13) subjects interest income (as well as rent, royalty, and annuity income) to UBIT if such income is received from a taxable or tax-exempt subsidiary that is more than 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax-exempt).⁸¹

⁷⁷ For a brief description of the legislative background of section 163(j), see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, pp. 21-23.

⁷⁸ Sec. 501(a).

⁷⁹ Secs. 511-514. In general, UBIT taxes income derived from a regularly carried on trade or business that is not substantially related to the organization's exempt purposes. Certain categories of income—such as interest, dividends, royalties, and rent—are generally exempt from UBIT. Sec. 512(b)(1)-(3). For example, tax-exempt organizations are not taxed on interest income they receive from investments in debt or other obligations.

⁸⁰ Tax-exempt organizations subject to UBIT include those described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2). Organizations liable for UBIT may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

⁸¹ In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, "control" means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent tax-exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

D. Rules to Address Corporate Base Erosion Without Regard to Holder's Tax Status

Several present law rules limit interest deductions in circumstances in which it appears a deduction would not be appropriate (*e.g.*, because the instrument more closely resembles equity or because deductibility would otherwise allow an inappropriate reduction of the corporate tax base). The inappropriate reduction of the corporate tax base through the use of deductible payments or other planning techniques is commonly referred to as “base erosion.” Some limitations on the deductibility of interest expense are linked to whether the recipient of the interest is exempt from Federal income tax (*e.g.*, the earnings stripping limitation of section 163(j)), while others consider whether the timing of the borrower's deduction matches the timing of the lender's corresponding income inclusion (*e.g.*, the interest and OID rules of sections 267(a)(3) and 163(e)(3)). Other interest deduction limitations apply without regard to the holder's tax status. Following is a brief description of some of these limitations.

1. Corporate equity reduction transactions

A net operating loss (“NOL”) is the amount by which a taxpayer's business deductions exceed its income. In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.⁸² An NOL is first carried back to the earliest taxable year to which such loss may be carried, with any remaining NOL carried back to the next earliest taxable year and then forward to future taxable years.⁸³

Section 172(b)(1)(D) and (g) limit the NOL carryback of a C corporation involved in a corporate equity reduction transaction (a “CERT”) to the extent such NOL carryback is attributable to interest deductions allocable to the CERT and is incurred (1) in the taxable year in which the CERT occurs, or (2) in either of the two succeeding taxable years. The portion of the corporation's NOL carryback that is limited is the lesser of (a) the corporation's interest expense allocable to the CERT, or (b) the excess of the corporation's interest expense in the loss limitation year over the average of the corporation's interest expense for the three taxable years prior to the CERT taxable year. Any portion of an NOL that cannot be carried back under the provision may be carried forward as otherwise allowed.

Except to the extent provided in regulations, interest is allocated to a CERT using the avoided cost method of allocating interest.⁸⁴ That is, the amount of indebtedness treated as incurred or continued to finance the CERT is based on the amount of interest expense that would have been avoided if the CERT had not been undertaken and the amounts expended for the CERT were instead used to repay indebtedness.

⁸² Sec. 172(b)(1)(A). However, a taxpayer may elect waive the entire carryback period with respect to an NOL for a particular tax year. See sec. 172(b)(3).

⁸³ Sec. 172(b)(2).

⁸⁴ Sec. 172(g)(2)(B) (adopting the avoided cost method described in sec. 263A(f)(2)(A)(ii)).

A corporate equity reduction transaction means either a major stock acquisition or an excess distribution. A major stock acquisition is the acquisition by a corporation (or any group of persons acting in concert with such corporation) of stock in another corporation representing 50 percent or more (by vote or value) of the stock of the other corporation.⁸⁵ A major stock acquisition does not include a qualified stock purchase to which a section 338 election applies.⁸⁶ An excess distribution is the excess of the aggregate distributions and redemptions made by a corporation during the taxable year with respect to its stock (other than certain preferred stock described in section 1504(a)(4)), over the greater of (a) 150 percent of the average of such distributions and redemptions for the preceding three taxable years, or (b) 10 percent of the fair market value of the stock of such corporation as of the beginning of such taxable year. The amount of distributions and redemptions made by a corporation during a taxable year are reduced by stock issued by the corporation during the applicable period in exchange for money or property other than stock in the corporation.

A corporation is treated as being involved in a CERT if it is either the acquired or acquiring corporation, or successor thereto (in the case of a major stock acquisition) or the distributing or redeeming corporation, or successor thereto (in the case of an excess distribution).⁸⁷

2. Debt expected to be paid in equity

Section 163(l) generally disallows a deduction for interest or OID on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in equity of the issuer or a related party (within the meaning of section 267(b) or 707(b)), or equity held by the issuer (or a related party) in any other person.

For this purpose, debt is treated as payable in equity if a substantial amount of the principal or interest is mandatorily convertible or convertible at the issuer's option into such equity (or the debt is part of an arrangement reasonably expected to achieve such a result).⁸⁸ In addition, a debt instrument is treated as payable in equity if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of such equity (or the debt is part of an arrangement reasonably expected to achieve such a result).⁸⁹ For this purpose, principal and interest is treated as required to be paid, converted, or determined if it may be required at the option of the holder

⁸⁵ Sec. 172(g)(3)(A)(i) and (B).

⁸⁶ Sec. 172(g)(3)(B)(ii). A section 338 election allows taxpayers to treat a qualifying stock acquisition as an asset acquisition for Federal income tax purposes.

⁸⁷ For a brief description of the legislative background of the CERT provisions, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, p. 26.

⁸⁸ Sec. 163(l)(3)(A) and (C).

⁸⁹ Sec. 163(l)(3)(B) and (C).

or a related party and there is a substantial certainty the option will be exercised.⁹⁰ An exception is provided for debt issued by a dealer in securities (within the meaning of section 475) or a related party which is payable in, or by reference to, equity (not of the issuer or related party) held in its capacity as a dealer in securities.⁹¹

Application of section 163(l) to an instrument generally disallows the issuer's interest or OID deductions, but the provision does not alter the treatment of amounts paid or accrued to the holder.⁹²

3. Applicable high-yield discount obligations

In general, the issuer of a debt instrument with OID may deduct the portion of such OID equal to the aggregate daily portions of the OID for days during the taxable year.⁹³ However, in the case of an applicable high-yield discount obligation (an "AHYDO") issued by a corporate issuer, (1) no deduction is allowed for the "disqualified portion" of the OID on such obligation, and (2) the remainder of the OID on any such obligation is not allowable as a deduction until paid by the issuer.⁹⁴

An AHYDO is any debt instrument if (1) the maturity date on such instrument is more than five years from the date of issue; (2) the yield to maturity on such instrument exceeds the sum of (a) the applicable Federal rate in effect under section 1274(d) for the calendar month in which the obligation is issued and (b) five percentage points, and (3) such instrument has significant original issue discount.⁹⁵ An instrument is treated as having significant OID if the aggregate amount of interest that would be includible in the gross income of the holder with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date five years after the date of issue exceeds the sum of (1) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and (2) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity.⁹⁶ The disqualified portion of the OID on an AHYDO is the lesser of (1) the amount of OID with respect to such obligation or (2) the portion of the total return on such obligation which bears the same ratio to such total return as the

⁹⁰ Sec. 163(l)(3).

⁹¹ Sec. 163(l)(5).

⁹² See H.R. Conf. Rep. 105-220. For a brief description of the legislative background of section 163(l), see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, pp. 27-28.

⁹³ Sec. 163(e)(1). For purposes of section 163(e)(1), the daily portion of the original issue discount for any day is determined under section 1272(a) (without regard to paragraph (7) thereof and without regard to section 1273(a)(3)).

⁹⁴ Sec. 163(e)(5).

⁹⁵ Sec. 163(i)(1).

⁹⁶ Sec. 163(i)(2).

disqualified yield (*i.e.*, the excess of the yield to maturity on the obligation over the applicable Federal rate plus six percentage points) on such obligation bears to the yield to maturity on such obligation.⁹⁷ The term “total return” means the amount which would have been the OID of the obligation if interest described in section 1273(a)(2) were included in the stated redemption to maturity.⁹⁸ A corporate holder treats the disqualified portion of OID as a stock distribution for purposes of the dividend-received deduction.⁹⁹

4. Interest on certain acquisition indebtedness

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 stock, or two-thirds of the assets, of another corporation, if each of the following conditions exists: (1) the debt is substantially subordinated;¹⁰⁰ (2) the debt carries an equity participation feature¹⁰¹ (*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 a debt-to-equity ratio that exceeds 2 to 1)¹⁰² or projected annual earnings do not exceed three times the annual interest to be paid or incurred.¹⁰³

⁹⁷ Sec. 163(e)(5)(C)(ii).

⁹⁸ Sec. 163(e)(5)(C)(ii).

⁹⁹ Sec. 163(e)(5)(B). For a brief description of the legislative background of the AHYDO rules, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, p. 29.

¹⁰⁰ Subordinated to the claims of trade creditors generally, or expressly subordinated in right of payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued (sec. 279(b)(2)(A) and (B)).

¹⁰¹ Convertible directly or indirectly into the stock of the issuing corporation or part of an investment unit or other arrangement which includes an option to acquire, directly or indirectly, stock in the issuing corporation (sec. 279(b)(3)(A) and (B)).

¹⁰² Sec. 279(b)(4)(A).

¹⁰³ Sec. 279(b)(4)(B). For a brief description of the legislative background of section 279, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, p. 30.

E. Rules to Address Tax Arbitrage in the Case of Borrowing to Fund Untaxed Income

When debt is used to finance an investment that produces income exempt from tax, taxed at preferential rates, or carrying associated tax credits, the deduction for interest on the debt financing can be used to offset other unrelated income. In addition, certain leveraged transactions by entities exempt from tax may present the opportunity for taxpayers to engage in transactions under terms they otherwise may not have in the absence of such tax-exemption. These outcomes are commonly referred to as “tax arbitrage.” Following is a brief discussion of certain rules that attempt to limit the ability of taxpayers to engage in these types of transactions.

1. Interest related to tax-exempt income

Section 265 disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax (“tax-exempt obligations”). This rule applies to tax-exempt obligations held by individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or carries indebtedness and a related person acquires or holds tax-exempt obligations.¹⁰⁴ Generally, there are two methods for determining the amount of the disallowance. One method disallows interest deductions to the extent a taxpayer’s borrowing can be traced to its holding of tax-exempt obligations. A second method disallows interest deductions based on the percentage of a taxpayer’s assets comprised of tax-exempt obligations.

The interest expense disallowance rules are intended to prevent taxpayers from engaging in tax arbitrage by deducting interest on indebtedness that is used to purchase tax-exempt obligations, so that the interest is available to offset other taxable income of the taxpayer.

In general

Debt is traced to tax-exempt obligations if the proceeds of the indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations. For example, this rule applies if tax-exempt obligations are used as collateral for indebtedness. In general terms, the tracing rule applies only if the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

Within the general framework of section 265, there are special rules for individuals, dealers in tax-exempt obligations, corporations that are not dealers, and certain financial institutions.

¹⁰⁴ Section 7701(f) provides that the Secretary of the Treasury will prescribe regulations necessary or appropriate to prevent the avoidance of any income tax rules that deal with the use of related persons, passthrough entities, or other intermediaries in (1) the linking of borrowing to investment, or (2) diminishing risks. See *H Enterprises International, Inc. v. Commissioner*, T.C. Memo. 1998-97, *aff’d*. 183 F.3d 907 (8th Cir. 1999) (section 265(a)(2) applies where a subsidiary borrows funds on behalf of a parent and the parent uses the funds to buy, among other investments, tax-exempt securities).

Corporations that are not dealers in tax-exempt obligations

In the case of a business that is not a dealer in tax-exempt obligations, if there is direct evidence of the purpose to purchase or carry tax-exempt obligations with the proceeds of indebtedness, then no interest on the indebtedness is deductible. In the absence of such direct evidence, the IRS provides specific inference rules. Generally, the purpose to purchase or carry tax-exempt obligations will not be inferred with respect to indebtedness incurred to provide funds for an active trade or business unless the borrowing is in excess of business needs.¹⁰⁵ In contrast, the purpose to carry tax-exempt obligations will be inferred (unless rebutted by other evidence) where a taxpayer could reasonably have foreseen at the time of purchasing tax-exempt obligations that indebtedness would have been incurred to meet future economic needs of an ordinary, recurrent variety.¹⁰⁶

De minimis exception

In the absence of direct evidence linking an individual taxpayer's indebtedness with the purchase or carrying of tax-exempt obligations, taxpayers other than dealers may benefit from a *de minimis* exception.¹⁰⁷ The IRS takes the position that it ordinarily does not infer a purpose to purchase or carry tax-exempt obligations if a taxpayer's investment therein is "insubstantial."¹⁰⁸ A corporation's holdings of tax-exempt obligations are presumed to be insubstantial if the average adjusted basis of the corporation's tax-exempt obligations is two percent or less of the average adjusted basis of all assets held in the active conduct of the corporation's trade or business.

If a corporation holds tax-exempt obligations (*e.g.*, installment obligations) acquired in the ordinary course of business in payment for services performed for, or goods supplied to, State or local governments, and if those obligations are nonsalable, the interest deduction disallowance rule generally does not apply.¹⁰⁹ The theory underlying this rule is that a corporation holding tax-exempt obligations in these circumstances has not incurred or carried indebtedness for the purpose of acquiring those obligations.

¹⁰⁵ Rev. Proc. 72-18, 1972-1 C.B. 419, 1972, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669, 1987. See sec. 6.01.

¹⁰⁶ *Ibid.* at sec. 6.02.

¹⁰⁷ *Ibid.* at sec. 3.05 (which provides that the insubstantial holding safe harbor is not available to dealers in tax-exempt obligations).

¹⁰⁸ *Ibid.* at sec. 3.05.

¹⁰⁹ *Ibid.* at sec. 6.03.

Financial institutions

After taking into account any interest disallowance rules under general rules applicable to other taxpayers,¹¹⁰ section 265(b)(2) disallows a portion of a financial institution's otherwise allowable interest expense that is allocable to tax-exempt interest. The amount of interest that is disallowed is the *pro-rata* amount of interest expense that equals the ratio of the financial institution's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, to the average adjusted bases of all the taxpayer's assets (the "*pro-rata* rule").¹¹¹ This allocation rule is mandatory and cannot be rebutted by the taxpayer. A financial institution, for this purpose, is any person who accepts deposits from the public in the ordinary course of such person's trade or business and is subject to Federal or State supervision as a financial institution, or is a bank as defined in section 585(a)(2).

2. Debt with respect to certain insurance products

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract¹¹² ("inside buildup").¹¹³ Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured ("death benefits").¹¹⁴

Present law imposes limitations on the deductibility of interest on debt with respect to life insurance contracts. These limitations address the potential for arbitrage that could arise in the event that deductible interest expense relates to amounts excludable as inside buildup or as death benefits under a life insurance contract.

¹¹⁰ Including section 265(a) (see sec. 265(b)(6)(A) and Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), p. 563). Section 265(b)(6)(B), however, specifies that the disallowance rule of section 265 is applied before the capitalization rule of section 263A (relating to the capitalization of certain expenditures, including interest as discussed above).

¹¹¹ Sec. 265(b).

¹¹² By contrast to the treatment of life insurance contracts, if a deferred annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

¹¹³ This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract for purposes of determining income taxes, other than those imposed on insurance companies such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (*i.e.*, income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (sec. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, *i.e.*, generally is funded more rapidly than a policy that would provide paid-up future benefits after the payment of seven annual level premiums (sec. 7702A).

¹¹⁴ Sec. 101(a).

Interest paid or accrued with respect to the contract

No deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity, or endowment contract (the “single premium” deduction limitation).¹¹⁵ A contract is treated as a single premium contract if substantially all the premiums on the contract are paid within a period of four years from the date on which the contract is purchased or if an amount for payment of a substantial number of future premiums is deposited with the insurer.¹¹⁶

In addition, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity, or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).¹¹⁷ Several exceptions are provided for this rule. The deduction denial does not apply if (1) no part of four of the annual premiums due during the initial seven year period is paid by means of such debt; (2) if the total amounts to which the provision would apply in a taxable year do not exceed \$100; (3) if the amounts are paid or accrued because of financial hardship; or (4) if the indebtedness is incurred in connection with the taxpayer’s trade or business.¹¹⁸

Finally, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity, or endowment contract covering the life of any individual,¹¹⁹ with a key person insurance exception.¹²⁰

Pro rata interest deduction limitation

A *pro rata* interest deduction disallowance rule also applies. This rule applies to interest for which a deduction is not disallowed under the other interest deduction disallowance rules relating to life insurance including, for example, interest on third-party debt that is not with respect to a life insurance, annuity, or endowment contract. Under this rule, in the case of a taxpayer other than a natural person,¹²¹ no deduction is allowed for the portion of the taxpayer’s

¹¹⁵ Sec. 264(a)(2).

¹¹⁶ Sec. 264(c).

¹¹⁷ Sec. 264(a)(3).

¹¹⁸ Sec. 264(d).

¹¹⁹ Sec. 264(a)(4).

¹²⁰ This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person exception (sec. 264(e)), otherwise nondeductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed \$50,000. Other special rules also apply.

¹²¹ See sec. 264(f)(5).

interest expense that is allocable to unborrowed policy cash values.¹²² Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values of life insurance, annuity, and endowment contracts, plus the average adjusted bases of other assets.

Under the *pro rata* interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is an employee, officer, director, or 20-percent owner of the entity of the trade or business.¹²³ The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

An employer may exclude the death benefit under a contract insuring the life of an employee if the insured was an employee at any time during the 12-month period before his or her death, or if the insured is among the highest paid 35 percent of all employees. Notice and consent requirements must be satisfied.¹²⁴

3. Dividends received deduction reduction for debt-financed portfolio stock

In general, a corporate shareholder is allowed a deduction equal to (1) 100 percent of certain qualifying dividends received from a corporation in the same affiliated group as the recipient;¹²⁵ (2) 80 percent of the dividends received from a corporation if it owns at least 20 percent of the payee's stock (by vote and value); and (3) 70 percent of dividends received from other corporations.¹²⁶ 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, if dividends are paid on debt-financed stock, the combination of the dividends received deduction and the interest deduction would enable corporate taxpayers to shelter unrelated income. Therefore, section 246A generally reduces the 80-percent and 70-percent dividends received deduction so that the deduction is available, in effect, only with respect to

¹²² Sec. 264(f). This applies to any life insurance, annuity, or endowment contract issued after June 8, 1997.

¹²³ Sec. 264(f)(4).

¹²⁴ For a brief description of the legislative background of a limitation on the deductibility of interest with respect to single premium life insurance contracts, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, pp. 37-38.

¹²⁵ Sec. 243(a)(3) and (b). An affiliated group generally consists of a common parent corporation and one or more other corporations at least 80 percent of the stock of which (by vote and value) is owned by the common parent or another member of the group.

¹²⁶ Sec. 243. Section 245 allows a 70-percent, 80-percent and 100-percent deduction for a specified portion of dividends received from certain foreign corporations. Section 244 allows a dividends received deduction on certain preferred stock of public utilities.

dividends attributable to that portion of the stock which is not debt-financed.¹²⁷ Under regulations prescribed by the Secretary, any reduction in the amount allowable as a dividends received deduction under the rule is limited to the amount of the interest allocable to the dividend.¹²⁸

Section 246A applies to dividends on “debt-financed portfolio stock” of the recipient corporation. Stock of a corporation is portfolio stock unless specifically excluded. Stock is not portfolio stock if, as of the beginning of the ex-dividend date for the dividend involved, the taxpayer owns stock (1) possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and (2) having a value equal to at least 50 percent of the value of all the stock, of such corporation.¹²⁹ Portfolio stock is debt-financed if there is a direct relationship between indebtedness and the portfolio stock. The provision does not incorporate any allocation or apportionment formula or fungibility concept.¹³⁰

¹²⁷ The reduction of the dividends received deduction may be viewed as a surrogate for limiting the interest deduction.

¹²⁸ Sec. 246A(e). Treasury has not yet issued regulations under section 246A.

¹²⁹ The 50-percent threshold is reduced to 20 percent if five or fewer corporate stockholders own, directly or indirectly, stock possessing at least 50 percent of the voting power and value of all the stock of such corporation. This rule was intended to exempt certain corporate joint ventures from the provision. See, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984.

¹³⁰ For a brief description of the legislative background of section 246A, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, p. 42.

F. Rules to Match Timing of Tax Deduction and Income Inclusion Relating to Debt

Statutory limitations on the deductibility of interest expense apply in some cases in which an immediate deduction would produce a mismatching of income and expense. If the full interest deduction is not permitted on a current basis, the deduction may be disallowed, deferred until a later time, or capitalized into the basis of related property.

Special rules apply to a debt instrument issuer's deduction for accrued but unpaid interest, and accrued OID, owed to certain related foreign persons. These rules are generally designed to match the issuer's deduction with the holder's corresponding income inclusion.

Accrued but unpaid interest

A number of rules limit deductions for losses, expenses, and interest with respect to transactions between related persons. In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid, but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.¹³¹ This rule is intended to prevent the mismatch of, for example, a deduction for interest accrued by a taxpayer on the accrual method of accounting that is payable to a related person on a cash method of accounting. In the absence of this rule, the issuer would take a deduction upon accrual of the obligation to pay interest (whether or not the interest was actually paid), but a related holder would not take the interest into income until it is paid.

U.S.-source "fixed or determinable annual or periodical" income, including dividends, interest, rents, royalties, and other similar income, is subject to a 30-percent gross-basis withholding tax when paid to a foreign person.¹³² This withholding tax can create a mismatch where, for example, a U.S. accrual-method taxpayer borrows amounts from a foreign corporation. In the absence of a special rule, the U.S. taxpayer would be allowed a deduction for accrued interest annually even if no interest were actually paid, and the foreign corporate lender would be subject to the 30-percent gross-basis withholding tax only when the interest was paid. The Code directs the Treasury Secretary to issue regulations applying the matching principle in this circumstance and other circumstances involving payments to related foreign persons.¹³³ With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations require a taxpayer to use the cash method of accounting in deducting amounts owed to related foreign persons (with an exception for income of a related foreign person that is

¹³¹ Sec. 267(a)(2).

¹³² Secs. 871, 881, 1441, and 1442.

¹³³ Sec. 267(a)(3)(A).

effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).¹³⁴

A foreign corporation's foreign-source active business income generally is subject to U.S. tax only when such income is distributed to any U.S. person owning stock of such corporation. Accordingly, a U.S. person conducting foreign operations through a foreign corporation generally is subject to U.S. tax on the foreign corporation's income only when the income is repatriated to the United States through a dividend distribution. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which a U.S. person holds stock. The main anti-deferral rules are the controlled foreign corporation ("CFC") rules of subpart F¹³⁵ and the passive foreign investment company ("PFIC") rules.¹³⁶ Section 267(a)(3)(B) provides special rules for items payable to a CFC or a PFIC. In general, with respect to any item payable to a related CFC or a PFIC, deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the relevant inclusion rules. Deductions that have accrued but are not allowable under this special rule are subsequently allowed when the amounts are actually paid.

Original issue discount

Rules similar to those discussed above apply in the case of OID on debt instruments held by a related foreign person. In such case, section 163(e)(3)(A) disallows a deduction for any portion of such OID until paid by the issuer (the "related-foreign-person rule").¹³⁷ This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the foreign related person's conduct of a U.S. trade or business (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).¹³⁸

In the case of any OID debt instrument held by a related foreign person which is a CFC or a PFIC, deductions for accrued but unpaid OID are similarly allowable only to the extent that such OID is, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation.¹³⁹

¹³⁴ Treas. Reg. sec. 1.267(a)-3(b)(1) and (c).

¹³⁵ Secs. 951-965.

¹³⁶ Secs. 1291-1298.

¹³⁷ Sec. 163(e)(3)(A).

¹³⁸ Sec. 163(e)(3)(A).

¹³⁹ Sec. 163(e)(3)(B). For a brief description of the legislative background of section 163(e)(3), see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS-41-11), July 11, 2011, p. 45.

II. DATA WITH RESPECT TO DEBT AND EQUITY

The following tables show selected data related to business debt, equity, and interest expense.

Table 1 provides an overall picture of the growth of nonfinancial corporate, household, and federal debt as a share of Gross National Product (“GNP”) from 1985 to 2015. Nonfinancial corporate debt has grown more modestly than either household debt or Federal debt. Nonfinancial corporate debt as a share of GNP has grown less than 10 percentage points since 1984, while household debt has grown about 25 percentage points and Federal debt has more than doubled.

Table 1.—Corporate, Household, and Federal Debt, as a Percentage of Gross National Product (“GNP”), 1985-2015

Year	Corporate¹ Debt as a Percentage of GNP	Household Debt as a Percentage of GNP	Federal Debt as a Percentage of GNP
1985	37.5	53.1	40.3
1986	40.5	56.2	43.6
1987	42.1	57.1	44.6
1988	42.9	58.4	44.9
1989	43.2	58.9	44.9
1990	43.0	60.0	47.1
1991	40.7	61.4	50.7
1992	38.7	61.1	53.1
1993	38.9	61.9	54.8
1994	39.4	62.7	54.2
1995	40.2	64.0	53.9
1996	39.9	64.9	53.4
1997	40.8	65.1	51.0
1998	42.8	66.5	48.3
1999	44.5	68.2	45.1
2000	45.2	69.7	39.6
2001	45.0	73.3	38.8
2002	43.6	77.9	40.2
2003	41.7	83.4	41.9
2004	40.4	87.4	42.5
2005	39.8	90.7	42.4
2006	40.6	95.1	41.7
2007	43.3	96.9	41.6
2008	44.3	94.1	49.5
2009	42.3	94.5	61.0
2010	39.8	89.1	69.4
2011	40.5	84.4	74.0
2012	41.0	81.5	78.4
2013	42.1	79.8	81.0
2014	43.3	78.8	82.0
2015	44.6	78.3	83.5

¹ Debt securities and loans of domestic nonfinancial corporations.

² Household debt includes debt of personal trusts, nonprofit organizations, partnerships and sole proprietorships.

Sources: Debt levels from The Board of Governors of the Federal Reserve System *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts*, March 10, 2016, Table D.3. GNP levels from the U.S. Bureau of Economic Analysis via the Federal Reserve Bank of St. Louis, March 25, 2016, available at <https://research.stlouisfed.org/fred2/data/GNPA.txt>. JCT staff calculations.

Table 2 shows the distribution of holdings of corporate equity and bonds by type of holder for the years 1995, 2005, and 2015. Over that 20-year period, the share of corporate equities held directly by the households and nonprofit organizations sector has declined by 15 percentage points, though the decline has leveled off in recent years. Private pension funds and government retirement funds also directly hold a smaller share of corporate equities than they once did. Regulated investment companies, including mutual funds, closed-end funds, and exchange-traded funds, show the largest growth in their share of ownership of corporate equities over the period. The household sector and private pension funds own the substantial majority of these shares, partially offsetting the decline in direct ownership of corporate equities by these groups. Foreign investors have steadily increased their holdings of corporate equities, owning nearly triple the share in 2015 that they held in 1995.

Over the same 20-year period, the share of corporate and foreign bonds held by the households and nonprofit organizations has fallen from 20 percent to less than three percent, offset by a nearly identical increase in the share of bonds held by regulated investment companies. Insurance companies have been replaced by foreign investors as the largest holders of corporate bonds. Foreign investors, regulated investment companies (including mutual funds), and insurance companies each held roughly one-quarter of corporate bonds in 2015. Other domestic financial companies held a smaller share of bonds over the 20-year period, led by declines in holdings by finance companies and brokers and dealers. The other notable change is the share of corporate bonds held by government sponsored enterprises, which grew from approximately one percent of holdings in 1995 to 5.7 percent in 2005 before falling below one-percent in 2015.

**Table 2.—Holdings of Corporate Equity and Bonds, 1995, 2005, and 2015
(Year End Balances in Billions of Dollars)**

	1995		2005		2015	
	Year End Balance	Percent of Total	Year End Balance	Percent of Total	Year End Balance	Percent of Total
Total corporate equities¹	8,481	100.0	20,601	100.0	35,687	100.0
Households and nonprofit organizations	4,434	52.3	8,014	38.9	13,311	37.3
Federal, State, and local governments	26	0.3	116	0.6	214	0.6
Private depository institutions	19	0.2	63	0.3	101	0.3
Insurance companies	443	5.2	1,360	6.6	2,087	5.8
Private pension funds	1,218	14.4	2,359	11.5	2,363	6.6
Government retirement funds	754	8.9	1,846	9.0	2,555	7.2
Regulated investment companies ²	1,068	12.6	4,566	22.2	9,183	25.7
Government sponsored enterprises	0	0.0	0	0.0	0	0.0
Other domestic financial companies ³	34	0.4	158	0.8	167	0.5
Foreign investors	485	5.7	2,118	10.3	5,707	16.0
Total corporate and foreign bonds⁴	3,085	100.0	8,236	100.0	11,732	100.0
Households and nonprofit organizations	617	20.0	692	8.4	296	2.5
Federal, State, and local governments	39	1.3	131	1.6	184	1.6
Private depository institutions	186	6.0	760	9.2	682	5.8
Insurance companies	990	32.1	2,088	25.3	2,786	23.7
Private pension funds	241	7.8	288	3.5	711	6.1
Government retirement funds	190	6.2	338	4.1	567	4.8
Regulated investment companies ²	232	7.5	994	12.1	2,974	25.3
Government sponsored enterprises	30	1.0	466	5.7	65	0.6
Other domestic financial companies ³	204	6.6	652	7.9	335	2.9
Foreign investors	355	11.5	1,804	21.9	3,116	26.6

¹ Corporate equities are shares issued by domestic corporations, or issued by foreign corporations and purchased by U.S. persons. It includes shares of publicly traded C corporations and closely held S corporations and C corporations. It does not include mutual fund shares.

² Regulated investment companies include mutual funds, closed-end funds, and exchange-traded funds.

³ Other domestic financial companies include finance companies, real estate investment trusts, brokers and dealers, holding companies, and funding corporations.

⁴ Corporate bonds include bonds issued by U.S. corporations, or issued by foreign corporations and purchased by U.S. persons. Other types of debt, including trade debt, mortgages, and bank loans, are excluded.

Source: The Board of Governors of the Federal Reserve System *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Historical Annual Tables 1995-2004*, and *2005-2015*, March 10, 2016, Tables L.213 and L.223, and JCT staff calculations.

Table 3 shows debt-to-net-worth ratios of nonfinancial corporations from 1985 to 2015. These measures are similar to debt-to-equity ratios for financial accounting purposes. Debt includes debt securities such as commercial paper and corporate bonds and bank loans. Net worth is measured as the value of assets minus all liabilities. In addition to debt securities and loans, liabilities include trade payables, taxes payable, foreign direct investment in the United States and miscellaneous liabilities. For the first series, both financial and nonfinancial assets are measured at market value. The second series measures financial assets at market value and nonfinancial assets, including real estate, equipment, intellectual property products, and inventories, at historical cost. Since market value generally exceeds historical costs, the debt ratios in the second series exceed those in the first series. The two series generally move together, except for periods of volatility in the market value of real estate.

**Table 3.—Debt-to-Net-Worth Ratios of Nonfinancial Corporations,
1985-2015**

Year	Ratio of Debt to Net Worth (Market Value)	Ratio of Debt to Net Worth (Historical Cost)
1985	36.57	68.55
1986	40.18	73.48
1987	42.10	75.96
1988	43.27	78.05
1989	45.17	81.74
1990	46.98	80.25
1991	47.02	73.99
1992	49.88	72.66
1993	50.76	70.60
1994	50.37	70.03
1995	49.90	68.31
1996	49.41	64.98
1997	46.06	64.62
1998	45.74	64.93
1999	46.09	63.83
2000	43.20	60.58
2001	44.93	60.74
2002	43.61	59.69
2003	41.57	56.60
2004	37.03	54.24
2005	35.29	53.38
2006	34.54	53.88
2007	34.60	57.22
2008	40.45	63.91
2009	43.14	55.63
2010	38.41	51.30
2011	38.36	52.80
2012	38.99	54.43
2013	36.71	53.44
2014	36.03	53.76
2015	35.51	54.24

Source: The Board of Governors of the Federal Reserve System *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Historical Annual Tables 1985-1994, 1995-2004, and 2005-2015*, March 10, 2016, Table B.103.

Table 4 shows interest expense and taxable income of nonfinancial corporations from 1987 to 2012 as reported on corporate income tax returns. For this purpose, nonfinancial corporations are corporations other than those in the finance and insurance industry based on the primary business activity code reported on the tax return. The table also shows the interest expense as a percentage of taxable income before interest expense and corporate bond interest rates. Though interest expense fluctuates with the level of debt and interest rates, this percentage appears to primarily reflect the effects of the business cycle, as the percentage has peaks in 1990 and 2001, when taxable income declined. In addition to business cycle effects, other changes in tax policy that have an impact on taxable income affect this percentage. For example, bonus depreciation lowers otherwise reported taxable income and potentially increases otherwise reported taxable income in later years.

**Table 4.—Interest Expense and Taxable Income of Nonfinancial Corporations,
1987-2012**

Year	Interest Expense (Billions of dollars)	Taxable Income (Billions of dollars)	Interest as a percent of taxable income before interest	Corporate bond interest rate¹
1987	314.9	261.0	54.7	9.38
1988	256.5	323.3	44.2	9.71
1989	309.7	306.2	50.3	9.26
1990	483.4	297.9	61.9	9.32
1991	309.0	269.2	53.4	8.77
1992	270.7	276.3	49.5	8.14
1993	253.4	312.3	44.8	7.22
1994	270.6	379.2	41.6	7.96
1995	311.3	418.0	42.7	7.59
1996	331.1	473.2	41.2	7.37
1997	365.4	502.8	42.1	7.26
1998 ²	621.7	549.5	53.1	6.53
1999	626.1	580.1	51.9	7.04
2000	797.4	637.5	55.6	7.62
2001	781.8	526.0	59.8	7.08
2002	621.0	483.0	56.3	6.49
2003	568.9	551.2	50.8	5.67
2004	596.9	694.1	46.2	5.63
2005	771.8	1,013.7	43.2	5.24
2006	1,036.1	1,069.0	49.2	5.59
2007	1,185.7	1,044.7	53.2	5.56
2008	987.8	862.2	53.4	5.63
2009	713.4	762.6	48.3	5.31
2010	1,020.4	883.0	53.6	4.94
2011	595.3	872.1	40.6	4.64
2012	569.7	1,003.0	36.2	3.67

¹ Corporate bond interest rate is the average rate on corporate Aaa bonds published by Moody's Investor Services.

² Results before 1998 are not directly comparable to those in 1998 and later due to changes in the IRS classification of financial and nonfinancial corporations.

Sources: JCT staff tabulations, IRS Statistics of Income *Corporation Income Tax Returns* (various years). Corporate bond interest rates are from Council of Economic Advisors, *Economic Report of the President*, February 2016, Table B-25.

Table 5 shows interest and net income for corporations (other than S corporations, RICs, and REITs), S corporations, and partnerships from 1995 to 2012, and also shows the interest expense as a percentage of net income before interest expense. These data reflect similar business cycle effects as noted above, as well as showing a significant downward trend for S corporations in interest expense as a percentage of net income before interest expense. Table 5 also shows that C corporations' interest expense, in the aggregate and as a percentage of net income before interest expense, exceeds the comparable figures for partnerships and S corporations throughout this period. These data reflect the larger size of the C corporate sector, but C corporations may also have a Federal income tax incentive to incur debt, as interest is deductible in determining the corporate tax. By contrast, partnerships and S corporations are not subject to an entity-level tax.

Table 5 illustrates that partnership interest expense, in the aggregate and as a percentage of net income before interest expense, has exceeded S corporation interest since 2002. Among other factors, these differences may reflect the difference in tax rules for determining basis of partners' and S corporation shareholders' equity interests, respectively.

**Table 5.—Interest Expense and Net Income of Nonfinancial Business Entities,
1995-2012**

Year	Corporations Other than S Corporations, RICs, and REITs			S Corporations			Partnerships		
	Interest Expense (Billions of dollars)	Net Income (Billions of dollars)	Interest as a Percentage of Net Income before Interest	Interest Expense (Billions of dollars)	Net Income (Billions of dollars)	Interest as a Percentage of Net Income before Interest	Interest Expense (Billions of dollars)	Net Income (Billions of dollars)	Interest as a Percentage of Net Income before Interest
1995	296.2	383.3	43.6	26.3	74.3	26.1	18.2	62.3	22.6
1996	314.9	421.8	42.7	25.1	89.7	21.9	20.1	75.5	21.0
1997	347.1	441.2	44.0	29.6	103.3	22.3	24.0	73.3	24.7
1998 ¹	588.5	434.0	57.6	33.3	169.9	16.4	30.9	83.2	27.1
1999	590.3	435.5	57.5	35.8	184.2	16.3	34.8	95.1	26.8
2000	754.7	414.6	64.5	42.7	184.7	18.8	41.9	117.7	26.3
2001	736.6	200.9	78.6	45.1	175.3	20.5	43.2	117.7	26.8
2002	585.7	177.2	76.8	33.3	169.5	16.4	44.5	181.4	19.7
2003	535.1	319.6	62.6	33.9	195.0	14.8	44.0	195.8	18.3
2004	561.8	546.8	50.7	35.0	252.9	12.2	46.8	248.8	15.8
2005	727.1	1183.2	38.1	44.7	324.6	12.1	56.3	348.3	13.9
2006	977.3	1022.2	48.9	58.7	359.2	14.1	69.1	385.0	15.2
2007	1110.7	928.3	54.5	66.1	367.4	15.3	77.0	360.7	17.6
2008	919.3	579.4	61.3	59.1	286.3	17.1	82.2	239.5	25.6
2009	657.1	368.4	64.1	47.6	248.5	16.1	72.0	202.5	26.2
2010	549.8	721.2	43.3	42.8	308.4	12.2	70.7	306.7	18.7
2011	545.7	687.3	44.3	39.8	345.7	10.3	67.7	406.1	14.3
2012	520.6	876.0	37.3	38.4	439.7	8.0	68.7	442.5	13.4

¹ Results before 1998 are not directly comparable to those in 1998 and later due to changes in the IRS classification of financial and nonfinancial corporations.

Source: JCT staff tabulations, IRS Statistics of Income *Corporation Income Tax Returns* (various years).

Table 6 shows data for interest expense and net income for all corporations, separated into those with annual business receipts either above or below \$5 million. The data on interest expense as a percentage of net income before interest expense again appear to reflect business cycle effects of the 2000-2001 economic slowdown, regardless of the size of corporations.

**Table 6.—Interest Expense and Net Income of Nonfinancial Corporations
by Size of Corporation,
1995-2012**

Year	Corporations with Business Receipts under \$5,000,000			Corporations with Business Receipts over \$5,000,000		
	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest
1995	25.3	24.4	50.9	286.0	433.0	39.8
1996	25.5	29.0	46.8	305.6	478.3	39.0
1997	26.7	34.0	44.0	338.6	507.9	40.0
1998 ¹	37.2	37.3	49.9	584.5	515.7	53.1
1999	37.7	33.2	53.2	588.3	535.1	52.4
2000	41.0	11.6	77.9	756.4	537.0	58.5
2001	43.6	5.9	88.1	738.2	329.6	69.1
2002	34.9	5.7	86.0	586.1	310.9	65.3
2003	34.1	30.1	53.1	534.9	446.9	54.5
2004	34.4	55.2	38.4	562.5	1,037.6	35.2
2005	38.1	96.2	28.4	733.7	1,351.9	35.2
2006	41.3	95.1	30.3	994.8	1,206.5	45.2
2007	54.2	122.3	30.7	1,131.5	1,113.5	50.4
2008	53.5	60.8	46.8	934.2	765.0	55.0
2009	48.2	42.9	52.9	665.2	545.9	54.9
2010	46.5	89.8	34.1	555.9	913.3	37.8
2011	41.7	94.3	30.6	553.7	887.1	38.4
2012	41.4	134.0	23.6	528.3	1,122.8	32.0

¹ Results before 1998 are not directly comparable to those in 1998 and later due to changes in the IRS classification of financial and nonfinancial corporations.

Note: Includes all active corporations filing a corporate income tax return, including S corporations, C corporations, RICs, and REITs.

Source: JCT staff tabulations, IRS Statistics of Income *Corporation Income Tax Returns* (various years).

Table 7 reports gross dividends paid by nonfinancial corporations from 1985 through 2014. To get a sense of how much of the profits of the corporations are distributed to shareholders, the table also shows profits before and after taxes on corporate income. For the entire period, dividends averaged 55.7 percent of pretax profits and 77.1 percent of after-tax profits. The percentage of profits distributed as dividends tends to rise in recession years,

perhaps reflecting a desire to maintain dividend levels even in years in which net income declines. There also appears to have been a reduction in the dividend distribution rate in the most recent decade as dividends averaged only 51.9 percent of pretax profits and 68.1 percent of after-tax profits for the period 2005 through 2014.

Table 7.—Dividends, Profits, and Taxes of Nonfinancial Corporations, 1985-2014

Year	Gross Dividends Paid of Domestic Nonfinancial Corporations	Profits before Taxes on Corporate Income	Taxes on Corporate Income	Profits after Taxes on Corporate Income	Dividends as a Percentage of Pretax Profits	Dividends as a Percentage of After-Tax Profits
1985	99.4	205.0	71.1	133.9	48.5	74.2
1986	103.7	170.4	76.2	94.2	60.9	110.1
1987	106.1	222.5	94.2	128.3	47.7	82.7
1988	127.9	264.5	104.0	160.5	48.4	79.7
1989	147.9	244.0	101.2	142.8	60.6	103.6
1990	158.5	238.3	98.5	139.8	66.5	113.4
1991	162.8	232.4	88.6	143.8	70.1	113.2
1992	174.9	257.1	94.4	162.7	68.0	107.5
1993	185.3	309.1	108.0	201.1	59.9	92.1
1994	198.8	397.9	132.4	265.5	50.0	74.9
1995	223.4	452.0	140.3	311.7	49.4	71.7
1996	250.2	488.9	152.9	336.0	51.2	74.5
1997	278.3	527.1	161.4	365.7	52.8	76.1
1998	299.2	486.4	158.7	327.7	61.5	91.3
1999	284.4	489.6	171.4	318.2	58.1	89.4
2000	313.4	451.2	170.2	281.0	69.5	111.5
2001	299.3	325.3	111.2	214.1	92.0	139.8
2002	305.1	359.5	97.1	262.4	84.9	116.3
2003	349.2	496.3	132.9	363.4	70.4	96.1
2004	430.8	700.2	187.0	513.2	61.5	83.9
2005	471.1	1,004.6	271.9	732.7	46.9	64.3
2006	550.8	1,180.1	307.7	872.4	46.7	63.1
2007	576.9	1,093.5	293.8	799.7	52.8	72.1
2008	582.2	880.3	227.4	652.9	66.1	89.2
2009	490.4	752.5	177.8	574.7	65.2	85.3
2010	509.9	1,039.2	220.6	818.6	49.1	62.3
2011	535.8	1,009.0	228.8	780.2	53.1	68.7
2012	624.8	1,241.4	266.7	974.7	50.3	64.1
2013	630.7	1,323.2	284.6	1,038.6	47.7	60.7
2014	676.9	1,366.1	316.2	1,049.9	49.5	64.5

Source: The Board of Governors of the Federal Reserve System *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Historical Annual Tables 1985-1994, 1995-2004, and 2005-2015*, March 10, 2016, Tables F.3 and S.5.a and JCT staff calculations.

III. TAX INCENTIVES UNDER PRESENT LAW FOR FIRM CAPITAL STRUCTURE

This section describes incentives issuers and holders have to use debt, to use equity, to create hybrid instruments blending aspects of each, to substitute for debt economically similar arrangements, and also discusses financial accounting and related considerations.¹⁴⁰

A. Tax Incentives for Debt

Incentive for corporate leverage

Although returns to debt investment (interest) are generally deductible by a borrowing business, returns to equity investment (*e.g.*, dividends on equity) are not. This tax distinction is particularly important to C corporations because only such entities are taxed at the entity level. For a C corporation, the after-tax effect of debt financing is more favorable than equity financing because of the deductibility of interest.

*Example 1:*¹⁴¹ Corporation X is in the 35-percent tax bracket and wants to raise \$100 million of additional capital. Corporation X may issue either debt with a 5-percent interest rate, or preferred stock with a 5-percent dividend. Assume that, after raising the capital, Corporation X earns \$10 million and pays \$5 million to the new investors. If the \$100 million raised is in the form of debt, Corporation X may deduct the \$5 million paid to the investors, leaving cash after tax of \$3.25 million.¹⁴² If the \$100 million is in the form of preferred stock, cash available to Corporation X after tax is only \$1.50 million.¹⁴³ Figure 1, below, depicts the results of this *Example 1*.

¹⁴⁰ A description of tax incentives passthrough entities have to use debt versus equity is beyond the scope of this document. For a recent description, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011.

¹⁴¹ The examples are simplified to assume that the top 35-percent corporate rate applies to all income (rather than the graduated rates) and that the rates of return on (*i.e.*, the cost of) equity and debt are the same.

¹⁴² Gross income of 10, less 5 distributed to the debt holders, less corporate tax of 1.75 ($.35 \times (10-5)$).

¹⁴³ Gross income of 10, less 5 distributed to the preferred shareholders, less corporate tax of 3.50 ($.35 \times 10$).

Figure 1.—Financing Additional \$100M Investment: Debt vs. Preferred Stock with Third Party Investor

C corporation needs \$100M additional capital to expand its business.
 Assume the corporation earns \$10M and pays corporate tax at 35% rate.

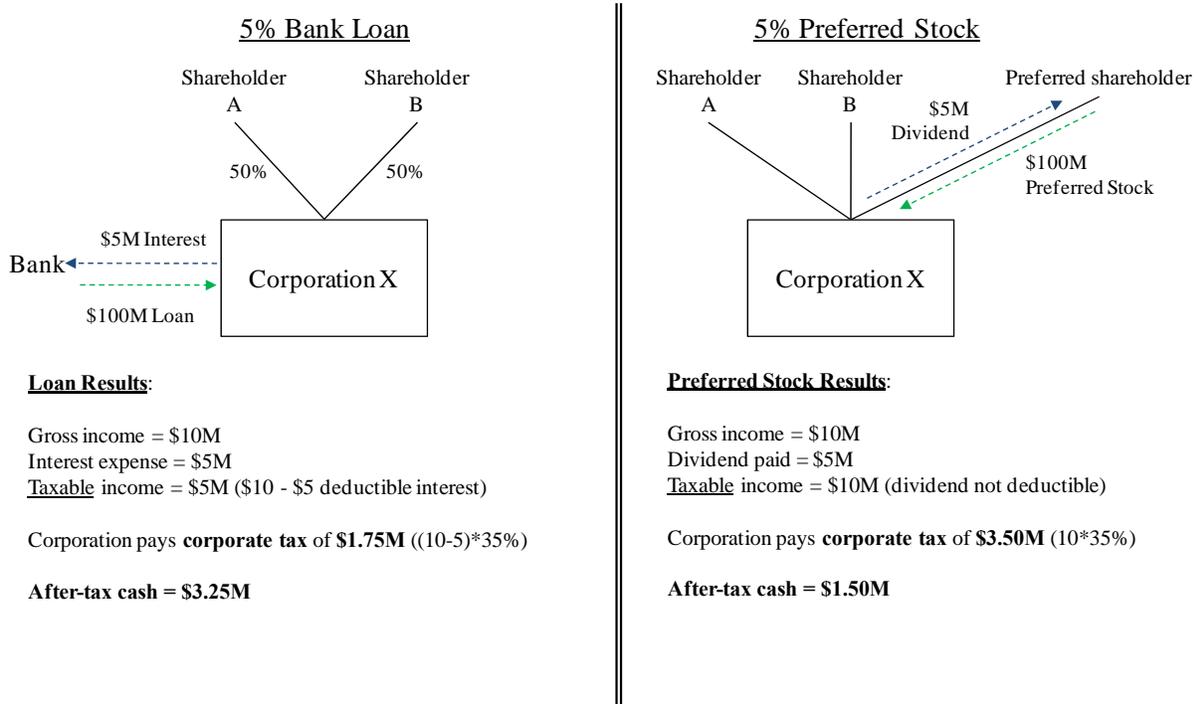


Figure 2, below, demonstrates the results of the \$100 million investment if, instead of involving a third party bank or preferred shareholder, the current shareholders of Corporation X finance the \$100 million investment themselves. Notwithstanding the fact that individual shareholders pay Federal income tax at a higher rate on interest (43.4 percent)¹⁴⁴ than on dividends (23.8 percent),¹⁴⁵ the total tax paid by Corporation X and the shareholders combined is less if the investment is debt financed. In addition, the tax savings associated with the interest deduction results in a greater net return from the \$100 million debt financed investment (\$5.31 million)¹⁴⁶ than results from the preferred stock investment (\$4.95 million).¹⁴⁷

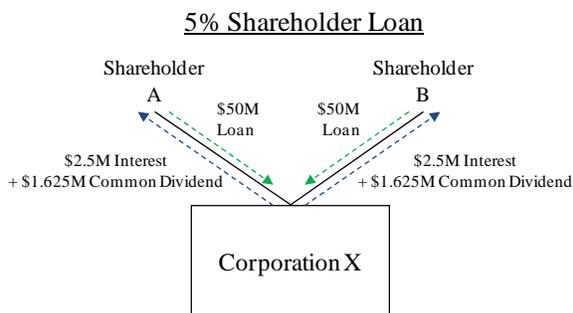
¹⁴⁴ This includes the maximum individual income tax rate of 39.6 percent plus the net investment income tax rate of 3.8 percent. It does not include the effect of any other tax provisions, such as the overall limitation on itemized deductions, on the effective marginal tax rate.

¹⁴⁵ This includes the maximum tax rate on qualified dividend income (which is the same as the maximum individual tax rate on capital gains) of 20 percent plus the net investment income tax rate of 3.8 percent. It does not include the effect of any other tax provisions, such as the overall limitation on itemized deductions, on the effective marginal tax rate.

¹⁴⁶ Net return on the investment financed with debt is equal to the gross income (\$10 million) less corporate taxes paid (\$1.75 million) and less individual taxes paid (\$2.17 million on interest and \$0.77 million on common stock dividends).

Figure 2.—Financing Additional \$100M Investment: Debt vs. Preferred Stock with Current Shareholders

Same facts as Figure 1, but current shareholders provide additional capital and the corporation distributes all after-tax cash for the year as a dividend on the common stock.
Assume shareholders are in the 43.4% tax bracket.

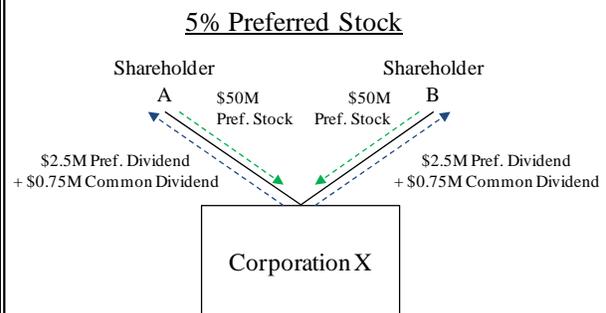


Loan Results:

Gross income = \$10M
 Interest expense = \$5M (\$2.5M paid to each)
Taxable income = \$5M (\$10 - \$5 deductible interest)
 Corporation pays **corporate tax** of **\$1.75M** $((10-5)*35\%)$
 Together, Shareholder A and B pay **individual tax**

- on interest of **\$2.17M** $(5*43.4\%)$ and
- on dividends of **\$0.77M** $((10 - 5 - 1.75)*23.8\%)$

Total Tax Paid = \$4.69M
Net Return from \$100M Investment = \$5.31M



Preferred Stock Results:

Gross income = \$10M
 Pref. dividend paid = \$5M (\$2.5M paid to each)
Taxable income = \$10M (dividends not deductible)
 Corporation pays **corporate tax** of **\$3.50M** $(10*35\%)$
 Together, Shareholder A and B pay **individual tax**

- on preferred dividend of **\$1.19M** $(5*23.8\%)$ and
- on common dividend of **\$0.36M** $((10 - 5 - 3.50)*23.8\%)$

Total Tax Paid = \$5.05M
Net Return from \$100M Investment = \$4.95M

Corporate transactions that substitute debt for equity may increase earnings per share

The effect of using debt rather than equity to capitalize a corporation means that a corporation may increase its after-tax earnings per share simply by substituting debt for equity capitalization. The accounting effect of allocating all after-tax earnings to a smaller pool of equity shares than before the transaction is magnified for a corporate issuer because the interest deduction from the substitution of debt for equity itself increases after-tax earnings. A common transaction in which this occurs is a leveraged buyout, which is an acquisition of corporate stock using debt imposed at the corporate level to provide the cash to buy out the former shareholders. Another common transaction is a corporation's redemption of its own stock with cash from the proceeds of a corporate borrowing (without any acquisition of corporate stock by an unrelated firm or its shareholders), or other corporate distributions to shareholders financed through corporate borrowing.

*Example 2:*¹⁴⁸ Corporation X is in the 35-percent tax bracket, and has outstanding 2.6 million shares of common stock and no debt. Corporation X has annual income of

¹⁴⁷ Net return on the investment financed with preferred stock is equal to the gross income (\$10 million) less corporate taxes paid (\$3.50 million) and less individual taxes paid (\$1.19 million on preferred stock dividends and \$0.36 million on common stock dividends).

¹⁴⁸ Examples 2, 3, and 4 are highly simplified. They assume a corporation with zero leverage that becomes highly leveraged in transactions substituting debt for equity. In considering stock price, the examples do not take

\$40 million on which it pays Federal income tax of \$14 million (\$40 million multiplied by 35 percent), resulting in net after-tax income of \$26 million (\$40 million less \$14 million). Earnings per share are \$10 (\$26 million divided by 2.6 million shares). The stock has a market value of \$80 per share (eight times after-tax earnings).

A buyout fund offers \$312 million in cash for all the outstanding Corporation X stock (\$120 cash per share, 50 percent more than the current market value). The acquisition is funded with \$42 million of the buyout fund's own cash, and the remaining \$270 million is raised by issuing notes paying eight percent interest to be secured by Corporation X's assets. Taxable shareholders who sell to the buyout fund recognize gain or loss on the sale of their shares.

Even if the annual pre-tax income of Corporation X after the buyout is unchanged, its taxes are significantly reduced by the deduction of the interest (\$270 million x 8 percent = \$21.6 million) paid to its bondholders. The reduction of Corporation X's income taxes by \$7.56 million (\$21.6 million multiplied by 35 percent) caused by the interest deduction produces an additional \$7.56 million for the investors. The buyout fund that invested \$42 million of equity obtains an after-tax return in the first year of \$11.96 million, a 28.5-percent return on its equity investment.¹⁴⁹

Example 3: Assume the same initial facts as in *Example 2*. Instead of being acquired in a leveraged buyout, Corporation X issues bonds to borrow \$270 million at eight percent interest, and repurchases \$270 million of its shares (approximately 87 percent of the outstanding shares) at a redemption price of \$120 per share, 50 percent more than the price at which the stock had been trading on the market. Taxable shareholders recognize gain or loss on the redemption of their shares. The resulting reduction in Corporation X's income taxes of \$7.56 million (\$21.6 million multiplied by 35 percent) exactly pays for the increased returns to the bondholders plus the remaining shareholders (after the transaction, \$33.56 million in interest paid to the bondholders and after-tax earnings of the corporation¹⁵⁰ equals the \$26 million of earnings

into account whether the stock price before the transaction may have reflected an expectation of eventual leverage. Also, the examples do not consider what level of debt may be considered optimal from a business standpoint for a particular business or industry, or how this may affect stock price (for example, if a corporation has debt in excess of the general level of debt of other businesses within its industry, this may result in a lower stock price as investors may infer that there are fewer assets available for distribution to shareholders in the event of bankruptcy or default).

¹⁴⁹ The transaction redistributed the operating income of Corporation X, including the benefit of the \$7.56 million reduction in corporate income taxes. Before the transaction, Corporation X had total annual operating income of \$40 million, bearing corporate income tax of \$14 million and producing after-tax corporate earnings of \$26 million (\$10 per share, for a market value at eight times earnings of \$80 per share). After the transaction, Corporation X continues to have total annual operating income of \$40 million. \$21.6 million is paid as interest to the new bondholders, resulting in taxable income of \$18.4 million from which \$6.44 million of corporate income tax is paid, and \$11.96 million remains as after-tax corporate earnings of the corporation in the hands of the new shareholder that invested \$42 million.

¹⁵⁰ Interest and earnings available to the bondholders and remaining shareholders after the transaction are equal to the interest paid on the bonds of \$21.6 million (\$270 million x 8 percent) plus after-tax earnings of \$11.96 million. Similar to *Example 2*, after-tax earnings of \$11.96 million in *Example 3* are equal to annual income of \$40 million less interest expense of \$21.6 million less corporate income tax of \$6.44 million (((\$40 million – \$21.6 million) x 35 percent).

before the transaction plus \$7.56 million in reduced income taxes). Depending on whether the increased returns are paid to taxable bondholders and shareholders, there may or may not be an increase in investor-level income taxes paid.

Example 4: Assume the same initial facts as in *Example 2*. Instead of engaging in a leveraged buyout or a stock redemption, Corporation X borrows \$270 million at eight percent interest and distributes the proceeds pro rata to its shareholders. Each share receives approximately \$104, or almost 30 percent more than the price at which the stock had been trading on the market. The distribution is, in general, a taxable distribution to shareholders that are subject to tax. After the distribution, the earnings per share of Corporation X are \$4.60 (\$11.96 million divided by 2.6 million shares outstanding). If the stock will sell for eight times after-tax earnings, the stock price would be \$36.80.¹⁵¹

Interest deductions may create a negative income tax rate for corporate income when combined with depreciation deductions, credits, preferential rates, or tax exemption of the earnings financed with debt

Interest deductions for borrowing, combined with the tax benefits associated with specific assets, may produce excess interest deductions that may be used to offset other income of the taxpayer. Thus, a taxpayer may have an incentive to incur debt so that deductible interest expense, in combination with other deductions such as depreciation or amortization, may shelter or offset the taxpayer's income. For example, if the purchase of depreciable assets is debt financed, the taxpayer may be able to acquire more assets than without incurring debt. The tax impact of leveraging the acquisition of depreciable or amortizable assets may result in a greater amount of deductible depreciation or amortization, as well as deductible interest expense, for the taxpayer.

For example, assume Corporation X is in the 35-percent tax bracket. Corporation X borrows \$1,000,000 in Year One at a six percent interest rate to purchase a new piece of equipment for \$1,000,000. The equipment is classified as three-year property under the modified accelerated cost recovery system ("MACRS") that it is subject to the 200-percent declining balance method of depreciation using the half-year convention.¹⁵² Therefore, the first year depreciation deduction is \$333,300; the second year depreciation deduction is \$444,500; the third year depreciation deduction is \$148,100; and the fourth year depreciation deduction is \$74,100. Corporation X has earnings before interest, taxes, depreciation, and amortization ("EBITDA") attributable to the new equipment of \$300,000 annually in each of Years One, Two, Three, and Four.¹⁵³

¹⁵¹ 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, a significant portion of the value remains because of the tax benefits from the leveraged transaction.

¹⁵² For this example, assume that the property is acquired in a year in which bonus depreciation does not apply and that a section 179 election is not made.

¹⁵³ After the fourth year, the equipment is no longer productive. Assuming a six percent cost of capital, the net present value of this \$300,000 annual income stream over the four-year period is \$1,039,532, which is greater

Table 8.—Depreciable Investment with Leverage

	Year 1	Year 2	Year 3	Year 4
EBITDA	300,000	300,000	300,000	300,000
Interest Expense	(60,000)	(60,000)	(60,000)	(60,000)
MACRS Depreciation	(333,300)	(444,500)	(148,100)	(74,100)
Taxable Income/(Loss)	(93,300)	(204,500)	91,900	165,900
Tax/(Refund)	(32,655)	(71,575)	32,165	58,065

The year-by-year taxable income or operating loss resulting from the acquisition of this equipment is detailed in Table 7, above. Corporation X may deduct interest expense of \$60,000 annually on the debt incurred to acquire the equipment. As a result of the deductions for depreciation and interest expense, in Year One, Corporation X reports a loss for income tax purposes of \$93,300. At a 35-percent tax rate, this creates a tax benefit of \$32,655 that Corporation X may use to offset a tax liability from other current year income (*i.e.*, shelter that other income from current tax) or to carry forward (or back) against future (or past) tax liability of the corporation. Likewise in Year Two, Corporation X records an income tax benefit of \$71,575. In Years Three and Four, Corporation X has positive tax liabilities of \$32,165 and \$58,065.¹⁵⁴

If one computes the net present value¹⁵⁵ of the tax liabilities (positive and negative) over the four-year recovery period of the equipment, the result is a negative \$21,509 and an average tax rate on the initial investment of negative 2.2 percent (negative \$21,509 divided by \$1,000,000). For this reason, some analysts observe that the combination of interest deductions and depreciation deductions may create negative tax rates on the income from investment.¹⁵⁶

Alternatively, Corporation X could have financed the acquisition of the equipment without borrowing, for example, through the use of retained earnings. The year-by-year taxable income or operating loss resulting from an equity financed acquisition is detailed in Table 8, below. Because the purchase is equity financed, Corporation X has no deductible interest expense with respect to the income generated by the equipment. In Years One and Two, Corporation X reports a loss for income tax purposes of \$33,300 and \$144,500, respectively. In

than the \$1,000,000 purchase price of the equipment. Therefore, Corporation X may consider acquiring the equipment independent of the associated tax benefits.

¹⁵⁴ This example assumes that tax losses generated in Years One and Two are not carried forward to reduce taxable income in Years Three and Four.

¹⁵⁵ Discounted at six percent.

¹⁵⁶ Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform*, October 2005, and Congressional Budget Office, *Computing Effective Tax Rates on Capital Income*, December 2006.

Years Three and Four, Corporation X reports taxable income of \$151,900, and \$225,900, respectively.¹⁵⁷ If one computes the net present value of the tax liabilities (positive and negative) over the four-year life of the equipment, the result is a positive \$51,258 and an average tax rate on the initial investment of 5.1 percent (\$51,258 divided by \$1,000,000). The difference in the present values of the net tax liabilities in each example is the present value of four years of \$60,000 in interest expense deductions valued at the 35-percent corporate tax rate (\$72,767).

Table 9.—Depreciable Investment Without Leverage

	Year 1	Year 2	Year 3	Year 4
EBITDA	300,000	300,000	300,000	300,000
MACRS Depreciation	(333,300)	(444,500)	(148,100)	(74,100)
Taxable Income/(Loss)	(33,300)	(144,500)	151,900	225,900
Tax/(Refund)	(11,655)	(50,575)	53,165	79,065

Negative effective rates may also result from the use of debt by a domestic corporation to finance a foreign acquisition. A domestic corporation may incur interest expense that is related to income eligible for deferral. Present law provides detailed rules for the allocation of expenses between U.S.-source and foreign-source income.¹⁵⁸ These rules do not, however, affect the timing of the expense deduction; rather, for a domestic corporation, they apply principally for purposes of determining the foreign tax credit limitation. Thus, a domestic corporation may claim a current deduction, even for expenses that it incurs to produce tax-deferred income through a foreign subsidiary. By reducing the amount of tax imposed on currently taxable income, these interest expense deductions enhance the benefits of the existing deferral regime by yielding low, and in some cases negative, effective tax rates on that income.¹⁵⁹

¹⁵⁷ This example assumes that tax losses generated in Years One and Two are not carried forward to reduce taxable income in Years Three and Four.

¹⁵⁸ Sec. 864.

¹⁵⁹ Note that present law imposes limitations on interest deductions in particular circumstances in which the underlying debt funds assets that produce untaxed income. For example, present law imposes a pro rata interest deduction limitation on financial institutions for interest expense that is allocable to tax-exempt interest, and imposes a somewhat similar pro rata interest deduction limitation on interest expense allocable to the unborrowed cash values of life insurance policies and annuity and endowment contracts held by entities other than natural persons. Secs. 265(b) and 264(f), respectively. A similar concept applies limiting the dividends received deduction for debt financed portfolio stock (sec. 246A). These rules address particular situations, however, and do not address other situations in which untaxed income of other types could be funded by leverage, the interest on which is deductible. For a more detailed discussion of these limitations, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011.

Borrowing as a monetization of asset value

If a taxpayer borrows money, the amount borrowed generally is not considered income. This is true even if the borrowing is secured by the taxpayer's appreciated assets, and even if the borrowing is nonrecourse, so that only the assets are subject to the debt and neither the taxpayer nor his business is otherwise liable. The borrowing is not considered income or a sale of the assets unless and until the borrower experiences difficulties that require the debt to be restructured, or defaults, so that debt is in effect cancelled without repayment of the borrowing in full or the assets are taken by the borrower in a foreclosure.¹⁶⁰ If none of these events occur, the amount borrowed generally is not income and does not cause any gain recognition because the taxpayer is considered still potentially liable for the debt and not to have received an unencumbered economic benefit.

Notwithstanding the fact that the borrowed amount generally is not income, the borrower may use the proceeds of borrowing to buy assets whose debt financed purchase price basis is depreciable (thus offsetting taxable income) and is used to determine whether a sale or other taxable disposition of the asset produces a taxable gain or a deductible loss.¹⁶¹

Timing of debt deductions and inclusions

In general

Interest on a debt instrument is generally deductible by the issuer (and includible by the holder) when the interest is paid or accrued. However, in certain cases the deduction (and inclusion) occurs prior to the time of payment. Tax-exempt or foreign holders that do not pay tax on interest income are indifferent to the consequence of including interest income for tax purposes prior to the receipt of cash. As in the case of any other interest payments to tax indifferent parties, the issuer deducts the interest expense and no tax is imposed on the holder. The value of the deduction is increased to the extent it is allowed before payment.

Original issue discount

When the amount to be paid at the maturity of a debt instrument exceeds the issue price by more than a minimal amount, a portion of the amount to be paid at maturity is treated as interest accruing on a constant yield basis over the life of the instrument as OID. This results in deemed interest being deductible by the issuer and includable by the holder prior to any payment of cash. Even in the case of significant OID subject to the AHYDO rules, there is no limit on the deduction if the instrument ceases to have significant OID by the end of the fifth year after it is issued.¹⁶²

¹⁶⁰ These situations are discussed below.

¹⁶¹ See sec. 1012; *Crane v. Commissioner*, 331 U.S. 1 (1947); and *Waddell v. Commissioner*, 86 T.C. 848 (1986).

¹⁶² See I.D.3. above for a discussion of when a debt instrument is treated as having significant OID.

Issuer treatment if an instrument is troubled and is modified, or cancelled

In the event an investment loses value or becomes worthless, the tax consequences to the issuer vary significantly depending on whether the instrument is debt or equity. In general, if debt is forgiven or restructured, a taxable issuer experiences either cancellation of indebtedness income or gain on the taking of property in foreclosure. By contrast, failure to pay dividends or to return equity capital to investors does not result in income to the issuer.

In some situations, retaining significant debt may have permitted a taxpayer to receive cash without tax when the business prospered, thereby benefitting from deferral. A subsequent default may require the taxpayer to recognize income and incur a tax obligation at that later (perhaps economically less opportune) time. However, a number of rules permit nonrecognition of income, including rules relating to discharge of indebtedness in bankruptcy or to the extent of insolvency.¹⁶³ Such rules possibly mitigate a potential disincentive to use debt financing.

¹⁶³ See sec. 108.

B. Comparison to Debt: Tax Incentives for Equity

Equity of a C corporation may bear more than one level of tax if the C corporation pays corporate tax on its nondeductible dividends or other stock distributions, and a taxable investor also pays tax on the dividend or other equity distribution. However, in some cases, this double tax effect is mitigated by deferral (*e.g.*, if the shareholder does not receive a dividend or sell the stock until years after the corporate earnings arise). The double tax effect may disappear entirely for stock held until the death of a shareholder to the extent the stock does not pay dividends and the appreciation in value of the stock (due to retained earnings or otherwise) obtains a stepped up basis at death. This may create an incentive to retain earnings. The effect is also mitigated if shareholder level income from enhanced corporate value is taxed to the shareholder at a lower tax rate than is available on other forms of income.

Equity may permit a corporate holder to obtain a dividends received deduction or an individual holder to obtain a favorable tax rate

A corporation that owns stock in another corporation is generally allowed a dividends received deduction¹⁶⁴ that in effect excludes between 70 percent and 100 percent of the dividend from the recipient's income. The percentage of the deduction increases depending upon the recipient corporation's percentage ownership of dividend paying corporation.¹⁶⁵ At the lowest percentage deduction, applicable to stock ownership of less than 20 percent, the maximum tax rate on dividends received is currently 10.5 percent.¹⁶⁶

Individual holders of corporate equity are currently eligible for a maximum 23.8 percent tax rate on qualified dividend income (compared to the maximum 43.4 percent rate on interest income), as well as a maximum rate of 23.8 percent on long-term capital gain from the sale of stock.

A corporate issuer that has significant losses or tax-exempt income and that does not expect to be able to use an interest deduction may nevertheless have "earnings and profits" that cause distributions to be treated as dividends.¹⁶⁷ Such a corporation may have an incentive to

¹⁶⁴ A number of special rules apply to limit use of the corporate dividends received deduction. The deduction is not allowed if the holder has not held the stock, at risk, for a specified time, or if the payor is a foreign corporation whose earnings were not subject to U.S. tax. The deduction is reduced to the extent the stock was debt financed by the holder. The basis of the stock with respect to which the dividend was paid must be reduced for certain dividends, to prevent the allowance of a loss on disposition of stock from which earnings have been extracted without tax.

¹⁶⁵ The deduction is equal to 100 percent for dividends received by a corporation that owns at least 80 percent of the vote and value of the payor stock; 80 percent for dividends received by a corporation that owns 20 percent or more of the stock but less than 80 percent, and 70 percent for ownership below that threshold. Sec. 243.

¹⁶⁶ The 35-percent maximum corporate tax rate multiplied by the 30 percent of the dividend that is taxable.

¹⁶⁷ "Earnings and profits" is a concept directed at identifying economic income of a corporation, generally for purposes of determining whether distributions to shareholders should be treated as dividends or as a return of capital. Earnings and profits include tax-exempt income and certain other income on which no tax has been paid

issue equity to provide a corporate holder with a dividends received deduction (or a taxable individual shareholder with a beneficial rate on dividends), even though the earnings did not bear corporate-level tax prior to distribution.

In addition, even a corporation that expects to have entirely taxable income may be able to obtain a lower cost of capital on at least part of its capital structure by issuing stock to those investors that are eligible for the lower rates on dividend income but would not receive the lower rates on interest income (*e.g.*, U.S. taxable individuals or corporations).

due to accelerated depreciation. Sec. 312. In addition, the Code requires a dividend paid out of current year earnings and profits to be treated as a dividend, even if the corporation has loss carryforwards that will cause it to have no taxable income (and no net accumulated earnings and profits) as of the end of the year in which the dividend is paid.

C. Tax Incentives to Create Hybrid Instruments

Taxpayers have significant flexibility to create economically similar instruments and categorize them either as debt or equity. In general, instruments are not bifurcated into part debt and part equity,¹⁶⁸ and the categorization as one type of instrument or the other applies across the board for all tax purposes. Taxpayers may have incentives to create instruments with hybrid features (*i.e.*, features of both debt and equity)¹⁶⁹ either solely for Federal income tax purposes, or because of additional benefits that may occur if the instrument is classified in a different manner for other purposes, including financial reporting, regulatory capital, or foreign tax purposes.

For example, issuers may seek to structure an instrument offering many of the attributes of equity while still providing an interest deduction. Some investors may seek debt-like protections while allowing for the possibility of sharing in the earnings or appreciation of a business. Instruments characterized as debt for tax purposes that have significant equity-like features may mitigate the economic risks of high leverage. For example, a debt instrument having a longer term that permits deferral of cash interest or principal payments, or an instrument that allows final payment of interest or principal (or both) in an amount of issuer stock rather than cash, may provide some cushion against an issuer's default and bankruptcy. Similarly, debt instruments held by a shareholder of the issuer could be perceived by third parties as equity-like to the extent the debt-holding shareholders are less likely to exercise their rights as creditors and drive a troubled issuer into bankruptcy. Such shareholders may instead voluntarily cancel or restructure the debt to avoid bankruptcy and preserve the potential for the corporation to improve its performance, ultimately increasing their overall return through their return to equity.

To the extent debt provides interest deductions, but also some flexibility to prevent bankruptcy, and lacks covenants that inhibit operations, it may be viewed in the marketplace as a less risky capital structure than other, more restrictive debt.

C corporation shareholder debt

Although identity of ownership of a corporation's debt and equity is one common law factor against classification as debt, there is no prohibition against such ownership. In the case of a C corporation, since interest payments eliminate the corporate level tax on the share of earnings that are interest rather than dividends, if the shareholders are also lenders to the corporation, they are able to extract corporate returns with only a single level of tax. Also, as noted previously, it is possible that outside lenders may perceive shareholder debt as less likely to drive a company into bankruptcy, when compared to debt owed to an unrelated party, because

¹⁶⁸ But see the discussion above in I.B.2. regarding the recently proposed regulations under section 385.

¹⁶⁹ See, *e.g.*, *Commissioner v. H.P. Hood & Sons, Inc.*, 141 F.2d 467, 469 (1st Cir. 1944) ("It is clear that a common stock is a proprietary interest on which dividends are paid and a bond is a debt on which interest is paid. Between the two extremes, however, there have grown diverse types of securities with many overlapping characteristics. Some of these myriad variations have, no doubt, been developed to meet fundamental business needs. Others have been mere window dressing to catch the eye of the purchasing public.").

shareholders may have an incentive to cancel or restructure such debt in order to preserve their future equity interest should the company become troubled.

In the case of a corporation controlled by shareholders where a tax treaty reduces the rate of gross-basis withholding tax on interest paid by that corporation, the earnings stripping limitations of section 163(j) permit such controlling shareholders to maintain a 1.5 to 1 debt to equity ratio and to receive up to half of the corporate earnings as interest payments (assuming the debt is respected). The amount of the one-half of earnings that may be deducted as interest to shareholders that are also creditors is computed before depreciation and other deductions that, after interest deductions, will further reduce corporate tax. Even if shareholders are not tax-exempt, there is still a motivation to have shareholders also own corporate debt to eliminate the corporate-level tax in cases where the shareholders are not corporate entities (for example, in the case of a corporation that is owned by private equity fund that is a partnership of individuals, or in the case of any other closely held corporation). This is because the corporate level interest deduction results in only one level of tax. Thus, it may be that domestically- and foreign-owned companies have equal incentives to reduce their corporate level tax with interest deductions to controlling shareholders. Any U.S. tax savings for a foreign-owned company as compared to a domestically-owned company may appear at the shareholder level to the extent no tax is paid on the interest income under applicable treaties or otherwise.

Corporate interest deductions on certain hybrid instruments¹⁷⁰

A corporation may issue debt that is convertible to corporate equity. Such an instrument could be viewed as part debt and part equity, with the amount paid to the corporation attributed, in part, to the fixed interest debt instrument, and, in part, to the conversion feature. Treasury regulations and rulings provide inconsistent results for similar types of instruments, depending upon how the conversion feature is structured. If an instrument is simply convertible into stock of the issuer or a related party, the amount of interest deduction that is considered the economic equivalent of a payment on the amount attributable to the conversion feature is denied.

Under an IRS ruling,¹⁷¹ if the instrument is not automatically convertible at a specific price, but rather is convertible only if one or more contingencies are satisfied (*e.g.*, only if corporate earnings or share prices change by a specified threshold amount), then the rules for determining the market comparable for interest deduction purposes allow the instrument to be treated as if it did not have a conversion feature, thus allowing more interest to be deducted in advance of actual payment. Depending on the point at which the fixed conversion price is set, compared to the conditions of the contingency, the two instruments could be economically very similar. The IRS has solicited comments on whether such approach allowing deductible interest to be determined as if there were no contingency should be extended beyond contingent convertible bonds. Commentators have expressed different views and have noted other

¹⁷⁰ A description of the structuring of hybrid instruments, as well as hybrid instrument advantages in cross-border investment, is beyond the scope of this document. For a recent description, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011.

¹⁷¹ Rev. Rul. 2002-31, 2002-1 C.B. 1023.

inconsistencies in the treatment of potentially similar instruments that offer a debt holder the opportunity to participate in corporate growth or appreciation.¹⁷² The inconsistencies in treatment may allow taxpayers to select the more favorable treatment through proper structuring of the instrument.

A corporation also may issue debt that is, under certain circumstances, payable in corporate equity. Section 163(l) denies interest deductions for such instruments. The IRS has ruled that certain hybrid instruments are not within the scope of this denial.¹⁷³

¹⁷² See, e.g., David P. Hariton, "Conventional and Contingent Convertibles: Double or Nothing," *Tax Notes* vol. 96 no. 1 (July 1, 2002), p. 123; Jeffrey Strnad, "Taxing Convertible Debt," 56 *Southern Methodist University Law Review* 399 (2003); Jeffrey Strnad, "Laboring in the Pin Factory: More on Taxing Convertible Debt," 56 *Southern Methodist University Law Review* 471 (2003); Dana L. Trier and Lucy V. Farr, "Rev. Rul. 2002-31 and the Taxation of Contingent Convertibles, Parts 1 and 2," *Tax Notes* vol. 95 no. 13 (June 24, 2002), p. 1963 and *Tax Notes* vol. 96 no.1 (July 1, 2002), p. 105; Edward D. Kleinbard, Erika W. Nijenhuis and William L. McRae, "Contingent Interest Convertible Bonds and the Economic Accrual Regime," *Tax Notes* vol. 95 no. 13 (June 24, 2002), p. 1949; and Edward D. Kleinbard, "Taxing Convertible Debt: A Layman's Perspective," 56 *Southern Methodist University Law Review* 453 (2003).

¹⁷³ See, e.g., Rev. Rul. 2003-97, 2003-34 I.R.B. 380.

D. Tax Incentives to Substitute Other Arrangements for Debt

Corporate equity owners can extract a stream of earnings from the corporation in a form that is deductible to the corporation (and thus does not bear corporate level tax) through transactions other than debt. For example, property to be used in the corporate business may be held outside the corporation and leased to the corporation. In this scenario, the corporation deducts the lease payments, the property owners pay one level of tax on the rent received, and appreciation in the assets remains outside of the corporation and is not subject to corporate tax.

Similarly, the equity owners of a corporation may extract other streams of earnings in a form that is deductible to the corporation by performing services to the corporation and extracting fees. Private equity owners of a corporation, for example, may require the corporation to pay them fees for management services, which are generally deductible by the corporation.

In situations where interest deductions may be limited, such arrangements could substitute for debt.

Tax-exempt organizations generally are subject to unrelated business income tax (“UBIT”) on the receipt of deductible payments (such as rent, royalties, or interest) from entities the organization controls.¹⁷⁴ However, deductible payments may be shared between taxable and tax-exempt organizations in other ways. For example, taxable entities controlled by tax-exempt organizations may bear deductible costs (*e.g.*, for shared office space or employees) that may otherwise be allocated to the controlling tax-exempt organization.

¹⁷⁴ See sec. 512(b)(13). UBIT generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt functions. Certain types of income are specifically exempt from UBIT, such as dividends, interest, royalties, and certain rents, unless derived from debt financed property or from certain 50-percent controlled subsidiaries. Secs. 511-515.

E. Financial Accounting and Other Considerations

Treatment of an instrument under rules other than tax rules may also affect the issuer. For example, the treatment as debt or equity under U.S. Generally Accepted Accounting Principles (“GAAP”) for financial reporting purposes may affect the issuer of financial statements in multiple ways. Similarly, the treatment for regulatory capital purposes is important to a financial institution subject to such requirements. The treatment by a ratings agency that rates the issuer’s stock or bonds is also a consideration. This section describes general considerations under GAAP.¹⁷⁵

Consequences of debt classification

The classification of an instrument as debt for financial reporting purposes generally will have an impact on the computation of the company’s net income. In general, any instrument treated as debt for financial reporting purposes will have an actual or imputed interest expense component. This interest expense must be taken into account in deriving net income and, therefore, earnings per share (generally determined by dividing net income by the weighted-average number of shares issued and outstanding).¹⁷⁶ Furthermore, some companies are required to meet interest coverage ratios¹⁷⁷ pursuant to covenants agreed to in existing loan documents.¹⁷⁸ The more interest expense a company is deemed to have, the more pressure may be put upon that company to generate sufficient earnings to avoid being in violation of these debt covenants.

The classification of an instrument as a debt instrument will also increase that entity’s leverage ratios.¹⁷⁹ These ratios are an important metric often used by lenders to determine whether an enterprise may obtain additional future financing, how expensive that financing will be (*e.g.*, incremental debt may reduce the issuer’s credit rating), as well as whether that enterprise is in compliance with its debt covenants under existing obligations.

¹⁷⁵ The Financial Accounting Standards Board (“FASB”) establishes and interprets the financial accounting standards that govern GAAP and are used by publicly traded companies within their annual reports filed with the Securities and Exchange Commission (“SEC”). Companies that are not publicly traded often provide financial statements prepared in accordance with GAAP to investors and creditors.

¹⁷⁶ See Accounting Standards Codification (“ASC”) 260, *Earnings Per Share*.

¹⁷⁷ The interest coverage ratio is a measure of the number of times a company could make the interest payments on its debt with its earnings before interest and taxes (“EBIT”). In general, the lower the interest coverage ratio, the higher the company’s debt burden, and the greater the possibility of bankruptcy or default. The formula for the interest coverage rate is: EBIT divided by interest expense.

¹⁷⁸ Debt covenants generally are agreements between a company and its creditors requiring or forbidding certain actions of the company. For example, a company may be required under a covenant to limit other borrowing or to maintain a certain level of leverage.

¹⁷⁹ In general, the leverage ratio is a measure of the amount of equity in comparison to debt or the amount of earnings in comparison to debt. Although there are variations on the formula used, one leverage ratio, the debt-to-equity ratio, is computed as follows: (short-term debt plus long-term debt) divided by equity.

From a balance sheet perspective, an instrument classified as debt will generally be recorded at its face or principal value (*i.e.*, generally the amount to be repaid upon maturity of the obligation),¹⁸⁰ with any accrued but unpaid interest also accounted for as a liability. The financial statement disclosure requirements with respect to debt vary depending on its nature.¹⁸¹

Consequences of equity classification

To the extent an instrument is classified as equity for financial reporting purposes, such a classification will generally not have the same impact on net income, interest coverage, and leverage ratios. Rather than being treated as interest expense, a payment on equity is generally treated as a dividend which is taken into account as a reduction to the company's retained earnings, rather than as a reduction to net income. Although payments on equity do not reduce net income, the issuance of an equity instrument generally will still have a dilutive impact on earnings per share (since the denominator, number of shares issued and outstanding, increases, while the numerator, net income, is not impacted by the additional equity issuance).¹⁸² Unlike debt, the issuance of equity will have no impact on the interest coverage ratio and will decrease leverage ratios. From a balance sheet perspective, equity will generally be recorded at fair value (*i.e.*, generally the amount of the proceeds received).¹⁸³

Financial accounting classification as either debt or equity

As with the Federal income tax rules, the classification of an instrument as debt (*i.e.*, a liability) or equity for financial reporting purposes can be a challenging area for the issuers of financial statements. Financial reporting rules generally define liabilities, including debt instruments, as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”¹⁸⁴ In general, a liability has three essential characteristics:

¹⁸⁰ If the proceeds received do not equal the amount due at maturity, the debt instrument has been issued at a discount or premium. ASC 470, *Debt*, provides guidance on accounting and reporting for debt, and ASC 835, *Interest*, provides guidance on recording debt discounts or premiums.

¹⁸¹ See ASC 470, *Debt*.

¹⁸² Under GAAP, companies are required to report basic earnings per share and are often also required to report diluted earnings per share. Diluted earnings per share measures the performance of an entity over the reporting period, while also giving recognition to all potentially dilutive common shares that are outstanding during the period. The calculation of diluted earnings per share requires a series of assumptions to be made about potentially dilutive securities being converted into common stock. See ASC 260, *Earnings Per Share*. Given the prevalence of potentially dilutive securities, much of the complexity in the GAAP rules for earnings per share computations relates to this issue.

¹⁸³ See ASC 505, *Equity*. See also ASC 810, *Consolidation*, for requirements regarding the presentation and disclosure of noncontrolling interests.

¹⁸⁴ FASB Concepts Statement No. 6, *Elements of Financial Statements* (“Con. 6”), par. 35. Although the FASB Concepts Statements do not establish generally accepted accounting standards, they are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide the selection of

- a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand;
- b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice; and
- c) the transaction or other event obligating the entity has already happened.¹⁸⁵

Solely with respect to financial instruments (and not contracts to provide services or other types of contracts), FASB defines an obligation as a conditional or unconditional duty or responsibility to transfer assets or to issue equity shares.¹⁸⁶

In contrast, in the case of a business enterprise, financial reporting rules generally define equity as the ownership interest in the enterprise stemming from ownership rights (or the equivalent) and involving a relation between the enterprise and its owners *as owners* rather than as employees, suppliers, customers, lenders, or in some other nonowner role.¹⁸⁷ Since equity ranks after liabilities as a claim to or interest in the assets of the enterprise, it is a residual interest: (a) equity is the same as net assets, the difference between the enterprise's assets and its liabilities, and (b) equity is enhanced or burdened by increases and decreases in net assets from nonowner sources, as well as investments by owners and distributions to owners.¹⁸⁸ An enterprise may have several classes of equity (*e.g.*, one or more classes of common or preferred stock) with different degrees of risk stemming from different rights to participate in distributions of enterprise assets or different priorities of claims on enterprise assets in the event of liquidation.¹⁸⁹ Even so, all classes of equity depend at least to some extent on the enterprise's profitability for distributions of enterprise assets, and no class of equity carries an unconditional

economic phenomena to be recognized and measured for financial reporting purposes and its display in financial statements or related means of communicating information to those who are interested. Furthermore, Concepts Statements guide the FASB in developing sound accounting principles, and provide the FASB and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting. Financial Accounting Standards Board, "FASB Home: Standards: Concepts Statements," <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156317989>.

¹⁸⁵ *Ibid.* at par. 36.

¹⁸⁶ ASC 480-10-20, *Distinguishing Liabilities from Equity: Overall: Glossary*.

¹⁸⁷ Con. 6, par. 60.

¹⁸⁸ *Ibid.*

¹⁸⁹ *Ibid.* at par. 62. An equity security is defined as any security representing an ownership interest in an entity (*e.g.*, common, preferred, or other capital stock) or the right to acquire (*e.g.*, warrants, rights, and call options) or dispose of (*e.g.*, put options) an ownership interest in an entity at fixed or determinable prices. The term "equity security" does not include any of the following: a) written equity options, b) cash-settled options on equity securities or options on equity-based indexes, or c) convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor. ASC 320-10-20, *Debt and Equity Securities: Overall: Glossary*.

right to receive future transfers of assets from the enterprise except in liquidation, and then only after liabilities have been satisfied.¹⁹⁰

Although the distinction between debt and equity is clear in concept, it can be obscured in practice as securities issued by business enterprises may have characteristics of both debt and equity in varying degrees.¹⁹¹ Additionally, the names given to these securities may not be reflective of their essential nature. By way of example, a bond may be viewed as a classic illustration of a debt instrument. Nonetheless, the traditional distinction between stocks and bonds has become blurred through the increased use of instruments with characteristics of both debt and equity. For example, convertible bonds have both liability and residual interest characteristics. Additionally, preferred stock may have characteristics more reflective of debt, such as maturity amounts and dates at which it must be redeemed for cash.¹⁹²

The mixed characteristics of these securities have historically made accounting for them under GAAP a challenge.¹⁹³ Convertible bonds typically give their holder the right to exchange the bond for common stock under certain stipulated terms. In circumstances in which these instruments may be settled wholly or partly in cash, GAAP requires the issuer of the instrument to split the instrument into its debt and equity components.¹⁹⁴ The issuer accomplishes this by first valuing the debt component and then subtracting this value from the total proceeds received to derive the equity component.

In other cases, GAAP requires financial instruments with some characteristics of debt and equity to be classified as a liability. An example is a mandatorily redeemable financial instrument such as mandatorily redeemable preferred stock.¹⁹⁵ These instruments are structured such that they embody an unconditional obligation requiring the issuer of the instrument to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

The FASB and International Accounting Standards Board (“IASB”) are undertaking a joint project to develop a comprehensive standard on financial instruments with characteristics of

¹⁹⁰ *Ibid.*

¹⁹¹ *Ibid.* at par. 55.

¹⁹² *Ibid.*

¹⁹³ Although U.S. tax rules generally treat an instrument as all debt or all equity, the recently proposed regulations under section 385 treat, in certain cases, an interest in a corporation as part debt and part equity. See discussion above at I.B.2.

¹⁹⁴ See ASC 470-20, *Debt: Debt with Conversion and Other Options*.

¹⁹⁵ See ASC 480-10-25, *Distinguishing Liabilities from Equity: Overall: Recognition*.

equity, liabilities, or both. Among other goals, this guidance is expected to revisit the definition of liabilities mentioned above.¹⁹⁶

¹⁹⁶ Prior to the project becoming a joint effort between the FASB and IASB, the FASB issued a report with its preliminary views in November 2007 soliciting comments. This report recommended an approach that would classify an instrument as equity if it (1) is the most subordinated interest in an entity, and (2) entitles the holder to a share of the entity's net assets after all higher priority claims have been satisfied. All other instruments, including forward contracts, options and convertible debt, would be classified as liabilities or assets. Financial Accounting Standards Board, *Preliminary Views: Financial Instruments with Characteristics of Equity* (No. 1550-11), November 2007. Although several comment letters were received that critiqued various aspects of the FASB report, an update to these preliminary views has not yet been released. An exposure draft addressing targeted improvements to the recognition and measurement of liabilities and equity is targeted for release by the FASB before the end of the second quarter of 2016.