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# LEVERAGED BUYOUTS AND TAX POLICY

PATRICIA L. BRYAN†

*In recent years the leveraged buyout, a corporate acquisition in which a publicly-held corporation is taken private by a group of investors who finance the purchase largely with borrowed money, has become increasingly popular. The popularity of the leveraged buyout has generated much controversy within the business community; part of this controversy involves the role of federal income tax provisions in this area. Critics of leveraged buyouts argue that the corporate interest deduction provides incentives for leveraged buyouts that would not be justified on financial or economic grounds alone.*

*In this Article Professor Bryan examines the tax code's impact on the recent increases in leveraged buyouts. Professor Bryan argues that although critics of leveraged buyouts have focused on the interest deduction, attention must be given to the overall consistency of the tax consequences of leveraged buyouts with the existing structure and underlying policy of the tax provisions. After describing the leveraged buyout and comparing its tax consequences to a theoretical model, Professor Bryan concludes that the primary tax incentive for leveraged buyouts has been the preference for capital gains at the shareholder level rather than the corporate interest deduction. Professor Bryan proposes various methods that would eliminate the tax incentive for leveraged buyouts and help achieve a more neutral and coherent tax policy.*

*This Article was completed before the Tax Reform Act of 1986, which eliminated, for now, the preferential treatment for capital gains. In the Afterword Professor Bryan shows that the tax incentive for the leveraged buyout has not been eliminated by the repeal of the capital gains preference. Even without the preferential rate for capital gains, certain forms of distributions to shareholders will continue to be tax-preferred. Thus, Professor Bryan concludes that the tax bias toward leveraged buyouts will remain a significant factor in corporate financial decisions under the new law.*

## I. INTRODUCTION

The stock market explosion of recent years has been accompanied by a dramatic upsurge in the number of corporate mergers and acquisitions, described as the "fourth major merger wave since the turn of the century."[1] One of the most

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1. *See* STAFF OF JOINT COMM. ON TAXATION, 99th Cong., 1st Sess., FEDERAL INCOME TAX

common types of transactions is the leveraged buyout, in which a publicly held corporation is taken private by a group of investors who finance the purchase largely with borrowed money.[2] Typically, a substantial portion of the debt is secured by the assets or the stock of the acquired corporation, and the full amount is to be repaid out of the corporation's future cash flow. Over the past several years, equity investors in these acquisitions, usually including unrelated parties as well as corporate managers, have realized spectacular and widely publicized gains through stock appreciation.[3] Consequently, the number of leveraged buyouts has continued to rise, with the sizes of the target companies increasing to the billions of dollars.[4]

The leveraged buyout market has also changed in other ways over the past few years. The acquisitions now are often initiated by investment bankers rather

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ASPECTS OF HOSTILE TAKEOVERS AND OTHER CORPORATE MERGERS AND ACQUISITIONS (AND S. 420, S. 476, AND S. 632) 2 (1985) [hereinafter HOSTILE TAKEOVERS]. According to those statistics, the amount spent on mergers and acquisitions increased by almost 70% from 1983 to 1984, rising from $73.1 billion in 1983 to $122.2 billion in 1984.

2. A leveraged buyout can also be structured as an acquisition of a subsidiary or a division of a publicly held corporation instead of the entire company.

3. Many of these gains are realized by investors when the corporation that has been taken private in a leveraged buyout is subsequently resold to the public. One of the most widely publicized payoffs was realized by an investor group headed by former Treasury Secretary William Simon, which purchased Gibson Greeting Card in the early 1980s for $81 million, borrowing $80 million. When Gibson was later sold to the public, the investors made $100 million on their initial cash investment of $1 million. *See* Adkins, *Why Leveraged Buyouts Are Getting Riskier*, DUN'S BUS. MONTH, Apr. 1984, at 33, 34; *see also* Ross, *How the Champs Do Leveraged Buyouts*, FORTUNE, Jan. 23, 1984, at 70 ("Not the least of the claims of Kohlberg, Kravis, Roberts & Co., the nation's leading specialist in leveraged buyouts, is that the equity invested in its deals has grown at the extraordinary average annual rate of 62%."); Sloan, *The Magician*, FORBES, Apr. 23, 1984, at 32, 34 [hereinafter Sloan, *The Magician*] ("At minimum, the [leveraged] buyout [of Metromedia, Inc.] makes [John Kluge, the primary equity investor] a centimillionaire. At maximum, he has a shot at being a billionaire."); Sloan, *Luring Banks Overboard?*, FORBES, Apr. 9, 1984, at 39 [hereinafter Sloan, *Luring Banks Overboard*] (describing leveraged buyouts as "Wall Street's equivalent of the philosophers' stone, that mythical substance that turned ordinary metal into gold [which] have produced payoffs as large as 200-to-1 for some happy investors.").

4. The investment banking firm of Kohlberg, Kravis, Roberts & Co. has been responsible for much of the growth in the leveraged buyout market. Prior to 1979 leveraged buyouts rarely involved more than $100 million. In 1979 Kohlberg purchased Houdaille Industries in a leveraged acquisition for $355 million, with larger deals to follow. *See* Ross, *supra* note 3, at 74. In November 1985 Beatrice accepted an offer from Kohlberg to purchase the company for $6.2 billion, a transaction that would be the largest leveraged buyout as of that date. Wall St. J., Nov. 15, 1985, at 2, col. 2. Other leveraged buyouts in the billions of dollars have included the acquisition by Kohlberg of Storer Communications in April 1985 for $2.5 billion and Pantry Pride's buyout of Revlon in November 1985 for $1.8 billion. *See* Cole, *Big Players in 1985*, N.Y. Times, Dec. 29, 1985, at F7, col. 1, col. 2; *see also* CONGRESSIONAL RESEARCH SERV., 98th Cong., 2d Sess., LEVERAGED BUYOUTS: SOUND CORPORATE RESTRUCTURING OR WALL STREET ALCHEMY? 10 (1984) [hereinafter LEVERAGED BUYOUTS] (listing the largest leveraged buyouts up to late 1984); *Roster Highlights: Top 25 Transactions; Quarterly Profile*, MERGERS & ACQUISITIONS, Jan./Feb. 1986, at 85, 87; Mar./Apr. 1986, at 89, 91 (statistics on leveraged buyouts during the third and fourth quarters of 1985); *A Feverish Market*, MERGERS & ACQUISITIONS, Nov./Dec. 1986, at 45 (statistics on leveraged buyouts during the first two quarters of 1986).

In addition to the dramatic gains realized by investors, reasons cited to explain the increase in the number and size of leveraged buyouts have included: the rise in divestiture of unprofitable divisions or subsidiaries by large, publicly held companies, *see* Miller, *What's Next for Leveraged Buyouts?*, INSTITUTIONAL INVESTOR, Nov. 1983, at 97, 98; significant changes in available financing sources, *see id.* at 101-02; Sloan, *Luring Banks Overboard?*, *supra* note 3, at 41; increasing use as an anti-takeover defense, *see* Ross, *supra* note 3, at 72; and declining interest rates, *see* Weiss, *ABCs of LBOs*, BARRONS, Aug. 19, 1985, at 42.

than by the corporation's existing management.[5] In addition, the purposes of leveraged buyouts are more varied, with such buyouts now frequently appearing in hostile takeover attempts, both as acquisition techniques[6] and as defenses by management against unwelcome suitors.[7]

The recent popularity of leveraged buyouts has generated controversy within the business community.[8] Some financial analysts have viewed the trend with alarm, and the success of leveraged buyouts has been called a "prelude to disaster."[9] Expressing concern over the "leveraging-up of American enterprise," some commentators emphasize the extreme vulnerability of firms with heavy debt to slight downturns in business conditions or the economy.[10] Others stress the additional risks arising from the increased participation of more inexperienced investors, who may evaluate a target less carefully, bidding prices up to unrealistic levels and borrowing excessive amounts.[11] Finally, some commentators discuss the lack of fairness to the public shareholders who are eliminated in a leveraged buyout, focusing on the inherent conflict of interest of a corpora-

5. *See* Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 736 (1985) (describing the buyout market as having become "increasingly institutionalized").

6. *See* Lowenstein, *supra* note 5, at 736 (stating that "MBO's [management buyouts] have in effect merged with that other recent phenomenon, hostile takeovers"); *see also* Bianco, *How Drexel's Wunderkind Bankrolls the Raiders*, BUS. WK., Mar. 4, 1985, at 90 (financing "corporate predators" through sales of "junk bonds"); Stewart, *Kohlberg Bid for Beatrice May Portend a Spate of Hostile Leveraged Buyouts*, Wall St. J., Oct. 22, 1985, at 5, col. 1 (characterizing lender's acceptance of buyouts hostile to management as "a new wrinkle").

7. *See* HOSTILE TAKEOVERS, *supra* note 1, at 19; Miller, *supra* note 4, at 97-98.

8. Some of the main issues in the controversy are summarized in a report prepared by the Congressional Research Service in November 1984. *See* LEVERAGED BUYOUTS, *supra* note 4. The report was prepared at the request of the Subcommittee on Telecommunications, Consumer Protection, and Finance of the Committee on Energy and Commerce of the House of Representatives. It was intended to give an overview of the changes in the leveraged buyout market, providing information on increasing legislative concern "regarding the fairness of the transactions and use of debt beyond conventional norms." *Id.* at 1.

9. *See* Adkins, *supra* note 3, at 33; *see also* BUS. WK., July 2, 1984, at 72 ("Like any gold rush, this one [involving leveraged buyouts] is giving rise to fears of a debacle."); Sloan, *Luring Banks Overboard?*, *supra* note 3, at 39 ("[L]ike all good things, leveraged buyouts are showing signs of wretched excess.").

10. The chairman of the Securities and Exchange Commission, John S.R. Shad, expressed this concern, stating that "the leveraging-up of American enterprise will magnify the adverse consequences of the next recession or significant rise in interest rates . . . . The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow." BUS. WK., *supra* note 9, at 72. Witnesses testifying before Congressional committees have also expressed these concerns. *See, e.g.*, *Tax Treatment of Hostile Takeovers: Hearings Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance on S. 420, S. 476, and S. 632*, 99th Cong., 1st Sess. 68 (1985) [hereinafter *Senate Hearings*] (statement of James R. Jones, U.S. Representative from Oklahoma).

11. More investors are now able to participate in leveraged buyouts through "blind pools," which are equity funds or partnerships formed to provide ready capital for leveraged buyouts. *See* LEVERAGED BUYOUTS, *supra* note 4, at 16; Sloan, *Luring Banks Overboard?*, *supra* note 3, at 40. For concerns about increasing debt-equity ratios in firms acquired in leveraged buyouts, which are often well above industry norms, see LEVERAGED BUYOUTS, *supra*, note 4 at 22-23; Miller, *The Dark Side of the Leveraged Buyout Boom*, INSTITUTIONAL INVESTOR, Apr. 1984, at 183-84. This change in debt-equity ratios, resulting both from increases in corporate debt and decreases in retained earnings, is reflective of a general trend in United States industry over the last several years. *See* Silk, *The Peril Behind the Takeover Boom*, N.Y. Times, Dec. 29, 1985, at F6, cols. 4-5 (according to Henry Kaufman, executive director and chief economist of Salomon Brothers, "[F]rom the start of 1984 to mid-1985, the sum of nonfinancial corporations' retained earnings and new equities issued (minus stock retirements due to mergers, acquisitions, and leveraged buyouts) was a negative $53 billion, while in the same period corporate debt rose by $233 billion").

tion's management that participates on both sides of the transaction.[12]

Although these concerns are widely publicized in the financial press, leveraged buyouts also have strong advocates who argue that the change in corporate ownership improves market allocation of resources and creates shareholder gains through higher productivity and efficiency.[13] These advocates emphasize the increased incentive of managers who typically hold a significant equity interest in the firm as a result of the buyout and the managers' new commitment to cutting unnecessary costs and eliminating wasteful overhead.[14] Defenders of buyouts also stress the ability of managers of a privately held firm to focus on long-range planning without the pressure imposed by the stock market to show continual rises in earnings per share.[15] The increased reliance on debt financing is seen to be of little concern, with some commentators citing the much higher levels of corporate debt in other countries.[16]

As leveraged buyouts have become more popular and more controversial, the role of the federal income tax provisions in this area has come under increased scrutiny.[17] It is generally agreed that it is important to understand

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12. Fairness to the public shareholders involves several different issues, including the role of the managers in structuring the deal, their responsibility for disclosure, the fairness of the price, and the remedies for shareholders challenging the transaction. For a summary of the legal literature on these issues, see LEVERAGED BUYOUTS, *supra* note 4, at 33-40.

13. *See* LEVERAGED BUYOUTS, *supra* note 4, at 1, 3; Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 729-30 (1982); Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 235 (1979); *Roundtable: The Leveraged Buyout Market*, MERGERS & ACQUISITIONS, Summer 1984, at 26-27 [hereinafter *Roundtable*].

14. *See* Ferenbach & Mancuso, *Leveraged Buyout—A Powerful Tool for Assertive Management*, MGMT. REV., Nov. 1983, at 59, 60-61; Jensen, *Takeovers: Folklore and Science*, HARV. BUS. REV., Nov.-Dec. 1984, at 109, 112; *Roundtable, supra* note 13, at 27-28, 34.

15. Perham, *The Joys and Woes of Managing an LBO*, DUN'S BUS. MONTH, Sept. 1985, at 40-41; *Roundtable, supra* note 13, at 36.

16. *Roundtable, supra* note 13, at 31. It has also been argued that, for some companies, increased debt may serve as an effective control of agency costs, requiring corporate managers to distribute free cash flow instead of investing in unproductive projects. *See* Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986).

17. Articles in popular business magazines frequently blame the tax laws for encouraging and subsidizing leveraged buyouts. *See, e.g.*, Sloan, *Luring Banks Overboard?*, *supra* note 3, at 39:

> What is this wonderful institution, the leveraged buyout? . . . Why are LBOs making so many people rich? . . . Credit much of the success of LBOs to our terrible tax laws, especially to the indefensible corporate income tax. . . . A key reason for the frenzied growth in buyouts is that Uncle Sam, in his wisdom, has subsidized the LBO business. Not directly, of course, but through the tax code.

*Id.* Legal commentators have also focused on tax benefits as a major incentive for leveraged buyouts. *See, e.g.*, Lowenstein, *supra* note 5, at 759-64.

Congressional concern about the role of the tax provisions in encouraging merger activity, including leveraged buyouts, is evidenced by a pamphlet prepared by the Congressional Research Service. *See* LEVERAGED BUYOUTS, *supra* note 4. In April 1985 several congressional subcommittees held hearings concerning the federal income tax aspects of hostile corporate takeovers, including leveraged buyouts. *See Tax Aspects of Acquisitions and Mergers: Hearings Before the Subcomm. on Oversight and Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 99th Cong., 1st Sess. (1985) [hereinafter *House Hearings*]; *Senate Hearings, supra* note 10. The Staff of the Joint Committee on Taxation prepared background material for these hearings, describing federal income tax considerations pertinent to mergers and discussing the policy implications of tax-motivated mergers. *See* STAFF OF JOINT COMM. ON TAXATION, 99th Cong., 1st Sess., FEDERAL INCOME TAX ASPECTS OF MERGERS AND ACQUISITIONS (1985); HOSTILE TAKEOVERS, *supra* note 1.

whether tax considerations have encouraged these transactions, providing incentives for leveraged buyouts that would not be justified on financial or economic grounds alone.[18] Most commentators also agree that tax incentives should be eliminated, making tax considerations a neutral factor in this area.[19] Strong opponents of leveraged buyouts, however, take a different position, arguing that the tax provisions should be designed to discourage such transactions.[20]

The major focus of attention in discussions of tax incentives for leveraged buyouts has been the corporate interest deduction.[21] After the transaction, the acquired corporation pays substantial amounts of interest on the debt incurred to finance the leveraged buyout. These interest payments are tax-deductible,[22] and thus they significantly reduce the taxes of a corporation that was previously making nondeductible dividend payments or accumulating amounts out of which future dividends could be paid. The deductibility of interest on debt, as opposed to the nondeductibility of dividends paid on stock, is an accepted principle under current tax law. Few proponents of reform in the leveraged buyout context suggest that the distinction be eliminated or argue that the debt involved should be recharacterized as stock under current judicial and regulatory guidelines.[23] Nevertheless, some have argued that significant limitations on the de-

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18. *See* HOSTILE TAKEOVERS, *supra* note 1, at 14-15.

19. *See, e.g.*, *House Hearings*, *supra* note 17, at 129 (statement of David H. Brockway, Chief of Staff, Joint Committee on Taxation); *Senate Hearings*, *supra* note 10, at 121 (statement of Ronald A. Pearlman, Assistant Secretary for Tax Policy, Department of Treasury); *see also* HOSTILE TAKEOVERS, *supra* note 1, at 14 (presenting arguments for and against the retention of these tax provisions).

20. *See, e.g.*, Silk, *supra* note 11, at F6, col. 5.

21. The deduction for interest allowed by I.R.C. § 163 (1985), has been emphasized by business commentators as the primary tax incentive for leveraged buyouts. *See, e.g.*, Sloan, *The Magician*, *supra* note 3, at 32 (describing the leveraged buyout as "one of those deals in which everyone benefits—everyone except the U.S. Treasury, which subsidizes all leveraged buyouts because of the nonsensical income tax laws, which make interest costs tax-deductible, thus encouraging borrowing at the cost of building up equity"). Specific proposals for reform of the tax provisions in this area have also focused on disallowance of the interest deduction. *See, e.g.*, Canellos, *The Over-Leveraged Acquisition*, 39 TAX LAW. 91, 115-19 (1985) (arguing that the problem of excessive leverage in corporate acquisitions should be dealt with by denying interest deductions on excessive debt—defined by reference to specified industry standards—incurred in connection with the acquisition of a controlling interest in a corporation by purchase or redemption). Proposals have been introduced in the Senate that would disallow deductions for interest paid or accrued on debt incurred to acquire corporate stock or assets, but only in the context of certain "hostile" acquisitions. S. 632, 99th Cong., 1st Sess., 131 CONG. REC. S2789-92 (1985) (introduced by Senator Chafee); S. 476, 99th Cong., 1st Sess., 131 CONG. REC. S1579-80 (1985) (introduced by Senators Boren and Nickles) (limiting the disallowance to interest on junior obligations, commonly referred to as "junk bonds"); S. 420, 99th Cong., 1st Sess., 131 CONG. REC. S1198-99 (1985) (introduced by Senators Boren and Nickles).

The other primary tax benefit that has been blamed for leveraged buyouts has been the increased depreciation deductions that result from the step-up in the bases of the target's assets. *See infra* note 52; *see also infra* note 115 (discussing the elimination of this benefit by the Tax Reform Act of 1986).

22. The interest deductions would have to be tested under I.R.C. § 279 (1985), which denies deductions for interest on certain types of acquisition indebtedness. The limited role of this provision in the leveraged buyout context is discussed in more detail *infra* note 46.

23. The difficulties in distinguishing between debt and equity are obvious from the problems the Treasury has had in finalizing regulations under I.R.C. § 385 (1985). Proposed regulations were published in December 1980, *see* 45 Fed. Reg. 86445-58, (1980) (codified at 26 C.F.R. §§ 1.385-1 to -10), but were withdrawn in the face of tremendous controversy. Still in effect, however, are the general guidelines for distinguishing between debt and equity developed prior to issuance of the § 385 proposed regulations. *See, e.g.*, Rev. Rul. 73-122, 1973-1 C.B. 66; Rev. Rul. 68-54, 1968-1

ductibility of interest on corporate debt incurred in connection with corporate acquisitions are necessary to prevent the growing trend toward highly leveraged takeovers of operating companies.[24]

Although critics of leveraged buyouts have focused primarily on the interest deduction, little attention has been paid to the overall consistency of the tax consequences of leveraged buyouts with the existing structure and underlying policy of the tax provisions. This Article attempts to provide that analysis, illustrating the major theoretical inconsistency and urging a different focus for proposals to neutralize the tax provisions in this area.

The conclusion that the corporate interest deduction is the primary tax incentive for leveraged buyouts ignores recent legal and economic studies that have focused on the relationship between the individual and corporate tax structures under current law. Analysis has shown that the individual and corporate tax burdens operate in a more compensatory fashion than might be expected and, under certain assumptions concerning rates of tax and return, achieve tax neutrality between corporate financial decisions.[25] Under this analysis, structural deviations from the assumptions are the source of tax incentives and, if tax neutrality is the goal, are the proper focus for reform.

By applying this theoretical analysis to leveraged buyouts, this Article illustrates that the currently accepted tax consequences do provide a clear tax incentive for the transaction. The incentive does not, however, arise from the corporate interest deduction that is available to the company in the years following the acquisition. Instead, the major source of the incentive, and therefore the more appropriate focus for reform, is the cost to the shareholders of the equity distribution.[26] That cost is computed at the time the shift in ownership occurs, when the outgoing public shareholders exchange their stock for the proceeds from the newly-incurred corporate debt. Under current law and administrative

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C.B. 69; Levin, *Tax Aspects of Leveraged Buyouts*, in LEVERAGED ACQUISITIONS: PRIVATE AND PUBLIC 113 (1985); *see also infra* notes 76-77 and accompanying text (discussing the characterization of the typical notes issued in leveraged buyouts).

24. *See, e.g.*, S. 632, *supra* note 21, at S2789; Canellos, *supra* note 21, at 115-17. On January 8, 1986, the Federal Reserve Board adopted a controversial rule that is expected to limit the debt incurred in connection with leveraged buyouts and hostile takeovers. Under the new rule, a shell corporation, formed solely for the purpose of the acquisition, would be subject to the Board's margin requirements. The financing of more than 50% of the purchase price with debt, collateralized with the acquired stock or assets, would be prohibited. *See* Lambert & Williams, *Fed Board Votes 3-2 to Restrict the Use of "Junk" Bonds in Corporate Takeovers*, Wall St. J., Jan. 9, 1986, at 2, col. 3. Although the new rule is expected to restrict the issuance of many high-yield, low-grade securities currently used in leveraged buyouts and referred to as "junk" bonds, Federal Reserve Chairman Paul Volcker has predicted that "corporate raiders will find 'innumerable devices' to get around the new requirement." *Id.*; *see also* Ehrlich, *Twilight for the Lone Raider?*, BUS. WK., Jan. 27, 1986, at 38 (discussing the impact of the new regulations on the takeover market).

25. *See* AMER. LAW INST., FEDERAL INCOME TAX PROJECT SUBCHAPTER C, REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS (1982) [hereinafter AMER. LAW INST., REPORTER'S STUDY]; Auerbach, *Share Valuation and Corporate Equity Policy*, 11 J. PUB. ECON. 291 (1979); Auerbach, *Tax Integration and the "New View" of the Corporate Tax: A 1980's Perspective*, 74 Nat'l Tax Ass'n Proceedings 21, 22-23 (1981); Bradford, *The Incidence and Allocation of Effects of a Tax on Corporate Distributions*, 15 J. PUB. ECON. 1 (1981); Stiglitz, *Taxation, Corporate Financial Policy, and the Cost of Capital*, 2 J. PUB. ECON. 1 (1973). This analysis is described in more detail *infra* text accompanying notes 62-66.

26. *See infra* notes 67-73 and accompanying text.

rulings, the exchange is treated as a sale, so that the distribution of shareholder equity is accomplished at the cost of a capital gains tax.[27] As the analysis will show, the preferential capital gains rate is inconsistent with the assumptions of the theoretical model, which would permit the corporate tax deduction for subsequent interest payments but which achieves neutrality by imposing a shareholder tax at ordinary rates on all withdrawals of corporate earnings. Allowing a shareholder withdrawal to be accomplished at a lower cost creates a strong tax incentive for leveraged buyouts that is wholly independent of their economic or financial motivation.

The tax incentive created by applying the capital gains rate to the shareholder withdrawal is hardly unique to leveraged buyouts, although that transaction provides a particularly dramatic illustration. The same incentive exists in the context of all distributions to shareholders that are taxed to them as sales, including certain redemptions and liquidations.[28] To eliminate tax incentives in any of these contexts, it is necessary to increase the tax cost of the shareholder withdrawal of corporate earnings. A higher cost could be imposed in a variety of ways, such as allocating the distribution to all or some of the shareholders as a dividend or imposing an excise tax at the corporate level.[29] If one of these reforms were enacted, certain corporate financial decisions, including the decision to eliminate public shareholders in a highly leveraged acquisition, would depend on business and economic factors, without tax considerations as an additional inducement. Strong arguments can be made that the goal of sound tax policy should be to achieve such neutrality, so that the tax provisions neither encourage nor inhibit corporate acquisitions. If, after eliminating tax incentives, the trend toward leveraged buyouts continues, and if that trend is determined to be economically or socially undesirable, changes in the securities or banking laws may well be more effective methods of regulation than additional changes in the tax provisions.

Part II of this Article describes the mechanics of leveraged buyouts, including the basic financial aspects and tax consequences. Part III describes the theoretical relationship between the taxes imposed on individuals and corporations and illustrates how, under certain assumed conditions, tax equivalence is achieved between corporate financial decisions. After a comparison of the tax consequences of leveraged buyouts to the theoretical model, the analysis concludes that a significant incentive for the transaction results from the inadequate cost of the shareholder withdrawal of corporate accumulations rather than from the subsequent corporate interest deductions. Part IV explains that the incentive inherent in the tax consequences of leveraged buyouts is not unique to that transaction but exists in other contexts as well. Part IV also briefly describes

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27. *See infra* notes 42-44 and accompanying text (discussing the tax consequences to public shareholders in more detail). The Tax Reform Act of 1986, signed by President Reagan on October 22, 1986, made significant changes in the taxation of capital gains. The Afterword to this Article discusses these changes and their relevance to the Article's analysis. *See infra* notes 107-28 and accompanying text.

28. *See infra* note 78.

29. *See infra* text accompanying notes 90-106.

various methods that would correct this broad structural inconsistency and that, if enacted, would eliminate tax incentives for leveraged buyouts as well as help achieve a more neutral and coherent tax policy.

## II. Financial Structures and Tax Consequences

The major consequence of a leveraged buyout occurs when the equity ownership of an operating corporation shifts from the public to a small investor group, accompanied by a significant change in the corporation's capital structure.[30] Before the transaction occurs, the target firm typically has a substantial net worth or shareholder equity, with its assets burdened by relatively little debt. After the buyout, net worth is reduced significantly, although the corporate asset base typically remains unchanged. The reduction in net worth is caused by two related financial events: the corporation borrows cash, incurring significant amounts of new corporate debt, and the loan proceeds are immediately distributed to shareholders. Corporate liabilities are substantially increased, and shareholder equity is substantially reduced. The recipients of the distribution are the public shareholders, whose stock interests are eliminated in the transaction. The equity interests that remain are held by an investor group, usually including some members of the firm's management,[31] who obtained or increased their interests with minimal cash contributions. Immediately after the transaction, the corporation's cash flow, which previously was used to pay dividends or increase shareholder equity, is used to service and repay the debt. After the debt is repaid, the new shareholders anticipate significant gain through appreciation in the value of their stock.

Participants in a leveraged buyout are usually brought together by an investment banker, who benefits from substantial fees and from the opportunity to

30. Detailed discussions of the corporate and financial aspects of leveraged buyouts may be found in Daitz, Kaufman, Ley, & Messineo, *Leveraged Buy-Outs*, in ACQUISITIONS AND MERGERS: TACTICS, TECHNIQUES, AND RECENT DEVELOPMENTS 143 (1985) [hereinafter Daitz].

If the target's stock rather than its assets is purchased, with the target then held as a subsidiary of the acquiring corporation, the capital structure of the target itself will not change. Instead, the capital restructuring will be reflected in the balance sheet of the acquiring corporation, whose only asset will be the target stock. The debt of the acquiring company, incurred in order to purchase the target stock, will be secured by the target's assets and repaid with the target's cash flow. Accordingly, the financial consequences (and the restructuring of capital) are basically the same whether the buyout is accomplished as a purchase of stock or assets. The tax consequences are also the same. *See infra* notes 47-48 and accompanying text.

31. In the past corporations that went private did so most frequently through the initiative of their management, which was able to acquire a large ownership stake in the company as a result of the transaction. One of the most significant changes in the leveraged buyout market has been the entry of investment banking concerns that specialize in such transactions, identifying attractive target firms and then obtaining funds from a variety of outside sources. *See* Cuff, *Buyout Firms Seek Returns, Not Synergy*, N.Y. Times, Aug. 5, 1985, at D1, col. 3. Typically, neither the investment banker nor the investors will have any interest in changing the operations of the firm after the transaction. Consequently, the uninterrupted continuation of corporate management is considered important, and managers often will be given the opportunity to participate in the equity ownership as an incentive for remaining with the firm. *See, e.g.*, Weiss, *supra* note 4, at 42. Some commentators have expressed concern over the decreasing equity participation of management in more recent transactions, providing less incentive to continue the smooth operations that are essential to the corporation's repayment of its new debt. *See, e.g.*, Adkins, *supra* note 3, at 34.

participate as an equity investor.[32] The target firm will have been selected by the investment banker on the basis of several different factors. Because of the substantial debt to be incurred, the firm ideally will enjoy those characteristics attractive to lenders: a stable earnings history that is not significantly affected by business cycles, an established position in the market, and modest requirements for future capital investment. A solid asset base, burdened with relatively little debt, is also important, as is a strong management team.[33] An ideal target company would also be substantially discounted on the stock market—at least in the estimation of insiders—with its market value significantly less than both the appraised liquidation value of its assets and a value based on capitalization of future profits. The gap assumed between market value and estimated real value is an important inducement to the new equity investors, who expect that difference to be reflected in future stock appreciation.[34]

A leveraged buyout typically is accomplished through the purchase of the stock or assets of the target firm by a corporation formed solely for the purposes of the acquisition. Although the acquiring entity initially will be capitalized with cash from the equity investors, its ultimate capital structure will be designed with one primary goal: obtaining the maximum amount of debt to finance the acquisition of the target company, with the debt to be serviced and repaid out of the target company's future cash flow. By maximizing the debt, the new equity investors can minimize the cash they need to obtain 100 percent of the outstanding stock.[35]

To the extent possible, loans will be obtained from banks or commercial lending companies in the form of senior debt, to be secured by the stock or assets of the acquired firm. These loans usually bear interest at a rate that floats several points above prime, with the lenders sometimes also benefitting from large front-end fees. Additional amounts, also loaned at variable rates, may often be obtained from banks based on appraisals of future cash flows.[36]

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32. The profits made by the investment bankers specializing in leveraged buyouts have been widely publicized. *See, e.g.*, Ross, *supra* note 3; Sloan, *Luring Banks Overboard?*, *supra* note 3, at 41. According to a recent article in the Wall Street Journal, the $45 million fee that Kohlberg, Kravis, Roberts & Co. will receive for arranging the leveraged buyout of Beatrice, valued at $6.2 billion, will be "the largest single investment advisory fee on record." *See* Ellis, *Leverage Leader*, Wall St. J., Apr. 11, 1986, at 1, col. 6.

33. LEVERAGED BUYOUTS, *supra* note 4, at 27. For discussions of the characteristics of ideal target firms that have evolved along with the popularity of leveraged buyouts, see Ferenbach, *L.B.O.s: A New Capital Market (And How to Cope with It)*, MERGERS AND ACQUISITIONS, Fall 1983, at 21; Miller, *supra* note 4, at 98-99.

34. Daitz, *supra* note 30, at 149-50. The equity investors also hope to realize gain by increased efficiency in operations after the leveraged buyout, resulting from several factors: increased incentive of management once they have an ownership stake; management's freedom to concentrate on cash flow rather than earnings per share; and elimination of certain reporting and disclosure requirements applicable to public companies. *See* authorities cited *supra* notes 13-16.

35. *See* LEVERAGED BUYOUTS, *supra* note 4, at 12-17.

36. *See* LEVERAGED BUYOUTS, *supra* note 4, at 12-14; Daitz, *supra* note 30, at 177, 179-80. In some situations the investor group is able to negotiate an interest rate cap, providing some protection against rising rates. *See* BUS. WK., *supra* note 9, at 72. As leveraged buyouts become larger and, according to some sources, riskier, the traditional senior lenders are being replaced by other banks willing to take more risks in exchange for the large front-end profits and high interest rates. *See* Sloan, *Luring Banks Overboard?*, *supra* note 3, at 40-41.

Even with significant undervaluation by the market, the purchase price for the target firm typically will still exceed its maximum secured loan capacity. "Mezzanine debt," unsecured and subordinated, will be obtained to fill in the gap between the senior debt and the minimum equity contributions of the investors. These loans usually bear high rates of interest and frequently are accompanied by an equity interest, such as a stock option or conversion right. Preferred stock, sometimes with mandatory dividend payments and redemption rights, also may be issued. The participants at this level, which include pension funds, insurance companies, and venture capitalists, take greater risks and provide an additional layer of protection for the senior lenders. As compensation, they share with the principals the opportunity to benefit from the discounted market valuation of the target through future equity growth.[37]

As leveraged buyouts increase in number and size, different and often more innovative financing methods are developed. Additional loans sometimes can be obtained if the equity investors agree to sell some of the company's assets or an entire division or subsidiary after the transaction, with executory sales contracts providing security for these creditors.[38] In recent transactions, additional financing has also been obtained with less traditional instruments, referred to as "junk bonds." These securities, which are high-yield and high-risk, fully subordinated and protected by a minimal equity cushion, may be issued directly to the public shareholders or may be sold by underwriters to provide a source of funding that otherwise would not be available.[39] Employee stock ownership plans, which offer significant tax advantages upon repayment of the debt, may provide an additional source of financing.[40]

Once the maximum loan capacity is determined and the borrowed funds obtained, the desired capital structure can be put into place in various ways.[41]

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37. *See* Sloan, *Luring Banks Overboard?*, *supra* note 3, at 41, 43 ("The phrase [mezzanine money], which GE Credit coined in the late 1970s, describes money above the ground floor (the equity investors) but below the roof (the senior lenders)."); *see also* LEVERAGED BUYOUTS, *supra* note 4, at 14-15 (describing the function of "mezzanine" financing as bridging a gap rather than serving as a debt or equity instrument).

38. *See* Daitz, *supra* note 30, at 158-59. The possibility of a sale of assets after the acquisition, with the sale proceeds used to reduce the new debt, has made it easier to acquire larger corporations in leveraged buyouts. *See With a Lever Long Enough . . .*, FORBES, June 4, 1984, at 220.

39. *See* Daitz, *supra* note 30, at 155, 178. These "junk" bonds are also frequently placed with institutional investors. *See* Bianco, *supra* note 6, at 90-91. Concerns have been mounting over the high risk associated with junk bonds, and the Federal Reserve Board has recently taken steps in an attempt to curb their use. *See supra* note 24. Witnesses testifying at congressional hearings on the tax aspects of hostile takeovers emphasized the dangers of the increasing use of junk bonds in hostile acquisitions, calling for an immediate moratorium on their use while changes in the tax laws to limit deductibility of interest on such debt are under consideration. *See, e.g.*, *Senate Hearings*, *supra* note 10, at 97-106 (statement of Nicholas F. Brady, Chairman, Dillon, Read & Co., Inc., calling the use of junk bond financing a "dangerous destabilizing element for our national savings system"); *id.* at 91-94 (statement of Sen. Pete Domenici).

40. *See* HOSTILE TAKEOVERS, *supra* note 1, at 50-52; Lowenstein, *supra* note 5, at 760-62. The increased use of employee stock ownership plans to provide funding for leveraged acquisitions has raised concerns that the incentives are being used in ways not intended by Congress. *See House Hearings*, *supra* note 17, at 209-14 (statement of Ronald A. Pearlman, Assistant Secretary for Tax Policy, Department of the Treasury).

41. For a discussion of these alternative structures, see Daitz, *supra* note 30, at 168-75. For detailed explanations of the tax aspects, see HOSTILE TAKEOVERS, *supra* note 1, at 30-45; Bowen,

Often, the transaction will proceed as a merger between the target and the acquiring corporation, with the public shareholders receiving the newly borrowed cash in exchange for their shares. Alternatively, the target firm may transfer its assets to the new entity in exchange for cash and then distribute the cash to its shareholders in redemption of their stock. Sometimes, if a two-tier structure is desired (with the operating firm to be held as a subsidiary of the acquiring corporation), the acquiring entity will make a tender offer for the target stock. Any non-tendering shareholders may be eliminated through a subsequent "clean-up" merger of the target with a transitory subsidiary of the acquiring corporation, giving the acquiring corporation 100 percent ownership of the target.

Whichever form the transaction takes, the public shareholders will terminate their equity interests in exchange for cash, with the distributions to them financed by the new corporate loans.[42] The public shareholders will be treated as if they had sold their stock, whether the stock is sold to the acquiring entity directly or is cancelled on the merger or liquidation of the target firm.[43] Accordingly, the shareholders will be taxed only to the extent of their gain, which equals the excess of the amount realized over their investment in the stock. Assuming the stock is a capital asset, tax will be computed at the preferential rate for capital gains.[44]

The financial position of the operating company after the acquisition will depend in large part on the tax provisions, with the company typically paying much less in taxes than it had prior to the acquisition.[45] Cash flow from operations will, of course, be used to service and repay the debt. In the years immedi-

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*Structuring Leveraged Buyouts—Selected Tax Problems*, 63 TAXES 935 (1985); Davis, *Leveraged Buyouts: Selected Issues Pre- and Post-TEFRA*, 41 N.Y.U. TAX INST. §§ 8.01-.05 (1983).

42. The price paid to the public shareholders for their stock typically will be at a premium over the current market value. *See* Daitz, *supra* note 30, at 155; Lowenstein, *supra* note 5, at 737-39. For an empirical study of the effect of leveraged buyouts on the wealth of public shareholders, see DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J.L. & ECON. 367 (1984).

43. *See, e.g.*, Levin, *supra* note 23, at 120-21. Depending on the form of the transaction, the public shareholders may also be treated as if their stock was redeemed by the target firm. This characterization results from disregarding the transitory acquiring corporation if, for example, that corporation merges into the target to accomplish the buyout. *See* Rev. Rul. 78-250, 1978-1 C.B. 83. In this case the public shareholders will be entitled to sale or exchange treatment under I.R.C. § 302(b)(3) (1985), which governs complete terminations of interest. As long as the public shareholders' interests are completely eliminated, their tax consequences should be straightforward. Issues may arise for shareholders of the target firm, such as members of the management team, who retain or increase their percentage interests in the corporation while also receiving cash. In some cases the cash may be treated as a dividend to them. For complete discussions of these and other tax issues, see Bowen, *supra* note 41; Davis, *supra* note 41.

44. Proceeds from the sale or redemption of stock held for more than six months generally are treated as long term capital gains. *See* I.R.C. §§ 1221-1222 (1985). The lower tax rate on capital gains has arisen, in the case of individuals, under I.R.C. § 1202 (1985) (allowing a deduction of 60% of net capital gain) and, in the case of corporations, under I.R.C. § 1201 (1985) (providing a maximum rate of 28% on net capital gain). The Tax Reform Act of 1986, signed by President Reagan on October 22, 1986, made significant changes in the taxation of capital gains. The Afterword to this Article discusses these changes and their relevance to the Article's analysis. *See infra* notes 107-28 and accompanying text.

45. For comparisons of the tax positions of specific firms (both real and hypothetical) after a leveraged buyout, see LEVERAGED BUYOUTS, *supra* note 4, at 16-21; Canellos, *supra* note 21, at 100-09; Lowenstein, *supra* note 5, at 743-48; Sloan, *Luring Banks Overboard?*, *supra* note 3, at 42.

ately after the acquisition, the corporation will have substantial tax deductions for interest payments,[46] whereas previously those amounts were used to pay nondeductible dividends or to increase corporate accumulations out of which future nondeductible shareholder distributions could be made. These tax consequences will not change if the target firm is operated as a subsidiary, with its parent, the newly formed corporation, repaying the loans with dividends received from the operating company. Such distributions will not be taxed to the parent corporation,[47] and the interest deductions of the parent will offset the operating company's business income on a consolidated tax return.[48]

Higher depreciation deductions, resulting from increased bases in assets after the acquisition, may also be available to the target firm after the buyout. If assets are acquired, the bases in the assets will automatically reflect the purchase price.[49] If stock is acquired, an election may be made to reach the same result.[50] In either case, however, the step-up in bases will be obtained only at the cost of recapturing and including in income prior tax benefits, such as previous depreciation deductions.[51] Whether the present value of the increase in future deprecia-

46. It is possible, although unlikely, that interest deductions (generally permitted under I.R.C. § 163 (1985)) would be disallowed by I.R.C. § 279 (1985). That section operates to restrict deductions for interest paid on corporate debt (in excess of $5 million per year) if it arises from specified types of "corporate acquisition indebtedness." *Id.* Section 279 will apply only if the following conditions are present: (1) the debt is issued as consideration for stock, or two-thirds of the assets, of another corporation; (2) the debt is subordinated to claims of trade creditors or any other substantial amount of unsecured debt; (3) the debt is convertible into stock of the acquiring corporation or is issued as part of an investment unit that includes an option to acquire such stock; and (4) on the last day of the acquiring corporation's taxable year in which it issued the debt, the debt to equity ratio of the corporation exceeds 2 to 1, or the corporation's projected earnings do not exceed 3 times the annual interest to be paid or incurred. *Id.*

Section 279 was enacted in 1969 in an attempt to eliminate "a special and unwarranted inducement to merger." *See Senate Hearings*, *supra* note 10, at 320-21 (statement of James S. Eustice, Professor, New York University Law School, discussing the reasons behind the enactment of § 279). Because the statute contains four specific conditions, all of which must be satisfied, it is regarded as relatively easy to avoid in the leveraged buyout context. *See* Canellos, *supra* note 21, at 111-12.

47. As long as the acquiring corporation holds at least 80% of the voting stock and at least 80% of the value of the stock of the target corporation, it will be entitled to deduct 100% of the dividends received. I.R.C. §§ 243(a), (b), 1504(a)(2) (1985).

48. The corporations will be able to file a consolidated return as long as the acquiring corporation owns at least 80% of the voting stock and at least 80% of the total value of the target corporation's stock. *See id.* §§ 1501, 1504 (1985).

49. If the transaction is treated as a taxable purchase of assets, the acquiring corporation will take a cost basis in the assets under *id.* § 1012 (1985). This result could be changed if the former shareholders of the target firm end up with a significant percentage of the stock in the acquiring corporation. In this case, the transaction could be treated as a reorganization, requiring a carryover basis in assets. For a discussion of this possibility in the context of various examples, see Bowen, *supra* note 41, at 943-48; Levin, *supra* note 23, at 149-51.

50. The election is allowed under I.R.C. § 338 (1985), but only if certain conditions are met, including the requirement that the acquiring corporation has purchased 80% of the target stock within a 12-month period. *Id.* § 338(d)(3). Whether this requirement is met will depend on the form of the transaction. For discussions of issues that may arise on the question of the availability of the election under § 338, see Bowen, *supra* note 41, at 938-41; Levin, *supra* note 23, at 131-39.

51. If a corporation sells its assets and then liquidates, its tax consequences will be governed by I.R.C. §§ 336, 337 (1985). Under those provisions, the corporation generally will not recognize the gain or loss on the sale or distribution of assets. The depreciation recapture provisions are only one of several significant exceptions to this rule of nonrecognition. Other exceptions include investment tax credit recapture and ordinary income recognized on certain LIFO inventory reserves. *See* HOSTILE TAKEOVERS, *supra* note 1, at 30-33. The same tax consequences will follow if the acquiring

tion deductions will be greater than the immediate tax cost of the recapture will depend on the nature and value of the assets acquired.[52]

## III. The Theoretical Model of Taxation of Corporations and Their Shareholders

The major tax consequences of a leveraged buyout involve the public shareholders, who are taxed on gain realized from their stock dispositions at the capital gains rate,[53] and the target corporation, which will be paying deductible interest after the buyout instead of paying nondeductible dividends or accumulating amounts for future distribution to shareholders.[54] A comparison of these tax consequences to the basic structural elements of the taxation of corporations and their shareholders exposes a serious theoretical inconsistency.

The taxation of corporations and their shareholders is governed by several basic principles. A fundamental concept is that a corporation is a separate taxpaying entity.[55] A corporation is thus subject to tax on its income, which may be defined as amounts realized by the entity over and above the after-tax capital contributions of its shareholders.[56] In line with this definition of entity gain, a

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corporation purchases stock of the target firm and makes an election under § 338 so that the asset bases reflect the stock purchase price. The target corporation will be deemed to have sold its assets and then liquidated. It will be required to file a final tax return and report gain or loss that is not protected by § 337, such as depreciation recapture. *See id.* at 33-35. The Tax Reform Act of 1986 made significant changes in these provisions. *See infra* note 115.

52. Despite the offsetting cost of recapture of previous depreciation deductions, the value of the step-up in basis may be significant. The benefit results because, although the recapture provisions include in income an amount equal to previous depreciation deductions, the basis step-up (on which future depreciation is based) will reflect fair market value. Accordingly, any increase in basis over original cost is obtained without tax liability. The benefits are magnified by the ability to depreciate assets at accelerated rates. Some practitioners have attempted to increase this benefit even more, arguing that a premium included in the purchase price for stock or assets could be allocated among the acquired assets, increasing their depreciable or amortizable bases to amounts in excess of their individual fair market values, instead of allocated to the nonamortizable asset, goodwill. *See, e.g.*, Banc One Corp. v. Commissioner, 84 T.C. 476, 502-09 (1985), in which the Tax Court rejected the taxpayer's allocations. The Treasury has recently acted to end this practice in the context of stock acquisitions. Temporary regulations published under § 338 now provide that the stepped-up basis in assets acquired shall not exceed their fair market values on the acquisition date, with any excess residual value allocated to goodwill or going concern value. Treas. Reg. § 1.338(b)-2T (1986).

The so-called "General Utilities" rule, which allows the nonrecognition of gain on a liquidation sale or distribution, has been widely criticized. *See* House Comm. on Ways & Means, Report on H.R. 3838, H.R. Doc. No. 99-426, 99th Cong., 1st Sess. 281-82 (1985). Under the tax bill passed by the House of Representatives, that rule would be changed so that, with limited exceptions, *all* gain or loss on assets sold or distributed would be recognized. H.R. Rep. No. 3838, 99th Cong., 1st Sess., §§ 331, 332 (1985). Under this proposal the cost of the basis step-up in a leveraged buyout would be substantially increased.

The Tax Reform Act of 1986 included these changes to the "General Utilities" rule. *See infra* note 115.

53. The Tax Reform Act of 1986 eliminated the preferential capital gains rate. For an analysis of the effects of this change, see *infra* notes 107-28 and accompanying text.

54. As mentioned previously in the text, the target may also enjoy higher depreciation deductions after the acquisition. The future benefits, however, will be offset by the immediate tax cost of depreciation recapture. *See supra* note 52.

55. *See* Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale L.J. 90, 97 (1977) (discussing the decision by Congress in 1909 to impose a separate corporate tax "apparently without a principled assessment of the wisdom of such a move").

56. *See* Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the*

corporation is not allowed a tax deduction for distributions to its shareholders.[57]

Corporate income by definition represents gain to the shareholders, and a "double tax" results because they, in addition to the corporation, are taxed on this gain.[58] The timing of the shareholders' tax does not, however, depend on accrual or realization of income at the entity level. Although corporate gain will cause appreciation in the shareholders' stock, appreciation alone will not trigger tax consequences to them.[59] They will pay tax on the gain only when it is realized by them, either upon stock sales or corporate distributions.[60] If the shareholders do not transfer stock, their full tax burden, computed at ordinary rates,

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*Congressional Solution to Debt-Equity Swaps*, 63 TEX. L. REV. 89, 107-20 (1984). Support for this definition of corporate income is found in the provisions that determine a corporation's basis in property received from its shareholders. When a corporation receives property from a shareholder, either in exchange for stock or as a capital contribution, the corporation will take a basis in the property that is generally equal to the shareholder's after-tax investment in the property. The corporation will exclude the value of the property from income under I.R.C. § 1032 (1985) and, if the transaction is taxable to the shareholder, the corporation will take a basis in the property equal to the fair market value of the stock. *See* Treas. Reg. 1.1032-1(a) (1985). Assuming that the values of the property and the stock are equal, the corporation's permanent exclusion (measured by its basis in the property) will equal the shareholder's after-tax capital investment. If the transaction is tax-free to the shareholder, so that the shareholder does not recognize inherent gain or loss on the transfer, the corporation will still be entitled to exclude the full value of the property from income on receipt under § 1032. In this case, however, the corporation's permanent exclusion, reflected by its basis in the property, will be derived from the shareholder's capital investment in the property under I.R.C. § 362(a) (1985). The shareholder will take that same amount as his or her basis in the stock under *id.* § 358. As a result of these provisions, income that accrues to the corporate entity over and above the excludable amount of corporate capital will necessarily be gain to its shareholders over and above their aggregate after-tax capital investments.

57. *But see* H.R. Rep. No. 3838, *supra* note 52, § 311 (provision would allow corporations a deduction for 10% of dividends paid out of previously taxed corporate income). Accompanying changes would ensure the imposition of some tax on such amounts when the recipients are tax-exempt or foreign shareholders. *See id.*

58. The double tax system has been criticized, and proposals to integrate the individual and corporate tax structures have gained strong support. *See, e.g.*, McLure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532, 549-74 (1975) (discussing alternative integration proposals). Many of the structural inconsistencies under current law, including the one discussed in this Article in the context of leveraged buyouts, could be eliminated by adopting some form of integration. *See* Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719 (1981).

59. *See* Eisner v. Macomber, 252 U.S. 189, 219 (1920).

60. These two modes of realization have quite different effects on how the gain is taxed to the individual shareholder. On a sale of stock, a shareholder will be taxed only to the extent the amount realized exceeds his or her basis in the stock and then typically at the preferential capital gains rate. On a corporate distribution, a shareholder will be taxed on the full amount received at ordinary rates if the corporation has sufficient earnings and profits. *See* I.R.C. §§ 301(c)(1), 316 (1985). A distribution out of corporate earnings and profits will be taxed at ordinary rates even to a new shareholder who has paid a price for stock that includes the distributed amount, so that the distribution does not represent a gain on the shareholder's investment. *See* United States v. Phellis, 257 U.S. 156 (1921). The result of this rule appears to be double taxation to the shareholder group on corporate profits, because the seller has already paid tax on that amount as capital gain. The gain, however, is balanced by the capital loss that is inherent in the stock held by the new shareholder to the extent that corporate profits included in the shareholder's cost were distributed to him or her as dividends and taxed as ordinary income. Accordingly, the net result to the shareholder group is only one tax on the corporate profits at the shareholder level, with that tax computed at ordinary rates to the extent of the dividend distributions. Although most withdrawals of corporate profits are taxed at ordinary rates, exceptions are made for certain transactions that are treated as dispositions of stock, including certain redemptions under I.R.C. § 302(a) (1985) and liquidation distributions under *id.* § 331(a). *See* Clark, *supra* note 55, at 100-17 (detailed analysis of the history and consequences of these provisions); *see also infra* notes 107-28 and accompanying text (discussing the changes brought about by the 1986 Tax Reform Act and their impact on this Article's analysis).

will be deferred as long as the funds are retained by the entity.[61]

Because of the potential deferral of shareholder tax, it initially may appear that these rules create a bias away from corporate distributions of earnings and toward corporate retention. However, the tax provisions actually operate in a more neutral fashion, achieving a rough equivalence between corporate retention and distribution.[62]

When a corporation retains, rather than distributes, its earnings, the deferral of shareholder tax is accompanied by a cost that roughly compensates for the benefit of the deferral. Retained funds generate profits that are subject to corporate tax, a burden that would have been avoided if the funds had been distributed and invested by the shareholders outside of the corporate entity. The system contemplates that the cost of the corporate tax on the yield will continue as long as the shareholders enjoy the benefit of the deferral, that is, until the funds are distributed and the shareholder tax imposed. Assuming no change in the shareholder tax rate, so that corporate retentions and accumulated yield are eventually taxed to shareholders at the same rate that would have applied to an earlier distribution, any benefit from the deferral will have been reduced significantly.

The benefits and costs of corporate retention compensate for each other exactly if all shareholder and corporate tax rates are equivalent, and if shareholders and the corporation can invest in assets earning equivalent rates of return.[63] The resulting equivalence between corporate retention and distribution

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61. An exception occurs in the case of certain stock dividends that generate a shareholder tax at ordinary rates on undistributed corporate profits. *See* I.R.C. § 305(b) (1985). For criticisms of this departure from the distinction between retained and distributed corporate earnings, see Cohen, *Taxing Stock Dividends and Economic Theory*, 1974 WIS. L. REV. 142 (1975); Stone, *Back to Fundamentals: Another Version of the Stock Dividend Saga*, 79 COLUM. L. REV. 898 (1979). Other exceptions occur in the case of corporate distributions that are taxed to shareholders as sales, such as certain redemptions under I.R.C. § 302 (1985) and liquidations under § 331. In these cases the distributed funds will escape tax at ordinary rates altogether. The recipient shareholder will be taxed at capital gains rate to the extent the amount realized exceeds the stock basis; the shareholder's basis (used as an offset to determine the amount of gain) will reflect amounts previously taxed to other shareholders on sales, typically at the capital gains rate. The incentive that results from extending the preferential treatment to certain forms of distribution is the subject of this Article, which focuses on the incentive in the context of leveraged buyouts. Under the reform possibilities discussed *infra* text accompanying notes 90-106, this preferential treatment would be eliminated. *See also infra* notes 107-28 and accompanying text (discussing the changes in capital gains treatment under the 1986 Tax Reform Act and their impact on this Article's analysis).

62. The compensatory relationship between the individual and corporate taxes was described in the early 1970s by an economist who sought to explain

> empirical studies of the effects of taxation on corporate finance [which] suggest that taxation has not had a very significant effect on corporate financial structure, let alone the dramatic changes that one might have anticipated given the very large increases in the corporate tax rates in the last fifty years.

Stiglitz, *supra* note 25, at 1. This relationship is also extensively described and analyzed in AMER. LAW INST., REPORTER'S STUDY, *supra* note 25.

63. This conclusion and the example that follows it in the text ignore the shareholder capital gains tax that may be imposed on retained corporate profits when a shareholder sells stock. In the example in the text, the shareholders are presumed to be enjoying a complete deferral of tax on earnings retained by the corporation, a benefit fully paid for by the imposition of corporate tax on the yield. In reality, that deferral may not be complete, because retained earnings will be taxed on sales to the extent reflected in stock appreciation. Considering aggregate shareholder wealth, the capital gains tax imposed on stock sales would appear to provide an incentive against corporate

may be illustrated by a numerical example. Assume that a shareholder group forms a new corporation, capitalizing it with 10,000 dollars. For purposes of this example, assume also that all shareholders and the corporation are subject to tax at the same fifty percent rate and that all shareholders and the corporation could invest funds at a pre-tax rate of return of ten percent.[64]

Each year, the corporation will earn 1000 dollars and, after paying tax, will have 500 dollars to distribute to its shareholders or to retain. Distribution will trigger immediate shareholder tax, but the future yield from the after-tax funds will be received directly by the shareholders and so will escape corporate tax. Retention will defer tax at the shareholder level, but the future yield from the retained funds will be subject to corporate tax in addition to the eventual shareholder tax imposed on distribution. Under the assumed conditions, the costs of either choice will exactly offset the benefits, and the shareholder group will be indifferent concerning the corporation's decision to retain or distribute its annual earnings.

If the corporation distributes its 500 dollars in earnings, the shareholder group, paying tax at the fifty percent rate, will have 250 dollars to reinvest at their individual rates of return. If the corporation made annual 500 dollar distributions for a ten-year period, with continual shareholder reinvestment at a ten percent rate of return, the shareholder group would have accumulated after-tax gain of 3144 dollars at the end of ten years.

The corporation could instead retain and reinvest its annual earnings of 500 dollars for the same ten-year period, with all of its yield subject to corporate tax. In this case, assuming continual corporate reinvestment, the corporation will have accumulated 6288 dollars, exactly twice as much as the shareholders were

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retention: the corporate tax will continue to be imposed on the yield from the retained funds despite the new after-tax investment of the purchaser. The purchaser may recoup part of the investment as a capital loss if he or she is subsequently taxed at ordinary rates on dividend distributions that were included as part of the purchase price for the stock. The net effect is one tax at ordinary rates to the shareholder group, with the capital loss of the dividend recipient balancing the prior capital gain of the seller. The shareholder group, however, suffers a detriment from the imposition of the capital gains tax prior to distribution of the funds. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 439; Warren, *supra* note 58, at 726-29.

The adverse consequences of the imposition of capital gains tax on a sale are considerably lessened because of the possibility that future distributions will be treated to the shareholders as sales. On such a distribution, the shareholder will use his or her entire basis as an offset to the amount realized in computing gain. To the extent that basis reflects gain taxed to other shareholders on sales, the capital gains tax imposed on those sales will become the permanent tax rate imposed on that amount of corporate earnings. If the basis of the recipient shareholder has been stepped-up because of death under I.R.C. § 1014 (1985), a significant amount of corporate earnings can be distributed to shareholders free of any tax burden whatsoever.

The Tax Reform Act of 1986 made significant changes in the tax treatment of capital gains. The Afterword to this Article discusses these changes and their impact on the Article's analysis. *See infra* notes 107-28 and accompanying text.

64. In this example, the investor will earn a 2.5% after-tax return on the investment in corporate stock, while an investment in an asset other than corporate stock would have yielded the same investor a return of 5%. This difference, which arises solely from the imposition of the double tax, may well cause investors to prefer noncorporate over corporate investments. The resulting shift in capital eventually could have an equilibriating effect on the rate of return, with the yield on corporate and noncorporate investments becoming more nearly equivalent. *See* Warren, *supra* note 58, at 725-26. The example does not consider the situation after such a potential market adjustment.

able to accumulate on their own. The excess, however, is eliminated on distribution, because, at that point, the shareholders will pay a fifty percent tax on the full accumulation. Accordingly, at the end of ten years, the shareholders will have the same amount, 3144 dollars, in after-tax funds as they would have had if the corporation had made periodic distributions. Because of the imposition of corporate tax on yield from the retained funds during the period of retention, the corporate accumulation has been effectively limited so that the deferral benefit disappears on distribution.[65] As long as the same tax rate applies whenever the retained funds are distributed to shareholders, whether annually or at the end of the ten-year period, retention by the corporation will be equivalent to distribution, with shareholder wealth unaffected by the corporation's decision.[66]

Under this model, which achieves equivalence between corporate distribution and retention, corporate tax on yield from retained earnings is required as long as shareholders enjoy the benefit of deferral of the tax that would have been imposed if the funds had been distributed. A single tax on yield at the shareholder level is permitted once the funds have been distributed and the shareholder tax imposed. The tax consequences that have followed from leveraged buyouts must be compared to this model.

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65. *See* Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1123-1126 (1974) (explaining the principle that the value of a tax deferral is equal to a tax exemption on the income that the taxpayer would have earned if he or she had not enjoyed the deferral, but had instead invested the after-tax amount). In the example in the text, the benefit of that deferral is exactly offset by annual imposition of the corporate tax, because that rate is assumed to equal the shareholder's individual rate.

66. Differences in shareholder and corporate tax rates will, of course, create biases toward corporate retention or distribution. If the shareholder rate is lower, a bias is created toward distribution, while a lower corporate rate creates a bias toward retention. If, for example, the corporate tax on the yield is imposed at 30%, while the shareholder would have paid 50% tax on the distribution, the corporate tax does not fully compensate for the value of the deferral. Using the example discussed in the text with these changes in rates, the corporation would have accumulated $9671 by reinvesting its earnings from the initial $10,000 contribution for 10 years. The shareholders would have had $4835 after paying tax on the final distribution, rather than the $3144 they would have accumulated individually if annual distributions had been made.

The difference in rates between corporations and shareholders has been considered as a significant influence on corporate financing decisions in the context of closely held firms. Not only are those corporations often subject to the lower, graduated corporate tax rates, but they frequently are controlled by a few shareholders who can determine the firm's distribution policies with their own tax positions firmly in mind. In an attempt to neutralize the impact of tax considerations on such a firm's decision to retain earnings, Congress enacted a penalty tax on "unnecessary accumulations," funds retained for the purpose of avoiding individual tax. *See* I.R.C. §§ 531, 532 (1985). Thus, the benefit of the deferral that may result from the low corporate tax rate is not eliminated, but is limited to retained funds actually needed for legitimate business purposes.

Differences in shareholder and corporate tax rates will exert less influence in the context of a publicly held corporation. With a large, varied, and constantly changing shareholder group, a public corporation is less likely to retain earnings on the basis of the marginal rates of its investors. If retention were motivated by the requisite tax avoidance purpose, the accumulated earnings tax could be applied to a public corporation. *See id.* § 532(c). A more effective limitation on unnecessary accumulations may come from the public shareholders themselves. In contrast to most shareholders of closely held firms, public shareholders appear to value a steady stream of current distributions despite the deferral benefit accompanying corporate retention. *See* Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 90-91 (1980); Cohen, *supra* note 61, at 154.

The Tax Reform Act of 1986 made significant changes in individual and corporate tax rates. The Afterword to this Article discusses these changes and their relevance to the Article's analysis. *See infra* notes 107-28 and accompanying text.

In a leveraged buyout, retained earnings are distributed to shareholders, triggering shareholder tax consequences and freeing the funds from the burden of future corporate tax. The distribution is financed with newly incurred corporate debt. Prior to the transaction, the yield on the retained earnings was subject to corporate tax, in addition to eventual shareholder tax on distribution. After the transaction, the yield on the principal of the debt is tax-deductible to the corporation, subject to a single tax when received by the creditor.[67]

The tax consequences as just described are perfectly consistent with the theoretical model. The benefit of deferral of the shareholder tax on retained earnings is eliminated by imposition of the corporate tax on yield during the period of retention. When the earnings are distributed, so that shareholders are taxed and the deferral ended, the corporate tax is eliminated on subsequent yield earned outside of the corporate entity. The analysis is not affected by the fact that, in the case of a leveraged buyout, the corporation borrows money simultaneously with its distribution of retained earnings to shareholders. Regardless of whether the borrowing is from the former shareholders or from new third-party creditors, the subsequent corporate interest deduction, allowing the yield on the debt principal to escape corporate tax, is consistent with the model. The model requires the compensating cost of corporate tax on the yield only if the funds are enjoying the benefit of deferral at the investor level, a benefit that extends to retained earnings but not to funds contributed in the form of debt.[68]

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67. This result is more obvious when the acquiring corporation purchases assets of the target corporation, with the sale followed by the target's complete liquidation. In this case, the acquiring corporation will continue the target's operations directly after the acquisition. The main difference between the target as it had previously existed and the acquiring corporation after the acquisition will be the substitution of debt for retained earnings and the new deduction for distributed yield. The same effect is achieved when the acquiring corporation purchases the target's stock from individual shareholders and retains the target as a separate subsidiary. Because of the dividends-received deduction of I.R.C. § 243 (1985) and the consolidated return provisions of *id.* §§ 1501-1563, distributions from the target can be used to pay the acquiring corporation's interest obligations, and the tax consequences will be the same as if the two corporations had been combined into one entity.

68. The interest deduction that is allowed on corporate debt results in a rough equivalence between a corporation's choices of financing an investment by retained earnings or by debt. Assume, for example, that a corporation is about to invest in a $40,000 project that will have a 10% before-tax rate of return. Investors in the project also expect a 10% rate of return, whether the investors are new creditors or current shareholders who will invest by foregoing dividends and allowing the corporation to retain its earnings. Both the corporation and the investors are subject to tax at the rate of 50%.

Under these conditions a corporation can borrow $40,000 and, because of the corporate interest deduction, its yield on the project will exactly cover the cost of the capital. The corporation will distribute its entire before-tax yield of $4000 to investors, giving them their required 10% rate of return. The same result is true if the corporation finances the project with $40,000 of retained earnings. The corporation will still earn $4000 but, after corporate tax, will have only $2000 to distribute to its shareholders. In this case, however, the $2000 is sufficient to meet the 10% required yield of the investors. Although the corporation used $40,000 of retained earnings, the cost of the financing to the shareholders is $20,000—the after-tax amount they gave up by foregoing a dividend distribution of $40,000. Accordingly, a distribution of $2000 yields them their required 10% pre-tax rate of return. Under these conditions, the corporation can earn the required return for its investors by using either debt or retained earnings, making its choice of financing irrelevant. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 351-52; Andrews, *Tax Neutrality Between Equity Capital and Debt*, 30 WAYNE L. REV. 1057, 1060-62 (1984).

The current system does discriminate against a corporation's choice to obtain financing by issuing new equity. The yield on new equity will be subject to corporate tax, just as retained earnings, although the new equity will not be enjoying the same deferral of individual tax. *See* AMER. LAW

The major inconsistency between leveraged buyouts and the theoretical model arises from the shareholder tax rate that applies to the corporate distribution of the retained earnings.[69] The model assumes that the eventual distribution of corporate retained earnings and accumulated yield will be taxed to the shareholders at the same rate that would have applied to a current distribution of the retained amount. As long as this equivalence is maintained, the corporate tax imposed on the yield prior to distribution will compensate for the deferral benefit, with escape from the corporate tax justified only when that deferral benefit ends and the full shareholder tax is imposed.

In a leveraged buyout, however, the shareholder tax imposed on the distribution of the funds is at a preferential rate.[70] The corporate tax on future yield is called off, despite the fact the shareholders have not paid the normal price for their withdrawal. In this case, the value of the future benefit obtained from the distribution, reducing the tax on the yield to a single level, will outweigh the shareholder cost of immediate tax. By lowering the cost of withdrawal, the preferential rate thus creates a strong incentive toward corporate distribution of retained earnings for reinvestment in assets yielding a rate of return that will not be taxed at the corporate level.

This analysis of leveraged buyouts may be illustrated by returning to the initial example. If a corporation has accumulated its earnings, it presumably will distribute those funds if it can maximize the return to its investors by doing so. The same motivation exists for a corporation to borrow money in order to accelerate a distribution to shareholders. Incurring debt involves no extra tax cost to the corporation, because the yield earned on the debt is payable as interest and tax-deductible. Accordingly, the decision to distribute depends in either case on whether the shareholder benefit from the distribution outweighs its cost. The example demonstrates that the corporation will always benefit its investors by distributing retained earnings and incurring new debt, as long as the shareholder withdrawal can be accomplished at the capital gains rate.[71]

In the previous example, assuming equivalent fifty percent tax rates for both the corporation and its shareholders and equivalent ten percent rates of return, a corporation with an initial capital contribution of 10,000 dollars was able to accumulate 6288 dollars in ten years. Under the assumed conditions, the corporation would not, at that point, have a tax incentive to distribute those funds whether the shareholders were to invest the net amount available to them in corporate debt or in any other asset free of the burden of corporate tax. On

INST., REPORTER'S STUDY, *supra* note 25, at 356-66 (summarizing a proposal to eliminate this bias by allowing a corporate deduction for dividends paid up to a specified percentage of newly contributed capital).

69. A theoretical inconsistency also exists to the extent that bases in the target's assets are stepped-up without requiring an accompanying inclusion in income. Because of the depreciation recapture rules, this benefit is limited. *See supra* note 52. It has been eliminated completely by the Tax Reform Act of 1986. *See infra* note 115.

70. Capital gains are no longer subject to preferential treatment. For a discussion of the impact of this change on this Article's analysis, see *infra* notes 107-28.

71. *See* Stiglitz, *supra* note 25, at 32 (explaining that the determination of a firm's optimal ratio of debt to retained earnings depends on the differential between corporate and individual tax rates).

distribution and payment of their fifty percent tax, the shareholders would have 3144 dollars to invest. If they continually reinvested their yield from that amount, they would accumulate after-tax funds of 5121 dollars in another ten years. They would be in precisely the same position if the corporation had retained the 6288 dollars, continuing the shareholder deferral, but paying corporate tax on the yield. At the end of ten years, the corporation would have accumulated 10,242 dollars which, after imposition of the fifty percent tax to the shareholders upon distribution, would give them the same net amount of 5121 dollars.

This conclusion changes dramatically if, at the end of the first 10 years, the shareholders can withdraw the 6288 dollars in accumulated earnings at the capital gains rate. Assuming a capital gains rate of twenty percent,[72] the shareholders would then have 5030 dollars in after-tax funds, which they could invest in corporate debt or in any other asset with yield taxed only at the individual level. In this case, the immediate shareholder tax cost clearly would be worth the future benefit to be gained from removing the corporate tax on subsequent yield, regardless of any corporate borrowing that might be necessary to finance the distribution. Assuming that the shareholders reinvested the full amount in assets yielding ten percent interest, the shareholders would have accumulated 8193 dollars after another 10 years, a significant increase over the 5121 dollars they would have accumulated by extending their deferral through corporate retention for that period.[73]

As the example shows, the distribution of retained earnings and the incurrence of equivalent amounts of debt is of no benefit to corporate investors as long as the corporate interest deduction is obtained only at the cost of a shareholder withdrawal that is taxed at ordinary shareholder rates. The benefit of the capital restructuring arises from the ability to withdraw funds at the lower, capital gains rate. In that case, the investor benefit from escaping future corporate tax will outweigh the accompanying cost, creating a strong incentive toward withdrawal

72. Under I.R.C. § 1202 (1985), an individual taxpayer is allowed a deduction for 60% of net capital gain. Because 40% of net capital gain is thus subject to tax, a 50% tax rate results in a tax on capital gains of 20%.

As noted previously, the Tax Reform Act of 1986 made significant changes in the tax treatment of capital gains. The Afterword to this Article discusses these changes and their impact on the Article's analysis. *See infra* notes 107-28 and accompanying text.

73. The bias that is created by the capital gains rate toward corporate financing by debt instead of by retained earnings can be illustrated in a slightly different way by returning to the illustration discussed *supra* note 68. In that example, assuming equivalent 50% tax rates, the corporation could finance its investment with either debt or retained earnings and earn the same 10% yield for its investors in either case. If, however, the shareholders can withdraw the retained earnings at a capital gains rate, the corporation will always prefer debt financing. By investing in an asset yielding 10%, the corporation could give its investors a 10% rate of return by financing the investment with debt. The corporation could earn only a 6% return for investors by financing the investment with retained earnings that could otherwise be withdrawn by shareholders at the capital gains rate. The shareholder cost of the investment would be $32,000 (assuming a 20% tax on capital gains instead of the 50% tax on ordinary income). After the corporation paid the tax on its earnings, it would distribute $2000, giving shareholders a yield of 6%. Under these circumstances, the corporation will benefit its shareholders by distributing the $40,000 retained earnings and financing its investment by borrowing. *See also infra* notes 107-28 (discussing the changes made by the Tax Reform Act of 1986 and their relevance to this Article's analysis).

of funds even if, as in a leveraged buyout, debt must be simultaneously incurred to finance the withdrawal.

## IV. Possible Solutions

The main goal of this Article has been to illustrate that the currently accepted tax consequences of leveraged buyouts depart from the theoretical model and thus provide a tax incentive for these transactions that is independent of their economic or financial motivations. The source of the inconsistency arises from the imposition of the capital gains tax on the shareholder withdrawals of corporate accumulations, with the preferential rate providing a strong incentive toward distribution.

This analysis conflicts with the suggestion that the primary incentive for leveraged buyouts, and thus the most appropriate focus for reform, is the corporate interest deduction available to the target firm after the transaction. New limitations on the deductibility of interest have been proposed,[74] and bills have been introduced in Congress that would, among other things, disallow interest deductions on debt incurred in specifically defined "hostile" takeovers.[75] These proposals, however, raise serious questions of tax policy.

Disallowing or limiting the interest deduction on debt issued only in certain types of acquisitions would seem to be incompatible with the structure of the tax code. The statute concedes a difference in tax consequences between fixed payments to outside creditors, which are deductible, and distributions to shareholders, which are not. The model achieves tax neutrality while accepting that distinction. Clearly, the distinction requires that a line be drawn between debt and equity. Relevant factors have been identified to protect substance over form, preventing shareholders from treating as a loan a contribution that in substance has all of the features traditionally associated with equity.[76]

The traditional standards, however, provide little or no support for recharacterizing as equity the debt that is typically incurred in a leveraged buyout. That debt typically is held by outside creditors rather than shareholders and it often lacks any of the characteristics associated with stock.[77] Disallowance of the interest deduction on this type of debt would not be based on an argument that the substance of a contribution should control the tax conse-

74. *See, e.g.*, Canellos, *supra* note 21, at 115-16 (suggesting a new provision to deny interest deductions on debt incurred in connection with the acquisition of a controlling interest in a corporation if the debt-equity ratio exceeds prevailing industry norms).

75. *See supra* note 21.

76. *See* Levin, *supra* note 23, at 176.

77. *See* Bowen, *supra* note 41, at 935-36. The final regulations issued under I.R.C. § 385 (1985), which were subsequently withdrawn by the Treasury, would not have treated straight debt (debt without equity features) as stock unless the debt was held proportionately with the issuer's stock. *See* 26 C.F.R. § 1.385-2(B)(1) (1983). Even if the debt had equity features, it would not be treated as stock unless the value of the equity features exceeded the value of the debt features. *See id.* § 1.385-5(a). It has been argued, however, that "junk bonds," high-yield securities which are sometimes used to finance hostile buyouts, have equity characteristics because of the high risks associated with them. *See, e.g.*, *Senate Hearings*, *supra* note 10, at 313-21 (statement of James S. Eustice, Professor, New York University Law School).

quences regardless of its form. Instead, the disallowance, which would appear inconsistent with the accepted distinction between debt and equity, would have to be justified on some ground other than tax neutrality.

Increasing the cost of the shareholder withdrawal would eliminate tax incentives for leveraged buyouts without sacrificing tax neutrality. This reform would provide consistency in the tax consequences of distributions to shareholders, bringing them into line with the theoretical model. Such a reform would seem far more appropriate than a proposal to revise the accepted tax treatment of payments to creditors in order to regulate specific transactions, a course of action that could have unintended and undesirable consequences.

The reform suggested by this analysis would affect other transactions in addition to leveraged buyouts. The inconsistency identified in the leveraged buyout context is clearly not unique to that transaction, but exists whenever shareholders are taxed on withdrawals of corporate accumulations at preferential rates. Certain liquidating distributions and distributions in redemptions that effect a meaningful reduction in ownership, including virtually any redemption from a minority shareholder, are all taxed to shareholders as dispositions of stock[78] and thus are inconsistent with the theoretical model described in this Article. The tax provisions could be said, in each case, to provide a strong incentive for shareholder withdrawal over corporate retention.

The consequences of these tax incentives have been recognized more fully in the context of closely held corporations, when the shareholders withdrawing the funds are typically also in control of the corporate entity. Their ability to structure a distribution primarily for their own tax advantage has been viewed as a significant source of abuse.[79] In some cases, the relevant statutory provisions have been amended to inhibit such abuse. In the case of redemptions, for example, a controlling shareholder must relinquish effective control of the entity before withdrawal of corporate accumulations will be taxed at the preferential

78. If the liquidation distribution is in complete liquidation and goes to a shareholder other than an 80% corporate shareholder, it will be treated as an amount received in exchange for stock under I.R.C. § 331 (1985). A distribution in partial liquidation (as defined by *id.* § 302(e)) will qualify as a stock disposition only if made to a noncorporate shareholder. *See id.* § 302(b)(4). Otherwise, a redemption will qualify as a disposition only if it is not essentially equivalent to a dividend, substantially disproportionate, or results in a complete termination of the shareholder's interest. *See id.* § 302(b). The Internal Revenue Service has interpreted § 302(b) broadly in the context of minority shareholders who have no semblance of control either before or after the redemption. *See, e.g.*, Rev. Rul. 76-385, 1976-2 C.B. 92 (finding that reduction in interest from .0001118% to .0001081% is "meaningful" for purposes of § 302(b)(1)). As a result, shareholders who redeem stock from publicly held corporations appear virtually assured of sale treatment unless their proportionate interest remains exactly the same after the redemption as it was before.

79. *See* H.R. REP. No. 1337, 83rd Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 4025, 4064-66 (The report suggested a statutory distinction in the consequences of reorganizations depending on whether the corporate taxpayer was publicly traded or privately held. The distinction was said to be justified because privately held firms are more likely to act in accordance with specific tax avoidance plans of their shareholders.); *see also* Cohen, Surrey, Tarleau, & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM. L. REV. 1, 43-45, 53 n.100 (1952) [hereinafter Cohen, Surrey] (discussing the possibility of a distinction for tax purposes between publicly traded and privately held corporations in the context of corporate distributions and stating that "most of the complexity arises because of the problems presented by the closely-held family corporation, where it is nearly always possible, and very often likely, that tax considerations will take the helm in certain transactions").

rate.[80]

The preferential treatment that remains for other distributions from closely held corporations, primarily distributions in liquidation or in redemption of stock held by minority shareholders, presents policy issues that are different from those raised by distributions from publicly held firms. Continuing preferential treatment may be justified in the context of closely held corporations by a congressional policy of bearing more lightly on small businesses.[81] Other policy concerns that are unique to that context can also be suggested. If a complete liquidation involves a termination of the business in corporate form, a transaction that is virtually limited to closely held corporations, it should perhaps be facilitated by the tax code, especially when unsuccessful operations are involved.[82] Redemptions of stock by closely held corporations may also merit special treatment. Because the stock is not publicly traded, sales will be difficult to arrange and infrequent. The corporation may be the only potential purchaser for a shareholder wishing to dispose of stock in a closely held corporation. Redemptions that effect changes of ownership in this context should perhaps be facilitated, a goal that would justify the tax incentive offered by the redemption provisions.[83]

These suggested policy considerations clearly deserve further analysis and discussion. They are not, however, relevant to determining the proper treatment of distributions by publicly held corporations. Less attention has been focused on the incentive effect of the tax provisions in this context. The issue may initially seem of less consequence, because the owners of the entity rarely are in a position to structure the distribution for their individual tax benefit. Management, however, presumably acts on behalf of the shareholders[84] and will seek to maximize the net value of any equity distribution. Accordingly, despite the sep-

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80. To qualify under the "substantially disproportionate" test of I.R.C. § 302(b)(3) (1985), the redemption must reduce the shareholder's voting control to less than 50%, in addition to accomplishing the specified percentage point reduction in ownership. In interpreting the "not essentially equivalent to a dividend" test of *id.* § 302(b)(1), the courts and the Service have also focused on the loss of voting power, requiring a majority shareholder to relinquish effective control over corporate policies and decisionmaking before a stock redemption will qualify as a sale. *See, e.g.*, Fehrs Fin. Co. v. Commissioner, 58 T.C. 174 (1972), *aff'd*, 487 F.2d 184 (8th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974); Rev. Rul. 78-401, 1978-2 C.B. 127; Rev. Rul. 75-502, 1975-2 C.B. 111; *see also* Postlewaite & Finneran, *Section 302(b)(1): The Expanding Minnow*, 64 VA. L. REV. 561, 564-69 (1978) (reviewing the legislative history of § 302).

Another statutory provision enacted to prevent abuse in the context of closely held corporations is I.R.C. § 341 (1985), dealing with "collapsible corporations." Designed to prevent the conversion of ordinary income into capital gain at the shareholder level by means of a corporate liquidation, the section treats shareholder gain on the liquidation or sale of a "collapsible corporation" as ordinary income rather than as capital gain. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 12.01-12.09 (4th ed. 1979).

81. See Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739, 750 (1969).

82. *See* H.R. REP. NO. 2475, 74th Cong., 2d Sess. 10 (1936), *reprinted in* 1939-1 C.B., pt. 2, at 667, 674; Andrews, *"Out of Its Earnings and Profits": Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403, 1424 (1956).

83. *See* Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions*, 33 TAX LAW. 743, 773-74 (1980); Chirelstein, *supra* note 81, at 749-50; Cohen, *supra* note 61, at 149.

84. *See* Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 712-13 (1981).

aration of ownership and control, shareholder consequences will be of prime importance, and a tax bias toward certain forms of distribution will significantly affect corporate financial decisions.

It is difficult to defend on policy grounds the continuation of preferential tax treatment for any distribution that is made to shareholders of a publicly held corporation that continues its business in corporate form. Distributions that are currently treated favorably, and so encouraged by the tax provisions, include equity distributions in leveraged buyouts, whether the transaction is structured as a purchase of target stock directly from the public shareholders or as a purchase of the target's assets followed by a liquidation of the target firm. In either case the funds are withdrawn from the corporate entity, eliminating corporate tax on future yield, at the cost of only a capital gains tax to shareholders.[85]

A similar tax incentive extends to shareholder distributions by a single corporation that are structured as stock repurchases rather than as dividends. Under current law repurchases are treated as sales to minority shareholders who relinquish stock as long as the effect is a nominal reduction in the individual shareholder's percentage interest,[86] creating a strong bias toward distributing corporate accumulations in this fashion. Because of the beneficial shareholder tax consequences, stock repurchases have become more popular in recent years as an alternative to dividends for publicly held corporations with excess funds available for distribution.[87] The tax incentives for repurchases have been subject to increasing criticism. The revenue loss is difficult to defend, especially because the non-tax differences between stock repurchases and dividends by a publicly held corporation are often insignificant to either the corporation or its shareholders.[88]

A proposal to eliminate tax incentives in the leveraged buyout context by increasing the cost of shareholder withdrawals could offer the additional advantage of reforming the widely criticized treatment of stock repurchases by publicly held corporations. Such a broad reform would be more neutral than an amendment to disallow the corporate interest deduction, as it clearly would be designed to do more than simply reduce the growing trend toward highly lever-

85. The transactions are equivalent because of the deduction for dividends received that is available under I.R.C. § 243(a) (1985), to a corporation that receives distributions from a 100%-owned subsidiary. Because of this deduction, the acquiring corporation may purchase the target's stock and retain the target as a subsidiary without the imposition of an additional corporate tax on the target's cash flow. Accordingly, the future corporate tax on the yield from the sales proceeds distributed to the public shareholders is eliminated (at the cost of the capital gains tax) without being replaced by an equivalent future corporate tax on the yield from the acquired assets. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 487-89. The same result, of course, occurs when a corporation acquires assets of the target and the target liquidates, distributing the sales proceeds to its shareholders who are taxed on their gain at the capital gains rate. *But see infra* notes 107-28 and accompanying text (discussing changes in capital gains treatment made by the Tax Reform Act of 1986).

86. *See, e.g.*, Rev. Rul. 76-385, 1976-2 C.B. 92.

87. *See, e.g.*, Loomis, *Beating the Market by Buying Back Stock*, FORTUNE, Apr. 29, 1985, at 42.

88. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 471-73; Chirelstein, *supra* note 81, at 756.

aged acquisitions. Instead, a reform proposal that applied to capital gain distributions—at least by publicly held corporations—would correct a serious theoretical inconsistency that has been tolerated despite the lack of any clear policy justification.[89] Although the immediate impetus of the reform may be leveraged buyouts, it would have a much more significant effect and would represent an important step toward achieving an internally consistent and coherent tax structure.

The mechanics of a proposal to accomplish the desired reform merit future detailed consideration. Several alternative possibilities should be explored: taxing the shareholders who receive the distribution at ordinary rates; allocating the distribution among all the shareholders for tax at ordinary rates; or imposing an excise tax at the corporate level. Each of these proposals could increase the cost of shareholder withdrawals that, under current law, are taxed only at the capital gains rate.

The least desirable or effective of the reform possibilities would appear to be the first, focusing only on those shareholders who dispose of their stock. Under current law these shareholders are the only ones who are taxed on the transaction, reporting as capital gain the excess of their amount realized over their basis in the stock. Under the analysis, it is this preferential treatment that creates the tax incentive to distribute corporate accumulations.

A proposal to tax these shareholders on their gain at ordinary rates would not be sufficient to eliminate the tax incentive. By selling shares to third parties immediately prior to the transaction, shareholders could realize their share of corporate earnings at the capital gains rate without detriment to the purchasers. The purchasers would simply take a basis in the shares equal to their cost, so that they would realize little or no gain on subsequent corporate distributions

89. Although distinguishing between publicly traded and privately held corporations for tax purposes would require a new statutory provision, it is not an unfamiliar idea. Such a distinction was discussed in the reorganization context prior to adoption of the 1954 Code. *See* H.R. REP. NO. 1337, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4025, 4064-66. It previously had been considered by the American Law Institute in the context of corporate distributions. *See* Cohen, Surrey, *supra* note 79. Commentators have also recognized the distinctions between corporations that are publicly traded and those that are privately held. Some have argued that the differences in types of transactions and characteristics of the stock are great enough to justify different tax consequences. *See, e.g.*, Chirelstein, *supra* note 81, at 751-52 (suggesting a difference in the tax treatment of redemptions from publicly traded corporations, when the non-pro rata aspect results from independent investment decisions of the shareholders, and redemptions from closely held firms, when the non-pro rata aspect is the result of planning and negotiation); Davies, *Public Stock, Private Stock: A Model For the Corporate Income Tax*, 124 U. PA. L. REV. 299 (1975) (suggesting that stock is a different type of property when its value is derived from a public stock market, justifying a complete distinction between the tax treatment of shareholders owning that stock and those owning stock of a private corporation); Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967) (suggesting that shareholders of publicly traded corporations, who have no semblance of control as do the shareholders in closely held corporations, should be taxed annually on stock appreciation); Stone, *supra* note 61, at 938 n.140 (suggesting the utility of the distinction in determining the tax consequences of stock dividends); *see also* Beghe, *supra* note 83, at 773 (describing the differences in patterns and effective rates of taxation for public and private corporations). The AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, considered limiting its excise tax proposal, discussed *infra* text accompanying notes 100-06, to publicly held corporations. Although the Study favored applying the reform to all corporations, it left the question open as one deserving further study. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 521-22.

that were treated as sales. Accordingly, the ordinary tax rate would be effectively avoided and replaced by the capital gains rate previously imposed as a result of the sale.[90]

In order to correct this result, the tax consequences to the recipient shareholder would have to depend on the amount of the distribution rather than the amount of gain. Stock basis, which reflects amounts taxed to other shareholders as capital gains on sales, could not be used as an offset. Instead, the shareholder would be taxed on the entire distribution at ordinary rates, at least to the extent the distribution would have been taxed as a dividend.[91] Individual shareholders could still take advantage of the more generous treatment of sales by selling their stock prior to the disposition, realizing their share of corporate earnings at capital gains rate. A sale would not, however, provide a permanent escape from ordinary tax for the gain realized by the seller. Under this proposal, the new purchaser would, in effect, step into the shoes of the selling shareholder. Accordingly, the purchaser would pay tax at ordinary rates on the distribution even if, to the purchaser, the amount represented a return of investment rather than gain.[92] A new shareholder forced to report a return of investment as ordinary income would then also have a capital loss on the accompanying disposition of stock. The new shareholder's capital loss, which would equal the amount of the distribution included in his or her cost, would offset the selling shareholder's prior capital gain, and the net result to the shareholder group would be one tax on corporate earnings at ordinary rates.

The adverse tax consequences to the purchaser would be reduced if the purchase price were discounted by the market to take into account the subsequent ordinary tax burden. Such an adjustment, however, would be possible only if the corporate distribution were anticipated and, even then, its accuracy would be doubtful. In any case, shareholders could substantially reduce any subsequent tax cost by selling shares to low-bracket or tax-exempt purchasers,

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90. If, for example, a shareholder has a basis of $10 in his or her stock, which has a value of $100, the shareholder could sell the stock to a third party and be taxed at the capital gains rate on $90. The new purchaser would take a basis of $100 in the stock and would have no tax consequences on a corporate distribution of $100 that was treated as a sale.

This analysis assumes that gain from stock sales to third parties will continue to be taxed at the capital gains rate. If that result were changed, so that gain from stock sales to third parties were taxed as ordinary income, the problem discussed in the text would be eliminated. Such a change, however, would be inconsistent with the theoretical model discussed *supra* text accompanying notes 62-66. Under that model the corporate tax imposed on the yield from retained earnings compensates for the privilege of shareholder deferral. If retained earnings could be taxed to shareholders on sales at ordinary rates, the tax burden imposed on corporate accumulations would be too great. Financing with retained earnings (at least to the extent taxed to shareholders on sales) would be as disadvantageous as financing with new equity under current law. In both cases, the funds would generate yield subject to corporate tax even though the amounts had been fully taxed to the shareholders. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 433; *see also infra* notes 107-28 and accompanying text (discussing the changes in capital gains treatment enacted by the Tax Reform Act of 1986 and their impact on this Article's analysis).

91. A distribution is taxed as a dividend to the extent the corporation has current or accumulated earnings and profits. *See* I.R.C. § 316(a) (1985).

92. This result would be the same as in the case of any dividend distribution, when a shareholder's tax consequences are controlled by the existence of corporate earnings and profits regardless of whether the distribution represents gain to the individual shareholder. *See* United States v. Phellis, 257 U.S. 156 (1921).

who have little concern about a future tax. As a result, the ordinary rates imposed on the withdrawal would not be representative of the rates of the shareholders, and the cost of the withdrawal could be minimized.[93]

An alternative to focusing on only some of the shareholders would be to allocate the tax burden among all of the shareholders, treating each shareholder owning stock on the date of distribution as if he or she had received a proportionate share as a dividend.[94] The basis for this treatment can be seen by examining the effect of a non-pro rata repurchase of stock. The repurchase has two consequences: funds are distributed out of the corporation and the relative percentage interests held by the shareholders change, with some shareholders increasing their interests and others reducing or terminating their interests. The exact same results could have been achieved in two separate steps. First, the full amount withdrawn could have been distributed pro rata to all of the shareholders as a dividend. Second, the shareholders could have adjusted their investment portfolios by purchases and sales among themselves, with those who increase their percentage ownership using their dividend proceeds to purchase the surrendered shares of the others.[95]

The non-pro rata redemption shortcuts these two steps, combining them into one. A strong argument can be made that the tax consequences of the transaction should still follow the dividend-sale route, at least in the context of publicly held corporations when the non-pro rata factor results from independent investment decisions of individual shareholders.[96] This proposal, which would allocate the distribution among all shareholders for tax at ordinary rates, recognizes that the remaining shareholders have increased their percentage ownership in the transaction only by relinquishing their share of the distributed cash. The redeeming shareholders have received more than their share of the distributed cash in exchange for their reduction in interest.[97]

The allocation proposal was originally suggested in the context of stock repurchases by publicly held corporations. However, it could be extended to cover the equity distributions to shareholders in leveraged buyouts, whether the transaction was structured as a purchase of stock or assets. In these cases, just as in a stock repurchase, funds are withdrawn from the corporate entity and

93. An alternative method of allocating the distribution among only some of the shareholders would be to allocate it among the continuing shareholders, rather than among only those who receive a portion of the distribution. *See* S. 2689, 97th Cong., 2d Sess., 128 CONG. REC. S7592 (1982) (introduced by Sen. Danforth), which would treat "all purchases of stock of a publicly traded corporation by that publicly traded corporation or its affiliate during a calendar quarter . . . as a distribution of property to the shareholders of the publicly traded corporation on the first day of the *subsequent* calendar quarter . . . ." (emphasis added).

94. *See* Chirelstein, *supra* note 81 (suggesting this analysis in the context of share repurchasing by publicly held corporations).

95. *See* Chirelstein, *supra* note 81, at 749.

96. *See* Chirelstein, *supra* note 81, at 751. Professor Chirelstein contrasts repurchases by publicly held corporations with non-pro rata redemptions by private firms that are "necessarily the product of negotiation and agreement among the shareholders." *Id.* at 750. According to Professor Chirelstein, such negotiated redemptions are the type to which the preferential treatment of the redemption provisions was intended to apply. *Id.* at 751.

97. *See* Chirelstein, *supra* note 81, at 749.

freed from future corporate tax, without being replaced by assets newly subject to the same tax burden. Any such distribution could be allocated to all shareholders for tax at ordinary rates, at least to the extent that such a distribution would have been taxed as a dividend.[98]

Although the mechanics of this proposal may seem unfamiliar at first, they are not especially complex. Each time a corporation made a distribution to shareholders that was taxable to them as a sale, whether in the context of a leveraged buyout or a repurchase of shares, the corporation would be required to allocate the distributed earnings among its outstanding shares. Shareholders on that date would be deemed to have received a dividend distribution in the amount of their allocable share, and they would be so notified. The deemed inclusion would be reflected by an equivalent basis increase in each shareholder's stock. After making this adjustment, the shareholders who surrendered stock in the transaction (as well as shareholders who subsequently sold their stock) would compute gain or loss on the disposition under the normal rules.[99]

This approach has considerable theoretical appeal, because the tax consequences of corporate distributions would be equivalent regardless of the form. Because no basis offset would be allowed, the same amount of the distribution, measured by corporate earnings, would be subject to tax at ordinary rates as if a dividend actually had been distributed. In addition, just as in the case of a dividend, the rates of the entire group would determine the cost of the withdrawal, instead of only the rates of the recipient shareholders. Avoidance of the ordinary tax by an individual shareholder would still be possible by selling stock prior to the corporate distribution. The same avoidance, however, is possible prior to the distribution of any taxable dividend and would not appear to create significant problems in the context of a publicly held corporation.

The major disadvantage of this approach, which is avoided by the next proposal, is that it introduces accounting and reporting procedures that may seem cumbersome. In a large, publicly held corporation allocating the distribution among shareholders as of a given date and notifying them of their share may impose an undue burden. Shareholders may not understand the procedure, which involves a deemed receipt of ordinary income that must be added on to their stock basis before they can compute gain or loss properly. Despite the theoretical appeal, the mechanics of this proposal may be sufficiently complex so

98. *See* I.R.C. § 316(a) (1985) (limiting dividends, for tax purposes, to corporate earnings and profits).

99. These results may be illustrated by an example given by Professor Chirelstein:

> [A]ssume that A and B each own 100 shares of a publicly held corporation which has 1,000,000 shares outstanding and which decides to repurchase 50,000 shares of its own stock at a total cost of $1,000,000. Assume that A, whose basis for his 100 shares is $2,500, elects to retain all of his shares, while B, whose basis is $1,500, elects to sell all of his. Under the view taken here, both A and B receive a taxable dividend of $100 ($1 per share). A's basis is increased to $2,600, B's to $1,600. If the sale price of B's shares is $2,000, B has a capital gain of $400 ($2,000, amount realized, less basis of $1,600) in addition to the dividend of $100. Similarly, if A later sells his shares for $2,000, he then has a capital loss of $600 ($2,600, basis, less $2,000, amount realized) in addition to the $100 dividend previously included.

Chirelstein, *supra* note 81, at 752-53.

that its adoption has little chance of success. The obstacles seem especially great given the current public pressure to simplify the tax system.

A final proposal to increase the cost of withdrawals of corporate accumulations would involve the imposition of an excise tax at the corporate level. This proposal, set forth in detail in the 1982 American Law Institute Reporter's Study on Distributions,[100] has the considerable appeal of simplicity. The tax would be set at a flat rate and collected from the corporation. The tax consequences to the shareholders would not be changed. Only those who received a portion of the distribution would be taxed, and they would compute gain or loss on dispositions of stock, regardless of the identity of the purchaser, according to the normal rules.

Just as the other proposals would do, the excise tax would attempt to eliminate the bias toward certain forms of corporate distributions. The tax would be imposed whenever corporate earnings were distributed to shareholders and taxed to them as amounts received in exchange for their stock.[101] These transactions would be fairly easy to define and would include stock redemptions as well as other equity withdrawals, such as corporate liquidating distributions and corporate purchases of stock.[102] The rate would be set so that it would approximate the difference between the capital gains tax actually imposed on the distributions[103] and the ordinary tax that would have been imposed if the amount had

100. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 401-86.

101. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 442. Under the proposal of the Reporter's Study, "nondividend distributions" (generally defined as distributions that are taxed to shareholders as sales) are actually charged first against a "qualified contributed capital" account, with the excise tax imposed only when that account is exhausted. The qualified capital account basically consists of newly contributed equity capital and, as such, is somewhat similar to the concept of a corporation's "capital account" under current laws. By charging distributions first against that account, the Reporter's Study would revise current law, which deems dividend distributions to come first out of corporate earnings and profits and other distributions (such as redemptions) to consist of both earnings and profits and some amount of paid-in capital. Under the proposal of the Reporter's Study, however, the charge to the qualified capital account imposes an implicit cost that does not exist under current law—reductions in that account will decrease future deductions for dividends, because those deductions are allowed only up to a specified percentage of the qualified capital account. *See id.* at 452-53. Under the proposal if a nondividend distribution attracts an excise tax and is also taxed to the recipient at ordinary rates because it is "dividend-equivalent," the taxpayer would be entitled to a credit, on a grossed-up basis, for the corporate excise tax paid. *See id.* at 443.

102. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 456-61. Under the proposal "nondividend distributions" include "every distribution in liquidation or in redemption of shares and every distribution of boot in a reorganization." *Id.* at 443. Any acquisition of a "direct investment" by one corporation in the stock of another is also treated as a nondividend distribution, with a direct investment requiring either ownership of 50% of the common stock *or* 10% ownership with designation of the holding as a direct investment. *See id.* at 490. In contrast to "direct investments" are "portfolio investments." Portfolio investments are not considered nondividend distributions, but the dividends received deduction is to be repealed for amounts received from such shares. These proposals are explained in detail in the study itself. *See id.* at 487-513.

103. In fact, the capital gains tax will not actually be imposed on the entire amount of the distribution. The recipient shareholder will pay tax at capital gains rate only to the extent the amount realized exceeds his or her basis in the shares. To the extent the basis exceeds the amount of the initial capital contribution allocable to the shares, it will represent gain that has been previously taxed to the shareholders at capital gains rate as a result of prior sales (or, if the basis has been stepped-up on death under I.R.C. § 1014 (1985), is to be treated as having been so taxed). To the extent of the initial capital contribution, the basis offset will reduce the aggregate amount of the distribution subject to shareholder capital gains tax. Allowing the basis offset on the distribution,

been distributed as a dividend.[104] As a result of the excise tax, the total tax burden levied on distributed corporate accumulations would be more nearly equivalent regardless of the distribution's form. If profits were distributed as dividends, shareholders themselves would pay tax at ordinary rates. If profits were distributed in nondividend transactions that qualified for sale treatment, the shareholders would be entitled to lower rates, but the distribution would also be subject to the corporate excise tax intended to compensate for the difference.[105]

A major problem in enacting the excise tax would be establishing an appropriate rate. Different corporations may attract shareholders with different marginal rates, and some firms may appeal to a greater number of tax-exempt shareholders than others. To retain its simplicity, the excise tax could not depend on these variations in shareholder groups, but would have to be set independently. Perhaps, as suggested by the American Law Institute Reporter's Study, the weighted marginal average tax rate of shareholders could be used as a guide to the normal tax on dividends. The excise tax rate then could be computed by reducing that rate by the weighted average capital gains tax rate that would represent the actual cost to the shareholders of a withdrawal that was treated as a sale. Changes to the excise tax rate would be necessary whenever the individual rate structure is revised.[106]

Although the excise tax approach may seem unfamiliar, it is a proposal that deserves attention. Considerable thought has gone into its design, and the Reporter's Study contains suggested statutory language in addition to extensive comments on the problems of implementation, transition rules, and the effects on other statutory provisions. The proposal in the Reporter's Study was designed to eliminate the bias under current law in favor of nondividend distributions that are taxed to shareholders at the capital gains rate. Once proponents of reform in the leveraged buyout context recognize that the incentive for that transaction is the same as the bias with which the Reporter's Study was concerned, they can begin to focus on the details of the excise tax proposal as a

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however, is a matter of deferral rather than exemption, because it decreases the remaining aggregate shareholder basis that can be distributed to the shareholders free of tax. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 447.

As noted previously, the Tax Reform Act of 1986 made significant changes in the taxation of capital gains. The Afterword to this Article discusses these changes and their impact on the Article's analysis. *See infra* notes 107-28 and accompanying text.

104. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 445-51 (discussing the factors to be considered in setting an appropriate excise tax rate).

105. Differences would remain because the shareholder basis offset would be allowed on certain distributions and not on others. These differences would be ones of timing of the shareholder capital gains tax and would not provide complete tax exemption.

106. *See* AMER. LAW INST., REPORTER'S STUDY, *supra* note 25, at 445-51. Although the excise tax rate could be set to reflect the approximate difference between the average shareholder taxes on ordinary income and capital gain, it can never achieve complete equivalence between corporate retention and distribution for all taxpayers, who are subject to different rates of tax. *See* Warren, *supra* note 58, at 761-72 (arguing that integration is a preferable solution to the excise tax, while agreeing that the excise tax as proposed by the REPORTER'S STUDY "is theoretically preferable to current law"). *Id.* at 772.

reform alternative. The simplicity of its accounting and collection procedures offers a great deal to commend it.

## V. Conclusion

As leveraged buyouts have become more popular, the debate about their inherent benefits and risks has intensified. An important issue in this debate is the incentive effect of the tax provisions. Most would agree that a goal of sound tax policy should be to minimize the influence of tax considerations in corporate acquisitions, so that business decisions are motivated by financial and economic factors rather than by tax savings.

In the recent debate over leveraged buyouts, reform proposals have focused on the incentive effect of the corporate interest deduction. This analysis, however, ignores the work that has been done in an attempt to explain and describe the relationship between the corporate and the individual tax structures. From this work, a theoretical model has been derived which, under assumed conditions, achieves neutrality between the distribution and the retention of corporate earnings. The currently accepted tax consequences of leveraged buyouts clearly deviate from this model. The primary structural deviation, however, is not the corporate interest deduction. Instead, the structural inconsistency results from the preferential capital gains tax that is imposed on the shareholder withdrawals. The lower cost results in a strong incentive to engage in leveraged buyouts, incurring debt in order to make distributions to shareholders, regardless of financial or economic justifications.

The incentive in the leveraged buyout context clearly is not unique to that transaction, but exists whenever shareholders are taxed on equity distributions as sales. Proposals to eliminate this bias in other contexts, such as stock repurchases, deserve serious consideration. The American Law Institute Reporter's Study is of prime relevance, because the excise tax it proposes was specifically designed to deal with the tax bias toward certain forms of shareholder distributions. The excise tax would eliminate the bias in a fairly simple fashion, by adding the cost of a corporate excise tax to distributions that are taxed to shareholders at lower, preferential rates. As a result of this additional cost, the aggregate tax imposed on the withdrawal would approximate the cost of an equivalent dividend distribution, taxed to the shareholders at the higher, ordinary rates. The incentive toward distribution would disappear, and the tax provisions would maintain neutrality between corporate distribution and retention.

The most effective reform in the leveraged buyout context would not focus on that transaction alone. Instead, it would recognize that leveraged buyouts provide a particularly striking example of a more general problem—the tax incentive that results from the inconsistent tax treatment accorded to shareholder distributions. The incentive would be eliminated most effectively by a broad reform, such as the excise tax, that would subject all shareholder distributions to an equivalent tax burden. Such a reform, motivated perhaps by leveraged buyouts but with a more far-reaching effect, would be a significant step toward achieving an internally coherent tax structure and a neutral tax policy.

## AFTERWORD

This Article was completed in the spring of 1986, before Congress passed the Tax Reform Act of 1986 in September of that year.[107] That legislation made two changes in the tax laws that are especially significant to the Article's analysis of leveraged buyouts.

First, the Tax Reform Act substantially reduced the top marginal rates for individuals and corporations. Assuming the amendments go into effect as scheduled, the top marginal rate for individuals, beginning in 1988, will be twenty-eight percent,[108] down from fifty percent;[109] the top corporate rate will be thirty-four percent,[110] down from forty-six percent.[111] Although the rate reductions are significant, the primary importance of the new rates for purposes of this Article lies in the changed relationship between the individual and corporate top rates. For the first time corporations will generally be taxed at a rate that is higher than that imposed on their individual shareholders.

The second significant change is that, after the Tax Reform Act becomes effective, capital gains will no longer be subject to preferential treatment.[112] However, the statutory structure that characterizes gain or loss as ordinary or capital was retained and remains relevant in applying the limits on deductions for capital losses.[113] The legislative history further justifies its retention "to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase."[114] Clearly, the capital gains preference may return to the tax law. Under the current Code, however, starting in 1988, capital gains will be taxed the same as ordinary income for the first time since 1921.[115]

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107. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). The Tax Reform Act was passed by Congress on September 27, 1986, and signed by President Reagan on October 22, 1986.

108. I.R.C. § 1 (West 1986). In 1987 the top marginal rate for individuals will be 38.5%. *Id.* § 1(h).

109. I.R.C. § 1 (1985).

110. I.R.C. § 11 (West 1986).

111. I.R.C. § 11 (1985).

112. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 100 Stat. 2085, xxx (1986) (repealing the 60% capital gains deduction for individuals); *id.* § 311, at xx (repealing the top 28% capital gains rate for corporations). Capital gains recognized by individuals will still be subject to a preference in 1987, when the top rate for capital gains will be 28% despite the top rate for ordinary income of 38.5%. *See* I.R.C. § 1(j) (West 1986). Under § 1(j) capital gains will be subject to a preferential rate of 28% in any year in which the highest stated rate for individuals is greater than 28%. *Id.*

113. I.R.C. § 1211 (West 1986). Because of these continued limitations, capital gains will still be preferred over ordinary income by taxpayers who realize capital losses. Such losses are deductible only to the extent of capital gains and, for individuals, an additional $3000.

114. S. REP. No. 99-841, 99th Cong., 2d Sess., pt. 1, at 106 (1986).

115. *See* Clark, *supra* note 55, at 104 n.61 (a brief summary of the preferences for capital gains since 1921). Under I.R.C. § 1(j)(2)(B) (West 1986), a preferential rate of 28% will automatically apply to capital gains if, in any future year, the top stated rate for individuals is higher than that.

In another change that is relevant to the tax consequences of leveraged buyouts, the Tax Reform Act repealed the "General Utilities" rule, discussed *supra* note 52. That rule provided for the nonrecognition of gain (with some exceptions, such as recapture) to a liquidating corporation on a sale or distribution. Nonrecognition was of substantial benefit in leveraged buyouts as well as in other acquisitions because the acquiring corporation could obtain a stepped-up basis in the target's assets without a full corporate level tax imposed on the target. The rule had been widely criticized and, according to the legislative history of the Act, was thought "to create significant distortions in

The Article concludes that the primary tax incentive for leveraged buyouts has been the preference for capital gains at the shareholder level rather than the interest deduction to the corporation. The repeal of the capital gains preference raises the question whether that incentive has now been eliminated. A reconsideration of the model discussed in the Article illustrates that the answer to that question is clearly no. Under the new rates corporations will have a stronger incentive to distribute rather than retain funds. Even without the preferential rate for capital gains, certain forms of distributions to shareholders will continue to be tax-preferred. Accordingly, the tax bias toward these forms of distribution, including leveraged buyouts and stock repurchases, will remain as a significant factor in corporate financial decisions.

The model described in the Article illustrates that, under certain assumptions concerning tax rates and yields, corporate retention of earnings is equivalent to a distribution of those funds to shareholders. Retention defers tax at the shareholder level, but the future yield from the retained earnings is subject to corporate tax in addition to the eventual shareholder tax imposed on distribution. If corporate and individual rates are equal and if all forms of withdrawal are taxed at the same rate to shareholders, the continued corporate tax on the yield exactly compensates for the shareholder deferral of tax. Under these assumptions shareholder wealth would be unaffected by a corporate decision to retain or distribute funds, and corporate financing and distribution decisions would depend on non-tax factors.

The Article focuses on the difference in shareholder tax rates that applied to different forms of distributions, arguing that the lower rate for capital gains encouraged leveraged buyouts. It does not discuss the fact that shareholder and corporate tax rates were not the same: Prior to the Tax Reform Act the top corporate rate was forty-six percent,[116] compared to a top shareholder rate of fifty percent.[117] Theoretically, this difference created a bias toward corporate retention over distribution, because the continued corporate tax on the yield would not fully compensate for the shareholder deferral. The tax penalties on accumulated earnings and personal holding companies were enacted to counter the tax incentive to retain, which was seen as a problem primarily in the context

business behavior" and "may be responsible, at least in part, for the dramatic increase in corporate mergers and acquisitions in recent years." *See* H.R. REP. NO. 426, 99th Cong., 1st Sess., at 281-82 (1985).

I.R.C. § 336 (West 1986) provides that "gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value." *Id.* The rules in I.R.C. § 337 (1985) providing for nonrecognition on liquidating sales also have been repealed. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, xxx. Accordingly, whether a sale of assets actually takes place or whether the sale is deemed to occur in the context of an election under I.R.C. § 338 (West 1986), a basis step-up in the target's assets can be achieved only at the cost of a full corporate level tax on all inherent asset gain. *See also id.* § 1060 (governing the allocation of the purchase price in asset acquisitions and adopting the rule of the § 338 regulations, discussed *supra* note 52).

116. I.R.C. § 11 (1985).

117. *See id.* §§ 1, 11. The incentives caused by differences between corporate and shareholder rates are discussed *supra* note 66.

of closely held firms.[118]

The Tax Reform Act has significantly affected the bias toward corporate retention. Starting in 1988 the top corporate rate will be higher than the top individual rate: thirty-four percent as compared to twenty-eight percent. Retention of corporate funds will no longer be the most beneficial strategy from a tax perspective. Continued corporate tax on yield—the cost of retention—will almost certainly be greater than the cost of the immediate shareholder tax triggered by a distribution. Accordingly, corporations will now have a stronger incentive to distribute funds in order to minimize taxes and maximize the wealth of their shareholders.[119]

Given the increased incentive to distribute, any tax preference for certain forms of distribution will be significant. In the past the major tax preference for certain distributions has been the shareholder capital gains rate. The Tax Reform Act has removed that benefit, but it has not eliminated the tax preference for distributions that are treated as dispositions rather than as dividends. The continuing incentive to distribute funds in leveraged buyouts or in non-pro rata stock repurchases arises from the different rules governing the computation of shareholder gain. These rules allow basis offset for dispositions but not for dividends.

In a non-pro rata redemption or a leveraged buyout, the corporation distributes funds to some but not all of the shareholders. As a result of the distribution, the relative percentage interests of the shareholders change, with some shareholders increasing their interests and others reducing or eliminating their interests. Alternatively, the corporation could have distributed the same amount of funds as a pro rata dividend to all shareholders. The dividend distribution could have been followed by purchases and sales among the shareholders, with those who increase their percentages using their dividend proceeds to purchase the shares of the others.[120] The non-tax consequences of these two alternatives are the same, and yet, even without capital gains, the shareholder

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118. See Clark, *supra* note 55, at 102-04.

119. The Tax Reform Act has strengthened the bias toward distribution over retention in another way. Under the model the continued corporate tax on yield is justified as compensation for the shareholder deferral of tax. As explained *supra* note 63, the benefit from that deferral has always been reduced by the possibility of shareholder stock sales to purchasers other than the corporation. Upon a sale of stock the selling shareholder is taxed on corporate accumulations to the extent reflected in stock appreciation. In the past that tax has been at the preferential capital gains rate. If distributions were all to be taxed at the ordinary tax rates, as the model assumes, the shareholders would still enjoy some benefit from the deferral as long as the funds were retained despite the imposition of some tax on stock sales. Although the corporate tax may have overcompensated for this deferral benefit to the extent of shareholder tax on sales, a rough equivalence was achieved.

With the elimination of the preferential rate for capital gains, corporate earnings that are taxed to shareholders on sales of stock will be taxed at the same rate as corporate earnings that are distributed. Accordingly, to the extent of gain recognized on sales, the shareholders will enjoy no further benefit from deferral. To be consistent with the model, the full tax to the shareholders should justify calling off the corporate tax on the yield. Yet the corporate tax will continue to be imposed until an actual distribution occurs. This result should also strengthen the corporate bias toward distribution over retention.

120. This analysis, which is drawn from Chirelstein, *supra* note 81, is discussed *supra* text accompanying notes 94-97.

tax consequences would encourage a corporation to choose the first form of distribution.

In a leveraged buyout or a non-pro rata redemption, the distribution is treated as a sale.[121] Thus, shareholders are allowed to reduce the amount reported as gain by their basis in their stock sold or redeemed. In contrast, when funds are distributed as a dividend, there is no basis offset and the shareholders are taxed on the full amount distributed to the extent of corporate earnings and profits.[122] In addition to the shareholder tax imposed on the full amount of the dividend distribution, the subsequent sales to achieve the ownership changes will also trigger tax consequences. As a result, the shareholder group will be subject to additional tax liability that could have been avoided if the distribution itself were treated as the disposition transaction.

The difference in the amount of shareholder gain can be illustrated most by a simple example of a corporation owned equally by two shareholders. Assume the corporation is worth 500 dollars, its earnings and profits account is 400 dollars, and each shareholder has a 50 dollar basis in her stock. If the corporation distributes 250 dollars to one shareholder in a distribution that is treated as a sale, the selling shareholder will have a gain of 200 dollars. The remaining shareholder will have no tax consequences, although, after the distribution, she will own 100 percent of the stock.

Alternatively, if the corporation were to distribute the 250 dollars as a pro rata dividend, the entire amount would be taxed as a dividend to the shareholders. Each shareholder's stock would be reduced in value to 125 dollars, and one shareholder could then use her dividend funds to purchase the entire stock interest of the other. The selling shareholder would realize a 75 dollar gain on the sale (125 dollars realized less the 50 dollar basis) for a total shareholder gain of 325 dollars, or 125 dollars more than under the first alternative.

The advantage of the first alternative is one of deferral. The shareholder group realizes 125 dollars less gain on the transaction, but the remaining shareholder has 200 dollars of inherent gain in her stock; the stock is worth 250 dollars and the basis is 50 dollars. Under the second alternative the immediate gain to the shareholders is increased by 125 dollars, but the inherent gain to the remaining shareholder is reduced by the same amount. After purchasing the other shareholder's stock, her basis in stock worth 250 dollars would be 175 dollars, leaving inherent gain of only 75 dollars. Although the benefit is one of deferral rather than complete exemption, it can still be a significant advantage to the shareholders.

The same advantage can be illustrated in a leveraged buyout context. Assume that a corporation is worth one million dollars and has two groups of shareholders: the public, which owns eighty percent, and the insiders, who own twenty percent. The corporation has 900,000 dollars of earnings and profits.

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121. *See supra* notes 43, 78.

122. *See* I.R.C. §§ 301(c), 316(a) (1985).

The public has an aggregate basis of 80,000 dollars and the insiders a basis of 20,000 dollars.

In a leveraged buyout the public will receive funds out of the corporation in a transaction that is treated as a sale. If the corporation in the example distributes 800,000 dollars to the public, the aggregate shareholder gain, realized by the public shareholders, will be 720,000 dollars. The insiders will have no tax consequences as a result of the transaction.

If, alternatively, the corporation had distributed 800,000 dollars to its shareholders as a pro rata dividend, the full amount would have been taxed: 640,000 dollars to the public and 160,000 dollars to the insiders. After the distribution the stock of the public would be reduced in value to 160,000 dollars, and the insiders could purchase it using their dividend funds. The public would realize an additional gain of 80,000 dollars on the sale (160,000 dollars reduced by their 80,000 dollar basis), and the insiders would increase their basis by 160,000 dollars. As a result, the aggregate shareholder gain realized on the transactions would be 880,000 dollars (800,000 dollars in dividends and 80,000 dollars on the sale), or 160,000 dollars more gain than if the 800,000 dollars had been distributed in a leveraged buyout.[123]

The difference in the amount of shareholder gain will continue to create a tax bias toward those forms of distribution that are treated as sales. The alloca-

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123. As in the first example, the benefit is one of deferral. The increased $160,000 of shareholder gain in the dividend alternative is balanced by the $160,000 increase in the basis of the insiders' stock. After the leveraged buyout, the insiders had inherent gain of $180,000 (basis of $20,000 in stock worth $200,000); after the dividend and sales, their inherent gain is reduced by $160,000 to $20,000 (basis of $180,000 in stock worth $200,000).

The same bias toward distributions in leveraged buyouts will exist if the two groups have increased their bases by sales prior to the distribution. Assume the public has a basis of $800,000 and the insiders have a basis of $200,000. If the corporation repurchases the public stock for $800,000, the public shareholders will realize no gain. If the corporation instead distributes the $800,000 as a dividend, the full amount will be taxed: $640,000 to the public, $160,000 to the insiders. The public will then have a $640,000 capital loss on the sale of their stock. Ignoring the limits on deduction of capital losses, the loss to the public will balance their dividend income. The total gain to the shareholders, however, will be $160,000 (the amount taxed to the insiders as a dividend) instead of zero. The advantage is, again, one of deferral. Under the second alternative, the insiders will have an inherent loss in their stock of $160,000, because their basis has been increased to $360,000 in stock now worth $200,000.

This last example illustrates the "miracle of income without gain," which the Supreme Court approved more than 60 years ago in United States v. Phellis, 257 U.S. 156 (1921). *See* Powell, *Income from Corporate Dividends*, 35 HARV. L. REV. 363 (1922). Thus, both groups of shareholders are taxed on dividends even though the distributions do not represent gain to them. Dividend income to shareholders depends only on corporate earnings and profits, which must be fully exhausted before any portion of capital is deemed withdrawn. Under this rule shareholders may, as in the example, be forced to pay tax on corporate distributions that represent a return of their investment. The extra gain to the shareholder is then balanced by an inherent capital loss in the shareholder's stock, and the additional tax liability on the dividend is theoretically balanced by the tax benefit from the loss.

This rule is changed when a distribution is treated as a sale, such as a distribution in a leveraged buyout or in a non-pro rata redemption. In those cases the current investments of the selling shareholders determine the amount of gain realized. A portion of the distribution is treated as a withdrawal of initial capital contributions, tax-free to the shareholders, regardless of the existence of corporate earnings and profits. This latter rule, of course, is far more advantageous to the shareholder group.

tion proposal, discussed in the Article, could eliminate that bias.[124] Under that proposal a distribution out of corporate funds, without replacement by assets newly subject to the same corporate tax burden, would always be allocated among the shareholders and taxed as a dividend to the extent of corporate earnings and profits. These distributions would include stock repurchases and distributions to the public in a leveraged buyout, whether the transactions were structured as an asset purchase or as a purchase of target stock.[125] The shareholders would be taxed on their pro rata share of the distribution, but would then be entitled to increase their stock basis by the same amount. Shareholders would then compute gain or loss on the sale of stock under the normal rules, regardless of whether the sale occurred in the distribution transaction or subsequently.

In the above example the 800,000 dollars distributed to the public shareholders would be taxed as if it had been distributed to all in proportion to their interests: 640,000 dollars to the public and 160,000 dollars to the insiders. Both groups would then increase their stock basis by that amount. The public would then report 80,000 dollars in additional gain on its sale of stock: the 800,000 dollars realized reduced by their new basis of 720,000 dollars (their old basis of 80,000 dollars increased in the manner described). Under this approach the total shareholder gain would be 880,000 dollars, just as if the corporation had distributed the 800,000 dollars as a dividend and the insiders had then purchased the stock of the public to bring their interest up to 100 percent.

The allocation proposal would solve the incentive to structure distributions in certain forms, but the bias toward distribution over retention would remain as a serious consequence of the Tax Reform Act of 1986. The disincentive to accumulate corporate earnings can be expected to have a significant effect on corporate financial decisions. Debt financing will become much more attractive than equity financing, whether the equity is newly contributed or accumulated. Furthermore, the bias against corporate retention may also have a significant effect on the forms of new businesses. Incorporation will become far less attractive unless a Subchapter S election[126] is possible, and new types of limited partnerships should become more popular.[127] It is doubtful that Congress fully consid-

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124. The allocation proposal, which was proposed in Chirelstein, *supra* note 81, is discussed *supra* text accompanying notes 96-99.

The Article concludes that imposing an excise tax on the corporation would be the most effective way to achieve consistency among types of shareholder distributions. As mentioned *supra* note 103, that proposal did not fully correct the inconsistency in the treatment of shareholder basis. However, it did deal with the incentive effect of the preferential rate in a manner that seemed relatively simple and administratively feasible. In light of the Tax Reform Act's repeal of the preferential rate for capital gains, the excise tax has become impractical. As a result, the allocation proposal, which would treat all shareholder distributions as pro rata dividends to the extent of earnings and profits, seems the only effective reform.

125. As described *supra* note 85, these transactions are equivalent because of the deduction for dividends received that is available under I.R.C. § 243(a) (1985) to a corporation that receives distributions from a 100%-owned subsidiary. *See supra* note 85.

126. I.R.C. § 1362 (1985).

127. *See, e.g.*, Freeman, *Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok with*

ered or intended these effects of the Tax Reform Act. Hopefully, the new biases against the corporate form will be analyzed seriously and reduced, possibly through some form of integration, in future Treasury proposals to reform the corporate tax structure.[128]

*the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsman of the Repeal of* General Utilities, 64 TAXES 962 (1986).

128. The Treasury has been directed by the Conference Committee to "consider whether changes to the provisions of subchapter C (relating to the income taxation of corporations and of their shareholders) and related sections of the Code are desirable, and to report to the tax-writing committees no later than January 1, 1988." *See* S. REP. NO. 99-841, *supra* note 114, pt. 2, at 207.