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## The Debt-Equity Distinction in a Second-Best World

Katherine Pratt

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## The Debt-Equity Distinction in a Second-Best World

*Katherine Pratt*\*

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## I. INTRODUCTION

This Article discusses the time-honored but outdated tax law distinction between corporate debt and equity. Economic and legal commentators and the Treasury Department have made various proposals to eliminate the debt-equity distinction. The theory of the second best posits that eliminating an economic distortion does not necessarily increase efficiency if other economic distortions remain.<sup>1</sup> Policymakers cannot simply assume that eliminating the distortionary debt-equity distinction will automatically increase efficiency because other distortions in the income tax will remain. This Article evaluates a number of the proposals to eliminate the debt-equity distinction, taking into account numerous distortions that are likely to remain in our tax system.

The problems associated with the debt-equity distinction have gotten worse in recent years. Part II traces the origins and evolution of the debt-equity distinction. The debt-equity distinction has its roots in the traditional, individualistic conception of debtor-creditor relations, which treats shareholders as the owners of the corporation and

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1. R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956-57).

debtholders as outside suppliers of capital. Things have changed since the early part of this century when Congress created the debt-equity distinction. For starters, public ownership of debt and stock has become widely dispersed, creating a separation of corporate ownership and control. The dispersion of investment led to the development of two alternative theories of the firm, investment theory and the new economic theory of the firm, both of which would treat debt and equity as qualitatively similar.

The recent explosion in financial contract innovation has laid bare the deficiencies of the debt-equity distinction. The traditional multi-factor case law tests for classifying debt and equity were created in the context of closely held corporations and focus on the relationship between the issuing corporation and the investors. The adventurers in the business, meaning those who expose their capital to the risks of the business, are shareholders; those who do not put their capital at risk are creditors. This traditional risk-based approach to classification simply does not make sense in an era in which (1) financial contract innovation allows parties to slice and dice risk and reallocate it in just about any way imaginable, and (2) the "risk premium" investors have historically required to invest in stocks instead of bonds has in recent years virtually disappeared.

The discussion of financial contract innovation in Part II illustrates three potential costs associated with the debt-equity distinction: (1) complexity; (2) uncertainty; and (3) the creation of tax arbitrage opportunities. Part II also discusses two other inefficiencies caused by the debt-equity distinction: (1) "overleveraging;" and (2) the tax bias against investment in risky technology businesses that may disproportionately fuel economic growth.

Part III discusses the relationship between the development of the corporate tax and the debt-equity distinction. It explains how the corporate tax came into existence and was influenced by turn-of-the-century theories of the firm. It also reviews the subsequent normative criticism of the corporate tax on efficiency and fairness grounds and discusses potential political and perhaps normative reasons for the failure of formal attempts to eliminate the double corporate tax. In addition, Part III explains the partial "back-door" elimination of the double corporate tax that has resulted from promulgation of the so-called check-the-box regulations, which permit unincorporated private (but not public) businesses to elect out of corporate taxation. This change in the corporate tax raises the question of how the corporate tax base should be defined, either normatively or positively, given that private companies can now elect out of the corporate tax but public companies cannot. Specifically, the conversion of the corporate tax into

a tax on public companies raises the question of whether public corporations should be permitted to deduct interest paid or accrued on corporate debt and dividends paid on corporate stock.

Part IV examines various proposals to eliminate the debt-equity distinction, taking into account second-best theory. For each proposal, this Article will: (1) describe the proposal; (2) consider whether the proposal would reduce the debt-equity distinction, in light of other distortions in the income tax; and (3) consider the effect of the proposal on other distortions. Each proposal to eliminate the debt-equity distinction has its strengths and weaknesses; each would reduce certain existing tax distortions but exacerbate or create other tax distortions. The effect that each of the proposals would have on certain distortions depends on the way in which the proposal would be implemented.

Part IV also evaluates the proposals, taking into account the consequences of adopting each of the proposals in light of other distortions, political feasibility, administrability, revenue concerns, and the likely reaction of various interest groups such as corporate managers. In the final analysis, this Article supports adoption of the "cost of capital allowance" deduction proposal, which would replace the corporate interest deduction with a corporate deduction based on a corporation's combined debt and equity capital.

## II. THE DEBT-EQUITY DISTINCTION

### A. *Why the Debt-Equity Distinction Matters*

Our federal income tax system treats corporations as taxpaying entities.<sup>2</sup> Each year, a corporation must pay tax on its income for the year.<sup>3</sup> The tax is on net income, not gross income, so corporations can

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2. I.R.C. § 11 imposes tax on "C" corporations. *See* I.R.C. § 11 (1994). For purposes of this Article, assume that the corporation is a "C" corporation, which is any corporation that has not elected to be treated as an "S" corporation. C corporations and S corporations are named for the subchapters of the Code that apply to those types of corporations. A corporation can be an S corporation only if it has 75 or fewer shareholders, no foreign or entity shareholders, and only one class of stock. *See id.* § 1361(b)(1) (1994) (amended 1998). S Corporations are not taxpaying entities; instead S Corporation income and other tax items pass through to the shareholders and each shareholder reports her allocable share of those items on her individual tax return. *See id.* § 1366 (1994) (amended 1996).

3. Our tax system employs an annual accounting period. *See id.* § 441 (1994). Although the annual accounting convention sometimes causes harsh results, for example where the income and expenses of a transaction do not occur within the same tax year, the Supreme Court has held that use of the annual accounting system is justified by the need for regular federal revenues and an administrable tax system. *See Burnet v. Sanford & Brooks*, 282 U.S. 359, 363-64 (1931).

deduct the costs of earning their income.<sup>4</sup> Corporations finance their operations by raising debt and equity capital.

A corporation, acting as a borrower, can issue debt (*e.g.*, bonds) to debtholders, the creditors, in exchange for cash or other property.<sup>5</sup> The corporation can also issue stock to shareholders in exchange for cash or other property.<sup>6</sup> As compensation for the use of the debtholders' money, the corporation pays the debtholders interest.<sup>7</sup> As compen-

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However, the Code includes a number of specific sections that are designed to ameliorate the potentially harsh consequences of using the annual accounting system. *See, e.g.*, I.R.C. § 172 (1994). Section 172 permits a corporation to use a net operating loss ("NOL") for a tax year to offset income, from other years, on which the corporation would otherwise pay tax. *See id.* § 172(b) (1994). NOLs may be carried back two years and forward 20 years. *See id.* § 172(b)(1)(A) (1994).

4. *See* I.R.C. § 63(a) (1994) (amended 1997).

5. When a corporation issues bonds, it is obligating itself to pay the holder a specified amount in the future. The bond typically has a stated term. The date on which that term ends is called the *maturity date* of the bond. The amount the corporate issuer is obligated to pay on that date (aside from any interest due on that date) is sometimes referred to as the *face amount* of the loan. The interest owed to the holder may have to be paid periodically throughout the term of the bond or all on the maturity date.

Bonds are typically denominated in \$1,000 increments, so the face amount of the bond is \$1,000. The price at which a bond is sold is referred to as the *issue price* of the bond. A bond will sell for \$1,000 if the interest rate on that bond is the same as the prevailing market rate of interest. If a holder pays \$1,000 for the bond, the bond is said to have been sold at *par*. Said another way, if a bond is sold at par, the issue price will equal the face amount due at maturity. If the stated interest rate on the bond exceeds the prevailing market rate of interest, the bond will sell for more than \$1,000, referred to as a *premium*. If the stated interest rate on the bond is less than the prevailing market rate of interest, the bond will sell for less than \$1,000, referred to as a *discount*.

After the bonds are issued, they may be traded in securities markets. The value of the bond depends in part on interest rates. If a bond is sold at par, but interest rates subsequently rise, the bond will sell at a discount because the bond bears a below-market rate of interest. If a bond is sold at par, but interest rates subsequently fall, the bond will sell at a premium because the bond bears an above-market rate of interest. *See* ROBERT W. HAMILTON & RICHARD A. BOOTH, *BUSINESS BASICS FOR LAW STUDENTS: ESSENTIAL TERMS AND CONCEPTS* 427 (2d ed. 1998).

Short term loans made by lenders to corporations are typically called notes. Longer term loans (*i.e.*, for a period of five or more years) made by lenders to corporations can be classified as bonds or debentures. The term *debenture* usually refers to an obligation that is unsecured and the term *bond* usually refers to an obligation that is secured by the corporate borrower's property. The term *bond* is also commonly used in a generic sense to refer to the class of debt securities that includes both debentures and bonds. *See* WILLIAM A. KLEIN & JOHN COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 135-36 (6th ed., 1996).

If a corporation issues bonds to the public, the corporation can alternatively be referred to as the *issuer*, the *borrower*, or the *debtor*. An investor who buys a bond issued by the corporation can alternatively be referred to as the *bondholder* or *holder*, the *lender*, or the *creditor*. The document that sets forth the terms of the bonds is referred to as the *indenture*.

6. The stock proceeds the corporate issuer receives from the shareholder are not included in the corporation's income. *See* I.R.C. § 1032(a) (1994).

7. The corporate borrower also eventually returns to the bondholders the amount they loaned the corporation. Interest paid on the bond includes a pure time value of money element (with an inflation component) and compensation for the risk that the issuer will default.

sation for the use of the shareholders' money, the corporation pays the shareholders distributions in the form of dividends.<sup>8</sup>

Although, for reasons discussed later, the Internal Revenue Code (the "Code") should treat debt and equity similarly for tax purposes, the Code has always distinguished between debt and equity. There are numerous tax differences between debt and equity.<sup>9</sup> Some of these differences relate to the tax consequences to the corporate issuer of the debt or equity.<sup>10</sup> Some relate to the tax consequences to the holder of the debt or equity.<sup>11</sup>

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8. Distributions to shareholders include "normal profit," which is the time value of money element and a "pure profit" element, which compensates the shareholder for the risk that the corporation will fail. Shareholders are also entitled to distributions when the corporation is liquidated. Exactly what the shareholders are entitled to receive depends on default rules under state corporate law, the terms in the corporation's articles of incorporation, and the type of stock the shareholder owns. Undistributed earnings increase the value of the stock of the corporation.

9. For an extensive discussion of the differences between debt and equity, see BORIS BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS* ¶¶ 4.01, 4.20-4.26 (1998) and sources cited therein.

10. For example, the tax consequences of a corporation retiring its stock or debt differ. A corporation does not have income when it receives cash or other property in exchange for its stock. See I.R.C. § 1032(a) (1994). For a discussion of I.R.C. § 1032, see BITTKER & EUSTICE, *supra* note 9, ¶ 3.12, at 3060-65. If the corporation later repurchases the stock for an amount of cash less than the amount for which the stock was issued, the corporation recognizes no income. See I.R.C. § 311(a) (1994). Section 1032(a), which insulates the corporate issuer from gain on the issuance of stock in exchange from property, does not technically apply to the issuer's repurchase of the stock. See *id.* § 1032(a) (1994). Treasury Regulations provide that § 1032 does not apply to a corporation's acquisition of its own shares unless the corporation acquires the shares in exchange for its own stock (although the regulation crossreferences the § 311 regulations). See Treas. Reg. § 1.1032-1(b). Section 311(a) provides that a corporation does not recognize gain on the distribution of property with respect to its stock. See I.R.C. § 311(a) (1994). Property includes cash under I.R.C. § 317(a). See *id.* § 317(a) (1994); see also BITTKER & EUSTICE, *supra* note 9, ¶ 4.25, at 4-71 (6th ed. 1998) ("Upon redeeming or repurchasing its own stock, a corporation recognizes no gain, even if the amount paid is less than the stock's par or stated value or the amount received when it was issued; any corporate level gain on the transaction is instead treated as a tax-free capital contribution under I.R.C. § 118(a), as a distribution covered by I.R.C. § 311(a)(2), or simply as a nontaxable capital adjustment.") (footnote omitted).

A corporation does not have to include proceeds from the issuance of debt in income. If a corporation retires debt for less than the amount owed on the debt, however, the corporation must generally include in income the difference between the amount owed on the debt and the amount paid to discharge the debt. See I.R.C. § 61(a)(12) (1994); *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931). If the debt discharge occurs in a bankruptcy proceeding, I.R.C. § 108(a)(1)(A) permits the corporation to exclude the debt discharge income completely. See I.R.C. § 108(a)(1)(A) (1994). If the debt discharge does not occur in a bankruptcy proceeding, I.R.C. § 108(a)(1)(B) and (3), and (d)(3) permit the corporation to exclude the debt discharge income to the extent of the corporation's insolvency (the corporation's liabilities less assets) prior to the discharge. See *id.* §§ 108(a)(1)(B), (a)(3), (d)(3) (1994). Section 108(a) often just defers the tax on debt discharge income because debt discharge income excluded under I.R.C. § 108(a) reduces the corporation's net operating losses. See *id.* § 108(b)(2)(A) (1994). A net operating loss for one tax year can be used to reduce the corporate taxpayer's tax liability for other profitable years. Net operating losses can be carried back two years and forward 20 years. See *id.* § 172(b) (1994). If the corporation that has excluded debt discharge income later begins earning income

This Article will focus on the most important difference between debt and equity at the level of the corporate issuer: a corporation can deduct interest paid or accrued on the debt it issues but cannot deduct the dividends it pays on the shares it issues.<sup>12</sup> It will also consider investor level character and timing differences between debt and equity because these differences affect the amount of debt and equity in corporate capital structures.

First consider the character differences. Debtholders pay tax at ordinary income tax rates on interest paid or accrued on the corporate debt they own.<sup>13</sup> Shareholders pay tax at ordinary income tax rates on the dividends they receive.<sup>14</sup> If a corporation retains earnings, instead of distributing them as dividends, the value of the assets of the corporation will increase, which will in turn increase the value of the stock of the corporation held by its shareholders. If a shareholder sells stock that has appreciated, the shareholder will realize gain equal to the amount for which the stock was sold less the amount the shareholder paid for the stock.<sup>15</sup> (The gain from the sale of the stock is usually taxed at preferential capital gains rates.<sup>16</sup>) In summary, shareholders typically pay tax on undistributed corporate earnings when they sell their stock.

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again, the § 108(b) reduction in its net operating losses will increase its tax liability because the net operating losses would otherwise have reduced the corporation's income.

11. Stock and debt instruments are generally "capital assets," so that gain from the sale of such securities qualifies for preferential capital gain rates and loss from the sale of such securities is subject to special loss limitation rules. See I.R.C. §§ 1(h) (amended 1997), 1201 (amended 1997), 1211, 1221, 1222 (1994); *Van Suetendael v. Commissioner*, 13 T.C.M. 1071, 1075-76 (T.C. 1944), *aff'd*, 152 F.2d 654 (2d Cir. 1945) (holding that sale by an individual who traded securities generated capital gain, not ordinary income). Special rules may apply, however, that distinguish between stock and debt instruments in certain circumstances. For example, I.R.C. § 306, which recharacterizes all or a part of the capital gain from the sale of preferred stock as ordinary income, does not apply to debt instruments. See I.R.C. § 306(a)(1) (1994). For a discussion of other special rules, see BITTKER & EUSTICE, *supra* note 9, ¶¶ 4.20. For a discussion of other investor level differences between debt and equity, see BITTKER & EUSTICE, *supra* note 9, ¶¶ 4.21-4.24.

12. See I.R.C. § 163(a) (1994) (amended 1998).

13. See I.R.C. §§ 61(a)(4) (amended 1997), 1272(a)(1) (amended 1997) (1994).

14. See *id.* §§ 61(a)(7), 301(c)(1) (1994). The precise treatment to the shareholder depends on a number of factors, *e.g.*, whether the distributing corporation has earnings and profits and whether the shareholder is a corporation that qualifies for the dividends received deduction. See *id.* §§ 316, 312, 243 (1994).

15. See *id.* § 1001(a) 1011(a), 1012 (1994).

16. See *id.* § 1(h) (amended 1997), §§ 61(a)(3), 1221, 1222 (1994). Sale of the stock typically qualifies for the preferential capital gain tax rates instead of the higher ordinary income tax rates. See *id.* §§ 1(a)-(e), 1(h), 1221 (1994); *Van Suetendael*, 13 T.C.M. at 1075-76 (holding that sale by an individual who traded stocks generated capital gain not ordinary income). For an overview of the distinction between ordinary income and capital gain, see JOSEPH BANKMAN ET AL., *FEDERAL INCOME TAX: EXAMPLES AND EXPLANATIONS* 451-494 (2d ed., 1998).



Second, consider the timing differences between the investor level tax consequences of stock and debt. Shareholders typically include dividends when they receive the dividends<sup>17</sup> and include gain from the sale of stock when they sell the stock.<sup>18</sup> In other words, corporate earnings are not typically taxed at the shareholder level until the corporation pays a dividend or the shareholder sells appreciated stock. Stock is therefore taxed using what is sometimes called a "wait-and-see" method.<sup>19</sup>

Debt holders include (and the issuer deducts) interest as it is paid or as it *accrues*. Interest on corporate debt may be stated interest or unstated interest.<sup>20</sup> If all of the interest is stated, the debt holders include the interest and the issuer deducts the interest as it is paid. If the debt instrument bears unstated interest, which the Code refers to as original issue discount ("OID"), the debt holder includes the OID and the issuer deducts the OID as it accrues.<sup>21</sup> In other words, the

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17. See I.R.C. § 61(a)(4) (1994). Under I.R.C. § 451(a) and Treas. Reg. §§ 1.451-1 and 1.451-2, cash method taxpayers include income when it is actually or constructively received. See *id.* § 451(a) (1994) (amended 1998); Treas. Reg. §§ 1.451-1, 1.451-2. Individual shareholders report their income on the cash method. See I.R.C. § 446 (1994).

18. See I.R.C. § 1001(a), (c) (1994).

19. See Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 463-64 (1993).

20. Interest is "stated" if the bond pays interest periodically throughout the term of the bond at a specified interest rate. Interest is unstated if the amount payable at maturity on the bond includes an implicit interest element as illustrated in the examples in the text below.

21. A debt instrument may be issued at a discount (*i.e.*, for less than par) because the stated interest rate on the bond is less than the prevailing market rate of interest. This discount inherent in the debt at issuance is referred to as OID. The total OID on a debt instrument equals (1) the *stated redemption price at maturity* of the debt instrument, which is the sum of all payments to be made on the debt instrument other than *qualified stated interest* (which, simplifying a bit, is defined as stated interest that is unconditionally payable in cash or property at least annually at a single fixed rate) less (2) the *issue price* of the debt instrument, which is conceptually the amount the corporate issuer borrows (*e.g.*, the price at which the debt is sold). See I.R.C. § 1273(a)(2) (1994); Treas. Reg. § 1.1273-1(c)(1). The stated redemption price at maturity is the face amount of the debt instrument if interest is payable periodically and the principal is to be repaid in a lump sum at maturity. See I.R.C. §§ 1273(a), 1273(b), 1274 (1994) (amended 1997); Treas. Reg. §§ 1.1273-1, -2.

The aggregate OID on a debt instrument is then allocated over the term of the debt instrument. The interest allocable to each accrual period equals (1) the product of multiplying (a) the *adjusted issue price* of the debt instrument, which is the issue price of the debt plus any prior accrued OID, by (b) the *yield-to-maturity* of the debt instrument, which is "the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument," less (2) any qualified stated interest on the debt instrument. See I.R.C. § 1272(a)(4) (1994) (amended 1997); Treas. Reg. § 1.1272-1(b)(1)(I).

The yield-to-maturity is a constant rate, stated as a percentage. The adjusted issue price increases each accrual period to reflect the accrued but unpaid OID from the prior periods. The OID accrued for each period increases over the term of the debt instrument as a constant percentage yield-to-maturity rate is applied to an ever-increasing adjusted issue price. The

bondholder's interest inclusion and corporate issuer's interest deduction may precede the payment of that interest. The following example illustrates this timing point.

*Example 1.*<sup>22</sup>

In year one, Alice pays \$1,000 for a BigCo bond which will pay \$1,340 at maturity in three years. The bond does not pay any stated interest during the three-year term of the bond. The \$340 difference between the \$1,000 for which the bond was sold and the \$1,340 payable at maturity is *original issue discount* ("OID").<sup>23</sup> The Internal revenue Code requires that the \$340 of OID be allocated over the three-year term of the bond, using the *yield-to-maturity* method.<sup>24</sup> To allocate the OID, first determine the interest rate that would produce \$1,340 in three years if \$1,000 had been invested, which turns out to be 10 percent (assuming that interest is computed on the outstanding balance

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corporate issuer deducts and the holder includes the OID allocable to their taxable year. See I.R.C. §§ 163(e)(1) (amended 1998), 1272(a)(1) (amended 1997), 1272(a)(3) (amended 1997) (1994). An example may help to illustrate these concepts. Assume that Art pays \$900 for a PublicCo bond that will pay \$30 of interest semiannually and \$1,000 at maturity in 10 years. The semiannual interest payments constitute qualified stated interest which is not included in the stated redemption price at maturity. The bond's stated redemption price at maturity equals \$1,000, the face amount payable at maturity. The bond's issue price is \$900, the price Art paid for the bond. The aggregate OID on the bond equals \$100, which is the \$1,000 stated redemption price at maturity less the \$900 issue price.

That \$100 of OID is allocated over the 10-year term of the bond. The yield-to-maturity on the bond equals 7.44 percent, compounding semiannually, because that is the discount rate that produces a \$900 issue price when used to compute the present value of the payments to be made under the debt instrument.

The OID allocable to the first six-month accrual period is \$3.46, which is (1) \$33.46, which in turn is the product of multiplying the \$900 issue price by the 3.72 percent yield-to-maturity, (7.44 annual yield-to-maturity, with semiannual compounding, divided by two compounding periods during the year), less (2) the \$30 of stated interest on the bond. The OID allocable to the second six-month accrual period is \$3.60, which is (1) \$33.60, which in turn is the product of multiplying the \$903.46 adjusted issue price by the 3.72 percent yield-to-maturity, (7.44 annual yield-to-maturity, with semiannual compounding, divided by two compounding periods during the year), less (2) the \$30 of stated interest on the bond. For the tax year which includes the first two six-month accrual periods, PublicCo deducts and Art includes \$7.06 of OID (\$3.40 OID allocable to the first accrual period plus \$3.60 allocable to the second accrual period) plus \$60 of stated interest that PublicCo paid on the bond. This example is based on Regulation § 1.1272-1(j), Example 2.

22. This example is based on an example in JOSEPH BANKMAN ET AL., *FEDERAL INCOME TAX: EXAMPLES AND EXPLANATIONS* 159-60 (2d ed., 1998).

23. The bond's stated redemption price at maturity is \$1,340. The issue price of the bond is \$1,000, the price Alice paid for the bond. The aggregate OID on the bond equals \$340, which is the \$1,340 stated redemption price at maturity less the \$1,000 issue price of the bond.

24. See Treas. Reg. § 1.1272-1(b)(1). The yield to maturity method is also sometimes referred to as the *constant yield* method. This method of allocating interest is more sophisticated than simply allocating the interest pro rata over the term of the bond. Professors Bankman and Klein have observed, however, that the yield to maturity method sometimes mismeasures interest because of the relationship between economic interest and the term structure of interest. See Joseph Bankman & William A. Klein, *Accurate Taxation of Long-Term Debt: Taking into Account the Term Structure of Interest*, 44 TAX L. REV. 335, 348 (1989).

every six months.)<sup>25</sup> Alice includes and BigCo. deducts \$102.50 of OID as interest in year one,<sup>26</sup> \$113.00 of OID in year two,<sup>27</sup> and \$124.50 of OID in year three.<sup>28</sup>

To summarize, the corporate earnings distributed or allocable to the debtholders as interest are taxed once at the debtholder level because the corporate issuer deducts the interest and the bondholder includes the interest.<sup>29</sup> On the other hand, corporate earnings distributed to shareholders as dividends are taxed twice, first at the corporate level (since the corporation cannot deduct the dividends paid to shareholders) and second at the shareholder level when the dividends are paid.<sup>30</sup> The corporate earnings that are not distributed are also taxed twice, first at the corporate level, and second at the shareholder level when the shareholder sells the stock, which has appreciated to reflect the earnings retained by the corporation.

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25. Said more technically, the yield-to-maturity is 10 percent, compounded semiannually, because discounting the \$1,340 payment to be made under the debt instrument at 10 percent, compounded semiannually, produces a \$1,000 issue price for the debt instrument.

26. The OID for the first six-month period during which the bond is outstanding equals \$50, which is 5 percent (10 percent annual interest rate divided by two compounding periods during the year) of the \$1,000 issue price of the bond. Alice includes in income that \$50 of OID and BigCo deducts that \$50 of OID. The OID allocable to the second six-month period is \$52.50, which is 5 percent of the \$1,050 adjusted issue price of the bond (\$1,000 issue price plus \$50 of OID allocable to the first six-month accrual period). Alice includes in income that \$52.50 of OID and BigCo deducts that \$52.50 of OID. Notice that the OID for the second accrual period is more than the OID for the first accrual period because the OID is calculated by applying a constant yield-to-maturity rate to an ever increasing adjusted issue price.

27. The OID for the third six-month period during which the bond is outstanding equals \$55.13, which is 5 percent of the \$1,102.50 adjusted issue price of the bond (\$1,000 issue price plus \$102.50 of OID allocable to the two prior six-month accrual periods). Alice includes in income that \$55.13 of OID and BigCo deducts that \$55.13 of OID. The OID allocable to the fourth six-month period is \$57.88, which is 5 percent of the \$1,157.63 adjusted issue price of the bond (\$1,000 issue price plus \$157.63 of OID allocable to the three prior six-month accrual periods). Alice includes in income that \$57.88 of OID and BigCo deducts that \$57.88 of OID.

28. The OID for the fifth six-month period during which the bond is outstanding equals \$60.78, which is 5 percent of the \$1,215.51 adjusted issue price of the bond (\$1,000 issue price plus \$215.51 of OID allocable to the four prior six-month accrual periods). Alice includes in income that \$60.78 of OID and BigCo deducts that \$60.78 of OID. The OID allocable to the sixth six-month period is \$63.81, which is 5 percent of the \$1,276.29 adjusted issue price of the bond (\$1,000 issue price plus \$276.29 of OID allocable to the five prior six-month accrual periods). Alice includes in income that \$63.81 of OID and BigCo deducts that \$63.81 of OID. The sum of all OID deductions (correcting a bit for rounding error) equals \$340.

29. This holds true only if the bondholder is not exempt from tax. Some taxpayers, such as pension plans, do not have to pay income tax. See I.R.C. § 501(a) (1994) (amended 1998). If the bondholder is exempt from tax, the corporate earnings distributed or allocable as interest are not taxed at the corporate or bondholder level.

30. If the shareholder is a "tax-exempt" organization, the corporate earnings retained or distributed as dividends are generally taxed only once at the corporate level. See *id.* §§ 501(a), 511(a), 512(a) (amended 1998), (b)(1), 513(a) (amended 1997) (1994).

## B. Standards for Classifying Debt and Equity

### 1. The Origins of the Debt-Equity Distinction

The adoption of the corporate tax at the beginning of the twentieth century required Congress to determine the base of the tax. Although the corporate tax enacted in 1909 was called an excise tax, the tax was based on corporate "income."<sup>31</sup> Income was a net income concept, not a gross income concept, so Congress had to determine which costs were deductible by corporations and which were not. Although it was generally agreed that the costs of labor and supplies were deductible, the question of whether a corporation should be allowed a deduction for its cost of debt capital was debated at the time of the 1909 Act.<sup>32</sup> That debate was colored by the theory of debtor-creditor relations that dominated at that time.

As Professor Bratton has observed, until the twentieth century, economic theory and legal theory were "individualistic," meaning that both theories assumed that economic producers were individuals and that transactions occurred between individuals.<sup>33</sup> A "traditional" notion of debtor-creditor relationships, which assumed that "flesh and blood" debtors borrowed funds from "flesh and blood" creditors, underlay early debtor-creditor legal rules.<sup>34</sup>

At the beginning of this century, the traditional debtor-creditor model dominated debtor-creditor theory. Shareholders were thought of as the owners of the corporation but debtholders were not thought of as owners.<sup>35</sup> Under the traditional debtor-creditor model:

[c]orporate law associates equity interests with risk, control, and ownership; it leaves debt out of this association. This conception draws on [nineteenth century] classical economic theory, which modeled economic life in terms of production by individual producers and transactions between individuals. . . . In the nineteenth century, corporate doctrine adapted this individual conception to group production, re-

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31. See Tariff Act of 1909, ch. 6, § 38(2d), 36 Stat. 113.

32. See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L. REV. 53, 111-12 (1990). For the history of the corporate interest deduction prior to the 1909 Act., see Michael Asimow, *Principal and Prepaid Interest*, 16 UCLA L. REV. 36, 62-63 (1968).

33. See William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1483 (1989). As Bratton notes, an "individual perspective undergirded business law." *Id.*

34. William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 98-99. Although the debtor and creditor usually knew each other and had a personal relationship, their interests were adverse so that unilateral action by one of the parties could injure the other party. See *id.* at 99. Legal rules governing debtor-creditor relationships developed to stop the parties from inflicting economic or physical injury on each other. See *id.*

35. See *id.* at 103.

constructing the classical individual's entrepreneurial behavior pattern within the corporate structure. Under this view, the entrepreneurial mantle—the role of “adventurer”—falls on the stockholder, conceived as the owner-manager. Among the corporate claimants, the stockholder faces the highest risk of loss and enjoys the highest potential for gain . . . .

Under this model, creditors join the firm not as “owners” or “members,” but as contractual suppliers of capital. . . . [C]reditors, being “contractually” tied to the firm, are not members of the firm entity. . . . Creditors trade incidents of ownership, like control and profit, first, for periodic payments made without regard to profit, and, second, for repayment of principal at a fixed date, with priority over the equityholders' claims to the corporation's assets. This paradigm contract, in effect, interprets the basic debtor-creditor exchange to exclude incidents of corporate ownership.<sup>36</sup>

Under this view of corporate debt, the shareholders “own” the corporation and the debtholders do not so the interest on corporate debt is deductible as a cost of the corporation earning income. Dividend distributions to shareholders, on the other hand, are considered distributions of corporate profits to the owners of the corporation, so the corporation is not entitled to a deduction for the dividends it distributes.<sup>37</sup>

During the debate of the 1909 Act, noted tax commentator Edwin Seligman challenged the traditional debtor-creditor model of corporate debt. He argued that, as a theoretical matter, interest on corporate debt should not be deductible in measuring the net income of corporations, despite the fact that an interest deduction should be allowed for purposes of computing individual income. In his view, an interest deduction on individual debt incurred to produce income was warranted because personal income was defined as “that which comes into an individual above all necessary expenses of acquisition, and which is available for his own consumption.”<sup>38</sup> However, Seligman conceptualized corporate income as the *earnings* on the assets invested in the corporation, either as debt or as equity. In his view, corporations should not be allowed an interest deduction because both equity and

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36. See *id.* at 103-104 (citations and footnotes omitted).

37. See Adam O. Emmerich, Comment, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118, 122 (1985).

Apparently, the idea that interest payments are deductible as an ordinary business expense is so intuitively appealing that Congress has thought it unnecessary to explain section 163(a) or its predecessors. Indeed, if one considers a typical small business that simply borrows money from the bank to finance its operations, it seems obvious that the cost of that capital is a business expense and therefore should be deductible. When one considers that equity is simply another source of capital, however, this basis for the distinction begins to fall apart.

*Id.* at 122 n.23 (citations omitted).

38. Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L. J. 1585, 1597 (1974) (quoting Edwin R.A. Seligman, *ESSAYS IN TAXATION* 246 (9th ed. 1921)).

debt comprised the corporation's "earning capacity."<sup>39</sup> Therefore, he defined corporate income as "total revenue from all sources minus all actual expenditures except interest and taxes."<sup>40</sup>

Congress, in 1909, ultimately adopted the traditional view of corporate debt and equity and permitted corporations to deduct interest on corporate debt.<sup>41</sup> Congress limited the interest deduction, however, to discourage corporations from converting their equity into debt in an attempt to avoid the new corporate tax. The 1909 Act limited the deduction to the interest on an amount of debt that did not exceed the stock of the corporation.<sup>42</sup> Congress relaxed this limitation on the interest deduction in 1913<sup>43</sup> and in 1916,<sup>44</sup> then eliminated it in 1918.<sup>45</sup>

## 2. Traditional Classification Standards

Prototypic equity and prototypic debt are end points on a conceptual continuum with most real securities falling in the middle of that continuum. Prototypic debt is "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof."<sup>46</sup> An example would be a corporate bond that will pay \$1,000 at maturity in 10 years and pays \$100 of interest a year for each of those 10 years. Prototypic equity "connotes an unlimited claim to the residual benefits of ownership and an equally unlimited subjection to the burdens thereof."<sup>47</sup> An example would be a share of common stock.

Courts have been forced to address the classification issue in part because Congress has not been willing to define the terms debt and equity in the Code.<sup>48</sup> Left to their own devices, courts have strug-

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39. *Id.* at 1597 (quoting Edwin R.A. Seligman, *ESSAYS IN TAXATION* 685 (9th ed. 1921)).

40. *Id.*

41. *See* Tariff Act of 1909, ch. 6, § 38(2d), 36 Stat. 113.

42. *See id.*

43. *See* Tariff Act of 1913, ch. 16, § IIG(b), 38 Stat. 173.

44. *See* Revenue Act of 1916, ch. 463, § 12(a)(3d), 39 Stat. 768.

45. Congress eliminated the limitation on the interest deduction in conjunction with enactment of the excess profits tax. *See* Revenue Act of 1918, ch. 18, § 234(a)(2), 40 Stat. 1077. The excess profits tax did not allow a corporation to include borrowings in the computation of the corporation's excess profits tax credit, so it was thought that the limitation on deductibility of interest on corporate borrowings should be repealed. Although the excess profits tax was subsequently repealed, the limitation on the deductibility of interest did not reappear. *See* Revenue Act of 1921, ch. 136, §§ 300-38, 42 Stat. 271-77.

46. BITTKER & EUSTICE, *supra* note 9, ¶4.02[1], at 4-12 (quoting *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957)).

47. BITTKER & EUSTICE, *supra* note 9, ¶4.02[1], at 4-12.

48. *See id.* ¶ 402[8][a]. In 1954, the House drafted definitions that would have distinguished between debt and equity, but the Senate deleted that language from the House

gled to distinguish between debt and equity. In an early case, the Second Circuit Court of Appeals defined classic debt and equity: "The stockholder is an adventurer in the corporate business; he takes the risk, and the profits from success. The creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives."<sup>49</sup>

The debt-equity classification issue has been heavily litigated over the years, with courts articulating many factors to be considered in classifying an instrument. For example, the court in *Fin Hay Realty Co. v. United States*<sup>50</sup> stated that classification is based on the following factors:

(1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.<sup>51</sup>

Courts have been reluctant to treat any one factor as dispositive or to assign weights to the various factors.<sup>52</sup> Their task has been made more complicated by the fact that many instruments are a blend of equity characteristics and debt characteristics. The fact that all of these factors bear on the classification allows taxpayers to manipulate the factors and courts to reach inconsistent results.<sup>53</sup>

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bill. See *id.* (citing H.R. Rep. No. 1337, 83d Cong., 2d Sess. A-98 - A-99 (1954) and S. Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954)); see also Anthony P. Polito, *Useful Fictions: Debt and Equity Classification in Corporate Tax Law*, 30 ARIZ. ST. L.J. 761, 783-85 (1998). For a discussion of § 385 and the regulations issued under that section, which were later withdrawn, see *infra* text accompanying notes 106 to 116.

49. *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935).

50. 398 F.2d 694 (3d Cir. 1968).

51. *Id.* at 696. As if 16 factors are not enough, William Plumb listed over 30 relevant classification factors derived from case law. See William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 407 (1971).

52. See BITTKER & EUSTICE, *supra* note 9, ¶4.03[2][a], 4-22 (citing *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969) as an example).

53. See Plumb, *supra* note 51, at 407-08; Polito, *supra* note 48, at 781.

Classifying instruments as debt or equity has always been problematic.<sup>54</sup> For the reasons discussed in the next section, debt-equity classification may be more problematic now than in the past, and may warrant the adoption of one of a number of proposals that would reduce or eliminate the debt-equity distinction.

Until fairly recently, debt-equity classification issues typically involved classification of the debt of a closely held corporation (*i.e.*, one with a small number of shareholders), not debt of public companies. For most of this century, investors were inclined to incorporate their businesses in order to obtain the benefit of limited liability. Investors wanted limited liability but did not want to owe corporate tax at the end of the tax year so investors tried to arrange for the corporation to have little or no income at the end of the year. One common device for reducing corporate income was to arrange for the corporation to pay returns to investors as interest instead of dividends.<sup>55</sup> In other words, shareholders of closely held corporations often financed some of the operations of the corporation by making loans to the corporation instead of making additional capital contributions.

Today, businesses can have the benefit of limited liability without being subject to the double corporate tax. First, a business can operate in corporate form but make an S Corporation election and be subject to pass-through tax treatment.<sup>56</sup> Second, a business can operate in noncorporate form (*e.g.*, as a limited liability company), still obtain the benefits of limited liability, and yet be subject to pass-

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54. Various commentators have made suggestions to simplify debt-equity classification. See generally, Alan J. Feld, *Feld Proposes Debt-Equity Ratio Test as LBO Solution*, 42 TAX NOTES 735 (1989) (reprinting testimony Professor Feld gave before the House Ways and Means Committee) (suggesting that debt of large corporations be treated as equity if the corporation's debt-equity ratio exceeds 4:1); see also Polito, *supra* note 48, at 795-810 (suggesting either (1) that debt be treated entirely as equity if the return on the debt exceeds the return on the corporation's safest debt multiplied by a fixed multiplier or (2) that debt be bifurcated into debt and equity components, again based on the expected rate of return on the instrument); David V. Ceryak, Noto, *Using Risk Analysis to Classify Junk Bonds as Equity for Federal Income Tax Purposes*, 66 IND. L.J. 273, 288 (1990) (suggesting that debt be treated as equity if the yield on the debt is at least equal to the one-month Treasury bill rate plus three percent); Emmerich, *supra* note 37, at 143 (suggesting that debt of large corporations be treated as debt only if the debt instrument provides for the payment of a fixed, certain sum on demand or on a specified future date).

55. Another common device was to "zero out" the corporate income by paying shareholder-employees salary in an amount equal to the earnings of the corporation. The corporation could deduct the salary so the corporation was left with zero income. See I.R.C. § 162(a)(1) (1994) (amended 1998). If the salary was high, the corporation ran the risk, however, that the Internal Revenue Service would disallow the salary deduction as unreasonable compensation. See Treas. Reg. § 1.162-7.

56. See I.R.C. §§ 1361-79 (1994) (amended 1996, 1997, 1998). Subchapter S was enacted in 1958. See Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650-57 (1958).



through tax treatment.<sup>57</sup> Allowing small private firms to have both limited liability and pass-through treatment has taken pressure off the debt-equity distinction in the context of closely held businesses since many small businesses are not subject to the double corporate tax.

Until the 1980s, debt-equity classification was not usually a problem for public companies because the debt and equity of such large corporations assumed fairly standard forms and only the preferred stock and common stock were considered to be equity.<sup>58</sup> During the 1980s, public corporations began to issue significantly more debt. This debt was frequently issued in exchange for outstanding stock of the corporation. The result was that corporate capital structures, on average, included more debt and less equity.<sup>59</sup>

What caused the rapid growth in the issuance of corporate debt by public companies during the 1980s? The development of the high-yield bond (or junk bond) market made debt financing available to corporations that could not issue so-called "investment grade" bonds.<sup>60</sup> At the same time, management perceptions of junk bonds and zero coupon bonds began to change:

Until [the mid-1980s] corporations were rather reluctant to accept high levels of debt despite the fact that interest payments on corporate debt are deductible. Although the restrained level of debt depressed the return to equity investors, and therefore lowered the price of corporate shares, it is easy to understand why corporate managers were

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57. Limited liability companies are subject to the pass through partnership rules of Subchapter K unless the LLC elects to be treated like a corporation. See Treas. Reg. § 301.7701-3(a), T.D. 8697, 61 Fed. Reg. 66590, Dec. 18, 1996. General partnerships have never been subject to the corporate tax but general partners have unlimited liability for partnership debts. See, e.g., Tariff Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114. If a business operates as a limited partnership, the general partner has unlimited liability for partnership debts but the limited partners have limited liability. Until recently, however, limited partnerships were taxed like corporations if the partnership had more than two of the following four corporate characteristics: limited liability, centralization of management, continuity of life, and free transferability of interests. See Former Treas. Reg. § 301.7701-3. Private limited partnerships are now subject to the pass through partnership rules of Subchapter K unless the partnership elects to be taxed as a corporation. Treas. Reg. § 301.7701-3(a), T.D. 8697, 61 Fed. Reg. 66590, Dec. 18, 1996. Publicly traded partnerships are generally taxed as corporations. See I.R.C. § 7704 (1994) (amended 1998).

58. Jeremy I. Bulow et al., *Distinguishing Debt from Equity in the Junk Bond Era*, in DEBT, TAXES, AND CORPORATE RESTRUCTURING 135, 139 (John B. Shoven & Joel Waldfogel eds., 1990).

59. See Henry Kaufman, *Halting the Leverage Binge*, INSTITUTIONAL INVESTOR, Apr. 1989, at 23. (During the 1980s, "the debt of U.S. nonfinancial corporations has gone up by an estimated \$840 billion while their equity position has contracted by nearly \$300 billion. That translates into a 15.4 percent annual growth rate in debt, compared with an average annual increase of only 8.4 percent for the previous six cycles of economic growth.")

60. See *Leveraged Buyouts and Corporate Debt: Hearings Before the Senate Finance Comm.*, 101st Cong., 1st Sess. 186, 187 (Jan. 25, 1989) (Statement of Lawrence H. Summers, Professor of Economics, Harvard University). Investment grade bonds are bonds that receive the highest credit ratings from credit rating agencies such as Moody's.

the price of corporate shares, it is easy to understand why corporate managers were nevertheless reluctant to use as much debt as their shareholders want. Although a shareholder [holding a diversified portfolio] can accept the risk of an occasional bankruptcy . . . a bankruptcy could destroy the career as well as the personal fortune of the manager. In [the mid-1980s], however, managers have overcome their previous reluctance and have begun to increase their debt-equity ratio. One reason for the change in their behavior has been the fear of a hostile takeover if they do not increase the return to shareholders through greater leverage.<sup>61</sup>

High-yield debt is typically deeply subordinated to other creditor interests, so that it is senior (in bankruptcy priority) only to equity interests. In return for assuming greater risk than more senior bondholders, high-yield bondholders are promised significantly more interest than the interest on senior bonds. High-yield bonds raise debt-equity classification issues because deeply subordinated debt that bears a disproportionately high interest rate starts to look like preferred stock.<sup>62</sup>

David Hariton has observed that, in recent years, corporate tax practitioners have begun focusing more on the debt-equity distinction

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61. *Tax Policy Aspects of Mergers and Acquisitions: Hearings Before the House Comm. on Ways and Means*, 101st Cong., 1st Sess. 210 (1989) (statement of Martin Feldstein, Professor of Economics, Harvard University) [hereinafter *House Hearings on Mergers and Acquisitions*]. Mark Gergen and Paula Schmitz have also explored the reasons for the change in the level of corporate borrowing during the 1980s:

[W]hy did taxpaying corporations wait so long to issue zeros and discounted bonds . . . ? An answer from a vice-president at Salmon [sic] Brothers is that corporate treasurers tend to be conservative and chary of innovative securities, and that it took the extraordinarily high interest rates of the early 1980s, along with the unusual inverse shape of the yield curve (short-term rates exceeded long-term rates) to make the tax benefits of discounted debt sufficiently attractive to overcome this resistance. . . .

It appears that even in this favorable environment, discounted debt was hard to sell to issuers. The reluctance of CFOs to be the first issuer need not be ascribed to their being irrational. There are costs to innovation—from the issuer's perspective . . . , the fear of sending a falsely negative signal that one's corporation had cash flow problems, for until the early 1980s, only distressed corporations used discounted debt. . . .

Thus, psychological factors seem to explain best why publicly issued zeros were not marketed until 1981.

Mark P. Gergen & Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States*, 52 TAX L. REV. 119, 150-51 (1997) (footnotes omitted).

62. Congress demonstrated concerns about the debt-equity classification of high-yield bonds in the late 1980s and later amended I.R.C. § 163 to provide that corporate issuers cannot deduct a portion of the OID on certain high-yield bonds. See Omnibus Budget Reconciliation Act of 1989, 101 Pub. L. No. 239, 7202, 103 Stat. 2106 (1989) (amending I.R.C. § 163(e)(5) (commonly referred to as the HYDO rules because they apply to "applicable high yield discount obligations")). The House bill in 1989 would have gone further and reclassified certain high-yield bonds as preferred stock. See H.R. 3299, 101st Cong., § 11202 (1989). The House provision was dropped in the Conference Committee because of concerns about potential manipulation of the proposed rule. See Lee A. Sheppard, *Conference Committee Goes After the Junk Bond Junkies*, 45 TAX NOTES 1042 (1989).

as various other loopholes in the corporate tax have been eliminated.<sup>63</sup> In the last five years, investment banks have begun to fashion innovative types of traded securities that are treated like debt for tax purposes, but are treated like equity for accounting, regulatory, and credit rating purposes. These new financial products, which will be discussed later in this Part, further blur the debt-equity distinction in the context of public companies. Debt-equity classification has thus become a significant problem for public companies.

### C. *Why the Debt-Equity Distinction Makes Even Less Sense Now*

#### 1. Convergence of Public Company Stock and Debt

The traditional individualistic debtor-creditor model that was in vogue at the turn of the century viewed shareholders, but not creditors, as the owners of corporations. By the 1930s, ownership of public company stock and debt became more dispersed and stock and debt began to look more passive and contractual.<sup>64</sup> Around 1930, a new "investment" or "managerialist" theory of the firm grew out of the Legal Realist movement.<sup>65</sup> Prominent corporate legal theorists, such as Berle and Means, observed that there was a separation of ownership and

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63. See David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499 (1994).

[T]he distinction between debt and equity still is foremost in the practitioner's mind. Perhaps this is because the double taxation of corporate earnings that are distributed to individual investors as dividends remains the greatest anomaly in the U.S. tax system. As each escape hatch from imposition of corporate level tax is closed . . . , more pressure is placed on the few that remain . . . . And most importantly, there is no double taxation of corporate earnings that are distributed to investors as interest and principal on debt capital.

*Id.* at 499-500 (footnotes omitted).

64. During the early part of this century, states relaxed their statutory creditor protections, such as the so-called legal capital rules. Creditors of large corporations nonetheless expected their loans to be repaid, even if the loan was unsecured, because the large public companies seemed stable and permanent. See Bratton, *supra* note 34, at 108-09. "As creditors abandoned the ancient requirement of a tangible security, contract became feasible as the sole basis for long-term corporate debt. Debt became 'contractual' in legal theory . . . . Creditors [evolved] into passive investors holding strictly delimited rights and presenting no threat to management control." *Id.* at 109 (footnote omitted).

The nature of stock ownership was evolving at the same time. Ownership of stock "became widely dispersed as small investors joined the full-time capitalists as equity investors" in large public corporations. See Bratton, *supra* note 33, at 1492 (footnote omitted). Stock, like debt, began to look more "contractual" in nature. See *id.* at 1493.

65. See Bratton, *supra* note 33, at 1493.

control in large public companies; management, not the shareholders, controlled the corporation.<sup>66</sup>

As managers of large public corporations took control from the corporations' shareholders, the characteristics of debt and stock of large public corporations converged. Repayment of funds borrowed by a debtor corporation was guaranteed only if the corporate debtor continued and was successful in the future. The debtor's promise to pay a fixed amount in the future "in reality, amounted to a promise to 'refund' if the enterprise succeeded, and a basis for priority over equity-holders if the enterprise failed . . . . Thus linked to the business's fortunes, creditors became investors."<sup>67</sup> The investment theory treats debt and equity securities as similar forms of investment in the corporation differing "only in degree."<sup>68</sup>

The classical stockholder-entrepreneur has disappeared, and the creditor no longer appears as a refined and hostile opponent. More likely than not, the creditor is a bondholder—a single investor holding a piece of paper that gives no practical means of achieving corporate power.

In this conception, creditors are aligned with the stockholders in the antimanagementist vision of corporate power relationships. Both occupy a position resembling that of the weak party in a trust relationship; the managers possess the power. Carried to its logical conclusion, the conception questions why corporate law directs management fiduciary duties to equity interests only. Creditor protection in law follows as a practical possibility and a policy priority.<sup>69</sup>

Investment theory played a central role in federal legislation enacted during the 1930s, including the 1933 and 1938 bankruptcy acts, the 1933 and 1934 securities acts, and the Trust Indenture Act of 1939.<sup>70</sup> The investment theory did not supplant traditional debtor-

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66. See *id.* at 1494-95. "With the separation of ownership and control, the entrepreneurial drive assumed in classical economics had become split between management and capital. Management, the group controlling the means of production, was not motivated primarily by profit-seeking, but by drives for power, prestige, and job security." *Id.* at 1494 (footnote omitted). Consistent with the managerialist theory, "Berle and Means recognized that shares of stock no longer carried the traditional incidents of property ownership. They offered a substitute concept of shareholder/corporate relations built around intermediate securities markets. This was a contractual concept . . ." Shareholders did not actually control management. *Id.* at 1493 (footnotes omitted). On the bondholder side, Professor Warren had noted that "exclusion of debtholders from the corporate family has traditionally been defended on the basis of property law concepts of ownership. The application of those concepts to the modern corporation is at the least problematic." Warren, *supra* note 38, at 1589 (footnote omitted).

67. Bratton, *supra* note 34, at 114. The investment theorists advocated greater creditor protections. For example, they argued that corporate management had a fiduciary duty to both equity and debt. See *id.* at 115.

68. *Id.* at 113 (footnote omitted).

69. *Id.* at 115 (footnotes omitted).

70. See *id.* at 115-16. The two bankruptcy acts treated both bondholders and stockholders as owners of the corporation, with the bondholders having a more senior claim against the corporation's assets. See *id.* The two securities acts protected both bondholders and

creditor theory, however. Although the implications of the two theories are quite different, the conflicting theories coexist.<sup>71</sup>

In the last thirty years, yet another competing theory has emerged. This new agency theory, incorporating concepts from neo-classical microeconomic theory, assumes that microeconomic actors are rational and profit maximizing.<sup>72</sup> The corporate firm is conceptualized as a "nexus of contracts among factors of production."<sup>73</sup>

Suppliers of capital hire managers as their agents. Rational actors, who retain some freedom to pursue their own ends, tend to shirk on the job and behave in other opportunistic ways with respect to the capital invested . . . [I]nformation asymmetries prevent market self protection from curing all conflicts of interest. These failures of self protection give rise to "agency costs." Contracting can reduce these costs and increase a firm's value. Indeed, the contractual devices that make up complex capital structures exist to control agency costs.<sup>74</sup>

The agency model treats debt and equity as qualitatively similar.<sup>75</sup> Investors, both debtholders and shareholders, determine the

stockholders. *See id.* The Trust Indenture Act required that "debt contracts governing publicly issued bonds include certain procedural protections, most notably a prohibition against less-than-unanimous waivers of important contract rights." *Id.* at 116 (footnotes omitted).

71. *See id.* at 98 (describing the normative contradiction created by competing debtor-creditor models). Following World War II, the investment and traditional theories coexisted in practice, with corporate practitioners incorporating into their debt contracting process both adversarial and cooperative features. *See id.* at 117. The model indentures drafted by the corporate bar included provisions designed to reach consensus among potential adversaries. *See id.*

As adversity waned, bondholders also demanded less security. With the largest, most stable corporate borrowers, contract protections, even those following model forms, began to disappear from practice. Given these institutions' strength and their managers' clear interest in continued stability, these protections seemed superfluous. Thus, bonds conceived in theory to resemble stock, began to resemble it in practice. A bond without covenants, like a share of stock, is an investment made under loose legal guidelines that leave management discretion largely unimpaired.

*Id.* at 117 (footnotes omitted).

Courts, on the other hand, viewed the investment and traditional debtor-creditor theories as mutually exclusive theories. The Delaware courts, for example, held that corporate directors owe fiduciary duties to shareholders, but not to creditors such as bondholders, which is consistent with the traditional model. The Delaware courts treat bondholders as having only the rights enumerated in their contract, unless the corporation is insolvent or fraud was involved. *See id.* at 118-19 (citing authorities). *See also* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y., 1989) (denying protection to RJR Nabisco bondholders whose RJR Nabisco bonds lost value as a result of a leveraged buyout of RJR Nabisco that increased RJR Nabisco's aggregate debt from \$5 billion to \$24 billion and caused the bond rating agencies to downgrade the outstanding RJR Nabisco bonds).

72. *See* Bratton, *supra* note 34, at 122.

73. *Id.* at 125.

74. *Id.* at 126 (footnotes omitted).

75. *See id.* Both the investment model and agency model treat debt and equity as comparable. However, the investment model envisions the investor maintaining a relationship with the corporate issuer for a long period of time, whereas the agency model assumes that the "investor" may trade her investment in the market at any time. *See id.* at 130.

terms of their participation in the corporation by contract.<sup>76</sup> The logical extension of the contractual theory of corporations is that debt and equity should receive equivalent treatment since both are contractual suppliers of capital to the corporation.<sup>77</sup>

During the last century, stock and debt interests have evolved into similar financial instruments, but in corporate law, the individualistic traditional debtor-creditor model, the investment model, and the agency each wield influence, with the traditional debtor-creditor model still dominating state corporate law.<sup>78</sup> In the tax area, the traditional debtor-creditor model also dominates.<sup>79</sup> To this day, tax law compares a financial instrument to "pure debt" and "pure equity," in order to classify the instrument.<sup>80</sup> As Professor Polito has stated, "existing law is hopelessly flawed . . . [I]t pursues the nonexistent holy grail of a security's true nature as debt or equity."<sup>81</sup>

## 2. Financial Contract Innovation

The recent explosion in financial contract innovation has further highlighted the deficiencies of the debt-equity distinction. Until the early 1970s, the types of financial instruments typically used, such as stock, bonds, options,<sup>82</sup> and futures,<sup>83</sup> were limited.<sup>84</sup> Since that time,

76. *See id.* at 129 ("Equity loses its property-based identity with the firm; its participation is restated in contractual terms.") (footnote omitted).

77. In fact, the true logical extension of the theory is to treat all parties with whom the corporation contracts, including suppliers of capital (stockholders, bondholders, and noteholders), suppliers of labor, and suppliers of materials as "owners" of the corporation.

78. *See id.* at 121, 134-35.

79. *See id.* at 104.

80. I.R.C. § 385(a), as amended in 1989, grants to the Secretary of the Treasury the authority to issue debt-equity classification regulations that bifurcate an instrument into debt and equity components. Treasury to date has not utilized this grant of authority to issue final § 385 regulations that require bifurcation.

81. Polito, *supra* note 48, at 777 (1998). Said another way: "There is nothing more complex than trying to draw a line which does not exist." Plumb, *supra* note 51, at 619 (1971), (quoting Lanning, *Some Realities of Tax Reform*, 1 COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE (Comm. Print 1959)). William Plumb also captured the essence of the problem: "The fault, dear Brutus, is not in our definition but in our dichotomy." *Id.* at 619 (adapted from WILLIAM SHAKESPEARE, JULIUS CAESAR, Act I, scene ii).

82. An *option* gives the option buyer the right, but not the obligation, to buy or sell a specified asset for a price specified at the time the option contract is written for the period of time specified in the contract. *See* CHARLES W. SMITHSON, *MANAGING FINANCIAL RISK: A GUIDE TO DERIVATIVE PRODUCTS, FINANCIAL ENGINEERING, AND VALUE MAXIMIZATION* 190-91 (3d ed. 1998). An option is a *call* option if the option buyer has the right to buy the specified asset. An option is a *put* option if the option buyer has the right to sell the specified asset. The buyer of the option pays the party writing the option for the option. The price at which the specified asset will be bought or sold is referred to as the *exercise price* or the *strike price* of the option. *See id.* An *American option* may be exercised throughout the term of the option. A *European option* may be exercised only on the last day of the term of the option. *See id.*

there has been an explosive growth of hundreds of new financial products.<sup>85</sup> This period of rapid innovation resulted from a number of factors.<sup>86</sup> In part, the new financial products were created to help corporations manage increased economic risks that emerged in the early 1970s.<sup>87</sup> In part, the new instruments were created to take advantage of asymmetries in tax or other regulatory rules governing financial instruments.<sup>88</sup> Also, issuers discovered they could reduce their cost of capital by offering investors instruments that prepackaged features that investors otherwise would have had to assemble on their own.<sup>89</sup> Advances in finance theory gave investment banks the tools for engineering the new financial products.<sup>90</sup>

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83. "A futures contract obligates its owner to purchase a specified asset at a specified exercise price on the contract maturity date." *Id.* at 30.

84. *Id.* at 321, Figure 15-1. Smithson explains the history of futures contracts (dating back to the 17th century), forward contracts (dating back to the 12th century), options (dating back to the 18th century), and hybrid securities (with a Civil War example), and the rediscovery of them in the 1970s and 1980s. *Id.* at 23-25.

85. See Warren, *supra* note 19, at 460. For a timeline of the development of hybrid securities, see SMITHSON, *supra* note 82, at 321, Figure 15-1.

86. See Warren, *supra* note 19, at 460 and sources cited in note 1, including John D. Finnerty, *An Overview of Corporate Securities Innovation*, 4 CONTINENTAL BANK J. APPLIED CORP. FIN. 23 (1992), Robert C. Merton, *Financial Innovation and Economic Performance*, 4 CONTINENTAL BANK J. APPLIED CORP. FIN. 12 (1992), Merton H. Miller, *Financial Innovation: The Last Twenty Years and the Next*, 21 J. FIN. & QUANTITATIVE ANALYSIS 459 (1986). See also Gergen & Schmitz, *supra* note 61, at 126. David Hariton has observed:

A corporation's objectives in raising capital (apart from obtaining it at the lowest possible price), vary, and may include obtaining a favorable rating agency treatment, meeting a specified regulatory objective, getting a certain accounting treatment, matching anticipated payments with anticipated cash flows, hedging a perceived exposure to price or interest rate risk, reducing exposure to the operation of certain high-risk businesses, hedging against perceived cyclical risk in business operations, responding to a wide variety of U.S. tax rules, lowering foreign taxes, meeting foreign regulatory requirements, manipulating control of the company, altering the perceptions of market analysts and providing incentives to employees and management. Investors' objectives vary as well, for investors are equally likely to have regulatory objectives or constraints, tax and accounting considerations and views as to the direction of the market. Furthermore, the relevant regulatory, accounting or other rules are themselves in evolution and flux. Rights or obligations satisfy objectives today that they could not have satisfied in the recent past.

Hariton, *supra* note 63, at 501.

87. See SMITHSON, *supra* note 82, at 2-23. These increased risks included foreign currency rate risk, interest rate risk, and commodity price risk. *Id.* Smithson observes that corporations, when faced with increased risk, first tried unsuccessfully to forecast the future prices better, then turned to risk management tools that included derivatives. See *id.* at 28.

88. See *id.* at 352.

89. See *id.* at 351; see also Gergen & Schmitz, *supra* note 61, at 127-28, 145-49. Innovative financial products were sometimes "low-cost substitutes for more costly synthetic strategies." *Id.* at 128.

90. See Gergen & Schmitz, *supra* note 61, at 126. Over time, firms began to use derivatives more and more. The perception of derivatives gradually evolved in the corporate community. During the 1980s and early 1990s, innovative financial instruments were perceived as

The put-call parity theorem is one of the most important of these financial concepts. That theorem posits that stock, bonds, puts, and calls are each financial building blocks that can be used to construct synthetic financial instruments. Assume that the bond is a zero-coupon bond, meaning that it does not pay any interest until it matures. The face amount payable at maturity on the bond is  $E$ , so the bond is represented as the present value of  $E$ , or  $PV(E)$ .<sup>91</sup> The share of stock is referred to as  $S$ . The call option, referred to as  $C$ , is an option to buy  $S$ . The call option expires on the date the bond matures. The strike price of the call option is the face amount of the bond. The put option, referred to as  $P$ , is an option to sell  $S$ . The put option expires on the date the bond matures. The strike price of the put option is the face amount of the bond. Any three of the four building blocks can be used to construct the fourth synthetically. For example:  $PV(E) = S + P - C$ . In other words, a zero coupon bond can be synthesized by an investor by buying the stock and the put and selling the call.<sup>92</sup>

*Example 2:*

A one-year Public Co. bond will pay \$100 at the end of the year. The bond is a zero-coupon bond, meaning that the bond pays no stated interest. Public Co. is a very creditworthy borrower, so investors are willing to lend money to Public Co. at a yield that approximates the yield on U.S. Treasury bonds. If that yield equals six percent,  $PV(E)$  equals \$94.33.<sup>93</sup>

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hypertechnical or risky by many conservative corporate managers and so were shunned. Today, innovative financial products, including derivatives "have come to be recognized simply as a corporate finance tool . . . . Today, the question is not whether the firm will use derivatives, but is instead how these tools can be used." SMITHSON, *supra* note 82, at ix (emphasis omitted). For a discussion of the role of psychological factors in the corporate community's acceptance of innovative instruments, see Gergen & Schmitz, *supra* note 61, at 150-51.

91. The face amount payable at maturity can be discounted to present value using the formula:

$$PV = \frac{FV}{(1 + r)^n}$$

$PV$  is Present Value.

$FV$  is Future Value.

$r$  is the discount rate.

$n$  is the number of periods of discounting.

92. See Michael S. Knoll, *Financial Innovation, Tax Arbitrage, and Retrospective Taxation: The Problem with Passive Government Lending*, 52 TAX L. REV. 199, 203 (1997); see also Warren, *supra* note 19, at 465-467 (setting forth other examples of the put-call parity theorem).

93. The face amount payable at maturity, \$100, discounted at 6 percent, compounded annually for one period, produces a present value of \$94.33:

$$PV = \frac{FV}{(1 + r)^n}$$



Public Co. common stock, S, currently trades at \$95 per share. The call option to buy a share of Public Co. common stock, C, has a strike price equal to the face amount of the bond, \$100. The price of the call option is \$11.63, based on the Black-Scholes option pricing model.<sup>94</sup> The put option to sell a share of Public Co. common stock, P, also has a strike price equal to the face amount of the bond, \$100. The price of the put option is \$10.96, based on the Black-Scholes option pricing model.<sup>95</sup> Both the call and put options are European options. Both the call and put options expire in one year, on the date the bond matures.

$$\begin{aligned} \text{PV(E)} &= S + P - C \\ \$94.33 &= \$95 + 10.96 - 11.63 \\ \$94.33 &= \$94.33 \end{aligned}$$

Based on this theorem, standard financial instruments like stock and bonds can be disaggregated into their component parts. The parts can be sold separately or recombined into new kinds of financial instruments.<sup>96</sup>

A separate class of innovative financial products, called notional principal contracts or swaps, also permits corporations to reallocate risk. Notional principal contracts allow a party to transfer risk, such as interest rate risk, to a counterparty.<sup>97</sup> Parties to a notional principal contract agree to exchange streams of payments based on a fictitious "notional principal amount."<sup>98</sup>

$$\text{PV} = \frac{\$100}{(1 + .06)^1}$$

$$\text{PV} = \frac{\$100}{1.06}$$

$$\text{PV} = \$94.33$$

94. This option price was calculated using the Black-Scholes option pricing formula on the Bloomberg L.P. Option Valuation Screen. The Black-Scholes price for an option is based on the following variables: (1) the risk-free interest rate; (2) the expiration date of the option; (3) the price of the stock; (4) the strike price of the option; and (5) the volatility of the stock. See JOHN C. HULL, *OPTIONS, FUTURES, & OTHER DERIVATIVES* 250, (4th ed. 2000). The volatility of the stock was assumed to be 30 percent here.

95. See *id.*

96. See Warren, *supra* note 19, at 460. Securitization and stripping transactions involve the disaggregation of cash flows and sale of the constituent parts. See David A. Weisbach, *Tax Responses to Financial Contract Innovation*, 50 TAX L. REV. 487, 495 (1995).

97. See Warren, *supra* note 19, at 460-61.

98. Here is an example of an interest rate swap, which is one type of notional principal contract. X Corporation has outstanding \$60 million of debt. The debt bears a floating interest rate, such as LIBOR (the London Interbank Offered Rate). X Corporation wants to cap its annual interest payments at \$6 million (or 10 percent of its debt); it does not want to run the risk that the LIBOR rate might increase to a rate in excess of 10 percent. In order to limit its interest rate risk, X Corporation enters into an interest rate swap contract with a counterparty, Y. The contract obligates X Corporation to pay Y an annual amount equal to 10 percent of a \$60 million

The shortcomings of the debt-equity dichotomy, as well as other tax asymmetries, have been highlighted as a result of financial contract innovation. The tax law determines the tax consequences of a financial instrument by assigning the instrument to a tax "cubbyhole," such as debt or equity, each of which has its own set of known tax consequences.<sup>99</sup> The problem with financial contract innovation is that there is often no existing cubbyhole that fits the new instrument and it is difficult to determine which existing cubbyhole the new instrument should go into because the instrument has characteristics of more than one traditional instrument. Sometimes the placement of an instrument is uncertain. Even if the placement is certain, it sometimes winds up mismeasuring income and creating opportunities for tax arbitrage.<sup>100</sup>

Innovative financial products highlight the problems with several traditional distinctions in the tax law. For example, the realization requirement creates a distinction between assets that provide for a fixed return and assets that provide for a contingent return. The current tax system taxes the former on an accrual basis and the latter when the contingent return is realized.<sup>101</sup> It also distinguishes between gain from the sale of a capital asset and ordinary income,<sup>102</sup> and between foreign source income and U.S. source income. As explained earlier, it also distinguishes between debt and equity.<sup>103</sup>

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notional principal amount. (The notional principal amount is not actually loaned. It is simply used to determine each party's payment obligation to the other party.) Y is obligated to pay X Corporation the floating LIBOR rate on the \$60 million notional principal amount. In year one, X Corporation pays \$7 million of interest on its outstanding debt, based on the LIBOR rate. Under the notional principal contract between X Corporation and Y, X Corporation is obligated to pay Y \$6 million and Y is obligated to pay X Corporation \$7 million. The payments are netted and Y pays X Corporation \$1 million. X Corporation's actual interest cost is \$6 million (\$7 million X Corporation paid the debtholders less \$1 million X Corporation received from Y). By entering into the notional principal contract, X Corporation has locked in a fixed 10 percent interest cost. What would have happened if, in year one, X Corporation had owed its debtholders \$5 million of interest based on the floating LIBOR rate? Under the notional principal contract between X Corporation and Y, X Corporation would have been obligated to pay Y \$6 million and Y would have been obligated to pay X Corporation \$5 million. The payments would have been netted and X Corporation would have owed Y \$1 million. X Corporation's actual interest cost would still have been \$6 million (\$5 million X Corporation paid the debtholders plus \$1 million X Corporation owed Y).

99. See Edward D. Klienbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1320 (1991).

100. See Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX L. REV. 571, 575-77 (1995).

101. See Warren, *supra* note 19, at 460 (citing I.R.C. §§ 1001, 1272, 1273 (1994)).

102. See *id.* at 461.

103. Commentators have struggled with the issue of how the income tax system should respond to the proliferation of new financial products. Professor Strnad has described four possible approaches to dealing with innovative financial instruments: bifurcation, integration,

Derivatives (also known as hybrid securities) deliberately blend debt and equity features, often for legitimate business reasons.<sup>104</sup> The cubbyhole approach requires that these instruments be labeled as debt or equity.<sup>105</sup> Although Congress enacted § 385<sup>106</sup> to address the debt-

local pattern taxation, and global pattern taxation. See Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569, 570 (1994). Bifurcation splits a financial instrument into its component parts, each of which has a known tax treatment. See *id.* at 570-71. (Deconstruction or decomposition might be more accurate terms, since the instrument may have more than two component parts, but the term bifurcation seems to be the term most often used.) Integration aggregates financial instruments and taxes the aggregate cash flow based on its "predominant characteristic." See *id.* at 571 (citing Randall K.C. Kau, *Carving Up Assets and Liabilities—Integration or Bifurcation of Financial Products*, 63 TAXES 1003, 1007-10 (1990)). Local pattern taxation "applies a single generic set of rules [including timing, characterization, and source rules] to all new financial products." See *id.* Global pattern taxation "applies a single generic treatment [e.g., cash flow taxation or accretion taxation] to all instruments." *Id.* at 572.

Commentators have generally focused on the bifurcation and integration approaches. Commentators have generally criticized the bifurcation approach although a minority of commentators support it. For example, Hariton, Kau, and Kleinbard have all criticized the bifurcation approach. See David P. Hariton, *New Rules Bifurcating Contingent Debt—A Mistake?*, 51 TAX NOTES 235, 235 (1991); Kau, *supra*, at 1003, and Edward D. Kleinbard, *Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System*, 67 TAXES 943, 952-53 (1989). On the other hand, Professors Lokken and Weisbach have argued for the bifurcation approach. See Lawrence Lokken, *New Rules Bifurcating Contingent Debt—A Good Start*, 51 TAX NOTES 495 (Apr. 29, 1991); Weisbach, *supra* note 96, at 539. Professor Strnad makes the point that bifurcation and integration are interdependent in second-best setting, so it is not clear that bifurcation alone could be used to resolve the problems caused by innovative financial contracts. See Jeff Strnad, *Taxing New Financial Products in a Second-Best World: Bifurcation and Integration*, 50 TAX L. REV. 545, 553 (1994) [hereinafter Strnad, *Bifurcation and Integration*].

104. See BITTKER & EUSTICE, *supra* note 9, ¶ 4.03[1], at 4-21:

As lenders have contemplated inflation and the growth in the value of real estate and some other equities, they have increasingly sought to share in the earnings and appreciation that historically inured exclusively to the benefit of the borrower's shareholders. Conversely, even in a high-risk financial environment, some entrepreneurial investors have attempted to cut their exposure by bargaining for some of the protections that have traditionally been the hallmarks of the lender. To satisfy these conflicting appetites for risk and security, financial planners have devised a bewildering variety of fence-straddling securities (a/k/a innovative financial products) that, although by no means innocent of tax motivations, seek to meet genuine business objectives achievable only by abandoning the historic distinction between the terms 'pure debt' and 'pure equity.'

*Id.*

105. Note that the case law debt-equity classification factors were typically litigated in cases involving closely held corporations, where the "debt" at issue was held by shareholders in proportion to their stock ownership. See BITTKER & EUSTICE, *supra* note 9, ¶ 4.03[2], at 4-22. I.R.C. § 385(a), as amended in 1989, grants Treasury the authority to issue debt-equity classification regulations that bifurcate an instrument into debt and equity components. Treasury to date has not utilized this grant of authority to issue final § 385 regulations that require bifurcation. For a discussion of various Clinton administration proposals that did and did not get enacted, including certain provisions that in effect treat the security as "neither fish nor fowl," with the "worst-of-both-worlds" tax consequences, see BITTKER & EUSTICE, *supra* note 9, ¶ 4.02, 4.03, 4-31, 4-36.

equity classification issue, § 385 does not actually define debt and equity. Instead, § 385 delegates to the Secretary of the Treasury the authority to issue regulations that would distinguish between debt or equity.<sup>107</sup> Section 385 provides that the regulations should set forth classification factors, including five listed factors.<sup>108</sup> Treasury labored on the § 385 regulations for a decade before they were issued in 1980.<sup>109</sup>

The § 385 regulations shifted the approach to the classification of debt and equity. The traditional case law approach characterized the instrument based on the relationship between the issuer and the holder of the instrument. The cases looked to all the facts and circumstances to determine whether the relationship was a debtor-creditor relationship or a corporation-shareholder relationship. The approach in the § 385 regulations characterized the instrument, in part, based on the factors that determined the amount of the payments under the instrument.<sup>110</sup> Under that approach, an instrument might be charac-

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106. See Tax Reform Act of 1969, Pub. L. No. 91-172, § 415(a), 83 Stat. 487, 613 (1969), reprinted in 1969-3 C.B. 10, 83-84.

107. See I.R.C. § 385(a) (1994). As Bittker, Eustice, and Cummings have colorfully stated, "[h]aving dropped the hot potato in 1954, Congress decided in 1969 to pass it on to the Treasury." BITTKER & EUSTICE, *supra* note 9, ¶ 4.02[8][a], at 4-18.

108. The five factors are: (1) whether there is a written unconditional promise to pay on demand or on a specified date a fixed amount in exchange for adequate consideration, and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the issuing corporation's debt-equity ratio; (4) whether the instrument is convertible into stock of the issuing corporation; and (5) the relationship between holdings of stock of the issuing corporation and the instrument to be classified. See I.R.C. § 385(b) (1994).

109. Proposed regulations were issued in 1980. Notice of Proposed Rulemaking, 45 Fed. Reg. 18,957 (1980). After hearings, the regulations were made final in 1981, but the effective date of those regulations was repeatedly postponed. T.D. 7747, 1981-1 C.B. 141; T.D. 7774, 1981-1 C.B. 168; T.D. 7801, 1982-1 C.B. 60; Notice of Proposed Rulemaking, 1982-1 C.B. 531; T.D. 7822, 1982-2 C.B. 84.

110. See David P. Hariton, *The Taxation of Complex Financial Instruments*, 43 TAX L. REV. 731, 771, 778 (1988). For the classification of publicly issued instruments, the regulations focused on two factors: first, the factors that determined the amount that would be paid under the instrument, and, second, the holder's right to compel the payments. The regulations provided that an instrument would be classified as debt if the present value of its "debt features" at least equaled 50% of the instrument's issue price. See Treas. Reg. § 1.385-5(a) (1981). A payment provided for in the obligation was a "debt feature" if (1) the amount of the payment was "definitely ascertainable," and (2) "the holder's right to receive it could not be impaired." Treas. Reg. § 1.385-5(d)(3), (4) (1981). A payment was "definitely ascertainable" if it (1) was fixed, or (2) was variable but not within the issuer's control or tied to the success of the issuer's business. Treas. Reg. § 1.385-5(d)(4)(I)(B) (1981). A holder's right to receive payment could not be "impaired" if the holder had the right to compel the payment even in the face of insufficient earnings and profits or insolvency. Treas. Reg. § 1.385-10(1981). Hariton noted:

This broad definition of when a holder's right to receive a payment could be impaired placed a substantial emphasis on creditor's rights. In fact, the emphasis on creditor's rights sometimes overshadowed the emphasis on the factors which determined the amount of the payments. Thus, a conventional 20-year debt obligation with annual payments floating at 3% above LIBOR was treated as equity if it did not

terized as equity if the amount of the payments due under the instrument depended on the trading price of the issuer's stock, the dividends the issuer paid, or the issuer's profits.

Just before the § 385 regulations were to take effect, the Borg Warner Corporation issued a type of instrument referred to as an adjustable rate convertible note (ARC�N).<sup>111</sup> The ARC�Ns were engineered to be classified as debt under the proposed § 385 regulations, despite the fact that the ARC�Ns also possessed certain equity characteristics.<sup>112</sup> The Internal Revenue Service (the "Service") responded by issuing Revenue Ruling 83-98,<sup>113</sup> in which it took the position that the ARC�Ns were equity, not debt, because there was no debtor-creditor relationship between the issuer and the holders of the ARC�Ns. The rationale of the ruling was that the instrument was not designed so that the amount payable at maturity on the debt would actually be paid. Instead, specifying the amount payable at maturity just ensured that the debt instrument would be converted into equity<sup>114</sup> or provided a floor that would be utilized only if the stock price dropped by more than 40 percent. The Ruling did not mention the § 385 regulations or the factors that determined the amount to be paid under the instruments, although the returns on the ARC�N's tracked the returns on the

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permit the holder to force the issuer into bankruptcy in the event of insolvency, and a share of perpetual preferred stock (*i.e.*, stock with no maturity date or other right of redemption) was treated as debt if the holder had a right to compel the payment of accrued dividends, notwithstanding insolvency.

*Id.* at 778 (footnote omitted).

111. *See id.* The following discussion of Revenue Ruling 83-92 is primarily based on Hariton's discussion of the ruling.

112. At the time the ARC�Ns were issued, Borg Warner common stock traded for about \$38 a share. The stock typically paid dividends of around \$1.52 per share per year. The ARC�Ns were issued for \$1,000 each and were convertible into about 26 shares of the Borg Warner common stock. (At the time the ARC�Ns were issued, \$1,000 equaled the fair market value of about 26 shares of the Borg-Warner common.) Each year the ARC�N was outstanding, the holder of the ARC�N was entitled to receive minimum annual interest of 4.95 percent until 1986 and 6.84 percent from 1987 until the ARC�N matured in 2002. In the alternative, the holder could be paid the sum of (1) \$7.36 of annual interest, plus (2) the annual dividends payable on 26 shares of Borg-Warner common stock, which was \$40 at the time the ARC�Ns were issued. If this latter sum exceeded the minimum interest due, the ARC�N holder was entitled to receive the latter sum. At maturity, the holder would also be paid \$550 if the holder had not yet converted the ARC�N into Borg Warner common stock. *See id.* at 778-79 & nn.149-52 (citing the Borg Warner Corp. Prospectus (Dec. 2, 1982)). The ARC�Ns would have been classified as debt under the § 385 regulations because the present value of the ARC�Ns' "debt features" at least equaled 50 percent of the ARC�Ns' issue price.

113. 1983-2 C.B. 40.

114. David Hariton criticized that rationale, arguing that "most convertible debt obligations are likely to be converted into common stock." Hariton, *supra* note 110, at 779. "If the ARC�Ns were equity rather than debt, it is not because they were convertible into the issuer's stock but rather because the amount of the payments under the instrument mimicked the returns on the issuer's common stock." *Id.* at 779-80.

Borg-Warner common stock, which would have been a factor in favor of equity classification.

Treasury subsequently withdrew the § 385 regulations.<sup>115</sup> The withdrawal of the § 385 regulations signaled a return to the traditional approach in the case law. The traditional factors in the case law look to risk-based ownership notions: Equity owns the corporation because it participates in the risk of the venture. Debt does not participate in the risk of the venture so is outside the corporation. David Hariton has noted:

The species of financial instruments began to mutate in the 1980s, as capital markets developed high yield debt, zero coupon debt, hybrid debt, floating rate debt, money-market preferred and liquid yield option notes. With the proliferation of derivative transactions in the 1990s, however, distinguishing between equity and debt has become especially difficult. In exchange for capital, corporations can offer investors any set of rights that can be described by words, subject to any conceivable set of qualifications, and in consideration of any conceivable set of offsetting obligations. In doing so, corporations do not have a specific objective to attract "shareholders," "creditors" or something in between. Nor do they have an intention that can be identified as such, such as to permit investors to embark upon the corporate venture or to permit investors to avoid taking risk.<sup>116</sup>

Said another way, using risk-based rules for classifying debt and equity makes even less sense now than it did at the beginning of the century because financial contract innovation permits the construction of synthetic corporate securities that slice and dice and re-allocate risk.<sup>117</sup>

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115. T.D. 7920, 1983-2 C.B. 69. For other descriptions of the § 385 regulations, see Polito, *supra* note 48, at 785-790; Ceryak, *supra* note 54, at 281; and Emmerich, *supra* note 37, at 118.

116. Hariton, *supra* note 63, at 500-01 (footnotes omitted). Hariton's thesis is that, if we must try to classify debt and equity according to risk-based ownership principals, we cannot classify instruments based on static factors; instead, we must classify the instrument based on how the instrument in question fits into the issuer's overall capital structure. He explains:

The real question, then, is not how many debt characteristics does the instrument possess, but rather to what extent does the instrument insulate the investor from the risks and rewards of the issuer's business. . . . The question only has meaning in the context of the relationships among various classes of investors in the corporate enterprise. . . . [O]ne must consider the rights conferred by other investments in the capital of the issuer, what other capital exists to support the issuer's obligations and what other obligations must be met by the issuer first.

Therefore, it is not possible to characterize an instrument as equity or debt by reference to a checklist of abstract attributes that equity or debt supposedly possesses; the relationships among different classes of investors will not always be on the checklist. The only way to shed light on these relationships is to ask such questions as: (1) How much equity capital supports the investor's rights? (2) How much debt capital is senior to it? (3) To what extent will the investor participate in the issuer's profits? and (4) What rights, if any, will the equity still have if the lender loses money? The factors in [Notice 94-47] and under case law are useful only insofar as they speak to these questions.

*Id.* at 522.

117. Professor Shaviro argues that we should abandon the debt-equity distinction:

Professor Gergen argues that the tax problems created by financial contract innovation have been overstated because transactions that work in theory are expensive or impossible to implement in the real world.<sup>118</sup> The theoretical possibilities created by the put-call parity theorem work only if long-term options on the underlying stock are readily available, because the term of the option must coincide with the term of the bond. Gergen notes that publicly traded long-term options are not readily available and creating substitutes for such long-term options is costly.<sup>119</sup>

On the other hand, the risk-based distinction between stock and debt may be outmoded, even if financial contract innovation works better in theory than in practice, because there is evidence that investors are no longer demanding a significant "risk premium" to invest in stock. Average stock returns have historically exceeded average bond returns.<sup>120</sup> The extra return on stock is sometimes referred to as a "risk premium." Investors historically have demanded a higher return on stock because owning stock is viewed as riskier than owning bonds; the notion is that returns on stocks are uncertain and volatile, whereas returns on bonds are fixed and stable.

The risk premium has historically averaged about 3.5 percent.<sup>121</sup> Recently, the risk premium has virtually disappeared.<sup>122</sup> Said another way, investors are investing at lower levels of equity returns. Although the press has decried the elimination of the risk premium as evidence of the irrationality of investors,<sup>123</sup> a few commentators have

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[T]he effort to subject stock and debt . . . to different tax regimes, under the assumption that, in at least some cases, investors' risk preferences will determine their tax positions, is seriously compromised if, by using such devices as options and offsetting positions, investors can construct any type of ownership interest synthetically, without needing to declare explicitly what risk position they really hold in the aggregate.

Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643, 652 (1995). Professor Shaviro's larger point is that, in light of the ability to slice and dice, reallocate, and repackage risk, relying on risk-based rules in our tax system is increasingly problematic. *See id.* at 724. Other commentators have made similar arguments. *See, e.g., id.* at 643 n.1.

118. *See* Mark P. Gergen, *Apocalypse Not?*, 50 TAX L. REV. 833, 841 (1995).

119. *See id.*

120. *See* James K. Glassman & Kevin A. Hassett, *Are Stocks Overvalued? Not a Chance*, WALL ST. J., Mar. 30, 1998, at A18.

121. *See* JOHN C. BOGLE, COMMON SENSE ON MUTUAL FUNDS 440 (1999).

122. *See* Jeremy J. Siegel, *Are Stocks Underpriced? Well, Not Quite.*, WALL ST. J., Apr. 14, 1998, at A23.

123. *See* James K. Glassman & Kevin A. Hassett, *Dow 36,000*, THE ATLANTIC MONTHLY, Sept. 1999, at 37, 38. In December, 1996, Federal Reserve Chairman Alan Greenspan spooked the financial markets by asking the following question in a speech: "How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions . . . ?" Floyd Norris, *Greenspan Asks a Question and Global Markets Wobble*, N.Y. TIMES, Dec. 7, 1996 (Saturday late ed., final), sec. 1, p. 1.

defended the reduction in the risk premium on the grounds that, in the long run, stocks are not riskier than bonds.<sup>124</sup>

In the short run, stocks are riskier than bonds. In the last two centuries, the worst annual inflation-adjusted return for the stock market was -38.6 percent. In other words, a \$100 investment made at the beginning of the year was worth only \$61.40 at the end of the year. The best annual inflation-adjusted return for the stock market was 66.6 percent. In other words, a \$100 investment made at the beginning of the year was worth \$166.60 at the end of the year.<sup>125</sup> These are large swings. In addition, the odds of losing money in the stock market in a given year are more than one in four.<sup>126</sup>

In the long run, however, stocks are less risky than bonds. The worst average annual return over a 30-year period was 2.6 percent. In other words, a \$100 investment made at the beginning of the 30-year period would have been worth \$215.98 at the end of the 30-year period.<sup>127</sup> In the long-run, investment in stock is even less risky than investment in short-term Treasury bonds or bills:

If you keep your money at work for more than twenty years, stocks are actually safer than short-term T-bills rolled over annually.

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124. See Glassman & Hassett, *supra* note 123, at 37, 38; Siegel, *supra* note 122, at A23.

125. See Glassman & Hassett, *supra* note 123, at 39.

126. See *id.*

127. See *id.* at 39. Glassman and Hassett illustrate the relationship between the riskiness of stock and the period of time over which an investment in stock is held:

Over a one-year period the standard deviation for stocks is 18 percent. This means that in two out of three years the return on a stock will vary by no more than 18 percentage points from the average—in either direction. Since the average real return is about seven percent, returns should vary two thirds of the time between 25 percent and -11 percent. That's very risky. But over ten-year holding periods the standard deviation drops to five percentage points. Over thirty-year periods it drops to about two percentage points—meaning that two thirds of the time the range is five to nine percent. That's not risky at all.

*Id.* at 40. Glassman and Hassett have made a controversial argument that “[s]tocks are . . . in the middle of a one-time-only rise to much higher ground—to the neighborhood of 36,000 for the Dow Jones Industrial Average.” *Id.* at 37. Glassman and Hassett made a less extreme claim earlier in the Wall Street Journal. See Glassman & Hassett, *supra* note 120, at A18. Professor Jeremy Siegel responded, taking issue with Glassman and Hassett’s assumptions about growth in per-share cash flows. See Siegel, *supra* note 122, at A23. Glassman and Hassett had assumed that per-share cash flows would grow at the same rate as the overall economy, plus inflation. See *id.* Siegel argued that Glassman and Hassett had failed to take into account the need to make additional future investments to fuel that future earnings growth; the future investment would have to be financed with retained earnings or new stock or debt, which would reduce per-share cash flows. See *id.* Siegel therefore concluded that “it is wrong to say that stocks are underpriced at current levels.” *Id.* Siegel agrees, however, that investors “are bidding up share prices so that there will be little premium return on stocks over bonds.” *Id.* Siegel notes that “there are favorable factors facing the stock market today that are unprecedented. These include extremely low inflation, high employment, and an international economy that positions American firms for outstanding growth.” *Id.*



Over a twenty-year period the worst inflation-adjusted return by stocks was an annual average of 1.0 percent. For bonds, however, the worst was -3.1 percent, and for T-bills -3.0 percent. Over one-year periods stocks have outperformed bonds only 61 percent of the time, but stocks beat bonds 92 percent of the time over twenty-year periods and 99 percent of the time over thirty-year periods.<sup>128</sup>

The risk-based debt-equity distinction does not make sense in an environment in which investors are willing to invest in stock with no significant risk premium.

Edward Kleinbard has also observed, that, since issuers often hedge interest rate risk, the nominal interest accrued on corporate debt may be a poor measure of the issuer's cost of debt capital.<sup>129</sup> In 1989, Kleinbard issued a warning:

As applied to corporate issuers, current tax law also places enormous stress on whether a particular capital market instrument is deductible debt or nondeductible equity, again without regard to the overall economic result achieved by that instrument in the context of the issuer's other positions. As the equity derivative product marketplace matures, corporate issuers can be expected to use those products more frequently, not only to manage their cost of equity capital but also to seek to convert nondeductible equity expenses into deductible derivative payments.<sup>130</sup>

Kleinbard was prescient. In the last five years, issuers have begun to issue a class of securities that the press has dubbed "tax deductible preferred stock."<sup>131</sup> This class of securities includes Monthly Income Preferred Shares (MIPS) and the progeny of MIPS.<sup>132</sup> These types of securities are treated like debt for federal tax purposes, but are treated like equity for accounting, credit rating, and bank regulation purposes.<sup>133</sup>

128. *Id.*

129. Kleinbard, *supra* note 103, at 946. He observes that, although we calculate the issuer's bond interest deduction using the relatively sophisticated economic accrual concepts of the OID rules (I.R.C. §§ 1272-74), the issuer's interest cost may have been swapped to a counterparty in a notional principal contract, in which case the interest on the issuer's nominal debt is not actually the issuer's cost of debt capital. *See id.* at 953. We nonetheless permit the issuer to deduct the interest on the issuer's nominal debt. *See id.*

130. Kleinbard, *supra* note 99, at 1363.

131. *See* Gergen & Schmitz, *supra* note 61, at 132.

132. The progeny of MIPS include Quarterly Income Capital Securities (QICs), Quarterly Income Debt Securities (QUIDs), Preferred Capital Securities, Trust Originated Preferred Securities (TOPrS), and Trust Preferred Stock (TRUPS). These instruments are explained in Gergen & Schmitz, *supra* note 61, at 134 n.58.

133. *See id.* at 132, nn.56, 126. Technically, the rating agencies do not actually classify MIPS as debt or equity; the rating agencies instead give partial equity credit for MIPS. *See* Gergen & Schmitz, *supra* note 61, at 132 n.56; Hariton, *supra* note 63, at 518. The discussion of MIPS that follows in the text is based on the discussion of MIPS in Gergen & Schmitz, *supra* note 61, at 153, and Hariton, *supra* note 63, at 517.

In a typical MIPS transaction (simplifying somewhat), a corporation creates a new entity.<sup>134</sup> The new entity issues preferred interests to investors. The new entity then lends the corporate parent the proceeds from the sale of the preferred interests and the funds the corporate parent invested in the new entity. The loan to the corporate parent is subordinated and has a 30-year term with a possible 20-year extension of the loan. The corporate parent pays the entity interest, which the entity then distributes to the holders of the preferred interests. The note agreement permits the corporate parent to defer the payment of interest for up to five years. The corporate issuer deducts the interest on the note.

In 1994, Treasury issued a ruling and two notices that the legal and investment communities interpreted as "blessing" MIPS.<sup>135</sup> A large volume of MIPS and MIPS progeny have subsequently been issued.<sup>136</sup> Some of the MIPS progeny have eliminated the new entity in the MIPS structure. In these transactions, the corporate borrower directly issues the long-term subordinated debt with an interest deferral provision to investors.<sup>137</sup> These types of tax deductible preferred stock permit the corporate issuer to deduct distributions to investors, while providing some of the flexibility of actual preferred stock. At the same time, these instruments receive beneficial accounting, regulatory, and rating agency treatment.

As the foregoing discussion of financial contract innovation has illustrated, it has grown increasingly difficult to distinguish between the stock and debt of public companies. The debt-equity distinction causes numerous problems including complexity, uncertainty, and opportunities for tax arbitrage. Tax lawyers devote significant time to camouflaging equity-like instruments to resemble debt for tax purposes.<sup>138</sup> Uncertainty about the tax consequences of innovative debt-equity hybrid securities inhibits the creation and sale of such

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134. In the original transaction, the entity was an off-shore Turks and Caicos Islands company, which was treated as a partnership for tax purposes. Gergen & Schmitz, *supra* note 61, at 153, n.125; Hariton, *supra* note 63, at 519. The SEC subsequently issued a no-action letter that alleviated regulatory concerns about using on-shore limited liability companies and limited partnerships MIPS transaction. *See id.* at 134 n.58. *See also* Hariton, *supra* note 63, at 518-19.

135. *See* Gergen & Schmitz, *supra* note 61, at 156 n.139 (citing and explaining Rev. Rul. 94-28, 1994-1 C.B. 86, Notice 94-47, 1994-1 C.B. 357, and Notice 94-48, 1994-1 C.B. 357). Notice 94-48 reiterated the traditional multifactor caselaw debt-equity classification test, listing eight factors to be considered, among others. *See* 1994-1 C.B. at 357. The Notice states, however, that two equity features are "of particular interest:" (1) an unreasonably long maturity, and (2) the ability to repay the principal on the note with the corporate parent's stock. *Id.* David Hariton analyzes the Notice in detail and criticizes its approach. *See* Hariton, *supra* note 63, at 513-24.

136. *See* Gergen & Schmitz, *supra* note 61, at 135 (Chart 1) & n.56.

137. *See id.* at 155 (describing QUIDs); Hariton, *supra* note 63, at 520.

138. *See, e.g.,* Bulow et al., *supra* note 58, at 146.

securities.<sup>139</sup> The inconsistent tax treatment of equivalent cash flows with different labels permits taxpayers to reap tax profits from paper transactions that otherwise produce no economic gain or loss.<sup>140</sup> The debt-equity distinction thus distorts behavior.<sup>141</sup>

### 3. Additional Inefficiencies

The debt-equity distinction causes inefficiencies in addition to those described above in connection with financial contract innovation. First, allowing a corporation to deduct interest but not dividends encourages corporations to overuse debt in their capital structures. (This problem is sometimes referred to as "overleveraging.") Second, the corporate interest deduction creates an inefficiency because it discourages investment in high growth businesses.

The greater the amount of debt in a corporation's capital structure, the greater the risk that the corporation will experience financial distress during recessions.<sup>142</sup> Financial distress is costly to the failing

139. See Gergen & Schmitz, *supra* note 61, at 157-63.

140. See Knoll, *supra* note 92, at 203-05. Knoll includes an example of a taxpayer issuing a bond and using the bond proceeds to (1) buy a share of stock, (2) buy a put option on the share of stock that matures on the date the bond matures and has a strike price equal to the face amount of the bond, and (3) sell a call option on the share of stock that matures on the date the bond matures and has a strike price equal to the face amount of the bond. *See id.* The interest on the bond is deductible against ordinary income, which is taxed at a maximum rate of 39.6 percent. *See id.* The gain from the stock-put-call portfolio is taxed at the preferential capital gains rate of 28 percent. *See id.* The transaction produces no economic gain or loss. (Under the put-call parity theorem, the cash flows from buying the bond will equal the cash flows from buying the stock and put and selling the call.) The transaction produces a tax profit of 11.6 percent because the interest is deductible at the 39.6 percent rate and the gain is taxed at the 28 percent rate. *See id.* Professor Knoll states: "Thus, the arbitrage possibility is a 'money machine,' generating cash for the trouble of shuffling papers." *Id.* at 205.

141. Edward Kleinbard also argues that inconsistent tax treatment of innovative financial contracts sometimes renders them ineffective as risk-management tools:

Corporate issuers have been substantial users of derivative interest rate financial products (such as interest rate swaps), primarily as devices to hedge or otherwise manage their liabilities. Issuers increasingly find, however, that many sophisticated liability strategies currently being developed, while appearing very elegant on a pretax basis, simply cannot be implemented once tax costs are taken into account, because the instrument-by-instrument approach required by current law leads to a wide variety of anomalous (and expensive) results.

Kleinbard, *supra* note 99, at 1363 (footnote omitted).

142. In this context, financial distress means difficulty paying debts as they come due. Dividends do not have to be paid until the corporation's board of directors approves the payment of the dividend. The board of a corporation can defer the payment of dividends during recessions. Interest due on corporate debt is owed regardless of whether there is a recession. The more debt in the corporation's capital structure, the greater the fixed obligations of the corporation and the greater the likelihood that the corporation will not be able to pay its debts as they come due during recessions. Numerous economic commentators have decried the decapitalization of United States corporations. *See, e.g.,* Kaufman, *supra* note 59, at 23; Henry

business. The costs of distress include both direct costs and indirect costs. The direct costs are the costs of being in bankruptcy.<sup>143</sup> The indirect costs include: (1) the increased cost of obtaining ongoing debt financing;<sup>144</sup> (2) the costs associated with operational constraints that the distress places on the corporation;<sup>145</sup> (3) the costs associated with management adopting risky projects that would disproportionately benefit equity or forgoing potentially profitable projects that would disproportionately benefit debtholders;<sup>146</sup> and (4) the costs associated with disruption in the corporation's relationships with employees, customers, and suppliers.<sup>147</sup> Studies of the indirect costs of bankruptcy indicate that the indirect costs of the sampled firms were significantly greater than the direct costs.<sup>148</sup>

Overleveraging can also have harmful macroeconomic effects. The failing businesses' failures to make interest payments may cause a domino effect in the economy, as creditors of the failing businesses in turn find themselves unable to service their debt. On a macroeconomic level, the increased economic vulnerability to recessions in-

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Kaufman, *Debt: The Threat to Economic and Financial Stability in DEBT, FINANCIAL STABILITY, AND PUBLIC POLICY: A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY* (Jackson Hole, Wyoming, Aug. 27-29, 1986). In his 1989 article, Kaufman notes:

During the latest economic cycle, the debt of U.S. nonfinancial corporations has gone up by an estimated \$840 billion while their equity position has contracted by nearly \$300 billion. That translates into a 15.4 percent annual growth rate in debt, compared with an average annual increase of only 8.4 percent for the previous six cycles of economic growth. In the process, interest payments by these companies have swelled to 26 percent of internal cash flow, and all-time high. And the explosion in leverage has caused a severe drop in [the credit ratings of U.S. companies].

Kaufman, *supra* note 59, at 23.

143. Estimates of the magnitude of these direct costs vary. For corporations with assets of \$100 million or more, the direct costs may be in the neighborhood of three percent of the asset value of the corporation. The direct costs for smaller corporations may be a higher percentage of asset value. See Michael S. Knoll, *Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking*, 38 VILL. L. REV. 1461, 1476, (1993) (citing Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority Claims*, 27 J. FIN. ECON. 285, 288-90 (1990) and Michelle J. White, *Bankruptcy Costs and the New Bankruptcy Code*, 38 J. FIN. 477, 486-87 (1983)).

144. See STAFF OF THE JOINT COMM. ON TAXATION, 101ST CONG., 1ST SESS., *FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES* 54, 70 (Comm. Print 1989) [hereinafter *CORPORATE FINANCIAL STRUCTURES*].

145. See *id.*

146. See Knoll, *supra* note 143, at 1477-79. The former problem is referred to as the asset substitution problem and the latter is referred to as the underinvestment problem. Knoll gives an example of each type of problem. See *id.* nn.77, 79.

147. See *id.* at 1479-80.

148. See, e.g., Edward Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1076-83 (1984). Knoll notes that it is difficult to measure indirect costs of distress. See Knoll, *supra* note 143, at 1476; see also *CORPORATE FINANCIAL STRUCTURES*, *supra* note 144, at 70.

cident to overleveraging may pressure the Federal Reserve to adopt defensive expansionist policies that may increase inflation.<sup>149</sup>

The problems associated with overleveraging are partially offset for various reasons. For example, the corporate level tax advantages of using debt in the capital structure are offset to some degree because of investor level tax consequences. Corporate capital structures are influenced both by the corporate tax and the investor level tax on the corporation's debt and equity.<sup>150</sup> Debtholders include interest income when it is paid or accrued. The interest income is taxed at ordinary income rates unless, as is often the case, the debtholder is tax-exempt. Shareholders include dividends in income when the dividends are paid. The dividends are taxed at ordinary income rates. If some of the corporation's earnings are not distributed, the shareholder is not currently taxed on those earnings. Those earnings are taxed, instead, when the shareholder sells the stock, the value of which has increased to reflect the shareholder's share of the undistributed earnings. In other words, the shareholder benefits from the deferral of the tax liability on those earnings.<sup>151</sup> In addition, the gain from the sale of the stock qualifies for preferential capital gains rates.

The long-run effect of the differing investor level tax consequences of debt and equity is that high bracket taxpayers tend to want to buy equities (which offer the benefits of deferral and capital gains rates) and low-bracket or tax-exempt taxpayers tend to want to buy corporate debt. This affects the demand for debt and equity investments. Over time, if the demand for equities is greater than the demand for debt, corporate issuers will be forced to discount the price of their debt, which will cause investors who would otherwise prefer to buy equity to buy the discounted debt instead. The tax advantages to issuing corporations of issuing debt are offset by the discounts at which the debt must be sold.<sup>152</sup>

Merton Miller has argued that, if the economy is in equilibrium, there would be an optimal level of debt in the corporate sector as

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149. In other words, the need to adopt expansionist policies may overconstrain the Fed. See Benjamin M. Friedman, *Increasing Indebtedness and Financial Stability in the United States*, in DEBT, FINANCIAL STABILITY, AND PUBLIC POLICY: A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY (Jackson Hole, Wyoming, Aug. 27-29, 1986).

150. See Merton H. Miller, *Debt and Taxes*, 32 J. FIN. 261, 268-72 (1977).

151. The benefit to the shareholder equals the tax that would have been paid currently, absent the deferral, less the present value of the tax payment that will be made in the future with the deferral.

152. See RONALD W. MASULIS, THE DEBT/EQUITY CHOICE 23 (1988); CORPORATE FINANCIAL STRUCTURES, *supra* note 144, at 57. Professor Knoll gives an example. See Knoll, *supra* note 143, at 1470 n.39.

a whole but an individual corporation could not increase its value by issuing debt.<sup>153</sup> Finance professor Ronald Masulis and law professor Michael Knoll, among others, have challenged Miller's model.<sup>154</sup> For example, Professor Knoll argues that each corporation does have an optimal capital structure that balances the tax shield from interest deductions and the costs of financial distress.<sup>155</sup>

Also, as noted above in the discussion of financial contract innovation, some instruments that are structured to be debt for tax purposes are de facto preferred stock. For example, billions of dollars of MIPS and other so-called tax deductible preferred stock have been issued in the last few years.<sup>156</sup> If some of the increased debt in this country is de facto equity, the documented increase in debt burdens in recent years may be exaggerated.<sup>157</sup>

In addition, increased corporate debt<sup>158</sup> could represent a beneficial form of do-it-yourself "back-door" integration of the individual tax and corporate tax. As discussed in the next Part, the double corporate tax also creates economic distortions. For years, commentators have argued for integration of the individual and corporate taxes, but so far all formal integration attempts have failed. One could also argue that, if corporate integration is the theoretically

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153. Miller, *supra* note 150, at 269.

154. See MASULIS, *supra* note 152, at 24-30; Knoll, *supra* note 143, at 1474.

155. Professor Knoll argues that Miller's model is incorrect, in part because it is based on faulty assumptions. Knoll, *supra* note 143, at 1474. For example, Miller assumed that corporations can always make immediate use of their interest deductions. *See id.* Corporate losses left after any carrybacks are not refundable. They may be carried forward and used to offset corporate income in later years, but the present value of the tax savings from such a loss are diminished because the tax savings from the loss are deferred. In addition, the losses are not freely transferable to a profitable corporation that could use them immediately. Knoll argues that, in such an environment, there would be an optimal level of debt which would take into account the expected marginal value of the tax shield and the marginal individual income tax rate. As leverage increases, it becomes more likely that the corporation will be unable to make full use of the tax shield attributable to the interest deductions. Said another way, as leverage increases, the value of the tax shield decreases. *See id.*; see also MASULIS, *supra* note 152, at 24-30. The theory of corporate capital structure is, of course, much more involved than the brief passage in the text of this Article indicates. Knoll summarizes the theory of corporate capital structures, including a brief description of static tradeoff theory and alternatives to that theory. *See* Knoll, *supra* note 143, at n.90.

156. For a discussion of MIPS, see *supra* notes 132-36 and accompanying text.

157. *See* Bulow et al., *supra* note 58, at 146.

158. *See id.* From 1984 to 1987, there was a dramatic increase in the debt burdens of United States corporations. In 1976, aggregate corporate interest deductions equaled about one-quarter of aggregate taxable income before the interest deduction. By 1985, aggregate corporate interest deductions equaled about one-half of aggregate taxable income before the interest deduction. The increased interest deductions have potentially reduced the corporate tax collected from the debtor corporations. The potential decrease in corporate tax may have been offset by increased income tax collected from the debtor corporations and their investors. *See* CORPORATE FINANCIAL STRUCTURES, *supra* note 144, at 80-81.

correct but politically unfeasible approach to corporation taxation, the backdoor integration from increased corporate debt could benefit United States corporations by reducing their cost of capital for new investments.<sup>159</sup> Bulow, Summers, and Summers noted the increased availability of the high-yield bond financing for risky businesses during the 1980s, but observed that most high-yield bonds were issued in restructurings, not to finance new investment.<sup>160</sup> They take the position that the increased use of debt in restructurings does not reduce the cost of capital.

Some commentators have also argued that using debt in a corporation's capital structure is beneficial because it reduces management incentives to retain earnings to the detriment of investors.<sup>161</sup> Without the constraint imposed by interest obligations, management has an incentive to hoard earnings even if the projects available to management do not have a positive net present value. If interest obligations force managers to distribute earnings, managers have to go back to the capital markets in order to raise capital to fund projects. This increased scrutiny potentially disciplines managers. Other commentators have countered, however, that debt is not a particularly effective device for disciplining management.<sup>162</sup>

Even in light of all of the potential offsets to the tax advantages of corporate debt, the consensus view of economists is that corporate

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159. See Bulow et al., *supra* note 58, at 146.

160. See *id.* at 147. Most of the high-yield debt issued in 1988 by Drexel Burnham Lambert was issued in connection with leveraged buyouts, recapitalizations, and refinancings.

161. See, e.g., Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 32 AM. ECON. REV. 323, 323-24 (1986). A variation of that argument is that debt-financed leveraged buyouts are beneficial because the debt obligations "force managers to disgorge cash rather than spend it on empire-building projects with low or negative returns." Michael C. Jensen, *Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 61, 67 (1989). The 1992 Treasury Integration Study cites the 1986 Jensen study and states:

Debt finance may have nontax benefits. Analysts most sanguine about high levels of corporate debt and debt-service burdens typically maintain that the discipline of debt is desirable because it gives lenders indirect means to monitor the activities of managers. This need for supervision owes to the separation between ownership and management that is characteristic of the traditional corporate structure.

UNITED STATES DEP'T OF THE TREASURY, INTEGRATION OF INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 11 (1992) (citing Jensen's 1986 article) [hereinafter TREASURY INTEGRATION STUDY].

162. See, e.g., Mark Gertler & R. Glenn Hubbard, *Taxation, Corporate Capital Structure and Financial Distress*, in 4 TAX POLICY AND THE ECONOMY 43, 51-53 (Lawrence Summers ed., 1990); Bulow et al., *supra* note 58, at 152-53. In addition, economist James Poterba notes that "when firms distribute a higher fraction of dividends the national savings rate declines, since corporations tend to retain earnings and save at a relatively high rate while shareholders tend to consume out of cash receipts to a higher degree." *House Hearings on Mergers and Acquisitions*, 101st Cong., 1st Sess. 210 (1989) [hereinafter *House Hearings on Mergers and Acquisitions*] (statement of James M. Poterba).

debt is significantly tax favored over corporate equity.<sup>163</sup> The tax advantages of debt financing encourage corporations to use debt in their capital structures.

Professor Knoll also argues that the corporate interest deduction creates inefficiency because it discourages investment in high growth businesses.<sup>164</sup> The interest deduction encourages investment in activities that have the capacity to employ a high level of debt and discourages investment in activities that do not have the capacity to employ a high level of debt. Activities with high debt capacity tend to have stable earnings and to employ tangible assets. Activities with low debt capacity tend to be riskier<sup>165</sup> and to employ intangible assets.<sup>166</sup> The upshot of this is that corporations with low debt capacity and high growth potential have a higher cost of capital than more stable corporations with high debt capacity.<sup>167</sup> The interest deduction thus discourages investment in businesses that have high growth potential.<sup>168</sup>

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163. See, e.g., JANE G. GRAVELLE, CRS REPORT FOR CONGRESS, CORPORATE TAX INTEGRATION: ISSUES AND OPTIONS 11 (1991) (estimating that the difference between the total effective tax rates on debt and equity is about 50 percent.).

164. Knoll, *supra* note 143, at 1465-66.

165. The greater the volatility of the corporation's earnings, the greater the likelihood that the corporation will not owe tax at the end of any year. Also, the greater the volatility of the corporation's earnings the greater the likelihood that the corporation will suffer financial distress. For these reasons, "a corporation's debt capacity is inversely related to risk." *Id.* at 1492; see also Knoll, *supra* note 143, at 1492 n.114 (documenting this effect).

166. Intangible assets tend to disproportionately lose value if a corporation experiences financial distress. Corporations that employ intangible assets tend to steer away from debt financing in order to avoid those disproportionately high financial distress costs. See *id.* at 1495. On the other hand, one could argue that the inefficiency described by Professor Knoll is offset to some degree by the Code's tendency to permit immediate expensing of the costs of generating intangible assets while permitting only cost recovery deductions over the useful life of tangible assets. Cf. *House Hearings on Mergers and Acquisitions*, *supra* note 162, at 214, 216 (statement of Martin Feldstein, Professor of Economics, Harvard University) (noting tax bias against investment in tangible property and in favor of creation of intangible assets). The costs of generating intangible assets (e.g., the costs of advertising and labor costs) may often be deducted currently. If the taxpayer maintains inventories, some of those costs may be allocated to inventory costs under the I.R.C. § 263A uniform capitalization rules and deducted as that inventory is sold. See I.R.C. § 263A (1994). The costs of tangible assets are typically deducted over a longer period of time based on the § 168 cost recovery rules. See I.R.C. § 168 (1994) (amended 1998). Some types of assets, such as tools may be immediately expensed, and I.R.C. § 179 permits a limited expensing of depreciable property. See I.R.C. § 179 (1994) (amended 1996). The cost of most depreciable property is deducted according to the cost recovery rules of I.R.C. § 168. If depreciable equipment is used to construct depreciable property with a useful life longer than the useful life of the assets used to construct the property, the costs of the equipment are capitalized into the cost of the property constructed and deducted according to the cost recovery schedule for the property constructed. See *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974).

167. Knoll, *supra* note 143, at 1492.

168. See *id.* at 1466. Knoll also points out that the interest deduction encourages corporations to reduce the volatility of their earnings by entering into conglomerate mergers, some of which are inefficient. See *id.* at 1493.



The next part of this Article will explore the relationship between the corporate tax and the tax treatment of debt and equity. The impact of eliminating the debt-equity distinction depends, in large part, on whether the corporate tax still exists and, if so, in what form. This part will explain how the historical debate regarding the theory of the firm has influenced the corporate tax. It will review the normative criticism of the corporate tax and potential normative and political reasons why attempts to formally integrate the corporate tax and individual income tax have failed. Understanding the past experience with failed formal integration attempts can provide lessons for designing a viable debt-equity proposal.

Part III will also discuss the informal partial integration that has resulted from the promulgation of the so-called "check-the-box" regulations, which allow many privately owned businesses (but not publicly owned businesses) to elect out of the corporate tax system. This part will then consider whether it makes sense to attempt to define a comprehensive corporate income tax base. Each of several potential definitions of a comprehensive tax base would imply a different tax treatment of corporate debt and equity.

### III. THE RELATIONSHIP BETWEEN THE DEBT-EQUITY DISTINCTION AND THE CORPORATE TAX

#### A. *The Historical Debate Regarding the Theory of the Firm*

The evolution of the corporate tax has been influenced by conceptions of the firm that date back to the turn of this century. Until 1850, very few businesses operated in corporate form because incorporation required that the state grant the business a "special charter."<sup>169</sup> From 1850 to 1880, states began to replace the special grant statutes with general incorporation statutes.<sup>170</sup> By the 1890s, large corporations appeared and rapidly gained economic power. These new large corporations were run by professional managers, not by the individual

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169. See Bratton, *supra* note 33, at 1484; Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L. REV. 53, 57, 58 (1990). Much of the text that follows is based on these articles by Professors Bratton and Kornhauser.

170. See Bratton, *supra* note 33, at 1485; Kornhauser, *supra* note 169, at 57. The first general incorporation statutes limited shareholder liability for the debts of the corporation but also imposed so-called "legal capital" rules that protected creditors of corporations. These rules required that shareholders pay for stock and restricted distributions to shareholders. Later turn-of-the-century "liberal incorporation" statutes diluted the legal capital rules. See Bratton, *supra* note 34, at 106-07 n.52.

corporate shareholders, so there was a separation of ownership and control of the corporations.<sup>171</sup>

The emergence of large corporations alarmed many citizens, legislators, and commentators.<sup>172</sup> They were worried that “[i]ndividual economic power seemed to decline as corporate manufacturing expanded.”<sup>173</sup> Commentators were concerned that conducting business in large corporations was inefficient and that corporations “subverted market control of private economic power.”<sup>174</sup> The economic model in vogue at the time, which assumed that the same individuals owned and managed the firm, did not fit the new management corporations, so new theories and forms of regulation developed.<sup>175</sup> Around the turn of the century, a consensus developed that the new large corporations required regulation,<sup>176</sup> but citizens and legislators disagreed about the form such regulation should take.<sup>177</sup>

Competing theories of the firm developed to describe the nature of the new large corporations. While some envisioned a corporation as the aggregate of its owners, others viewed a corporation as an entity separate from its owners.<sup>178</sup> The entity theory proponents either viewed a corporation as a natural entity, with the rights of a natural person, or as an artificial entity created by the grant of the corporate charter from the state.<sup>179</sup>

The aggregate theory, on the other hand, was contractual in nature and treated the corporation as the analogue of a partnership.<sup>180</sup> The analogy between the corporate form and the partnership form was not perfect, however, because partnerships did not have the special

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171. See ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) (identifying and analyzing problems caused by separation of corporate ownership and control).

172. See Bratton, *supra* note 33, at 1486-87; Kornhauser, *supra* note 169, at 56-57.

173. Bratton, *supra* note 33, at 1486.

174. *Id.* (citing JAMES WILLARD HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970*, at 43, 48 (1970) (expressing the concern that corporate agents would not work as hard as individual business owners)).

175. See Bratton, *supra* note 33, at 1486-87, 1489-91.

176. The proposed regulation responded to several concerns that were mentioned during the debate of the Corporate Excise Tax of 1909. For example, one aspect of the proposed regulation, publicity, was intended to expose “stock watering” abuses. Stock watering occurred when little or no consideration, or property the value of which was overstated, was received by the corporate issuer in exchange for its stock. The assets of a corporation with watered stock tended to be only the proceeds from the corporation’s issuance of bonds. Stock watering was thought to injure both investing bondholders and the general public. Kornhauser, *supra* note 169, at 75-79.

177. See *id.* at 56.

178. See *id.* at 57-58.

179. See *id.* at 57-59.

180. See Bratton, *supra* note 33, at 1489; Kornhauser, *supra* note 169, at 58.

corporate characteristics of limited liability, centralization of management, and continuity of life.<sup>181</sup>

The natural entity theory was thought to be consistent with the special corporate characteristics of limited liability, continuity of life, and centralization of management because those characteristics depended on the separate existence of the entity.<sup>182</sup> However, treating corporations as natural entities was thought to be inconsistent with adopting special measures to regulate the emerging large corporations.<sup>183</sup> The artificial entity theory was consistent with the various special corporate characteristics and with regulation of the state-created artificial entity.<sup>184</sup>

The debates as to the legal personality of corporations continued during the consideration of the Corporate Excise Tax of 1909.<sup>185</sup> The 1909 Act was designed to both tax and regulate corporations so

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181. See Kornhauser, *supra* note 169, at 58.

182. See *id.* at 59.

183. See Bratton, *supra* note 33, at 1490 (According to the corporate realist conceptualization of the corporation, "[t]he corporate entity was real, and group dynamics were more significant than individual contributions. . . . Since individuals and not the state supplied the creative force that brought the group into existence, respect for individuals counseled against regulation.")

184. See Kornhauser, *supra* note 169, at 61-62.

185. The first income tax statutes, enacted around the time of the Civil War, required shareholders to include corporate dividends in their income but did not tax corporations. In other words, corporate earnings were only taxed at the shareholder level, consistent with an aggregate model. See, e.g., Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 281-82. Under the 1894 Act, corporations and individuals were both subject to a two percent income tax but shareholders did not include corporate dividends in their income. In other words there was still a single layer of tax on corporate earnings but it was imposed at the corporate level. See Act of August 27, 1894, ch. 349, §§ 27, 28, 32, 28 Stat. 509, 553-54, 556. For a discussion of the debates surrounding the enactment of the 1894 Act, see Kornhauser, *supra* note 169, at 86-91. The Supreme Court later held that the 1894 Act was unconstitutional as a direct tax that had not been properly apportioned among the states based on population. See *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429, *reh'g granted*, 158 U.S. 601 (1895). At the time the 1909 Act was being debated, Congress was also considering the proposal that later became the Sixteenth Amendment to the Constitution. See Kornhauser, *supra* note 169, at 93. The Sixteenth Amendment paved the way for Congress to enact a new income tax in 1913. See U.S. CONST. amend. XVI; Tariff Act of 1913, ch. 16, 38 Stat. 114. The 1913 income tax subjected corporations and individuals to income taxation; the individual income tax had two components: a flat rate "normal" individual income tax and a progressive rate "additional" income tax. See Tariff Act of 1913, ch. 16, §§ II(A)1, II(A)2, 38 Stat. 114, 166-67. Shareholders did not include dividends, for purposes of computing their normal tax liability, but did include dividends for purposes of computing their additional tax liability. See Tariff Act of 1913, ch. 16, §§ II(B), 38 Stat. 114, 167-68. For a chart showing corporate tax rates, shareholder tax rates, and effective tax rates for corporate income distributed as dividends, in effect from 1913 to 1935, see Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, n. 32 (1990).

the theory of legal personality adopted needed to be consistent with both goals.<sup>186</sup>

President Taft advocated an artificial entity view of corporations and argued that corporations should pay taxes, based on a "benefit" theory, for the special privileges of operating in corporate form, such as limited liability.<sup>187</sup> Opponents of the corporate tax argued that taxing corporate earnings at both the corporate level and again at the shareholder level was a double tax on the shareholders of the corporation, in effect adopting an aggregate view of the corporation.<sup>188</sup> Opponents of the corporate tax also took issue with the benefit theory of the tax, arguing that the privileges granted to corporations were granted by the states and could only be taxed by the states.<sup>189</sup> Consistent with artificial entity theory and the benefit theory, Congress enacted the 1909 Act, which subjected corporations to an excise tax.<sup>190</sup> In 1910, the Supreme Court upheld the tax "as an excise upon the particular privilege of doing business in a corporate capacity."<sup>191</sup>

The burden on income earned through corporations has increased over the course of this century. Until 1935, dividends were only partially subject to individual income tax.<sup>192</sup> Beginning in 1936, dividends were fully included for purposes of the individual income tax. As Professor Kwall has noted, this structure may have been inad-

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186. Professor Kornhauser argues that the Corporate Excise Tax of 1909 was, in part, a measure to regulate the emerging large public corporations. *See* Kornhauser, *supra* note 169, at 54, 62-82. Although President Taft advocated the adoption of a federal incorporation statute, his proposal to directly regulate corporations was rejected. *See id.* at 65-68. Later, in 1914, the Clayton Antitrust Act became law and the Federal Trade Commission was established. *Id.* at 67; Clayton Act, ch. 323, 38 Stat. 730 (1914) (current version at 15 U.S.C. § 18 (1998)); Federal Trade Commission Act, ch. 311, 38 Stat. 717 (1914) (current version at 15 U.S.C. § 44-51 (1998)). The 1909 Act served a regulatory function because its "publicity feature" (*i.e.*, reporting requirements) provided the federal government with information about corporations. Kornhauser, *Origins of the Corporate Tax*, *supra* note 169, at 54, 113-118.

187. *See* Kornhauser, *supra* note 169, at 103, 107.

188. *See id.* at 94.

189. *See id.* at 107. Professor Kornhauser notes that, throughout the consideration of the 1909 Act, distinctions were drawn between large and small corporations, and that members of Congress were hostile towards large corporations and believed that they should be regulated. *See id.* at 106. Some supporters of the 1909 corporate tax proposal argued for an exemption for small corporations for various reasons; for example, some of the people arguing for a small corporation exemption thought that only large corporations created the type of abuses that warranted government regulation. *See id.* at 106.

190. *See* Tariff Act of 1909, ch. 6, § 38(2d), 36 Stat. 113.

191. *Flint v. Stone Tracy Co.*, 220 U.S. 107, 108-09 (1910).

192. Until 1935, the individual income tax included a "normal" tax and an "additional" tax. Until 1936, shareholders did not include dividends in income for purposes of computing the normal tax but did include dividends for purposes of computing the additional tax. For a chart of corporate tax rates on corporate income, individual tax rates on dividends, and effective tax rates on dividends, from 1913 to 1935, see Kwall, *supra* note 185, at 618-19 n.32.

vertent.<sup>193</sup> In 1936, President Roosevelt proposed that shareholders fully include dividends in income and that the corporate tax apply to earnings retained but not to earnings distributed as dividends.<sup>194</sup> In other words, this proposal would have eliminated the partial double taxation of dividends, with dividends being taxed at the shareholder level but not the corporate level and retained earnings being taxed at the corporate level. This proposal was apparently based on the view that the partial double taxation of dividends overtaxed dividends and that dividends could be appropriately taxed solely under the individual income tax.<sup>195</sup> Retained earnings, on the other hand, would be undertaxed under the individual income tax so retained earnings needed to be taxed at the corporate level.<sup>196</sup> Ultimately, however, Congress fully subjected dividends to the individual income tax but failed to repeal the corporate tax.<sup>197</sup> The double corporate tax has been with us ever since.

### B. Normative Criticism of the Corporate Tax

The goals of a good tax system include efficiency and equity.<sup>198</sup> Commentators have criticized the separate corporate tax on both

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193. See Kwall, *supra* note 185, at 619-20.

194. See *id.* at 620 (citing 1939-1 C. B. 667).

195. See *id.*

196. See *id.*

197. See Revenue Act of 1936, ch. 690, 49 Stat. 1648.

198. See, e.g., PAUL MCDANIEL ET AL., FEDERAL INCOME TAXATION 46 (4th ed. 1998). Basically, efficiency means allocating resources to their most productive use. More specifically, an allocation of resources is Pareto-efficient if there are no further opportunities for making changes that would not harm one group of people and would improve the situation of another group. See EDWIN MANSFIELD, MICROECONOMICS 511 (9th ed. 1997). Any tax distorts economic decision-making, so, as applied to the tax system, the efficiency norm would require that we try to minimize the misallocation of resources on our way to collecting revenue and accomplishing various social goals. See MCDANIEL, *supra*, at 47.

The equity norm is sometimes divided into two components: (i) "vertical equity" (*i.e.*, we should apply an appropriate pattern of differentiating between taxpayers who are unequally situated), and (ii) "horizontal equity" (*i.e.*, taxpayers in equal positions should be treated alike). See generally Paul A. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993) (arguing against formulaic use of the horizontal and vertical equity norms). Tax policymakers typically look to economic income as the measure of equality and inequality. See RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 165 (1959). Tax policymakers have traditionally applied the vertical equity norm by considering whether taxpayers pay tax according to their ability to pay. Money is assumed to have declining marginal utility, so a progressive income tax is thought to represent the most appropriate pattern for differentiating between taxpayers with different amounts of income. See MUSGRAVE, *supra*, at 90-115; Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139, 143, 147 (1989). Some commentators, however, have cautioned that the concept of vertical equity is meaningful only if it is infused with a specific theory of distributive justice. See, e.g., McDaniel & Repetti, *supra* at 611. In addition, tax policymakers disagree as to whether

efficiency and equity grounds.<sup>199</sup> The corporate tax is generally thought to produce three types of inefficiency. First, the corporate tax raises the cost of capital for corporate businesses and encourages investment in businesses that are not subject to the corporate tax.<sup>200</sup> Second, the corporate tax creates an incentive for corporations to retain their

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the horizontal equity norm should be considered an independent equity norm; for a summary of these controversies involving the equity norm, see Katherine Pratt, *Funding Health Care with an Employer Mandate: Efficiency and Equity Concerns*, 39 ST. LOUIS L.J. 155, n. 140 (1994). In applying the vertical equity norm, various theories of distributive justice could provide an "appropriate" standard for differentiating between two unequally situated taxpayers. These theories of distributive justice may either be entitlement theories or welfarist theories. See Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1915 (1987). Entitlement theories focus on a person's right to keep what she owns. See, e.g., ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 150-53 (1974). Welfarist theories instead focus on the welfare of some or all members of society. See Bankman & Griffith, *supra*, at 1915. The two most prominent welfarist theories are utilitarianism and the leximin. See *id.* at 1915-16. Utilitarianism seeks to maximize the aggregate welfare of a society; the leximin seeks to maximize the welfare of the least well off persons in society. See *id.* at 1916. If seeming inequities are discovered, tax policymakers must also consider whether the potential inequities might be eliminated as people adapt their behavior due to economic incentives. See generally Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, in THE ECONOMICS OF TAXATION 19-31 (Henry J. Aaron & Michael J. Boskin eds., 1980).

199. See, e.g., Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265, 268-278 (1995); Thomas D. Griffith, *Integration of the Corporate and Personal Income Taxes and the ALI Proposals*, 23 SANTA CLARA L. REV. 715 (1983); Charles E. McLure, Jr., *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532, 534-49 (1975); Alvin C. Warren, Jr., *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717, 721-38 (1981); CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 7, 19-42 (1979).

For sources defending the corporate tax, see generally RICHARD GOODE, THE CORPORATION INCOME TAX (1951); Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991); Kwall, *supra* note 185; Stanley Surrey, *Reflections on Integration of Corporation and Individual Income Taxes*, 28 NAT'L TAX J. 335 (1975). Professor Rudnick advocates a profits tax imposed at the corporate level. See Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?* 39 CASE W. RES. L. REV. 965, 1066-98 (1988-89).

200. TREASURY INTEGRATION STUDY, *supra* note 161, at *vii*, 112-15. The double rate of tax on corporate equity investments is higher than the single rate of tax on equity investments in businesses that do not operate in corporate form, such as partnerships or limited liability companies. The higher tax on corporate equity encourages businesses to operate in noncorporate form. See *id.*

Under the classical Harberger view of the long-run effects of the corporate tax, the corporate tax reduces the after-tax return on corporate equity, which encourages investors to buy noncorporate equity which has a higher after-tax return. Relative demand for noncorporate equity, over time, reduces the returns on noncorporate equity and increases the returns on corporate equity until they are equal. An inefficiency results because the corporate tax causes investors to invest in less productive uses, which, in turn, reduces total production. The Harberger theory is based on a number of assumptions that are controversial. See Griffith, *supra* note 199, at 729-31.

earnings instead of distributing them.<sup>201</sup> Third, the corporate tax, in conjunction with the debt-equity distinction discussed in Part II, encourages corporations to use debt instead of stock to raise new capital<sup>202</sup> and to substitute new debt for outstanding stock.<sup>203</sup>

The corporate tax is also generally thought to be unfair, because it does not impose a single level of tax at the shareholder's individual rate.<sup>204</sup> The imposition of the double corporate tax is thus thought to overtax shareholders on corporate income. The alleged overtaxation is greater for taxpayers in low tax rate brackets than it is for taxpayers in high tax rate brackets.<sup>205</sup>

Advocates of integration argue that only shareholders should be taxed on corporate income because a corporation should be viewed as a conduit, not an artificial entity.<sup>206</sup> For years following the 1909 Act, the benefit theory of the corporate tax and the artificial entity

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201. See Griffith, *supra* note 199, at 729-31. This arguably causes a misallocation of resources because it encourages managers to retain earnings instead of distributing the earnings and having the shareholders invest the earnings in the potential project with the highest yield. In addition, the bias in favor of retained earnings favors established businesses with retained earnings over growth businesses without retained earnings. See *id.* at 732-33.

202. See TREASURY INTEGRATION STUDY, *supra* note 161, at vii, 115-16. The inefficiencies caused by overleveraging, such as increasing the risk of widespread defaults in economic downturns, have been discussed earlier. See *supra* notes 142-49 and accompanying text.

203. See *id.* at vii. The Treasury Integration Study indicates that "[b]y 1990, over one-quarter of corporate interest payments were attributable to the substitution of debt for equity through share repurchases." *Id.*

204. See, e.g., Dodge, *supra* note 199, at 293 ("On the normative plane (fairness, distributive justice, economic efficiency), the focus should be on the taxation of the income of shareholders derived from their ownership of corporate equity.").

205. See Griffith, *supra* note 199, at 718-19. The following is an example, based on Griffith's article. Assume that a corporation, X Co., is subject to a 35 percent corporate tax rate and an individual, Z, is subject to a 40 percent individual tax rate. Income of an incorporated firm is not taxed at the entity level; the income flows through to the investors and is reported by them on their individual income tax returns. If Z invested in an unincorporated firm and Z's share of the earnings of that firm were \$200, Z would owe \$80 of tax on that \$200 of business income. If Z instead invested in a corporation, how much tax would be paid on \$200 of corporate income? If X Co. earned \$200 of income, the corporation would owe \$70 of tax at the corporate level, leaving \$130 to distribute to the shareholder. Z would owe \$52 of tax (40 percent of \$130) on that distribution, leaving Z with \$78. The total tax on the \$200 of corporate income would be \$122 (\$70 plus \$52), \$42 more than the tax would have been had the income been earned by an unincorporated firm. The extra \$42 of tax is a 52.5 percent increase in the shareholder's tax burden. Individual Y is subject to a 20 percent individual tax rate. Y would owe \$40 of tax on \$200 of noncorporate income passed through to Y. If Y instead invested in a corporation, how much tax would be paid on \$200 of corporate income? If X Co. earned \$200 of income, the corporation would owe \$70 of tax at the corporate level, leaving \$130 to distribute to Y. Y would owe \$26 of tax (20 percent of \$130) on that distribution, leaving Y with \$104. The total tax on the \$200 of corporate income is \$96 (\$70 plus \$26), \$56 more than the tax would have been had the income been earned by an unincorporated firm. The extra \$56 of tax is a 140 percent increase in the shareholder's tax burden.

206. See, e.g., Dodge, *supra* note 199, at 293.

view of corporations were dominant.<sup>207</sup> Over time, however, commentators discredited both the benefit theory and the artificial entity view. The benefit theory has been attacked on several grounds.<sup>208</sup> First, income taxes are not generally imposed on a "benefits received" basis.<sup>209</sup> Second, states, not the federal government, charter corporations and it is the charter that creates the corporate privileges of limited liability and continuity of life.<sup>210</sup> In addition, the corporate tax rates are not related to the costs of granting a business the various corporate privileges.<sup>211</sup>

Aggregate views of the corporation began to emerge as economic and legal commentators noted that corporate entities do not bear the economic burden of the corporate tax because only natural persons can bear economic burdens.<sup>212</sup> Commentators rejecting the entity view of the corporation endorsed an aggregate or "conduit" view of the corporation. Under this view, the corporation is a conduit through which the shareholders of the corporation accrue wealth, either in the form of dividends or retained earnings.<sup>213</sup> Commentators have noted that the income of a corporation ultimately inures to the benefit of its owners, and argued that a corporation should not therefore pay a separate level of tax on its earnings.<sup>214</sup> Instead, the owners of the corporation should pay a single layer of tax on the earnings of the corporation.

As Victor Thuronyi has stated, "income . . . is best considered an attribute that only individuals can have. A corporation cannot have

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207. In 1920s, a series of critiques of corporate realism made a "conclusive" case for the artificial entity theory of corporations. See Bratton, *supra* note 33, at 1491.

208. See, e.g., Griffith, *supra* note 199, at 715, 722-24 (1983); Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1600, n.72 (1974).

209. See Griffith, *supra* note 199, at 723.

210. See *id.*

211. See *id.*

212. See Warren, *supra* note 208, at 1598 (citing RICHARD MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 173-74 (1959)).

213. See, e.g., Leon Gabinet & Ronald J. Coffey, *The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems*, 27 CASE W. RES. L. REV. 895, 913-14 (1977) (quoting McLure):

[T]he corporation is simply the aggregate of its owners and can best be described as a 'conduit' through which income earned in the corporation is passed to the shareholders as dividends or retained earnings. Under this view, the corporation cannot be said to have tax paying ability beyond that of its shareholders.

214. See, e.g., *id.* at 912-18:

In fact, it may be argued that a firm cannot have income. If income is indeed a measure of better-offness, can a firm be better off apart and distinct from the better-offness of stockholders, managers, or employees? People may be better off, but a firm, a fictional entity, cannot be better-off and thus does not have income.

*Id.* at n.72 (quoting George Sorter, *Accounting Income and Economic Income*, in 2 AICPA, OBJECTIVES OF FINANCIAL STATEMENTS 107 (1974)).



income, any more than it can have a blood type. [T]he appropriate taxable units under an ideal income tax are individuals, not entities.<sup>215</sup> Although some commentators have argued that a corporation has capacity to pay tax, separate from the investors' ability to pay tax,<sup>216</sup> the consensus view is that a corporation should be treated as a conduit through which income flows to the corporate investors.<sup>217</sup> From this conduit theory, it follows that corporate income should be taxed once at the individual shareholders' tax rates, not at a separate corporate rate.<sup>218</sup>

The argument that the corporate tax is an unfair double tax on shareholders rests on an assumption that corporate shareholders bear the burden of the corporate tax. In fact, some or all of the corporate tax may be shifted forward to consumers or backward to suppliers of labor or materials.<sup>219</sup> If the corporate tax were shifted forward or backward, the corporate tax would be the rough equivalent of a general sales tax on corporate production, measured by corporate profits.<sup>220</sup>

Even if the corporate tax is not shifted to consumers or suppliers of labor or capital, it may be shifted to other suppliers of capital. The alleged inequitable overtaxation of shareholders from the double corporate tax may be eliminated because stock prices will reflect the extra tax burden on the stock. If noncorporate equity bears a higher after-tax return than corporate equity, investors may invest in the noncorporate sector which would, in turn, decrease the return on noncorporate equity and increase the return on corporate equity. Under this model, the returns in each sector would be equal in equilibrium.<sup>221</sup> This model is based on a number of controversial assumptions and it may or may not be accurate.<sup>222</sup> To the extent it is accurate, the corporate tax would create an inefficiency instead of an inequity.<sup>223</sup>

If one were to assume that the corporate tax is not shifted, one might defend the corporate tax on the grounds that progres-

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215. Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 78-79 (1990).

216. See, e.g., Rudnick, *supra* note 199, at 991-99.

217. See, e.g., Dodge, *supra* note 199, at 293.

218. See *id.*

219. For a discussion of the potential shifting of the corporate tax, see Griffith, *supra* note 199, at 724-28.

220. See *id.* at 726.

221. See *id.* at 719 (discussing this model, which is referred to as the classic Harberger view of the long-run effects of the corporate tax).

222. See *id.* at 729-31.

223. Cf. Bittker, *supra* note 198 (pointing out that one must consider whether a seeming inequity is eliminated by taxpayer responses to economic incentives).

sivity is desirable and that the corporate tax is borne by high income shareholders.<sup>224</sup> On the other hand, a large percentage of stock is held by institutional investors, such as pension funds and mutual funds, which invest on behalf of many people who are not in the highest tax brackets.<sup>225</sup> Also, the corporate tax overtaxes low-income shareholders relatively more than it overtaxes high-income shareholders.<sup>226</sup>

### C. *The Conversion of the Corporate Tax into a Tax on Public Companies*

Based on the conduit view of corporations, commentators have increasingly argued for "integration" of the corporate and individual income taxes, which means that corporate income would be taxed only once and preferably at the shareholders' individual tax rates.<sup>227</sup> The American Law Institute<sup>228</sup> and some members of Congress<sup>229</sup> have also studied and advanced integration proposals. Both in 1977 and in 1992, the Treasury Department issued reports that proposed some form of integration to make the income tax more fair and efficient.<sup>230</sup> The 1992 Treasury Integration Study noted that most of the United States' major trading partners have adopted some form of integration and stated that United States corporations are disadvantaged in international markets because of the economic inefficiencies caused by the corporate tax.<sup>231</sup> The study concluded that integration would create billions of dollars a year of welfare gains for the U.S. economy.<sup>232</sup>

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224. See Polito, *supra* note 48, at 767-68.

225. See *id.* at 768 n.14.

226. See Griffith, *supra* note 199, at 718-19. This does not necessarily mean, however, that integration would increase progressivity because shareholders are disproportionately high-bracket taxpayers. See *id.* at 734, 739.

227. See, e.g., Dodge, *supra* note 199, at 268-78. For an illustrative list of commentators favoring integration, see sources cited at *supra* note 199. As indicated in that note, a minority of commentators have defended the corporate tax or some variation of double tax on corporations.

228. In 1993, the American Law Institute released a report in which it advocated integration of the corporate tax. See generally ALI, FEDERAL INCOME TAX PROJECT, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (Mar. 31, 1993) (Prof. Alvin C. Warren, Jr., Rep.) [hereinafter ALI INTEGRATION STUDY]. For an overview and critique of the ALI integration proposal, see George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431, 436-49 (1992).

229. For a list of House and Senate bills that would have partially or completely integrated the corporate income tax and individual income tax, see Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 330 n.20 (1995).

230. See generally U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977); see also TREASURY INTEGRATION STUDY, *supra* note 161.

231. See TREASURY INTEGRATION STUDY, *supra* note 161, at 2.

232. See *id.* (predicting annual welfare gains for the U.S. economy of \$2.5 billion to \$25 billion in 1991 dollars).

Despite widespread support from academics and the Treasury Department, formal attempts to integrate the corporate tax and individual tax have failed thus far.<sup>233</sup> Given this support for integration, what accounts for the resilience of the corporate tax?

First, the transition from our current system to an integrated system may cause many economic dislocations, with windfall winners and losers.<sup>234</sup> The adoption of an integration proposal that causes such windfall gains and losses could itself be criticized on both equity and efficiency grounds.<sup>235</sup>

Second, integration is complex and can take many forms, each of which has its strengths and weaknesses.<sup>236</sup> Adopting any integration prototype would require trade-offs that may be difficult to accept.<sup>237</sup>

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233. For a discussion of integration failures, see generally Robert J. Leonard, *A Pragmatic View of Corporate Integration*, 35 TAX NOTES 889 (1987); William A. Klein & Eric M. Zolt, *Business Form, Limited Liability and Tax Regimes: Lurching Towards a Coherent Outcome?*, 66 U. COLO. L. REV. 1001, 1024-26 (1995).

234. See Bulow et al., *supra* note 58, at 161; see also, Griffith, *supra* note 199, at 734-39. The degree to which one thinks that integration would confer windfall benefits depends on the type of integration proposal. For example, if integration were accomplished by adopting one of the dividend relief prototypes, the extent to which the dividend relief would confer windfall benefits on outstanding equity depends on whether one subscribes to the "new view" or "traditional view" of dividend taxation. According to the "new view" of dividend taxation, the taxes to be paid when retained earnings are later distributed as dividends have been capitalized into the value of the equity. Under this view, shareholder level taxes on dividends do not prevent dividend distributions. Extending the benefits of integration to the outstanding equity would therefore result in a windfall to the outstanding equity. Under the "traditional view" of dividend taxation, the burden of the tax on dividends is offset by nontax benefits of dividends, such as sending a positive signal to the investing community about the economic health of the distributing corporation. Under the traditional view, a corporation will pay dividends as long as the nontax benefits at least equal the tax burden on the dividend. The tax burden on dividends is a relative burden which takes into account the shareholder level tax burdens on dividends and capital gain from the sale of shares. The 1992 Treasury Integration Study subscribed to the traditional view and took the position that a reduction of the tax on dividends would increase the amount of dividends paid and economic efficiency. For a description of the "traditional view" and the "new view" of dividend taxation, see TREASURY INTEGRATION STUDY, *supra* note 161, at 109 & ch. 13.

235. See, e.g., Griffith, *supra* note 199, at 734-39.

236. The 1992 Treasury Integration Study discusses five integration prototypes: (1) a shareholder allocation prototype; (2) an imputation credit prototype; (3) a dividend exclusion prototype; (4) a dividend deduction prototype; and (5) a Comprehensive Business Income Tax prototype. See TREASURY INTEGRATION STUDY, *supra* note 161, at viii. The Treasury Integration Study favored the dividend exclusion prototype and the Comprehensive Business Income Tax prototype. See *id.* The Study discussed the shareholder allocation prototype but ultimately rejected it; the Study mentioned the imputation credit prototype and the dividend exclusion prototype but rejected those prototypes. See *id.* at vii, 93, 107. The shareholder allocation prototype would effectively treat the corporation as a conduit through which corporate income passes to shareholders. See *id.* at 27-37 (discussing this approach). This integration method would tax shareholders annually on their allocable share of corporate income whether the corporation distributed the income or not, in a manner similar to the current "pass through" treatment of partnerships and S corporations. See I.R.C. §§ 702, 1366 (1994) (amended 1996).

Third, eliminating the corporate tax would require Congress to make up a large amount of lost revenue.<sup>238</sup> This need to make up reve-

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The corporation would still pay tax on its corporate income at corporate tax rates but that tax would be conceptualized as a withholding tax. Each shareholder would receive a credit for her allocable share of the tax withheld at the corporate level. The credit would offset the shareholder's taxes due on her allocable share of the corporate income. Like the shareholder allocation prototype, the imputation credit prototype would ultimately tax the shareholders but would require the corporation to withhold tax at the corporate level. The TREASURY INTEGRATION STUDY discussed but rejected this approach. See TREASURY INTEGRATION STUDY, *supra* note 161, at 95-105. Professor Alvin Warren, the ALI Reporter, favored a more full-blown variation of this method of integration. See generally ALI INTEGRATION STUDY, *supra* note 228. The imputation credit system would, however, not require shareholders to include in income undistributed corporate earnings; instead, shareholders would include dividends in income when the dividends are distributed but that dividend income would be offset by a credit for the shareholder's portion of the tax withheld by the corporation. The shareholder dividend exclusion prototype would retain the separate corporate tax but would allow shareholders to exclude from income the dividends distributed to them out of earnings that had already been taxed at the corporate level. See *id.* at 17-25. The corporate dividend deduction prototype would retain the separate corporate tax but would allow corporations to deduct dividends paid to shareholders. See *id.* at 107.

The Comprehensive Business Income Tax ("CBIT") prototype would retain the corporate level tax and not permit the corporation to deduct interest or dividends. See *id.* at 39-60. Bondholders would exclude from income interest paid or accrued on corporate debt. Shareholders would exclude from income corporate dividends. CBIT would apply to almost all businesses, regardless of whether the business was operated as a C corporation, an S corporation, a partnership, a limited liability company, or a sole proprietorship. See *id.* at 39-40. Very small businesses would be exempt from CBIT. According to the 1992 Treasury Integration Study, the main goal of corporate integration is to tax business income once, either at the business entity level or the shareholder level. See TREASURY INTEGRATION STUDY, *supra* note 161, at 12-13. The Study articulated several other goals as well: first, integration should not permit corporations to pass their corporate tax preferences through to their shareholders; second, integration should not reduce the aggregate tax collected on corporate income allocable to tax-exempt shareholders; third, foreign shareholders should not be permitted to benefit from integration unless the benefits are specifically extended through foreign tax treaties. See *id.* at *viii-ix*. Much of the discussion of the various integration prototypes focuses on these ancillary goals, which greatly complicate the choice of integration prototype.

237. For example, commentators who advocate the conduit theory view the shareholder allocation prototype as the most theoretically pure form of integration. See Yin, *supra* note 228, at 433-34. Treasury, however, chose not to endorse the shareholder allocation method in the 1992 Integration Study for a variety of policy and administrative reasons. For example, Treasury considered modifying the shareholder allocation method to avoid extending corporate tax preferences to shareholders, but rejected that approach because it would be unwieldy and was inconsistent with the theory of the shareholder allocation method. See TREASURY INTEGRATION STUDY, *supra* note 161, at 30. Allowing corporate tax preferences to pass through to shareholders was flatly inconsistent with one of the ancillary goals articulated in the Treasury Study, so Treasury rejected the shareholder allocation method. See *id.*

238. See TREASURY INTEGRATION STUDY, *supra* note 161, at 119. The corporate tax raises over \$110 billion a year. In percentage terms, the corporate tax represents around 7 percent of total Federal tax receipts. See *id.* at 156; INTERNAL REVENUE SERVICE, STATISTICS OF INCOME (1993): CORPORATE INCOME TAX RETURNS 25 (1996) (dollar amounts of corporate tax revenue); STAFF OF THE JOINT COMM. ON TAXATION, 103D CONG., 2D SESS., DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX 130 tbl. 7 (Comm. Print 1995) (corporate tax percentage of total tax receipts). One 1989 estimate of the revenue loss from corporate integration put the cost at around \$40 billion. Kwall, *supra* note 185, at n.15 (1990) (citing Brady

nue raises both normative and political issues. Professor Kwall argues that the efficiency and equity arguments made in favor of integration fail to consider the potential inefficiencies and inequities of tax measures that would have to be adopted to make up for the lost corporate tax revenue.<sup>239</sup>

Professor Kwall argues that raising the lost corporate tax revenue by increasing individual income tax rates may make the income tax more inequitable. Increasing marginal individual tax rates would make it less likely that the capital markets would reach a state of equilibrium, in which investment on corporate returns and investment on noncorporate returns produce the same yield, because taxpayers of more divergent rates would all be investing in the markets together.<sup>240</sup> He also argues that increasing the marginal individual income tax rates would pressure Congress to adopt inequitable base-narrowing tax preferences.<sup>241</sup> The combination of these factors may make the income tax less equitable than it is now with a corporate tax. Professor Kwall also argues that the revenue-raising substitute tax might be less efficient than the existing corporate tax. For example, he argues that increasing individual income taxes to fund integration would be replacing part of the corporate tax, some of which does not distort behavior, with a distortionary tax on labor.<sup>242</sup>

The need to make up revenue lost by corporate integration also raises political issues. The public seems to prefer the corporate tax to its alternatives. Most taxpayers would be unhappy about having their income taxes raised in order to fund repeal of the corporate tax.<sup>243</sup>

Most taxpayers are unaware that they may ultimately be bearing the economic burden of the corporate tax. There are two variations on this theme.<sup>244</sup> One variation is that some voters think of corpo-

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*Offers Sermon on Capital Gains Cut and Corporate Integration to the Converted*, 44 TAX NOTES 1311, 1311 (1989)).

239. See Kwall, *supra* note 185, at 616 ("To determine whether integration is desirable, the equity and efficiency gains achieved by eliminating double taxation must be weighed against the equity and efficiency costs incurred by utilizing an alternative revenue source.")

240. See *id.* at 640.

241. See *id.*

242. See *id.* at 652-54. Professor Kwall points out that part of the corporate tax base represents a normal profit for investors and part represents a pure profit for investors. Although the corporate tax on the normal profit distorts behavior, the corporate tax on the pure profit portion does not distort behavior. Kwall argues that eliminating the corporate tax on the portion of the base that does not distort behavior will make the tax system more inefficient if the replacement tax is distortionary. See *id.*

243. See, e.g., Leonard, *supra* note 233, at 895. Congress could raise additional revenue by increasing tax rates or increasing the tax base, for example by reducing specific types of tax subsidies such as accelerated depreciation.

244. See Arlen & Weiss, *supra* note 229, at 331.

rations as entities with taxpaying capacity.<sup>245</sup> The second variation is that some voters understand that people bear the burden of a tax but think that the burden is borne by rich shareholders who deserve to pay more taxes.<sup>246</sup>

Consider the first class of voters; it does not occur to them that only people can bear the burden of a tax.<sup>247</sup> Professor Klein has argued that early reification of corporations as separate entities was followed by animism or anthropomorphism. In his view, people mentally transformed the abstract legal device, the corporation, into a physical body with human attributes, including the capacity to bear the burden of a tax.<sup>248</sup> Conceptualizing the corporation as a person was “a significant element in the public’s support of the law imposing the [corporate] tax.”<sup>249</sup>

This view is consistent with polling data on the corporate tax: Around three quarters of the polled public favors corporate tax increases; around half oppose a corporate dividend deduction; yet only about a third of those polled were in favor of double taxation.<sup>250</sup> One could infer from these data that the public thinks of the corporation as having taxable capacity and its own income, separate from its shareholders.<sup>251</sup>

Other voters understand that people bear the burden of a tax but think that the burden is borne by rich shareholders who deserve to

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245. See *id.*; see also MERVYN KING, *PUBLIC POLICY AND THE CORPORATION* 50 (1977).

246. See Arlen & Weiss, *supra* note 229, at 331-32.

247. Professor McCaffery characterizes the corporate tax as a “fully hidden” tax, meaning that “money is diverted from what would otherwise be its course in private commerce and sent to the government, without the potential recipient of the value ever necessarily being aware of the levy.” Edward J. McCaffery, *Cognitive Theory and Tax*, 41 *UCLA L. REV.* 1861, 1876, 1886 (1994).

248. See William A. Klein, *Income Taxation and Legal Entities*, 20 *UCLA L. REV.* 13, 53 (1972).

249. *Id.* at 54. Some voters may even believe that large public corporations should pay tax because they are somehow suspect or even “evil.” Professor Klein argues that the public perception of corporations affects the taxation of corporations:

[T]here is some evidence, however uncertain, that political ideology and American social history do help to account for the existing tax system. In fact, I would venture that the current willingness to rely so heavily on the corporation income tax as a source of revenue—and the corresponding unwillingness to talk about raising individual rates without simultaneously raising corporate rates—is in part a function of the public’s lingering (some might say reawakened) image of the corporation as the embodiment of evil.

*Id.* at 70.

250. See Arlen & Weiss, *supra* note 229, at 333-34.

251. Professors Arlen and Weiss draw a different inference from these data. They conclude that respondents’ answers are colored by the way in which the polling questions are framed and that framing differences account for the apparent discrepancies between the polling results. See *id.* at 334-35.

pay more taxes.<sup>252</sup> Economists disagree about who bears the burden of the corporate tax.<sup>253</sup> In the short run, the corporate shareholders probably do bear the tax.<sup>254</sup> Over half of all corporate stock is held by institutional investors, such as pension plans, mutual funds, mutual insurance companies, and charitable endowments, however. These institutional investors represent many people who are not wealthy.<sup>255</sup> In the long run, the corporate tax may be shifted to corporations' employees, suppliers of materials, customers, or even to suppliers of capital in general.<sup>256</sup> If economists cannot agree on the issue of who bears the burden of the corporate tax in the long run, it is likely that many of the individuals who currently bear a portion of the corporate tax have no idea that they may be bearing it.

Third, public corporation managers have not unanimously supported integration; some public corporation managers have been ambivalent towards integration or even have opposed it.<sup>257</sup> Some managers have not supported integration because they are more concerned about preserving special tax subsidies, such as accelerated depreciation, than about eliminating the corporate tax.<sup>258</sup> Some public company managers have opposed integration because the double tax encourages the retention of earnings and the managers prefer to use retained earnings to fund new corporate projects instead of having to raise new capital.<sup>259</sup> Corporate managers would, on the whole, probably be most enthusiastic about partial integration proposals that would eliminate

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252. Cf. Klein, *supra* note 248, at 69. In speculating about the reasons for different early tax treatment of cooperatives, which were not taxed, and corporations, which were taxed, Professor Klein has suggested that:

[I]n the past there were many people, including members of Congress, whose image of a cooperative had something to do with a small group of hardy, hard working, honest Midwestern farmers banding together to protect themselves from the rapacious Eastern robber barons on whose corporate alter egos the farmers were dependent for their economic life. At the same time, their probable image of the corporation was that of a small group of wealthy, heartless individuals endowed with enormous economic power and determined to increase their riches with callous disregard for the interest of all other people. These notions may have been founded partly on reality and partly on predispositions determined by egalitarian political ideologies. It is largely irrelevant for our purposes how accurate this set of images may have been in promoting desired political objectives. If these images were operative . . . they could easily account for the initial pattern of taxation of cooperatives and corporations: the bad guys (the corporations) were taxed and the good guys (the cooperatives) were not.

*Id.*  
253. For a summary of the debate surrounding the shifting of the corporate tax, see Griffith, *supra* note 199, at 724-31.

254. *See id.* at 728.

255. *See* Polito, *supra* note 48, at 768, n.14.

256. *See* Arlen & Weiss, *supra* note 229, at 328-29 n.9.

257. *See id.* at 327-28, 338-41; Leonard, *supra* note 233, at 895.

258. *See* Arlen & Weiss, *supra* note 229, at 338-41.

259. *See id.* at 356-62.

the incentive to issue debt instead of equity, but would not eliminate the incentive to retain earnings.<sup>260</sup>

Although the consensus view among academics is that the conduit theory of the corporation is correct and that integration is warranted from a normative point of view, a few commentators argue that the corporate tax, or a related form of double tax, can be justified from a normative perspective. Professor Rudnick argues that it is appropriate to double tax the equity of public companies whose stock is traded and liquid because shareholders benefit from the regulated trading markets and have greater ability to pay based on the liquidity of their stock positions.<sup>261</sup> Liquidity permits shareholders to diversify and be less exposed to idiosyncratic firm-level risk.<sup>262</sup> She argues that the demand for liquidity is inelastic, so taxing liquid investments at a higher rate than nonliquid investments would not distort behavior.<sup>263</sup> Professor Rudnick distinguishes between the “normal profit” return to equity, which is the portion of the equity return that merely compensates the shareholder for the use of the shareholder’s money, and the “pure profit” return to equity, which is the rest of the equity return.<sup>264</sup> She argues that the corporate tax should be replaced with a profits tax on the “pure profit” return to equity.<sup>265</sup> The profits tax base would not include the normal return to equity, so the corporation would be permitted to deduct that amount.<sup>266</sup>

Professors Kanda and Levmore also offer a justification for the corporate tax that is based on the efficiency norm.<sup>267</sup> They argue that the corporate tax reduces certain agency costs that arise in the corporate context because of the separation between ownership and control.<sup>268</sup> If shareholders of a corporation are in different tax brackets and the corporate manager (whom they refer to as *M*) is also a shareholder, *M* may make decisions on behalf of the business in a self interested way.<sup>269</sup> Kanda and Levmore focus on management (1) *disposition*

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260. *See id.* at 362.

261. *See* Rudnick, *supra* note 199, at 1088, 1090-92, 1094, 1099.

262. *See id.* at 1098.

263. *See id.* at 1178-86. Professor Rudnick bases this argument on optimal tax theory, which posits that taxing inelastic goods can be justified from an efficiency perspective because the tax would not distort behavior. *See id.*

264. *See id.* at 1172-73 & n.729.

265. *See id.* at 969, 1171-78. Professor Dodge argues that the liquidity advantage enjoyed by shareholders could be better addressed by adopting the imputation credit type of integration or by taxing shareholders on unrealized appreciation in their stock on mark-to-market basis. Dodge, *supra* note 199, at 267, 271-72.

266. *See* Rudnick, *supra* note 199, at 1172.

267. *See* Kanda & Levmore, *supra* note 199, at 229-34.

268. *See id.* at 213, 229-34.

269. *See id.* at 231.



policies, (deciding when unrealized firm-level gains should be realized)<sup>270</sup> and (2) *distribution* policies (deciding when retained earnings should be distributed).<sup>271</sup> If the firm is operated in a pass-through form, *M* will be motivated to act in self-interest in making the firm-level decision on these two issues. For example, if *M* is a high-bracket taxpayer, *M* may choose to defer the sale of an appreciated firm asset even if most of the equity investors would have preferred to sell the asset.<sup>272</sup> This type of problem creates agency costs. Kanda and Levmore observe that the corporate tax eliminates agency costs as to disposition decisions because the tax on the sale of firm assets depends on the corporate tax rate, not the tax rates of individual equity investors.<sup>273</sup> On the other hand, the corporate tax does not eliminate the agency costs associated with the distribution decision; high bracket equity investors will prefer that the firm retain earnings, even if the amount retained could better be used if distributed.<sup>274</sup> Kanda and Levmore argue that disposition policy conflicts are more significant than distribution policy conflicts.<sup>275</sup> The pass-through form may be best for businesses that can control the agency costs associated with the disposition conflict (*e.g.*, by adopting contractual provisions to regulate self-interested behavior by managers). Most large firms could better reduce agency costs by operating in corporate form.<sup>276</sup>

Professor Rudnick's profits tax proposal is explicit about subjecting corporations to double tax only if the corporation's securities are publicly traded.<sup>277</sup> She argues that a profits tax based on liquidity is normatively justified by benefit theory, ability to pay theory, and optimal tax theory.<sup>278</sup> The efficiency argument made by Professors Kanda and Levmore would also warrant a distinction between large public companies and closely held corporations because the corporate tax is justified, in their view, if the agency costs associated with disposition decisions exceed the costs of the double tax. These disposition agency costs are highest where shareholders tax rates vary and it would be difficult to arrange by contract to limit self-interested

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270. *See id.* at 230-34.

271. *See id.* at 234-35.

272. *See id.* at 231.

273. *See id.* at 233.

274. *See id.* at 234.

275. *See id.* at 237.

276. *See id.* at 239 ("so long as the corporate tax rate is not prohibitive, investors who face different individual rates may best reduce their agency costs by agreeing on a form of organization in which their individual tax circumstances will not color decisions regarding the purchase and sale of assets").

277. *See Rudnick, supra* note 199, at 1099.

278. *See id.* at 1084-93, 1178-91.

behavior by management. These agency costs are likely to be lower for closely held corporations than for large public corporations, whose shareholders will have difficulty responding to the agency problems because of collective action problems.

To date, formal integration proposals have failed for political and perhaps normative reasons. Meanwhile, back in the trenches of tax law practice, an informal type of backdoor integration has developed. Although Treasury's formal integration models described in the 1992 Integration Study have not been adopted, Treasury in 1996 issued regulations that permit most unincorporated businesses to decide whether to be subject to the corporate tax system or the pass-through system.<sup>279</sup> These regulations tax most unincorporated businesses as partnerships unless the business elects to be taxed under the corporate tax system. (The regulations are commonly referred to as the "check-the-box" regulations.) Until the promulgation of the check-the-box regulations, the government had classified an unincorporated business as a corporation and subjected it to the corporate tax system if the business possessed more than two of four possible corporate characteristics: limited liability, continuity of life, centralization of management, and free transferability of interests.<sup>280</sup> The upshot of the check-the-box regulations is that most unincorporated businesses can elect to have pass-through tax treatment regardless of state law formalities. In other words, it operates like a pure integration model for eligible businesses.

Unincorporated businesses with publicly traded securities are still stuck with the corporate tax, however, because a "partnership" (which would include an unincorporated business electing noncorporate classification under the check-the-box regulations)<sup>281</sup> is treated like a corporation for tax purposes if any interests in the partnership are publicly traded.<sup>282</sup> In other words, eligibility for pass-through treatment turns, in part, on whether the interests in the unincorporated business are publicly traded.<sup>283</sup>

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279. See Treas. Reg. § 301.7701-3(a), T.D. 8697, 61 FR 66590 (1996).

280. See Former Treas. Reg. § 301.7701-3. For a representative list of articles in which the former "corporate resemblance" test was criticized, see George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 126 n.6 (1997).

281. See Treas. Reg. § 301.7701-3(b)(1)(i).

282. See I.R.C. § 7704(a) (1994) (amended 1998). Section 7704 was originally enacted to staunch revenue loss from conversions of corporations into publicly traded partnerships. See Yin, *supra* note 280, at 131-32.

283. See Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229, 230 (1998).

Following the promulgation of the check-the-box regulations, there are two separate systems of business taxation: (1) a double tax system for public firms,<sup>284</sup> and (2) a pass-through system for private firms. The pass-through system includes the Subchapter S regime<sup>285</sup> applicable to eligible corporations making a pass-through election and the Subchapter K partnership regime<sup>286</sup> applicable to unincorporated businesses that do not elect out of pass-through under the check-the-box regulations.

As indicated earlier, a pass-through system of corporate integration has long been favored by academics because they subscribe to the conduit theory of corporations.<sup>287</sup> Recently, however, Professor Kwall has argued for an entity level tax even for complex *private* businesses on the grounds that pass-through taxation does not work well for complex businesses.<sup>288</sup> Although in an ideal world, taxing shareholders annually on their allocable share of corporate income, deductions, gains, losses, and credits would make sense, it is impracti-

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284. Commentators do not agree on the issue of whether public trading should be used to draw the line for pass through treatment. For example, Professor Yin has argued that a distinction based on public trading has no basis in policy. *See* Yin, *supra* note 280, at 131-33. Although liquidity does provide some benefit, Professor Yin argues that private firms can access the capital markets indirectly without issuing traded securities. *See id.* at 132. In addition, he is concerned that drawing the double tax line at public trading would create a new type of distortion by discouraging public trading and causing capital to flow to private, unincorporated businesses. *See id.* at 132-33. He concedes, however, that pass through taxation of public businesses, whether operated in corporate or noncorporate form, is problematic from an administrative perspective. *See id.* at 133. Professor Yin argues that, if administrative and enforcement problems require excluding public businesses from pass through treatment, the exclusion should be broader. *See id.*

Professor Kurtz, on the other hand, supports a distinction based on public trading. *See* Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 825 (1992). Professor Kurtz's article responds to a proposal made by Professor Berger that the income of "large" corporations be taxed at the entity level but that the income of "small" corporations be passed through to its shareholders, as under the current S corporation or partnership systems. *See id.* at 823-26 (discussing Curtis J. Berger, *Whether Partnership Taxation?*, 47 TAX L. REV. 105, 162-63 (1991)). Professor Berger recommended that corporations be classified as large or small based on the corporation's gross revenues. *See* Berger, *supra*, at 163-67. Professor Kurtz, in his response to Professor Berger, argued that classification based on whether an entity is publicly traded would be preferable to classification based on gross revenue. *See* Kurtz, *supra* at 823-26. He argued that public trading is a workable distinction and is less subject to manipulation than a gross revenue standard. *See id.* He also argued that pass through treatment for all business income is the ideal and should be extended as broadly as possible, but that the problems of allocating income among a large number of ever-changing shareholders make pass through treatment of public companies unworkable. *See id.* at 826.

285. *See* I.R.C. §§ 1361-79 (1994) (amended 1996, 1997, 1998).

286. *See id.* §§ 701-77 (1994) (amended 1997, 1998).

287. *See, e.g.*, George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 153 (1999).

288. *See* Kwall, *supra* note 283, at 242-53.

cal in the real world; in fact, the Subchapter K pass-through regime is not working very well now for non-publicly traded complex partnerships.<sup>289</sup> It would likely work even less well for public companies.

So where does business taxation stand now? Although no formal integration model has been adopted, our system of taxing businesses is evolving into a system that distinguishes between public and private companies.<sup>290</sup> Public companies are taxed at the entity level and again at the shareholder level. It remains to be seen whether the earnings of public companies will continue to be taxed twice or whether Congress will adopt an integration proposal that would result in only one level of tax. Most private firms are taxed once on a pass-through basis at the investor level. Whether Congress will adopt two separate systems of taxation for private firms, as Professor Kwall has suggested, is uncertain.

#### D. *The Base of the New Corporate Tax*

How should "corporate income" be defined in light of that fact that public companies are subject to the corporate tax? Given the widely accepted view that, in an ideal world, there would be no corporate "income" separate from the income of the investors, it is not surprising that very few commentators have attempted to define income for purposes of the corporate income tax.<sup>291</sup> For purposes of the personal income tax, "income" is generally defined, under the Haig-Simons formula, as the sum of (1) the taxpayer's consumption during the period and (2) the taxpayer's change in wealth during the period.<sup>292</sup>

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289. As Professor Larry Lokken has acknowledged, "Subchapter K is a mess." Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 250 (1999). Professor Lokken's article highlights some of the shortcomings of the Subchapter K partnership tax rules. See *id.* at 250-53. Professor Yin also catalogues the deficiencies of the partnership tax rules. See Yin, *supra* note 287, at 153-64.

290. Many commentators regard the chances of Congress adopting an integration proposal as slim. See, e.g., Klein & Zolt, *supra* note 233, at 1024 (noting the "bleak prospects for large-scale integration reform").

291. The few articles in which authors have attempted to define income for purposes of the corporate income tax include Warren, *supra* note 208, at 1589-98; Patricia Bryan, *When Junk Bonds Go Bad: Protecting the Corporate Tax Base on Repurchases and Defaults*, 42 FLA. L. REV. 645, 658-661 (1990) [hereinafter Bryan, *Junk Bonds*]; Patricia Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt Equity Swaps*, 63 TEX. L. REV. 89, 114-115 (1984) [hereinafter Bryan, *Swaps*]; Loon Gabinet & Ronald J. Coffey, *The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems*, 27 CASE W. RES. L. REV. 895, 915 (1977); Charlotte Crane, *Toward a Theory of the Corporate Tax Base: The Effect of a Corporate Distribution of Encumbered Property to Shareholders*, 44 TAX L. REV. 113, 142-43 (1988).

292. See Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 7 (Robert M. Haig, ed., 1921), reprinted in AM. ECON. ASS'N, READINGS IN

"Income" is a net income concept, meaning that expenditures incurred to produce income should be excluded from the base. Therefore, in this context, "consumption" denotes personal expenditures.<sup>293</sup>

The Haig-Simons "ideal" definition of income fits the corporate taxpayer poorly, for as Professor Alvin Warren has said, "it is difficult to comprehend how a corporation can consume anything."<sup>294</sup> Since the Haig-Simons definition is incongruous in the corporate income tax context, the conventional tax policy approach, starting out by defining the "ideal" income tax base, is not helpful in the context of the corporate tax.<sup>295</sup>

Given the fact that the corporate tax exists, however, it may be helpful to think about defining a "comprehensive" corporate tax base in order to try to reduce discontinuities that create inefficiencies.<sup>296</sup>

THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl Shoup eds., 1959); HENRY SIMONS, PERSONAL INCOME TAXATION 50 (1938).

293. Commentators have defined consumption in a variety of ways. See, e.g., Warren, *supra* note 208, at 1591 (defining consumption as "the use of wealth for personal gratification" or "the destruction of economic resources") (citing George F. Break, *Capital Maintenance and the Concept of Income*, 62 J. POL. ECON. 48, 52 (1954)).

294. *Id.*

295. Professor Polito has observed:

The term "corporate income" is an oxymoron. As a legal fiction designed to facilitate the assembling of resources into a joint enterprise, a corporation is not capable of accruing income in the economic sense. Income is commonly defined as consumption plus increases in wealth. A corporation cannot consume because it cannot experience utility, but individuals are able to consume through corporate expenditures on their behalves. A corporation accumulates wealth only for the benefit of individuals who have claims against that wealth. Few, if any, would question that a corporation is only a stand-in for those who hold claims against it. Nevertheless, the tax law persists in imposing tax upon the "taxable income" of every corporation.

Polito, *supra* note 48, at 766-67 (footnotes omitted).

296. Discontinuities create opportunities for tax arbitrage, meaning the taxpayer can structure a transaction that does not produce any net cash flow but does produce tax savings. See Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569, 573 (1994) ("the usual presumption is that tax arbitrage is an evil to be controlled"). Professor Strnad carves out an exception to that general rule, however: Since high-bracket taxpayers' ability to take advantage of tax arbitrage is limited, it may make sense to keep or create less destructive types of tax arbitrage to displace more destructive forms of tax arbitrage. See Strnad, *supra* note 103, at 555-60.

Professor Strnad argues that a good tax system displays the properties of "universality" and "consistency." See Strnad, *supra*, at 572. A tax system displays the property of universality only if the system specifies particular treatment for any possible transaction. See *id.* A tax system displays the property of consistency only if the system provides a unique tax treatment for any possible cash flow pattern. See *id.* at 573. In a consistent tax system, "it is not possible to manipulate tax outcomes by repackaging cash flows into different financial vehicles." *Id.* Universality and consistency are both theoretically possible in a first-best setting. See Strnad, *supra* note 103, at 550. In a second-best world, however, a tax proposal has to be considered in light of the discontinuities that the policymaker cannot eliminate. See *id.* at 553. Professor Strnad also advocates the properties of "linearity" and "continuity." See Strnad, *supra*, at 572, 575-76. A tax system displays the property of linearity if "the tax on any transaction equals the

The corporate tax itself is thought to create significant economic distortions.<sup>297</sup> However, given the fact that the income tax includes many other distortions, the distortionary corporate tax must be considered in light of those other distortions.

For example, one could conceptualize the corporate tax as a crude device for reducing the individual income tax distortion caused by the realization requirement.<sup>298</sup> Under an ideal income tax base, increases in wealth would be taxed, even if they were not realized, but our individual income tax system waits to tax corporate retained earnings until shareholders receive dividends or sell their appreciated stock at a gain.<sup>299</sup>

The corporate tax could be thought of as a second-best measure to tax unrealized shareholder level income. If earnings are retained and dividend distributions or stock sales are deferred, the effective rate of the double tax on the corporate earnings may approximate the tax that would have been imposed solely at the shareholder level had all of the earnings been distributed currently.<sup>300</sup> If the corporate tax exists to ensure that the tax collected at least approximates the tax that would have been collected solely at the shareholder level had all corporate earnings been distributed currently as dividends, dividends made out of current earnings should not be included in the corporate tax base but retained earnings should be included in the base.<sup>301</sup> The corporate tax base would fit this efficiency justification if the corporate tax base included retained earnings but not dividends paid to shareholders.<sup>302</sup>

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sum of the taxes on any collection of subtransactions that comprise that transaction." *Id.* at 576. A tax system displays the property of continuity if nearly identical portfolios have nearly identical tax consequences. *See id.* Our current tax system includes numerous inconsistencies and ambiguities, including the debt-equity distinction and the double corporate tax. *See id.* at 592-93. A tax system with such inconsistencies cannot be linear, meaning that, in such a system, altering the form of a transaction may alter its consequences. *See Strnad, supra* note 103, at 553.

297. *See Strnad, supra* note 296, at 592-93.

298. Professor Polito has observed,

One must assume, therefore, that the policy of imposing an "income tax" upon the contrived measure of the income of a legal fiction is itself a stand-in for the achievement of some other policy goal . . . Many . . . may . . . view the corporate income tax as a device to reduce the personal income tax's mismeasurement of income.

Polito, *supra* note 48, at 767-69 (footnotes omitted).

299. *See* I.R.C. §§ 61(a)(3), 1001 (1994).

300. *See* Miller, *supra* note 150, at 266-68.

301. Recall that Professor Kwall takes the view that the double tax on distributed corporate earnings was created inadvertently in 1936. *See supra* note 193 and accompanying text. Had President Roosevelt's proposal become law, the corporate tax would have applied to retained earnings but not to dividend distributions. *See supra* text accompanying note 194.

302. Of course we could eliminate this realization distortion more directly by abandoning the realization requirement and taxing shareholders currently on a mark-to-market basis. *See, e.g.,*

Another way to conceptualize the corporate tax base is to think of it as reducing a distortion that is created by federal law making investments in public companies highly liquid. Professor Rudnick argues that liquidity benefits public corporations and their shareholders. Based on optimal tax theory, she argues that the corporate tax should be converted into a profits tax that would tax the pure profits of the investors both at the entity level and at the investor level.<sup>303</sup> Consistent with this view, the investors' normal profit would be excluded from the corporate tax base. In other words, corporations would be permitted to deduct the normal profits, meaning the portion of dividend distributions that compensates investors for the time value of money, but not for risk.<sup>304</sup> Investors would include interest, dividends, and gain from the sale of stock.

One could also conceptualize the corporate tax as an entity level tax on shareholder return on capital. This normative argument would not be based on efficiency; instead it would be a fairness-based argument that depends on subscribing to the view that corporations (or their investors) have greater ability to pay tax than other persons. One variant of this is the discredited "benefit" theory of corporate tax. Also, if one subscribed to the artificial entity view of corporations instead of the conduit theory, one might reify and anthropomorphize the corporation and view it as having capacity to pay tax. Under this conception of the corporate tax, dividends and interest would be included in the corporate tax base and again at the investor level. In other words, corporations would not be permitted to deduct interest or dividends and investors would include interest, dividends, and gain from the sale of stock. Edwin Seligman advocated this view of the corporate tax base when the Corporate Excise Tax of 1909 was being debated.<sup>305</sup>

A variation on this theme would be that there should be a double tax on the return on shareholder capital, since the shareholders are the "owners" of the corporation, but there should not be a double tax on the return on bondholder capital, since bondholders are not the owners of the corporation. This view of shareholders as owners of the corporation and bondholders as outside the corporation is, however, based in part on an individualistic view of debtor-creditor relations that was in vogue at the turn of the century but is outmoded today.

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Dodge, *supra* note 199, at 268-78 (advocating mark-to-market taxation with respect to traded stock and pass through taxation with respect to nontraded stock).

303. See text accompanying notes 261-266, *supra*.

304. See Rudnick, *supra* note 199, at 1172.

305. See Warren, *supra* note 208, at 1597 (citing EDWIN R.A. SELIGMAN, *THE INCOME TAX* 19 (2d ed., 1914)).

This conception of the corporate tax base is consistent with current law and with some commentators' positive definition of corporate income as the sum of dividend distributions made during the period plus the increase in the value of the corporation during the period. In effect, the commentators who subscribe to this definition think of dividend distributions as the corporate analog of personal consumption.<sup>306</sup>

The next part of this Article discusses proposals that would reduce or eliminate the current corporate tax bias in favor of issuing debt instead of equity.

#### IV. EVALUATION OF THE PROPOSALS TO ELIMINATE<sup>307</sup> THE DEBT-EQUITY DISTINCTION

##### A. *The Second-Best Problem with Eliminating the Distinction*

Commentators and the Treasury have made and considered numerous proposals to eliminate the debt-equity distinction.<sup>306</sup> The classes of proposals include proposals that would:<sup>309</sup>

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306. See, e.g., Bryan, *Junk Bonds*, *supra* note 291, at 652. ("A corporation's distributions to shareholders are analogous to an individual taxpayer's expenditures for consumption: both transactions reduce the taxpayer's retained assets, and yet both are nondeductible and require the use of after-tax dollars.")

Professor Warren suggested an alternate definition of corporate income, which would look to the increase in wealth of all investors in the corporation, including both debtholders and shareholders. See Warren, *supra* note 208, at 1589-98. Under this formulation, corporate income would be defined as "the algebraic sum of (1) distributions to investors minus advances from investors, and (2) the value of their investment at the end of the period minus its value at the beginning." *Id.* at 1592. Although tax law has traditionally treated only the shareholders as the investors in the corporation, Professor Warren argued that both debtholders and shareholders should be treated as investors for purposes of defining the base of the corporate income tax. Professor Warren later decided that corporations should not be denied interest deductions on their debt. See Warren, *supra* note 199, at 717, 734 n.43.

If the corporate tax reached all corporate income [including profits and the pure cost of capital], it would distort corporate investment decisions because the return subjected to tax would not be reduced by the cost of capital. For example, a 12% annual return financed by borrowing at 10% would produce a 2% profit before taxes, but a 4% loss after taxes if the corporate tax rate were 50% and interest were nondeductible. [12% pretax return less (6% taxes plus 10% interest) equals negative 4% after-tax loss.]

*Id.* at 734 (footnotes omitted).

307. The proposals discussed would bring the tax treatment of interest and dividends more in line. Most of the proposals would not require that we completely eliminate the myriad distinctions in the Code between debt and equity, so it is a bit of a misnomer to say that these proposals would "eliminate" the debt-equity distinction. I will use the word "eliminate" here, however, because that is the expression commonly used.

308. See generally William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971) (arguing for the elimination of the debt-equity distinction and cataloguing approaches for accomplishing that goal); TREASURY INTEGRATION STUDY, *supra* note 161, at 17-60.



- (1) adopt a shareholder allocation form of integration;
- (2) adopt the comprehensive business income tax form of integration;
- (3) allow a shareholder level dividends received exclusion;
- (4) allow a corporate level dividends paid deduction;
- (5) eliminate all or a part of the corporate interest deduction; or
- (6) allow a limited deduction for a corporation's cost of capital, regardless of whether that capital is equity or debt (referred to as a cost of capital allowance system).

The general theory of second best<sup>310</sup> reminds us that eliminating an economic distortion does not necessarily increase efficiency if other economic distortions remain, so any proposals to eliminate the debt-equity distinction should be considered in light of the remaining distortions in our tax system.<sup>311</sup> For each proposal, this Article will: (1) describe the proposal; (2) consider whether the proposal would reduce the debt-equity distinction, in light of other distortions that will remain in the income tax; and (3) consider the effect of the proposal on other distortions. The other distortions considered in this Article include the distortions caused by:

- (1) the bias in favor of investing in noncorporate equity instead of corporate equity;
- (2) the bias in favor of retaining earnings;
- (3) the investor level differences in the treatment of interest, dividends, and gain from the redemption or sale of stock;

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309. In addition, more radical proposals to completely replace the income tax system with a cash flow tax system would eliminate the distinction between debt and equity. See, e.g., U.S. DEPT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977). Those proposals are not discussed in this Article. There are also proposals to adopt a corporate cash-flow tax even if we retain the individual income tax. See TREASURY INTEGRATION STUDY, *supra* note 161, at 192, n.39; see also Alan J. Auerbach, *Debt, Equity, and the Taxation of Corporate Cash Flows*, in DEBT, TAXES, AND CORPORATE RESTRUCTURING 91, 119-25 (John B. Shoven & Joel Waldfogel eds., 1990).

310. See generally R. G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956-57).

311. As Professor Schenk has stated:

One obvious problem with the incremental approach [limiting discontinuities], as with any second-best proposal, is that although it might solve a specific problem, it might exacerbate others because it only moves in the direction of an ideal, but, by definition, does not reach it. It is rational, therefore, to evaluate a second-best proposal not by comparing it to the ideal, but by comparing it to current law. Would it improve the current regime or make it worse?

Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX L. REV. 571, 640 (1995).

- (4) the limitations on the utilization of corporate losses;
- (5) the immediate expensing of the costs of creating intangible assets, but not the costs of creating tangible assets;
- (6) the taxation of U.S. shareholders under the provisions of the Code, while foreign shareholders are taxed under a combination of Code and tax treaty rules;
- (7) the tax preferences that apply to corporate taxpayers but not individual taxpayers; and
- (8) the difference in the tax rates applied to taxable and tax-exempt investors.

None of the proposals completely eliminates the debt-equity distinction but some of the proposals do a better or worse job of equating debt and equity. Corporate managers make decisions about the capital structure of a corporation based on both corporate level and investor level consequences of issuing debt or equity. Some of the proposals discussed below would equalize the corporate level consequences of debt and equity but would not equalize the investor level consequences of debt and equity. As long as investors are required to include any portion of their returns on debt and equity (including interest on bonds, dividends on stock, and gain from stock sales), the investor level consequences of debt and equity will continue to vary.

There are several reasons for this. First, there are timing differences between the taxation of bondholder interest, shareholder dividends, and stock gain. Bondholders must include interest when it is paid or accrued under the OID rules. Shareholders do not include dividends until the shareholder is paid the dividends. Stock gain is generally included only when the stock is sold, due to the realization requirement.<sup>312</sup> Second, there are character and rate differences between the taxation of bondholder interest, shareholder dividends, and stock gain. Interest and dividends are taxed at ordinary income rates but gain from the sale of stock typically qualifies for preferential capital gain rates.<sup>313</sup> Third, there are basis recovery differences between the taxation of bondholder interest, shareholder dividends, and stock gain. Bondholders include all of interest paid or accrued on their bonds and shareholders include all of the dividends they receive.<sup>314</sup> On the other hand, gain included from the sale of stock equals the amount realized on the sale less the shareholder's basis in the stock.<sup>315</sup> These

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312. See I.R.C. §§ 1001(a) and (c) (1994).

313. See *supra* note 16.

314. See I.R.C. §§ 61(a)(4), (7) (1994).

315. See I.R.C. § 1001(a) (1994).

timing, character, rate, and basis recovery differences will affect the consequences of each of the proposals to eliminate the debt-equity distinction.

The debt-equity proposals that have been made have not been fully developed, which makes it difficult to predict some of the consequences of adopting the proposals. For example, the effects of some of the proposals depend, in part, on how the proposal would tax gain from the redemption or sale of stock. Recall that there is currently a bias in favor of retaining corporate earnings. The effect of the debt-equity proposals on the retained earnings bias depends on how the proposals would treat such gain from stock redemptions and sales.

If there were no investor level tax on distributions (*e.g.* if shareholders could exclude dividends), corporate earnings would be taxed once at the entity level. If gain on redemptions and sales were included in income, as under current law, that would create a bias in favor of current distributions and against retention of earnings because taxing the gain on redemptions and sales would impose a second layer of tax on corporate earnings.<sup>316</sup> If, on the other hand, shareholders were permitted to exclude gain from redemptions or sales of stock, that would create a bias in favor of corporations not disposing of appreciated property and shareholders realizing that appreciation through redemptions and sales that would not be taxed at the shareholder level. In other words, it would encourage corporations to defer earnings by deferring the realization of corporate level gain.

This part will also consider the distortion caused by taxing corporate earnings at higher rates than noncorporate earnings and two other distortions that may, to some extent, offset each other. First, limitations on utilization of corporate losses discourage investment in high growth businesses with volatile earnings and intangible assets and encourage investment in lower growth businesses with stable earnings and tangible assets. Second, allowing immediate expensing of the costs of creating intangible assets but not the cost of tangible

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316. See TREASURY INTEGRATION STUDY, *supra* note 161, at 83. To the extent that a shareholder's gain is attributable to retained earnings on which the corporation had already paid tax, taxing the gain would be the second layer of tax. To the extent that a shareholder's gain is attributable to future corporate gain or earnings, the first layer of tax would be imposed at the shareholder level and the second layer of tax would be imposed at the corporate level when the income was earned or the assets were sold. The Treasury Study notes that corporations might be permitted to adopt a dividend reinvestment plan ("DRIP"), which would permit a shareholder to increase stock basis by earnings reinvested in the corporation. See *id.* at 87. Capital gain from the sale of stock then would not double tax prior earnings. DRIP plans are discussed later in this section. See *infra* text accompanying notes 378, 379.

assets encourages investment in intangible assets and discourages investment in tangible assets.<sup>317</sup>

The Treasury Integration Study also focused on three other distortions that will be considered in this part: (1) distortions caused by taxing U.S. shareholders under the Code but taxing foreign shareholders under a combination of Code rules and tax treaty rules; (2) distortions caused by having certain tax preferences that apply to corporate taxpayers but not individual taxpayers; and (3) distortions caused by distinguishing between taxable and tax-exempt investors. The Study recommended that: (1) the benefits of corporate integration should only be extended to foreign shareholders through tax treaties;<sup>318</sup> (2) corporate integration should not result in corporate tax preferences being extended to individuals;<sup>319</sup> and (3) corporate income distributed to tax-exempt shareholders should not escape tax altogether.<sup>320</sup> In other words, the Treasury Integration Study concluded that these distortions should not be eliminated.

The next section will consider each proposal to eliminate the debt-equity distinction, in light of the existing distortions mentioned above. The following two sections will summarize and evaluate the proposals.

## *B. The Proposals to Eliminate the Debt-Equity Distinction*

### 1. Shareholder Allocation

The shareholder allocation proposal discussed in the Treasury Study would continue to treat the corporation as a separate reporting entity. The corporation would continue to pay corporate tax based on its annual corporate income at regular corporate tax rates. The corporation would then allocate its aggregate taxable income among its shareholders. Shareholders would have to include in income their share of the corporate income and would owe tax on that income, computed using the shareholders' tax rates, but the shareholders would receive a tax credit for their share of corporate taxes paid. The credit would offset the tax due from the shareholder. If the shareholder's tax

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317. See *supra* note 166; *infra* note 402.

318. See TREASURY INTEGRATION STUDY, *supra* note 161, at ix. The U.S. government negotiates tax treaties with many other countries. A tax treaty provides special rules for the taxation of residents of the countries that are the parties to the treaty. Treaty provisions usually override the rules in the Internal Revenue Code. If foreign shareholders qualified for favorable tax treatment without regard to specific tax treaties, the U.S. would be less able to bargain for reciprocal tax treaty benefits for U.S. citizens and residents. See *id.*

319. See *id.*

320. See *id.*

rate exceeded the corporation's tax rate, the shareholder would have to pay some tax on the corporate income. A shareholder would have an excess credit if the corporation's tax rate exceeded the shareholder's tax rate. A shareholder with an excess credit could use the excess credit to offset tax owed on other income, but unused credits would not be refundable.<sup>321</sup>

Shareholders would increase their stock bases to account for their share of corporate income on which extra shareholder level tax was paid.<sup>322</sup> This basis increase would reduce potential gain from the redemption<sup>323</sup> or sale of stock, but gain in excess of the increased basis would be fully included and subject to capital gain rates.<sup>324</sup>

The Treasury shareholder allocation proposal would not pass corporate losses through to shareholders.<sup>325</sup> The proposal would permit corporate level preferences to be passed through to shareholders. Tax-exempt and foreign shareholders would not be able to get a refund of their shareholder credit for tax paid by the corporation.<sup>326</sup>

The shareholder allocation method would reduce the current bias in favor of issuing debt because it would reduce the double tax on equity.<sup>327</sup> Corporations would still be able to deduct interest on corporate debt, so interest on debt would continue to be subject to one layer (or, if the bondholder were a tax-exempt entity, zero layers) of tax. Tax losses would, however, not be passed through to shareholders. In addi-

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321. *See id.* at 27-28.

322. The shareholder's basis would be increased by the amount of taxable corporate income allocated to the shareholder, less the portion of the tax paid by the corporation that is allocable to the shareholder. *See id.* at 28. Basis would also be increased to reflect some, but not all, preference income. *See id.* at 30-31. Presumably, basis would be reduced by any excess credit that the shareholder could use to reduce other tax due.

323. A redemption is a repurchase of the corporation's equity by that corporation. *See I.R.C.* § 317(b) (1994). As used in this Article, the term "redemption" means a redemption that is treated, for tax purposes, as a sale of the stock by the shareholder, not as a dividend from the redeeming corporation. *See I.R.C.* § 302(b) (1994).

324. *See id.* at 82-83. Gain could be attributable to unrealized appreciation or inflation.

325. *See id.* at 27-28.

326. *See id.* at 28-29. Nor could a foreign shareholder use the credit to offset the foreign shareholder's dividend withholding tax liability. *See id.* at 29. For a separate discussion of the shareholder allocation treatment of foreign taxes paid, see *id.* at 36-37. Basically, the Treasury proposal treats foreign taxes paid like tax paid to the U.S. government, which may result in zero tax being paid on foreign source corporate income. Treasury considered denying foreign tax credits to shareholders but decided that that approach was too complicated and was inconsistent with the conduit nature of the shareholder allocation proposal. Allowing the corporate foreign tax credit to be passed through to shareholders introduces its own complexity because it is not clear how the corporate level foreign tax credit limitation rules should be applied if that credit is passed through to shareholders. *See id.* at 36.

327. The shareholder allocation proposal would not completely eliminate the second layer of tax on equity because the proposal limits utilization of the shareholder level credit for corporate taxes paid.

tion, the corporation's ability to utilize losses would be even more limited than under current law because loss carrybacks would be eliminated.<sup>328</sup>

The shareholder allocation model would tax corporate income once, at the shareholder's tax rate, as the corporation earned the income. Shareholders would be taxed on distributions and stock redemptions and sales only to the extent that the dividend or amount realized on sale exceeded the shareholder's basis, which would have been increased to reflect additional tax paid by the shareholder. Retaining earnings would no longer offer a shareholder level timing or basis recovery advantage over dividend distributions so the proposal would reduce the current bias in favor of retained earnings. The shareholder allocation method would not eliminate this bias, however, because taxable stock redemptions and sales would still offer a shareholder level character and rate advantage over taxable dividends;<sup>329</sup> shareholders would typically pay tax on gain from redemptions and sales at preferential capital gains rates, but would pay tax on dividend income at ordinary income rates.

The shareholder allocation method would greatly reduce the bias against investment in corporate form since corporate earnings would be taxed once at the shareholder rate with the corporation effectively acting as a withholding agent for the tax. Utilization of corporate losses would continue to be limited under the Treasury shareholder allocation formula, so it might seem as though the shareholder allocation method would retain a bias against investment in corporate form. This bias is not too pronounced, however, since various Code provisions currently limit individual investors' utilization of losses they report.<sup>330</sup> For example, the passive loss rules of § 469 prevent an investor from using passive activity losses to offset active business income or portfolio losses. If corporate losses were passed through to passive public shareholders, these individual investor limitations

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328. The current law carryback of losses would be eliminated because the taxes already paid would have been allocated and credited to the shareholders. Corporate losses would continue to be carried forward. See TREASURY INTEGRATION STUDY, *supra* note 161, at 28. Professor Knoll argues that the loss limitation rules would even discourage corporations from issuing debt. See Knoll, *supra* note 143, at 1514.

329. Stock redemptions and sales are taxable under this proposal if the shareholder's amount realized on the sale exceeds the shareholder's adjusted stock basis. Stock dividends are taxable under this proposal if the dividend amount exceeds the shareholder's adjusted stock basis.

330. These limitations include the I.R.C. § 704(b) substantial economic effect rules, the basis limitation rule of § 704(d), the passive loss limitations of § 469, and the at-risk limitations of § 465.

would apply, which would prevent full utilization of the losses passed through to many shareholders.<sup>331</sup>

The Treasury Study rejected the shareholder allocation prototype due to what it called "policy" and "administrative" concerns.<sup>332</sup> Recall that one of the Study's recommendations was that the benefits of corporate integration should only be extended to foreign shareholders through tax treaties.<sup>333</sup> The shareholder allocation method could be consistent with that recommendation only by denying the shareholder credit to foreign shareholders and imposing withholding tax on dividends paid by U.S. corporations.<sup>334</sup> Another recommendation was that corporate integration should not result in corporate tax preferences being extended to individuals.<sup>335</sup> Treasury considered versions of the shareholder allocation method that would not have extended corporate tax preferences and the corporate foreign tax credit to shareholders, but concluded that such a system would be unworkable and would be inconsistent with the conduit nature of the shareholder allocation method.<sup>336</sup>

If the shareholder allocation proposal were implemented in a manner completely consistent with conduit theory, it would also lose significant revenue because corporate income allocable to zero-rate shareholders would escape tax altogether. Making up that revenue would potentially introduce new inequities and inefficiencies.<sup>337</sup>

The Treasury Integration Study also noted that using even a basic shareholder allocation method would create significant accounting and reporting difficulties.<sup>338</sup> For example, using the shareholder allocation method would require corporations to report corporate income and shareholder basis adjustments quarterly to every shareholder who held any class of the corporation's stock for any

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331. I.R.C. § 469 does not apply to corporations other than closely-held corporations, so under current law, non-closely-held corporate shareholders would be able to utilize pass through losses if the shareholder allocation method permitted the pass-through of losses. If losses did pass through under the shareholder allocation method, Congress might amend § 469 to make it more generally applicable. Permitting the pass-through of losses would make administration of a shareholder allocation system even more difficult. The Treasury Study states that the shareholder allocation method would not permit the pass-through of losses "[t]o avoid the complexity created by applying additional loss limitations at the shareholder level and the need for anti-abuse rules." TREASURY INTEGRATION STUDY, *supra* note 161, at 30.

332. *See id.* at 27.

333. *See id.* at ix.

334. *See id.* at 36.

335. *See id.* at ix.

336. *See id.* at 30, 36.

337. *See* Kwall, *supra* note 185, at 616.

338. *See* TREASURY INTEGRATION STUDY, *supra* note 161, at 35. The Treasury Study articulated several reporting and auditing concerns.

period of time during the quarter.<sup>339</sup> In addition, the timing of reporting presents a problem under this method where corporations own stock in other corporations with a different fiscal year; a corporate shareholder would have to know its share of the income of the corporation in which it held stock before the corporate shareholder could compute its income and allocate it to its own shareholders.<sup>340</sup>

Although the shareholder allocation method is the darling of academics, the complexity it would create is daunting and it would lose significant revenue if it were implemented in a manner consistent with the conduit theory that underlies it (e.g., if it extended corporate tax preferences to shareholders and permitted foreign shareholders to benefit directly from integration).

## 2. Comprehensive Business Income Tax

The Comprehensive Business Income Tax proposal was one of the two integration proposals favored in the Treasury Integration Study.<sup>341</sup> Under the CBIT prototype, debtholders and shareholders would not have to include interest, dividends, and possibly capital gain from the sale of equity in income.<sup>342</sup> There would be an entity level tax, like the current corporate tax, but it would apply to all but the smallest businesses regardless of whether the business was operated in corporate, partnership, limited liability company, or sole proprietorship form. The entity would not be permitted to deduct interest or dividends.<sup>343</sup> Entity-level losses would not pass through to the shareholders.<sup>344</sup>

At the entity level, CBIT would treat debt and equity the same.<sup>345</sup> Under CBIT, the business would pay the tax at the business's

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339. A huge volume of shares trade during the course of a year. During the fourth quarter of 1998, the daily average trading volume for the New York Stock Exchange alone was around 730 million shares. See *New York Stock Exchange Market Information Fact Book* <www.nyse.com>. In addition, many corporations have multiple classes of stock, which would complicate allocation of corporate income. A smaller number of corporations have many classes of stock. For example, Citigroup has one class of common stock and 13 classes of preferred stock. See *THE WALL ST. J.*, Sept. 14, 1999, at C6.

340. See *TREASURY INTEGRATION STUDY*, *supra* note 161, at 35.

341. See *id.* at viii.

342. See *id.* at viii, 83-84. The Study notes that not all gains and losses in the value of stock or debt are attributable to income or losses that have been taken into account at the corporate level. See *id.*

343. See *id.* at 40.

344. See *id.*

345. See *id.* at 39. Simulation models in the Treasury Study indicate that CBIT, relative to the other integration prototypes, would produce the greatest economic welfare gains from elimination of the bias in favor of debt. See *id.* at 132.



marginal rate on interest and dividends distributed and on earnings retained. Only very small businesses could escape the CBIT tax. CBIT would thus reduce the bias against operating in corporate form.<sup>346</sup>

Whether CBIT would reduce the bias in favor of retaining earnings depends on several variables. First, the effect of CBIT on retained earnings would depend on whether the CBIT proposal includes a mechanism for preventing entity-level tax preferences from being passed through to shareholders. CBIT would tax business earnings at the entity level but would not tax investors on interest or dividends.

Recall that the Treasury Study recommended that corporate tax preferences not be passed through to individuals.<sup>347</sup> There would be two ways to eliminate the pass through of the entity-level preferences.<sup>348</sup> Either (1) a tax could be imposed at the investor level on interest or dividends made out of preference income,<sup>349</sup> or (2) a compensatory tax could be imposed at the entity level on distributions made out of preference income.<sup>350</sup> The Treasury Study notes that the compensatory tax would be simpler because it would permit investors to exclude all distributions.<sup>351</sup> It would, however, increase the tax burden on distributions, which would encourage entities to retain earnings.

If that problem could be resolved, the CBIT proposal might replace the incentive to retain earnings with an incentive to distribute earnings on which entity-level tax had been paid. The corporation would owe tax on its earnings whether they were distributed or not. If the after-tax earnings were distributed, the holder would have the use of the dividend immediately. If the after-tax earnings were not distributed currently, the holder would lose the use of those funds until they were later distributed tax-free. This proposal would encourage distribution of earnings<sup>352</sup> but that incentive might be offset if redemptions and sales of equity were treated more favorably than distributions.

The tax treatment of redemptions and sales under CBIT is uncertain. If a compensatory tax were adopted, Treasury's position was that CBIT could exclude investor level gain or loss from redemptions

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346. *See id.* at 40.

347. *See id.* at ix.

348. *See id.* at 43.

349. *See id.* This alternative is further developed in the Treasury Study. *See id.* at 45-49.

350. *See id.*

351. *See id.*

352. Shareholders would be in favor of the corporation retaining earnings as long as the corporate managers could invest the retained earnings effectively for the shareholders.

and sales of equity in the entity.<sup>353</sup> If CBIT did not include a compensatory tax, Treasury's position was that capital gain may or may not be excluded, since it would be unclear what percentage of the gain is attributable to entity-level earnings that had already been taxed but were retained, and what percentage would be attributable to untaxed entity-level earnings or future entity-level earnings.<sup>354</sup> Excluding investor level gain from income would create an incentive for the business entity to defer its earnings, for example by deferring the sale of appreciated entity assets. Taxing investor level gain would encourage the current distribution of earnings since distributions would be taxed once but gain would be taxed twice.

CBIT would potentially create another type of distortion. Business entities would have an incentive to recharacterize nondeductible interest as a deductible form of expense, such as rent or principal on debt used to acquire a depreciable asset. This incentive under CBIT would not be as great as under the proposal to eliminate the corporate interest deduction. Under the interest elimination proposal, bondholders would be required to include interest in income. Under the CBIT proposal, the bondholder would be able to exclude interest. If the bondholder's tax rate exceeded the entity's CBIT tax rate, interest would be tax advantaged. If the entity's CBIT tax rate exceeded the bondholder's tax rate (*e.g.*, if the bondholder were tax exempt), the entity would have an incentive to recharacterize interest.

The large amount of revenue raised by significantly expanding the base of the business tax could be used to reduce the top business tax rate. The 1992 Treasury Integration Study suggested replacing the 34 percent marginal corporate tax rate with a 31 percent CBIT rate, bringing the business tax rate in line with the marginal individual tax rate at that time, 31 percent.<sup>355</sup> Since the issuance of the Treasury Study, the top marginal corporate tax rate has increased to

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353. Treasury noted:

If CBIT includes a compensatory tax, exempting gains and losses from the sale of equity interests in CBIT entities could be justified on the ground that those gains and losses either have been, or will be, taken into account in calculating the income tax imposed at the entity level. Retained taxable income has already been subject to tax, retained preference income will be subject to compensatory tax under CBIT when distributed, and unrealized appreciation represents anticipated higher future earnings that will be subject to entity level tax if and when they are realized.

*Id.* at 83.

If a compensatory tax were imposed on dividends but not on redemptions, redemptions would be tax favored because they would allow the pass through of preferences. If redemptions were treated like dividend distributions, that would create a bias in favor of shareholder sales to third parties, instead of redemptions. *See id.* at 85.

354. *See id.* at 83.

355. *Id.*

35 percent and the top marginal individual income tax rate has increased to 39.6 percent.<sup>356</sup>

Having a 39.6 percent rate on individual income and a lower rate on business income would create a new type of distortion, encouraging individuals to run their income through a business form subject to the lower tax rate.<sup>357</sup> This problem could be ameliorated by using some of the revenue raised from broadening the business tax base to reduce both the business tax rate and the individual tax rate. Depending on the incidence of the business tax, such a move may represent a redistribution of tax burdens. Another approach would be to set the CBIT rate at the top marginal individual income tax rate, currently 39.6 percent.

The CBIT proposal would undermine the progressivity of the income tax.<sup>358</sup> CBIT would impose business tax at a single rate, *e.g.*, 31 percent or 39.6 percent, but the individual income tax would impose tax at progressive rates (currently 15 percent, 28 percent, 31 percent, 36 percent and 39.6 percent<sup>359</sup>). Since CBIT would apply to all but the tiniest businesses, CBIT would reduce the progressivity of the individual income tax because all business income (except perhaps capital gain on the sale of CBIT equity) would be subject to the CBIT flat rate. If low-bracket taxpayers responded by substituting wage income for business income,<sup>360</sup> the effect on progressivity would be reduced but a new inefficiency would be created.<sup>361</sup> The bias against business income would be offset to some extent if gain from the redemption or sale of CBIT equity were taxed at a lower rate.

Under the Treasury Study CBIT proposal, business losses would not pass through to investors. Under current law, utilization of corporate losses is very limited,<sup>362</sup> losses of pass-through entities like

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356. See I.R.C. § 1(a)-(e) (West Supp. 1999). Various provisions (*e.g.*, the phase out of itemized deductions under I.R.C. § 68) may make a taxpayer's effective tax rate higher than the rate specified in I.R.C. § 1.

357. This may also undermine the progressivity of the income tax because high-bracket taxpayers could reduce their effective tax rate by running their income through a CBIT entity.

358. The progressivity of the income tax is the subject of a highly regarded article by Professors Bankman and Griffith. See generally Bankman & Griffith, *supra* note 198.

359. See I.R.C. §§ 1(a)-(e) (West Supp. 1999).

360. A significant amount of publicly traded stock is owned by individuals and families who are not subject to the top tax rate bracket. In 1992, American individuals and families with income of under \$15,000 owned 2.7 million shares of stock. Individuals and families with income of between \$15,000 and \$25,000 owned another 4.9 million shares and individuals and families with income of between \$25,000 and \$50,000 owned another 15.2 million shares. Individuals and families with income of \$40,000 or less collectively owned 40 percent of publicly traded stocks. NEW YORK STOCK EXCHANGE, INC., FACT BOOK FOR THE YEAR 1997, at 57, 59 (1998).

361. See Bittker, *supra* note 198.

362. See I.R.C. §§ 172, 382 (amended 1996) (1994).

partnerships do pass through to investors, but may be subject to several statutory limitations that effectively prevent passive individual and closely-held corporate investors from using pass-through losses to offset their other income.<sup>363</sup> Adopting CBIT with corporate-style loss limitations may increase the current bias against investment in risky businesses, including start-ups.<sup>364</sup> Professor Knoll has argued that risky technology businesses disproportionately fuel economic growth, so the tax system should encourage investment in such businesses.<sup>365</sup> Congress could reduce that distortion by liberalizing our existing loss limitation rules. That would, of course, reduce the amount of revenue raised by CBIT.

### 3. Shareholder Level Dividends Received Exclusion

Under the shareholder level dividends received exclusion proposal, corporations would continue to pay the corporate tax at the corporate tax rates, but shareholders would exclude dividends received to the extent that corporate tax had already been paid on those distributed earnings.<sup>366</sup> The shareholder would include in income the portion of a dividend that exceeded the excludable amount. Corporate interest would still be deducted by the corporate issuer and included by the bondholder. Dividends received by tax-exempt or foreign shareholders would be subject to corporate level tax at the corporate rate. This proposal would require shareholders to pay tax on dividends to the extent the dividends were paid out of corporate income that had not been taxed at the corporate level because of a corporate tax preference.<sup>367</sup>

The shareholder level dividends received exclusion prototype would reduce the debt-equity distortion, but it would not eliminate it because the dividend exclusion prototype taxes interest and dividends differently: interest would be deducted by the corporate issuer and

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363. These limitations include the I.R.C. § 704(b) substantial economic effect rules, the basis limitation rule of § 704(d), the passive loss limitations of § 469, and the at-risk limitations of § 465.

364. On the other hand, Professor Bankman's research indicates that many risky Silicon Valley start-ups are initially organized as corporations despite the fact that doing so frequently results in the inability to utilize millions of dollars of losses incurred in the start-up phase. See Joseph Bankman, *The Structure of Silicon Valley Start-ups*, 41 UCLA L. REV. 1737, 1737, 1743-46 (1994).

365. See Knoll, *supra* note 143, at 1504-05.

366. See TREASURY INTEGRATION STUDY, *supra* note 161, at 17. Corporations would maintain an "Excludable Distributions Account" ("EDA") to keep track of the distributable amount on which corporate tax had already been paid. See *id.*

367. See *id.*

included by the bondholder when paid or accrued. Dividends would not be deducted by the corporation but would be excluded by the shareholders when received. In other words, corporate interest would be taxed at the bondholder's tax rate and dividends and retained earnings would be taxed at the corporate rate.

The effect of this proposal on the bias in favor of issuing debt would also depend on the corporation's marginal tax rate and its marginal investor's top tax rate. If the corporation's effective tax rate were higher than the marginal investor's tax rate, issuing corporate debt would still be tax advantaged.<sup>368</sup> As the corporation issues debt, the corporate interest deductions would reduce the corporation's effective tax rate.<sup>369</sup> The incentive to issue corporate debt would be eliminated when the corporation's effective tax rate equaled the marginal investor's tax rate.<sup>370</sup>

If, on the other hand, the corporation's effective tax rate were lower than the marginal shareholder's tax rate, issuing debt would be disadvantaged from a tax point of view.<sup>371</sup> For example, if a corporation's effective tax rate were 35 percent (the top corporate rate today) and the marginal investor's tax rate were 39.6 percent (the top individual rate today), issuing corporate debt would be tax disadvantaged because the interest on the debt would be taxed at a 39.6 percent rate instead of a 35 percent rate. If the corporation instead issued equity, the dividend return on that equity would be taxed at the 35 percent corporate rate instead of the 39.6 rate. Adopting a shareholder level dividend exclusion model would thus retain a distortion based on the debt-equity classification.

The dividend exclusion proposal does not affect loss utilization directly. If the proposal created a bias in favor of issuing equity instead of debt, as it would with the current corporate and individual rates, corporate losses would be lower, which would reduce the effect of the distortion caused by incomplete corporate loss offsets.

The dividend exclusion proposal would, at first, seem to eliminate the incentive to retain earnings instead of paying them out as dividends. The corporation would owe tax on its earnings whether they were distributed or not. If the after-tax earnings were distributed, the shareholder would have the use of the dividend immediately at no additional tax cost. If the after-tax earnings were not distributed currently, the shareholder would lose the use of those

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368. See Knoll, *supra* note 143, at 1513.

369. See *id.* at 1513-14.

370. See *id.* at 1514.

371. See *id.*

funds until they were later distributed. This aspect of the proposal would encourage distribution of earnings,<sup>372</sup> but this incentive might be offset if redemptions and sales of stock were treated more favorably than distributions.

In other words, the effect of dividend exclusion on retained earnings depends in part on how gain from the redemption or sale of stock would be treated. The treatment of redemptions and stock sales to third parties is uncertain under this prototype. The possibilities are that shareholders: (1) fully include gain from stock redemptions and sales as they do under current law; (2) fully exclude gain from stock redemptions and sales; or (3) exclude a portion of gain from stock redemptions and sales. If the gain on the redemption or sale of stock were solely attributable to appreciation from retained earnings already taxed at the corporate level, it would be consistent to permit the shareholder to exclude all of the gain.

The Treasury Study notes, however, that retained earnings may not account for all of the appreciation in the value of stock for several reasons.<sup>373</sup> First, the corporation may have realized and retained some income that is not taxed at the corporate level because of a corporate tax preference.<sup>374</sup> Second, corporate assets may have appreciated but that appreciation will not have been taxed at the corporate level if gain from that asset has not yet been realized at the corporate level.<sup>375</sup> Third, the stock may have appreciated in value because investors have increased their estimates of the future cash flows of the corporation, which have not yet been earned.<sup>376</sup> In any of these cases, the shareholder gain from the sale or redemption of stock would not be attributable to earnings that have already been taxed at the corporate level, so it may not make sense to permit the shareholder to exclude all of the sale or redemption gain.

Permitting shareholders to exclude gain from redemptions or sales of stock would create a bias in favor of corporations not disposing of appreciated property and shareholders realizing that appreciation through stock redemptions and sales that would not be taxed at the

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372. Shareholders would be in favor of the corporation retaining earnings as long as the corporate managers could invest the retained earnings effectively for the shareholders. The shareholders would not be in favor of managers retaining earnings to invest in projects with a negative net present value.

373. See TREASURY INTEGRATION STUDY, *supra* note 161, at 82.

374. See *id.* The Treasury Study articulates a recommendation that corporate tax preferences not be passed through to shareholders. See *id.* at viii. Consistent with that recommendation, shareholder level gain attributable to such preference income should be taxed at the shareholder level.

375. See *id.* at 82.

376. See *id.*

shareholder level. In other words, it would encourage corporations to defer the realization of gain.

Requiring shareholders to fully include gain, as under current law, would create a bias against retaining earnings because taxing the gain on redemptions and sales would impose a second layer of tax on corporate income.<sup>377</sup> To the extent a shareholder's gain was attributable to retained earnings on which the corporation had already paid tax, taxing the gain would be the second layer of tax. To the extent a shareholder's gain was attributable to future corporate gain or earnings, the first layer of tax would be imposed at the shareholder level, and the second layer of tax would be imposed at the corporate level when the income was earned or the assets were sold. Imposing a double tax on these corporate earnings would encourage corporations to distribute earnings instead of retaining them.

The Treasury Study notes that corporations could be permitted to adopt a dividend reinvestment plan ("DRIP").<sup>378</sup> Under such a plan, the corporation would be deemed to have distributed the taxed earnings of the corporation. The shareholder would exclude the deemed dividend, then be deemed to have reinvested it in the corporation, which would increase the shareholder's basis in the stock by the reinvested amount.<sup>379</sup> Any capital gain from the sale of the stock would then, at least theoretically, be attributable to appreciation that had not been taxed at the corporate level. If this were the case, Treasury's position is that the gain should be taxed at the shareholder level. Note that this would still result in double taxation of future corporate income and gain, which would still be subject to corporate tax in the future. This problem arises in part because of the distortion caused by the realization requirement.

The other problem with the DRIP mechanism is the complexity it would add to the shareholder dividend exclusion proposal.<sup>380</sup> Employing a DRIP would require corporations to allocate earnings shareholder by shareholder. On the other hand, corporations have to do just that type of allocation when they declare and pay a real dividend. The task of allocating and paying real dividends is made simpler by fixing the list of shareholders as of a so-called record date. The shareholder dividend exclusion proposal, combined with a DRIP, is less complex than the shareholder allocation proposal because the

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377. *See id.* at 83.

378. *See id.* at 87.

379. *See id.*

380. Kwall argues that the DRIP mechanism is even too complex to be applied to complex private firms. *See* Kwall, *supra* note 283, at 273-75.

former could allocate earnings and distribute a deemed dividend to shareholders of record as of a record date while the latter requires the allocation of earnings to all shareholders who held stock throughout the year.

If this proposal taxed shareholder capital gain but did not permit DRIPs, the proposal would replace the bias in favor of retaining earnings with a bias in favor of distributing earnings. Inverting an existing distortion may be just as inefficient as the existing distortion. In this case, however, replacing the bias in favor of retaining earnings with a bias in favor of distributing earnings may increase efficiency. The current bias encourages managers to retain earnings to fund projects even if the projects do not have a positive net present value.<sup>381</sup> If the bias in favor of retaining earnings were replaced with a bias in favor of distributing earnings, managers who needed to raise capital to fund projects would have to justify those projects to investors in order to raise the capital. If a corporation were permitted to adopt a DRIP, there would be a deemed distribution and reinvestment in the corporation, which would exacerbate the current distortion caused by the retained earnings bias.

#### 4. Corporate Level Dividends Paid Deduction

Under this proposal, corporations would continue to pay corporate tax but would be allowed to deduct both interest and dividends. This proposal would do a better job of eliminating the debt-equity distortion than the shareholder level dividend exclusion proposal because this proposal would tax both interest and dividends at the investor's rate. It would not eliminate the distinction, however, in part because it would not eliminate the investor level differences between stock and debt. Whether the proposal would encourage the issuance of debt or equity depends on whether it would force corporate managers to currently distribute earnings, which in turn depends on how gain from the redemption or sale of stock would be treated.

Under current law, retaining earnings is tax advantaged compared to distributing dividends. If shareholders were required to fully include gain from stock redemptions and sales, this proposal would invert the current bias in favor of retaining earnings. Under this proposal, one level (or perhaps zero levels) of tax would be imposed on earnings currently distributed as dividends. If a corporation retained earnings, the corporation's income would include those earnings. In addition, any shareholder stock gain attributable to

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381. See Arlen & Weiss, *supra* note 229, at 348.



those retained earnings would presumably be taxed a second time when the shareholder sold the stock. This would create pressure to distribute dividends currently. Replacing the bias in favor of retaining earnings with a bias in favor of distributing earnings may increase efficiency for the reasons discussed above in conjunction with the shareholder dividend exclusion proposal.

If the potential double tax on retained earnings forced managers to currently distribute earnings, the corporate dividend deduction proposal would invert, not simply neutralize, the bias in favor of issuing debt because of investor level differences between stock and debt. For example, there are timing differences between the investor level consequences of stock and debt. Bondholders include the interest when it is paid or accrued under the OID rules and pay tax on that interest at ordinary income rates. Shareholders include dividends when they are paid and pay tax on those dividends at ordinary income rates. Considering this timing difference, it would seem that high-bracket taxpayers would prefer to own equity so they have cash with which to pay the tax on the distribution. Bonds would no longer be tax favored at the corporate level, so corporations would not be willing to discount their bonds to attract taxpayers other than tax-exempt shareholders. (If managers did not currently distribute earnings, the double tax on retained earnings would make equity much less desirable to investors.)

Inverting an existing distortion may be just as inefficient as the existing distortion. In this case, however, replacing the bias in favor of debt with a bias in favor of equity would probably increase efficiency. Debt levels have grown significantly in the last 15 years, increasing the overleveraging problem discussed in Part II. Replacing the debt bias with an equity bias would reverse that problematic trend, but what kind of new inefficiencies might the equity bias create? Some commentators have argued that high corporate debt levels are beneficial because lenders are effective monitors of corporate management,<sup>382</sup> although other commentators disagree.<sup>383</sup> If reduced debt levels led to reduced monitoring of corporate managers, however, that monitoring problem could be addressed directly.

Allowing corporations to deduct dividends would increase corporate losses<sup>384</sup> so this proposal would increase the distortion

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382. *See supra* note 161.

383. *See supra* note 162.

384. Even without the additional corporate dividend deduction, a significant percentage of public corporations have net operating losses.

caused by the limitations on utilization of corporate losses. This proposal would also lose a significant amount of revenue.<sup>385</sup>

The 1992 Treasury Integration Study rejected the dividend deduction prototype.<sup>386</sup> Recall that the Study recommended taxing corporate income once<sup>387</sup> but suggested that (1) integration should not reduce the total tax collected from tax-exempt shareholders, and (2) integration benefits should be extended to foreign shareholders by treaty, not by statute.<sup>388</sup> Treasury was concerned that, if a corporation deducted the dividends it paid shareholders, and the dividends were paid to tax-exempt or foreign shareholders, no tax would be collected on the corporate earnings.<sup>389</sup> A dividend deduction model was thus inconsistent with Treasury's goal of taxing business income once.<sup>390</sup>

##### 5. Eliminate the Corporate Interest Deduction<sup>391</sup>

If Congress eliminated the corporate interest deduction, earnings distributed as interest would be taxed twice, first at the corporate rate, then at the bondholder's ordinary income rate.<sup>392</sup> Under this system, current distributions would be taxed twice at ordinary income rates, whether distributed as interest or dividends. Retained earnings would be taxed first at the corporate rate. The second layer of

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[I]n 1993, . . . just slightly over one-half of the [C corporation] income tax returns filed . . . reported net income. The C corporation returns without net income reported an aggregate loss of over \$127 billion, an average loss of over \$136,000 for each C corporation return without net income. Moreover, over 39% of the C corporation returns with net income claimed a net operating loss deduction from a prior year loss, with a total of over \$45 billion in such deductions claimed.

Yin, *supra* note 287, at 182 (citing INTERNAL REVENUE SERVICE, 1993 STATISTICS OF INCOME, CORPORATION INCOME TAX RETURNS, Publ. 16, tbl. 18, col. (1), (1996)).

385. In 1984, Treasury estimated that a proposal to permit corporations to deduct half of the dividends they paid would lose \$38 billion of revenue for fiscal year 1990. See 1 TREASURY DEP'T REPORT, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 248 (1984).

386. *See id.* at 107.

387. *See id.* at 12.

388. *See id.* at ix.

389. *See id.* at 107.

390. *See id.*

391. There are many versions of this type of proposal. For example, the report on corporate restructurings prepared by the Joint Committee on Taxation included the following variations: (1) disallowing a flat percentage of all interest deductions; (2) disallowing interest deductions in excess of a specified rate of return to investors; (3) interest indexing for inflation; (4) disallowing interest deductions in excess of a specified percentage of pre-interest deduction taxable income or earnings and profits; (5) disallowing interest deductions on debt issued in exchange for repurchasing the issuer's equity; and (6) disallowing interest deductions on debt issued to purchase another corporation. See CORPORATE FINANCIAL STRUCTURES, *supra* note 144, at 103-12. In the discussion in the text, I will consider the broad-based disallowance of the corporate interest deduction.

392. Again, this assumes that the bondholder is not tax-exempt.

tax would be deferred until the corporation distributed the retained earnings as a dividend or the shareholder sold stock that had appreciated because of the retained earnings. Retaining earnings would be the only way to defer the second layer of tax, so retaining earnings would be even more tax favored under this proposal than under current law.

If the retained earnings were later distributed to the shareholder as a dividend, they would be taxed again at the shareholder's ordinary income rate. If the shareholder sold the stock, the value of which had increased because of undistributed retained earnings, the shareholder would pay tax on the gain from the sale of the stock at capital gain rates.<sup>393</sup> If two layers of tax on corporate earnings were unavoidable, deferring the second layer of tax, being allowed basis recovery, and qualifying for capital gains rates would be even more tax-advantaged than they are now. In addition, if the marginal corporate rate were lower than the marginal individual rate, as it is now for taxpayers in the top bracket, and the shareholder capital gain tax were deferred for long enough, the effective tax on corporate equity under this proposal could be lower than the shareholders' marginal individual tax rates. In other words, deferral of the second layer of tax could reduce the second layer of tax substantially.

Under this proposal, debt would no longer be tax-advantaged at the corporate level, so corporations would not be willing to discount their debt to attract higher bracket investors. High bracket taxpayers would still prefer to own equity, because retained earnings would be tax-favored, so eliminating the corporate interest deduction would probably encourage the issuance of equity instead of debt.<sup>394</sup> Replacing the bias in favor of debt with a bias in favor of equity would probably increase efficiency for the reasons discussed above in conjunction with the corporate dividends paid deduction proposal.

The increased bias in favor of retained earnings could potentially be offset by expanding the enforcement of the accumulated earnings tax.<sup>395</sup> Under current law, a corporation that retains earnings beyond the reasonable needs of the corporation is subject to a penalty

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393. The same would be true for a redemption.

394. The magnitude of this effect depends on the breakdown of investors between high and low bracket taxpayers. Demand from taxpayers in different brackets would affect the returns on those investments. Over time, if the economy reaches equilibrium, there may be no tax advantage to issuing debt or equity.

395. See I.R.C. § 531 (1994).

tax of 39.6 percent. Expanding the enforcement of the accumulated earnings tax could discourage the retention of earnings.

Eliminating the interest deduction for corporate taxpayers but not other taxpayers would magnify the current distortion caused by taxing corporations differently than other businesses. New businesses that could use the tax shield provided by interest deductions would be encouraged to operate in noncorporate form. Existing corporations that could use the tax shield provided from an interest deduction would be encouraged to disincorporate. Disincorporating is less tax-advantaged than initially setting up a business in noncorporate form, however, because disincorporating would trigger gain at both the corporate and shareholder levels.<sup>396</sup> In addition, operating as an unincorporated business would permit the business to deduct interest on its debt only if the business remained private, since unincorporated businesses with publicly traded interests are subject to the corporate tax.<sup>397</sup>

Eliminating the interest deduction would raise significant revenue.<sup>398</sup> The substantial revenue raised from eliminating the corporate interest deduction could be used to reduce the corporate tax rates, thereby reducing the disadvantage from operating in corporate form. Eliminating the corporate interest deduction would expand the corporate tax base, but the tax rate on that expanded base could be reduced so that there would be no aggregate increase in corporate tax revenue. There would however be industry-wide and individual winners and losers under the new system. Businesses in industries with higher debt capacity would owe more corporate tax and businesses in industries with lower debt capacity would owe less corporate tax. New businesses with low debt capacity potential would be encouraged to incorporate, but businesses with high debt capacity would be discouraged from incorporating.

On the other hand, the incentive to operate in corporate form may be offset to some extent because of the limitations on the utilization of corporate losses. Recall that utilization of corporate losses is severely limited. Pass-through entities, however, are permitted to pass losses through to investors, although many individual shareholders would not be able to fully utilize the losses

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396. See Auerbach, *supra* note 309, at 93-94.

397. See I.R.C. § 7704 (1994 & West Supp. 1999) (amended 1998); Treas. Reg. § 301.7701-3(b)(1).

398. *cf.* U.S. DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 544, tbl. 863 (118th ed., 1998). The table shows the aggregate annual interest corporations deducted in nine years between 1980 and 1995. In 1995, for example, corporations deducted \$744 billion of interest.

because of various statutory limitations.<sup>399</sup> Start-ups, for example high tech start-ups, are risky and are likely to generate tax losses, although the interest elimination proposal would increase corporate income and reduce the likelihood of a corporation having losses. The corporate limitations on full loss offsets may thus discourage risky, low debt capacity businesses from incorporating; by operating in noncorporate form, the business could offer investors the advantage of the pass through of losses.<sup>400</sup> On the other hand, the proposal would encourage incorporation of low debt capacity businesses that are expected to be profitable.

If elimination of the interest deduction and corporate tax rate reduction favored low debt capacity businesses, that might be beneficial to the economy because low debt capacity companies disproportionately spur economic growth.<sup>401</sup> On the other hand, this proposal would magnify another distortion that already encourages investment in such companies—the costs of creating intangible assets are often currently deductible, but the costs of purchasing tangible assets are deducted over time. That distortion is already considered significant enough that commentators have felt the need to make proposals to eliminate it.<sup>402</sup>

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399. Losses passed through are subject to various limitations, including the I.R.C. § 704(b) substantial economic effect rules, the basis limitation rule of § 704(d), the passive loss limitations of § 469, and the at-risk limitations of § 465.

400. However, Professor Bankman has observed that risky new technology ventures with intangible assets often incorporate despite the limitations on the utilization of corporate losses. *See* Bankman, *supra* note 364, at 1737, 1743-46. The Silicon Valley executives who Professor Bankman interviewed offered several justifications for incorporating start-ups (although many of the executives admitted that they had never focused on the tax incentives). For example, one justification for incorporating was that organizing a start-up as a corporation permitted the business to do a future initial public offering without having to pay to convert the business into a corporation. *See id.* at 1749.

401. *See* Knoll, *supra* note 143, at 1504-05.

402. *See, e.g., House Hearings on Mergers and Acquisitions, supra* note 162 (proposing a corporate cash flow tax that would permit corporations to immediately deduct the cost of tangible assets).

Professor Feldstein, among others, has argued that we should replace the corporate income tax with a corporate cash flow tax, even if we retain the rest of the income tax. *See id.*; *see also* R. Glenn Hubbard, *Tax Corporate Cash Flow, Not Income*, WALL ST. J., Feb. 16, 1989; Mervyn A. King, *The Cash Flow Corporate Income Tax*, in *THE EFFECTS OF TAXATION ON CAPITAL ACCUMULATION* 378 (Martin Feldstein ed., 1987).

The base of the corporate cash flow tax would be (1) the corporation's cash revenue less (2) its cash expenses other than payments to debt and equity capital providers. In other words, corporations would not be able to deduct interest or dividends. Under this corporate cash flow tax, investments in plant, equipment, and inventory would be expensed immediately. Eliminating the interest deduction would reduce the current bias in favor of issuing debt. *See House Hearings on Mergers and Acquisitions, supra* note 162. Allowing immediate expensing of the cost of tangible assets would remove a perceived distortion that encourages investment in

Professor Knoll would also tax shareholders currently on their share of corporate retained earnings to ameliorate the increased incentive to retain earnings.<sup>403</sup> In effect, his proposal blends elimination of the corporate interest deduction and current shareholder level tax on undistributed earnings allocable to the shareholder. This would seem to offer high debt capacity corporations the worst of both worlds: (1) loss of the interest deductions the business would have been allowed had it operated in noncorporate form, and (2) current shareholder level taxation of earnings in line with a pass-through model (but perhaps without crediting the shareholder for the corporate tax paid). Professor Knoll would reduce corporate rates, but operating in corporate form may still be tax-disadvantaged for high debt capacity businesses.

Eliminating the corporate interest deduction would create a new type of distortion. Corporate taxpayers would have an incentive to characterize the costs of financing as a deductible form of expense (e.g., rent or principal on debt used to acquire a depreciable asset) instead of as interest. This new distortion could create new forms of uncertainty, complexity, and tax arbitrage, but this new problem would be limited to the types of costs that could be plausibly recharacterized.

## 6. Corporate Cost of Capital Allowance Deduction

A number of economists and tax commentators have proposed that Congress repeal the corporate interest deduction and replace it with a cost of capital allowance ("COCA") deduction.<sup>404</sup> The COCA deduction would equal a fixed percentage of the corporation's

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intangible assets, the cost of which can be immediately deducted, and discourages investment in tangible assets, the cost of which is deducted over a period of years. *See id.* On the other hand, Professor Knoll argues that we *should* encourage investment in risky, potentially high-growth businesses, which tend to employ intangible assets.

Under a corporate cash flow tax, there may still be a bias against investing in the corporate sector. *See* TREASURY INTEGRATION STUDY, *supra* note 161, at 192 n.39. If the effective tax rate on dividends exceeded the effective tax rate on capital gain from the sale of stock, the bias in favor of retaining earnings would continue. *See id.*

403. *See* Knoll, *supra* note 143, at 1508-10. The increased incentive to retain earnings could also be offset by expanded enforcement of the accumulated earnings tax. *See* I.R.C. § 531 (1994).

404. *See, e.g.,* George N. Hatsopoulos et al., *Overconsumption: The Challenge to U.S. Economic Policy*, 1989 AM. BUS. CONF. & THERMO ELECTRON CORP.; *The Cost of Capital Consequences of Curbing Corporate Borrowing: Hearings Before the House Comm. on Ways and Means*, 101st Cong., 1st Sess. (1989) (statement of James M. Poterba); Kleinbard, *supra* note 103. The Joint Committee on Taxation included discussion of a variation of COCA in its 1989 report on corporate restructurings. *See* CORPORATE FINANCIAL STRUCTURES, *supra* note 144, at 116.

aggregate capitalization, regardless of whether that capital was in the form of debt or equity.<sup>405</sup> The effect would be similar to giving a corporation a partial interest deduction and a partial dividends paid deduction. The COCA deduction percentage rate could be set to make the substitution of COCA for the interest deduction revenue neutral,<sup>406</sup> or it could be set to track a risk-free rate, such as the interest rate on Treasury bonds.<sup>407</sup>

Under Edward Kleinbard's version of COCA, if a corporation entered into a contract to manage interest rate risk, such as an interest rate swap, gain or loss on that risk management contract would be disregarded for tax purposes.<sup>408</sup>

*Example 3:*

X Corporation's total capitalization is \$100 million. The COCA percentage is five percent. X Corporation has outstanding \$40 million of equity and \$60 million of debt. The debt bears a floating interest rate, such as LIBOR.<sup>409</sup> X Corporation wants to cap its annual interest payments at \$6 million (or 10 percent of its debt), so it enters into an interest rate swap contract with a counterparty, Y. The contract obligates X Corporation to pay Y an annual amount equal to 10 percent of a \$60 million notional principal amount.<sup>410</sup> Y is obligated to pay X Corporation the floating LIBOR rate on the \$60 million notional principal amount. In year one, X Corporation pays \$7 million of interest on that debt. Under the notional principal contract between X Corporation and Y, X Corporation is obligated to pay Y \$6 million and Y is obligated to pay X Corporation \$7 million. The payments are netted and Y pays X Corporation \$1 million. X Corporation's actual interest cost is \$6 million (\$7 million X Corporation paid the debtholders less \$1 million X Corporation received from Y). Under the Kleinbard COCA proposal, X Corporation's COCA deduction would equal \$5 million, which is the product of multiplying the \$100 million X Corporation capitalization by the five percent COCA rate. Although X Corporation made \$1 million on its contract with Y, X Corporation

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405. Hatsopoulos, *supra* note 404, at 16.

406. Hatsopoulos, Krugman, and Poterba give an example, computed in 1989, employing 1989 debt-equity ratios and interest rates. They estimate that a COCA deduction could be revenue neutral if the COCA percentage were set at five percent. *See id.* at 26-27, app. IV.

407. *See* Kleinbard, *supra* note 103, at 943.

408. *See id.* at 959.

Since the whole purpose of the COCA System would be to substitute an arbitrary annual deduction for all the various components of a corporate taxpayer's actual annual cost of capital, under the COCA System corporations would not recognize gain or loss on any liability management transaction, just as corporations currently recognize no gain or loss on trading in their own stock . . . Similarly, gain or loss attributable to any designated liability management tool employed by a corporate issuer to manage capital costs (*e.g.*, an interest rate swap, cap or forward contract), once identified as part of a taxpayer's cost of capital "account," simply would generate tax-free cash flows.

409. LIBOR (London Interbank Offered Rate) is a standardized interest rate used as the benchmark in many international loan transactions.

410. The notional principal amount is not actually loaned. It is simply used to determine each party's payment obligation to the other party.

does not have to include that \$1 million in income because it is part of X Corporation's cost of capital management system<sup>411</sup>

The COCA deduction would appear to reduce the debt-equity distinction, focusing only on the corporate level consequences of the proposal. Corporate capital structure is, however, a function of both corporate level consequences and investor level consequences. Taking into account the investor level consequences, the COCA deduction proposal would invert the bias in favor of issuing debt, creating a new bias in favor of issuing equity.

Under a COCA deduction system, corporate earnings in excess of a time value of money component would be taxed twice, first at the corporate level and again at the investor level. Bondholders would include interest when it is paid or accrued. Shareholders would include dividends when they were paid. If the corporation retained earnings and paid dividends later, shareholders would be able to defer the second layer of tax until the dividends were paid. If the corporation retained earnings and did not pay the earnings out as dividends, the shareholders could later sell the stock and qualify for basis recovery and capital gains rates. If the sale (at which time the second layer of tax would be imposed) were deferred for long enough, the effective cost of the second layer of tax could be substantially reduced. Retaining earnings would be the only way to defer the second layer of tax, so retaining earnings would be even more tax favored under this proposal than under current law. The increased incentive to retain earnings could perhaps be offset by expanded enforcement of the accumulated earnings tax.<sup>412</sup>

High bracket taxpayers would prefer equity as they do now. Debt would no longer be tax-advantaged at the corporate level, so corporations would not be willing to discount their debt in order to achieve tax savings. The COCA proposal would thus discourage the issuance of debt and encourage the issuance of equity. Replacing the bias in favor of debt with a bias in favor of equity would probably

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411. Here is a variation on the example: Assume the same facts as in the last example except that, in year one, *X Corporation* pays \$5 million of interest to its debtholders. Under the notional principal contract between *X Corporation* and *Y*, *X Corporation* is obligated to pay *Y* \$6 million and *Y* is obligated to pay *X Corporation* \$5 million. The payments are netted and *X Corporation* pays *Y* \$1 million. *X Corporation's* actual interest cost is \$6 million (\$5 million *X Corporation* paid the debtholders plus \$1 million *X Corporation* paid *Y*). Under the Kleinbard COCA proposal, *X Corporation's* COCA deduction would equal \$5 million, which is the product of multiplying the \$100 million *X Corporation* capitalization by the five percent COCA rate. Although *X Corporation* lost \$1 million on its contract with *Y*, *X Corporation* would not be allowed to deduct that \$1 million payment because it is part of *X Corporation's* cost of capital management system.

412. See I.R.C. § 531 (1994).



increase efficiency for the reasons discussed above in conjunction with the corporate dividends paid deduction proposal.

Since the COCA deduction proposal would eliminate the current corporate level incentive to sell equity dressed up as debt, it would also render certain complex financial products obsolete.<sup>413</sup> In addition, it would simplify the reporting of risk management devices such as interest rate swaps and currency swaps. This would reduce complexity, uncertainty, and tax arbitrage opportunities. It might create a new distortion though, as corporations try to recharacterize the nondeductible portion of their cost of capital as some type of deductible cost.<sup>414</sup> Although this new distortion could create new forms of uncertainty, complexity, and tax arbitrage, this new problem would be limited to the types of costs that could be recharacterized.

Professor Knoll argues that the debt-equity distinction should be eliminated because it discourages investment in high growth businesses with intangible assets and encourages investment in stable businesses with tangible assets. High growth businesses with intangible assets are less able to borrow than stable businesses with tangible assets. Adopting a COCA deduction would seem to favor low debt capacity businesses. On the other hand, risky, high growth businesses have a higher cost of capital than stable businesses.<sup>415</sup> The annual COCA deduction would be a higher percentage of a stable business's actual cost of capital than the high growth business's cost of capital, so a COCA deduction proposal might still favor stable businesses.

The COCA deduction proposal might also magnify the bias created by rules in the Code that do not permit corporations to make current use of all their losses. Not permitting corporations to completely use their loss offsets discourages investment in risky businesses.<sup>416</sup> Adopting a COCA deduction would increase this bias because it would reduce corporate income.<sup>417</sup> Replacing the interest deduction with a COCA deduction would reduce the income of corporations that would not use much debt in their capital structures

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413. For a discussion of Monthly Income Preferred Shares (MIPS) and related products, see *supra* notes 132-37 and accompanying text.

414. For example, a corporation buying a depreciable asset with purchase money indebtedness would have an incentive to try to recharacterize the nondeductible portion of the economic interest on the loan as part of the purchase price of the asset, which would be deductible over time.

415. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 320 (6th ed., 1996).

416. See Knoll, *supra* note 143, at 1502-03.

417. See *id.* at 1509 n.183.

and increase the income of corporations that would use lots of debt in their capital structures.<sup>418</sup>

Profitable low debt capacity corporations would pay less tax under this proposal. Unprofitable low debt capacity may have losses even without a COCA deduction; increasing the losses by the amount of the COCA deduction would not currently benefit the corporation because of the limitations on the utilization of losses.<sup>419</sup> Of course

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418. For example, assume that *ABC Co.* has outstanding \$40 million of debt and \$60 million of equity. *ABC Co.*'s net income for the year, before taking into account the interest on the debt, is \$6 million. The debt pays annual interest at 10 percent, so *ABC Co.* pays \$4 million of interest each year to its bondholders. Under current law, *ABC Co.* deducts the \$4 million of interest and is left with \$2 million of income on which it would have to pay tax. Assume that *ABC Co.* is in the 35 percent rate bracket. *ABC Co.* owes \$700,000 (35 percent of \$2 million of net income) of tax.

Under the COCA proposal, assuming a fixed COCA percentage of 5 percent, *ABC Co.*'s COCA deduction would be \$5 million (5 percent of \$100 million combined debt and equity). *ABC Co.*'s net income would be \$1 million (\$6 million net income before the COCA deduction less \$5 million COCA deduction). *ABC Co.* would owe \$350,000 (35 percent of \$1 million of income) of tax instead of \$700,000 of tax.

Next, consider an example where the corporation has more debt than equity. For example, assume that *XYZ Co.* has outstanding \$60 million of debt and \$40 million of equity. *XYZ Co.*'s net income for the year, before taking into account the interest on the debt, is \$6 million. The debt pays annual interest at 10 percent, so *XYZ Co.* pays \$6 million of interest each year to its bondholders. Under current law, *XYZ Co.* deducts the \$6 million of interest and is left with zero income so *XYZ Co.* owes no tax for the year.

Under the COCA proposal, assuming a fixed COCA percentage of 5 percent, *XYZ Co.*'s COCA deduction would be \$5 million (5 percent of \$100 million combined debt and equity). *XYZ Co.*'s net income would be \$1 million (\$6 million net income before the COCA deduction less \$5 million COCA deduction). Assume that *XYZ Co.* is in the 35 percent tax bracket. *XYZ Co.* would owe \$350,000 (35 percent of \$1 million of net income) of tax instead of zero tax.

419. Consider an example with an unprofitable, low debt capacity start-up company. Assume that high tech start-up company *Edge Co.* has outstanding \$2 million of debt and \$8 million of equity. In each of the first two years of operations, *Edge Co.* had a \$300,000 net operating loss. Before taking into account the year three interest on the debt, *Edge Co.* has year three net income of \$50,000. The debt pays annual interest at 10 percent, so *Edge Co.* pays \$200,000 of interest each year on its debt. Under current law, *Edge Co.* deducts the \$200,000 of interest and is left with a year three loss of \$150,000. *Edge Co.* would not owe any tax for year three but would not be able to utilize the year three loss currently. The \$150,000 year three loss would be carried forward, under I.R.C. § 172, along with the \$600,000 of losses from years one and two.

Under the COCA proposal, assuming a fixed COCA percentage of 5 percent, *Edge Co.*'s COCA deduction would be \$500,000 (5 percent of \$10 million combined debt and equity). *Edge Co.*'s year three loss under the COCA proposal would be \$450,000 (\$50,000 of net income before the COCA deduction less the \$500,000 COCA deduction). *Edge Co.* would not owe any tax for year three but would not be able to utilize the year three loss currently. The \$450,000 year three loss would be carried forward along with the \$600,000 of losses from years one and two.

Although *Edge Co.*'s hypothetical \$500,000 COCA deduction would be greater than its \$200,000 interest deduction under current law, the increased year three loss that would result from the higher COCA deduction would not benefit *Edge Co.* currently because of the limitations on the utilization of corporate losses.

Worse yet, if more than 50 percent of the equity of *Edge Co.* changed hands, for example because venture capitalists acquired equity in exchange for venture capital, the utilization of losses would be even more severely restricted by I.R.C. § 382. For a discussion of the § 382

Congress could address that problem by liberalizing the rules that limit utilization of corporate losses.<sup>420</sup> In addition, as noted earlier, low debt capacity businesses that anticipated losses might choose to operate in noncorporate form in order to permit greater utilization of firm losses.

If Congress replaced the corporate interest deduction with a corporate COCA deduction, high debt capacity businesses would have an increased incentive to operate in noncorporate form (assuming the business did not need to raise capital in the public markets, which would necessitate corporate tax treatment<sup>421</sup>). Said another way, a business would have an incentive to operate in noncorporate form if the interest on the business's potential debt would exceed the COCA deduction the business could deduct if it operated in corporate form.<sup>422</sup> This incentive would be stronger for new businesses than for existing corporations that would need to disincorporate.<sup>423</sup> Profitable low debt capacity businesses would have an incentive to operate in corporate form because the COCA deduction would exceed the corporation's interest deduction under current law.

The average corporate cost of capital would likely be lower with a COCA deduction than with elimination of the corporate interest deduction and a reduction of the corporate tax rate.<sup>424</sup> Eliminating the

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limitations in the context of start-ups, see Richard L. Parker, *The Innocent Civilians in the War Against NOL Trafficking: Section 382 and the High-Tech Start-Up Companies*, 9 VA. TAX REV. 625 (1990).

420. See, e.g., Mark Campisano & Roberta Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 NW. U. L. REV. 709 (1981).

421. See I.R.C. § 7704 (1994 & West Supp. 1999) (amended 1998); Treas. Reg. § 301.7701-3(b)(1).

422. This assumes that the incomplete loss offset rules would not prevent the business from utilizing the potential interest deduction currently.

423. Disincorporating is less tax-advantaged than initially setting up a business in noncorporate form because disincorporating would trigger gain at both the corporate and shareholder levels. See Auerbach, *supra* note 309, at 93-94. Return to the earlier example involving XYZ Co. in *supra* note 418. XYZ Co. could save \$350,000 by operating in noncorporate form, other things being equal. XYZ Co. may nonetheless not disincorporate for two reasons. First, as Professor Auerbach has noted, disincorporation would result in tax at the corporate and shareholder level. Second, even if XYZ Co. disincorporated, it would be subject to the corporate tax and the COCA rules if interests in XYZ Co. were publicly traded. See I.R.C. § 7704 (1994) (amended 1998); Treas. Reg. § 301.7701-3(b)(1).

424. See Hatsopoulos, *supra* note 404, at 26-27 (app. IV). Hatsopoulos, Krugman, and Poterba give an example to illustrate the relative advantage of adopting the COCA deduction proposal. The following example tracks their example. Assume that shareholders demand a 12 percent return on investment, and creditors demand a 10 percent interest rate on corporate bonds. Also assume that inflation is 4 percent and that the corporate tax rate is 40 percent. Assume that the corporation can earn a 20 percent pre-tax return on investment. (They note that a reduction in corporate tax rates would probably reduce pre-tax returns over time, but assume for purposes of the example that the proposals would not change the pre-tax return.)

corporate interest deduction would provide a windfall to owners of outstanding capital and increase the cost of capital for new capital.<sup>425</sup> The COCA deduction, on the other hand, would not increase the cost of capital or discourage new investment.<sup>426</sup> In addition, investments that can be expensed, such as research and development costs, can typically be financed only with equity, so adopting a COCA proposal would provide a stronger incentive to make those types of investments than under either the interest elimination proposal or under current law.<sup>427</sup>

### C. Summary of the Proposals

How effective is each proposal at eliminating the debt-equity distinction and what happens to the remaining distortions under each

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Based on these assumptions, the after-tax equity cost of funds for the average corporation would be 8 percent, which equals the 12 percent return on equity less 4 percent inflation. The after-tax debt cost of funds for the average corporation would be 2 percent, which equals 6 percent (the 10 percent bond interest multiplied by .6, which is 1 less the .4 corporate tax rate) less 4 percent inflation. If a corporation had a 1:1 debt equity ratio, meaning that it had 50 percent debt and 50 percent equity in its capital structure, its cost of funds would be 5 percent, which is the sum of 4 percent (.5 multiplied by 8 percent equity cost of funds) plus 1 percent (.5 multiplied by 2 percent debt cost of funds).

The corporation's cost of capital depends on the rate at which the funds invested could be deducted. If the invested amount were used to purchase an asset that would depreciate, for economic purposes, at a rate of 10 percent a year, the corporation's cost of capital would be 5 percent if the cost could be expensed immediately, 8.1 percent if the tax code permitted double declining balance cost recovery deductions, and 9.7 percent if the tax code permitted only cost recovery at the economic depreciation rate.

Under the proposal to eliminate the interest deduction and lower corporate rates, Hatsopoulos, Krugman, and Poterba arrive at a cost of funds of 7 percent. *See id.* at 27. In order to compute this percentage, they first compute the rate that the corporate tax would be if the revenue from eliminating the interest deduction were used to fund the rate reduction. Based on the assumptions in the example, they compute the new corporate tax rate of 29 percent. The cost of funds would be 7 percent, which is the sum of (.5 multiplied by (12 percent return on equity less 4 percent inflation)) plus (.5 multiplied by (10 percent interest less 4 percent inflation)).

This raises the corporation's cost of capital to 7 percent if the cost could be expensed immediately, 9.5 percent if the tax code permitted double declining balance cost recovery deductions, and 10.6 percent if the tax code permitted only cost recovery at the economic depreciation rate.

Under a COCA deduction proposal, with a COCA deduction of 5 percent of the combined debt and equity, the cost of funds and the cost of capital are the same as before adopting either proposal. *See id.* at 27. Although the COCA deduction proposal increases the cost of debt, it decreases the cost of equity by the same amount. *See id.*

425. *See id.*

426. *See id.* An example in their article, explained in *supra* note 424, illustrates the effect of an interest elimination proposal and the COCA proposal on the cost of capital.

427. *See id.* This assumes that the business is profitable.

proposal? This section will summarize the effects of each proposal, as discussed in the last section.<sup>428</sup>

Under current law, interest on corporate debt is taxed once at the bondholder's rate. Other corporate earnings are taxed twice, first at the corporate level and again when the shareholder receives a dividend or sells stock that has appreciated in value at least in part due to earnings that have not been distributed. The following four proposals (simplifying a bit) would tax corporate *distributions*, including both interest and dividends, only *once*: (1) shareholder allocation; (2) CBIT; (3) shareholder dividend exclusion; and (4) corporate dividend deduction.

The shareholder allocation proposal opts for conduit treatment and would tax interest at the bondholders' rates and corporate earnings at the shareholders' rates. The CBIT proposal opts for expanded entity taxation and would tax dividends and interest at the same entity rate. The shareholder dividend exclusion proposal would tax dividends at the corporate rate and interest at the bondholders' rates. The corporate dividend deduction proposal would tax dividends at the shareholders' rates and interest at the bondholders' rates.

The proposal to eliminate the corporate interest deduction would tax all corporate earnings twice. The COCA proposal would tax normal profits distributed as dividends at the shareholders' rates and normal profits distributed as interest at the bondholders' rates. The COCA proposal would tax pure profits twice.

The following table illustrates the layers of tax on corporate earnings under each proposal and the rate that would apply to each layer of tax.

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428. The discussion in this section assumes that the reader is familiar with the detailed discussion of each of the proposals in the last section.

**TABLE 1: Layers of Tax on Corporate Earnings  
Under Current Law and Proposals**

<i>Type of proposal</i>	<i>Number of layers of tax and rates</i>
<i>Current law</i> Dividends Interest Gain from sale	1-2 (corporate rate and shareholder ordinary income rate) 0-1 (bondholder ordinary income rate) 1-2 (corporate rate and shareholder capital gain rate)
<i>Shareholder Allocation</i> Dividends Interest Gain from sale	0-1 (shareholder ordinary income rate) 0-1 (bondholder ordinary income rate) 0-2 (shareholder ordinary income rate and capital gain rate)
<i>CBIT</i> Dividends Interest Gain from sale	1 (entity rate) 1 (entity rate) 1-2 (entity rate and shareholder capital gain rate)
<i>Shareholder dividend exclusion</i> Dividends Interest Gain from sale	1 (corporate rate) 0-1 (bondholder ordinary income rate) 1-2 (corporate rate and shareholder capital gain rate)
<i>Corporate dividends paid deduction</i> Dividends Interest Gain from sale	0-1 (shareholder ordinary income rate) 0-1 (bondholder ordinary income rate) 1-2 (corporate rate and shareholder capital gain rate)
<i>Eliminate corporate interest deduction</i> Dividends Interest Gain from sale	1-2 (corporate rate and shareholder ordinary income rate) 1-2 (corporate rate and bondholder ordinary income rate) 1-2 (corporate rate and shareholder capital gain rate)
<i>COCA</i> Dividends  Interest  Gain from sale	0-1 on normal profits (shareholder ordinary income rate) 1-2 on pure profits (corporate rate and shareholder ordinary income rate) 0-1 on normal profits (bondholder ordinary income rate) 1-2 on pure profits (corporate rate and bondholder ordinary income rate) 1-2 (corporate rate and shareholder capital gain rate)

The discussion in the last section demonstrates that there are several ways in which Congress could impose tax once on distributions and make the treatment of dividend and interest distributions roughly or exactly equivalent. Doing so creates collateral problems, however. One problem that came up repeatedly in the last section is *the failure*

of some proposals to ensure that corporate income will be taxed at least once where the investor is foreign or tax-exempt or the corporation has benefited from corporate tax preferences.

Although the current system is thought of as a double tax system, the current system may result in only one layer of tax on corporate earnings if the shareholder is tax-exempt or foreign (so subject to either no tax or a reduced rate of tax) or the corporation takes advantage of corporate tax preferences. The shareholder allocation proposal and the corporate dividends paid deduction proposal would attempt to tax corporate earnings once at the investor level. To the extent that the investors were tax-exempt or foreign or the corporation qualified for corporate level tax preferences, there may be *less than one* layer of tax on the corporate earnings.

The shareholder dividend exclusion proposal would attempt to tax corporate earnings once, with dividends being taxed at the corporate rate and interest being taxed at the bondholders' rates. This proposal removes the second layer of tax on dividends but ensures that at least one layer of tax will be collected on dividends at the corporate level. This proposal, like current law, would result in less than one layer of tax being collected on interest, since the bondholder may be tax-exempt or foreign.

CBIT is the only proposal that ensures that one layer of tax will be collected, because it is the only method that taxes corporate earnings at the entity level.<sup>429</sup> Under CBIT, the tax rates of the investors are irrelevant. Therein lies the beauty of CBIT and the problem with CBIT: investor rates would be irrelevant for purposes of computing the tax on business income, so CBIT would undermine the progressivity of the income tax.

The proposal to eliminate the corporate interest deduction puts debt and equity on more equal footing by taxing all corporate earnings twice. Again, if investors were tax-exempt or foreign or the corporation qualified for corporate tax preferences, the earnings might be taxed only once. For investors that are subject to tax, however, this proposal would impose a double tax on all corporate earnings.

The COCA proposal would impose one layer of tax, at the investor rate, on the normal returns on debt and equity (*i.e.*, the

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429. CBIT could result in less than one layer of tax on business earnings where the entity level tax is reduced by entity level tax preferences and investors exclude distributions. The Treasury Integration Study suggested two mechanisms for preventing the pass through of entity level preferences: (1) tax investors on distributions made out of preference income, or (2) impose a compensatory tax at the entity level on preference income. See *supra* notes 349-50 and accompanying text.

portion of the return that simply compensates the investor for the time value of money). It would impose two layers of tax on the pure profit returns on debt and equity (*i.e.*, the returns in excess of the normal returns). Again if investors were tax-exempt or foreign, or the corporation qualified for corporate tax preferences, the pure profit portion of the earnings might be taxed only once.

Another problem that came up repeatedly in the last section was the *inability of the proposals to equate the tax treatment of corporate distributions and gain from stock redemptions and sales*. If all gain were attributable to corporate earnings that had already been taxed once, then gain should not be taxed under the proposals that attempt to tax corporate earnings once. The problem is this: All, part, or none of the gain from the sale of stock may be attributable to previously taxed corporate earnings. Some of the gain may be attributable to unrealized appreciation in corporate assets or increased estimates of future corporate earnings.

Under the shareholder allocation proposal, the shareholders' stock bases would be increased to reflect the corporate income allocated to the shareholders each year. If the shareholder exclusion proposal were combined with a DRIP, the shareholders' stock bases would be increased if the corporation did not make a dividend distribution.<sup>430</sup> Any capital gain from the redemption or sale of the stock would then be attributable to appreciation that had not already been taxed at the corporate level. If this were the case, Treasury's position is that the gain should be taxed at the shareholder level. Note that this would still result in double taxation of *future* corporate income and gain, which would still be subject to corporate tax when realized in the future.

CBIT theoretically taxes business income once at the entity level. Recall that CBIT could have an entity level compensatory tax on distributions made out of income that was not taxed at the entity level because of a preference. Treasury's position was that, if such a compensatory tax were part of CBIT, investors could be permitted to exclude gain even though some of the investors' gains might be attributable to future entity level income and gain. Excluding investor level gain from income might create an incentive for the business entity to defer its earnings, for example by deferring the sale of appreciated entity assets.

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430. Under the dividend exclusion proposal with a DRIP, a shareholder would exclude the deemed dividend then be deemed to have reinvested it in the corporation, which would increase the shareholder's basis in the stock by the reinvested amount.



The corporate dividend deduction proposal, the proposal to eliminate corporate interest deductions, and the COCA proposal would not alter the current treatment of gain from stock redemptions and sales. The corporate dividend deduction proposal would impose one layer of tax on distributions on debt and equity, but would impose two layers of tax on some corporate earnings (prior corporate earnings that have been retained and future corporate earnings) that cause the value of stock to appreciate. This would encourage the distribution of corporate earnings. Under the proposal to eliminate the corporate interest deduction, however, even distributions would be double taxed so distributions would not be tax favored. If two layers of tax were inevitable, equity would be tax favored because gain would be tax favored over distributions. If the corporation retained earnings, and the retained earnings increased the value of the stock, shareholders could reduce the effective rate on the second layer of tax on the corporate earnings by holding the stock and later selling it. This would permit the shareholder to take advantage of preferential capital gain rates, basis recovery, and the deferral of the gain until the stock is sold. The COCA proposal would have a similar effect because the benefits of the COCA deduction do not depend on the distributions the corporation actually makes.

The next two tables summarize the effects of each proposal on the current biases in favor of retained earnings and debt financing. Again, the consequences of the proposals depend on how capital gain is treated.

**TABLE 2: Effect of Proposals on Bias in Favor of Retaining Earnings**

<i>Type of proposal</i>	<i>Effect on the distortion</i>
<i>Shareholder Allocation</i>	Reduces it.
<i>CBIT</i>	Reduces it (but device to prevent pass through of corporate tax preferences might discourage distributions).
<i>Shareholder dividend exclusion</i>	Inverts it (creating a bias in favor of distributing earnings) if shareholder level capital gain is taxed.
<i>Corporate dividends paid deduction</i>	Inverts it (creating a bias in favor of distributing earnings) if shareholder level capital gain is taxed.
<i>Eliminate corporate interest deduction</i>	Increases it (but could perhaps be offset by expanded enforcement of the accumulated earnings tax).
<i>COCA</i>	Increases it (but could perhaps be offset by expanded enforcement of the accumulated earnings tax).

TABLE 3: Effect of Proposals on Bias in Favor of Debt

<i>Type of proposal</i>	<i>Effect on the distortion</i>
<i>Shareholder Allocation</i>	Reduces it.
<i>CBIT</i>	Creates slight bias in favor of equity if investor level capital gain is not taxed and corporate gain can be deferred. Retains it but reduces bias in favor of debt if capital gain is taxed.
<i>Shareholder dividend exclusion</i>	Reduces it if corporation's effective tax rate is lower than the marginal shareholder tax rate.
<i>Corporate dividends paid deduction</i>	Inverts it, creating a bias in favor of equity, if the double tax on retained earnings forces managers to distribute earnings currently. Retains it if managers do not distribute earnings currently.
<i>Eliminate corporate interest deduction</i>	Inverts it, creating a bias in favor of equity.
<i>COCA</i>	Inverts it, creating a bias in favor of equity.

The next table summarizes the consequences of the proposals on the distortion caused by taxing corporate earnings at higher rates than noncorporate earnings. Each of the proposals that would (at least theoretically) eliminate one layer of tax on corporate earnings would reduce this distortion. The interest elimination proposal would subject all corporate earnings to two layers of tax, which would increase the distortion. The COCA proposal subjects the corporation's normal profits to one layer of tax and subjects the corporation's pure profits to two layers of tax, so it retains the current distortion.

**TABLE 4: Effect of Proposals on Distortion Caused by Taxing Corporate Earnings at Higher Rates than Noncorporate Earnings**

<i>Type of proposal</i>	<i>Effect on the distortion</i>
<i>Shareholder Allocation</i>	Reduces it.
<i>CBIT</i>	Reduces it.
<i>Shareholder dividend exclusion</i>	Reduces it.
<i>Corporate dividends paid deduction</i>	Reduces it.
<i>Eliminate corporate interest deduction</i>	Increases it.
<i>COCA</i>	Retains it.

#### *D. Evaluation of the Proposals*

Which proposals, on balance, would be the most efficient and fair and which would be politically feasible? This section will evaluate the proposals, incorporating political feasibility concerns about the administrability of each proposal,<sup>431</sup> the normative justifications for and revenue effects<sup>432</sup> of each proposal, and likely support or opposition from interest groups such as corporate managers.<sup>433</sup>

If one subscribes to the conduit view of corporations, the shareholder allocation proposal would be the fairest proposal because it would eliminate the separate corporate tax base altogether and tax corporate earnings at the shareholders' rates. In addition, the shareholder allocation proposal would seemingly increase efficiency because it would: (1) reduce the bias in favor of retained earnings; (2) reduce the bias in favor of debt financing; and (3) reduce the distortion

431. Administrative complexity can cause inefficiencies. See Schenk, *supra* note 311, at 577. Administrative complexity can also cause political resistance to a particular proposal.

432. Revenue lost by a proposal may be made up in less efficient or equitable ways. Cf. Kwall, *supra* note 185, at 616. "To determine whether integration is desirable, the equity and efficiency gains achieved by eliminating double taxation must be weighed against the equity and efficiency costs incurred by utilizing an alternative revenue source." *Id.* The political feasibility of a proposal also depends on whether it would lose revenue that would have to be made up with income tax rate increases, income tax base broadening measures or elimination of special rules such as accelerated cost recovery.

433. Past experience with integration proposals indicates that opposition from corporate managers can kill a proposal. See Arlen & Weiss, *supra* note 229, at 365-66.

caused by taxing corporate earnings at higher rates than noncorporate earnings.

Unfortunately, there is an efficiency downside to the shareholder allocation proposal; it is too complicated to administer because it would require the allocation of income to all shareholders, from all classes of stock, who held stock during the year. In addition, this method would lose significant revenue if implemented in a manner consistent with its conduit theory underpinnings (*e.g.*, passing through corporate preferences and taxing corporate earnings distributed to tax-exempt or foreign shareholders less than once). Replacing the lost revenue may create new inequities and inefficiencies. The shareholder allocation method would be even more complicated if it were modified to reduce the revenue loss, for example by preventing the pass through of corporate preferences to shareholders.

The CBIT proposal is just as extreme as the shareholder allocation proposal but it takes the opposite tack to solve the distortions of the corporate tax. Instead of taxing corporate income once at the shareholder rate, CBIT would tax business income once at the entity level and expand the scope of the business tax to reach all but the smallest businesses. CBIT, with its consistent treatment of most businesses, seemingly earns high marks for efficiency because it would: (1) reduce the distortion caused by taxing corporate earnings at higher rates than noncorporate earnings; (2) reduce the distortions caused by the debt-equity distinction; (3) reduce the bias in favor of retaining earnings; and (4) ensure that corporate income distributed to tax-exempt and foreign shareholders would be taxed.

The CBIT proposal has its drawbacks, however. The paramount problem with CBIT is that it would be unfair because it would undermine the progressivity of the income tax, since business income would be subject to the CBIT rate regardless of the investor's tax rate. This new inequity may be reduced if low bracket taxpayers substituted wage income for business income, but that would in turn create a new inefficiency.

In addition, adoption of the CBIT proposal may not be politically feasible for several reasons. First, corporate managers would likely oppose CBIT if it discouraged retention of earnings.<sup>434</sup>

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434. The behavior of corporate managers in connection with corporate tax integration proposals is an example of the old adage that "losers scream louder than winners." See, *e.g.*, JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH* 15 (1st ed., 1988):

Senator Russell Long, who chaired the Senate Finance Committee from January 1966 to December 1980 . . . saw the tax code as his tool for changing society. He had no interest in reform. A wise student of human behavior, Long realized the losers from tax overhaul

Second, uncertainty about how CBIT would be implemented may make corporate managers and pass-through investors and managers wary of CBIT. Third, pass-through investors and managers may oppose CBIT if it would subject CBIT entities to the severe corporate-style loss limitation rules, as suggested by the Treasury in its CBIT proposal.

The shareholder dividend exclusion proposal would seemingly increase efficiency because it would: (1) reduce the bias in favor of debt financing; (2) reduce the distortion caused by taxing corporate earnings at higher rates than noncorporate earnings; and (3) invert the bias in favor of retaining earnings, replacing it with a bias in favor of dividend distributions. It would also insure that dividend distributions are subject to tax even if the shareholder is tax-exempt or foreign. In addition, the shareholder dividend exclusion proposal is easier to administer than the shareholder allocation proposal even if the dividend exclusion proposal includes a DRIP.

There are two major drawbacks with the dividend exclusion proposal. First, it would be a big revenue loser. Replacing the lost revenue may create both political and normative problems. Second, instead of merely neutralizing the current bias in favor of retaining earnings, it replaces that bias with one in favor of distributions. Corporate managers would therefore likely oppose this proposal.

The dividend deduction proposal would also seemingly increase efficiency because it would: (1) reduce the distortion caused by taxing corporate earnings at higher rates than noncorporate earnings; (2) invert the bias in favor of retaining earnings, replacing it with a bias in favor of dividend distributions; and (3) invert the bias in favor of debt financing, replacing it with a bias in favor of equity financing (assuming that the higher tax rate on retained earnings forces managers to distribute earnings currently). This proposal would not

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would make far more noise than the winners. "When we proceed to shift the taxes around so that one set of taxpayers pays a lot more taxes and somebody else pays a lot less taxes, the people who benefit from it do not remember it very long," Chairman Long said in 1976. "They tend to feel that it should have been that way all the time, and the people who are paying the additional taxes resent it very bitterly."

*Id.*

Although corporate integration would have benefited many companies, corporate managers nonetheless opposed corporate integration because they were more concerned about preserving existing tax subsidies, such as accelerated depreciation, than about eliminating the corporate tax. In addition, many corporate managers wanted to keep the tax bias in favor of retaining earnings because it frees them from having to justify to the corporate investors the corporate projects in which the managers will invest. See Arlen & Weiss, *supra* note 229, at 366-67.

ensure that dividends distributed to tax-exempt and foreign shareholders would be taxed.

In addition, this proposal shares the two drawbacks of the shareholder dividend exclusion proposal. First, it would be a big revenue loser. In fact, this proposal would lose even more revenue than the shareholder dividend exclusion proposal because it would fail to tax the dividends paid to tax-exempt and foreign shareholders. Second, the corporate dividend deduction proposal would create a bias against retained earnings so corporate managers would likely oppose it.

The proposal to eliminate the corporate interest deduction would be relatively easy to administer and would raise a huge amount of revenue, some or all of which could be used to reduce corporate tax rates. Taxing both dividends and interest at the corporate and investor levels would be consistent with the notion that it is fair to impose greater tax liability on corporate investor returns *on* capital because corporations have greater ability to pay than individuals do. The notion that corporations have greater ability to pay has been discredited, however.

The proposal would invert the current bias in favor of debt financing, replacing it with a bias in favor of equity financing, which would probably increase efficiency as discussed earlier. On the other hand, the proposal would: (1) increase the distortion caused by taxing corporate earnings at rates higher than noncorporate earnings; (2) increase the bias in favor of retaining earnings; and (3) potentially create a new distortion as corporations recharacterize nondeductible interest as deductible forms of expense.

The increased distortion caused by taxing corporate earnings at rates higher than noncorporate earnings would be offset to some extent if the corporate tax rates were reduced in conjunction with this proposal. Also, this distortion would affect new businesses more than existing ones, because existing businesses would incur tax liabilities if they disincorporated. In addition, this distortion would be offset to some extent because businesses could qualify for the lower noncorporate rates only if they did not raise capital in the public markets.

The increased bias in favor of retaining earnings presents a problem, but that distortion may be reduced by expanded enforcement of the accumulated earnings tax. The new incentive to recharacterize interest is also a problem, although that problem is limited in scope.

The proposal to eliminate the corporate interest deduction is probably not politically feasible, despite its administrability and positive revenue effects. Although corporate managers would like the

fact that this proposal does not eliminate the bias in favor of retained earnings, the managers of corporations that stand to lose the most from elimination of the interest deduction are likely to strongly oppose this proposal.

Although each of the proposals would create winners and losers, this proposal is the most likely to create a clear and vocal class of losers. Past experience and behavioral psychology indicate that the outcry of the potential losers may outweigh the support of the potential winners. People exhibit a *status quo bias*, meaning a preference for remaining at the status quo.<sup>435</sup> More importantly in this context, Kahneman and Tversky have documented the phenomenon of *loss aversion*, meaning that the disutility associated with giving up an object is greater than the utility of acquiring it.<sup>436</sup>

It is in connection with this proposal that loss aversion would be the most pronounced. The interest deduction losers would be a clearly identifiable group. This group would probably oppose the interest elimination proposal vocally. The group could perhaps even garner the support of the public by arguing that the proposal would unfairly limit corporations from deducting a real cost of earning income.

The COCA proposal is consistent with the notion, based on optimal tax theory, that the corporate tax should be a form a profits tax.<sup>437</sup> Adopting the COCA proposal would turn the corporate tax into a form of profits tax because the COCA proposal would permit the corporation to deduct its normal returns (*i.e.*, the time value of money component on the corporation's debt and equity), but would not permit the corporation to deduct the corporation's pure profits (*i.e.*, the returns in excess of the normal returns). In other words, the COCA proposal would double tax only pure profits.

The COCA proposal would invert the current bias in favor of debt financing, replacing it with a slight bias in favor of equity financing, which would probably increase efficiency. On the other hand, it would: (1) retain the distortion caused by taxing corporate earnings at rates higher than noncorporate earnings; (2) increase the bias in favor of retaining earnings; and (3) potentially create a new distortion as corporations recharacterize nondeductible interest as deductible forms of expense. The first of these three problems may be

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435. William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. OF RISK & UNCERTAINTY 7 (1988).

436. See generally Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 AM. PSYCHOLOGIST 341 (1984).

437. See *supra* note 303 and accompanying text.

offset for the reasons discussed in conjunction with the proposal to eliminate the interest deduction. The second problem could be addressed through expansion of the accumulated earnings tax, and the third problem is of limited scope.

The COCA deduction proposal is the most politically feasible of all of the proposals. Like the proposal to eliminate the corporate interest deduction, the COCA deduction proposal is easy to administer. In fact, it would eliminate some of the complexity that exists under current law in connection with the tax treatment of risk management transactions like interest rate swaps. In addition, the COCA proposal can be made revenue neutral. As economists George Hatsopoulos, Paul Krugman, and James Poterba have observed: "Ideally, we would want to lower the cost of equity to that of debt without affecting the latter. That, however, would be too costly to the federal government and, therefore, we have to find other ways to bring these two costs in line."<sup>438</sup> In addition, the COCA proposal would also likely produce a lower cost of corporate capital than the interest elimination proposal.

The fact that the COCA proposal does not eliminate the retained earnings distortion may improve the chances of getting broad-based support for the proposal from corporate managers. In addition, although the COCA proposal takes away part of the current interest deduction, it gives back a partial dividend deduction, which may make the COCA proposal more politically palatable to corporate managers. The corporations that would be big losers under the interest elimination proposal would not be losers under this proposal or would lose much less.<sup>439</sup>

## V. CONCLUSION

Given the strengths and weakness of each of the proposals, the author prefers the shareholder level dividend exclusion model to the other proposals since it would produce many of the benefits of the

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438. Hatsopoulos, *supra* note 404, at 15.

439. Consider the effect of the COCA proposal on corporations in the examples in note 418, *supra*. ABC Co., financed with \$40 million of debt and \$60 million of equity, would lose a \$4 million annual interest deduction under the interest elimination proposal; under the COCA proposal, ABC Co.'s \$4 million annual interest deduction would be replaced by a \$5 million COCA deduction. XYZ Co., financed with \$60 million of debt and \$40 million of equity, would lose a \$6 million annual interest deduction under the interest elimination proposal; under the COCA proposal, XYZ Co.'s \$6 million annual interest deduction would be replaced by a \$5 million COCA deduction.



shareholder allocation model with less administrative complexity.<sup>440</sup> That proposal, however, is not politically feasible. One compromise would be to pair (1) a percentage cap on the corporate interest deduction (e.g., permit corporations to deduct 50 percent of the interest on their debt), with (2) a limited shareholder level dividend exclusion (e.g., permit shareholders to exclude 50 percent of dividends received). This compromise would take care of the revenue loss disadvantage of the shareholder dividend exclusion proposal, but would probably not eliminate the opposition of (1) corporate managers who do not want to be forced to distribute earnings, and (2) the interest deduction losers.

The COCA proposal is the most politically feasible proposal. As the earlier summaries of the proposals make clear, the more extensive integration proposals, such as the shareholder dividend exclusion proposal, would neutralize multiple current distortions more effectively than the COCA proposal. The COCA proposal is a limited proposal that targets only the debt-equity distinction. On the other hand, the debt-equity problem, by itself, warrants a solution and the salutary effects of the COCA proposal outweigh its negative effects. In addition, the COCA proposal is consistent with notion that the corporate tax should be a profits tax. Congress should thus adopt the COCA proposal. Even in a second-best world, half a loaf is *sometimes* still better than none.

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440. This assumes that Congress would not be willing to adopt more radical reform measures, such as a mark-to-market corporate tax.