TAX REFORM AND THE TAX TREATMENT OF DEBT AND EQUITY

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Thank you for inviting me to participate in this historic joint hearing on tax reform and the tax treatment of debt and equity. I am an Associate Professor of Law at the University of Colorado, where I teach Deals, Partnership Tax, and Tax Policy. My research focuses on how tax policy affects the structuring of corporate transactions. After three years practicing law in New York, I have spent the last ten years researching how corporate financings and other deals are structured. My research approach includes talking to deal lawyers about new legal structures, as well as doing qualitative and quantitative analysis of deal documents and trends over time. My testimony today draws on that experience and focuses on the ways in which the tax treatment of debt and equity changes the way that deals are structured.

Summary. The main point I want to make today is that the debt/equity distortion, like other distortions in the tax code, is costly on two levels. The first level of costs is obvious. Deals are restructured to reduce taxes, which erodes the tax base. This is the explicit cost of the distortion. The second level of costs is implicit. When a corporation restructures a deal to reduce taxes, the restructuring imposes an implicit cost on the corporations themselves: corporate managers are willing to add complexity to their capital structure, distort corporate governance, and even change investment policy and other critical business decisions as long as the tax savings are worth it.

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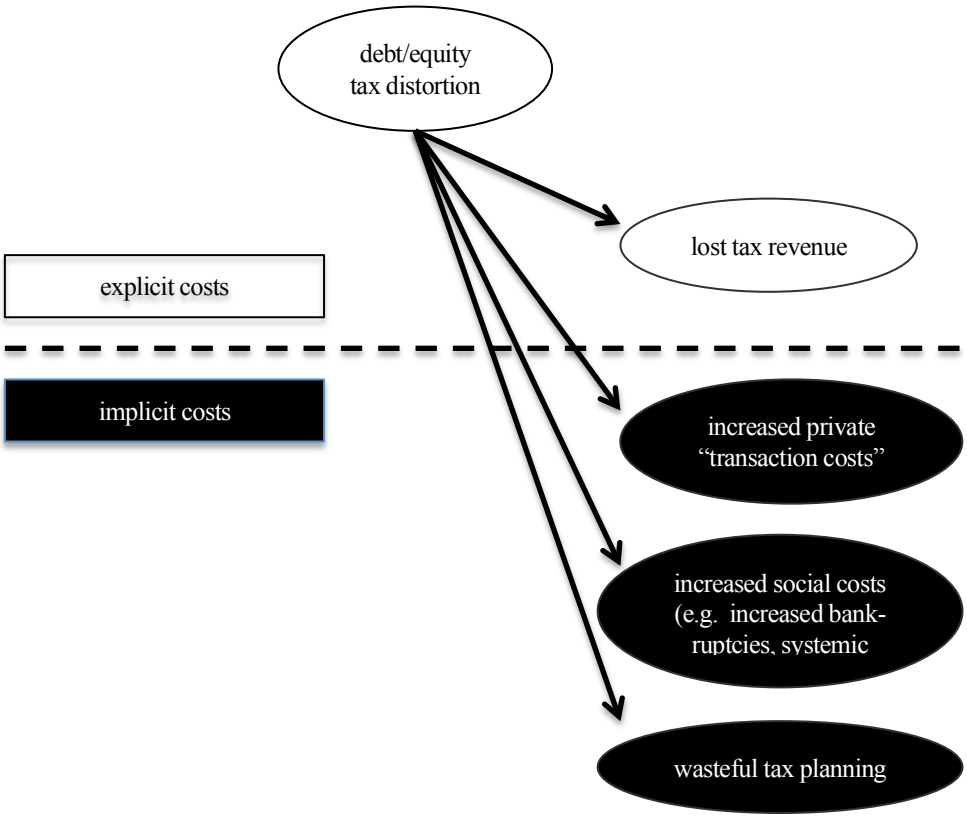
Furthermore, the debt/equity distortion imposes an additional implicit cost on the public in the form of increased firm bankruptcies, plant closings, taxpayer bailouts and the like. Finally, the distortion encourage a lot of wasteful tax planning. One can think of these implicit costs collectively as the "collateral damage" of the debt/equity distinction.



The best way to reduce these implicit costs is to minimize or eliminate the underlying distortions in the tax code. So long as one financial product, like equity, is burdened by the tax code, and another similar instrument, like debt, is favored by the tax code, capital seeps away from the overtaxed product like air from a leaky tire. Legal distinctions in the tax code that have no basis in the underlying economics are almost always a bad idea. Even when Congress creates a tax incentive on purpose, there can be unintended consequences. When

the tax preference itself is the product of historical accident, like the tax preference for debt over equity, the resulting market distortions have no redeeming features. From an economic perspective, it's a self-inflicted wound.

Let me briefly summarize the costs of the debt/equity distortion. Replacing equity with debt reduces tax revenue, which increases the tax burden that other taxpayers must bear. This explicit cost of the distortion could be quite large or quite small, depending on one's baseline. Beyond the shifting of tax burdens, however, the tax preference for debt imposes other costs.

- *Capital structure distortions.* The tax preference for debt encourages excessive leverage that distorts the capital structure of corporations. Historically, firms owned by private equity sponsors, which have more institutional capacity to carry debt, put publicly-held corporations at a competitive disadvantage. In response, publicly-held firms have increased leverage, resulting in more of a short term focus on debt service and cash flow than would occur in a tax-neutral environment. The end result is that we have more firms owned by private equity sponsors, and the public companies that remain have more debt in their capital structure than would occur in a tax system that treated debt and equity the same.

- *Risky managerial behavior.* Relatedly, excessive leverage distorts managerial incentives, encouraging corporate executives to engage in risky behavior. As firms take on more leverage, the common stock issued to executives behaves economically like a risky stock option, giving executives unlimited upside but limited downside risk. As debt is added to the capital structure, it even becomes rational for executives to make negative expected value bets with company assets: the debtholders, not the executives, bear most of the downside risk.

- *Increased bankruptcy and systemic risk.* The tax preference for debt increases the social costs associated with bankruptcies and restructurings. Because the tax code's preference for debt

applies to all corporations, including banks and other financial institutions, it creates a systemic distortion. Excessive leverage fuels risky speculation that has repercussions even for businesses, employees, and taxpayers that never engaged in risky behavior themselves. While any bankruptcy is costly, the problem is especially acute with banks and other financial institutions because the external costs are larger than in other sectors.

- *Wasteful tax planning.* Finally, the debt/equity tax distortion encourages wasteful tax planning. In a world without a tax distortion, corporations would make financing decisions based on the firm's investment policy and the cost of capital dictated by market conditions, not a tax calculation.

Our existing tax code has some piecemeal rules that try to address the distortions caused by the tax preference for debt. These rules are ineffective and easily gamed. The best solution is to treat debt and equity as the same for tax purposes. There are a variety ways to accomplish this as part of a broader tax reform effort, including eliminating the tax deduction for interest, allowing an imputed deduction for equity, or adopting a consumption tax.

Policy proposal. A broader corporate tax reform effort may take some time. If Congress is interested in moving more quickly, policymakers should focus on the source of the largest source of collateral damage costs: financial institutions. Financial institutions have the most excessive leverage of any industry, and the failure of a systemically risky financial institution imposes enormous social costs. One approach would be to eliminate the deduction of interest by financial institutions to the extent the debt/equity ratio of the institution exceeds 2 to 1. The goal of such a tax is not to punish banks, but rather to remove the tax incentive to increase leverage beyond the ratio that would arise in a world without taxes.

With that summary in mind, the remainder of my testimony will discuss the various implicit costs of the debt/equity distortion in more detail. I return to policy considerations at the end.

Regulatory Arbitrage. To shed some light on the costs of the debt/equity distortion, I'll refer to a concept called regulatory arbitrage.[1] Regulatory arbitrage is a perfectly legal planning technique used to avoid taxes, accounting rules, securities disclosure, and other regulatory costs. Regulatory arbitrage—or what tax lawyers simply call tax planning—exploits the gap between the economic substance of a transaction and its legal or regulatory treatment. The technique takes advantage of the legal system's intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision. In the tax planning context, deals are structured to exploit the fact that similar economic transactions are often treated differently for tax purposes. A tax lawyer provides value to her client by suggesting ways to tweak the structure of a deal in a way that keeps the economic substance of the deal more or less the same, but reduces the tax cost. For example, to reduce taxes, a company might pay an executive with carried interest instead of cash, or it might shift the ownership of some intellectual property to an offshore subsidiary, or it might raise capital by selling hybrid debt securities instead of stock.

This kind of tax planning is, on net, beneficial to the private parties involved. But it imposes both private costs and social costs. The private costs arise because the firm may be willing to accept higher transaction costs – increased complexity, an inefficient corporate governance structure, distorted managerial incentives, or increased opportunities for accounting fraud – so long as the tax savings outweigh the increase in transaction costs. Regulatory arbitrage can also create social costs by reducing tax revenue and increasing the likelihood of transactional failures, like bankruptcy, that impose costs that are external to the parties involved.

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[1] This section of my testimony draws on my prior work in *Regulatory Arbitrage*, 89 TEXAS L. REV. 227 (2010).

The focus of the hearing today is on the tax treatment of debt and equity. Debt/equity is a classic example of an artificial distinction in the tax code that distorts behavior on the margins. Debt is tax-favored because interest payments are deductible by the corporation while dividend payments or redemptions are not. This difference in tax treatment creates an opportunity for regulatory arbitrage. On the margins, companies engage in regulatory arbitrage by replacing equity with debt. One might not think, at first glance, that debt and equity are close economic substitutes. Because most corporations raise capital with a mix of debt and equity, however, tax encourages corporations to substitute debt for equity at the margin. A corporation that, in a world without taxes, would raise 50% debt and 50% equity might instead raise 70% debt and 30% equity. The creation of complex hybrid securities that are treated as debt for tax purposes but equity for financial accounting or bank regulatory purposes makes this arbitrage easier to accomplish.

Excessive Leverage and Capital Structure. The tax preference for debt distorts the ownership structure of American corporations. In a world without this distortion, corporate balance sheets would have more equity than they do now, and corporate managers would have more flexibility to manage the company for the long run.

When a corporation is figuring out how to raise money, two competing factors come into play. The first is tax policy, which favors debt. The more debt a corporation carries, the more interest payments it makes, which reduces its taxable income. The second factor, which cuts in the other direction, is the threat of bankruptcy. Interest payments, unlike dividend payments, are mandatory whether times are good or bad. If a corporation misses an interest payment, creditors can force the corporation into restructuring or insolvency.

Historically, public corporations have been conservative in how they strike this balance, raising some debt capital but keeping adequate equity cushions to avoid bankruptcy. This began to change in the 1980s when leveraged buyout firms entered the landscape of corporate finance. We now call these LBO firms "private equity firms."

Private equity firms are institutionally better positioned to take full advantage of the tax shield from debt. In a typical scenario, a private equity firm sponsors an investment fund that raises money from institutional and private investors. The fund managers then identify target companies, or divisions of existing companies, and negotiate a buyout from the existing managers and shareholders. Once they have agreed on a price, the target corporation borrows money to fund most of the purchase price. Tax is not the only reason that target companies are loaded up with debt; the structure also supercharges the returns to the equity holders – in this case the managers and investors in the private equity fund. It is not unusual for a buyout to be followed by the payment of a special dividend; from a finance perspective, the company has simply shifted a portion of its capital structure from equity into debt.

Debt has some useful nontax attributes. By forcing managers to pay out real cash on a periodic basis, it can be useful in holding managers accountable. Similarly, it can create high powered financial incentives for managers who hold equity. But there is no reason to think that the tax system should be putting a thumb on the scale when it comes to capital structure. Tax policy works best when it stays out of the way, allowing market participants to set prices for assets without taking tax consequences into account. Instead we have a tax system that puts firms with large amounts of equity at a competitive disadvantage compared to firms with large amounts of debt.

The tax preference for debt is available to any corporation, but not every corporation takes full advantage of the tax shield that debt provides. The reasons for this vary, including the availability of non-debt tax shields—i.e., other ways of reducing corporate taxable income, like accelerated depreciation or shifting income to an offshore subsidiary. As we continue to close corporate tax loopholes, we can expect renewed fervor for increasing leverage as a method of managing effective tax rates. The solution is to take the debt shield off the table by equalizing the tax treatment of debt and equity.

Excessive Leverage and Managerial Behavior. The tax treatment of debt distorts managerial incentives and executive compensation.

When a company takes on more debt, the equity that remains become riskier and starts to behave economically more like a stock option. Many corporate executives today are compensated with stock awards that vest over a period of years. If the corporation were financed mostly with equity, such executives would share in the upside if things go well, but they would also share in the downside if things go badly. If the corporation is financed mostly with debt, on the other hand, the managers' upside potential is amplified, and their downside risk remains limited. With this asymmetric payoff structure, managers become risk-seeking in ways that are beneficial neither to the firm nor to the public at large.

> *Asymmetric payoff problem.* Consider a simple stylized example. Corporation A has $100 in assets, 5 shares of common stock and no debt. Manager A holds 1 share of common stock, worth $20. If Corporation A's assets double in value, to $200, A's stock is worth $40. If Corporation A goes bankrupt, then the stock is worth $0.
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> Corporation B has $100 in assets, 1 share of common stock, and $80 of debt. Manager B again holds $20 of common stock – but it now represents 100% of the equity of the company. If B's assets double in value to $200, B can pay off the debt ($80) and net $120. B's common stock has increased in value 500%, from $20 to $120. If Corporation B goes bankrupt, then B's stock is still worth $0.
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> Manager B is going to behave in a more risk seeking fashion than Manager A. Both managers have $20 of downside exposure, but B has 5 times as much upside potential. Common stock of a highly leveraged firm behaves economically more like a call option, meaning that the holder will want to increase the volatility of the firm's stock performance.
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> The distortion can even lead to managers investing in projects with a negative expected value. If Manager B is presented with an opportunity to invest $100 of B's assets in a project that has a 40% chance of doubling in value and a 60% chance of going bankrupt, it is rational for him to take that bet, even though on average it is a losing bet for the firm.

Asymmetric payoffs can distort managerial incentives in any industry. But the problem is most acute in the case of banks and other financial institutions. Financial institutions already have competitive reasons to increase leverage ratios beyond what we observe elsewhere

in the economy. The tax distortion reinforces this trend and makes it difficult for responsible bank executives to justify reducing debt loads.

The interaction of tax and nontax incentives to increase leverage ratios makes it difficult to isolate and quantify the tax distortion. Perhaps the strongest evidence that tax affects the debt/equity ratio is the fact that financial institutions are the biggest issuers of so-called hybrid instruments that are treated as debt for tax purposes but equity for nontax purposes (financial accounting, credit agency, or bank regulatory purposes). These instruments are complex, confusing to many investors, and would not exist in a world without a debt/equity tax distortion. Hybrids allow financial institutions to appear safer by having greater capital; in fact, they are masking an increase in debt. AIG, Lehman Brothers, Bear Stearns, and other failed institutions all had large amounts of these hybrid instruments on their balance sheets before the crisis.

Excessive leverage and the social costs of bankruptcy. Finance scholars normally assume that the fear of bankruptcy will partially counterbalance the company's desire to increase its debt/equity ratio. Diversified institutional shareholders, however, are not overly concerned if a company or two in their portfolio goes bankrupt. There may be a loss of enterprise value as debts are written off and assets reorganized into a new venture, but bankruptcy reorganizations have become more efficient, and the firm-specific risk of bankruptcy is easy for investors to diversify away. So long as the tax savings from debt outweigh the potential transaction costs associated with bankruptcy, firms will continue to increase debt levels, and investors will continue to buy the equity that remains.

What is missing from the bankruptcy discussion is the social cost associated with the failure of a U.S. corporation. Finance scholars focus on the costs to shareholders, bondholders, and managers, not on the costs to employees or customers, or to the public at large. But as recent events have shown, the bankruptcy or restructuring of a large firm like GM, Chrysler, AIG, Lehman Brothers, Washington Mutual or the Tribune Company can impose costs on all of us. It takes time for unemployed workers to find new jobs. Job insecurity slows

spending and economic growth. And firms that get bailed out shift costs onto taxpayers.

Wasteful tax planning. Finally, the debt/equity tax distortion generate an enormous amount of pointless work for CFOs, in-house counsel, and outside tax lawyers. Tens of millions of dollars a year in billable hours and investment banking fees are devoted to analyzing whether particular financial products will or should be treated as debt or equity for tax purposes. A common rite of passage among junior tax associates is to write a memo summarizing a forty year-old law review article known simply by the author's name, Plumb.[2] The experience is memorable because Plumb's article runs 271 pages and contains 1,591 footnotes. Why so long? The legal distinction between debt and equity has no real underlying basis in economics. At the extremes, we can tell the difference, but parsing the legal difference between hybrid products in the middle like trust preferred securities or contingent convertible bonds is more art than science. And the analysis has only become more difficult and complex over time. Yet all this work by some of the most talented minds in the country produces nothing of lasting social value.

Policy Recommendations. There are several different ways one could eliminate the debt/equity distortion, including eliminating the deduction for interest paid, allowing a deduction for corporate equity, or moving to a corporate cash-flow or consumption tax. There has been a great deal of work done on each of these various proposals, which goes beyond the scope of my testimony here. A comprehensive reform to eliminate the debt/equity distortion could take some time to implement and would make the most sense as part of a package that reduces corporate tax rates. Given the focus of this hearing on debt/equity, it might be useful for me to offer a specific, smaller proposal that could be enacted quickly.

My proposal is to allow banks and other financial institutions to deduct interest only up to a limit of a 2 to 1 debt to equity ratio. The

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[2] William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 369-640 (1971).

reason for focusing on financial institutions is that they are the source of most of the externalized social costs of excessive leverage. The tax distortion makes it difficult for bank executives to build equity cushions, as doing so hurts them competitively. Removing the tax distortion at least keeps the tax system from making the problem worse.

The goal here is not to punish banks or impose a Pigouvian tax on systemic risk. While I am not averse to tax policy solutions to social problems, there are times when the taxing authorities are not the ideal regulatory agency. Bank regulatory requirements should be set by bank regulators, not the IRS.

Rather, the goal here is simply to remove the tax distortion that encourages excessive leverage. Nearly all banks have debt/equity ratios in excess of 2 to 1; by taking the tax deduction off the table at the margins, companies will set debt/equity ratios based on market conditions and regulatory requirements, not tax considerations.

As with any policy proposal, detailed consideration of administrative concerns and potential for gamesmanship will be important. To ease these administrative concerns, the tax legislation could conform its definition of debt and equity to the company's categorization for bank regulatory purposes.

Some pressure might remain on the definition of a financial services firm. The scope of the proposal could be limited to bank holding companies, or it could be expanded to nonbank financial institutions as well (perhaps tied to the definition of "financial company" in Dodd-Frank). One approach that would minimize definitional problems would be to apply the limit on deductibility across the board to financial and non-financial companies alike. Because most firms with high debt/equity ratios are in the financial sector, the proposal would have little impact outside the sector.

Thank you.

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Short Bio

Professor Fleischer is an Associate Professor of Law at the University of Colorado. He specializes in tax, venture capital and the structuring of corporate transactions. He has also taught as an associate professor at the University of Illinois, as an Acting Professor of Law (tenure-track) at UCLA, as a visiting professor of law at Georgetown University and at NYU, and as a research fellow in transactional studies at Columbia Law School. Before entering academia, Professor Fleischer was an associate at Davis Polk & Wardwell in New York. He clerked for the Honorable M. Blane Michael, U.S. Court of Appeals for the Fourth Circuit, and the Honorable Alex Kozinski, U.S. Court of Appeals for the Ninth Circuit.

Professor Fleischer's research focuses on tax policy and the structuring of corporate transactions. Recent publications have appeared in the NYU LAW REVIEW (twice), MICHIGAN LAW REVIEW, TEXAS LAW REVIEW and the TAX LAW REVIEW (three times). His most recent article, *Taxing Founders' Stock*, will be published in the UCLA LAW REVIEW.