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TAX REFORM AND THE TAX TREATMENT OF DEBT AND EQUITY

JOINT HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

AND THE

FINANCE COMMITTEE
U.S. SENATE

ONE HUNDRED TWELFTH CONGRESS

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JOINT HEARING ON TAX REFORM AND THE TAX TREATMENT OF DEBT AND EQUITY

WEDNESDAY, JULY 13, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The joint hearing met, pursuant to call, at 9:07 a.m., in Room HVC210, Capitol Visitors Center, the Honorable Dave Camp [chairman of the House Committee on Ways and Means] presiding.

[The advisory of the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Chairmen Camp and Baucus Announce Joint Hearing on Tax Reform and the Tax Treatment of Debt and Equity

Wednesday, July 13, 2011

Congressman Dave Camp (R–MI), Chairman of the House Committee on Ways and Means, and Senator Max Baucus (D–MT), Chairman of the Senate Committee on Finance, today announced that the Committees will hold a joint hearing to review the tax treatment of debt and equity and to consider distinctions in the treatment of each in the context of comprehensive tax reform. In connection with the hearing, the staff of the Joint Committee on Taxation (JCT) will release two reports that analyze the taxation of household debt and business debt. **The joint hearing will take place on Wednesday, July 13, 2011, in Room HVC–210 of the Capitol Visitor Center, beginning at 9:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committees and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

At the March 15, 2011 organizational meeting of the Joint Committee on Taxation, Chairman Camp and Chairman Baucus—in their capacities as JCT Chair and Vice Chair, respectively—directed JCT staff to analyze how debt financing is taxed relative to equity financing and to report on the effects of such differences on household and business debt levels. Chairman Camp and Chairman Baucus believe that the policy and economic information provided by JCT staff will be important for the tax-writing committees to consider in the formulation of comprehensive tax reform legislation. The two JCT reports will be formally presented to the Ways and Means Committee and Senate Finance Committee at the joint hearing.

With regard to the joint hearing, Chairman Camp made the following statement:**"The relative taxation of debt and equity has serious consequences for the economy and job creation, and it needs to be given careful consideration in the context of comprehensive tax reform. With both the Ways and Means Committee and the Senate Finance Committee actively pursuing tax reform, it will be critical for Congress's two tax-writing panels to be working together closely. I look forward to having our two committees convene this historic joint hearing—the first on a tax issue since 1940—to receive these staff reports on this important issue."**

Chairman Baucus said, **"As part of tax reform, we must examine how we can improve our economy and create jobs, and to do so, we need to ask how to encourage businesses to invest in growth. This hearing will look at the effects of different tax treatment of debt and equity on our economy. We'll need to work together to simplify and improve our tax code to help businesses create jobs, which is why these joint hearings between our two committees are so important."**

FOCUS OF THE HEARING:

The hearing will focus on the taxation of debt and equity and the broader economic implications of this treatment. At the hearing, JCT staff will formally present

two reports on the taxation of debt financing relative to equity financing. These JCT staff reports were requested by Ways and Means Committee Chairman Camp and Senate Finance Committee Chairman Baucus at the organizational meeting of the Joint Committee on Taxation on March 15, 2011.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, http://waysandmeans.house.gov, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Wednesday, July 27, 2011**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–3625 or (202) 225–2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days' notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at http://www.waysandmeans.house.gov/.

Chairman CAMP. Good morning, and thank you all for joining us this morning. According to the Congressional Research Service, the last time both the House Ways and Means and the Senate Finance Committees met together for a joint hearing on tax issues was 1940, more than 70 years ago, to discuss a war profits tax.

And while I have said that I have been looking forward to our two committees working closely together on tax reform, I hope that you all know I didn't necessarily mean that we would be squeezed

in here quite so tightly. But it is a beautiful new room, and I appreciate the opportunity to be able to use it.

I want to thank Senator Baucus and his staff, and all of the staffs, for working out the details. And also, I want to thank my colleagues in both the House and Senate for being here today. It is a clear illustration of how serious the issue of tax reform is to both of these committees and, of course, to the American economy.

As former Treasury Secretary James Baker said at the April 6th Joint Tax Committee hearing, "Tax reform has something in it for everybody." For an American family, it means greater simplicity, fairness, and predictability, so that families can plan and prosper. And for employers and their employees, transforming our tax code is critical to making America a more vibrant competitor abroad, and a more attractive place to invest and create the jobs we need here at home.

However, before we can begin to tackle and craft a plan for comprehensive tax reform, we must take the time to better understand how the current code influences our economy and the decisions made by families and businesses. The issue of debt and equity, the topics of our hearing today, is among the most complex issues we must grapple with, and among the most important to get right in moving forward.

Earlier this week, the staff of the Joint Tax Committee issued two reports responding to a request Chairman Baucus and I made, one on household debt, and one on business debt. The report on household debt examines provisions in current law related to the deduction of interest expenses, including personal interest deductions for mortgage interest, interest on student loans, and investment interest.

The business debt report focuses more on the tax treatment of debt, relative to equity, and its implication for corporate capital structures. These are all crucial issues, and I think it is fitting to have both of Congress's tax-writing committees here today to receive these reports and hear from our distinguished panel of experts.

And before I yield to my friend from Montana, I would like to just take a moment to congratulate him on his recent marriage. And I now recognize Senator Baucus for his opening statement.

Chairman BAUCUS. Oh, well, thank you very much, Mr. Chairman. That was something I did not expect. That is very thoughtful, that is very sensitive, is very nice, and I deeply appreciate it.

Also, I appreciate our holding a joint hearing. I think there is an opportunity here for the Ways and Means Committee and the Finance Committee to work together in many areas—in this case, with tax reform, both individual and corporate. We have been working together, we have already set good precedent by working out an agreement with the trade adjustment assistance, you and I and our staffs, and I hope that is good precedent for future cooperation, because both—with us working together, it is clear that we are more likely to get something accomplished than if we don't. And I deeply appreciate that.

The author, Henry Wheeler Shaw, once wrote—and I quote him—"Debt is like any other trap: easy enough to get into, but hard enough to get out of." We meet together today because we

share a common goal. We believe the tax code should boost American competitiveness, should encourage economic growth and job creation. It should be fair, simple, efficient, and certain. And it should also not encourage households or businesses to take on too much debt that they cannot get out of.

Today we examine the taxation of debt and equity. Right now we are confronting a massive debt problem due, in part, to 2008 financial crisis. The year before the crisis, the 5 major investment banks had a leverage ratio of 40 to 1, which means for every $40 in assets, there is only $1 in equity to cover losses. This raises the question of whether excessive private debt played a major role in creating that meltdown.

As we work to emerge from that crisis, we seek to understand how our tax code affects private debt, and how does debt affect stability and growth. Does the code encourage households and businesses to become more leveraged? Do tax preferences for corporate debt or equity provide incentive for riskier capital structures? And did the tax code's treatment of debt contribute to the crisis?

We clearly did not want to encourage households and business to assume too much. Yet we want to ensure that businesses can borrow at modest rates, because that is an essential step on the road to economic recovery.

In today's code it can be hard to tell what is considered borrowing and what is equity investment. A business can make an infusion of cash that looks like either one. And naturally, some businesses choose to cast their financing in a light that gets the best tax treatment. But this requires sophisticated tax planning, which not everyone can afford.

Debt and equity can both be vital tools in today's economy. But as we work to inspire growth, we must make sure our code does not encourage businesses and individuals to put themselves in precarious positions. Tax reform should simplify these issues, make our code fairer. Americans deserve a tax system they can understand and benefit from, without an extensive tax planner.

So, let us work together to address these issues, make our code more competitive, more fair. Let us find creative solutions to our nation's pressing problems. Given all the debt discussion, Mr. Chairman, it is my hope that as that proceeds in whatever way it does proceed, that we, in the meanwhile, have extensive hearings on tax reform, individual and corporate, because I think that will provide a good foundation for whatever we do this year or next, or perhaps even in 2013. But let us work together, have our separate hearings, have joint hearings, but provide a real service to our country. Thank you.

Chairman CAMP. Well, thank you, Chairman Baucus. And let me now yield to the ranking member of the Ways and Means Committee, Mr. Levin, for his opening statement.

Mr. LEVIN. Thank you very much. I think you noticed this is the first time I have been in this room. There are TV sets here. I want you to know that they have been, I think, turned off. I noticed that FOX News, CNN, and ASPN is on these sets. I am not sure why. I missed the baseball game last night. But I think we have turned it off.

Chairman BAUCUS. Yours isn't off.

Mr. LEVIN. No.

[Laughter.]

Mr. LEVIN. I pushed it and it says, "U.S. House Guest, no new messages."

[Laughter.]

Mr. LEVIN. As you mentioned, Mr. Camp, this is the first time since 1940 that there has been this kind of a combined meeting on tax issues. And, as we know, it is scheduled, and we will discuss certain aspects of the current tax law relating to debt and equity.

But let me make this comment that I deeply feel. Because of the uniquely serious challenge facing this nation, action on the debt limit, today would seem most appropriate, if we are gathering to discuss this challenge. The issue, the debt limit, is squarely within the jurisdiction of our two committees.

That does not mean that the specific topic before us is unimportant. Indeed, if we are to seriously address tax reform, issues relating to debt and equity must be considered and, like other significant issues, done so in depth and with open debate.

As our witnesses' prepared testimony very much demonstrates, the subject is complex and answers do not always automatically fall into usual ideological frameworks. But I fear the chances of the discussion at this joint hearing leading to fruitful action have been dimmed immeasurably by the environment created on the overarching action on the debt ceiling.

Yesterday, Senator McConnell said—and I quote—"After years of discussions and months of negotiations, I have little question that as long as this President is in the Oval Office, a real solution is probably unattainable." In my judgement, this approach politicizes and can poison the well for tax reform in the near future. It also flies in the face of basic facts. President Obama inherited a debt that had risen under President Bush from 5.7 trillion to 10 trillion. And he inherited a record 1.5 trillion deficit that had wiped out the record surplus inherited by President Bush.

President Obama has said very clearly that we need a balanced framework to reduce the deficit now and in the future, while allowing for needed investments to promote economic growth and job creation. It is not helpful to walk away from the table. It is not helpful to insist on an ideological agenda that cannot become law.

We should hear and review carefully the testimony now to be presented to us by our distinguished—and if you have read these documents in advance—very knowledgeable witnesses. But my fear is that any insights that we gain in the process today will be washed away if the debt ceiling is not raised and we suffer the momentous consequences that would result from destroying the full faith and credit of the United States of America.

Thank you, Mr. Chairman.

Chairman CAMP. Thank you. I now yield to the ranking member of the Senate Finance Committee, Senator Hatch, for his opening statement.

Senator HATCH. Well, thank you, Chairmen Baucus and Camp, for this historic hearing. And thank you, Mr. Barthold, and the staff of the Joint Committee on Taxation for producing this important report on the tax treatment of debt and equity, and we appreciate you other witnesses, as well.

Tax reform should be based on the same three principles that led to the enactment of the Tax Reform Act of 1986: fairness, simplicity, and economic growth. I am very much looking forward to hearing what our witnesses have to say on these three principles, as they relate to the tax treatment of debt and equity.

Allow me to share a few of my initial thoughts, first with respect to individuals, and then with respect to corporations, on the topic of debt and equity.

On the individual side, we can all agree that savings and investment is a good thing, and that the savings rate in the United States has traditionally been low when compared to many other countries. But an income tax system, by its nature, discourages savings and investment by taxing the returns to such savings and investment. This was an observation made by John Stuart Mill over 160 years ago. Thus, the code encourages consumption, and even "negative savings." That is, debt.

Our tax system encourages the use of debt, rather than equity, in the area of corporate finance, as well as household finance. If a corporation is in need of additional funds, our tax system encourages the corporation to borrow money, rather than raising funds by issuing stock. And why? Because any interest payments on the borrowing are deductible, while any dividends paid on the stock are not deductible.

In addition, many U.S. multinational corporations are sitting on large piles of cash. Yet these corporations are borrowing money. One reason is that their cash is trapped offshore, and the corporations will be subject to a 35 percent U.S. tax on repatriating the cash back to the United States.

The increased use of debt by both households and corporations makes both more vulnerable to the risks of bankruptcy and other downturns in the economy.

I would like to thank our witnesses for attending this historic hearing. I thank our two chairmen and all others on this—on these two very important committees. And I look forward to the comments of our witnesses here today on the tax treatment of debt and equity.

So, again, Chairman Camp and Chairman Baucus, thank you very much for this important hearing that you have called on tax reform. I appreciate it.

Chairman CAMP. Well, thank you, Senator Hatch. And without objection, any other Member who wishes to have an opening statement included in the formal record may submit one in writing.

We are fortunate to have a panel of witnesses here this morning with a wealth of experience in private practice, academia, and government. And let me briefly introduce them.

First, I would like to welcome Tom Barthold, the chief of staff for the Joint Committee on Taxation. We thank you and your staff for your efforts in putting together the household and business debt reports for today's hearing, and we look forward to your presentation.

Second, we will hear from Pam Olson, who is currently serving as the head of the Washington office tax group of the law firm Skadden, Arps, and has also formerly served as the Assistant Secretary for Tax Policy at the Treasury Department, and has held several positions at the IRS.

Third, we will hear from Victor Fleischer, who is an associate professor of law at the University of Colorado Law School. His research is focused on tax planning and the structuring of corporate transactions.

And fourth, we will hear from Mihir Desai, who is a professor of finance at Harvard Business School, and recently accepted an appointment as a tenured professor of law at Harvard Law School. He is also a research associate in the National Bureau of Economic Research's public economics and corporate finance program.

And finally, we will hear from Simon Johnson, the Ronald A. Kurtz professor of entrepreneurship at the Massachusetts Institute of Technology. He is also a senior fellow at the Peterson Institute for International Economics in Washington, D.C. And from March 2007 to August 2008, Mr. Johnson was an economic counselor and director at the research department at the International Monetary Fund.

Thank you all for being here with us today. The committee has received each of your written statements, and they will be made part of the formal record. Each of you will be recognized for five minutes for your oral remarks.

And, Mr. Barthold, we will begin with you, and you are recognized for five minutes.

STATEMENT OF THOMAS A. BARTHOLD, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. BARTHOLD. Well, thank you very much, Chairman Camp, Chairman Baucus, Mr. Levin, and Senator Hatch, and members of the committees. It is my pleasure to deliver to the Ways and Means Committee and the Finance Committee two reports requested by the chairmen relating to the tax treatment of the use of debt by households and the use of debt finance, as compared to equity finance, by business.

Now, the Joint Committee's staff's efforts in these reports was to describe what the law is, and what incentives the law might create. And I will just use my brief time here to highlight a few points.

First, while, as was noted in some of the opening statements, the recent recession raised valid concerns about leverage in the U.S. economy, it is important to remember that there are many sound economic reasons for both households and businesses to finance with debt. Debt is not inherently a bad thing.

Now, relative to the growth of the economy, as measured by the gross national product, over the past 25 years non-financial corporate debt has been largely unchanged, while the debt of the household sector and the debt of the Federal Government have increased by more than 50 percent each. This is shown in table I of each of the two documents that we prepared.

In looking at the household debt, the primary source of the growth of household debt is the growth of mortgage debt, and that is documented in figure 3 on page 18 of the household document. As you know, mortgage interest is favored as an itemized deduction in the Internal Revenue Code.

Yet over this same 25-year period where we see this substantial growth in household debt, Congress has generally lowered individual tax rates, which lowers the benefit of that interest deduc-

tion, Congress has capped the aggregate amount of acquisition indebtedness that a taxpayer may claim as part of the itemized deduction, and Congress has limited the interest deductibility of home equity debt. With those factors, it is difficult to conclude that the deductibility of mortgage interest would explain the growth of household debt over that period.

On the business side, one cannot discuss debt finance without discussing equity finance. And, as our staff report details, there are tax rules that create incentives to choose debt finance over equity finance. Most initially, for the issuer, the deductibility of interest expense and, oppositely, the non-deductibility of dividends, make debt a cheaper source of capital for the business.

Also, other incentives exist to choose debt finance. In a partnership, for partners, the inclusion of debt at the partnership level increases the partners' basis, and increases the limit on the deductibility of partner shares of partnership losses and deductions. Debt finance of investments can create interest deductions that can shelter other taxable income of the business, and can lead, in some situations, to negative effective tax rates on returns to investment.

On the other hand, there are also tax rules that favor equity finance. At the individual level, the individual investor may often prefer equity finance because, under present law, there are low rates of—relatively low rates of tax on dividend income, compared to interest income. And if the investor recognizes a capital gain that results from the retained earnings of the business, that is also taxed at a lower rate than would be interest income.

For a corporate equity holder, there are low effective tax rates from the dividends received deduction, whereas a corporation which had lent money would be paying tax on the interest earned at full corporate rates. For both investors and issuers, equity promotes the possibility of tax-free mergers, and reorganizations, facilitating fluidity in the business sector.

Taxpayers have considerable flexibility to design instruments that are characterized as debt or equity under the code. And it is difficult to create bright-line rules to distinguish debt from equity. The courts, through time, have identified multiple indicia of what is debt. And because of these factors, instruments can be constructed that, as an economic matter, and as our two finance experts can probably explain better than I, that can blend the characteristics of debt and equity.

In the 1950s, the Congress attempted to define "debt" and "equity" in the Internal Revenue Code, but retreated from that effort. Treasury has the authority to issue regulations to identify debt and equity but has never exercised that authority to do so.

I think those are some broad points that you can draw from our reports. Thank you for the opportunity to prepare this material for you. We would be—our staff would be happy to provide more detailed work on any questions that might arise in today's hearing. And, of course, I am happy to answer any questions that you may have today.

[The prepared statements of Mr. Barthold follow:]

PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF BUSINESS DEBT

A REPORT TO THE JOINT COMMITTEE ON TAXATION

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



July 11, 2011
JCX-41-11

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INTRODUCTION AND SUMMARY

Introduction

This document[1] has been prepared by the staff of the Joint Committee on Taxation, in response to the request of the Chairman and Vice Chairman of the Joint Committee on Taxation for a report of Federal tax rules relating to the use of leverage by households and businesses in the United States.[2]

There has been concern about the level of debt in the U.S. economy. Below is a table illustrating corporate debt, household debt, and Federal debt as a percentage of gross national product (GNP), 1987-2010. This document relates to business debt; corporate data is shown in column one of Table 1, below.

Table 1.–Corporate Debt, Household Debt, and Federal Debt, as a Percentage of Gross National Product (GNP), 1987-2010

Year	Corporate Debt[1] as a Percentage of GNP	Household Debt[2] as a Percentage of GNP	Federal Debt[3] as a Percentage of GNP
1987	42.8	57.9	41.0
1990	43.6	61.4	42.8
1995	39.5	65.0	48.9
2000	46.4	69.9	33.9
2005	43.0	92.4	36.9
2010	48.3	90.2	63.2

[1] Corporate debt of nonfinancial C corporations and S corporations excluding farms.
[2] Household debt includes debt of personal trusts, nonprofit organizations, partnerships and sole proprietorships.
[3] Federal debt excludes federal debt held by Federal agency trust funds.

Sources: Debt levels from The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2011* Table D.3. GNP levels from the Federal Reserve Bank of St. Louis.

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

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011. This document can be found on our website at www.jct.gov.

[2] The request was made at the 112th Congress Organizational Meeting of the Joint Committee on Taxation on March 15, 2011.

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

The third part of this document describes incentives for debt or equity that exist in the absence of tax considerations, a discussion of the incentives that may be created by the present-law tax treatment of instruments as debt or as equity.

A companion document[3] provides economic data with respect to household debt and provides a description of Federal tax rules governing household debt and economic incentives under present law.

Summary

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

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

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

Debt instruments can permit the accrual of the interest deduction along with the inclusion in income by the holder at a time prior to the payment of cash. Interest income may be taxed at a higher rate to a taxable holder than the holder's dividends or capital gains attributable to corporate retained earnings (to which lower tax rates currently apply). However, some forms of debt investments are not subject to U.S. tax or are taxed at reduced rates in the hands of a tax-exempt or foreign investor. A number of special rules in the Code are designed to limit the tax benefits that can be obtained from interest deductions to protect the corporate tax base.

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

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[3] Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Household Debt* (JCX-40-11), July 11, 2011 (hereinafter "*Tax Treatment of Household Debt*"). This document can be found on our website at www.jct.gov.

In addition to the tax benefits of interest deductibility, debt permits owners of business or investment assets to extract cash or to obtain a higher basis in the leveraged asset without an additional equity investment. A higher basis in a leveraged asset that is depreciable, for example, can increase depreciation deductions. This effect may in some situations create an incentive for a business to borrow.

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

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

Equity can be beneficial for tax purposes in certain cases. Although corporate distributions and sales of corporate stock subject the holder to tax in addition to any tax paid by the corporation, reduced tax rates apply to holders with respect to such distributions or gain. Dividends on corporate equity are largely excludable by corporate holders (currently resulting in a maximum 10.5-percent tax rate under the 70-percent dividends received deduction). For individual shareholders, both dividends and capital gains on the sale of corporate stock are generally subject to a maximum 15 percent rate (compared to the top individual rate of 35 percent).[4] The present value of the shareholder-level tax on corporate earnings may be reduced to the extent earnings are retained and to the extent shareholders do not sell their stock. This second level of tax and may be eliminated entirely to the extent non-dividend-paying stock is

[4] The top individual rate on dividends of individuals is scheduled to increase to 39.6 percent after 2012, as is the top rate on other individual ordinary income. The top rate on long term capital gains of individuals is scheduled to increase to 20 percent after 2012.

held until the death of the owner. Receipt of equity also permits tax-free business combinations and distributions, both in the case of corporations and partnerships.

The treatment of an instrument for purposes of financial reporting, for regulatory capital purposes in a regulated industry (such as an insurance or banking), for ratings agency purposes, and under foreign tax and nontax laws, may differ from it's Federal income tax treatment. These differences may result in more favorable overall business treatment when the benefits of debt or of equity for a Federal income tax purpose are combined with the benefits of a different treatment for another purpose.

I. PRESENT LAW AND LEGISLATIVE BACKGROUND

A. General Rules

1. Issuer treatment of debt and equity

Interest and dividend payments

Interest paid or accrued by a business is generally deductible, subject to a number of limitations.[5] By contrast, dividends or other returns to equity are not deductible.

Timing of interest deduction

Interest generally is deducted as it is paid or accrues. However, interest can be deducted in advance of actual payment or other accrual under the terms of the instrument when the amount to be paid at the maturity of a debt instrument exceeds the issue price by more than a *de minimis* amount. In such cases, a portion of the amount to be paid at maturity is treated as interest accruing on a constant yield basis over the life of the instrument and is thus deducted in advance of actual payment.[6] Such interest is referred to as original issue discount ("OID").

Principal payments and return of equity capital

Principal payments on business debt are not generally deductible.[7] The return of capital to investors in an equity investment likewise is not deductible.

Receipt of cash from debt or equity investors

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

Basis of assets purchased with debt or equity

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

Effect of entity level debt on partnership and S corporation equity holders

Equity investors in a partnership or an S corporation[8] can deduct their allocable share of partnership deductions (including depreciation, interest, or loss, for example.) only to the extent

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[5] Sec. 163(a). Some of these limitations are discussed below.

[6] Secs. 1273-1275.

[7] There is an exception for certain debt incurred through a leveraged employee stock ownership plan ("ESOP"). ESOPs are discussed at Part I.G.1.

the basis of their interest in the partnership or S corporation.[9] A partner's share of entity level debt is included in the partner's basis in his partnership interest. An S corporation shareholder does not include entity level debt in his S corporation stock basis. However, the S corporation shareholder may deduct losses to the extent of his basis in stock and his basis in debt that the corporation owes to him.

Nonpayments on equity compared to discharge or restructuring of indebtedness

If dividends are not paid on equity, or the capital contributed by an equity holder is not returned, there is generally no taxable income, gain, or other consequence to the issuer.[10]

The effects to the issuer if debt is modified, cancelled, or repurchased depend upon the type of debt, the nature of the holder, and whether or not the debt (or property given in exchange for it) is traded on an established securities market. If debt is cancelled, modified, or repurchased, the borrower generally realizes income from the discharge of indebtedness. Exceptions to this income inclusion are provided for bankruptcy and insolvency, for other situations including seller financing of purchased property, qualified farm indebtedness, qualified real property business indebtedness, and contributions of debt by an equity holder. The exceptions usually require the taxpayer to reduce the basis of property, or to reduce tax attributes such as net operating losses.[11] If nonrecourse debt is satisfied by foreclosure on the assets securing the debt, the borrower generally realizes gain from the disposition of the assets for the amount of the debt (even if the assets are not worth that amount).[12]

Recourse indebtedness

If a taxpayer's recourse debt is discharged, the taxpayer generally recognizes income from the discharge of indebtedness at that time.[13] A satisfaction of the debt with property worth less than the debt,[14] or a repurchase of debt for less than its face amount by the taxpayer or a

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[8] An S corporation is a corporation that has only one class of stock, has no more than 100 shareholders (after applying attribution rules), meets specific other requirements, and makes an election enabling its income and deductions to pass through to its shareholders without entity level tax. Sec. 1371 *et seq*.

[9] Other limitations on a partner's or S corporation shareholder's deductions also can apply, such as the limitation on passive activity losses (sec. 469), or the at-risk limitation (sec. 465).

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

[11] Sec. 108. The rules relating to debt cancellation are discussed more fully at Part III.B. 2.

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

[13] Sec. 108.

[14] For example, if a creditor contributes its debt to a corporation and receives corporate stock in exchange, the corporation generally recognizes cancellation of indebtedness income to the extent the value of the stock given is less than the amount of the debt cancelled. However, if the debt was held by a person that was also a shareholder,

related party, is treated as a discharge of the taxpayer's debt to the extent of the difference between the outstanding debt and (generally) the value of the property.[15]

A significant modification of a debt instrument is treated as the disposition of the old instrument in exchange for the new instrument.[16] Such modifications include a change in the obligor, a change in term or interest rate; a change in principal amount, and certain modifications of security. The modification of a debt instrument can thus cause the issuer to recognize discharge of indebtedness income, measured by the difference between the adjusted issue price of the old debt and the fair market value (or other applicable issue price) of the new debt.[17] If the debt instrument is publicly traded or is issued in exchange for property (including other debt) that is publicly traded, then the issue price of the new debt is deemed to be the fair market value of the debt or other property that is publicly traded. [18] If neither the old nor the new debt instrument is traded on an established securities market the issue price of the new debt is generally the stated principal amount unless there is inadequate stated interest (i.e., interest less than the Treasury rate for an instrument of comparable term).[19] Thus, in such traded situations, discharge of indebtedness income is likely to be recognized if troubled debt is modified or satisfied with other debt instruments. However, in private situations there may be no discharge of indebtedness income.

In 2008, special temporary rules were enacted allowing any taxpayer that experiences discharge of indebtedness income arising from the reacquisition of its debt (including modifications treated as a reacquisition) to defer including that income for a period of years and then recognize the income ratably over a number of subsequent years. These rules applied to any debt issued by a corporate taxpayer and to debt issued by any other taxpayer in connection with the conduct of trade or business. They expired at the end of 2010.[20]

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the debt may be considered contributed in a nontaxable contribution to capital, not creating discharge of indebtedness income.

[15] Sec. 249.

[16] Treas. Reg. sec. 1.1001-3.

[17] The discharge of indebtedness income is taken into income at the time of the exchange. The new debt may be deemed to be issued with original issue discount (to the extent the amount payable at maturity exceeds the issue price) that the issuer can deduct, which can offset the amount of debt discharge income, but the deductions occur in the future over the period of the new debt, while the income is recognized immediately.

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

[19] In certain "potentially abusive" cases, the principal amount of debt given in exchange for other property (including other debt) is the fair market value of the property exchanged.

[20] Pub. L. No.111-5, sec. 1231. Section 1232 gives the Treasury Department authority to suspend the AHYDO rules or modify the rate for determining what is an AHYDO in certain distressed debt capital market conditions.

Special rules allow a taxpayer not to recognize discharge of indebtedness income if the taxpayer is in bankruptcy or is insolvent. These rules permit such taxpayers to reduce net operating loss carryovers, depreciable asset basis, and other tax attributes that would provide tax benefits in the future, in lieu of recognizing current income from the discharge of indebtedness. The rules differ depending on whether the issuer is insolvent or is in a bankruptcy or similar proceeding.

If the discharge of indebtedness occurs in a Title 11 bankruptcy case, the full amount of any debt discharged is excluded from income. If the taxpayer is insolvent, cancellation of debt income is excludable only to the extent of the insolvency. In either case, if the tax attributes subject to reduction are insufficient to cover the amount of the discharge, there is no inclusion of debt discharge income for the excess. In the case of an entity that is taxed as a partnership, the determinations whether the discharge occurs in a Title 11 bankruptcy case, whether the taxpayer is insolvent, and the reduction of tax attributes, all occur at the partner level.

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

Other special rules allow a taxpayer that is not in bankruptcy or insolvent to exclude discharge of indebtedness income and instead reduce the basis of certain real property. These rules apply only for discharge of certain qualified real estate indebtedness or qualified farm indebtedness. The rules relating to qualified real estate indebtedness are available only to noncorporate taxpayers.

Purchase money financing

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

Nonrecourse indebtedness

Nonrecourse debt is subject to different rules than recourse debt.[21] Because the taxpayer is not personally liable on the debt, there is no cancellation of indebtedness income. However, if the creditor forecloses or otherwise takes the property securing the debt, the borrower treats the transaction as a sale of the property for a price equal to the outstanding indebtedness (even if the

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

property securing the debt is worth less than the debt at the time of foreclosure).[22] Such a transaction generally produces capital gain (rather than ordinary income) to the debtor.

2. Holder treatment of debt and equity

Current income and sales of interests

Taxable investors

Interest on debt is taxed to a taxable individual or corporate holder at the ordinary income tax rate of the holder (currently, up to 35 percent).[23] Dividends paid by a taxable C corporation,[24] are generally taxed to a taxable individual shareholder at a maximum rate of 15 percent.[25] Such dividends are generally taxed to a taxable C corporation shareholder at a maximum rate of 10.5 percent (or less, depending on the percentage ownership the corporate shareholder has in the issuing corporation).[26] Gain on the sale of an equity interest in a C corporation or in an S corporation is generally capital gain. If the stock has been held for at least one year, such gain is generally taxable to a taxable individual shareholder at a maximum rate of 15 percent.[27] Gain on the sale of C corporation stock[28] is taxed to a taxable corporate shareholder[29] at regular corporate rates (generally 35 percent). Gain on the sale of an equity

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

[23] The ordinary income rate for individuals is scheduled to increase to 39.6 percent after 2012.

[24] A C corporation is defined by reference to subchapter C of the Code (tax rules relating to corporations and shareholders) and is taxable as a separate entity with no deduction for dividends or other equity distributions. For purposes of the discussion in this document,, such corporations are distinguished from certain corporations that meet specific tests relating to organization, functions, assets, and income types can deduct dividends and certain other equity distributions to shareholders, (e.g., real estate investment trusts (REITs) or regulated investment companies (RICs)). A C corporation is also distinguished from an S corporation, governed by the additional rules of subchapter S. An S corporation is a corporation that has only one class of stock, has no more than 100 shareholders (after applying attribution rules), meets other specific requirements, and makes an election enabling its income and deductions to pass through to its shareholders without entity level tax. Sec. 1371 et seq.

[25] The maximum 15 percent rate on dividends of individuals is scheduled to increase to 39.6 percent after 2012.

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

[27] The maximum 15 percent rate on long-term capital gains of individuals is scheduled to increase to 20 percent after 2012.

[28] A corporate shareholder cannot own S corporation stock.

interest in a partnership is generally also capital gain of the partner, except for amounts attributable to unrealized receivables and inventory items of the partnership, which are taxable as ordinary income.[30]

Interest is generally taxable when paid or accrued. Interest generally is includable in income, and thus taxable, before any cash payment if the original issue discount rules apply. Dividends are generally not taxable until paid. However, in limited circumstances certain preferred stock dividends may be accrued under rules similar to the rules for debt. Also, a shareholder may be treated as having received a dividend if his percentage stock ownership increases as a result of the payment of dividends to other shareholders.[31]

Tax-exempt investors

A tax-exempt investor (for example, a university endowment fund or a pension plan investor) is generally not taxed on investment interest, subject to certain unrelated business income tax (UBTI) rules for debt-financed income.[32] This is true whether the debt is issued by a C corporation or by any other entity.

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

However, tax-exempt equity investors in a partnership are taxed as engaged in an unrelated trade or business on their distributive share of partnership income from such a business, as if they had conducted the business directly. And tax-exempt equity investors in an S corporation (other than an ESOP investor) are taxed on their entire share of S corporation income or gain on sale of the stock.[33]

Foreign investors

Debt interests in U.S. entities

Although U.S.-source interest paid to a foreign investor is generally subject to a 30-percent gross basis withholding tax, various exceptions exist in the Code and in bilateral income

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[29] A C corporation is not an eligible S corporation shareholder and therefore cannot own S corporation stock.

[30] Sec. 751.

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

[32] Secs. 512, 514.

[33] Sec. 512(b).

tax treaties.[34] Interest is generally derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a noncorporate resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[35] For this purpose, a noncorporate resident includes a domestic partnership which at any time during the year was engaged in a U.S. trade or business.[36] Additionally, interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[37]

Statutory exceptions to this general rule apply for interest on bank deposits as well as portfolio interest. Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S.-source income but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[38] Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[39] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.[40]

Portfolio interest received by a nonresident individual or foreign corporation from sources within the United States is exempt from U.S. withholding tax.[41] For obligations issued before March 19, 2012, the term "portfolio interest" means any interest (including original issue

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[34] Where a foreign investor is engaged in a U.S. trade or business, any U.S. source interest income or U.S. source dividend income (see "Equity interest in U.S. Entities" below) derived from assets used in or held for use in the conduct of the U.S. trade or business where the activities of the trade or business were material factor in the realization of such income will be treated as effectively connected with that U.S. trade or business. Sec. 864(a)(2).

[35] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1). However, special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions. Sec. 861(a)(1). Prior to January 1, 2011, all (or a portion) of a payment of interest by a resident alien individual or domestic corporation was treated as foreign source if such individual or corporation met an 80-percent foreign business requirement. This provision was generally repealed for tax years beginning after December 31, 2010.

[36] Treas. Reg. sec. 1.861-2(a)(2).

[37] Sec. 884(f)(1).

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

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

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

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

discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person, as well as interest paid on an obligation that is not in registered form and that meets the foreign targeting requirements of section 163(f)(2)(B). Portfolio interest, however, does not include interest received by a 10-percent shareholder,[42] certain contingent interest,[43] interest received by a controlled foreign corporation from a related person,[44] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[45]

For obligations issued after March 18, 2012, the term "portfolio interest" no longer includes interest paid with respect to an obligation not in registered form. This narrowing of the scope of the portfolio interest exemption is a result of the repeal of the exception to the registration requirements for foreign targeted securities in 2010, effective for obligations issued two years after enactment.[46]

U.S.-source interest payments that do not qualify for a statutory exemption from the 30-percent withholding tax often are exempt from withholding under U.S. bilateral income tax treaties. Many treaties, including, for example, those with Canada, Germany, and the United Kingdom, broadly eliminate the withholding tax on U.S.-source interest payments. The result is that large volumes of interest payments are exempt from withholding under the Code or a treaty.

Equity interests in U.S. entities

A foreign equity investor's receipt of U.S.-source dividend income from a U.S. domestic corporation is generally subject to a 30-percent gross basis withholding tax. Dividend income is generally sourced by reference to the payor's place of incorporation such that dividends paid by a domestic corporation are generally treated as entirely U.S.-source income.[47] As with interest, the 30-percent withholding tax on dividends received by foreign investors may be reduced or eliminated under U.S. bilateral income tax treaties. In general, the dividend withholding tax rates in treaties vary based on the percentage of stock of the dividend-paying company owned by the recipient of the dividend. Treaties typically provide lower withholding tax rates (five percent, for example) at ownership levels of ten percent and greater. Twelve treaties, including those with Germany, Japan, and the United Kingdom, eliminate the withholding tax on dividends in circumstances in which, among other requirements, the foreign treaty resident is a company that owns at least 80 percent (in the case of Japan, 50 percent) of the U.S. corporation paying the dividend.

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[42] Sec. 871(h)(3).

[43] Sec. 871(h)(4).

[44] Sec. 881(c)(3)(C).

[45] Sec. 881(c)(3)(A).

[46] Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

[47] Secs. 861(a)(2), 862(a)(2).

Foreign investors also are not generally subject to tax on the sale of C corporation stock.[48]

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

Treatment if investment becomes worthless

A taxable holder of either debt or equity held as an investment generally recognizes a capital loss if the instrument is sold to an unrelated party at a loss.[49] Capital losses can generally offset only capital gains; however, an individual may deduct up to $3,000 per year of capital loss against ordinary income.

A taxable holder of investment equity or debt also generally realizes a capital loss if the instrument becomes worthless. Certain other transactions, such as liquidating a subsidiary,[50] can permit recognition of a stock loss without a sale to an unrelated party.

In certain circumstances, an individual holder of debt that is not a security may take an ordinary bad debt loss.[51]

3. Acquisitions and dispositions

The Code permits certain corporate acquisitions and dispositions to occur without recognition of gain or loss, generally so long as only equity interests are received or any securities received do not exceed the amount surrendered.[52] Similarly, the Code permits certain contributions and distributions of property to and from partnerships without tax if made with respect to an equity interest.[53]

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

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

[50] See Sec. 267(a)(1), second sentence.

[51] Sec. 166.

[52] Secs. 351-368 and sec. 1032.

[53] Secs. 721 and 731.

A transfer of property to a corporation or partnership in exchange for debt of the entity is generally treated as a sale of the property.[54] Gain or loss is recognized, except that loss may be deferred if the transfer is to a related party.[55]

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

[55] Secs. 267 and 707.

B. Definition of Debt and Equity

1. Distinguishing debt from equity

In general

The characterization of an instrument as debt or equity for Federal income tax purposes is generally determined by the substance of the investor's investment. An instrument's characterization depends upon the terms of the instrument and all the surrounding facts and circumstances analyzed in terms of economic and practical realities. Neither the form of the instrument nor the taxpayer's characterization of the interest is necessarily determinative of the instrument's treatment for Federal income tax purposes. Nonetheless, between the extremes of instruments that are clearly debt or clearly equity, taxpayers have some latitude to structure instruments incorporating both debt- and equity-like features (commonly referred to as "hybrid securities").[56]

There is currently no definition in the Code or Treasury regulations that can be used to determine whether an interest in a corporation constitutes debt or equity for tax purposes. Moreover, the IRS will ordinarily not provide individual taxpayers guidance on whether an interest in a corporation is debt or equity for tax purposes because, in its view, the issue is primarily one of fact.[57]

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

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

[57] Rev. Proc. 2011-3, sec. 4.02(1), 2011-1 I.R.B. 111. The IRS has identified factors to weigh in determining whether a particular instrument should be treated as debt or equity. See, e.g., Notice 94-47, 1994-1 C.B. 357.

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

[59] *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957) (noting that debt involves "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof."); sec. 385(b)(1) ("a written unconditional promise to pay on demand or an a specified date a sum certain in money in return for an adequate consideration in money or

of whether an interest constitutes debt or equity is generally made by analyzing and weighing the relevant facts and circumstances of each case.[60]

Courts have created differing (though generally similar) lists of factors[61] to distinguish debt from equity with no one factor controlling or more important than any other.[62] One commentator provides a list of thirty factors along with the Circuit courts that have considered these factors.[63] Another commentator groups the factors discussed in the cases into four categories: (1) those involving the formal rights and remedies of the parties; (2) those bearing on the genuineness of the alleged intention to create a debtor-creditor relationship; (3) those bearing on the reasonableness or economic reality of that intention (the risk element); and (4) those which are merely rhetorical expressions of a result, having no proper evidentiary weight in themselves.[64]

Some commonly cited factors considered, among others, are:

1. whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future;

2. whether the holder possesses the right to enforce the payment of principal and interest;

3. whether there is subordination to, or preference over, any indebtedness of the issuer, including general creditors;

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money's worth, and to pay a fixed rate of interest"); Treas. Reg. sec. 1.165-5(a)(3) (defines security as an evidence of indebtedness to pay a fixed or determinable sum of money); sec. 1361(c)(5)(B) (straight-debt safe harbor for subchapter S purposes).

[60] *John Kelley Co. v. Commissioner*, 326 U.S. 489 (1943) (stating "[t]here is no one characteristic, not even the exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.").

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

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

[63] Christensen, "The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion," 74 *University of Chicago Law Review* 1309, 1313 (2007).

[64] Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax Law Review* 369, 411-412 (1971). According to a study of 126 Tax Court opinions issued from 1955 to 1987, seven factors were found to be conclusive of debt classification 97 percent of the time. Robertson, "Daughtrey & Burckel, Debt or Equity? An Empirical Analysis of Tax Court Classification During the Period 1955-1987," 47 *Tax Notes* 707 (1990).

4. the intent of the parties, including the name given the instrument by the parties and its treatment for nontax purposes including financial accounting, regulatory, and rating agency purposes;

5. the issuer's debt to equity ratio;

6. whether the instrument holder is at risk of loss or has the opportunity to participate in future profits;

7. whether the instrument provides the holder the right to participate in the management of the issuer;

8. the availability and terms of other credit sources;

9. the independence (or identity) between holders of equity and the holders of the instrument in question;

10. whether there are requirements for collateral or other security to ensure the payment of interest and principal; and

11. the holder's expectation of repayment.

2. Regulatory authority pursuant to section 385

Section 385 authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation should be characterized as debt or equity (or as in part debt and in part equity) for Federal income tax purposes. Section 385(b) lists five factors which "may" be included in regulations prescribed under the section as relevant to the debt/equity analysis. Section 385(b) lists the factors as:

1. whether there is an unconditional written promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;

2. whether there is subordination to or preference over any indebtedness of the corporation;

3. the corporation's debt to equity ratio;

4. whether the interest is convertible into stock of the corporation; and

5. the relationship between the holdings of stock in the corporation and holdings of the interest in question.

As detailed below, regulations under section 385 were promulgated but withdrawn without ever having taken effect. The withdrawn regulations are not legally binding on the IRS or taxpayers.

Section 385(c) provides that an issuer's characterization of an instrument (at the time of issuance) is binding on the issuer and any holder, but not the Secretary. However, the holder of an instrument may treat an instrument differently than the issuer provided the holder discloses the inconsistent treatment on his return.

Legislative Background

Section 385 was enacted by the Tax Reform Act of 1969.[65] The Senate Finance Committee noted that:

> "In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations."[66]

The Treasury promulgated proposed regulations under section 385 in March of 1980[67] and final regulations on December 31, 1980, with an effective date of April 30, 1981. The effective date was extended twice.[68] The Treasury promulgated proposed amendments to the regulations in 1982.[69] The effective date of the proposed amendments, and the final regulations,

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[65] Pub. L. No. 91-172.

[66] S. Rep. No. 91-552 (November 21, 1969). The Senate Finance Committee previously considered whether to define debt and equity in the context of creating the Internal Revenue Code of 1954. At that time the issue was whether the Senate should adopt the House of Representatives' draft version of the Code which defined participating stock (common stock) and nonparticipating stock (preferred stock) and defined the term security. The Senate Finance Committee ultimately recommended that these definitions be dropped, noting:

> Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments. Accordingly, your committee has returned to the use of the terms "stock," "common stock," "securities," etc., and, as is the case under existing law, has not attempted to define them in the statute. S. Rep. No. 1622, 83 Cong., 2d Sess. 42 (1954).

[67] 45 F.R. 18957.

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

[69] See 47 F.R. 164.

were again postponed.[70] The final regulations were withdrawn in 1983 without ever having taken effect.[71]

Section 385 was amended by the Omnibus Budget Reconciliation Act of 1989[72] to specifically add authority for the Secretary to treat an interest in a corporation as part stock and part debt.[73] In 1992, section 385 was amended to add section 385(c) regarding the effect of an issuer's classification.[74]

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[70] T.D. 7822, 47 F.R. 28915.

[71] T.D. 7920, 48 F.R. 50711. One commentator suggests that the regulations were not finalized because tax planners could design instruments contained all of the essential features of equity but which qualify as debt under the regulations. As an example, he noted that an instrument would be classified as debt if its debt features accounted for more than half of its value and that as a result of this rule, hybrid instruments such as adjustable rate convertible notes began appearing that provided for guaranteed payments having a present value just greater than half of the issue price, variable payments tied to the issuer's common-stock dividends, and an option to convert these instruments into shares of the issuer's stock. Adam O. Emmerich, "Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation," 52 *University of Chicago Law Review* 118, 129-131 (1985).

[72] Pub. L. No. 101-239.

[73] Section 7208(a)(2) of Pub. L. No. 101-239 provides that the authority granted to bifurcate an interest in a corporation may not be applied retroactively.

[74] Energy Policy Act of 1992, Pub. L. No. 102-486.

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

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

1. Earnings stripping

Present Law

Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the safe harbor ratio); and the payor's net interest expense exceeds 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest;[75] (2) unrelated parties in certain instances in which a related party guarantees the debt; or (3) to a real estate investment trust ("REIT") by a taxable REIT subsidiary of that trust.[76] Interest amounts disallowed under these rules can be carried forward indefinitely.[77] In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.[78]

The operation of these rules is illustrated by the following example. ForCo, a corporation organized in country A, wholly owns USCo, a corporation organized in the United States. ForCo's investment in USCo stock totals $6.5 million. In addition, USCo has borrowed $8 million from ForCo and $5 million from Bank, an unrelated bank. In 2010, USCo's first year of operation, USCo's adjusted taxable income is $1 million (none of which is from interest income), and it also pays $400,000 of interest to ForCo and $300,000 of interest to the unrelated bank. Under the U.S.-country A income tax treaty, no tax is owed to the United States on the interest payments made by USCo to ForCo.

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

[76] Sec. 163(j)(3).

[77] Sec. 163(j)(1)(B).

[78] Sec. 163(j)(2)(B)(ii).

- USCo has a 2:1 debt-to-equity ratio (total borrowings of $13 million ($8 million + $5 million) and total equity of $6.5 million), so USCo's deduction for the $700,000 ($400,000 + $300,000) of interest it paid may be limited.

- USCo's disqualified interest is $400,000 (the amount of interest paid to a related party on which no Federal income tax is imposed).

- USCo's excess interest expense is $200,000 ($700,000 - ($1 million x 50%)).

- Accordingly, USCo may deduct only $500,000 ($700,000 - $200,000) for interest expense in year 2010.

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

Legislative Background

Section 163(j) was enacted in 1989 in response to Congressional concerns over earnings stripping.[79] Congress believed it was "appropriate to limit the deduction for interest that a taxable person pays or accrues to a tax-exempt entity whose economic interests coincide with those of the payor. To allow an unlimited deduction for such interest permits significant erosion of the tax base."[80]

In 1993, the earnings stripping rules were amended so that they applied to interest paid on unrelated party loans if guaranteed by a related party under certain circumstances.[81] Congress made this change because it was concerned about the distinction made under the existing earnings stripping rules between the situation in which unrelated creditors all lend to the parent of a group, which in turn lends to the U.S. subsidiary, and the situation in which the creditors lend directly to the U.S. subsidiary with a guarantee from the parent.[82] The existing rules applied to the first situation but not the second situation, even though the "same 'excess' interest deductions, and the same resultant 'shifting' of net income out of U.S. taxing jurisdiction, is obtainable through borrowing by U.S. corporations on [the parent's] credit."[83]

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[79] Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7210.

[80] H.R. Rep. No. 101-247, p. 1241 (1989).

[81] Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 13228.

[82] H.R. Rep. No. 103-111, p. 683 (1993).

[83] *Ibid.,* p. 682.

The definition of disqualified interest was expanded in 1999 to include interest paid or accrued by a taxable REIT subsidiary to a related REIT.[84]

In 2006, the earnings stripping rules were modified to apply to corporate owners of partnership interests.[85] Specifically, the modifications provided that for purposes of applying the earnings stripping rules when a corporation owns an interest in a partnership, (1) the corporation's share of partnership liabilities are treated as liabilities of the corporation, and (2) the corporation's distributive share of interest income and interest expense of the partnership is treated as interest income or interest expense, respectively, of the corporation. Treasury was also granted expanded regulatory authority to reallocate shares of partnership debt, or distributive shares of the partnership's interest income or interest expense.

The American Jobs Creation Act of 2004 required the Secretary of the Treasury to submit a report to the Congress by June 30, 2005, examining the effectiveness of the earnings stripping provisions of present law, including specific recommendations to improve the provisions of the Code applicable to earnings stripping.[86] The Treasury Department submitted its report to Congress on November 28, 2007.[87] In summary, the report concludes that "[t]here is strong evidence that [inverted corporations][88] are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping."[89] The report also concludes, however, that the evidence that other foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive, and that it is not possible to determine with precision whether section 163(j) is effective generally in preventing earnings stripping by foreign-controlled domestic corporations.[90]

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[84] Tax Relief Extension Act of 1999, Pub. L. No. 106-170, sec. 544. Technical corrections were also made in 1996 and 2005. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, secs. 1703(n)(4), 1704(f)(2); Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, sec. 403(a)(15).

[85] Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, sec. 501 (2006).

[86] Pub. L. No. 108-357, sec. 424.

[87] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007). For a detailed discussion of the report, including an analysis of its methodology and conclusions, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, pp. 259-65.

[88] An "inverted corporation" is a former U.S.-based multinational that restructured to replace a U.S. parent corporation with a new foreign parent for the group. For purposes of the Treasury report, inverted corporations are a subset of foreign-controlled domestic corporations.

[89] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (2007), p. 26.

[90] *Ibid.,* pp. 25-26.

Subsequent to its 2007 report on earnings stripping, the Treasury Department created a new tax form, Form 8926 Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information, to collect information related to earnings stripping. Form 8926 must be filed by a corporation (other than an S corporation) if it paid or accrued disqualified interest during the taxable year or had a carryforward of disqualified interest from a previous tax year.

2. Tax treatment of certain payments to controlling exempt organizations

Present Law

Although tax-exempt organizations described under section 501(c) are generally exempt from Federal income tax,[91] such organizations may be subject to the unrelated business income tax (UBIT)[92] on interest and other income received from the organization's controlled subsidiaries.[93] Section 512(b)(13) subjects interest income (as well as rent, royalty, and annuity income) to UBIT if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax-exempt).[94]

A special rule relaxes the general rule of section 512(b)(13) for qualifying specified payments made pursuant to a binding written contract that was in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms).[95] The special rule applies to payments received or accrued before January 1, 2012.

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[91] Sec. 501(a).

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

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

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

[95] Sec. 512(b)(13)(E). For such payments covered by the special rule, the general inclusion rule of section 512(b)(13) applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of section 482 (i.e., at arm's length). In addition, the special rule imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

Legislative Background

Congress enacted section 512(b)(13) as part of the Tax Reform Act of 1969[96] for the purpose of preventing organizations from avoiding taxation through arrangements in which a taxable organization controlled by a tax-exempt organization would make deductible payments of interest, rent, annuities, or royalties to the tax-exempt organization to reduce taxable income.[97] Congress amended section 512(b)(13) in 1997 to broaden the definition of control to capture arrangements using constructive ownership and second-tier subsidiaries.[98]

The Pension Protection Act of 2006 enacted the special rule for qualifying specified payments under section 512(b)(13)(E).[99] The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 extended the special rule to such payments received or accrued before January 1, 2009,[100] and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[101] extends the special rule to such payments received or accrued before January 1, 2012.

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[96] Pub. L. No. 91-172.

[97] See H.R. Rep. No. 413, 91st Cong., 1st Sess. 49 (1969).

[98] Tax Relief Act of 1997, Pub. L. No. 105-34.

[99] Pub. L. No. 109-280.

[100] Pub. L. No. 110-343.

[101] Pub. L. No. 111-312.

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

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

1. Corporate Equity Reduction Transactions

Present Law

A net operating loss ("NOL") is the amount by which a taxpayer's business deductions exceed its income. In general, an NOL may generally be carried back two years and carried forward 20 years to offset taxable income in such years.[102] NOLs offset taxable income in the order of the taxable years to which the NOLs are carried.[103]

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

Except to the extent provided in regulations, interest is allocated to a CERT using the "avoided cost" method of allocating interest in lieu of a direct tracing rule.[104] That is, the amount of indebtedness treated as incurred or continued to finance the CERT is based on the amount of interest expense that would have been avoided if the CERT had not been undertaken and the amounts expended for the CERT were used to repay indebtedness.

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[102] Sec. 172(b)(1)(A).

[103] Sec. 172(b)(2).

[104] Sec. 172(h)(2)(B) (adopting the avoided cost allocation method described in section 263A(f)(2)(A)(ii) and not the direct tracing method described in section 263A(f)(2)(A)(i)).

A corporate equity reduction transaction means either a major stock acquisition or an excess distribution. A major stock acquisition is the acquisition by a corporation (or any group of persons acting in concert with such corporation) of stock in another corporation representing 50 percent or more (by vote or value) of the stock of another corporation.[105] A major stock acquisition does not include a qualified stock purchase to which a section 338 election applies.[106] An excess distribution is the excess of the aggregate distributions and redemptions made by a corporation during the taxable year with respect to its stock (other than certain preferred stock described in section 1504(a)(4)), over the greater of (a) 150 percent of the average of such distributions and redemptions for the preceding three taxable years, or (b) 10 percent of the fair market value of the stock of such corporation as of the beginning of such taxable year. The amount of distributions and redemptions made by a corporation during a taxable year are reduced by stock issued by the corporation during the applicable period in exchange for money or property other than stock in the corporation.

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

Legislative Background

The CERT provisions were added to the Code by the Omnibus Budget Reconciliation Act of 1989[107] because Congress believed that the ability of corporations to carry back NOLs created by certain debt-financed transactions is contrary to the purpose of the NOL rules. The NOL carryover rules generally serve the purpose of smoothing swings in taxable income that can result from business cycle fluctuations and unexpected financial reverses. Congress believed that the underlying nature of a corporation is substantially altered by a CERT, and that the interest expense associated with such transaction lacks a sufficient nexus with prior period operations to justify the carryback of NOLs attributable to such expense.[108] The definition of a CERT was expanded by the Omnibus Budget Reconciliation Act of 1990[109] to include the acquisition of 50 percent or more of the vote or value of the stock of any corporation, regardless of whether the corporation was a member of an affiliated group (unless an election under section 338 were made).

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[105] Secs. 172(h)(3)(A)(i) and 172(h)(3)(B).

[106] Sec. 172(h)(3)(B)(ii). A section 338 election allows taxpayers to treat a qualifying stock acquisitions as an asset acquisition for tax purposes.

[107] Pub. L. No. 101-239.

[108] H.R. Rep. No. 101-247.

[109] Pub. L. No. 101-508.

2. Debt expected to be paid in equity

Present Law

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

For this purpose, debt is treated as payable in equity if a substantial amount of the principal or interest is mandatorily convertible or convertible at the issuer's option into such equity. In addition, a debt instrument is treated as payable in equity if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of such equity.[110] A debt instrument also is treated as payable in equity if it is part of an arrangement that is reasonably expected to result in the payment of the debt instrument with or by reference to such equity, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such equity, or certain debt instruments that are paid in, converted to, or determined with reference to the value of equity if it may be so required at the option of the holder or a related party and there is a substantial certainty that the option will be exercised.[111] An exception is provided for debt issued by a dealer in securities (within the meaning of section 475) or a related party which is payable in, or by reference to, equity (not of the issuer or related party) held in its capacity as a dealer in securities.[112]

Application of section 163(l) to an instrument will generally disallow the issuer's interest or OID deductions, but the provision does not alter the treatment of amounts paid or accrued to the holder.[113]

Legislative Background

Section 163(l) was enacted by the Taxpayer Relief Act of 1997[114] in response to Congressional concern that corporate taxpayers could issue instruments denominated as debt, but that more closely resembled equity for which an interest deduction is not appropriate.[115]

The American Jobs Creation Act of 2004[116] expanded the provision to disallow interest deductions on certain corporate debt that is payable in, or by reference to the value of, any equity

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[110] Sec. 163(l)(3)(B).

[111] Sec. 163(l)(3)(C).

[112] Sec. 163(l)(5).

[113] See H.R. Conf. Rep. 105-220.

[114] Pub. L. No. 105-34.

[115] H.R. Rep. No. 105-148.

held by the issuer (or any related party) in any other person, but provided for the dealers in securities exception. Prior to AJCA, section 163(l) operated to disallow a deduction with respect to an instrument payable in stock of the issuer or an a related party (using a more than 50 percent ownership test). Expansion of the scope of section 163(l) was prompted, at least in part, by transactions undertaken by Enron Corporation to effectively monetize affiliate stock.[117] For example, in 1995 Enron issued investment unit securities which provided for an amount payable at maturity in stock of a more than 50-percent owned Enron affiliate. In 1999, after the enactment of section 163(l), Enron issued similar investment unit securities with respect to the same corporate affiliate. Enron took the position that section 163(l), however, did not apply because Enron's ownership of the affiliate had decreased below the 50-percent threshold.[118] Congress believed the Enron transactions cast doubt on the rule excluding stock ownership interests of 50-percent or less. Congress believed that eliminating the related party threshold furthered the tax policy objective of similar tax treatment for economically similar transactions.[119]

3. Applicable high-yield discount obligations

Present Law

In general, the issuer of a debt instrument with OID may deduct the portion of such OID equal to the aggregate daily portions of the OID for days during the taxable year.[120] However, in the case of an applicable high-yield discount obligation (an AHYDO) issued by a corporate issuer, (1) no deduction is allowed for the "disqualified portion" of the OID on such obligation, and (2) the remainder of the OID on any such obligation is not allowable as a deduction until paid by the issuer.[121]

An AHYDO is any debt instrument if (1) the maturity date on such instrument is more than five years from the date of issue; (2) the yield to maturity on such instrument exceeds the sum of (a) the applicable Federal rate in effect under section 1274(d) for the calendar month in which the obligation is issued and (b) five percentage points, and (3) such instrument has significant original issue discount.[122] An instrument is treated as having significant OID if the

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[116] Pub. L. No. 108-357.

[117] See S. Rep. No. 108-192.

[118] For a discussion of the Enron transactions, see Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, pp. 333-345.

[119] S. Rep. No. 108-192.

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

[121] Sec. 163(e)(5).

[122] Sec. 163(i)(1).

aggregate amount of interest that would be includible in the gross income of the holder with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date five years after the date of issue exceeds the sum of (1) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and (2) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity.[123] The disqualified portion of the OID on an AHYDO is the lesser of (1) the amount of OID with respect to such obligation or (2) the portion of the total return on such obligation which bears the same ratio to such total return as the disqualified yield (i.e., the excess of the yield to maturity on the obligation over the applicable Federal rate plus six percentage points) on such obligation bears to the yield to maturity on such obligation.[124] The term total return means the amount which would have been the original issue discount of the obligation if interest described in section 1273(a)(2) were included in the stated redemption to maturity.[125] A corporate holder treats the disqualified portion of OID as a stock distribution for purposes of the dividend received deduction.[126]

Legislative Background

Sections 163(i) and 163(e)(5) were enacted by the Omnibus Budget Reconciliation Act of 1989,[127] following a series of Congressional hearings on corporate leverage. Congress enacted the AHYDO rules because it believed that a portion of the return on certain high-yield OID obligations is similar to a non-deductible distribution of corporate earnings paid with respect to equity rather than a deductible payment of interest.[128]

The American Recovery and Reinvestment Tax Act of 2009 ("ARRA")[129] suspended the deduction denial and deferral rules of section 163(e)(5) for certain obligations issued in debt-for-debt exchanges (including deemed exchanges resulting from a significant modification) after August 31, 2008 and before January 1, 2010. ARRA also provided authority to the Secretary to (1) apply the suspension rule for periods after December 31, 2009, where the Secretary determines that such application is appropriate in light of distressed conditions in the debt capital markets, and (2) use a rate that is higher than the applicable Federal rate for purposes of applying section 165(e)(5) for obligations issued after December 31, 2009, in taxable years ending after such date if the Secretary determines that such higher rate is appropriate in light of distressed debt capital market conditions.

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[123] Sec. 163(i)(2).

[124] Sec. 163(e)(5)(C).

[125] Sec. 163(e)(5)(C)(ii).

[126] Sec. 163(e)(5)(B).

[127] Pub. L. No. 101-239.

[128] H.R. Conf. Rep. 101-386 (November 21, 1989).

[129] Pub. L. No. 111-5.

4. Interest on certain acquisition indebtedness

Present Law

Section 279 denies a deduction for interest on "corporate acquisition indebtedness." The limitation applies to interest in excess of $5 million per year incurred by a corporation with respect to debt obligations issued to provide consideration for the acquisition of stock, or two thirds of the assets, of another corporation, if each of the following conditions exists: (1) the debt is substantially subordinated;[130] (2) the debt carries an equity participation feature[131] (e.g., includes warrants to purchase stock of the issuer or is convertible into stock of the issuer); and (3) either the issuer is thinly capitalized (i.e., has a debt-to-equity ratio that exceeds 2 to 1)[132] or projected annual earnings do not exceed three times annual interest costs (paid or incurred).[133]

Legislative Background

Section 279 was enacted by the Tax Reform Act of 1969[134] in response to concerns over increased corporate acquisitions and the use of debt for such corporate acquisitions.[135] In 1976, the section was amended to delete the provision which would deny a deduction for interest on corporate acquisition indebtedness where a corporation which had acquired at least 50 percent of the total combined voting power of all classes of stock of another corporation by October 9, 1969, incurred acquisition indebtedness in increasing its control over the acquired corporation to 80 percent or more.[136]

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

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

[132] Sec. 279(b)(4)(A).

[133] Sec. 279(b)(4)(B).

[134] Pub. L. No. 91-172.

[135] S. Rep. No. 91-552 (November 21, 1969). See also, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, p. 123.

[136] Pub. L. No. 94-514.

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

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

1. Interest related to tax-exempt income

Present Law

Section 265 disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax ("tax-exempt obligations"). This rule applies to tax-exempt obligations held by individual and corporate taxpayers.[137] The rule also applies to certain cases in which a taxpayer incurs or carries indebtedness and a related person acquires or holds tax-exempt obligations.[138] Generally, there are two methods for determining the amount of the disallowance. One method asks whether a taxpayer's borrowing can be traced to its holding of exempt obligations. A second method disallows interest deductions based on the pro rata percentage of a taxpayer's assets comprised of tax-exempt obligations.

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

General rules

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

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[137] The rules applicable to individual taxpayers are discussed in the companion document, *Tax Treatment of Household Debt*.

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

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

Dealers in tax-exempt obligations

In the case of a dealer in tax-exempt obligations (whether a corporation, partnership or sole proprietorship), if the proceeds are directly traceable to the purchase of tax-exempt obligations, no interest on the indebtedness is deductible.[139] If the use of the proceeds cannot be directly traced, an allocable portion of the interest deduction is disallowed. The amount of interest disallowed is determined by the ratio of (1) the dealer's average amount of tax-exempt obligations held during the taxable year to (2) the average amount of the dealer's total assets less the amount of any indebtedness the interest on which is not subject to disallowance to any extent under the provision.[140]

Corporations that are not dealers in tax-exempt obligations

In the case of a business that is not a dealer in tax-exempt obligations, if there is direct evidence of the purpose to purchase or carry tax-exempt obligations with the proceeds of indebtedness, then no interest on the indebtedness is deductible. In the absence of such direct evidence, the IRS provides specific inference rules. Generally, the purpose to purchase or carry tax-exempt obligations will not be inferred with respect to indebtedness incurred to provide funds for an active trade or business unless the borrowing is in excess of business needs.[141] In contrast, the purpose to carry tax-exempt obligations will be inferred (unless rebutted by other evidence) where a taxpayer could reasonably have foreseen at the time of purchasing tax-exempt obligations that indebtedness would have been incurred to meet future economic needs of an ordinary, recurrent variety.[142]

De minimis exception

In the absence of direct evidence linking an individual taxpayer's indebtedness with the purchase or carrying of tax-exempt obligations, taxpayers other than dealers may benefit from a de minimis exception.[143] The IRS takes the position that it will ordinarily not infer a purpose to purchase or carry tax-exempt obligations if a taxpayer's investment therein is "insubstantial."[144]

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[139] Rev. Proc. 72-18, sec. 5.02.

[140] *Ibid.*, secs. 5.02 and 7.02.

[141] Rev. Proc. 72-18, sec. 6.01.

[142] Rev. Proc. 72-18, sec. 6.02.

[143] Rev. Proc. 72-18, sec. 3.05 provides that the insubstantial holding safe harbor is not available to dealers in tax-exempt obligations.

[144] Rev. Proc. 72-18, 1972-1 C.B. 740.

A corporation's holdings of tax-exempt obligations are presumed to be insubstantial if the average adjusted basis of the corporation's tax-exempt obligations is two percent or less of the average adjusted basis of all assets held in the active conduct of the corporation's trade or business.

If a corporation holds tax-exempt obligations (installment obligations, for example) acquired in the ordinary course of its business in payment for services performed for, or goods supplied to, State or local governments, and if those obligations are nonsalable, the interest deduction disallowance rule generally does not apply.[145] The theory underlying this rule is that a corporation holding tax-exempt obligations in these circumstances has not incurred or carried indebtedness for the purpose of acquiring those obligations.

Financial institutions

After taking into account any interest disallowance rules under general rules applicable to other taxpayers,[146] Section 265(b)(2) disallows a portion of a financial institution's otherwise allowable interest expense that is allocable to tax-exempt interest. The amount of interest that is disallowed is an amount of interest expense that equals the ratio of the financial institution's average adjusted bases of tax-exempt obligations acquired after August 7, 1986 to the average adjusted bases of all the taxpayer's assets (the "pro rata rule").[147] This allocation rule is mandatory and cannot be rebutted by the taxpayer. A financial institution, for this purpose, is any person who accepts deposits from the public in the ordinary course of such person's trade or business, and is subject to Federal or State supervision as a financial institution or is a bank as defined in section 585(a)(2).

Exception for certain obligations of qualified small issuers

The general rule in section 265(b) denying financial institutions' interest expense deductions allocable to tax-exempt obligations does not apply to "qualified tax-exempt obligations." Instead, only 20 percent of the interest expense allocable to such qualified tax-exempt obligations is disallowed.[148] A qualified tax-exempt obligation is a tax-exempt obligation that is (1) issued after August 7, 1986, by a qualified small issuer, (2) is not a private

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[145] Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669.

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

[147] Sec. 265(b).

[148] Secs. 265(b)(3) and 291(a)(3). Section 291(a)(3) reduces by 20 percent the amount allowable as a deduction with respect to any financial institution preference item. Financial institution preference items include interest on debt to carry tax-exempt obligations acquired after December 31, 1982, and before August 8, 1986. Section 265(b)(3) treats qualified tax-exempt obligations as if they were acquired on August 7, 1986. As a result, the amount allowable as a deduction by a financial institution with respect to interest incurred to carry a qualified tax-exempt obligation is reduced by 20 percent.

activity bond, and (3) is designated by the issuer as qualifying for the exception. A qualified small issuer is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be $10 million or less. The Code specifies circumstances under which an issuer and all subordinate entities are aggregated.[149] The special rule for qualified small issuers also applies to certain aggregated issuances of tax-exempt obligations in which more than one governmental entity receives benefits.[150]

Composite issues (i.e., combined issues of bonds for different entities) qualify for the "qualified tax-exempt obligation" exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as a single issue) and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue).[151] Thus a composite issue may qualify for the exception only if the composite issue itself does not exceed $10 million, and if each issuer benefitting from the composite issue reasonably anticipates that it will not issue more than $10 million of tax-exempt obligations during the calendar year, including through the composite arrangement.

Special rules for obligations issued in 2009 and 2010

The American Recovery and Reinvestment Act of 2009 ("ARRA") modified certain provisions of section 265. Tax-exempt obligations issued during 2009 or 2010 and held by a financial institution, in an amount not to exceed two percent of the adjusted basis of the financial institution's assets, are not taken into account for the purpose of determining the portion of the financial institution's interest expense subject to the pro rata interest disallowance rule of section 265(b).

In connection with this change, ARRA also amended section 291(e) to provide that tax-exempt obligations issued during 2009 and 2010, and not taken into account for purposes of the calculation of a financial institution's interest expense subject to the pro rata interest disallowance rule, are treated as having been acquired on August 7, 1986. As a result, such obligations are financial institution preference items, and the amount allowable as a deduction by a financial institution with respect to interest incurred to carry such obligations is reduced by 20 percent.

With respect to tax-exempt obligations issued during 2009 and 2010, ARRA relaxed several rules related to qualified small issuers.

Legislative Background

A provision denying a deduction for interest incurred in connection with tax-exempt obligations has been a part of the U.S. tax system since the Revenue Act of 1917, which allowed

[149] Sec. 265(b)(3)(E).

[150] Sec. 265(b)(3)(C)(iii).

[151] Sec. 265(b)(3)(F).

a deduction for "all interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation under this title."[152] Prior to 1986, banks were largely exempted from section 265 pursuant to IRS rulings providing, inter alia, that interest paid to depositors was not interest incurred or continued to carry tax-exempt obligations[153] and that section 265 would generally not apply to interest on indebtedness incurred by banks in the ordinary course of business absent a direct connection between the borrowing and the tax-exempt investment.[154]

As part of the Tax Reform Act of 1986,[155] Congress amended section 265 to deny financial institutions an interest deduction in direct proportion to their tax-exempt holdings. Congress believed that allowing financial institutions to deduct interest payments regardless of tax-exempt holdings discriminated in favor of financial institutions at the expense of other taxpayers, and Congress was concerned that financial institutions could drastically reduce their tax liability using such rules. Congress believed that a proportional disallowance rule was appropriate because of the difficulty of tracing funds within a financial institution and the near impossibility of assessing a financial institution's purpose in accepting particular deposits.[156]

2. Debt with respect to certain insurance products

Present Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[157] ("inside buildup").[158] Further, an exclusion from

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[152] Section 1201(1) of the Revenue Act of 1917. For a history of section 265, see George Craven, "Disallowance of Interest Deduction to Owner of Tax-Exempt Bonds," 24 *Tax Lawyer* 287 (1971).

[153] Rev. Rul. 61-222, 1961-2 C.B. 58.

[154] Rev. Proc. 70-20.

[155] Pub. L. No. 99-514.

[156] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, pp. 562-3.

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

[158] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract for purposes of determining income taxes, other than those imposed on insurance companies such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life

Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[159]

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

Interest paid or accrued with respect to the contract

No deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity, or endowment contract (the "single premium" deduction limitation).[160] A contract is treated as a single premium contract if substantially all the premiums on the contract are paid within a period of four years from the date on which the contract is purchased or if an amount for payment of a substantial number of future premiums is deposited with the insurer.[161]

In addition, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity, or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[162] Several exceptions are provided for this rule. The deduction denial does not apply if (1) no part of four of the annual premiums due during the initial seven year period is paid by means of such debt; (2) if the total amounts to which the provision would apply in a taxable year does not exceed $100; (3) if the amounts are paid or accrued because of financial hardship; or (4) if the indebtedness is incurred in connection with the taxpayer's trade or business.[163]

Finally, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity, or endowment contract covering the life of any individual,[164] with a key person insurance exception.[165]

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insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than a policy that would provide paid-up future benefits after the payment of seven annual level premiums (sec. 7702A).

[159] Sec. 101(a).

[160] Sec. 264(a)(2).

[161] Sec. 264(c).

[162] Sec. 264(a)(3).

[163] Sec. 264(d).

[164] Sec. 264(a)(4).

[165] This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person

Pro rata interest deduction limitation

A pro rata interest deduction disallowance rule also applies. This rule applies to interest for which a deduction is not disallowed under the other interest deduction disallowance rules relating to life insurance including, for example, interest on third-party debt that is not with respect to a life insurance, annuity, or endowment contract. Under this rule, in the case of a taxpayer other than a natural person,[166] no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[167] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values of life insurance, annuity, and endowment contracts, plus the average adjusted bases of other assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is an employee or is an officer, director, or 20-percent owner of the entity of the trade or business.[168] The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

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

Legislative Background

A limitation has applied to the deductibility of interest with respect to single premium life insurance contracts since 1942.[169] Additional interest deduction limitations with respect to life insurance, annuity, and endowment contracts were added in 1964 and 1986.[170] More recently,

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exception (sec. 264(e)), otherwise nondeductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed $50,000. Other special rules apply.

[166] See sec. 264(f)(5).

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

[168] Sec. 264(f)(4).

[169] Current sec. 264(a)(2) (former sec. 24(a)(6) of the 1939 Code), enacted in the Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 798, sec. 129, 77th Cong., 2d Sess., October 21, 1942.

[170] Sec. 264(a)(3), enacted in the Revenue Act of 1964, Pub. L. No. 88-272, sec. 215, 88th Cong., 2d Sess., 1964; sec. 264(a)(4) and (e)(1) (subsequently modified), enacted in the Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 99th Cong., 2d Sess., October 22, 1986. In addition to interest deduction limitations, limitations are imposed on the deductibility of premiums with respect to life insurance, annuity, and endowment contracts (sec. 264(a)(1)).

further interest deduction limitations with respect to such insurance contracts were added in 1996 and again in 1997.[171] In general, these interest deduction limitations have been based in part on concern over the opportunity for tax arbitrage, that is, the deductibility of interest expense with respect to untaxed investment income (inside buildup) of the insurance contract.[172]

For example, in enacting the interest deduction limitations in 1997, Congress expressed concern about the tax arbitrage of deducting interest expense that funds untaxed income:

> In addition, the Committee understands that taxpayers may be seeking new means of deducting interest on debt that in substance funds the tax-free inside build-up of life insurance or the tax-deferred inside buildup of annuity and endowment contracts. The Committee believes that present law was not intended to promote tax arbitrage by allowing financial or other businesses that have the ongoing ability to borrow funds from depositors, bondholders, investors or other lenders to concurrently invest a portion of their assets in cash value life insurance contracts, or endowment or annuity contracts. Therefore, the bill provides that for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of any life insurance policy or annuity or endowment contract issued after June 8, 1997.[173]

In 2006, additional rules for excludability of death benefits under a life insurance contract were added in the case of employer-owned life insurance contracts[174] (generally, those contracts insuring employees that are excepted from the pro rata interest deduction limitation).[175]

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[171] Current sec. 264(e), enacted in the Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, sec. 501, 104th Cong., 2d. Sess., July 31, 1996; and sec. 264(f), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 105th Cong., 1st Sess., July 30, 1997.

[172] For example, in enacting the 1964 interest deduction limitation, Congress stated, "The annual increase in the cash value of the insurance policy to reflect interest earnings, which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal or exceed the net interest charges the taxpayer pays. Thus, for taxpayers in higher brackets, where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured." Revenue Act of 1963, Report of the Committee on Ways and Means, H.R. Rep. No. 749, 88th Cong., 1st Sess., page 61, September 13, 1963. As a further example, following enactment of the 1986 interest deduction limitation, the reasons for change included this statement: "This provision provides a cap on the deductibility of such interest, rather than phasing out deductibility. The provision was structured in this manner to allow small businesses to use loans on life insurance policies for their employees as a source of short-term capital when necessary. Congress did not intend to allow these loans to be an unlimited tax shelter as under prior law." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, p. 579, May 4, 1987.

[173] Revenue Reconciliation Act of 1997 (as Reported by the Senate Committee on Finance), S. Rep. No. 105-33, 105th Cong., 1st Sess., p. 187, June 20, 1997 (footnotes omitted).

[174] Sec. 101(j).

[175] Pension Protection Act of 2006, Pub. L. No. 109-280.

3. Debt-financed income of tax-exempt organizations

Present Law

Although tax-exempt organizations described under section 501(c) are generally exempt from Federal income tax,[176] such organizations may be subject to the unrelated business income tax ("UBIT")[177] on income derived from property financed with debt.[178]

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business taxable income in proportion to the amount of acquisition indebtedness on the income-producing property.[179] Certain educational organizations, pension funds, title holding companies, and retirement income accounts are eligible for an exception to the debt-financed income rules for investments in real property.[180]

Legislative Background

Until the introduction of the UBIT in 1950, there was no statutory limitation on the amount of business activity an exempt organization could conduct so long as the earnings from the business were used for exempt purposes. In response to certain abusive transactions,[181]

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[176] Sec. 501(a).

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

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

[179] Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization in acquiring or improving the property and indebtedness incurred either before or after acquisition or improvement that would not have been incurred but for the acquisition or improvement of the property. Sec. 514(c)(1).

[180] Sec. 514(c)(9)(A). Additional requirements must be met for the real property exception to apply where the real property is held by a partnership in which a qualified organization is a partner. In addition to the real property exception, acquisition indebtedness does not include (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, and (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low- and moderate-income persons. See secs. 514(c)(4), (5), and (6), respectively.

[181] For example, in one type of transaction, a tax-exempt organization borrows the entire purchase price of real property, purchases the property and leases it back to the seller under a long-term lease, and services the loan with tax-free rental income from the lease. H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

Congress subjected charitable organizations (not including churches) and certain other exempt organizations to tax on their unrelated business income as part of the Revenue Act of 1950.[182]

The 1950 Act taxed as unrelated business income certain rents received in connection with the leveraged sale and leaseback of real estate.[183] This provision was a precursor to the present-law tax on unrelated debt-financed income.

In the Tax Reform Act of 1969, Congress extended UBIT to all tax-exempt organizations described in section 501(c) and 401(a) (except United States instrumentalities).[184] In addition, the 1969 Act expanded the tax on debt-financed income beyond rents from debt-financed acquisitions of real property to encompass debt-financed income from interest, dividends, other rents, royalties, and certain gains and losses from any type of property.[185]

In the Miscellaneous Revenue Act of 1980, Congress enacted an exception to the debt-financed income rules for certain real property investments by qualified pension trusts (the progenitor of the real property exception).[186]

In the Deficit Reduction Act of 1984, Congress extended the real property exception to educational organizations and layered on additional conditions, including an absolute bar on seller financing and an anti-abuse rule in the case of qualified organizations that were partners in partnerships investing in debt-financed real property.[187] In 1987, Congress further modified the restrictions on partnerships of qualified organizations investing in debt-financed real property by

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[182] Revenue Act of 1950, Pub. L. No. 81-814, sec. 301. In 1951, Congress extended the UBIT to the income of State colleges and universities. Sec. 511(a)(2)(B).

[183] There was an exception for rental income from a lease of five years or less. For a discussion of Congress's objections to such transactions, see H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[184] Pub. L. No. 91-172. The tax also applies to certain State colleges and universities and their wholly owned subsidiaries. Sec. 511(a)(2)(B).

[185] For a discussion of the reason for the expanding the debt-financed income rules in 1969, see Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

[186] Pub. L. No. 96-605. Congress believed that such an exception was warranted because "the exemption for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose—the payment of employee benefits." S. Rep. No. 96-1036, 96th Cong., 2d Sess. 29 (1980). In addition, the exemption provided to pension trusts was appropriate because, unlike other exempt organizations, the assets of such trusts eventually would be "used to pay taxable benefits to individual recipients whereas the investment assets of other [exempt] organizations . . . are not likely to be used for the purpose of providing benefits taxable at individual rates." *Ibid*. In other words, the exemption for qualified trusts generally results only in deferral of tax; unlike the exemption for other organizations.

[187] Pub. L. No. 38-369. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 1151.

enacting the fractions rule.[188] In 1993, Congress relaxed some of the conditions required to meet the real property exception.[189]

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

Present Law

In general, a corporate shareholder is allowed a deduction equal to (1) 100 percent of certain qualifying dividends received from a corporation in the same affiliated group as the recipient;[190] (2) 80 percent of the dividends received from a corporation if it owns at least 20 percent of the payee's stock (by vote and value); and (3) 70 percent of dividends received from other corporations.[191] The purpose of the dividends received deduction is to reduce multiple corporate-level taxation of income as it flows from the corporation that earns it to the ultimate noncorporate shareholder.

However, if dividends are paid on debt-financed stock, the combination of the dividends received deduction and the interest deduction would enable corporate taxpayers to shelter unrelated income. Therefore, section 246A generally reduces the 80 percent and 70 percent dividends received deduction so that the deduction is available, in effect, only with respect to dividends attributable to that portion of the stock which is not debt-financed.[192] Under regulations prescribed by the Secretary, any reduction in the amount allowable as a dividends received deduction under the rule is limited to the amount of the interest allocable to the dividend.[193]

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[188] Sec. 514(c)(9)(B)(vi) & (E), enacted in section 10214 of The Revenue Act of 1987, Pub. L. No. 100-203. The fractions rule generally is intended to prevent the shifting of disproportionate income or gains to tax-exempt partners of the partnership or the shifting of disproportionate deductions, losses, or credits to taxable partners. See H.R. Rep. No. 100-391, H.R. 3545, Report to accompany recommendations from the Committee on Ways and Means, House of Representatives, October 26, 1987, p. 1076. Under the fractions rule, the allocation of items to any partner that is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of overall partnership loss for the taxable year for which such partner's loss share will be the smallest. Sec. 514(c)(9)(E)(i)(I). A partnership generally must satisfy the fractions rule both currently and for each taxable year of the partnership in which it holds debt-financed property and has at least one partner that is a qualified organization. Treas. Reg. sec. 1.514(c)-2(b)(2)(i).

[189] See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66.

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

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

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

[193] Sec. 246A(e). Treasury has not issued regulations under section 246A.

Section 246A applies to dividends on debt-financed "portfolio stock" of the recipient corporation. Stock of a corporation is portfolio stock unless specifically excluded. Stock is not portfolio stock if, as of the beginning of the ex-dividend date for the dividend involved, the taxpayer owns stock (1) possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and (2) having a value equal to at least 50 percent of the value of all the stock, of such corporation.[194] Portfolio stock is debt-financed if there is a direct relationship between indebtedness and the portfolio stock. The provision does not incorporate any allocation or apportionment formula or fungibility concept.

Legislative Background

Section 246A was enacted by the Deficit Reduction Act of 1984,[195] in response to concern that corporate taxpayers were borrowing money (giving rise to deductible interest payments) to purchase portfolio stock that paid dividends (partially excluded from income by the dividends received deduction), thus allowing such taxpayers to use the deduction for dividends paid or accrued to shelter unrelated income. Congress did not believe these two deductions were intended to provide such shelter.[196]

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

[195] Pub. L. No. 98-369.

[196] See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 128.

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

Statutory limitations on the deductibility of interest expense apply in some cases in which an immediate deduction would produce a mismatching of income and expense. If the full interest deduction is not permitted on a current basis, the deduction may be disallowed, deferred until a later time, or required to be capitalized into the basis of related property. Following is a brief description of some rules designed to match the timing of income and deductions related to debt.

1. Interest and OID on amounts payable to related foreign lenders

Present Law

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

Accrued but unpaid interest

A number of rules limit deductions for losses, expenses, and interest with respect to transactions between related persons. In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid, but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.[197] This rule is intended to prevent the mismatch of, for example, a deduction for interest accrued by a taxpayer on the accrual method of accounting that is payable to a related person on a cash method of accounting. In the absence of this rule, the issuer would take a deduction upon accrual of the obligation to pay interest (whether or not the interest was actually paid), but a related holder would not take the interest into income until it is paid.

U.S.-source "fixed or determinable annual or periodical" income, including dividends, interest, rents, royalties, and other similar income, is subject to a 30-percent gross-basis withholding tax when paid to a foreign person.[198] This withholding tax can create a mismatch where, for example, a U.S. accrual-method taxpayer borrows amounts from a foreign corporation. In the absence of a special rule, the U.S. taxpayer would be allowed a deduction for accrued interest annually even if no interest were actually paid, and the foreign corporate lender would be subject to the 30-percent gross-basis withholding tax only when the interest was paid. The Code directs the Treasury Secretary to issue regulations applying the matching principle in this circumstance and other circumstances involving payments to related foreign persons.[199]

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[197] Sec. 267(a)(2).

[198] Secs. 871, 881, 1441, 1442.

[199] Section 267(a)(3)(A).

With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations require a taxpayer to use the cash method of accounting in deducting amounts owed to related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[200]

A foreign corporation's foreign-source active business income generally is subject to U.S. tax only when such income is distributed to any U.S. person owning stock of such corporation. Accordingly, a U.S. person conducting foreign operations through a foreign corporation generally is subject to U.S. tax on the foreign corporation's income only when the income is repatriated to the United States through a dividend distribution. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which a U.S. person holds stock. The main anti-deferral rules are the controlled foreign corporation ("CFC") rules of subpart F[201] and the passive foreign investment company ("PFIC") rules.[202] Section 267(a)(3)(B) provides special rules for items payable to a CFC or a PFIC. In general, with respect to any item payable to a related CFC or a PFIC, deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the relevant inclusion rules. Deductions that have accrued but are not allowable under this special rule are allowed when the amounts are actually paid.

Original issue discount

Rules similar to those discussed above apply in the case of OID on debt instruments held by a related foreign person. In such case, section 163(e)(3)(A) disallows a deduction for any portion of such OID until paid by the issuer (the "related-foreign-person rule").[203] This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the foreign related person's conduct of a U.S. trade or business (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).[204]

In the case of any OID debt instrument held by a related foreign person which is a CFC or a PFIC, deductions for accrued but unpaid OID are similarly allowable only to the extent that

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[200] Treas. Reg. sec. 1.267(a)-3(b)(1), -3(c).

[201] Secs. 951 – 964.

[202] Secs. 1291 – 1298.

[203] Sec. 163(e)(3)(A).

[204] Sec. 163(e)(3)(A).

such OID is, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation.[205]

Legislative Background

Section 163(e)(3) was enacted by the Deficit Reduction Act of 1984[206] to address the mismatch that occurred if a current deduction was allowed for the accrual of interest on an OID instrument before the interest was actually paid. The Conference Report notes that "there is no justification for mismatching in the case of related-party OID debt. Such mismatching allows an economic entity that has divided itself into more than one legal entity to contract with itself at the expense of the U.S. Government."[207]

The section 267(a)(3) rule directing the Secretary of the Treasury to issue regulations extending the matching principle to payments made to a non-U.S. person was enacted in the Tax Reform Act of 1986.

In 2004, as part of AJCA, Congress added the special rules for CFCs and PFICs because prior law (which assumed there would be little material distortion in the matching of income and deductions in the context of the these anti-deferral regimes) failed to take into account the situation in which amounts are included in the income of a related foreign corporation but are not currently included in the income of the foreign corporation's U.S. shareholder(s).

2. Construction period interest

Present Law

Section 263A generally denies a deduction for costs incurred in manufacturing or constructing tangible property, requiring that such costs be capitalized. In particular, section 263A(f) provides that interest paid or incurred during the production period of certain types of property, and that is allocable to the production of the property, must be capitalized into the adjusted basis of such property. Interest is allocable to the production of property for these purposes if it is interest on debt that can be specifically traced to production expenditures. If production expenditures exceed the amount of the specifically traceable debt, then other interest expense that the taxpayer would have avoided if amounts incurred for production expenditures instead had been used to repay the debt also is treated as allocable to the production of property (the "avoided cost" method of allocating interest). Section 263A(f) requires the capitalization of interest on debt that is allocable to property which has a long useful life,[208] an estimated

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[205] Sec. 163(e)(3)(B).

[206] Pub. L. No. 98-369.

[207] H.R. Conf. Rep. 98-861.

[208] Property has a long useful life for this purpose if such property is real property or is property with a class life of 20 years or more (as determined under section 168) (sec. 263A(f)(4)(A)).

production period exceeding two years, or an estimated production period exceeding one year and a cost exceeding $1 million.[209]

By requiring that certain interest expense be capitalized, section 263A effectively defers the deduction for interest paid until the related income is recognized.

Legislative Background

Section 263A was enacted by the Tax Reform Act of 1986.[210] Congress believed that a comprehensive set of rules governing the capitalization of costs of producing, acquiring, and holding property, including interest expense, was advisable to reflect income more accurately, and to alleviate distortions in the allocation of economic resources and the manner in which certain activities are organized.[211] The Technical and Miscellaneous Revenue Act of 1988[212] clarified the application of the interest allocation rule.

3. Interest in the case of straddles

Present Law

A straddle generally refers to offsetting positions with respect to actively traded personal property.[213] Positions are offsetting if there is a substantial diminution in the risk of loss from holding one or more other positions in personal property.[214]

Section 263(g) requires taxpayers to capitalize certain otherwise deductible expenditures allocable to personal property that is part of a straddle. Thus, these expenditures effectively reduce the gain or increase the loss recognized upon disposition of the property. Expenditures subject to this requirement are interest on indebtedness incurred or continued to carry property (including any amount paid or incurred in connection with personal property used in a short sale) as well as other amounts paid or incurred to carry the property, including insurance, storage or transportation charges ("carrying charges"). The amount of expenditures to be capitalized is reduced by certain income amounts with respect to the personal property.[215]

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[209] Sec. 263A(f)(1)(B).

[210] Pub. L. No. 99-514.

[211] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, pp. 508-509.

[212] Pub. L. No. 100-647.

[213] Secs. 1092(c)(1) and 1092(d)(1).

[214] Sec. 1092(c)(2).

[215] Sec. 263(g)(2)(B)(i) - (iv).

Legislative Background

The limitation on deductibility of straddle interest and carrying charges (along with the straddle rules more generally[216]) was enacted in 1981[217] in response to the use of certain straddles, which were executed with deductible financing and carrying charges, to defer ordinary income and to convert it into long-term capital gain (referred to as "cash and carry" shelters). Such shelters typically involved the debt-financed purchase of a physical commodity, for example silver, and an offsetting futures contract to deliver the silver in a subsequent taxable year. The taxpayer would deduct interest expense, storage and insurance costs in the first year, offsetting ordinary investment income. After 12 months, if the price of silver declined, the taxpayer could deliver the silver to satisfy the futures contract, realizing a gain on the silver. If the price of silver had increased, the taxpayer could sell the silver, producing long-term capital gain, and close out the short futures position, creating a short-term capital loss. In either event, the net gain on the two positions would approximately equal the carrying charges, but would be reported as capital gain. By requiring the capitalization of financing and carrying charges Congress sought to discourage these transactions.[218]

In 1984, the straddle rules were expanded to include exchange traded stock options in response to transactions exploiting the exemption of stock and exchange-traded stock options from the straddle rules.[219] For example, such transactions used offsetting deep-in-the-money options on stock, the value of which could be expected to move in roughly opposite directions.[220]

In 1986, section 263(g)(2) was amended to include in the definition of interest and carrying charges any amount which is a payment with respect to a securities loan.[221]

In 2004 the straddle rules were broadened to include actively traded stock. The same legislation provided, among other things, that at the time a taxpayer acquires a straddle the taxpayer is permitted to identify the straddle as an 'identified straddle' and thereby subject the positions composing the straddle to a basis adjustment rule rather than to the general loss deferral rule of section 1092(a)(1).

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[216] Sec. 1092. The straddle rules generally defer a loss on a position that is part of a straddle to the extent the amount of the loss does not exceed the amount unrecognized gain on offsetting positions in the straddle.

[217] Economic Recovery Tax Act of 1981, Pub. L. No. 97-37.

[218] See Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 29, 1981, pp. 292-293.

[219] Deficit Reduction Act of 1984, Pub. L. No. 98-369. See also, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984.

[220] See, e.g., Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 306-308.

[221] Tax Reform Act of 1986, Pub. L. No. 99-514.

G. Other Rules Relating to Business Debt and Equity

1. Employee Stock Ownership Plans

Present Law

In general

An employee stock ownership plan ("ESOP") generally is a type of qualified retirement plan that is designed to invest primarily in securities of the employer maintaining the plan.[222] An ESOP can be maintained by either a C corporation or an S corporation. An employer corporation may lend money to an ESOP, or the employer corporation may guarantee a loan made by a third-party lender to the ESOP, to finance the ESOPs purchase of employer securities. An ESOP that borrows funds to acquire employer securities generally is called a leveraged ESOP. In the case of an ESOP maintained by a C corporation, payments of principal on the ESOP acquisition loan are deductible to the extent permitted under the general deduction limits for contributions to qualified retirement plans (which generally limit the deduction for contribution to a defined contribution plan for a year to 25 percent of the participants' compensation),[223] and interest payments are deductible without regard to the limitation. In addition, dividends paid with respect the employer stock of a C corporation held by an ESOP that are passed through to participants or used to make acquisition loan payments generally may also be deductible.[224] This deduction is also allowed without regard to the general deduction limits on contributions to qualified plans. There is also a nonrecognition provision for sales of C corporation employer stock to an ESOP by a shareholder.

Because an ESOP is a qualified retirement plan, the assets of an ESOP, including the employer securities purchased with the loan are held in a tax-exempt trust. For an S corporation maintaining an ESOP, the trust of the ESOP is also exempt from UBIT.[225] There are restrictions

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[222] Under section 4975(e)(7), in order to be an ESOP (as opposed to another type of qualified retirement plan), the plan must satisfy certain other requirements. The employer securities must be qualified employer securities as defined in section 409(l) (which generally requires use of readily tradable securities, if available, or common stock with the greatest voting power and dividend rights). The plan must satisfy the distribution and put option requirements of section 409(h) and (o) (which generally require distributions be available in employer stock for other than S corporation stock, and distributions of stock that is not readily tradable to be able to put to the employer), the voting rights requirements of section 409(e) (which require that voting rights on shares held by the ESOP be passed through to ESOP plan participants in certain circumstances), and the nonallocation requirements of section 409(n) (which apply if the seller of stock to an ESOP claims nonrecognition treatment) and 409(p) (which apply in the case of ESOP maintained by an S corporation). The plan also must satisfy other requirements provided in Treasury regulations.

[223] Sec. 404(a)(9)(B).

[224] Sec. 404(k). If the dividend is paid with respect to stock allocated to a participant's accounts, the plan must allocate employer securities with a fair market value of not less than the amount of such dividend to the participant's account for the year in which such dividend would have been allocated to such participant.

[225] Sec. 512(e)(3).

that limit the grant of stock options by an S corporation that maintains an ESOP but it is possible in certain circumstances to grant options or warrants for S corporation stock that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the stock.[226]

Because an ESOP is a qualified retirement plan, it must satisfy the rules applicable to qualified plans generally (that are designed to protect the interest of participants and limit the amount of deferred compensation that is permitted in the plan) as well as a number of rules that only apply to leveraged ESOPs (to protect the plan against fiduciary self-dealing and to ensure that employees actually enjoy the benefits of stock ownership).

Prohibited transaction exemption for ESOPs

Prohibited transaction rules

In order to prevent persons with a close relationship to a qualified retirement plan from using that relationship to the detriment of plan participants and beneficiaries, the Code and ERISA prohibit certain transactions between a qualified retirement plan and a disqualified person.[227] A disqualified person includes any fiduciary, a person providing services to the plan, an employer any of whose employees are covered by the plan, an employee organization of which any members are covered by the plan, and certain persons related to such disqualified persons. Transactions prohibited between the plan and a disqualified person include among others (1) the sale or exchange, or leasing of property; (2) the lending of money or other extension of credit; and (3) the furnishing of goods, service, or facilities.

Exemptions for leveraged ESOPs

Two statutory exemptions to the prohibited transaction rules permit the existence of leveraged ESOPS. First, qualified plans are allowed to acquire qualifying employer securities for "adequate consideration."[228] Second, an ESOP (but not any other qualified retirement plan) is permitted to borrow from the employer or other disqualified person, or the employer is permitted to guarantee a loan to an ESOP by a third party lender, to acquire employer securities.[229]

To qualify for the loan exemption, the loan must be primarily for the benefit of participants and beneficiaries of the plan. The loan must be for a specific term and the interest

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[226] See the nonallocation rules under section 409(p) for the limits on stock options and other synthetic equity, provided by an S corporation that maintains an ESOP, and section 4976A for the excise tax consequences.

[227] Section 4975 of the Code and section 406 of ERISA. The Code imposes a two-tier excise tax on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction.

[228] Sec. 408(e) of ERISA and section 4975(e)(13) of the Code..

[229] Sec. 408(b)(3) of ERISA and sec. 4975(d)(3) of the Code.

rate for the loan must not be in excess of a reasonable rate.[230] Any collateral given to a disqualified person by the plan in connection with the loan must consist only of qualifying employer securities and generally only those acquired with the proceeds of the loan.[231] The shares are held in a suspense account under the plan but must be released and allocated to participants as the loan is repaid under one of two specific methods provided in the regulations.[232] In the event of default on the loan, the value of plan assets transferred in satisfaction of the loan must not exceed the amount of default.[233]

In the case of a distribution of cash by an S corporation (as described in section 1368(a)) to a leveraged ESOP with respect to its stock, the ESOP is permitted to use distributions with respect to unallocated shares held in the suspense account to make payments (principal and interest) on the acquisition loan.[234] Such use of the distribution is not a prohibited transaction and will not cause the plan to violate the qualification requirements.

Nonrecognition of gain for certain sales of stock to an ESOP

A taxpayer selling certain qualifying employer securities to an ESOP may elect to defer recognition of gain on the sale to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period.[235] Gain is recognized upon the disposition of the qualified replacement property, with the basis in employer securities carrying over to the qualified replacement property.[236] The only qualifying employer securities that are eligible for this gain deferral are securities that are (1) issued by a domestic C corporation that, immediately after the sale and for at least one year before the sale, has no readily tradable securities outstanding,[237] (2) have been held by the seller for more than one year, and (3) have not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer (other than stock acquired for full consideration). In order for the seller to be eligible for nonrecognition treatment, the ESOP must own, immediately after the sale, at least 30 percent of each class of outstanding

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[230] Treas. Reg. sec. 54.4975-7(b)(7).

[231] Treas. Reg. sec. 54.4975-7(b)(5).

[232] Treas. Reg. sec. 54.4975-7(b)(8).

[233] Treas. Reg. sec. 54.4975-7(b)(6).

[234] Sec. 4975(f)(7). If the distribution is paid with respect to allocated stock purchased with the loan being repaid and is used to repay the acquisition loan, the plan must allocate employer securities with a fair market value of not less than the amount of such distribution to the participant for the year in which such distribution would have been allocated to such participant.

[235] Sec. 1042(a) and (b)

[236] Sec. 1042(e).

[237] See Notice 2011-19, 2011-11 I.R.B. 550, for the definition of readily tradable securities. For the same period, the domestic corporation that issued the employer securities must not be a member of a controlled group of corporations that has readily tradable securities outstanding.

stock, or the total value of all outstanding stock of the corporation issuing the qualified securities.[238]

After purchasing the stock, in order for the plan to remain an ESOP, the plan must preclude allocation of assets attributable to qualified securities to any taxpayer who makes an election to defer gain on the sale for at least 10 years after the date if the sale of the qualified securities to the plan or, if later, the date of the plan allocation attributable to the final payment of the acquisition indebtedness for the securities.[239]

Legislative Background

In general

The term "employee stock ownership plan" was added to the Code by the Employee Retirement Income Security Act of 1974 ("ERISA"). However, prior to ERISA, stock bonus plans could be structured to be the equivalent of a leveraged ESOP.[240]

The Tax Reform Act of 1984[241] and Tax Reform Act of 1986[242] added most of the present law special deduction and nonrecognition of gain provisions with respect to leveraged ESOPs.

S corporations

Prior to 1998, trusts of retirement plan qualified under section 401(a) were not permitted as shareholders of S corporations. Thus, prior to 1998, ESOPs could be maintained only by C corporations. The Small Business Job Protection Act of 1996 ("SBJPA") amended section 1361 to allow trusts qualified under section 401(a) to be S corporation shareholders. This change was specifically intended to allow S corporations to maintain ESOPs. Under SBJPA, the pass-through income from an S corporation to an ESOP as an S corporation shareholder was subject to UBIT. The Taxpayer Relief Act of 1997 amended section 512(e) to provide an exemption from UBIT for the pass-through income from an S corporation to an ESOP with respect to the S corporation shares held by the ESOP as qualified securities.[243] A qualified plan that is not an

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[238] Subsequent to the sale, the ESOP must hold the qualified securities for at least three years. An excise tax applies for certain dispositions during that three- year period.

[239] Sec.409(n). This limitation generally also applies to any other person who owns 25 percent of the stock of the corporation.

[240] Specifically a stock bonus plan, a type of retirement plan qualified under section 401(a), could be structured as a plan invested primarily in employer securities acquired using funds borrowed by the plan.

[241] Pub. L. No. 98-369.

[242] Pub. L. No. 99-514.

[243] The exemption from UBIT treatment for an ESOP holding stock of an S corporation allowed an S corporation with one employee (or a very small number of employees) to establish an ESOP and transfer all their shares of S Corporation stock to the ESOP (possibly through a leveraged transaction that allowed the stock to be

ESOP continues to be subject to UBIT on the pass-through income on any shares of S corporation stock held in the plan's trust. The legislative history to the Taxpayer Relief Act of 1997[244] gives as the reason for the ESOP exemption from UBIT that subjecting S corporation ESOP income to UBIT is not appropriate because "such amounts would be subject to tax at the ESOP level and also again when benefits are distributed to ESOP participants." [245]

The Economic Growth and Tax Reconciliation Act of 2001[246] added section 409(p) which placed some limitations on the concentration of stock ownership through the ESOP and the use of synthetic equity, as defined in section 409(p)(6)(C) (which generally includes any stock option, warrant, restricted stock, deferred issuance stock right or similar interest or right to acquire or receive stock in the S corporation in the future, and certain other rights).

2. Nonqualified preferred stock not treated as stock for certain purposes

Present Law

In general

Under section 351 of the Code, a transfer of property to a corporation in exchange solely for stock of the transferee corporation is generally tax-free to each transferor. Neither gain nor loss is recognized with respect to the transferred property, provided that immediately after the transfer the transferors, in the aggregate, are in control (as defined in section 368(c)) of the corporation.[247]

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held in a suspense account until they could be allocated to the participant's accounts). This allowed the creation of a tax-exempt S corporation with shares owned through the ESOP by a small number of individuals.

[244] Pub. L. No. 105-34, Senate Report 105-033.

[245] When the stock is redeemed or sold to provide distributions from the plan to plan participants, the pass-through income may ultimately be subject to tax as ordinary income. However, this may occur many years after the income was earned by the S corporation, a deferral that can significantly reduce the present value of the tax. Furthermore, if the stock declines in value such that the value of all the income allocations to the ESOP is not included in the amount distributed to plan participants, the S corporation income is never taxed to that extent.

[246] Pub. L No. 107-16.

[247] Control for this purpose means ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. The IRS has ruled that "control" requires ownership of 80 percent of each class of stock that is not entitled to vote (Rev. Rul. 59-259, 1959-2 C.B. 115). Taxpayers may be able to construct stock that has a higher percentage of the vote than of value (or vice versa) and retain (or fail to retain) the amount of each class necessary to satisfy (or to fail to satisfy) this test in various circumstances.

The definition of control for this purpose is different from the definition for certain other purposes – for example, for purposes of allowing a tax-free liquidation of a subsidiary corporation into a parent (sec. 332), or for purposes of the rules treating certain transfers of stock between commonly controlled corporations as a contribution of the stock followed by a redemption distribution that is generally treated as a dividend (sec. 304).

If, in addition to stock, the transferor receives other property ("boot"), such as money or securities of the transferee corporation, then the transferor recognizes gain (but not loss) on the transfer (to the extent of the value of the other property).

The transferor recognizes gain or loss on a transfer of property, however, if the transfer fails to meet the requirements of the nonrecognition rules, for example, by failing the applicable control requirement,[248] or not receiving any stock in the exchange.

Since 1997, the Code has required nonqualified preferred stock ("NQPS") to be treated as if it were not stock for some purposes but not others unless the Secretary of the Treasury so prescribes.[249] In particular, section 351(g) provides that NQPS is not stock for purposes of section 351, with the result that NQPS received in an otherwise valid section 351 transaction is taxable boot.[250]

Definition of nonqualified preferred stock

Preferred stock is defined as stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.[251] Preferred stock is generally "nonqualified preferred stock" if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock within the 20-year period beginning on the issue date of the stock, and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase; (2) the issuer or a related person is required to redeem or purchase the stock within such 20-year period and such right or obligation is not subject to a contingency which as of the issue date makes remote the likelihood of redemption or repurchase; (3) the issuer or a related person has the right to redeem or purchase the stock within such 20-year period and, as of the issue date, it is more likely than not that such right will be exercised; or (4) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.[252]

A right or obligation will not cause preferred stock to be NQPS, however, if (1) the stock relinquished or received is not in a corporation any of whose stock is, or is to become, publicly

[248] Certain prearranged dispositions of stock that would cause a failure of the control requirement may cause a transaction not to be within the scope of section 351, so that loss or gain on the transferred property is recognized. See, e.g., Rev. Rul. 54-96, 1954-1 C.B. 111 (prearranged plan caused loss of control); *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976) (finding incorporator lacked requisite control under section 351 where, as part of the incorporation, he irrevocably contracted to sell 50 percent of the stock received).

[249] The Secretary of the Treasury has regulatory authority to prescribe the treatment of NQPS for any other purpose of the Code. The regulatory authority has never been exercised.

[250] For a discussion of certain incentives to use nonqualified preferred stock, and consideration of other aspects of present law taxpayers may use to accomplish similar results, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-11), June 2011, pp. 385-394.

[251] Sec. 351(g)(3)(A).

[252] Sec. 351(g)(2)(A) and (B).

traded, and the right or obligation may be exercised only upon the death, disability, or mental incompetency of the holder, or (2) in the case of a right or obligation to redeem or purchase stock transferred in connection with the performance of services for the issuer or a related person (and which represents reasonable compensation), it may be exercised only upon the holder's separation from service from the issuer or a related person.[253]

Other consequences of nonqualified preferred stock

In addition to the rules dealing with transfers to a controlled corporation, other corporate tax rules also permit certain reorganizations, divisions, and recapitalizations of corporations to be accomplished without tax to the exchanging shareholders or the corporations involved, provided that certain requirements are met and only to the extent that certain permitted property is received. Under these rules, NQPS that is exchanged or received with respect to stock other than NQPS is generally not treated as permitted property (with an exception for certain recapitalizations of family-owned corporations) so that gain (but not loss) is generally recognized on certain exchanges of stock in one corporation for NQPS in another, where the basic requirements of a qualifying transaction are otherwise met. However, except as provided in regulations, unlike the case of the section 351 transaction, the NQPS is treated as stock for purposes of determining whether a transaction qualifies as a tax-free reorganization or division (apart from the rules for determining the extent of taxable boot received in such a transaction).[254]

Legislative Background

Section 351(g) was enacted by the Tax Relief Act of 1997.[255] The legislative history states that the Congressional concern leading to the adoption of the rules was that "certain preferred stocks have been widely used in corporate transactions to afford taxpayers non-recognition treatment, even though the taxpayer may receive relatively secure instruments in exchange for relatively risky instruments."[256]

In 2004, the statute was amended to add a statement that stock shall not be treated as so participating unless there is "a real and meaningful likelihood" of the shareholder actually participating in the earnings and growth of the corporation."[257] The change was made in response to Congressional concern that taxpayers might attempt to avoid the characterization of

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[253] Sec. 351(g)(2)(C).

[254] Secs. 354(b)(2)(C), 355(a)(3)(D), and 356(e).

[255] Pub. L. No. 105-34.

[256] H.R. Rep. No. 105-148, June 24, 1997, p. 472; S. Rep. No. 105-33, June 20, 1997, p. 150. See, also, Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts* (August 2010), ¶ 902.1 et seq., giving an example of a similar transaction that could have been impacted by the 1997 legislation. That example is based on the facts of the acquisition of National Starch & Chemical Corp. detailed in *National Starch & Chemical Corp. v. Commissioner*, 93 T.C. 67 (1978) *aff'd*, 918 F.2d 426 (3rd Cir. 1990) which refers to a private letter ruling dated June 28, 1978 (described by Ginsburg and Levin as PLR 7839060 (June 28, 1978)).

[257] Pub. L. No. 108-357, sec. 899(a), amending section 351(g)(3).

an instrument as NQPS by including illusory participation rights or including terms that taxpayers could argue create an "unlimited" dividend.[258] In 2005, the statute was amended again, to provide that "if there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends."[259]

[258] S. Rep. No. 108-192.

[259] Pub. L. No. 109-135, sec. 403(kk), amending section 351(g)(3).

II. DATA WITH RESPECT TO BUSINESS DEBT

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

Table 2 provides an overall picture of the growth of non-financial corporate, household, and federal debt as a share of Gross National Product ("GNP") from 1987 to 2010. Non-financial corporate debt has grown more modestly than either household debt or Federal debt. Non-financial corporate debt as a share of GNP has grown about 13 percent since 1987, while household debt and Federal debt have each grown by more than 50 percent.

Table 3 shows the distribution of holdings of corporate equity and bonds by type of holder for the years 1990, 2000, and 2010. Over that 20-year period, the share of corporate equities held directly by the household sector has declined significantly while that held by mutual funds has risen significantly. Because most mutual fund shares are owned by the household sector, there appears to be little change in the combined share of corporate equities owned directly by the household sector or through mutual funds. The share of corporate equities held by insurance and pension funds has declined while that of foreign investors has risen substantially.

Over the same 20-year period, the share of corporate bonds held by the household and mutual fund sectors considered together has risen 62 percent, while the share of corporate bonds held by foreign investors has nearly doubled. The share of corporate bonds held by insurance and pension funds has declined by about 50 percent, from over 55 percent in 1990 to under 28 percent in 2010. The other notable change is the share of corporate bonds held by government sponsored enterprises and funding corporations, including financial stabilization programs, from zero percent of holdings in 1990 to 9.3 percent in 2010.

Table 4 shows debt-to-equity and debt to net worth ratios of nonfinancial C corporations and S corporations (excluding farms) from 1987 to 2010. For the former series, equity is measured as the market value of equities outstanding. For the latter, net worth is measured as total assets minus liabilities, with nonfinancial assets measured at market value in the case of real estate and at replacement cost in the case of inventories and equipment and software. The former series generally shows more volatility owing to its reliance on the market value measure of outstanding equities. The latter series shows that the debt-to-net-worth of nonfinancial corporations has been relatively stable over the 24-year period.

Table 5 shows interest expense and taxable income of nonfinancial corporations from 1987 to 2008 as reported on corporate income tax returns, from 1987 to 2008. The table also shows the interest expense as a percentage of taxable income before interest expense. Though interest expense fluctuates with the level of debt and interest rates, this percentage appears to primarily reflect the effects of the business cycle, as the percentage has peaks in 1990 and 2001, when taxable income declined. In addition to business cycle effects, other changes in tax policy that have an impact on taxable income affect this percentage. For example, bonus depreciation enacted in 2010 would lower otherwise reported taxable income in 2010, 2011 and 2012, and potentially increase otherwise reported taxable income in later years.

Table 6 shows interest and net income for corporations, S corporations, and partnerships from 1991 to 2008, and also shows the interest expense as a percentage of net income before interest expense. These data reflect similar business cycle effects as noted above, as well as showing a significant downward trend for S corporations in interest expense as a percentage of net income before interest expense. Table 6 also shows that C corporations' interest expense, in the aggregate and as a percentage of net income before interest expense, exceeds the comparable figures for partnerships and S corporations throughout this period. These data reflect the larger size of the C corporate sector, but C corporations may also have a Federal income tax incentive to incur debt, as interest is deductible in determining the corporate tax. By contrast, partnerships and S corporations are not subject to an entity-level tax.

Table 6 illustrates that partnership interest expense, in the aggregate and as a percentage of net income before interest expense, has exceeded S corporation interest since 1999. Among other factors, these differences may reflect the difference in tax rules for determining basis of partners' and S corporation shareholders' equity interests, respectively.

Lastly, Table 7 shows data for interest expense and net income for all corporations, separated into those with annual business receipts either above or below five million dollars. The data on interest expense as a percentage of net income before interest expense again appear to reflect business cycle effects of the 2000-2001 economic slowdown, regardless of the size of corporations.

Table 2.−Corporate Debt, Household Debt, and Federal Debt, as a Percentage of Gross National Product ("GNP"), 1987-2010

Year	Corporate Debt[1] as a Percentage of GNP	Household Debt[2] as a Percentage of GNP	Federal Debt[3] as a Percentage of GNP
1987……....	42.8	57.9	41.0
1988……....	43.6	59.4	41.1
1989……....	43.7	60.3	40.9
1990……....	43.6	61.4	42.8
1991……....	41.3	62.6	46.1
1992……....	39.4	62.3	48.3
1993……....	38.1	62.9	49.8
1994……....	37.8	63.7	49.1
1995……....	39.5	65.0	48.9
1996……....	39.9	65.8	48.1
1997……....	41.5	65.6	45.5
1998……....	43.7	67.0	42.6
1999……....	45.5	68.2	39.2
2000……....	46.4	69.9	33.9
2001……....	46.7	74.1	32.7
2002……....	45.5	79.3	34.0
2003……....	44.3	84.8	36.0
2004……....	43.2	88.4	36.8
2005……....	43.0	92.4	36.9
2006……....	44.1	96.1	36.3
2007……....	47.3	97.3	36.1
2008……....	47.8	95.2	43.7
2009……....	48.8	95.4	54.7
2010……....	48.3	90.2	63.2

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

Sources: Debt levels from The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2011* Table D.3. GNP levels from the Federal Reserve Bank of St. Louis.

Table 3.−Holdings of Corporate Equity and Bonds in Billions of Nominal Dollars, 1990-2010
(Amounts in Billions of Dollars)

Sector	Year-End Balance, 1990	Percent of Total, 1990	Year-End Balance, 2000	Percent of Total, 2000	Year-End Balance, 2010	Percent of Total, 2010
Corporate Equities	**3,531**	**100.0**	**17,575**	**100.0**	**22,962**	**100.0**
Household Sector[1]	1,961	55.5	8,147	46.4	8,240	35.9
Mutual funds[1,2]	249	7.1	3,329	18.9	5,716	24.9
Foreign investors	243	6.9	1,483	8.4	3,071	13.4
State and local government excluding retirement funds	5	0.1	93	0.5	115	0.5
Federal government and monetary authority	0	0.0	0	0.0	68	0.3
Commercial banks	2	0.1	12	0.1	38	0.2
Mutual Savings banks	9	0.2	24	0.1	20	0.1
Insurance and Pension Funds	1,053	29.8	4,409	25.1	5,550	24.2
Life Insurance companies	82	2.3	892	5.1	1403	6.1
Private pension funds	606	17.2	1,971	11.2	2012	8.8
State and local government retirement funds	285	8.1	1,299	7.4	1783	7.8
Federal government retirement funds	0	0.0	57	0.3	134	0.6
Other insurance companies	80	2.3	191	1.1	220	1.0
Brokers and dealers	10	0.3	77	0.4	117	0.5
Funding corporations	0	0.0	0	0.0	26	0.1
Corporate bonds[3]	**1,733**	**100.0**	**4,827**	**100.0**	**11,332**	**100.0**
Household Sector[1]	238	13.7	551	11.4	1,763	15.6
Mutual funds[1,2]	77	4.4	549	11.4	1,551	13.7
Foreign investors	209	12.0	842	17.4	2,447	21.6
State and local government excluding retirement funds	16	0.9	84	1.7	161	1.4
Federal government	0	0.0	0	0.0	1	0.0
Commercial banks	89	5.1	266	5.5	747	6.6
Savings institutions and credit unions	76	4.4	109	2.3	74	0.7
Insurance and Pension Funds	956	55.2	1,983	41.1	3,149	27.8
Life Insurance companies	567	32.7	1,215	25.2	2,027	17.9
Private pension funds	158	9.1	266	5.5	484	4.3
State and local government retirement funds	142	8.2	314	6.5	312	2.8
Federal government retirement funds	0	0.0	1	0.0	3	0.0
Other insurance companies	89	5.1	188	3.9	323	2.8
Government-sponsored enterprises	0	0.0	131	2.7	294	2.6
Finance companies and REITs	44	2.6	183	3.8	201	1.8
Brokers and dealers	29	1.7	104	2.2	184	1.6
Funding corps. including financial stabilization programs	0	0.0	25	0.5	760	6.7

[1]The household sector and mutual funds includes assets invested in Individual Retirement Accounts (IRAs).
[2]The great majority of mutual fund shares are owned by the household sector.
[3]Corporate bonds include bonds issued by foreigners held by U.S. persons. Other types of debt, for example, trade debt, mortgages, and bank loans, are excluded.
Source: The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2011* Tables L.212 and L.213.

Table 4.−Debt-to-Equity and Debt-to-Book Ratios of Nonfinancial C Corporations and S Corporations Excluding Farms, 1987-2010

Year	Ratio of Debt to Equity (Market) (Percent)	Ratio of Debt to Net Worth (Market) (Percent)
1987	89.0	45.3
1988	87.3	46.5
1989	76.8	48.5
1990	86.0	50.9
1991	62.2	51.5
1992	57.6	55.5
1993	52.7	54.4
1994	56.1	52.9
1995	45.9	53.4
1996	46.2	52.6
1997	40.0	52.3
1998	35.2	51.9
1999	29.5	51.7
2000	37.2	49.0
2001	44.4	51.4
2002	59.2	50.5
2003	45.8	48.3
2004	42.7	45.9
2005	43.1	41.5
2006	40.7	39.7
2007	42.6	42.5
2008	69.4	51.3
2009	55.8	54.5
2010	50.4	49.1

Source: The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Annual Flows and Outstandings Historical Data* Table B.102

Table 5.–Interest Expense of Nonfinancial Corporations, 1987-2008

Year	Interest Expense (billions of dollars)	Taxable Income (billions of dollars)	Interest as a Percentage of Taxable Income before Interest (Percent)
1987	314.9	261.0	54.7
1988	256.5	323.3	44.2
1989	309.7	306.2	50.3
1990	483.4	297.9	61.9
1991	309.0	269.2	53.4
1992	270.7	276.3	49.5
1993	253.4	312.3	44.8
1994	270.6	379.2	41.6
1995	311.3	418.0	42.7
1996	331.1	473.2	41.2
1997	365.4	502.8	42.1
1998[1]	621.7	549.5	53.1
1999	626.1	580.1	51.9
2000	797.4	637.5	55.6
2001	781.8	526.0	59.8
2002	621.0	483.0	56.3
2003	568.9	551.2	50.8
2004	596.9	694.1	46.2
2005	771.8	1,013.7	43.2
2006	1,036.1	1,069.0	49.2
2007	1,185.7	1,044.7	53.2
2008	987.8	862.2	53.4

[1]Results before 1998 are not directly comparable to those in 1998 and later due to changes in the IRS classification of Financial and Nonfinancial corporations.

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

Table 6.−Interest Expenses of Nonfinancial Business Entities, 1991-2008

	Corporations Other Than S Corporations, RICs and REITs			S Corporations			Partnerships		
Year	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income Before Interest	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest
1991	266.5	160.7	62.4	21.3	29.8	41.6	20.9	34.2	38.0
1992	233.7	166.4	58.4	18.5	44.3	29.4	14.9	43.7	25.5
1993	217.0	210.9	50.7	18.2	51.0	26.3	14.8	51.4	22.4
1994	250.4	338.2	42.5	20.2	70.3	22.3	15.3	58.1	20.9
1995	286.4	385.0	42.7	24.9	72.4	25.6	18.2	62.3	22.6
1996	305.9	420.8	42.1	25.2	86.6	22.6	20.1	75.5	21.0
1997	337.5	437.8	43.5	27.8	104.1	21.1	24.0	73.3	24.7
1998[1]	574.3	429.2	57.2	31.6	154.8	17.0	30.9	83.2	27.0
1999	970.4	535.3	64.4	34.6	173.7	16.6	34.8	95.1	26.8
2000	1,216.0	517.9	70.1	40.3	171.2	19.1	41.9	117.7	26.2
2001	1,146.6	270.8	80.9	39.8	162.7	19.7	43.2	117.7	26.9
2002	867.3	258.7	77.0	33.2	157.6	17.4	44.5	181.4	19.7
2003	773.8	455.4	63.0	31.9	179.4	15.1	44.0	195.8	18.3
2004	550.6	546.8	50.2	33.1	233.8	12.4	46.8	248.8	15.8
2005	711.3	1,167.9	37.8	42.0	297.3	12.4	56.3	348.3	13.9
2006	961.5	1,007.9	48.8	55.2	333.0	14.2	69.1	385.0	15.2
2007	1,093.3	914.4	54.5	62.6	346.4	15.3	77.0	360.7	17.6
2008	903.8	582.5	60.8	55.9	276.4	16.8	82.2	239.5	25.6

[1]Results before 1998 are not directly comparable to those in 1998 and later due to changes in the IRS classification of Financial and Nonfinancial corporations.

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

Table 7.–Interest Expense of Nonfinancial Corporations by Size of Corporation, 1994-2008

Year	Corporations with Business Receipts under $5,000,000			Corporations with Business Receipts over $5,000,000		
	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest	Interest Expense (billions of dollars)	Net Income (billions of dollars)	Interest as a Percentage of Net Income before Interest
1994	22.5	23.6	0.49	248.1	384.4	0.39
1995	25.3	24.4	0.51	286.0	433.0	0.40
1996	25.5	29.0	0.47	305.6	478.3	0.39
1997	26.7	34.0	0.44	338.6	507.9	0.40
1998[1]	37.2	37.3	0.50	584.5	515.7	0.53
1999	37.7	33.2	0.53	588.3	535.1	0.52
2000	41.0	11.6	0.78	756.4	537.0	0.58
2001	43.6	5.9	0.88	738.2	329.6	0.69
2002	34.9	5.7	0.86	586.1	310.9	0.65
2003	34.1	30.1	0.53	534.9	446.9	0.54
2004	34.4	55.2	0.38	562.5	1,037.6	0.35
2005	38.1	96.2	0.28	733.7	13,51.9	0.35
2006	41.3	95.1	0.30	994.8	12,06.5	0.45
2007	54.2	122.3	0.31	1,131.5	11,13.5	0.50
2008	53.5	60.8	0.47	934.2	765.0	0.55

[1]Results before 1998 are not directly comparable to those in 1998 and later due to changes in the IRS classification of Financial and Nonfinancial corporations.

Note: Includes all active corporations filing a corporate income tax return, including S corporations, C corporations, RICs, and REITs.
Source: JCT staff tabulations, IRS Statistics of Income *Corporation Income Tax Returns* (various years).

III. ECONOMIC INCENTIVES CREATED UNDER PRESENT LAW FOR BUSINESS DEBT

A. Incentives Related to Firm Capital Structure

In the absence of taxes and bankruptcy costs, the market value of any firm is independent of its capital structure.[260] Leveraged companies cannot command a premium over unleveraged companies because investors can replicate the borrowing of the firm by putting the equivalent leverage into their portfolio directly by borrowing on their own account. The combination of the unleveraged company and the individual borrowing replicates the risk and return of holding a leveraged company. Arbitrage opportunities between these two equivalent portfolios prevent a leveraged firm from being valued more highly than an unleveraged firm. Similarly, leveraged companies cannot sell at a discount to unleveraged companies because investors have the opportunity of undoing the leverage by holding the bonds of the leveraged company in their portfolio in proportion to the debt of the levered company. The combination of the leveraged company and its bonds is equivalent to an unleveraged company. Arbitrage opportunities between these two equivalent portfolios prevent an unleveraged firm from being valued more highly than a leveraged firm. Thus, under these assumptions, the value of a firm does not depend on whether or to what extent it is leveraged.

In the presence of a tax system in which interest is deductible, a firm can increase its value by taking on debt. The value of the leveraged firm is equal to the value of the unleveraged firm plus the present value of the tax savings associated with the interest deductions on the debt.[261] The deductibility of interest means that a firm can reduce its tax bill by the amount of interest it pays multiplied by the tax rate. In valuing the benefit of these reduced tax payments to the firm, the stream of tax savings is discounted at the interest rate on the debt, such that the increase in the value of the leveraged firm is equal to the tax rate multiplied by the amount of debt outstanding. This implies that the optimal capital structure of the firm might be all debt.

This analysis does not, however, consider the numerous additional factors that influence a firm's choice of capital structure. These additional factors include both economic considerations, features of Federal income tax law, and interactions with nontax laws and rules.

Economic considerations

Equity and debt capitalization of a business each involves a cost of capital, and the required rate of return to the equity of a leveraged firm may be higher than that of the unleveraged firm due to the additional risk associated with leverage. A business (the issuer of debt or equity) typically wishes to obtain capital at the lowest cost. Generally, an investor seeks a higher rate of return (and thus may impose a higher cost of capital) on an investment that is

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[260] Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, vol. 48, no. 3, June 1958, pp. 261-297.

[261] Franco Modigliani and Merton Miller, "Corporate Income Taxes and the Cost of Capital: A Correction," *American Economic Review*, vol. 53, no. 3, June 1963, pp. 433-443.

riskier than on a less risky investment. Debt might commonly be thought of as more secure than equity, and thus perhaps less costly to the issuer, due to rights the debt may have in bankruptcy and various protective covenants required by a creditor in connection with a loan. However, it has been observed that a portion of the expected equity return of a stable company could be considered as secure as any debt instrument the same company might issue. Similarly, in certain highly leveraged situations, debt may be considered as risky as equity and may command a high cost of capital.

To the extent the holders of common equity capital (that is, equity capital that has full participation in the future profits of the business) also capitalize their business with other interests that have a limited participation, the rate of return on investment to the common equity holders increases if the investment is successful. At the same time, because of the need to pay the other capital returns prior to obtaining the common equity return, the risk that the common equity holder will not obtain any significant return is also higher. The desire to enhance the potential rate of return on investment may be a nontax factor in choosing to leverage a business. However, this financial result also can be obtained through the use of a preferred equity instrument that is limited in its participation in future profits, but the preferred equity would carry no tax advantage.

Given that debt typically gives creditors rights to force a debtor into bankruptcy, the relative risk of bankruptcy given a specified debt level may serve to limit the amount of debt in a firm's capital structure. Even short of bankruptcy, other costs of financial distress imposed on a business by debt covenants may influence a firm's financing. These costs include not only the direct costs of legal and accounting fees but also the indirect costs of financial distress. Suppliers or employees may demand less favorable payment terms, putting further strain on the cash flow of a highly-leveraged company. Customers may switch to competitors rather than face the risk of diminished quality or customer service. Companies without sufficient cash from current operations may need to sell assets at fire-sale prices to service their debt. In addition, even absent bankruptcy, the requirements of debt covenants may limit a firm's flexibility in its operations. These factors, among others, affect the optimal level of debt for a firm.

The extent to which business owners choose to incur debt also depends in part on the availability of limited participation equity capital on acceptable terms. None may be available or the level of participation or control required by the investor may be unattractive.

Features of Federal income tax law

Numerous features of Federal income tax law create potentially conflicting incentives for businesses to structure capital investments as debt or equity because the tax treatment of these investments may differ for both issuers and holders. In addition, if one form of investment provides an advantage to either the issuer or the holder (or to both), the tax savings can potentially be shared between the parties. Such sharing can result in an increase in an investor's after-tax return and thus lower the cost of capital to the business.

A principal difference in the Federal income tax treatment of debt and equity is that interest and dividends are treated differently for both issuers and holders. For C corporations, the deductibility of interest on debt can reduce or eliminate corporate-level income tax.

The tax treatment of holders of debt or equity depends on the status of a particular holder. For example, certain holders such as U.S. tax-exempt organizations may be indifferent as to holding debt or equity of a C corporation issuer because income in either case is exempt from tax. However, a tax-exempt organization may not be indifferent as between debt and equity in a partnership as a result of the unrelated business income tax rules. In the case of U.S. individuals, preferential income tax rates apply to dividends paid with respect to qualifying equity interests, but not on payments of interest with respect to debt. Individual taxpayers may also benefit from preferential tax rates on capital gains that may accrue to retained corporate earnings

Combinations of features of the Federal income tax can further influence the choice between debt and equity. For example, the deduction for interest on debt can be combined with other tax benefits to produce a negative tax rate greater than produced if the other benefits were equity financed.[262] This can occur if debt giving rise to deductible interest payments is used to finance an investment that produces income taxed at preferential rates, offering special tax credits, or not taxed at all. In such cases, the otherwise unused interest deduction can be deducted against other taxable income of the issuer, while the debt-financed asset produces low-tax or tax-exempt income.

Rules governing the recognition of income enable a business owner to obtain funds for use in his business, or may allow an owner to extract value from the business, in either case without the recognition of gain that would result from a sale of assets.

Federal income tax law treats different business entities differently in various circumstances that can create incentives for debt or equity financing. For example, the partnership rules that increase a partner's basis in his partnership interest by his allocable share of partnership debt may encourage partners to incur debt at the entity level because such debt can increase the amount of partnership losses a partner can deduct, and the amount of cash distributions that a partner can receive without tax. In contrast, the S corporation rules do not contain a similar incentive for entity level debt.

Interaction with nontax laws and rules

Whether a particular instrument is classified as debt or equity has significance in a number of nontax contexts, including financial accounting, the regulation of banks, insurance companies and other financial institutions, securities law and the credit determinations of rating agencies. In addition, the rules for determining what constitutes debt or equity for these different purposes are not always consistent with the Federal income tax rules.

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

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[262] If the same investment were equity financed, the special credits or accelerated deductions would be available to shelter other income, but the interest deduction for debt finance magnifies the effect.

1. Tax incentives for debt

Incentive for corporate leverage

Although returns to debt investment (interest) are generally deductible by a borrowing business, returns to equity investment (e.g., dividends on equity) are not. This tax distinction is particularly important to C corporations because only such entities are taxed at the entity level. For a C corporation, which is subject to entity-level tax, the after-tax effect of debt financing is more favorable than equity financing due to the deductibility of interest.[263]

Example 1:[264] Corporation X is in the 35 percent tax bracket and wants to raise $100 million of additional capital. X can issue either debt with a 5 percent interest rate, or preferred stock with a 5 percent dividend. Assume that after raising the capital, Corporation X earns $10 million and pays $5 million to the new investors. If the $100 million raised is in the form of debt, corporation X can deduct the $5 million paid to the investors, leaving cash after tax of $3.25 million.[265] If the $100 million is in the form of preferred stock, cash available to Corporation X after tax is only $1.50 million.[266]

Figure 1, below, depicts the results of this *Example 1*. Figure 2 demonstrates the results of a $100 million investment if, instead of involving a third party bank or preferred stock holder, the current shareholders of Corporation X finance the $100 million investment themselves. Notwithstanding the fact that individual shareholders pay Federal income tax at a higher rate on interest (35 percent) than on dividends (15 percent), the total tax paid by Corporation X and the shareholders together is less if the investment is debt financed. In addition, the tax savings associated with the interest deduction result in a greater net return from the $100 million investment ($6.01 million)[267] than results from a preferred stock investment ($5.52 million).[268]

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[263] If debt is substituted for equity, increased cash flow from the reduction in taxes may enable a corporation to cover much of its debt service over a period of years and retire the debt (although the corporation might also have to sell some of its assets to cover the debt service).

[264] The examples are simplified to assume the 35 percent rate applies to all income (rather than the corporate graduated rates) and that the equity and debt rates that can be obtained are equal.

[265] Gross income of 10, less 5 distributed to the debt holders, less corporate tax of 1.75 (.35 x (10-5)).

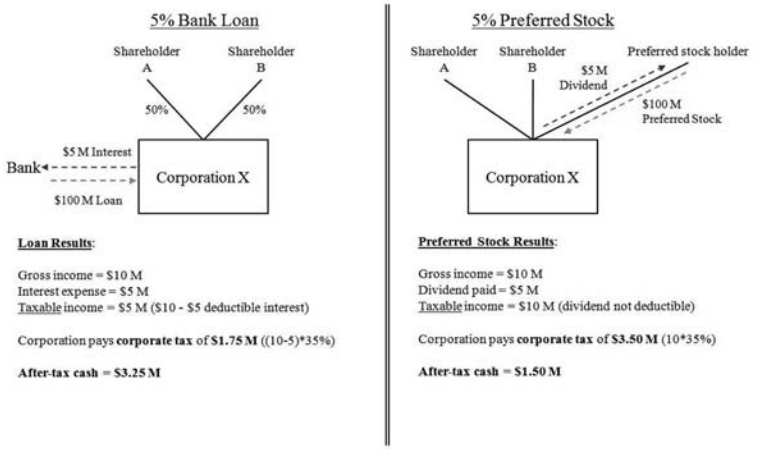
[266] Gross income of 10, less 5 distributed to the preferred shareholders, less corporate tax of 3.50 (.35 x 10).

[267] Net return on the investment financed with debt is equal to the gross income from the property ($10 million) less corporate taxes paid ($1.75 million) and individual taxes paid ($1.75 million on interest and $0.49 million on dividends).

[268] Net return on the investment financed with preferred stock is equal to the gross income from the property ($10 million) less corporate taxes paid ($3.50 million) and individual taxes paid ($0.75 million on preferred stock dividends and $0.225 million on common stock dividends).

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

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



Loan Results:

Gross income = $10 M
Interest expense = $5 M
Taxable income = $5 M ($10 - $5 deductible interest)

Corporation pays **corporate tax** of **$1.75 M** ((10-5)*35%)

After-tax cash = $3.25 M

Preferred Stock Results:

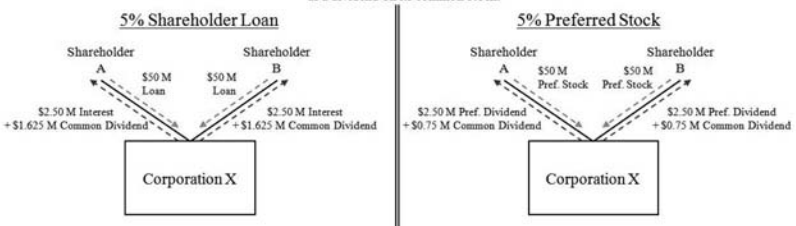
Gross income = $10 M
Dividend paid = $5 M
Taxable income = $10 M (dividend not deductible)

Corporation pays **corporate tax** of **$3.50 M** (10*35%)

After-tax cash = $1.50 M

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

Same facts as Figure 1, but current shareholders provide additional capital.
Assume shareholders are in the 35% tax bracket and the corporation distributes all its after-tax cash for the year as a dividend on its common stock.



Loan Results:

Gross income = $10 M
Interest expense = $5 M ($2.50 M paid to each)
Taxable income = $5M ($10 - $5 deductible interest)

Corporation pays **corporate tax** of **$1.75 M** ((10-5)*35%)
Together, Shareholder A and B pay **individual tax**
- on interest of **$1.75 M** (5*35%) and
- on dividends of **$0.49 M** ((10 – 5 – 1.75)*15%)

Total Tax Paid = $3.99 M
Net Return from $100 M Investment = $6.01 M

Preferred Stock Results:

Gross income = $10 M
Dividend paid = $5 M ($2.50 M paid to each)
Taxable income = $10 M (dividend not deductible)

Corporation pays **corporate tax** of **$3.50 M** (10*35%)
Together, Shareholder A and B pay **individual tax**
- on preferred dividend of **$0.75 M** (5*15%) and
- on common dividend of **$0.225 M** ((10 – 5 – 3.50)*15%)

Total Tax Paid = $4.48 M
Net Return from $100 M Investment = $5.52 M

Example 2: Assume, Partnership Y has partners who are in the 35 percent tax bracket and wants to raise $100 million additional capital. Y can issue either debt with a 5 percent interest rate, or new preferred partnership interests with a 5 percent preferred distribution. Partnership Y earns $10 million and pays $5 million to the new investors. If the $100 million raised is in the form of debt, the $5 million interest is not included in the partnership income allocated to any of the partners. If the $100 million is in the form of a preferred partnership equity interest, none of the $5 million return allocated to the preferred equity interest is included in the share of partnership income of the other partnership interests. The original partners are thus indifferent to the feature of debt that interest is deductible.

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

The effect of using debt rather than equity to capitalize a corporation means that a corporation can increase its after-tax earnings per share simply by substituting debt for equity capitalization. The accounting effect of allocating all after-tax earnings to a smaller pool of equity shares than before the transaction is magnified for a corporate issuer, because the interest deduction from the substitution of debt for equity itself increases after-tax earnings. A common transaction in which this occurs is a leveraged buyout ("LBO") which is an acquisition of corporate stock using debt imposed at the corporate level to provide the cash to buy out the

former shareholders. Another common transaction is a corporation's redemption of its own stock with cash from the proceeds of a corporate borrowing (without any acquisition of corporate stock by an unrelated firm or its shareholders), or other corporate distributions to shareholders financed through corporate borrowing.

Example 3:[269] Corporation X is in the 35 percent income tax bracket, and has outstanding 2.6 million shares of common stock and no debt. It has annual income of $40 million. It pays Federal income tax of $14 million ($40 million multiplied by 35 percent), resulting in net after-tax income of $26 million ($40 million less $14 million). Earnings per share are $10 ($26 million divided by 2.6 million shares). The stock has market value of $80 per share (eight times after-tax earnings).

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

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

Example 4: Assume the same initial facts as in *Example 3*. Instead of being acquired in a leveraged buyout, Corporation X issues bonds to borrow $270 million at eight percent interest, and repurchases $270 million of its shares (approximately 87 percent of the outstanding shares) at a redemption price of $120 per share, 50 percent more than the price at which the stock had been trading on the market. Taxable shareholders recognize gain or loss on the redemption of their shares. The resulting reduction in Corporation X's income taxes by $7.56 million exactly pays for the increased returns to the bondholders plus the remaining shareholders ($33.56 million

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[269] Examples 3, 4 and 5 are highly simplified. They assume a corporation with zero leverage that becomes highly leveraged in transactions substituting debt for equity. In considering stock price, the examples do not take into account whether the stock price before the transaction might have reflected an expectation of eventual leverage. Also, the examples do not consider what level of debt might be considered optimal from a business standpoint for a particular business or industry, or how this might affect stock price.

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

in interest and earnings = $26 million of earnings before the transaction plus $7.56 million in reduced income taxes). Depending on whether the increased returns are paid to taxable bondholders and shareholders, there may or may not be an increase in investor-level income taxes paid.

As a result of the leveraged redemption, the after-tax earnings per share of Corporation X increase from $10 per share ($26 million divided by 2.6 million shares outstanding) to over $34.17 per share ($11.96 million divided by 350,000 shares outstanding). If the stock will still sell for eight times its after-tax earnings after the transaction, the stock price would rise from $80 to $273.37 ($34.17 x 8).

Example 5: Assume the same initial facts as in *Example 3*. Instead of engaging in a leveraged buyout or a stock redemption, Corporation X borrows $270 million at eight percent interest and distributes the proceeds pro rata to its shareholders. Each share receives approximately $104, or almost 30 percent more than the price at which the stock had been trading on the market. The distribution is, in general, a taxable distribution to shareholders that are subject to tax. After the distribution, the earnings per share of Corporation X are $4.60 ($11.96 million divided by 2.6 million shares outstanding). If the stock will sell for eight times after-tax earnings, the stock price would be $36.80.[271]

Passthrough entities - debt minimizes U.S. income taxation of tax-exempt or foreign investors

A tax-exempt investor generally may prefer to hold debt rather than equity of a partnership or S corporation. A foreign investor must own debt to invest in an S corporation, because foreign persons are not permitted to own S corporation stock.[272]

Tax-exempt or foreign equity investors in a partnership that are not otherwise engaged in the conduct of a trade or business would nevertheless be deemed to be so engaged to the extent the partnership is so engaged. As a result, the investors would be taxed on their share of partnership income if they make an equity investment in a partnership that conducts active business in the U.S.[273] For U.S. tax-exempt equity investors, if an investment partnership is debt-financed at the partnership level, the rules relating to debt-financed income can cause tax-exempt partnership investors to be taxed on their shares of dividends, interest, or other

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[271] Thus, although it may have appeared that most if not all the value of the stock would be depleted as a result of the borrowing, a significant portion of the value remains because of the tax benefits from the leveraged transaction.

[272] Sec. 1361(b)(1)(C). There is no limitation on a foreign investor's ownership of partnership equity, but the investor is taxed on the partnership's income from the conduct of a trade or business in the U.S. Secs. 871(b) and 882.

[273] In the case of a tax exempt entity that is a partner, income from the partnership's conduct of an active business is "unrelated business taxable income." Secs. 512 and 513. In the case of a foreign partner, the active business income is subject to U.S. tax only if the business is conducted in the U.S and the income is "effectively connected" with the conduct of the U.S. trade or business. Secs 871(b) and 882.

investment income. Foreign equity investors in investment real estate partnerships would also be taxed on gain from the sale of U.S. real property interests under rulers treating such gain as income from the conduct of a business effectively connected with the U.S.[274] In the case of an S corporation investment, tax-exempt investors may own equity investments but are generally subject to unrelated business income tax on their share of S corporation income, and on any gain on sale of the S corporation stock.[275]

However, if a tax-exempt or foreign investor makes its investment in a partnership or S corporation in the form of debt rather than equity, the return to the investment is generally not subject to U.S. tax unless, in the case of a foreign investor, interest payments on the debt are subject to withholding tax. These factors encourage use of debt when capital is raised from tax-exempt or foreign investors.

Within limits, debt instruments can be constructed that allow such holders to have some participation in equity appreciation. For example the interest rate could include an "equity kicker" that increases the amount payable as interest to reflect up to a specified amount of equity appreciation of the entity.

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

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

For example, assume Corporation X is a domestic taxpayer in the 35-percent income tax bracket. Corporation X borrows $1,000,000 in Year One at a six percent interest rate to purchase a new piece of equipment for $1,000,000. The equipment is classified as three-year property under the modified accelerated cost recovery system ("MACRS") such that it is subject to the 200 percent declining balance method of depreciation under the midyear convention.[276]

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[274] Secs. 897, 1445 (enacted in the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), Pub. L. No. 96-499, sec.1122).

[275] Sec. 512(e). There is an exception for an ESOP that owns stock of an S corporation. Unlike other tax exempt investors, the ESOP is not subject to unrelated business income tax on its share of S corporation income or its sale of S corporation stock. Sec. 512(e)(3).

[276] For this example, assume that the property is acquired in a year in which bonus depreciation does not apply.

Therefore, the first year depreciation deduction is $583,000; the second year depreciation deduction is $277,800; the third year depreciation deduction is $123,500; and the fourth year depreciation deduction is $15,400. Corporation X has earnings before interest, taxes, depreciation, and amortization ("EBITDA") attributable to the new equipment of $300,000 annually in each of Years One, Two, Three, and Four.[277]

Table 8.–Depreciable Investment with Leverage

	Year 1	Year 2	Year 3	Year 4
EBITDA	300,000	300,000	300,000	300,000
Interest Expense	(60,000)	(60,000)	(60,000)	(60,000)
MACRS Depreciation	(583,300)	(277,800)	(123,500)	(15,400)
Taxable Income/(Loss)	(343,300)	(37,800)	116,500	224,600
Tax/(Refund)	(120,155)	(13,230)	40,775	78,610

The year by year taxable income or operating loss resulting from the acquisition of this equipment is detailed in Table 8, above. Corporation X may deduct interest expense of $60,000 annually on the debt incurred to acquire the equipment. As a result of the deductions for depreciation and interest expense, in Year One, Corporation X reports a loss for income tax purposes of $343,300. At a 35-percent tax rate this creates a tax benefit of $120,155 that Corporation X may use to offset a tax liability from other income (shelter that other income from current tax) or to carry forward (or backward) against future (or past) tax liability of the corporation. Likewise in Year Two, Corporation X records an income tax benefit of $13,230. In Years Three and Four, Corporation X has positive tax liabilities of $40,775 and $78,160.[278]

If one computes the net present value[279] of the tax liabilities (positive and negative) over the four-year life of the equipment, the result is a negative $28,626 for the investment. For this reason, some analysts observe that the combination of interest deductions and depreciation deductions can create negative tax rates on the income from investment.[280]

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[277] After the fourth year, the equipment is no longer productive. Assuming a six percent cost of capital, the net present value of this $300,000 annual income stream over the four-year period is $1,039,532 which is greater than the $1,000,000 purchase price of the equipment. Therefore, Corporation X might consider acquiring the equipment independent of the associated tax benefits.

[278] This example assumes that tax losses generated in Year One and Year Two are not carried forward to reduce Year Three and Year Four taxable income.

[279] Discounted at six percent.

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

Alternatively, Corporation X could have financed the acquisition of the equipment without borrowing, for example, through the use of retained earnings. The year by year taxable income or operating loss resulting from an equity financed acquisition is detailed in Table 9, below. Because the purchase is equity financed, Corporation X has no deductible interest expense with respect to the income generated by the equipment. In Year One, Corporation X reports a loss for income tax purposes of $283,300. In Years Two, Three, and Four, Corporation X reports income of $22,200, $176,500, and $284,600. If one computes the net present value of the tax liabilities (positive and negative) over the four-year life of the equipment, the result is a positive, $44,141. The difference in the present values of net tax liabilities in each example is the present value of four years of $60,000 in interest expense deductions valued at the 35-percent corporate tax rate ($72,767).

Table 9.−Depreciable Investment Without Leverage

	Year 1	Year 2	Year 3	Year 4
EBITDA	300,000	300,000	300,000	300,000
MACRS Depreciation	(583,300)	(277,800)	(123,500)	(15,400)
Taxable Income/(Loss)	(283,300)	22,200	176,500	284,600
Tax/(Refund)	(99,155)	7,770	61,775	99,610

Negative effective rates may also result from the use of debt by a domestic corporation to finance a foreign acquisition. A domestic corporation may incur interest expense that is related to income eligible for deferral. Present law provides detailed rules for the allocation of expenses between U.S. source and foreign source income.[281] These rules do not, however, affect the timing of the expense deduction; rather, for a domestic corporation they apply principally for purposes of determining the foreign tax credit limitation. Thus, a domestic corporation may claim a current deduction, even for expenses that it incurs to produce tax-deferred income through a foreign subsidiary. By reducing the amount of tax imposed on currently taxable income, these interest expense deductions enhance the benefits of the existing deferral regime by yielding low and, in some cases, negative effective tax rates on that income.

Present law imposes limitations on interest deductions in particular circumstances in which the underlying debt funds assets that produced untaxed income. For example, present law imposes a pro rata interest deduction limitation on interest expense of financial institutions that is allocable to tax-exempt interest, and imposes a somewhat similar pro rata interest deduction limitation on interest expense allocable to the unborrowed cash values of life insurance policies and annuity and endowment contracts held by entities other than natural persons.[282] These rules

[281] Sec. 864.

[282] Secs. 265(b) and 264(f), respectively, described in more detail above. A similar concept applies limiting the dividends received deduction for debt-financed portfolio stock (sec. 246A).

are addressed to particular situations, however, and do not address other situations in which untaxed income of other types could be funded by leverage, the interest on which is deductible.

Borrowing as a monetization of asset value

In general

If a taxpayer borrows money, the amount borrowed is not considered income. This is true even if the borrowing is secured by the taxpayer's appreciated assets, and even if the borrowing is non-recourse, so that only the assets are subject to the debt and neither the taxpayer nor his business is otherwise liable. The borrowing is not considered either income or a sale of the assets unless and until the borrower experiences difficulties that require the debt to be restructured, or defaults, so that debt is in effect cancelled without repayment of the borrowing in full or the assets are taken by the borrower in a foreclosure.[283] If none of these events occurs, the amounts borrowed are not income and do not cause any gain recognition, because the taxpayer is considered still potentially liable for the debt and not to have received an unencumbered economic benefit.

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

Partnership debt affects partners' loss deductions and the tax treatment of cash distributions

The partnership tax rules may give rise to an incentive to take on debt at the partnership level. When a partnership borrows money, the same general principle applies that the proceeds of the borrowing are not income. A partnership is a passthrough entity for Federal income tax purposes, so partnership items of income, loss, deduction, and credit are taken into account by the partners. Debt of the partnership generally can have the effect of increasing the amount of losses and deductions of the partnership that can be deducted by partners, as well as the amount of cash that can be distributed to the partners without current taxation.

More specifically, under the partnership tax rules, a partner's basis in its partnership interest limits the partner's deduction for its share of partnership losses and deductions, as well as the amount of cash that may be distributed to the partner without current taxation.[284] A partner's basis in his partnership interest includes his allocable share of amounts borrowed by the partnership.[285]

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[283] These situations are discussed below.

[284] Secs. 704(d), 731.

[285] A partner's basis in a partnership interest is increased by the adjusted basis of the partner's contributions of money or other property to the partnership, and by the amount of partnership income allocated to the partner, and is decreased by the amount of cash and the adjusted basis of other property distributions to the

Because a partner can deduct its share of items of partnership loss and receive distributions of cash or other property from a partnership without tax (so long as the deduction or distribution does not exceed the partner's basis in his partnership interest), there is a tax incentive (if the partners do not wish to contribute additional funds to the partnership that would increase their basis) to ensure that partnership level borrowing does not fall below the level necessary to support the partners' full deduction of losses and full exclusion from income of any partnership distributions. Guarantees of partnership debt may also be used. [286]

The determination, under regulations, of what portion of partnership debt is allocable to a partner depends on an analysis of who bears the economic risk of loss, and is based on presumptions that may be simplifying but that do not always fully reflect the particular economic situation. In the case of recourse debt of the partnership, a partner who is personally liable for such debt is considered to bear as his share the amount for which he would be liable if all the partnership's assets (including cash) had no value and the partnership liquidated.[287] If a partner guarantees a portion of debt incurred by the partnership, it is generally irrelevant whether the debt is small in comparison to the partnership's assets and the likelihood may be minimal that these "last dollars" of partnership assets would have to be reached to pay the debt. Nevertheless, the partner's basis generally can be increased by the amount guaranteed. In the case of nonrecourse debt, all partners are considered to bear a proportionate share of the debt, generally in accordance with the partners' shares of partnership profits.[288] Unlike situations in which a single owner borrows and acquires property, the partnership rules attempt to deal with situations in which a number of owners who are partners agree on the allocation of income and the allocation of deductions of an enterprise, as well as the distribution of partnership cash flow and of other partnership property, all in possibly different ratios over time or in any taxable year. In these circumstances, a partner's proportionate share of debt would be important if, for example,

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partner and by partnership deductions allocated to the partner. For these purposes, an increase in the partner's share of partnership indebtedness is treated as a contribution of money, and a decrease in such share is considered a distribution of money. Further, a partner's basis in his partnership interest is decreased by the amount of partnership loss allocated to the partner and by distributions made to the partner, and increased by the amount of partnership income allocated to the partner and by capital contributions made by the partner. Secs. 705, 721, 733 and 752.

[286] See Blake D. Rubin, Andrea Macintosh Whiteway, and Jon G. Finkelstein, "Working With the Partnership Liability Allocations Rules: Guarantees, DROs and More," 68 *N.Y.U. Federal Tax Institute*, chapter 10, 2010; Eric B. Sloan, Steven E. King, and Judd A. Sher, "Through the Looking Glass: Seeing Corporate Problems as Partnership Opportunities,"Practising Law Institute Course Handbook, Tax Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (2008)(813 PLI/Tax 567); Deloitte Development LLC (2007).

[287] Sec. 752 and Treas. Reg. secs. 1.752-2(b) and -2(c)(2). It is difficult to see how a partnership's cash would have no value, but, perhaps in order to accommodate potential fluctuating cash balances as the partnership invests in other assets while giving certainty to the partners, the regulations so provide. See William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, Fourth Edition, Volume 1, paragraph 8.02[3], describing the circumstances assumed under the regulations as a "hypothetical cataclysm."

[288] Treas. Reg. sec. 1.752-3.

the partner were entitled to losses or distributions in a greater proportion than other partners during the taxable period.

The IRS, in litigation, has challenged as sales certain types of transactions involving guarantees by partners of partnership debt (or other methods of retaining a high basis in a partnership interest) that are designed to minimize gain recognition on the withdrawal of cash from a partnership.[289]

S corporation rules

An S corporation, like a partnership, generally is treated as a passthrough entity for Federal income tax purposes, in that items of S corporation income, loss, deduction, and credit are taken into account by the S corporation shareholders for tax purposes.[290] A shareholder can deduct its share of S corporation losses to the extent of the sum of the shareholder's basis in the S corporation stock and the shareholder's basis of any debt of the S corporation to the shareholder.[291] Unlike a partnership interest, the basis of an S corporation shareholder does not include debt incurred at the entity level by the S corporation, other than the S corporation's debt to the shareholder.

The S corporation tax rules may not create the same incentive to incur debt at the S corporation level that the partnership rules provide to incur debt at the partnership level to increase partners' bases in their partnership interests.[292] Since shareholders obtain basis for either stock or loans to the S corporation, they may be indifferent to what form their own investment takes except to the extent they might obtain priority over other creditors through the loan form.

Timing of debt deductions and inclusions

In general

Interest on a debt instrument is generally deductible by the issuer (and includible by the holder) when the interest is paid or accrued. However, in certain cases the deduction (and inclusion) occurs prior to the time of any payment. Tax-exempt or foreign holders that do not

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[289] See, e.g., *Canal Corporation v. Commissioner*, 135 T.C. 199 (2010). This case involved a leveraged partnership which made a cash distribution to one of the partners that was funded by partnership borrowing. The Tax Court held that the transaction should be recharacterized as a sale of assets to the other partner by the partner that received the cash distribution. The partner that received the cash also indemnified the partnership-level borrowing. The court disregarded this indemnity in analyzing whether that partner had the economic risk of loss with respect to the debt, applying an anti-abuse rule in Treas. Reg. sec. 1.752-2(j).

[290] Sec. 1363(a). If the S corporation was previously a C corporation or acquired assets from a C corporation with a carryover basis, any built-in gain on those assets is subject to corporate level tax if recognized within a specified period following the conversion or acquisition. Sec. 1374.

[291] Sec. 1366(d).

[292] Table 6, above, illustrates that for the most recent year for the period 1999 - 2008, partnership interest expense exceeds S corporation interest expense.

pay tax on interest income in any event are indifferent to the consequence of including interest income for tax purposes earlier than the receipt of cash. As in the case of any other interest payments to tax indifferent parties, the issuer deducts the interest expense and no tax is imposed on the holder. The value of the deduction is increased to the extent it is allowed before payment.

Original issue discount

When the amount to be paid at the maturity of a debt instrument exceeds the issue price by more than a minimal amount, a portion of the amount to be paid at maturity is treated as interest accruing on a constant yield basis over the life of the instrument as OID. This results in deemed interest amounts being deductible by the issuer and included by the holder prior to any payment of cash. Even in the case of significant OID subject to the AHYDO rules, there is no limit on the deduction if the instrument ceases to have significant OID by the end of the fifth year after it is issued.[293]

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

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

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

2. Tax incentives related to equity

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

[293] An instrument is treated as having "significant original issue discount" if the aggregate amount of interest that would be includible in the gross income of the holder with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date five years after the date of issue, exceeds the sum of (1) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and (2) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity. Sec. 163(i)(2).

shareholder level income from enhanced corporate value is taxed to the shareholder at a lower tax rate than is available on other forms of income.

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

A corporation that owns stock in another corporation is generally allowed a dividends received deduction[294] that in effect excludes between 70 percent and 100 percent of the dividend from the recipient's income. The percentage of the deduction increases depending upon the recipient corporation's percentage ownership of dividend paying corporation.[295] At the lowest percentage deduction, applicable to stock ownership of less than 20 percent, the maximum tax rate on dividends received is currently 10.5 percent.[296]

Individual holders of corporate equity are currently eligible for a maximum 15 percent tax rate on qualified dividend income (compared to the maximum 35 percent rate on interest income), as well as a maximum rate of 15 percent on long term capital gain from the sale of stock.[297]

A corporate issuer that has significant losses or tax-exempt income and that does not expect to be able to use an interest deduction may nevertheless have "earnings and profits" that cause distributions to be treated as dividends.[298] Such a corporation may have an incentive to issue equity to provide a corporate holder with a dividends received deduction (or a taxable individual shareholder with a beneficial rate on dividends), even though the earnings did not bear corporate level tax prior to distribution.

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

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

[296] The 35 percent maximum corporate tax rate multiplied by the 30 percent of the dividend that is taxable.

[297] The 15 percent rate is scheduled to expire at the end of 2012. After that time, dividends of individuals are taxed at the maximum ordinary income rate of 39.6 percent, and long term capital gain of individuals with respect to corporate stock is generally taxed at a maximum 20 percent rate.

[298] "Earnings and profits" is a concept directed at identifying economic income of a corporation, generally for purposes of determining whether distributions to shareholders should be treated as dividends of as a return of capital. Earnings and profits includes tax exempt income and certain other income on which no tax has been paid due to accelerated depreciation. Sec. 312. In addition, the Code requires a dividend paid out of current year earnings and profits to be treated as a dividend, even if the corporation has loss carryforwards that will cause it to have no taxable income (and no net accumulated earnings and profits) as of the end of the year in which the dividend is paid.

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

3. Incentives to create hybrid instruments

In general

Taxpayers have significant flexibility to create economically similar instruments and categorize them either as debt or equity. In general, instruments are not bifurcated into part debt and part equity, and the categorization as one type of instrument or the other applies across the board for all tax purposes. Taxpayers may have incentives to create instruments with hybrid features, that is, having features of both debt and equity,[299] either solely for Federal income tax purposes, or because of additional benefits that may occur if the instrument is classified in a different manner for other purposes such as financial reporting, regulatory capital, or foreign tax purposes.

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

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

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

C corporation shareholder debt

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

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

Corporate interest deductions on certain hybrid instruments

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

Under an IRS ruling,[300] if the instrument is not automatically convertible at a specific price, but rather is convertible only if one or more contingencies is satisfied (e.g., only if corporate earnings or share prices change by a specified threshold amount), then the rules for

[300] Rev. Rul. 2002-3.

determining the market comparable for interest deduction purposes allow the instrument to be treated as if it did not have a conversion feature, thus allowing more interest to be deducted in advance of actual payment. Depending on the point at which the fixed conversion price is set compared to the conditions of the contingency, the two instruments could be economically very similar. The IRS has solicited comments on whether the approach allowing deductible interest to be determined as if there were no contingency should be extended beyond contingent convertible bonds. Commentators have expressed different views and have noted other inconsistencies in the treatment of potentially similar instruments that offer a debt holder the opportunity to participate in corporate growth or appreciation.[301] The inconsistencies in treatment may allow taxpayers to select the treatment most favorable by proper structuring of the instrument.

A corporation also may issue debt that is under certain circumstances payable in corporate equity. Section 163(l) denies interest deductions for such instruments. The IRS has ruled that certain hybrid instruments are not within the scope of this denial.[302]

Advantages when debt instrument for tax is treated as equity or part equity for financial accounting, rating agency or regulatory purposes

Federal income tax is not the only context in which classification of an instrument as debt or equity has significance. And because classification rules applicable in different contexts vary, taxpayers have designed hybrid instruments to achieve different, advantageous results under the different rules. Examples of other contexts include rules under U.S. GAAP determining the treatment of instruments for financial accounting purposes, bank regulatory rules determining whether an instrument qualifies as equity capital for purposes of bank capital requirements and the rules of various rating agencies considering how an instrument is treated for purposes of financial tests in assigning credit ratings to issuers. Although the treatment of an instrument for purposes non-tax purposes is a factor in the Federal income tax classification analysis, it is not determinative.

Trust preferred securities[303] are an example of a hybrid instrument developed, and adapted over time, to be classified differently for tax, financial accounting, regulatory or rating

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

[302] See, e.g., Rev. Rul.2003-97, 2003-34 IRB 380.

[303] The term "trust preferred securities" as used in this pamphlet is a generic term for various, but similar, financial products including monthly income preference shares (MIPS), trust originated preferred securities (TOPrS), quarterly income preference shares (QUIPS), trust preferred securities (TruPS) and more recent variants such as enhanced capital advantaged preferred securities (ECAPS) and Enhanced TruPS (ETruPS).

agency purposes. Trust preferred securities are an instrument used to raise capital involving the creation of an additional entity to stand between the corporation raising the funds and the investors in the instrument.[304] For example, a corporation interested in raising capital could issue debt or preferred stock directly to investors. As an alternative, in the case of trust preferred securities, a corporate issuer forms a passthrough entity by contributing capital in exchange for a common equity interest. The passthrough entity then sells preferred equity interests to investors. The passthrough entity then lends the money it received from the corporation (as a capital contribution) and the investors (in exchange for the preferred equity interests) back to the corporation. As a result, the corporation has funds raised from investors, and has an obligation to make payments on indebtedness to the newly created passthrough entity. Payments on the corporation-passthrough entity indebtedness are typically designed to match the payments required on the passthrough entity-investor preferred securities. In other words, the passthrough entity operates as a conduit to receive payments of interest from the corporation, which it pays on to its preferred interest holders.

Prior to changes in the financial accounting rules in 2003,[305] the simplified structure described above allowed the corporation interest deductions on amounts paid through to the investors for Federal tax purposes without treating the arrangement as a liability for financial accounting purposes. For Federal income tax purposes, the debt between the corporate issuer and the passthrough entity was designed to qualify as debt. Similarly, the terms of the preferred interests issued to investors was designed to qualify as debt for Federal income tax purposes even if treated as issued by the corporate issuer directly.[306] Under U.S. GAAP rules, the passthrough entity was consolidated with the corporate issuer, with the effect that the loan between the corporate issuer and the passthrough entity (which would be treated as a liability for GAAP) was ignored for financial accounting purposes, and the preferred securities were treated as issued directly by the corporation. These preferred securities were designed to qualify as equity for GAAP purposes.

In 2003, U.S. GAAP rules were revised to require that trust preferred securities be reflected as a liability for financial accounting purposes. However, the trust preferred security structure has also involved benefits for credit rating purposes. Very generally, rating agencies such as Moody's Investor Services and Standard and Poor's may assign a credit rating to certain company instruments. These agencies are concerned primarily with a company's ability to make payments on an instrument as required, without default. An important component of such an analysis is the composition of the issuer's capital structure, and the degree of flexibility a

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[304] The additional entity can be a foreign limited liability company, a domestic partnership or state law trust. Different structures have used different entities for a variety of non-tax reasons over time including compliance with securities laws, transaction costs and investor convenience.

[305] Accounting Standards Codification ("ASC") 480 (formerly FASB Statement No. 150).

[306] In TAM 199910046, the IRS concluded, *inter alia*, that in a trust preferred securities structure using a foreign limited liability company that (1) loans to the foreign LLC were debt for Federal tax purposes and (2) that preferred securities issued by the foreign LLC would constitute debt for tax purposes if issued directly to the public by the corporate owner of the foreign LLC. In CCA 200932049, IRS Chief Counsel reached a similar conclusion for a trust preferred securities structure employing a State law trust.

company has in periods of impaired cash flow. For example, Moody's Investor Services' rules have granted partial "equity credit" to hybrid instruments that allow, like trust preferred securities, for the deferral of periodic payments.[307] In effect, giving "equity credit" for hybrid instruments could make such instruments more attractive to issuers than other financing alternatives, especially if such credit improved the company's credit rating.[308]

In addition to credit rating benefits, for an issuer of trust preferred securities that is a bank holding company, such securities were designed to count as Tier 1 regulatory capital. Very generally, under U.S. bank regulatory capital requirements, banks are required to hold some minimum level of capital (e.g., three percent of total assets) and satisfy a minimum risk-based capital ratio (e.g., a ratio of total capital to total risk-weighted assets of eight percent). These requirements are generally designed to insure banks hold capital sufficient to absorb potential losses. Debt issued directly by a bank could give rise to tax deductible interest payments, but would not qualify as capital for regulatory purposes. Preferred stock issued directly by the bank could count as equity capital, but generally would not give rise to interest deductions. For certain banks, specifically, bank holding companies regulated by the Federal Reserve Board, trust preferred securities meeting certain requirements counted as Tier 1 capital. For banks other than bank holding companies, trust preferred securities did not count as Tier 1 capital. Section 171(b) of the Dodd-Frank Wall Street Reform and Protection Act[309] generally phases out the treatment of trust preferred securities as Tier 1 capital for most large bank and thrift holding companies.[310]

Hybrid instrument advantages in cross-border investment

Instruments may be treated as debt for foreign income tax purposes but as equity or U.S. tax purposes. Other instruments exist that may be treated as debt for U.S. tax purposes and as equity for foreign tax purposes. These instruments are often used within a multinational group to achieve cross-border tax arbitrage, to accomplish foreign or U.S. tax base erosion, or to engage

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[307] See, e.g., TAM 199910046; Richard A. Kahn, "The Evolution of Hybrid Securities" 1866 PLI/Corp 463, February 2011 (describing rating agency treatment of hybrid securities).

[308] See, e.g., "The Law of Unintended Consequences: New Generation of Trust Preferred Squeezes Market for DRD Preferreds," 2006 TNT 69-18 (April 11, 2006) (describing issuances of trust preferred securities by Lehman Brothers, Inc., Burlington Northern Santa Fe Corp., and US Bancorp following a 2005 change in the equity credit rules by Moody's Investor Services).

[309] Pub. L. No. 111-203.

[310] Specifically, section 171(b) Dodd-Frank prohibits bank holding companies with assets in excess of $15 billion on December 31, 2009 to count trust preferred securities issued after May 19, 2010 as Tier 1 capital and phases previously issued trust preferred securities out of Tier 1 capital by January 2016. Bank holding companies with $15 billion or less in assets are not allowed to include trust preferred securities issued on or after May 19, 2010 in Tier 1 capital, but are not required to phase out trust preferred securities outstanding before that date. Federal home loan banks and certain small bank holding companies (i.e., bank holding companies with less than $500 million in assets) are exempted from the limitation provision (i.e., these entities may continue to count trust preferred securities as Tier 1 capital), as are trust preferred securities issued to the United States or any agency or instrumentality thereof pursuant to the Emergency Economic Stabilization Act of 2008.

in foreign tax credit planning.[311] Such instruments may also be used by investors (e.g., investment funds) making cross border investments. One such example is a Convertible Preferred Equity Certificate ("CPEC"). A CPEC is a hybrid financing instrument designed to be regarded as debt of a Luxembourg issuer from a Luxembourg tax perspective,[312] but equity from a U.S. tax perspective.[313] Typical features of the CPEC include a 49-year term; a fixed annual interest rate computed based on the "arm's-length" principle, taking into consideration their conversion feature; convertibility into shares of the issuer at a fixed ratio established upon the issuance of the CPECs; an ability to be redeemed at fair market value under certain conditions; transferability by the holder only with the simultaneous transfer of an equivalent portion of the holder's shares of the issuer; subordination to other debt; and no voting power.

Because CPECs are treated as debt for Luxembourg tax purposes, interest expense may be imputed on CPECs resulting in Luxembourg tax deductions. In addition, interest paid on CPECs is generally exempt from Luxembourg withholding tax. From a U.S. perspective, assuming the holder is treated as owning equity, interest imputed on a CPEC does not result in corresponding imputed interest income in the United States. Holders typically owe U.S. tax on dividend income only when declared and paid. In addition, CPECs are convertible into common shares and under certain circumstances are redeemable. Because conversion or redemption is typically carried out at the fair market value of the shares at the time of the conversion or redemption, holders are able to extract appreciation in the issuer in a tax efficient manner. From a Luxembourg perspective, a conversion is not a dividend subject to withholding, and from a United States holder's perspective, the exchange may qualify for a preferential rate of tax as qualified dividend income or the sale or exchange of a capital asset.[314]

4. Incentives to substitute other arrangements for debt

Shareholders may extract other deductible payments not subject to interest limitations

Corporate equity owners can extract a stream of earnings from the corporation in a form that is deductible to the corporation (and thus does not bear corporate level tax) through transactions other than owning debt. For example, property to be used in the corporate business might be held outside the corporation and leased to the corporation. The corporation could deduct the lease payments, the owners who are leasing the property pay one level of tax on the

[311] The ability to use hybrid instruments to engage in foreign tax credit planning was significantly curtailed with the enactment of Code section 909. Pub. L. No. 111-226, sec. 211. Prior to enactment of section 909, certain hybrid instruments treated as debt for foreign tax purposes and as equity for U.S. tax purposes were used to help facilitate certain "foreign tax credit splitter" transactions where creditable foreign taxes were separated from the underlying foreign earnings and profits.

[312] Although the IRS will typically not issue a private letter ruling, it is not uncommon for issuers of CPECs to obtain a ruling from Luxembourg tax authorities confirming the treatment of CPECs as debt.

[313] Profit participating loans are another example of a hybrid instrument that may be treated as debt in Luxembourg and certain other foreign jurisdictions while being treated as equity from a U.S. tax perspective.

[314] Since CPECs are also treated as equity in certain foreign jurisdictions, CPECs may also be used to facilitate cross-border arbitrage between Luxembourg and other foreign jurisdictions.

rent received, and appreciation in the assets remains outside of the corporation and not subject to corporate tax.

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

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

Tax-exempt organizations are subject to UBIT on the receipt of deductible payments from entities the organization controls. However, deductible payments might be shared between taxable and tax-exempt organizations in other ways. For example, taxable entities controlled by tax-exempt organizations might bear deductible costs that might otherwise be allocated to the controlling tax-exempt organization.

5. Incentives to use leveraged ESOPs

C Corporation ESOP leveraged transactions

Examples of leveraged transactions

In general

In a leveraged ESOP transaction, the trust of a retirement plan borrows funds, which are used to purchase employer stock either from the employer (e.g., to raise capital for the corporation), or from a third party with the employer's guarantee (e.g., to buy out an existing shareholder). Generally the sources of funds lent to a leveraged ESOP are banks and existing equity owners (seller financing). The purchased shares are collateral for the loan and are held by the ESOP in a suspense account. At the retirement plan trust level, the debt is nonrecourse debt with only the shares of employer stock acquired with the loan as security, but the debt is generally guaranteed by the employer corporation. The loan is repaid by the trust using contributions by the employer to the qualified retirement plan. As the loan is repaid with these employer contributions to the plan, the shares of stock are released from the suspense account and allocated to the accounts of plan participants. Leveraged ESOP financing may be used as a substitute for debt issued by the corporation. A corporation might use a leveraged ESOP to (1) provide new capital for expansion or improvements, (2) to buy out stock of a retiring owner (or owners), or (3) to divest a division of the corporation.

Mergers and divestitures

A leveraged ESOP may be used to acquire a company. For example, a leveraged ESOP maintained by the acquiring corporation or its subsidiary could borrow funds in an amount equal to the amount needed to acquire the target company. The proceeds of the loan would be used to purchase employer securities from the employer. The employer corporation (or a newly formed subsidiary) would then use the proceeds of the sale to purchase the stock or assets of the target

company. Finally, the employer corporation would make annual qualifed retirement plan contributions to the leveraged ESOP until the loan is repaid.

One variation of this leveraged-ESOP financing technique is for the employer to purchase target stock, either directly or through a subsidiary, using funds borrowed from a financial institution or other lender. Once the acquisition has been completed, the newly acquired subsidiary could establish a leveraged ESOP. The ESOP borrows money and purchases either newly issued stock of the subsidiary or stock of the subsidiary from the acquiring corporation; the acquiring corporation could then use the proceeds of this sale to pay off the original acquisition loan. The subsidiary would make annual qualified retirement plan contributions sufficient to amortize the ESOP loan and pay interest.

A leveraged ESOP could be similarly used in a divestiture. First, the employer corporation could create a subsidiary which sets up an ESOP. Next, the ESOP would borrow from a lender, with the parent corporation acting as a guarantor. The leveraged ESOP then acquires the stock of the newly formed corporation and that corporation would then make annual qualified retirement plan contributions to the leveraged ESOP to amortize the loans.

Purchase of shareholder interest

A leveraged ESOP transaction may be used to purchase the interest of an existing shareholder rather than having the shareholder sell to an unrelated third party. First, the ESOP would borrow the funds to purchase the stock, second the shareholder would sell the stock to the leveraged ESOP, and finally the employer corporation would make a contribution to the leveraged ESOP to amortize the loan. Perhaps one of the most significant tax incentives for using a leveraged ESOP transaction is that a shareholder of a closely held C corporation may defer the gain on the sale of qualifying employer securities to an ESOP through the purchase of qualifying replacement property if certain requirements are satisfied. For at least 10 years after the sale, no assets attributable to qualified employer securities may be allocated to the account of the seller under the ESOP. Immediately after the sale, the ESOP generally must own at least 30 percent of the employer corporation.

Advantages and disadvantages to a C corporation of using a leveraged ESOP for corporate financing

There are two primary tax advantages for a C corporation to using leveraged ESOPs for corporate financing.[315] First, because ESOP contributions are tax deductible as contributions to a qualified retirement plan, a corporation that repays an ESOP loan with employer contributions

[315] Those who favor the special tax benefits available to ESOPs generally argue that ESOPs serve to expand capital ownership to workers. Some would also argue that worker ownership, in turn, increases worker productivity and profitability of the company. Proponents of the tax benefit of ESOPs argue that leveraging is an integral part of the transfer of ownership process because borrowing is often the only way that an ESOP can obtain funds to acquire a significant block of employer securities. Those opposing these tax benefits argue that, for an employer in financial difficulties, ESOPs double the risk to employees by putting both their job and retirement plan benefits at risk.

to the ESOP is effectively able to deduct principal[316] as well as interest.[317] The deduction of payments for principal reduces the after-tax cost of the loan for the corporation. Second, dividends paid on ESOP stock passed through to employees or used to repay the ESOP loan are deductible by C corporations as plan contributions. This may further reduce the after-tax cost of the loan for the corporation.

The tax benefit of a deduction for principal and interest may also be achieved by the corporation borrowing directly from a third party lender and directly repaying the lender, and then contributing shares of employer stock to a qualified retirement[318] with a fair market value equal to the principal portion of the loan payment. This approach may allow the corporation to avoid certain costs and risks of using a leveraged ESOP. For example, the loan need not satisfy the requirements for the prohibited transaction exemption. However, this approach does not allow other tax benefits of a leveraged ESOP, such as deferral of gain by a selling shareholder for stock sold to the ESOP. Such deferral of gain may cause the shareholder to be willing to sell at a lower price. Similarly, there is no opportunity to repay the loan with dividends paid with respect to the employer stock held by the plan and obtain a deduction for those dividends.

S corporation ESOP leveraged transaction

General rules

The same types of transactions for which a C corporation uses a leveraged ESOP may also be used by an S corporation. However, given the inherent structure of an S corporation (which only permits one class of stock and up to 100 shareholders who generally must be U.S. individuals), an S corporation may be less likely to use a leveraged ESOP transaction for a merger or divestiture. An S corporation most commonly uses a leveraged ESOP transaction to buy out the interests of existing shareholders.

An S corporation with an ESOP may also need to borrow funds in order to cash out or reacquire shares from terminated employees or employees who decide to diversify their accounts. If reacquisitions are predictable or manageable, the S corporation may have sufficient

[316] The payment of principal is used to allow the shares of stock to be released from the suspense account and be allocated to the accounts of plan participants. In that respect, the contributions are not different from other contributions to qualified defined contribution plans that are used to purchase plan assets which are then allocated to participant accounts. In the context of a qualified retirement plan, it is the additional deduction of interest without regard to the general limitation on the deduction for plan contributions that is a departure from the normal rule.

[317] This tax benefit of a deduction for principal and interest may also be achieved by debt at the corporate level with direct repayment to the lender and contributions of the shares of employer stock to the plan equal to the principle payment on the loan rather than using a leveraged ESOP. However, this approach does not allow other tax benefits of a leveraged ESOP, such as deferral of gain by a selling shareholder for stock sold to the ESOP.

[318] Plan must be an eligible individual account plan under section 407 of ERISA which generally requires that the plan be a profit-sharing plan, stock bonus plan, or an ESOP.

tax-free[319] build up of assets to allow it to make these repurchases without incurring debt. However, unpredictable events may require a large unexpected reacquisition. Further the S corporation may decide that debt is a better mechanism for repurchases than depleting working capital.

A C corporation may structure a leveraged transaction using an ESOP and then make an S election after the ESOP and acquisition loan are in place.[320] In this case, a leveraged ESOP transaction might be used for a divestiture or even a transaction where a publicly held corporation becomes a privately owned corporation.[321]

A transaction that begins with the corporation being a C corporation may also allow a selling shareholder of a nonpublic C corporation to take advantage of the nonrecognition provisions for sales to an ESOP. To qualify for nonrecognition treatment by the seller, the stock when purchased by the ESOP must be stock of a nonpublic C corporation and the ESOP must retain the stock for at least three years after the sale but there is no requirement that it remain C corporation stock.

Tax benefits available to S corporations that maintain ESOPs

The special rules for allowing a deduction of the amount of loan payments of interest and the amount of dividends on employer stock held by the ESOP without regard to the 25 percent of compensation limit on qualified plan contributions are not available to an S corporation. However, the tax benefits of being exempt from both income tax and UBIT with respect to income on the shares of the S corporation stock held by an ESOP generally exceed these tax benefits available to C corporations. The potential for tax-free build up of income within the S corporation to provide working capital makes the company more viable and thus likely to be more attractive to lenders.

Further, to the extent that shares of the S corporation are held by the ESOP, the allowance or disallowance of deductions for contributions to the ESOP would not affect any shareholder's income tax liability. However, the amount in excess of the 25 percent limit may still be a nondeductible contribution and thus subject to the 10 percent excise tax at the S corporation level. The S corporation can avoid such a consequence by using cash distributions to the ESOP with respect to the stock the ESOP owns to repay the loan. However, in this case, if the stock is not 100-percent owned by the ESOP, cash distributions will also need to be made in the same proportion with respect to any shares of stock not owned by the ESOP.

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[319] The S corporation would pay no tax on its earnings to the extent it is owned by an ESOP, whether or not it makes current distributions to the ESOP. In many cases, the S corporation ESOP owns all the stock of the corporation.

[320] See, e.g., Robert Willens, "ESOPs and S Corporations," *Tax Notes*, vol. 126, no 11 (March 15, 2010) 1407.

[321] Michael S. Knoll, "Samuel Zell, the Chicago Tribune, and the Emergence of the S ESOP: Understanding the Tax Advantages and Disadvantages of S ESOPs," 70 *Ohio State Law Journal* 519 (2009).

Role of warrants or similar interests in leveraged S corporation ESOP transaction

A leveraged ESOP transaction by an S corporation may include mezzanine debt with warrants (which in certain circumstances can provide options for shares that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the stock).[322] Thus, for example, if the shareholders of an S corporation want to retire and sell their S corporation shares, they might decide to establish an ESOP and sell their shares to the ESOP in a leveraged transaction. The transaction might be structured as a combination of senior debt in the form of a bank loan and junior debt in the form of a loan by the seller. The senior debt is at the market rate for commercial lenders. The junior debt held by the seller may include warrants[323] in combination with an interest rate that is lower than the rate that actually reflects the level of risk associated with the junior debt. In fact the senior debt holder might condition its approval of the loan on the combination of debt and warrants at the junior debt level to reduce the cash drain on the S corporation during the initial years of the loan.

The seller may be willing to accept the warrant as consideration for the debt rather than interest because the seller can expect to recognize little ordinary interest income from the sale. Instead, when the warrant is put to the S corporation for cash, the warrant holder can recognize any return as long term capital gain, taxed at a lower rate than ordinary income.[324] To the extent that the S corporation is owned by the ESOP, its income is not taxed currently, and if not distributed to shareholders can accumulate tax-free. The seller may view this as increasing the potential for S corporation stock to appreciate in value during the period that the warrant is outstanding reducing the risk of accepting a warrant.

6. Financial accounting and other considerations

In general

Treatment of an instrument under rules other than tax rules can also affect the issuer. For example, the treatment as debt or equity under U.S. Generally Accepted Accounting Principles (hereinafter "GAAP" or "financial reporting") purposes can affect the issuer of financial statements in multiple ways. Similarly, the treatment for regulatory capital purposes is important

[322] The transaction must be structured so that is does not cause a nonallocation year. If no ESOP plan participants are disqualified persons, as defined in section 409(p)(4),and there is no other synthetic equity within the meaning of section 409(p)(6)(C) (and Treasury regulations)with respect to the S corporation, the transaction generally can provide for warrants for any portion up to (but still less than) 50 percent of the outstanding share of the S Corporation, after synthetic equity is taken into account, as part of the corporate finance transaction without causing a nonallocation year.

[323] Such warrants are frequently structured not to allow the seller to regain ownership of the S Corporation but rather to allow the seller to share in the profits during a specified period.

[324] The cash payment to the warrant holder dilutes the value of the S corporation and thus of the remaining ESOP stock and stock of any other shareholders. Furthermore, to the extent the payment reflects the tax-free increase in corporate value from S corporation income that was not taxed during the period that the lender held the warrant (because it was allocated to the tax-exempt ESOP), such income might not ever be paid to the ESOP or its employee beneficiaries.

to a financial institution subject to such requirements. The treatment by a ratings agency that rates the issuer's stock or bonds is also a consideration. This section describes general considerations under GAAP.

Consequences of debt classification

The classification of an instrument as debt for financial reporting purposes will generally have an impact on the computation of the company's net income. In general, any instrument treated as debt for financial reporting purposes will have an actual or imputed interest expense component. This interest expense must be taken into account in deriving net income and, therefore, earnings per share (generally determined by dividing net income by the number of shares issued and outstanding). Furthermore, some companies are required to meet interest coverage ratios[325] pursuant to covenants agreed to in existing loan documents.[326] The more interest expense a company is deemed to have, the more pressure may be put upon that company to generate sufficient earnings to meet these leverage coverage ratios to avoid being in violation of these debt covenants.

The classification of an instrument as a debt instrument will also increase that entity's leverage ratio.[327] This ratio is an important metric often used by lenders to determine whether an enterprise can obtain additional future financing, how expensive that financing will be (for example, incremental debt can reduce the issuer's credit rating), as well as whether that enterprise is in compliance with debt covenants under existing obligations.

From a balance sheet perspective, an instrument classified as debt will generally be recorded at historic cost with any accrued but unpaid interest also accounted for as a liability. The company, however, will be required to disclose the fair market value of the debt in the notes to its financial statements.

Consequences of equity classification

To the extent an instrument is, instead, classified as equity for financial reporting purposes, such a classification will generally not have the same impact on net income, interest coverage and leverage ratios. Rather than being treated as interest expense, a payment on equity is generally treated as a dividend which is taken into account as a reduction to the company's

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[325] The interest coverage ratio is a measure of the number of times a company could make the interest payments on its debt with its earnings before interest and taxes ("EBIT"). In general, the lower the interest coverage ratio, the higher the company's debt burden and the greater the possibility of bankruptcy or default. The formula for the interest coverage rate is: EBIT (earnings before interest and taxes) / Interest Expense.

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

[327] In general, the leverage ratio is a measure of the amount of equity in comparison to debt or the amount of earnings in comparison to debt. Although there are variations on the formula used, one leverage ratio, the debt-to-equity ratio, is as follows: (Short Term Debt + Long Term Debt) / Equity.

retained earnings rather than as a reduction to net income. Although payments on equity do not reduce net income, the issuance of an equity instrument generally will still have a dilutive impact on earnings per share (since the denominator, number of shares issued and outstanding, increases, while the numerator, net income, is not impacted by the additional equity issuance). Unlike debt, the issuance of equity will have no impact on the interest coverage ratio and will decrease the leverage ratio. Like debt, equity also is recorded on the balance sheet at its historical cost; however, there is no requirement that it be reflected at fair market value in the company's notes to the financial statements.

Financial accounting classification as either debt or equity

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

1. it embodies a present duty or responsibility to one or more other entities (including a business enterprise, an educational or charitable organization, a natural person and the like) that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand;

2. the duty or responsibility obligates a particular person, leaving it little or no discretion to avoid the future sacrifice; and

3. the transaction or other event obligating the entity has already happened.[328]

Solely with respect to financial instruments (and not contracts to provide services or other types of contracts), GAAP defines an obligation as a conditional or unconditional duty or responsibility to transfer assets or to issue equity shares.[329]

In contrast, in the case of a business enterprise, financial reporting rules generally define equity as the ownership interest in the enterprise stemming from ownership rights (or the equivalent) and involves a relation between the enterprise and its owners as owners rather than as employees, suppliers, customers, lenders, or in some other nonowner role. Since equity ranks

[328] FASB Concepts Statement No. 6 ("Con. 6"), par. 60. Although the FASB Concepts Statements do not establish generally accepted accounting standards, they are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide selection of economic phenomena to be recognized and measured for financial reporting and their display in financial statements or related means of communicating information to those who are interested. Furthermore, Concepts Statements guide the FASB in developing sound accounting principles and provide the FASB and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting. Financial Accounting Standards Board, "FASB Home: Standards: Concepts Statements," http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156317989.

[329] ASC 480-10-20 - Distinguishing Liabilities from Equity: Overall: Glossary.

after liabilities as a claim to or interest in the assets of the enterprise, it is a residual interest: (a) equity is the same as net assets, the difference between the enterprise's assets and its liabilities, and (b) equity is enhanced or burdened by increases and decreases in net assets from nonowner sources as well as investments by owners and distributions to owners.[330] An enterprise may have several classes of equity (for example, one or more classes of common or preferred stock) with different degrees of risk stemming from different rights to participate in distributions of enterprise assets or different claims on enterprise assets in the event of liquidation.[331] Even so, all classes of equity depend at least to some extent on the enterprise's profitability for distributions of enterprise assets, and no class of equity carries an unconditional right to receive future transfers of assets from the enterprise except in liquidations, and then only after liabilities have been satisfied.[332]

Although the distinction between debt and equity is clear in concept, it can be obscured in practice as securities issued by business enterprises may have characteristics of both debt and equity in varying degrees. Additionally, the names given to these securities may not be reflective of their essential nature. By way of example, a bond may be viewed as a classic illustration of a debt instrument. Nonetheless, the traditional distinction between stocks and bonds has become blurred through the increased use of instruments with characteristics of both debt and equity. For example, convertible bonds have both liability and residual interest characteristics. Additionally, preferred stock, may have characteristics more reflective of debt such as maturity amounts and dates at which it must be redeemed.[333]

The mixed characteristics of these securities have historically made accounting for them under GAAP a challenge. Convertible bonds typically give their holder the right to exchange the bond for common stock under certain stipulated terms. In circumstances in which these instruments can be settled wholly or partly in cash, GAAP requires the issuer of the instrument to split the instrument into its debt and equity components. The issuer accomplishes this by first valuing the debt component and then subtracting this value from the total proceeds received to derive the equity component. As discussed above, although Congress gave Treasury regulatory authority under section 385 to treat an interest in a corporation as part debt and part equity in 1989, no regulations have been promulgated. The U.S. tax rules generally treat an instrument as all debt or all equity.

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[330] Con. 6, par. 60.

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

[332] Con. 6, par. 62.

[333] Con. 6, par. 55.

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

The FASB and International Accounting Standards Board ("IASB") are undertaking a joint project to develop a comprehensive standard on financial instruments with characteristics of equity, liabilities or both. Among other goals, this guidance is expected to revisit the definition of liabilities mentioned above.[334]

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

IV. TAX TREATMENT OF CORPORATE DEBT IN SELECTED COUNTRIES

A. Summary

There are similarities and differences in the tax treatment of corporate debt across countries. A strict country-to-country comparison of these provisions is difficult because each country has distinct market institutions as well as a distinct set of policies (both tax and nontax) that may be similar in certain ways but dissimilar in others. A comprehensive analysis of foreign taxation of corporate debt is therefore beyond the scope of this publication. However, following is a brief overview of the similarities and differences in key tax provisions of corporate debt across seven countries: Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom.

Thin capitalization rules[335]

Thin capitalization rules, which are intended to limit interest deductions for highly leveraged companies, vary across the seven countries.

In Australia, corporate debt deductions are denied when an entity's worldwide debt-to-equity ratio of 3:1 is exceeded. Canada also has thin capitalization rules that require interest payments withdrawn by non-residents from resident corporations to be treated as dividends that must be paid out of earnings accumulated after Canadian tax. In France, a borrowing corporation is deemed thinly-capitalized if the overall indebtedness granted by related parties exceeds 1.5 times the net equity of the borrower, the amount of interest exceeds 25 percent of the adjusted operating profits realized by the borrower, and the amount of interest paid to related parties exceeds the amount of interest received from affiliated parties. Under rules enacted in Germany in 2008, a company's excess of interest expense over interest income is deductible only up to 30 percent of the company's taxable income before interest, taxes, and depreciation and amortization unless one of three possible exceptions applies. The rules apply irrespective of where the ultimate shareholders of the company are residents of Germany. Japan's thin capitalization rules provide that when liabilities exceed three times the capital held by the foreign controlling shareholder, the amount of interest payable on the excess amount is not deductible. Also, when a company maintains less than a 3:1 debt-to-equity ratio, it is not treated as thinly capitalized. In Mexico, a corporate taxpayer may not deduct interest derived from the amount of its debt contracted with nonresident related parties that exceeds three times its equity. Interest deductions in the United Kingdom may be limited if the amount of a borrowing, either domestic or cross-border, exceeds what is considered an arm's-length amount.

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[335] For a more detailed description of the treatment of expenses, including interest, in Australia, Canada, France, Germany, Japan, and the United Kingdom, see Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income* (JCX-33-11), May 20, 2011.

General anti-avoidance rules

As just described, the seven surveyed countries have specific rules that limit interest deductions in particular situations in which taxpayers are thinly capitalized. Four of the seven countries, Australia, Canada, France, and Germany, also have what are commonly referred to as general anti-avoidance rules (often termed GAARs) intended to prevent inappropriate tax reduction through transactions that may satisfy the literal requirements of the tax rules but that violate the intent of those rules. Application of these GAARs may limit interest deductions in circumstances that are determined to be abusive or non-arm's-length.

Limitations on double taxation of corporate earnings

Countries may limit double taxation of corporate earnings by various means. The United States, for example, imposes a reduced rate of taxation (generally 15 percent) on dividends received by individual shareholders from domestic corporations and some foreign corporations. Other countries, including Australia, Canada, and Mexico, have what are referred to as imputation systems under which resident shareholders who receive dividend distributions are credited with their shares of the corporate tax imposed on the earnings out of which the dividends have been paid.

In part to comply with European Union rules forbidding countries from discriminating against residents of other European Union countries, some European countries such as Germany have abandoned their imputation systems because, for instance, the systems had been available only to resident shareholders.

Treatment of cancelled debt

In Australia, if a debt is "commercial,"[336] then the creditor may be able to claim a deduction in relation to waiving the debt, while the amount of the forgiven debt may be applied to reduce certain deductions of the debtor. However, these debt forgiveness rules do not apply if the debtor is a shareholder or employee of the company. Similarly, in Canada the forgiven amount of a debt is used to reduce non-capital losses and capital loss carryforwards. In France, the creditor of cancelled debt may deduct the amount if the cancellation is considered of "normal nature."

In Germany, Japan, Mexico and the United Kingdom, cancelled debt is considered taxable income for the corporate taxpayer.

[336] A debt is "commercial" if "part or all of the interest payable on the debt is, or would be, an allowable deduction."

B. Law Library of Congress: Tax Treatment of Corporate Debt

Following is the Report for Congress, June 2011, Tax Treatment of Corporate Debt, prepared by the Law Library of Congress.



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REPORT FOR CONGRESS

June 2011

Global Legal Research Center
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TAX TREATMENT OF CORPORATE DEBT

This report deals with the deductibility of corporate interest expenses in Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom. It focuses on equity-stripping and thin capitalization rules and also discusses other tax-related limitations on debt financing, the deductibility of corporate distributions, and the treatment of debt forgiveness.

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TAX TREATMENT OF CORPORATE DEBT

Executive Summary

Under Australian tax law, the interest paid on a debt by a company is deductible if it meets the criteria of the general deduction provision. Specific rules apply to determine whether an interest in a company is classed as debt or equity, and therefore whether a resulting payment is deductible interest or a nondeductible dividend. Interest deductions are limited by thin capitalization rules and by other anti-avoidance provisions that allow the Commissioner of Taxation to cancel tax benefits that arise from tax avoidance arrangements. Rules also apply that may result in a distribution being deemed to be a dividend, particularly in situations involving related parties.

I. Introduction

The Australian Income Tax Assessment Act 1997 (Cth) contains a general deduction provision and also sets out specific deductions that may be claimed by businesses.[1] The general deduction provision, section 8-1, allows businesses to claim a deduction for interest on loans, provided it is an expense that is incurred in gaining or producing taxable income[2] or is necessarily incurred in carrying on a business for the purpose of gaining or producing taxable income.[3] The ability to deduct interest expenses is, however, limited by the second part of section 8-1, which state that an expense cannot be deducted to the extent that it is of a capital, private, or domestic nature, if it is incurred in relation to gaining or producing exempt income, or if another provision prevents it from being deductible.[4] Expenditure that is deductible under section 8-1 is generally deductible in full in the year it is incurred.[5]

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[1] *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), *available at* http://www.comlaw.gov.au/Details/C2011C00374. Additional rules relevant to this report are contained in the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936), *available at* http://www.comlaw.gov.au/Details/C2011C00427.

[2] Gross taxable income is called "assessable income" in Australia. The net taxable income that remains after deductions have been taken out is then called "taxable income." *See* ITAA 1997 s 4-15(1). However, for the purposes of clarity, this report uses "taxable income" throughout to refer to gross taxable income.

[3] ITAA 1997 s 8-1.

[4] ITAA 1997 s 8-1(2).

[5] R.L. DEUTSCH ET AL., AUSTRALIAN TAX HANDBOOK 867 (2009).

Debt/equity rules were introduced in 2001. These rules define what can be classed as equity in a company and what constitutes debt for tax purposes.[6] The tests therefore determine whether a distribution by a company is treated as a dividend or as deductible interest on a debt. The rules are also important in determining what deductions may be disallowed under the thin capitalization rules, which were also expanded in 2001.

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

Thin capitalization rules "operate when the amount of debt used to finance the Australian operations exceeds specified limits."[7] The aim of the rules is to "limit the amount of debt that can be allocated to Australian entities that are foreign-controlled and to non-residents with Australian investments, as well as Australian companies with overseas investments."[8] In addition to applying to both inbound and outbound investors, the current thin capitalization regime "limits the deductions relating to the total debt of the Australian operations of those investors, rather than the foreign debt only."[9]

Under the rules, when the entity's overall debt-to-equity ratio of 3:1 (20:1 for financial entities) is exceeded, debt deductions (including interest deductions) in relation to the excess "will be permanently denied."[10] However, debt deductions will not be denied if the entity shows that the debt amount is at arm's length.[11] The provisions may also be avoided if Australian entities with overseas investments show that the average value of their Australian assets constitutes at least 90 percent of their worldwide assets.[12] Furthermore, the rules do not apply to taxpayers whose annual debt deductions do not exceed AU$250,000 (about US$266,000).

Whether an interest in a company is characterized as debt or equity is relevant to determining the application of the thin capitalization rules, as well as the imputation system (described below). Debt/equity rules introduced in 2001 "operate to determine what constitutes equity in a company and what constitutes debt for tax purposes."[13] The rules classify an interest

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[6] These rules were introduced through the *New Business Tax System (Debt and Equity) Bill 2001*. For a detailed explanation of the rules, *see* Parliament of the Commonwealth of Australia, New Business Tax System (Debt and Equity) Bill 2001 – Explanatory Memorandum, *available at* http://www.austlii.edu.au/au/legis/cth/bill_em/nbtsaeb2001441/memo1.html.

[7] AUSTRALIAN MASTER TAX GUIDE 1303 (CCH Australia, 47th ed. 2010). The thin capitalization rules are contained in ITAA 1997 Div 820.

[8] Tom Toryanik, *Australia – Corporate Taxation* ¶ 10.3., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (AUSTRALIA), http://ip-online.ibfd.org/kbase/ (by subscription) (last visited June 17, 2011).

[9] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 1,304.

[10] Toryanik, *supra* note 8, ¶ 10.3.

[11] *Id.*

[12] *Id.*

[13] *Id.*, ¶ 10.6.

in a company "according to the economic substance of the rights and obligations of an arrangement," rather than just looking at its legal form.[14] They apply only to financing arrangements.[15] Broadly, "a financing arrangement is a scheme entered into or undertaken to raise finance for the company or a connected entity, or to fund another financing arrangement."[16]

Essentially, if the interest in a company is considered to be an equity interest, the distributions arising from it may be dividends, whereas if it constitutes debt the interest payments made by the company may be deductible under the deduction provisions.

An interest in a company will be considered a debt interest where:

- the scheme is a financing arrangement (defined above) or is one that constitutes a share;
- the entity or associate receives or will receive a financial benefit under the scheme;
- the entity or a connected entity has an effectively non-contingent obligation under the scheme to provide a financial benefit in the future; and
- it is substantially more likely than not that the value of the financial benefit to be provided will equal or exceed the value of the financial benefit received.[17]

If the return paid on the debt interest meets the general deduction criteria in section 8-1 it will be deductible.[18] Even if it does not meet the criteria it may still be deductible but "the deduction is capped by reference to the rate of return on an equivalent straight debt interest, increased by a margin to recognize the premium paid for the increased risk of non-payment because of the contingency."[19] Under the legislation, the limit is the benchmark rate of return plus 150 basis points (i.e., 1.5 percent).[20]

Special rules apply to "at-call" loans from related parties. These loans do not have a fixed term and are repayable on demand. Such loans "are treated as debt interests if the borrowing company has an annual turnover of not less than AU$20 million [about US$21.17 million]."[21]

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[14] *Id.*

[15] *See* ITAA 1997 Div 974.

[16] Toryanik, *supra* note 8, ¶ 10.6. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 1,267; ITAA 1997 s 974-130.

[17] Toryanik, *supra* note 8, ¶ 10.6 (referring to ITAA 1997 s 974-20). Note that "if the term of the interest is 10 years or less, the amount to be paid to the holder must equal or exceed the issue price in nominal value terms. If the term of the interest is greater than ten years, the amount to be paid to the holder must equal or exceed the issue price in present value terms." *Id.* (referring to ITAA 1997 s 974-35).

[18] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 1,269.

[19] Toryanik, *supra* note 8, ¶ 10.6.

[20] *Id. See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 1,269 (referring to ITAA 1997 s 25-85). This rule is mirrored in the rules relating to the Taxation of Financial Arrangements, which are referred to below.

[21] Toryanik, *supra* note 8, ¶ 10.6 (referring to ITAA 1997 s 974-75).

Where an interest is not a debt interest, it will be an equity interest if it arises under the following financial arrangements:

- shares;
- interests providing variable or fixed returns from the company that are contingent on economic performance, or at the discretion of the company; and
- interests that may or will convert into such equity interests.[22]

Where an equity interest is not a share in a legal form it is called a "non-share equity interest" and is generally treated in the same way as a share for tax purposes. Shares that are debt interests are known as "non-equity shares." They are not equity interests but are still treated as shares for tax purposes, although the dividends paid are not able to be franked under the imputation system, and thus, the recipient may not claim a tax credit for them.[23]

B. Limits on Borrowing for Tax-Exempt Income

As noted in the introduction to this report, expenses incurred in gaining exempt income are not deductible under the general deduction provision (section 8-1). Exempt income can be divided into three main classes: income of particular entities that are exempt from income tax, regardless of what kind of income they have (e.g., charities, trade unions); income of a particular type that is exempt from income tax, no matter who earns it; and income of a particular type that is exempt only if it is derived by certain entities.[24] An entity will not be exempt merely because it is controlled by an entity; the company must itself be covered by the relevant provisions.[25]

Anti-avoidance provisions apply to ensure that "entities that would otherwise be tax exempt are specifically made liable to pay tax on income that is diverted to them as part of a tax avoidance agreement, e.g., where a person with a right to receive an amount on which he/she would be liable to pay tax assigns that right to an exempt entity for a lesser or non-taxable amount."[26] No deductions are allowed for expenses incurred under or in connection with a tax avoidance agreement.[27] In addition, "a tax-exempt entity that distributes funds offshore may be penalized" as a result of anti-avoidance rules.[28] These rules have the effect of disqualifying charitable trusts from exempt status if they directly distribute funds overseas, or if overseas

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[22] *Id.* (referring to ITAA 1997 s 974-130).

[23] *Id.* Franked dividends are dividends paid by an Australian resident company from profits that have had Australian tax paid on them. Under Australia's imputation system, a shareholder can receive a tax offset for franking credits that are attached to a dividend. If dividends are not franked, no franking credits are available to the recipient. *See infra*, notes 53 and 54, and accompanying text.

[24] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 432 (referring to ITAA 1997 ss 11-1, 11-5, 11-10, and 11-15).

[25] *Id.* at 433 (referring to ITAA 1936 Pt III Div 9C).

[26] *Id.* at 438.

[27] *Id.*

[28] ROBIN WOELLNER ET AL., AUSTRALIAN TAXATION LAW SELECT 1,015 (2011) (referring to ITAA 1997 ss 50-60 to 50-70).

organizations with a physical presence in Australia do not incur expenditure or pursue their objectives principally in Australia.[29]

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

The legislation includes a general anti-avoidance rule that allows the Australian Commissioner of Taxation to cancel the effects of any tax benefits that a taxpayer derives from an agreement or arrangement entered into for the purpose of obtaining a tax benefit, such as a deduction being allowed.[30] This includes where a benefit is obtained by the stripping of company profits as a result of a "dividend stripping" or a similar scheme, including one that involves the disposal of property by way of the payment of a dividend or the making of a loan by the company.[31]

In addition, other anti-avoidance provisions mean that payments to related entities "are deductible only to the extent to which, in the Commissioner's opinion, they are reasonable in amount."[32] An amount that is in excess of what is reasonable is not deductible. The Australian Taxation Office considers that if the amount paid is equivalent to an arm's length payment, the whole payment will be a reasonable amount.[33] Similarly, where a taxpayer prepays interest with the aim of reducing the nondeductible capital amount payable for a property, deductions may be denied unless the amount was no more than what would be expected to be paid under an arm's length transaction.[34]

Provisions targeted at hidden profit distributions mean that amounts that are paid, loaned, or forgiven by a private company to certain associates, including individual shareholders, may be deemed to be dividends and therefore nondeductible.[35] Such dividends are included in the taxable income of the recipient and are generally unfrankable (see the explanation of the imputation system, below).[36] However, there is an exclusion from this rule for all payments and loans to another company.[37]

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[29] *Id.*

[30] Toryanik, *supra* note 8, ¶ 10.1. The general anti-avoidance rules are set out in ITAA 1936 Pt IVA.

[31] ITAA 1936 s 177E.

[32] R.L. DEUTSCH ET AL., *supra* note 5, at 762 (referring to ITAA 1997 s 26-35). *See also* ROBIN WOELLNER ET AL., *supra* note 28, at 1,131. In the case of a partnership this includes, for example, relatives of a partner and "an individual, company or other entity that is or has been a shareholder in a company that is a partner in the partnership and which is a private company for the income year." *Id.*

[33] *Id.*

[34] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 880 (referring to ITAA 1936 s 82KJ).

[35] *Id.* at 123. These anti-avoidance provisions are contained in ITAA 1936 Pt III Div 7A.

[36] *Id.* at 124.

[37] Toryanik, *supra* note 8, ¶ 1.2.1.1. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 125–27; ROBIN WOELLNER ET AL., *supra* note 28, at 1,448 (referring to ITAA 1936 s 109K).

Payments made to shareholders or directors of a company, or their relatives, or to persons associated with a partner of a partnership, may also be treated as dividends where they are considered unreasonably high.[38] Deductions will be denied for the amount that is deemed to be a dividend.

B. Other Limitations

In 2009, the Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009 was enacted.[39] This legislation implemented the final stages of the reforms that saw the introduction of new rules, known as the Taxation of Financial Arrangements (TOFA) rules, regarding the tax treatment of gains and losses from financial arrangements. These rules are aimed at emphasizing the economic effects of an arrangement instead of its legal form.[40] Aspects of the debt/equity rules and thin capitalization rules referred to above were part of the first stages of the implementation of the TOFA rules.[41] The TOFA rules are compulsory for entities with an annual turnover or aggregate financial assets of AU$100 million (about US$106 million) or more. Taxpayers that are not subject to the rules may also elect to use them. The TOFA rules apply to arrangements that involve "cash-settleable" rights or obligations to receive or provide a financial benefit.[42] Under the rules, there are specific limitations and conditions on deductions arising from such arrangements. This includes "a deduction limit of 150 basis points over the benchmark rate of return for returns on debt instruments that are contingent on economic performance."[43]

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

Companies pay a flat rate of tax, which is currently 30 percent.[44] Australian resident companies are taxed on their income from all sources, whether within or outside of Australia.[45] Nonresident companies are taxed only on their Australian-sourced income.[46] Generally, an

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[38] Toryanik, *supra* note 8, ¶ 1.2.1.1. (referring to ITAA 1936 ss 65 and 109). *See also* ROBIN WOELLNER ET AL., *supra* note 28, at 1,449.

[39] *Tax Laws Amendment (Taxation of Financial Arrangements)* 2009 (Cth), *available at* http://www.comlaw.gov.au/Details/C2011C00030.

[40] *See Guide to the Taxation of Financial Arrangements (TOFA) Rules*, AUSTRALIAN TAXATION OFFICE (ATO), http://www.ato.gov.au/businesses/content.aspx?doc=/content/00194622.htm&pc=001/003/109/001/002&mnu=0&mfp=&st=&cy= (last visited June 17, 2011).

[41] *Id.*

[42] Toryanik, *supra* note 8, ¶ 1.2.1.2.1.

[43] *Id.* (referring to ITAA 1997 s 820-15). This mirrors ITAA 1997 s 25-85, referred to above.

[44] *Income Tax Rates Act 1986* (Cth) s 23(2); 24; 25, *available at* http://www.comlaw.gov.au/Details/C2011C00187. This is the "general corporate tax rate." Special rates apply to certain companies, such as life insurance companies and non-profit companies.

[45] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 17 & 56. *See also* ITAA 1997 ss 6-5 and 6-10.

[46] *Id.*

Australian branch of a foreign resident company is not a separate entity from the company itself and has the same residence status.[47]

Special rules apply in relation to income derived by Australian resident companies from foreign resident companies or from other foreign sources.[48] Generally, amounts paid by certain foreign companies and trusts may be "attributed" to an Australian resident,[49] while there are also rules that exempt "non-portfolio dividends,[50] income of foreign branches conducting an active business and disposal of non-portfolio interests in foreign companies conducting an active business."[51] Where foreign tax has been paid on foreign source income, Australia "uses the credit method to grant relief from the effects of international double taxation."[52]

In terms of profit distributions, Australia operates an imputation system that allows Australian resident companies to pass on credits to shareholders for the tax that has already been paid on the profits.[53] To do so, an entity must "frank" a distribution to a shareholder. Only those distributions that are attributable to a company's realized taxed profits are able to be franked.[54] A resident individual or corporate entity that receives a franked distribution then includes the amount of the franking credit on the distribution in their gross taxable income and is entitled to a tax offset equal to the amount of the franking credit.[55]

Distributions of franked dividends to nonresident shareholders are not subject to a withholding tax.[56] Nonresidents do not need to include the franking credit in their gross taxable income and are not entitled to a tax offset for the credit.[57]

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[47] *Id.* at 56. However, a special tax regime provides limited separate entity treatment to Australian branches of foreign banks and foreign financial entities. *See* ITAA 1936 Pt IIIB.

[48] *Id.* at 58.

[49] R.L. DEUTSCH ET AL., *supra* note 5, at 11. There are three broad provisions that subject the income of a foreign company or trust to Australian taxation: the controlled foreign company (CFC), transferor trust, and foreign investment fund (FIF) rules.

[50] A dividend is a "non-portfolio dividend" if the company receiving it has "an interest of 10% or more in the voting power of the distributing company at the time the dividend is paid." Toryanik, *supra* note 8, ¶ 7.2.1.3. Note that while this income is not taxable and therefore interest incurred in relation to deriving it would be denied under ITAA 1997 s 8-1, a deduction is allowed for such interest under s 23AJ. *See id.* ¶ 1.4.5.

[51] Toryanik, *supra* note 8, ¶¶ 7.2.1.1, 7.2.6. *See also* ITAA 1936 ss 23AI, 23AJ.

[52] Toryanik, *supra* note 8, ¶ 7.2.6.

[53] *Id.* ¶ 6.1.1.

[54] *Id.*

[55] *Id.* ¶ 6.1.1. *See also* ITAA 1997 s 207-20; Toryanik, *supra* note 8, ¶ 1.4.4 (stating that "from 1 July 2002, the rebate for intercorporate dividends was replaced by the simplified imputation system. As such, intercorporate dividends are generally included in the assessable income of the recipient."); *id.* ¶ 1.2.1.1. (stating that "A resident shareholder of a company is liable to income tax on all dividends paid to him by the company out of profits derived by it from any source (Sec. 44(1)(a) ITAA 36), except those which are exempt from tax in certain circumstances.").

[56] *Id.* ¶ 6.1.2. and 6.1.1. *See also id.* ¶ 1.2.1.1. (stating that "A non-resident is liable to income tax on all dividends paid out of profits derived from sources in Australia. It is irrelevant whether the dividends are paid by resident or non-resident companies (Sec. 44(1)(b) ITAA 36). Nevertheless, if dividends are subject to withholding

B. Deductibility of Distributions

In general, dividends are not deductible for the distributing company.[58] However, dividends paid under instruments that are classified as "debt" under the debt/equity rules discussed above are deductible, subject to limitations.[59] In addition, "a deduction may be allowed for on-payments of unfranked non-portfolio dividends (including non-share dividends) by an Australian resident company to its foreign resident parent."[60]

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

New laws relating to the taxation of Employee Share Schemes (ESS) came into effect from July 1, 2009.[61] An ESS is "a scheme under which ESS interests in a company are provided to employees (including past or prospective employees and their associates) in relation to the employee's employment."[62] Such schemes are now specifically excluded from being taxed under the standard fringe benefit provisions[63] and will qualify for concessional treatment depending on the type[64] of scheme offered and if certain conditions[65] are met. In some cases, up to an AU$1,000 (about US$1,060) concession is available to an employee participating in a "taxed up-front" scheme where the employee's net taxable income is AU$180,000 (about US$190,480) or less.[66]

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tax or would be subject to withholding tax if they were not franked, they are exempt from ordinary income tax (Sec. 128D ITAA 36).").

[57] *Id.* ¶ 6.1.1.

[58] *Id.* ¶ 1.4.5.

[59] *Id.*

[60] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 106 (referring to ITAA 1936 s 46FA). A "non-portfolio dividend" is, broadly speaking, a dividend paid to a company with at least a 10 percent voting interest in the company paying the dividend.

[61] *ESS – Guide for Employers*, ATO, http://www.ato.gov.au/businesses/content.aspx?doc=/content/00224626.htm (last visited June 20, 2011). *See generally Employee Share Schemes*, ATO, http://www.ato.gov.au/businesses/pathway.aspx?pc=001/003/120&mfp=001/003&mnu=49312#001_003_120 (last visited June 20, 2011).

[62] *ESS – Guide for Employers: Taxation Arrangements for Employee Share Schemes*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=3&H3 (last visited June 20, 2011).

[63] *See* Toryanik, *supra* note 8, ¶ 4.3. The rules relating to the taxation of fringe benefits are contained in the *Fringe Benefits Tax Assessment 1986* (Cth).

[64] *ESS – Guide for Employers: Types of Employee Share Schemes*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=4&H4 (last visited June 20, 2011).

[65] *ESS – Guide for Employers: General Conditions for Concessional Tax Treatment*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=5&H5 (last visited June 20, 2011).

[66] *ESS – Guide for Employers: Taxed-upfront Schemes*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=6&H6 (last visited June 20, 2011).

Generally, there is no deduction available for employers who issue interests to employees under an ESS. However, the new rules provide for a limited deduction in situations where the above $1,000 concession is available. Where an employer provides interest in such a scheme, "a deduction equal to the amount of the upfront concession is available to employers up to a maximum of $1,000."[67] A general deduction may also be available if an employer provides "money or other property to an employee share trust to enable it to acquire securities to provide" to employees who then have "an interest in a specific number of shares in the trust (rather than specific shares)."[68]

VI. Treatment of Debt Cancellation

Debt forgiveness rules apply to the "commercial debts" of both businesses and individuals.[69] A debt is "commercial" if "part or all of the interest payable on the debt is, or would be, an allowable deduction."[70] Under these rules, the creditor may be able to claim a deduction in relation to waiving the debt, while (in order to avoid double deductions) the amount of debt that is forgiven may need to be applied to reduce certain deductions of the debtor.[71] Specifically, a forgiven amount may reduce, in the following order, a taxpayer's prior income year revenue losses, net capital losses from earlier years, deductible expenditure, and cost base and reduced cost base of assets.[72]

In line with the above reference to payments to related entities, the debt forgiveness rules will not apply where the debtor is a shareholder of the company. They will also not apply where the debtor is an employee and the forgiveness constitutes a form of benefit or payment arising from the employment relationship.[73] In those situations the forgiven amount will be deemed to be a dividend or considered a fringe benefit and treated as such for tax purposes. The commercial debt forgiveness rules also do not apply if the debt is forgiven as a result of an action under bankruptcy law, in a deceased person's will, or for reasons of "natural love and affection."[74]

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[67] *ESS – Guide for Employers: Deduction by Employers*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=30&H30 (last visited June 20, 2011).

[68] *ESS – Guide for Employers: Share Trusts*, ATO, http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00224626.htm&page=32#P553_50390 (last visited June 20, 2011).

[69] *See* ITAA 1997 Div 245. A debt is defined for these purposes as "an enforceable obligation imposed by law on a person to pay an amount to another person, and includes accrued interest." DEUTSCH ET AL., *supra* note 5, at 779.

[70] *CGT and Debt Forgiveness*, ATO, http://www.ato.gov.au/content/36559.htm (last modified May 18, 2011). *See also* DEUTSCH ET AL., *supra* note 5, at 779.

[71] DEUTSCH ET AL., *supra* note 5, at 779.

[72] *CGT and Debt Forgiveness*, *supra* note 70.

[73] AUSTRALIAN MASTER TAX GUIDE, *supra* note 7, at 980.

[74] *CGT and Debt Forgiveness*, *supra* note 70.

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CANADA

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

A reasonable amount of interest paid by a business on money borrowed to earn income is generally deductible in calculating taxable income. Interest paid on money borrowed to produce tax-exempt income is not deductible. Thin capitalization rules exist to prevent nonresidents from withdrawing corporate profits in the form of interest payments. Canadian law does not establish equity thresholds. Dividends received by individual taxpayers are taxable. Such dividends are multiplied by 125 or 144 percent, but a tax credit can then be claimed to reduce the amount otherwise owing. Canada's tax laws do not directly address employee stock ownership plans, but do contain debt forgiveness rules. Under these rules, half of the amount forgiven is generally taxable after non-capital and capital losses are taken into account.

I. Introduction

The general rule under Canada's Income Tax Act (I.T.A.) is that a reasonable amount of interest paid on money borrowed for the purpose of earning income from a business or property is deductible in the year in which it is paid, provided that there was a legal obligation to pay the interest and the money was not borrowed to earn tax-exempt income or acquire a life insurance policy.[1] The provision of the Income Tax Act that creates this general rule was added after the courts had ruled that interest paid on acquired properties should generally be capitalized.[2] The addition of this rule has not, however, ended litigation over the deductibility of interest paid by a business. Such questions as what is a reasonable amount, what is a legal obligation, what is interest, and what must be shown to demonstrate an intention to earn income have all been extensively reviewed by the judiciary and tax authorities. The Canada Revenue Agency has issued an Interpretation Bulletin on Interest Deductibility and Related Issues.[3] The Bulletin is not binding on the courts, but summarizes the Agency's interpretation of the current state of the law.

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[1] Income Tax Act, R.S.C. ch. 1, § 20(1)(c) (5th Supp. 1989), *as amended*, http://laws-lois.justice.gc.ca/eng/acts/I-3.3/index.html.

[2] 2 Canadian Tax Rep. (CCH Canada) ¶ 5061a.

[3] Canada Revenue Agency, Interest Deductibility and Related Issues, No. IT-533 (Oct. 31, 2003), http://www.cra-arc.gc.ca/E/pub/tp/it533/it533-e.html.

One other notable restriction on the deductibility of interest by a business is that interest paid on money borrowed to acquire property in the hope of earning only a capital gain and not income is not currently deductible, but may be capitalized.

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

Canada does have thin capitalization rules that are designed to prevent "non-residents of Canada who own significant shareholding (generally over 25%) in Canadian resident corporations from withdrawing the profits of that Canadian resident corporation from Canada in the form of interest payments."[4] If this was allowed these payments would be deductible in computing income. The thin-capitalization rules require the payments to be treated as dividends that must be paid out of earnings accumulated after Canadian tax.[5]

This limitation is only imposed on debtors who are corporations. The general rule is that, if the amount of outstanding debts to specified nonresidents exceeds two times the equity of the Canadian corporation, a prorated portion of any interest paid is not allowed in computing the income of the Canadian corporation. This is a fairly technical rule and the formulas for prorating disallowed interest expenses are complex.

The amount of "equity" of a borrower corporation is the aggregate of retained earnings, contributed surplus, and paid-up capital. Contributed surplus and paid-up capital are calculated on a monthly basis and then divided to give monthly averages. This method is intended to limit the ability of nonresidents of Canada who have significant shareholding in Canadian resident corporations from being able to inject capital into a corporation at the end of a year in order to avoid a thin-capitalization problem.[6]

B. Limits on Borrowing for Tax-Exempt Income

The I.T.A. does not allow the deduction of interest paid on money borrowed to produce tax-exempt income.[7]

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

Canada has a general anti-avoidance rule (GAAR), which can apply to "any transaction … that, but for [the GAAR], would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for

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[4] 3 Canadian Tax Rep. (CCH Canada) ¶ 4867.

[5] *Id.*

[6] *Id.* ¶ 4869.

[7] Income Tax Act, R.S.C. ch. 1, § 20(1)(c).

bona fide purposes other than to obtain the tax benefit."[8] However, it is limited to cases of misuse of Canada's laws or tax treaties. The cases summarized in the *Canada Tax Reporter* do not indicate that the GAAR has been used to limit the amount of debt a corporation can carry.[9]

B. Other Limitations

Canadian law does not appear to protect the paid-in share capital by requiring a threshold amount of equity, or by preventing corporations from buying their own stock. No investment laws that are intended to protect investors from highly leveraged investments have been found.

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

In Canada, the basic federal corporate income tax rate is 16.5 percent. This rate is reduced to 11 percent for Canadian-controlled private corporations that can claim the small business deduction.

The provinces have two tax rates. The appropriate rate for a corporation is usually determined by the size of its profits. The lower rates extend from 0 to 5 percent, but are mostly 4 to 4.5 percent. The higher rates extend from 10 to 16 percent, but average approximately 13 percent. Provincial income taxes are added to federal taxes.[10]

The taxation of dividends in Canada is an extremely complex subject as it is dependent on many factors and subject to many exceptions. However, the basic rule is that dividends are not tax deductible in computing taxable income and are therefore usually paid out of after-tax profits. Intercorporate dividends are generally not taxed in the hands of the recipient, unless the recipient is a closely-held corporation being used to avoid tax, but they are taxed in the hands of individual shareholders.[11]

There is a system for partially mitigating double taxation in these cases, which is basically designed to try to ensure that the amount of tax being paid by Canadian residents on Canadian dividends is roughly equal to what the individual would have paid on a direct investment. This system requires the taxpayer to first "gross up" his or her dividends and then allows him or her to claim a dividend tax credit. There are two types of dividends. "Eligible dividends" are usually from small Canadian corporations that are taxed at a lower rate. These dividends must be grossed up by 144 percent. Other dividends must be grossed up by 125

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[8] *Id.* § 245(1).

[9] *See* 5A Canadian Tax Rep. (CCH Canada) ¶ 27,886e.

[10] Canada Revenue Agency, Corporation Tax Rates, http://www.cra-arc.gc.ca/tx/bsnss/tpcs/crprtns/rts-eng.html (last modified June 21, 2011).

[11] Income Tax Act , R.S.C. ch. 1, § 112.

percent.[12] The grossed up dividends are added to income and the taxpayer must calculate the amount of tax he or she would have to pay on that total amount at their marginal tax rate. Once this calculation is made, the taxpayer can claim a tax credit of approximately 18 percent on eligible dividends and 13.3 percent on other dividends.[13]

B. Deductibility of Dividends

Dividends are not a deductible expense for distributing corporations as they are paid out of after-tax profits.[14]

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

The I.T.A. does not appear to have provisions specifically addressing employee stock ownership plans. The Canada Revenue Agency reports that payments to such a plan would be deductible as a business expense and, if paid to the employee, would be considered income.[15]

VI. Treatment of Debt Cancellation

The I.T.A. contains complex debt forgiveness rules that apply when a commercial obligation of a debtor is settled without payment, or with a payment of an amount that is less than the principle amount or the amount for which it was issued.[16] Basically, the forgiven amount is used to reduce non-capital losses and capital loss carryforwards as well as tax costs of properties and resource expenditures. One half of any remainder must be added to a corporation's income for a tax year. In the case of a partnership, the full amount must be added to the partnership's income. The debt forgiveness rules apply to trade debts as well as other forms of commercial obligations.[17]

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[12] Canada Revenue Agency, Line 120–Taxable Amount of Dividends (Eligible and Other Than Eligible) from Taxable Canadian Corporations, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/rprtng-ncm/lns101-170/120/menu-eng.html (last modified Jan. 5, 2011).

[13] Canada Revenue Agency, Line 425–Federal Dividend Tax Credit, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns409-485/425-eng.html (last modified Jan. 5, 2011).

[14] Income Tax Act, R.S.C. ch. 1, § 112.

[15] Telephone Interview with Canada Revenue Agency Official (June 26, 2011).

[16] Income Tax Act, R.S.C. ch. 1, §§ 80–80.04.

[17] Canada Revenue Agency, IT-293R, Debtor's Gain on Settlement of Debt, http://www.cra-arc.gc.ca/E/pub/tp/it293r/it293r-e.html (last modified Aug. 5, 2002).

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FRANCE

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

As a general rule interest paid on corporate debt is deductible from a corporation's gross income under French law. The deductibility of interest, however, may be restricted by thin capitalization rules. Corporations are subject to corporate tax on their earnings and profits whether or not distributed to the shareholders. Once distributed, the profits are again taxed either under the personal income tax or the corporate tax depending on the status of the beneficiary of the distribution. This "double taxation" is mitigated either by the parent-subsidiary tax exemption regime or by the 40 percent income allowance for individual taxpayers. Dividends distributed under an employee stock ownership plan are not deductible. The tax treatment of debt cancellation depends on whether or not such cancellation is of a "normal nature" and on whether the debt cancellation is of a financial or commercial nature.

I. Introduction

As a general rule, financial expenses (essentially interest paid on money borrowed or advanced) are deductible from a corporation's gross income under French law. There are, however, two situations in which the deductibility of interest is cut back by special rules. The first concerns the case where the lender is an associate of, controlled by, or in control of the borrowing corporation. The second deals with interest incurred by a corporation on loans to another corporation that is directly or indirectly related (earnings stripping/thin capitalization).[1]

New thin-capitalization rules were introduced by the 2006 Finance Law applicable on or after January 1, 2007.[2] In addition, the 2011 Finance Law introduced a provision extending the scope of the rules to certain loans granted by third-party lenders and guaranteed by a related party.[3] Previous thin capitalization provisions had been challenged on two grounds: inconsistency with bilateral tax treaties and inconsistency with the freedom of establishment principle as set forth in the Treaty of Rome, which founded the European Union (EU).[4]

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[1] FRENCH TAX & BUSINESS LAW GUIDE (Sweet and Maxwell) ¶ 21760.

[2] *Id.* ¶¶ 21772–21774.

[3] *Id.* ¶ 21774; CODE GENERAL DES IMPÔTS [C.G.I.] art. 212, *available at* LEGIFRANCE, http://legifrance.gouv.fr/ (*Les codes en vigueur*).

[4] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶¶ 21772–21774.

A limitation on interest deductions previously applied to loans by foreign parent corporations to their French subsidiaries. The same limitation was not imposed on French parent corporations. This discriminatory treatment violated nondiscrimination provisions of bilateral treaties that followed the Organisation for Economic Co-operation (OEDC) model and the EU freedom of establishment clause. The new regime applies to French parent corporations as well as foreign parent corporations.[5]

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

Thin-capitalization rules apply to the following:

1. *Entities subject to corporate income tax.*

2. *Loans granted to the borrowing corporation by any related party or secured directly or indirectly by a related party.* Two corporations are considered related where (i) one of the corporations, directly or indirectly, holds the majority of the share capital of the other or de facto exercises the power to make decisions; or (ii) the two corporations are under the control of a third corporation, directly or indirectly, under the conditions stated in (i), above.[6]

3. *Loans granted by unrelated lenders when the reimbursement of such loans is guaranteed by a related party.*[7] This provision is set forth by the 2011 Finance Law aimed at excluding back-to-back loans that might be used to avoid the thin capitalization rules. There are two exceptions so that normal corporate financial transactions are not affected: obligations issued in the context of a public offering and certain categories of loans incurred for leveraged buyouts.[8]

Interest incurred by a borrowing corporation on loans granted by related parties is only deductable within the limit of a maximum interest rate, which is either the rate referred to in article 39-1-3-1 of the General Tax Code (average effective floating rate on bank loans with a minimum maturity of two years) or, if higher, the rate that the borrowing corporation could have obtained from independent financial institutions in similar circumstances.[9]

If the interest rate on the related-party loan complies with the rate explained above, interest on such a loan will be fully deductable subject to thin capitalization limitations described

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[5] *Id.*

[6] C.G.I. art. 39(12).

[7] *Id.* art. 212.

[8] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶ 21-774.

[9] C.G.I. art. 39-1-3-1.

below. If the interest rate exceeds the maximum interest rate, the excess portion will be included in the borrowing corporation's taxable income and treated as a constructive dividend.[10]

A borrowing corporation will be deemed thinly-capitalized if the total amount of interest incurred on related party loans, which is deductable under the interest rate test, simultaneously exceeds the three following limits within the relevant fiscal year:

- The overall indebtedness in respect of loans granted by the related parties (i.e. all receivables, except trade receivables) exceeds 1.5 times the net equity of the borrower (including share premiums [and] retained earnings), i.e. a debt/equity ratio of 1.5:1;

- The amount of the interest paid to the related companies exceeds 25% of the adjusted operating profits (grossed-up by the tax, the interests paid to related parties, depreciation and amortization, [and] certain lease payments) realized by the borrower, i.e. interest/profit ratio of 1:4; and

- The amount of interest paid to related parties exceeds the amount of interest received from affiliated companies, i.e. interest paid/interest received ratio of 1:1.[11]

The part of the interest paid by the borrowing corporation that exceeds the three limits described above is not deductible unless it does not exceed €150,000.[12] Interest exceeding this threshold may be carried forward in subsequent years under certain conditions.[13]

The General Tax Code also includes a safe-harbor provision. The borrowing corporation may avoid the limitation if it brings evidence that the overall debt/equity ratio of the group to which it belongs is, with respect to the relevant fiscal year, equal to or higher than its own overall debt/equity ratio.[14]

As mentioned in the introduction, the deductibility of interest may also be restricted where the lender is an associate of, controlled by, or in control of the borrowing corporation. Deductibility is subject to three conditions: (1) the corporation capital must be entirely paid; (2) the interest rate must not exceed a set maximum, which is set by the Bank of France each quarter and published in the *Journal Officiel*, France's official gazette (however, the maximum rate may be exceeded for shareholders loans that are regular commercial credit transactions in which shareholders are acting as regular clients or suppliers of the corporation paying the interest); and (3) the total loans must not exceed a debt-equity ratio of 1:5. This third restriction applies to

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[10] *Id.* art. 212.

[11] Eric Robert, *France – Corporate Taxation* ¶ 10.3, *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: EUROPEAN TAX SURVEYS, *available at* http://ip-online.ibfd.org/eth/ (by subscription) (last visited June 15, 2011); C.G.I. art. 212.

[12] At the current exchange rate €1 is equal to approximately US$1.43.

[13] C.G.I. art. 212 III.

[14] *Id.*

loans made to a corporation by managing associates or associates holding more than 50 percent of the voting or capital stock of such corporation.[15]

B. Limits on Borrowing for Tax-Exempt Income

N/A

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

France has a general anti-avoidance rule. The French tax authorities are empowered to disregard or recast any legal arrangements, transactions, or legal acts that are either "artificial" and/or have been executed or entered into for the sole purpose of avoiding French tax by relying on a literal application of the law to achieve a result that contradicts the real objective of lawmakers.[16]

No information on whether this rule is used to limit debt versus equity could be located.

B. Other Limitations

It does not appear that there is any other significant limitation. Prior to 1998, the Commercial Code prohibited corporations from subscribing to or repurchasing its own shares. The Code now only prohibits a corporation from subscribing to its own shares. Repurchasing of its own shares by a corporation is authorized: (1) to achieve a reduction in capital not motivated by losses; (2) to redistribute the shares to the corporation's employee pursuant to a tax-qualified profit-sharing plan or to offer the employees tax-qualified stock options; and (3) within the framework of a redemption plan. This procedure permits French corporations that are quoted on a regular stock exchange to repurchase their shares without a public offering.[17]

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

A corporation established in France is subject to corporate tax at 33.33 percent on its earning and profits whether or not distributed to its shareholders. Once distributed, the profits are again taxed either under the personal income tax or the corporate tax depending on the status of the beneficiary of the distribution. This "double taxation" is mitigated either by the parent-subsidiary tax exemption regime or by the 40 percent income allowance for individual taxpayers.[18]

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[15] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶ 21-770.

[16] Robert, *supra* note 11, ¶ 10.1.1.

[17] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶ 14-030.

[18] *Id.* ¶ 27-500.

Under the parent-subsidiary tax exemption regime, 95 percent of the gross dividends the parent corporation receives from its subsidiaries are tax exempt. A lump sum of 5 percent of the gross dividends, deemed to represent nondeductible expenses, must be added back to the taxable income of the parent corporation and taxed at the standard rate. If, however, the parent corporation can establish that its expenses incurred during the year of receipt of the dividends were less than 5 percent, the difference between the 5 percent and the paid expenses may also be excluded from taxable income.[19]

As a general rule, 40 percent of dividends received by an individual from a corporation subject to corporate income tax or equivalent tax whose registered office is located in France or in an other EU member state, or in a country that entered into a double taxation treaty with France containing an administrative assistance clause, is exempt from tax. An additional €1,525 for a single taxpayer or €3,050 for a married couple is also exempt from tax. The remaining dividends are subject to income tax at the ordinary tax rate.[20]

B. Deductibility of Distributions

Generally, a corporation cannot claim any deductions for dividend distributions. There is, however, one minor exception to this rule: compensation of the administrative board members for attending board meetings is considered a dividend in the hands of the administrators and taxed as such even though it is still deductible for corporation purposes as a personnel expense.[21]

V. Deductions for Distributing Dividends under an Employee Stock Ownership Plan

France has adopted several statutory schemes to encourage the ownership by employees of stocks in their employer corporations or other French corporations. They include employee stock option plans (*options de souscription ou d'achat d'actions*), employee free share plans, and savings investment plans. Below is a brief discussion of the key features of employee stock option plans and of the tax consequences for the granting corporation.[22]

A corporation may grant to some or all of its employees either an option to subscribe to shares of stock to be issued by the corporation pursuant to an increase in registered capital or an option to purchase shares repurchased by the corporation for the purpose of the stock option plan. The implementation of a stock option plan by a French corporation requires shareholder approval. The shareholders must adopt a resolution at an Extraordinary General Meeting (EGM) authorizing the Board of Directors to grant such options. The EGM determines the period during which said authorization may by used by the Board of Director, the conditions under which the

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[19] C.G.I. art. 216(I); Robert, *supra* note 11, ¶ 6.1.3.1.

[20] Marc Henderson, *France–Individual Taxation* ¶ 1.5.1, *in* IBFD: EUROPEAN TAX ANALYSIS, http://online.ibfd.org/kbase/ (by subscription) (last visited June 15, 2011).

[21] FRENCH TAX & BUSINESS LAW GUIDE, *supra* note 1, ¶ ¶ 10-140; 27-530.

[22] DOING BUSINESS IN FRANCE (Matthew Bender) ¶ 12.05[3][b].

options may be granted, and the period, if any, during which the shares issued upon the exercise of the option will remain inalienable. This period cannot exceed thee years.[23]

The granting corporation is entitled to claim a deduction for the following expenses: (1) expenses incurred in connection with the purchase of shares that are intended for the employees; (2) capital increase expenses in the case of a subscription option; (3) expenses related to the management of the shares purchased or issued until the date the option is exercised; and (4) various expenses paid in relation to the exercise by the employees of subscription or purchase options (e.g. agent's commission, taxes related to stock exchange activities, stamp duties, etc.).[24]

In addition, any capital losses incurred upon the repurchase of stock that is subsequently sold to an employee pursuant to the stock option plan may be deductible. Where the stock option plan provides for a capital increase, the corporation is entitled to deduct the difference between the purchase price it paid and the exercise price paid by the employee if (1) the stock option plan benefits all the employees; and (2) the distribution of the stock options is uniform, proportionate to salary or seniority, or a combination of these factors.[25]

No provision authorizing deductions for the distribution of dividends under an employee stock ownership plan could be found.

VI. Treatment of Debt Cancellation

A. General Statement

Debt cancellation and the grant of a subsidy receive the same tax treatment under French tax law. The tax treatment of debt cancellation depends on whether or not such cancellation is of a "normal nature."[26] In order to be considered of a normal nature, the debt cancellation granted by a parent/creditor to its subsidiary/debtor must rest on valid business reasons. The fact that the debt cancellation was granted in the interest of the corporation and that there exists real and sufficient consideration must be established. Debt cancellation is generally not considered abnormal where a creditor waives its receivables from an affiliated corporation in financial distress, specifically if there is a risk that recovering the debt could result in the insolvency or bankruptcy of the affiliated corporation and thus have an impact on the creditor's commercial or financial status.[27]

The tax treatment will further depend on whether the debt cancellation was of a financial or commercial nature. The debt cancellation is of a financial nature where the ties between the

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[23] *Id.*

[24] I LAMY FISCAL, IMPÔTS SUR LE REVENU § 794 (Lamy 2011).

[25] *Id.*

[26] I LAMY FISCAL, IMPOTS SUR LE REVENU, *supra* note 24, § 797; Les abandons de créances et subventions entre entreprises [Debt cancellation and subsidies between companies], *in* DROIT FISCAL, *available at* http://www.lexbase.fr/ (by subscription) (last visited June 23, 2011).

[27] *Id.*

creditor and debtor and the reasons behind the cancellation are of a strict financial nature. The tax administration, for example, ruled that the following debt cancellations have a financial nature: debt cancellation or subsidy granted by a corporation to another corporation in order to terminate their commercial relations; debt cancellation or subsidy granted by the parent corporation to its subsidiary in the absence of any significant commercial relations; and debt cancellation or subsidy granted by a corporation participating in the financial reorganization of another corporation, group, or a determined economic sector.[28]

Debt cancellation is of a commercial nature if it has its source in a business relationship between the debtor and the creditor, i.e., for the creditor to maintain its customer base or to preserve its source of supply.[29]

B. Tax Treatment of the Creditor

The creditor may not deduct the amount of the debt cancellation if such debt cancellation is considered abnormal.[30]

A debt cancellation of a financial nature is deductible only up to a certain amount. As waiving a debt owed to a parent corporation increases the net asset value of the subsidiary, the deduction of the debt waived is only permissible up to the amount of the negative net asset value of the subsidiary, if any, and the positive net asset value after debt waiver allocable to the other shareholders.[31] The following example illustrates this rule:

> A parent corporation owns 90 percent of the capital of its subsidiary. This subsidiary has a negative net asset of €50,000. The parent corporation grants its subsidiary a debt forgiveness of €70,000. The parent corporation will be able to deduct €50,000 (amount of negative net asset of the subsidiary) plus €2000 ([70,000-50,000] x 10%), which is the positive net asset value after debt waiver allocable to the other shareholders.[32]

When the debt cancellation is of a commercial nature, the entire amount is fully deductible by the creditor. This charge has to be deducted from the result of the financial year during which the cancellation takes place.[33]

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[28] I LAMY FISCAL, IMPOTS SUR LE REVENU, *supra* note 24, § 798; Les abandons de créances et subventions entre entreprises [Debt cancellation and subsidies between companies], *in* DROIT FISCAL, *available at* http://www.lexbase.fr/ (by subscription) (last visited June 23, 2011).

[29] I LAMY FISCAL, IMPOTS SUR LE REVENU, *supra* note 24, § 798; Les abandons de créances et subventions entre entreprises, *in* DROIT FISCAL.

[30] I LAMY FISCAL, IMPOTS SUR LE REVENU, *supra* note 24, §§ 799, 800; Les abandons de créances et subventions entre entreprises [Debt cancellation and subsidies between companies], *in* DROIT FISCAL, *available at* http://www.lexbase.fr/ (by subscription) (last visited June 23, 2011).

[31] *Id.*

[32] *Id.*

[33] *Id.*

If the debt cancellation contains a recapture clause on return to better fortune, the eventual reimbursement of the reinstated debt leads to taxation in the hands of the creditor but only for any sums that were initially deducted for tax purposes.[34]

C. Tax Treatment of the Debtor

The debtor is taxable on the amount of the debt cancelled if such debt cancellation is considered to be abnormal. The tax treatment will again depend on whether the debt cancellation is of a financial or commercial nature if the debt cancellation is considered normal.[35]

If a debt cancellation is of a financial nature, the part that is deductible by the creditor constitutes taxable profit in the hands of the debtor subject to a corporate income tax rate of 33.1/3 percent. The part that is not deductible by the creditor is not taxable in the hands of the debtor provided that (1) the creditor is the parent corporation of the debtor for tax purposes, and (2) the debtor undertakes to increase its capital by an amount equal to the debt waiver within the following two years. If these conditions are not fulfilled, the entire amount of the debt waived is taxable in the hands of the debtor.[36]

If a debt cancellation is of a commercial nature, it is fully taxable in the hands of the debtor.[37]

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[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *Id.*

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GERMANY

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

In 2008, Germany replaced its equity-stripping rules with a more stringent restriction on the deductibility of interest that applies to domestic and foreign creditors irrespective of their relationship to the debtor company. In addition, Germany disallows deductions for interest that is attributable to tax-exempt income, and treats inappropriate interest payments to shareholders as constructive dividends.

Germany lowered its tax rate in recent years and grants relief from economic double taxation of corporate incomes through the tax exemption of 95 percent of all domestic and foreign intercorporate dividends.

Germany treats the forgiveness of a corporate debt as taxable income while granting relief from this principle in bankruptcy situations.

I. Introduction

German tax law underwent numerous changes in the past decade that were aimed at making Germany a more competitive business location. The most striking of these was a drop in the corporate tax rate from 40 percent to 25 percent in 2001,[1] followed by a drop from 25 percent to 15 percent in 2008.[2] The treatment of debt, however, did not participate in this "race to the bottom." To the contrary, Germany intended to recoup some of the revenue losses when it flanked the enactment of the lower tax rate for 2008 with the enactment of a novel and stringent limitation on debt financing (interest barrier).[3]

In Germany, corporations and limited liability companies are taxed in accordance with the Corporate Income Tax Act.[4] Their taxable income, however, is computed in accordance with the net worth comparison method as provided in the Income Tax Act for the business of

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[1] Lorenz Jarass & Gustav Obermair, *Earnings before Interest (EBIT) instead of Profits as a Tax Base?* EUROPEAN TAXATION 38, 41 n.13 (2007).

[2] Unternehmenssteuerreformgesetz 2008 [UntStRefG 2008], Aug. 14, 2007, BUNDESGESETZBLATT [BGBL.] I at 1912.

[3] Bernd Jonas, *Zinsschranke–Neuorientierung der Konzernfinanzierung*, *in* Harald Schaumburg & Detlev Piltz, Grensüberschreitende Gesellschaftsstrukturen im Internationalen Steuerrecht 33 (2010).

[4] Körperschaftsteuergesetz [KStG], repromulgated Oct. 15, 2002, BGBL. I at 4210, *as amended.*

individual taxpayers.[5] Under this method, the taxable annual income is the difference between the net worth of the taxable year and that of the preceding year.[6] The net worth at the end of each year is established through the annual financial statement in which profits show up as increases in assets or decreases in liabilities. Deductible expenses, on the other hand, show up as decreases in assets or increases in liabilities.[7] Under German tax law, interest expenses are generally deductible if they are occasioned by the business;[8] the major exception from this principle is the recently enacted interest barrier that limits the amount of deductible interest.

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

1. The Development of the Interest Barrier

Until 2008 Germany had equity-stripping rules that were aimed at limiting debt financing by foreign shareholders in order to protect against revenue losses.[9] These rules applied a 1.5-to-1 debt-to-equity ratio to the corporate debtor and converted interest paid on certain shareholder loans to constructive dividends. From 2002 on, these rules applied to interest paid to domestic as well as foreign shareholders[10] in order to comply with the *Lankhorst-Hohorst* decision of the European Court of Justice,[11] which held that earlier German equity-stripping rules violated the freedom of capital movements of the European Treaty[12] by discriminating against loans from other EU member states.

The new deductibility limitation on interest was enacted in 2007 and became effective in 2008.[13] It is aptly referred to as an interest barrier, and it departs from former concepts by limiting the deductibility of interest from all types of loans, including bank loans. The harshness of the measure has led to numerous complaints and to two modest reforms that raised the interest threshold and enhanced the carry-forward of undeducted interest, and thereby may have helped smaller German companies avoid the measure.[14] Nevertheless, German business is complaining about the timing of the restriction, which hit business during a recession.[15]

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[5] Einkommensteuergesetz [EStG], repromulgated Oct. 19, 2002, BGBL. I at 4210, § 5.

[6] Id.

[7] Henry J. Gumpel et al., 1 Taxation in the Federal Republic of Germany ¶ 2/2.3 (CCH, 1991).

[8] *Id.* ¶ 7/2.5.

[9] KStG § 8a, as effective until Dec. 31, 2008.

[10] First by case law, *see* BERND ERLE & THOMAS SAUTER, KÖRPERSCHAFTSSTEUERGESETZ 610 (3rd ed., 2010), and then by virtue of KStG § 8a as enacted by Gesetz, Dec. 22, 2003, BGBL. I at 2840.

[11] Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, Sept. 26, 2002, E.C.R. I-11779.

[12] EC Treaty art. 43 (as in effect in 2002) (now Consolidated Version of the Treaty on the Functioning of the European Union art. 49).

[13] KStG § 8a in conjunction with EStG § 4h.

[14] In July 2009, relief was granted by increasing the exempted amount of net interest from €1 million (about US$1.41 million) to €3 million (ahout US$4.23 million) on a temporary basis. Bürgerentlastungsgesetz Krankenversicherung July 16, 2009, BGBL. I at 1959. A stimulus law of December 2009 made that ehange

Both the former and present thin capitalization rules were influenced by section 163(j) of the U.S. Internal Revenue Code.[16] It appears, however, that the current German interest barrier disallows more interest deductions than the equity-stripping system of the United States.[17] Moreover, German critics have asserted that the German system is more restrictive than that of other European countries.[18]

The interest barrier rules of 2008 had the legislative purpose of preserving domestic revenue by disallowing excessive interest payments to foreign shareholders.[19] Nevertheless, the rules do not distinguish on their face between domestic and foreign creditors, in order to comply with European Union law. Domestic shareholders, however, may mitigate the effects of the rules by forming a consolidated group, thereby shifting the applicability of the rules from the affiliated companies to the overall group while permitting them to borrow from each other within the group.[20] Commentators have already raised the possibility that this preferred treatment of German creditors may once again lead to a European court decision invalidating the German rules.[21]

2. The Current Interest Barrier Rules

a) Subjected Entities

The interest barrier rules apply to an enterprise (*Betrieb*; hereinafter subjected entity),[22] and this concept does not necessarily coincide with an individual or corporate taxpayer. Individual taxpayers, in particular, may have several subjected entities.[23] Corporations usually are one entity,[24] yet they are only subjected to the regime if they are part of a group.[25] "Stand

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permanent and made it easier to carry undeducted interest forward. Wachstumsbeschleunigungsgesetz, Dec. 22, 2009, BGBL. I at 3950.

[15] Jonas, *supra* note 3, at 33.

[16] Markus Ernst, Gesellschafter-Fremdfinanzierung im Deutschen und U.S. –Amerikanischen Steuerrecht 19, 315 (Berlin, 2010).

[17] BDI/KPMG-Studie 2009, Die Behandlung von Finanzierungsaufwendungen: Ein Vergleich der Zinsschranke in Deutschland mit den Regelungen in den USA, Italien, Frankreich, den Niederlanden und Schweden 19, http://www.bdi.eu/download_content/Marketing/91707_BDI_Zinsschranke_final.pdf.

[18] *Id.* at 19.

[19] Antwort der Bundesregierung, Aug. 3, 2010, BUNDESTAG DRUCKSACHE 17/2696.

[20] KStG § 15(3).

[21] Sören Goebel & Karolina Eilinghoff, *(nicht-) Konformität der Zinsschranke mit dem Grundgesetz und Europarecht?*, DEUTSCHE STEUER ZEITSCHRIFT 550 (2010).

[22] EStG § 4h(1).

[23] Bundesministerium der Finanzen, Zinsschranke (§ 4h EStG; § 8a KStG), IV C 7- S 2742-a/o7/10001, July 4, 2008.

[24] Id.

[25] EStG § 4h(2)(b).

alone" corporations are subjected entities only if they pay interest to a related shareholder and that interest exceeds the net interest of the corporation (excess of interest expenses over interest earnings) by more than 10 percent.[26]

Members of a group, however, are also exempted if they belong to a consolidated group that submits one consolidated tax return for the entire group.[27] In such a situation, the affiliated companies may borrow from each other without penalty, and the interest barrier regime is applied to the overall group in its relations with third parties.[28]

In addition, an "escape clause" is provided that exempts a corporation from the interest barrier regime if its equity-to-profit ratio is not significantly less favorable than that of the overall group to which it belongs.[29]

b) The Interest Threshold and its Consequences

The regime restricts the deductibility of net interest (annual interest expenses exceeding annual interest earnings) if it is higher than 3 million Euros (approximately US$4.23 million) during the tax year.[30] Interest that falls below this threshold is fully deductible. Interest in excess of this threshold, however, can only be deducted up to 30 percent of the tax year's earnings before interest, taxes, depreciation, and amortization (EBITDA).[31] Nondeductible interest may be carried forward indefinitely, and it can be deducted against any "unused" 30 percent EBITDA allowance of future years. "Unused" EBITDA allowances also are carried forward, but only for five years, to be used according to the first-in, first-out method.[32]

B. Limits on Borrowing for Tax-Exempt Income

Section 3c of the Income Tax Code provides that expenses are not deductible if they are incurred in relation to tax-exempt income.[33] This provision applies to individual as well as corporate taxpayers.

The principle of denying deductions for tax-exempt income also seems to be realized in the taxation of intercorporate dividends. These are exempt from taxation, except for 5 percent of such income, which is taxed as a proxy for the disallowance of deductions.[34]

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[26] KStG § 8a(2).

[27] KStG § 14.

[28] KStG § 15.

[29] EStG § 4h(2)(c).

[30] EStG § 4h(2)(a).

[31] EStG § 4h(1).

[32] *Id.*

[33] EStG § 3c.

[34] *Infra* note 69 and accompanying text.

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

1. Overview

A significant disallowance of deductions for interest expenses is applied in the trade tax. Within the realm of corporate taxation, however, restrictions on the deductibility of interest are limited to the nondeductibility of interest payments without a business purpose,[35] the interest barrier, and the disallowance of deductions for interest attributable to tax-exempt income.[36] For businesses owned by individuals or partnership, the law also denies the deductibility of interest for debts contracted after the owners stripped the business of its assets.[37] This rule is closely related to the denial of non-business-related interest.[38] For corporations, however, the withdrawal of capital is to some extent prevented by rules of corporation law, as explained immediately below (Part III(B), "Other Limitations").

In addition, corporate interest expenses cannot be deducted for inappropriate corporate interest payments that are to be reclassified as constructive dividends, thus leading to the addition of the interest expense to the annual taxable income of the corporate entity.[39] The law provides two vehicles for accomplishing this goal—the constructive dividend rule of Corporation Tax Act § 8 and the general anti-avoidance rule of Fiscal Code § 42[40]—yet in the scant case law that has developed on this issue, the courts have not always been in agreement on how to draw the distinction between these two remedies.[41] Transfer pricing rules,[42] on the other hand, have until now not played a role in reevaluating inappropriate dividends.[43]

2. Trade Tax

The trade tax is a supplemental income tax that is imposed on plants and other business installations that are located in Germany. It is imposed on the basis of a federal law,[44] yet the local communities determine the applicable tax rate by applying a multiplier to the statutory

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[35] EStG § 4(4).

[36] Rolf Schwedhelm, *Die neue Zinsschranke für Kapitalgesellschaften*, DIE AKTIENGESELLSCHAFT 540 (2007).

[37] EStG § 4(4a).

[38] LUDWIG SCHMIDT, EINKOMMENSTEUERGESETZ § 4 nn.522–524 (27th ed. 2008).

[39] DIETMER GOSCH, KÖRPERSCHAFTSSTEUERGESETZ § 8 nn.192–194 (2nd ed. 2009).

[40] Abgabenordnung [AO], Mar. 16, 1976, BGBL. I at 613, *as amended.*

[41] *Id.*

[42] Aussensteuergesetz, Sept. 8, 1972, BGBL. I at 1713, *as amended*, § 1.

[43] GOSCH, *supra* note 39.

[44] Gewerbesteuergesetz [GewStG], repromulgated Dec. 15, 2002, BGBl. I at 4167, *as amended.*

rate.[45] The trade tax rate is applied to taxable income as determined for the individual or corporate income tax, and as adjusted by provisions of the Trade Tax Act.

One of these adjustments is an addition of deductions claimed for interest expenses. Currently, 25 percent of interest expenses that were deducted on a corporate or individual income tax return and that are attributable to the plant that is subject to the trade tax must be added to the adjusted taxable income to which the trade tax rate is applied.[46] The effect of this rule is the denial of the deductibility of 25 percent of interest expenses for the trade tax.

3. Constructive Dividends

According to Corporation Tax Act § 8(3), hidden distributions of profits to shareholders are reclassified as constructive dividends and added to the taxable income of the distributing corporation.[47] The courts have interpreted this provision as applying to benefits bestowed on a shareholder if these transfers lacked an appropriate business connection and diminished the profit of the distributing corporation.[48] This principle is also applied to interest payments that are excessive or not based on a valid legal or business reason,[49] yet it is immaterial for this reclassification whether the improper contribution was made with the intent of avoiding tax or for other reasons.[50] If interest is thus reclassified to a dividend, it will no longer be counted as an interest expense in the application of the interest barrier rules.[51]

4. General Anti-Avoidance Rule

Inappropriate interest payments can also be converted into a constructive dividend under application of Fiscal Code § 42. This general anti-avoidance rule can be applied when the taxpayer chooses a legal form or transaction that serves no purpose other than that of obtaining a tax advantage. Currently, it appears that this provision is not much used for interest payments,[52] due to the existence of the more specific provisions of the constructive dividend rule and the tax barrier rules.

In the past, however, the general anti-avoidance rule was the major vehicle for developing equity-stripping rules. Until the first enactment of the equity-stripping rules of section 8a of the Corporate Tax Code in 1993, the courts used the anti-avoidance provision to convert excessive interest into constructive dividends.[53] This practice, however, led to a lack of

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[45] GewStG § 11.

[46] GewStG § 8 no. 1(a).

[47] KStG § 32a.

[48] GOSCH, *supra* note 39, § 8 nn.166–170.

[49] *Id.* § 8 n.192.

[50] *Id.* § 8 nn.192–194.

[51] *Id.* at § 8 n.196.

[52] *Id.* § 8 nn.192–196.

[53] ERNST, *supra* note 16, at 19.

legal certainty because the courts oscillated between striking down abusive transactions between related taxpayers on the one hand and upholding a corporation's right to choose its form of financing on the other. To make the law more predictable, the 1993 version of section 8a of the Corporate Tax Code was enacted.[54]

B. Other Limitations

Company law imposes some restrictions on debt financing that aim at preserving the capital of the company. These include minimum capital requirements, limitations on a company's right to purchase its own stock, and limits on distributions to shareholders. Such rules exist for the limited liability company and the corporation.[55]

Limited liability companies must have a paid-in capital of at least €25,000 (approximately US$35,000).[56] The share capital, moreover, must be paid in[57] and may not be distributed to the shareholders.[58] The repurchase of a company's own shares is also restricted; in particular, the shares must be purchased from sufficient reserves.[59]

Corporations must have a paid-in share capital of €50, 000 (approximately US$70,000).[60] Corporations may acquire their own shares only for certain restricted purposes and to a limited extent. Most repurchase situations are limited to a repurchase of 10 percent of the stock and the purchase must be financed from reserves, not debt.[61] In addition, contributions may be repaid to shareholders only in very limited situations, and distributions to shareholders must be limited to distributable profits.[62]

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

The German corporate tax rate is 15 percent.[63] This rate is augmented by a 5.5 percent surcharge on taxable income, which is imposed to finance German unification.[64] This increases

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[54] *Id.*

[55] *Id.* at 21.

[56] Gesetz betreffend die Gesellschaft mit beschränkter Haftung [GmbHG], Apr. 20, 1892, BGBL. III no. 41231, *as amended*, § 5.

[57] GmbHG § 14.

[58] GmbHG § 30.

[59] GmbHG § 33.

[60] Aktiengesetz [AktG], Sept. 6, 1965, BGBL. I at 1089, *as amended*, § 7.

[61] AktG § 71.

[62] AktG § 7.

[63] KStG § 23.

[64] Solidaritätszuschlagsgesetz, repromulgated Oct. 15, 2002, BGBL. I at 4130, *as amended.*

the tax rate to 15.83 percent. In addition, domestic corporations are subject to trade tax at the plant level,[65] which, on average, amounts to 17 percent of taxable income.[66]

When Germany began lowering its corporate tax rate in 2000,[67] it abolished a complex imputation system for the taxation of corporate distributions that had been in effect since 1977. That system gave the shareholder a credit for the tax the corporation had paid on the distributed profits and also granted the corporation a lower tax rate for distributed profits.[68]

Since 2000, the current system of corporate taxation has governed. It taxes corporate profits with the same rate, irrespective of the distribution of the profits, and it exempts 95 percent of intercorporate dividend income from taxation. The remaining 5 percent is taxed as compensation for deductible business expenses that may have been attributable to this tax-exempt income.[69]

B. Deductibility of Distributions

The Corporation Tax Act states categorically in section 8(3) that the income of a corporation is not affected by its profit distributions. This denial of deductibility of distributions applies to dividends on shares. For hybrid instruments that straddle the distinction between participatory rights and debt instruments, deductibility is denied if the security grants the owner a right to participate in the profits of the company and in any return on its liquidation.[70] In Germany, the most common of these hybrid instruments is the jouissance share,[71] which has much in common with preferred stock in American corporate practice.

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

Germany does not have Employee Stock Ownership Plans that involve Employee Share Ownership Trusts.[72] German experts have been studying the American model, yet doubt whether it would be transferrable to Germany.[73] Germany encourages employee stock ownership through tax measures, primarily through partial income tax exemptions for the employee.[74] Companies that compensate employees with shares can deduct this compensation

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[65] *See supra* note 44 and accompanying text.

[66] Jarass & Obermair, *supra* note 1, at 41 n.13.

[67] *Id.* and accompanying text.

[68] ERLE & SAUTER, *supra* note 10, at 29.

[69] KStG, § 8b

[70] GOSCH, *supra* note 39, § 8 nn.148–151.

[71] Id.

[72] Jens Lowitzsch, Mitarbeiterbeteiligung und Unternehmensnachfolge in KMU – Der Employee Stock Ownership Plan, BETRIEBS-BERATER [BB] Beilage no. 001, 12 (2009).

[73] *Id.*

[74] Gregor Thüsing, Zum Entwurf eines Gesetzes zur steuerlichen Förderung der Mitarbeiterkapitalbeteiligung, BB Beilage no. 001, 6 (2009).

as an expense.[75] There is no rule that would allow the corporate employer to deduct dividend distributions on shares held by employees or groups of employees.[76]

VI. Treatment of Debt Cancellation

The forgiveness of a debt is taxable income for the corporate taxpayer. There is no statutory provision to this effect, yet this is an undisputed principle in German tax law that also applies to the forgiveness of a business debt of an individual taxpayer.[77] Cancelled debts are income because they decrease the liabilities of a company or business and thereby increase the taxable profit.[78]

Special rules, however, apply to debt cancellations in the course of a bankruptcy-related reorganization or an informal effort of creditors to salvage a failing company.[79] To the extent that such cancelled debts are not absorbed by losses and show a profit, their taxation is deemed to be a hardship that may lead to a forgiveness of the tax or to a postponement until the enterprise has recovered.[80]

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[75] SCHMIDT, *supra* note 38, § 4 n.520 – Arbeitslohn.

[76] There is no statutory exception to KStG § 8(3), which disallows the deductibility of corporate profit distributions.

[77] SCHMIDT, *supra* note 38, §5 n.671.

[78] Id.

[79] Gerhard Bruschke, *Der steuerfreie Sanierungsgewinn*, DEUTSCHE STEUER-ZEITUNG 166 (2009).

[80] *Id.*; AO §§ 163, 222 & 227; Bundesministerium der Finanzen, Erlass IV A 6 – S 2140 – 8/03, Mar. 27, 2003, BUNDESTEUERBLATT I at 240.

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JAPAN

TAX TREATMENT OF BUSINESS DEBT

Executive Summary

Interest paid on debt is regarded as a "non-operating expense" in Japan and reduces income. The thin capitalization rule provides an exception to this.

Dividends paid are not deducted from taxable income. There are Employee Stock Ownership Plans in Japan, but they are different from such plans in the United States.

When a debt is reduced or cancelled, the borrower has taxable income from the reduction or cancellation.

I. Introduction

Net taxable income for corporation tax purposes is calculated based on the results reflected in the company's financial statements, prepared in accordance with Japan's generally accepted accounting principles.[1] Interest paid on debt is regarded as a "non-operating expense"[2] and reduces income.

II. Limitations on the Deductibility of Interest

Japan has thin capitalization rules. Where the average balance of liabilities due to either a foreign controlling shareholder or capital supplier[3] exceeds three times the capital in the company held by the foreign controlling shareholder, the amount of interest payable on the excess amount is not deductible. Where a company maintains a less than three-to-one debt-to-equity ratio, it is not treated as thinly capitalized even if the amount borrowed from a foreign controlling shareholder or capital supplier exceeded three times the foreign controlling shareholder or capital supplier's equity interest. In cases where the total average liabilities for

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[1] Hōjin zei hō [Corporation Tax Law], Law No. 34 of 1965, *last amended by* Law No. 65 of 2010, arts. 21, 22.

[2] Eigyōgai hiyō [non-operating expenses], KOTOBANK (Japanese online dictionary), http://kotobank.jp/word/%E5%96%B6%E6%A5%AD%E5%A4%96%E8%B2%BB%E7%94%A8 (last visited June 14, 2011).

[3] According to Eric Rose & Takeo Mizutani, *Japan – Corporate Taxation* ¶ 10.3, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (JAPAN), http://ip-online.ibfd.org/kbasc/ (by subscription) (last visited June 23, 2011), the thin capitalization rules also apply to a loan guaranteed by a foreign controlling shareholder and to interest paid on such a loan, and also to a loan mortgaged with bonds borrowed from a foreign controlling shareholder and to interest paid on such a loan.

the year of a company that may be subject to this rule do not exceed three times its own capital, the disallowance of the interest deduction does not apply.[4]

In this context a foreign controlling shareholder means a nonresident or foreign company that can control the domestic company because

1. it owns more than 50 percent of its capital directly or indirectly;[5]
2. the same person or entity owns more than 50 percent of the domestic and foreign company's capital directly or indirectly;[6] or
3. it holds a special relationship, such as one in which the domestic company's business mainly relies on transactions with the foreign shareholder.[7]

Interest payable on certain repurchase agreement (repo) transactions with a foreign controlling shareholder or capital supplier is exempted from thin capitalization rules and can be deducted from the total amount of interest due to a foreign controlling shareholder or capital supplier. However, in this case, a more restrictive 2-to-1, rather than 3-to-1, debt-to-equity ratio is applied to the calculation of thin capitalization.[8]

III. Tax-Related or Other Limitations on Debt Financing

N/A

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

Japan's effective corporate tax rate as of January 2011 is 40.69 percent.[9] The corporate tax rate under the Corporation Tax Law is 30 percent.[10] A lower tax rate applies to small companies.[11] Local taxes are added to this amount.

Dividends paid are not deducted from the corporation's taxable income. Individuals who have received dividends must pay taxes on them. In some cases a tax deduction is allowed.[12]

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[4] Sozei tokubetsu sochi hō [Tax Special Measures Law], Law No. 26 of 1957, *last amended by* Law No. 12 of 2011, art. 66-5, para. 1.

[5] *Id.* art. 66-5, para. 4, item 1.

[6] Sozei tokubetsu sochi hō shikō rei [Tax Special Measures Law Enforcement Order], Order No. 43 of 1957, *last amended by* Order No. 206 of 2010, art. 39-13, para. 11.

[7] *Id.*

[8] Tax Special Measures Law art 66-5, para. 2.

[9] Hojin shotoku kazei no jikkō zeiritsu no kokusai hikaku [International comparison of effective corporate tax rate] (as of Jan. 2011), MINISTRY OF FINANCE JAPAN, http://www.mof.go.jp/tax_policy/summary/corporation/084.htm.

[10] Corporation Tax Law, Law No. 34 of 1965, *last amended by* Law No. 65 of 2010, art. 66, para. 1.

[11] *Id.* para. 2.

Among domestic corporations, 50 percent of dividends received from other domestic corporations less that portion of interest incurred on borrowed funds attributable to the principal amount on which such dividends have been received is not included in the calculation of profit. In cases where a domestic corporation receives a dividend from a subsidiary in which the corporation directly or indirectly owns 100 percent of the shares, the entire dividend from the subsidiary is excluded from profit for the purpose of corporation tax.[13] Certain exemptions also apply to dividends received from foreign corporations.

B. Deductibility of Distributions

Dividends paid are not deducted from taxable income.

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

There are Employee Stock Ownership Plans (ESOPs) in Japan. However, they are different from ESOPs in the United States. While a U.S. ESOP is a retirement benefit plan, a Japanese ESOP is not. There is not a specific law to define and regulate Japanese ESOPs. Most Japanese ESOPs are partnerships.[14] In recent years, some companies have begun using trusts for ESOPs.[15] In such cases, corporations are regarded as deemed beneficiaries of trusts and may be allowed to claim a deduction for interest paid on debts incurred to buy stock.[16] In either case, companies are not allowed to claim a deduction for dividends paid out to ESOPs.

VI. Treatment of Debt Cancellation

When a debt is reduced or cancelled, the borrower has taxable income from the reduction or cancellation.[17] When a corporation files bankruptcy, it is important to plan how to deal with the profit from exempted debt. There are special provisions in the Corporation Tax Law that allow corporations that have filed bankruptcy to minimize this profit.[18]

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[12] Japan's taxation scheme for dividends paid to individuals is complicated. *See* Japanese Dividend Taxation for Individuals, THE JAPAN TAX SITE (Sept. 14, 2010), http://japantax.org/?p=3103; Shiro Sakakibara, Outline of Japanese Individual Income Taxes on Dividend Income (Sakakibara & Co., Nov. 2010), *available at* http://minatokobe-kaikei.com/wp/wp-content/uploads/2010/11/Japanese-taxation-on-dividend_Nov2010.pdf.

[13] Corporation Tax Law, Law No. 34 of 1965, *last amended by* Law No. 65 of 2010, art. 23.

[14] Masahiro Michino, Jūgyōin mochikabu kai no mondai ten [Questions Regarding Employee Stock Ownership Plans], RITSUMEIKAN HŌGAKU 6 (256), 340 (1552) (1996), http://www.ritsumei.ac.jp/acd/cg/law/lex/97-6/michino.htm (last visited June 14, 2011).

[15] Aratana jisha kabushiki hoyū sukīmu kentō kai [Committee on New Scheme on Company Holding Its Own Stocks], Aratana jisha kabushiki hoyū sukīmu ni kansuru hokokusho [Report on New Scheme on Company Holding Its Own Stocks] 1 (Nov. 17, 2010), http://www.meti.go.jp/press/20081117002/20081117002-2.pdf.

[16] *Id.* at 30–32.

[17] Saimu menjo eki [Profit of exempted debt], KOTOBANK, http://kotobank.jp/word/%E5%82%B5%E5%8B%99%E5%85%8D%E9%99%A4%E7%9B%8A (last visited June 16, 2011).

[18] Saimu menjo eki kazei taisaku [Countermeasures Against Profit of Exempted Debt], CITY-YUWA PARTNERS, http://www.city-yuwa.com/explain/ex_glossary/detail/saimumenjo.html (last visited June 16, 2011).

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MEXICO

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

Interest is deductible so long as the borrowed capital has been invested in activities that support the business's purpose. Interest on capital that is borrowed for the acquisition of nondeductible or partially deductible investments or expenses may be deducted only in the same proportion as such investments or expenses. A corporate taxpayer may not deduct interest derived from the amount of its debts that exceeds three times its equity incurred from debts contracted with nonresident related parties. Dividends are not deductible for the distributing corporation. The recipient of the dividend, however, generally obtains a credit for the tax paid by the distributing corporation under the Mexican imputation system, which operates under the principle that corporate profits should be taxed only once.

I. Introduction

Mexico's Income Tax Law (MITL) provides that corporate taxpayers may deduct interest due in the tax year, so long as the borrowed capital has been invested in activities that support the business's purpose.[1] To be deductible, interest must correspond to the interest rates available in the market.[2] If paid interest exceeds the market price the excess may not be deducted.[3]

If a corporate taxpayer borrows money and lends it to third parties, its employees, partners, or shareholders, the interest payments for the borrowed funds used by such taxpayer to make the loan may be deductible only up to the amount of the lowest stipulated interest rate on loans to third parties, its employees, partners, or shareholders.[4] This rule is not applicable to financial institutions.[5]

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[1] Ley del Impuesto sobre la Renta [Income Tax Law] arts. 29(IX), 31(VIII), *as amended*, Diario Oficial de la Federación [DO], Jan. 1, 2002, available on the website of Mexico's House of Representatives *at* http://www.diputados.gob.mx/LeyesBiblio/pdf/82.pdf.

[2] Income Tax Law art. 31 (XIV).

[3] *Id.*

[4] *Id.* art. 31(VIII).

[5] *Id.*

Interest on funds that are borrowed for the acquisition of nondeductible or partially deductible investments or expenses may be deducted only to the extent that such investments or expenses are deductible.[6]

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

The MITL provides that a corporate taxpayer may not deduct interest derived from the amount of its debt contracted with nonresident related parties that exceeds three times its equity.[7]

The amount of debt that exceeds this limit is determined by subtracting, from the annual average balance of all the taxpayer's debts, the amount that results from multiplying by three the quotient that is obtained by dividing by two the sum of equity at the beginning and at the end of the tax year.[8] If the domestic party has an excess of debt under this formula, the interest paid to the foreign related party is not deductible, either in whole or in part.[9]

The MITL considers that two or more parties are related when one of them participates directly or indirectly in the administration, control, or capital of the other, or when an individual, a company, or a group of individuals or companies participate(s) directly or indirectly in the administration, control, or capital of such parties.[10]

B. Limits on Borrowing for Tax-Exempt Income

No information could be located concerning specific limits on borrowing to acquire tax-exempt income. However, as stated above, the MITL provides that interest on a debt that is borrowed for the acquisition of nondeductible or partially deductible investments or expenses may be deducted only in the same proportion as such investments or expenses.[11]

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

The MITL does not appear to include an anti-avoidance rule.[12] However, the MITL provides that there are a number of situations where corporate taxpayers must treat as dividends

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[6] *Id.*

[7] *Id.* art. 32(XXVI). *See also* Jaime González-Bendiksen et al., Mexican Tax Guide (CCH) ¶ 831, http://intelliconnect.cch.com (by subscription) (last visited June 20, 2011).

[8] Income Tax Law art. 32(XXVI). *See also* González-Bendiksen et al., *supra* note 7, ¶ 831.

[9] Income Tax Law art. 32(XXVI).

[10] *Id.* art. 215.

[11] *Id.* art. 31(VIII).

[12] Ricardo León & Mariana Eguiarte, *Mexico – Corporate Taxation* ¶ 7.1, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY SURVEYS (MEXICO), http://online.ibfd.org/kbase/ (by subscription) (last visited June 22, 2011).

(which are not deductible) the interest derived from loans granted to resident companies, or to the permanent establishments in Mexico of nonresidents, by entities that reside in Mexico or abroad who are related to the payor, including:

- When the borrower agrees in writing to an unconditional promise to pay all or part of the credit received on a date determinable at any time by the lender,
- When the interest agreed exceeds the interest rate available in the market,
- When the lender has the right to intervene in the direction or administration of the borrowing company in cases where the borrowing company is noncompliant, and
- When the interest to be paid by the borrower is conditional upon it obtaining profits or when the amount of interest to be paid is determined based on such profits.[13]

B. Other Limitations

Corporate Law

Article 134 of the General Law of Business Entities provides that *Sociedades Anónimas* (i.e., privately held corporations) may not acquire their own stock.[14] However, article 56 of the Securities Market Law provides that publicly held companies may acquire their own stock provided that applicable requirements are met.[15]

Investment Law

Mexico's Banking and Securities Commission has the authority to determine the minimum capital of financial companies.[16]

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

The corporate tax rate is 30 percent.[17] Corporate taxpayers that distribute dividends are responsible for paying income tax at this rate.[18] However, if a corporate entity distributes dividends using profits for which it paid income tax, then these dividends are not taxable at the

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[13] González-Bendiksen et al., *supra* note 7, ¶ 305. *See also* Income Tax Law arts. 31(XIV), 92.

[14] Ley General de Sociedades Mercantiles [General Law of Business Entities], *as amended*, art. 134, DO, Aug. 4, 1934, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/144.pdf.

[15] Ley del Mercado de Valores [Securities Market Law], *as amended*, art. 56, DO, Dec. 30, 2005, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/LMV.pdf.

[16] Ley de la Comisión Nacional Bancaria y de Valores [Banking and Securities Commission Law], *as amended*, art. 4(XI), DO, Apr. 28, 1995, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/46.pdf.

[17] Arturo Pérez Robles, *Mexico – Corporate Taxation* ¶ 6.1.1.5., IBFD: COUNTRY ANALYSES (MEXICO), http://online.ibfd.org/kbase/ (by subscription) (last visited June 23, 2011).

[18] *Id.*

level of the individual or intercorporate shareholder.[19] The principle of this imputation system is that corporate profits should be taxed only once, to the corporation that realized the profit.[20] Dividends paid are not subject to withholding income tax applicable to shareholders.[21] Individuals must add paid dividends to their annual taxable base, but they may get a tax credit for the income tax paid by the distributing company.[22]

B. Deductibility of Distributions

Corporate taxpayers may not claim a deduction for the distribution of dividends.[23]

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

No information could be located concerning Employee Stock Ownership Plans in Mexico.

VI. Treatment of Debt Cancellation

The MITL provides that corporate taxpayers obtain taxable income from unpaid debts during the month in which the limitations period applicable to debt collection actions expires, or before then if it is evident that collection is not possible, e.g., when it is proved that the debtor has been judicially declared bankrupt.[24]

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[19] *Id.* *See also* León & Eguiarte, *supra* note 12, ¶ 1.1.

[20] *Id.*

[21] Pérez Robles, *supra* note 17, ¶ 6.1.1.5.

[22] Ricardo León & Mariana Eguiarte, *Mexico – Individual Taxation* ¶ 1.5.1., IBFD: COUNTRY SURVEYS, http://online.ibfd.org/kbase/ (by subscription) (last visited June 23, 2011).

[23] Pérez Robles, *supra* note 17, ¶ 1.4.4.

[24] González-Bendiksen et al., *supra note* 7, ¶¶ 180, 645. *See also* Income Tax Law art. 18(IV), 31(XVI-c).

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UNITED KINGDOM

TAX TREATMENT OF CORPORATE DEBT

Executive Summary

Although interest payments are deductible under the United Kingdom's corporate tax system, a number of provisions—including the UK's thin capitalization legislation and a "worldwide" debt cap—do exist that limit the deductibility of interest. However, dividends and other distributions are not deductible under the current corporate tax regime. The UK maintains an imputation tax system where companies are taxed through a corporation tax and shareholders are taxed at a reduced rate through the operation of an imputation tax credit. Though there is no exact equivalent to US Employee Stock Ownership Plans, the UK does operate Employee Share Ownership Trusts (hereinafter, ESOP trusts). In respect to ESOP trusts, the distribution of shares are only tax deductable at the time the employee acquires shares pursuant to the plan.

I. Introduction

Interest payments are generally deductable under the UK's corporate tax regime. However, such deductions are subject to specific anti-avoidance provisions, which primarily include thin capitalization rules and a "worldwide" debt cap.

II. Limitations on the Deductibility of Interest

A. Thin Capitalization or Equity-Stripping Rules

The current UK tax regime has included thin capitalization rules since April 1, 2004. Those rules apply to both domestic and cross-border loan transactions. The Finance Act 2004[1] introduced provisions to the Income and Corporation Tax Act 1988 (ICTA 88)[2] that extended the transfer pricing regime to include thin capitalization rules. Now, however, all of the transfer pricing legislation, including the thin capitalization rules, can be found in Part 4 of the Taxation (International and Other Provisions) Act 2010,[3] which, in essence, "represents a restatement" of all transfer-pricing rules enacted through ICTA 88 and subsequent amending legislation.[4]

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[1] Finance Act 2004, c. 12.

[2] Income and Corporation Act 1998, c. 1.

[3] Taxation (International and Other Provisions) Act 2010, c. 8.

[4] PRICEWATERHOUSE COOPERS, INTERNATIONAL TRANSFER PRICING 2011 – 7002 STATUTORY RULES (updated through Mar. 1, 2010), http://www.pwc.com/en_GX/gx/international-transfer-pricing/assets/itp-2011.pdf.

The thin capitalization rules prior to April 1, 2004, "were changed in the Finance Act 2004 (2004 Act) with the intention of bringing them into line with the EC Treaty following the ECJ's decision in *Lankhorst-Hohorst*."[5] In 2007 the European Court of Justice found, in *Thin Cap Group Litigation v. Commissioners of Inland Revenue*[6] that the pre-2004 thin capitalization rules were "a restriction on the freedom of establishment, but that such a restriction is permissible in the context of wholly artificial arrangements entered into for tax reasons alone, provided certain criteria are met."[7] Subsequently on November 17, 2009, the UK High Court held, as summarized by IBFD, that the "UK thin capitalization rules, as applied before 2004, constituted a breach of freedom of establishment, and should therefore be disapplied in respect of transactions with a genuine commercial justification, in whole or in any relevant part."[8] However, the UK Court of Appeal overturned the decision and found that UK's thin capitalization rules did not infringe freedom of establishment.[9]

According to the UK's tax authority, Her Majesty's Revenue & Customs (HMRC), a UK company is thinly capitalized for tax purposes under the old and new rules when it has "more debt than it could and would have borrowed on its own resources, because it is borrowing either from or with the support of connected persons."[10] Thin capitalization is, therefore, normally seen within the context of intragroup borrowing. A typical scenario is when a UK holding company grants a loan to a UK subsidiary on favorable terms it would normally not receive given its borrowing capacity. With increasing indebtedness the UK subsidiary can claim tax deductions on the excessive interest payments, as a result reducing its UK corporate tax liability. Since "the interest remains within the group; the group as a whole is no less profitable, but the borrower has paid less tax, and, where the lender is in a country with a lower corporation tax rate than the borrower or has losses to absorb interest received, the group can end up far better off overall."[11]

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[5] Practical Law Company, *Thin Capitalisation: The ECJ Weighs In*, PLC MAGAZINE (Mar. 23, 2007), http://plc.practicallaw.com/7-242-0133.

[6] Case C-524/04, Thin Capitalisation Group Litigation v. Comm'rs of Inland Revenue, 2007 E.C.R. I-2107.

[7] *Id.*

[8] Belema Obuoforibo, *United Kingdom-Corporate Taxation* ¶ 10.3., *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (UNITED KINGDOM), http://ip-online.ibfd.org/eth/ (by subscription) (last visited June 20, 2011).

[9] Test Claimants in the Thin Cap Group Litigation v. HM Revenue & Customs, [2011] A.C. 127 (EWCA Civ) [57] (appeal taken from Eng.), *available at* http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWCA/Civ/2011/127.html&query=thin+and+cap&method=boolean. *See also Court of Appeal Concludes UK's Thin Capitalization Legislation is Compatible with European Law*, BRICK COURT CHAMBERS (Feb. 22, 2011), http://www.brickcourt.co.uk/news/22-02-2011---court-of-appeal-concludes-uk-s-thin-capitalisation-legislation-is-compatible-with-european-law.asp.

[10] HM Revenue & Customs, *International Manual – INTM542005 – Introduction to Thin Capitalisation (Legislation & Principles)*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542005.htm (last visited June 20, 2011).

[11] *Id.*

However, thin capitalization does not only apply within the context of intragroup debt financing. It can also apply if the borrower is an unrelated third party that has received a guarantee of support from the UK holding company or other members of the group.[12]

Under the UK's tax regime, there are general transfer pricing rules in Taxation (International and Other Provisions) Act (TIOPA) 2010, Part 4 that apply to thin capitalization and there are sections in the same Act that are specific to thin capitalization, in other words, debt financing between two companies. The UK tax regime "relies exclusively upon the arm's-length standard" to "regulate excessively leveraged financing structures."[13] The test that HMRC applies is whether "the borrower could have borrowed the amount in question were it dealing at arm's length."[14] The general transfer pricing rules in regard to thin capitalization can apply to tax-paying companies that are "either borrowers or lenders."[15] According to Fursdon's *British Corporate Tax Guide 2010-11*, "in respect of borrowers, the transfer pricing legislation will, generally, disallow a corporation tax deduction for an interest (or discount) expense if the interest (or discount as the case may be) exceeds what it would have been in the absence of the special relationship between the borrower and lender."[16] The guide further explains that "in respect to lenders, the transfer pricing legislation will, generally, apply to impute a higher rate of interest (or discount) if the loan has been made at more favorable rates (for the borrower)."[17]

According to the *HMRC Tax Manual*, the main general transfer pricing sections in TIOPA 2010 that apply to thin capitalization are

- s.147: The basic pre-condition;
- s.148: The participation condition;
- s.150: The provision can be made up from a single transaction or a series of transactions;
- s.155: The requirement that the provision under consideration gives rise to a potential UK tax advantage; [and]
- s.164: The requirement that the UK's transfer pricing legislation should be interpreted in accordance with OECD principles.[18]

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[12] HM Revenue & Customs, *International Manual – INTM542090 – The Main Thin Capitalisation Legislation: Guarantees – What They Do and What They Are*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542090.htm (last visited June 20, 2011).

[13] Stuart Webber, *Thin Capitalization and Interest Deduction Regulations*, Copenhagen Research Group on International Taxation – CORIT, Discussion Paper No. 8 at 34 (2010), *available at* http://corit.dk/login/spaw2/uploads/files/CORIT%208%20Thin%20Capitalization%20and%20Earnings%20Stripping%20Regulations%202%201.pdf (last visited June 20, 2011).

[14] JON FURSDON, BRITISH TAX GUIDE: CORPORATION TAX 2010-11 at 210 (Roger Barnard ed., Walters Kluwer (UK) Ltd., 2010).

[15] *Id.* at 209.

[16] *Id.*

[17] *Id.* at 210.

[18] HM Revenue & Customs, *International Manual – INTM542010 – The Main Thin Capitalisation Legislation: Introduction*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542010.htm (last visited June 20, 2011).

Sections in the TIOPA 2010 that are specific to thin capitalization include

- s. 152: Requires certain factors to be considered when comparing the arm's length provision with the actual provisions in s.147(1)(d) of TIOPA 2010;
- ss. 181–184: Sets out the conditions required for a lender to make a valid compensating adjustment claim where a disallowance has been made in the borrower's computations;
- s. 153: Deals with the factors that are taken into account when a loan is supported by a guarantee, and the borrower and the guarantor have a special relationship; [and]
- ss. 191-194: Sets out the conditions required for a guarantor to make a valid compensating adjustment claim.[19]

According to the *HMRC Tax Manual*, the thin capitalization rules apply "as much to transactions between two or more connected UK companies as to cross-border transactions involving the UK and other countries, if the basic conditions and relationships . . . are present."[20] The only difference would be that one of the parties to a UK-UK transaction "may be entitled to claim a compensating adjustment."[21]

B. Limits on Borrowing for Tax-Exempt Income

There do not appear to be any rules that restrict the deduction of interest in respect to tax-exempt or favorably taxed income.

III. Tax-Related or Other Limitations on Debt Financing

A. Tax-Related Limitations

In the context of group taxation, besides the thin capitalization rules, UK's corporate tax regime also imposes a "worldwide debt cap" on the tax deductibility of interest expenses "of UK companies which form part of a large group."[22] According to an International Bureau of Fiscal Documentation tax analysis,

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[19] HM Revenue & Customs, *International Manual – INTM542015 – The Main Thin Capitalisation Legislation: Summary of Sections Specific to Thin Capitalisation*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542015.htm (last visited June 20, 2011).

[20] HM Revenue & Customs, *International Manual – INTM542070 – The Main Thin Capitalisation Legislation: UK-UK Thin Capitalisation*, http://www.hmrc.gov.uk/manuals/intmanual/INTM542070.htm (last visited June 20, 2011).

[21] *Id.*

[22] *Worldwide Debt Cap Rules Have Now Commenced – Are You Prepared?*, KPMG: UNITED KINGDOM: ISSUES AND INSIGHTS, http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Pages/WorldwideDebtCapRuleshavenowCommenced-AreYouPrepared.aspx (last visited June 28, 2011).

> [for] UK companies (in a worldwide group) that have net finance expenses, the available aggregate deduction for interest (or similar payments) is restricted to the consolidated gross financing expense of the group. . . . The worldwide debt cap rules also provide for the exemption of financing income where there has been a disallowance as a result of the restriction. In such a case, there is to be disregarded, for corporation tax purposes, an amount of financing income received by the UK companies within the group.[23]

The United Kingdom does not have a general anti-avoidance rule (GAAR) established by statute. However, an anti-avoidance rule has been developed by the UK courts. According to the IBFD, the rule in *Furniss v. Dawson* states that

> transactions will be disregarded for tax purposes where:
>
> - there is a composite or a preordained series of transactions which may or may not include the achievement of business purposes; and
> - steps are inserted which have no commercial purpose other than the avoidance of a tax liability.[24]

In addition, specific anti-avoidance provisions have been enacted through various tax legislation that does attempt to limit the debt versus equity ratio of companies. For example, section 443 of the CTA 2009 "contains a general disallowance for interest payments made pursuant to a tax avoidance scheme."[25] Moreover, tax arbitrage rules exist that target "the use of hybrid entities and hybrid instruments in order to obtain a tax advantage."[26] As discussed above, transfer pricing rules, and specific thin capitalization provisions also exist to limit "not at arms length" loan transactions between connected companies.

The UK treasury announced in January 2011 the creation of a study group that would "explore the case for a GAAR in the UK."[27]

B. Other Limitations

There do not appear to be any other limitations on debt financing.

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[23] Obuoforibo, *supra* note 8, ¶ 1.4.5.

[24] *Id.* ¶ 10.1.

[25] *Id.*

[26] *Id.* ¶ 10.6.

[27] Press Release, HM Treasury, Details of Avoidance Study Group Set Out (Jan. 14, 2011), http://www.hm-treasury.gov.uk/press_04_11.htm.

IV. Deductions for Corporate Profit Distributions

A. Basic Principles of Taxing Corporate Income

Currently, the UK's corporate tax structure is based on the imputation system, where companies are charged through a corporation tax and dividends of shareholders "are taxable at a reduced rate due to operation of an imputation tax credit system."[28]

Between 1965 and 1973 the UK tax regime was structured along the lines of a classical system where company profits were charged through a corporation tax and the distributions of shareholders were charged through an income tax. Between 1973 and 1999 a partial imputation system was maintained where the profits of corporations continued to be taxed while shareholders who were recipients of dividends were entitled to an income tax credit. According to Fursdon's *British Corporate Tax Guide*,

> If the company paid a dividend or made any qualifying distribution during the accounting period, prior to 6 April 1999, it had to make a payment on account of its corporation tax liability for that period. This was called advance corporation tax (ACT). Subject to certain limits, this corporation tax paid in advance (ACT) could be deducted from the company's corporation tax liability.[29]

After April 1999 the ACT system was abolished; however, "a notional tax credit, associated with dividends, of one-ninth of the dividend," was maintained.[30]

B. Deductibility of Distributions

According to IBFD, "[d]ividends and other distributions paid by a company are not deductible in computing profits for corporation tax (Sec. 338(2) ICTA)."[31]

V. Deductions for Distributing Dividends Under an Employee Stock Ownership Plan

Unlike the U.S., the term "ESOP" is used in the UK as a broad term "for any employee share ownership plan, or trust."[32] UK ESOPs are not restricted to being a part of an employee's retirement plan but operate "as a means to deliver shares to employees, at intervals, throughout their career with the company".[33] Though there is no exact counterpart, the closest equivalent to a U.S. Employee Stock Ownership Plan (ESOP) is an employee benefit trust (EBT) set up as an employee share ownership trust (ESOT) (also known as an ESOP trust). According to HM

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[28] Obuoforibo, *supra* note 8, ¶ 6.1.2.

[29] FURSDON, *supra* note 14, at 2.

[30] *Id.*

[31] Obuoforibo, *supra* note 8, ¶ 1.4.4.

[32] POSTLETHWAITE, UK SHARE PLANS FOR US COMPANIES, http://www.postlethwaiteco.com/documents/US-share-plans-guide-updated-12-2-08.pdf (last visited June 20, 2011).

[33] *How Esops Work*, THE EMPLOYEE SHARE OWNERSHIP CENTRE, http://www.mhcc.co.uk/esop/esop/bak/abesop2.htm (last visited June 20, 2011).

Revenue & Customs, EBT is a "trust set up by an employing company or its group parent company to provide employees with benefits which may take a variety of different forms."[34] An ESOT or ESOP trust is set up if the company seeks to "provide employees with benefits in the form of shares or options over shares in that company"[35] in the form of a trust.

According to Fursdon's *British Corporate Tax Guide*,

> In its current form, any act or omission by an employer (e.g., payment of a contribution to the EBT) which results in value being added to an employee benefit trust, will result in a disallowance for corporation tax purposes for the employer company. A deduction can be obtained subsequently where, broadly, remuneration is paid out of the EBT to an employee.[36]

In respect to share awards, "[t]he deduction is prescribed by statute at the time the employee acquires his shares pursuant to the option or units."[37] However, in order for the employer to receive a corporate tax deduction for an award of shares certain conditions in CTA 2009, Part 12 need to be fulfilled.[38]

VI. Treatment of Debt Cancellation

There do not appear to be any rules under UK's corporate tax regime that treat cancelled or reduced corporate debt as taxable income. It appears, however, that under accountancy principles in the UK a written-off debt is treated as income for corporation tax purposes.[39]

Prepared by Tariq Ahmad
Foreign Law Specialist
June 2011

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[34] HM Revenue & Customs, *Specific Deductions – BIM4401 Employee Share Schemes: Glossary*, http://www.hmrc.gov.uk/manuals/bimmanual/bim44001.htm (last visited June 20, 2011).

[35] *Id.*

[36] FURSDON, *supra* note 14, at 445.

[37] *Id.* at 446.

[38] *Id.* at 447.

[39] Information obtained from an expert on UK accounting. Due to time constraints in drafting this report this statement could not be substantiated.

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PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF HOUSEHOLD DEBT

A REPORT TO THE JOINT COMMITTEE ON TAXATION

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



July 11, 2011
JCX-40-11

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INTRODUCTION AND SUMMARY

Introduction

This document[1] has been prepared by the staff of the Joint Committee on Taxation in response to the request of the Chairman and Vice Chairman of the Joint Committee on Taxation for a report of Federal income tax rules relating to the use of leverage by households and businesses in the United States.[2]

There has been concern about the level of debt in the U.S. economy. Below is a table illustrating corporate debt, household debt, and Federal debt as a percentage of gross national product (GNP), 1987-2010. This document relates to household debt, the data shown in column two of Table 1, below.

Table 1.–Corporate Debt, Household Debt, and Federal Debt, as a Percentage of Gross National Product (GNP), 1987-2010

Year	Corporate Debt[1] as a Percentage of GNP	Household Debt[2] as a Percentage of GNP	Federal Debt[3] as a Percentage of GNP
1987	42.8	57.9	41.0
1990	43.6	61.4	42.8
1995	39.5	65.0	48.9
2000	46.4	69.9	33.9
2005	43.0	92.4	36.9
2010	48.3	90.2	63.2

(1) Corporate debt of nonfinancial C corporations and S corporations excluding farms.

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

(3) Federal debt excludes Federal debt held by Federal agency trust funds.

Sources: Debt levels from The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2011* Table D.3. GNP levels from the Federal Reserve Bank of St. Louis.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Household Debt* (JCX-40-11), July 11, 2011. This document can be found on our website at www.jct.gov.

[2] The request was made at the 112th Congress Organizational Meeting of the Joint Committee on Taxation on March 15, 2011.

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The first part of this document provides economic data with respect to household debt. The second part provides a description of the major present-law Federal income tax rules governing household debt. The third part provides a discussion of the economic incentives created by the major present-law Federal income tax rules governing household debt. The last part provides a comparison of the tax treatment of common types of household debt in seven other countries: Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom.

A companion document[3] relates to business debt and provides a description of present-law Federal tax rules, economic data, and a discussion of business capital structures (without taking into account Federal tax rules) as well as of the economic incentives created by the present-law Federal income tax rules governing business debt.

Summary

Trends in household debt

Household debt principally consists of home mortgage debt and consumer credit (such as automobile loans, student loans and credit card debt).[4]

While debt as a percentage of disposable personal income has fallen below recent peak levels, it remains high by historical standards. The ratio of total credit market debt outstanding in the household sector to disposable personal income is roughly 20 percent higher in 2010 than it was in 2000, 40 percent higher than in 1990, and twice that of 1960. This growth is due largely to the growth in home mortgage debt.

Federal income tax rules for household debt

The central Federal income tax issues arising in connection with these types of household borrowings are whether interest paid on debt is deductible and whether the amount of a debt that has been forgiven must be included in income.

Deductibility of interest paid

A deduction generally is allowed under the Federal income tax law for interest paid or accrued in the course of a trade or business or with respect to investment.[5] In an income tax system, interest expense can be viewed as a cost of earning taxable business income or investment income. A deduction is allowed for this cost in order to measure the taxpayer's income accurately, net of expenses of earning the income. For example, the deduction for interest expense may be considered analogous to the business deduction for the cost of wages

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[3] Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011 (hereinafter "*Tax Treatment of Business Debt*"). This document can be found on our website at www.jct.gov.

[4] See tables below illustrating categories of household debt.

[5] Sec. 163.

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paid to workers or the cost of repairs and maintenance in a business because each of these expenditures is a cost of earning income of the business. Similarly, the cost of margin interest incurred in making an investment in stock may be considered a cost related to the income derived from earnings on, or sale of, the stock investment.

Interest expense on most types of household debt generally is either personal interest that is not deductible for Federal income tax purposes or investment interest that is deductible, but only to the extent of investment income. The general rule that a deduction is allowed for business interest and investment interest but not allowed for personal interest is subject to a variety of exceptions and special rules under present law. For example, home mortgage interest is deductible notwithstanding the fact that it is a form of personal interest and that the imputed rental value of the individual's home is excluded from income.[6] Interest on home equity debt of up to $100,000 is deductible even if the proceeds of the debt are used for consumer purchases. Interest deduction limitations apply to debt incurred with respect to insurance and tax-exempt bonds. These and other rules related to the deductibility of interest on debt of a type typically owed by households are described below.

Cancellation of indebtedness income

Households generally recognize income if debt is forgiven or cancelled, or if there is a foreclosure or default on the debt.[7] Economically, it is as if the debtor has received the money to pay the amount of debt forgiven, so that amount is considered income. The forgiveness of certain student loans, however, is excluded from income. Cancellation of indebtedness income is excluded from income in certain other circumstances, for example if the debt discharge occurs in a Title 11 bankruptcy proceeding, or to the extent a taxpayer is insolvent.[8] If cancellation of indebtedness income is excluded in these circumstances, the taxpayer generally reduces other tax attributes (such as the basis of property) by the amount excluded.[9]

Other tax issues related to household debt

Other Federal income tax rules governing household debt relate to less common types of household debt, to households as investors or lenders rather than as borrowers, or to both

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[6] When mortgage interest is a cost of producing taxable income, such as income on rental property, for example, such interest is generally deductible against the rental income received.

[7] Sec. 61(a)(12).

[8] A temporary exclusion is provided for qualified principal residence indebtedness that is discharged before January 1, 2013.

[9] Secs. 108(b) and 1017.

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households and businesses, and are not addressed in this document.[10] Federal tax issues relating to business debt are addressed in a companion document.[11]

Economic incentives for households under present law

The mortgage interest deduction, by subsidizing mortgage debt, may lead households to demand houses that are larger and more expensive than they would in the absence of the deduction or to finance their purchases more heavily with debt. Supporters of the home mortgage interest deduction believe that this policy has a positive effect on the U.S. economy, encouraging homeownership and accompanying positive spillover benefits. On the other hand, some research questions whether the home mortgage interest deduction serves its intended purpose of encouraging homeownership. The distributional impact of the mortgage interest deduction indicates that the largest tax expenditures accrue to those households with the highest incomes, who may have purchased homes even in the absence of the deduction. Because money is fungible, it is also possible that these taxpayers use mortgage loans to increase consumption rather than home purchases.

Deductions for interest on home equity loans, because the use of proceeds is not restricted, may create an incentive for households to borrow for any purpose, including for consumption or investment. For example, a home equity loan can be used to pay off other debt, purchase a car, or for medical or educational expenses. In fact, some researchers find a significant negative correlation between a household's stock of second mortgage debt and its net worth, consistent with the view that households primarily use home equity loans to increase consumption.

There are three main arguments in favor of tax benefits for student loans. First, there may be positive spillover effects associated with education. For example, higher education levels are associated with increased average productivity and wages, lower crime rates, increased civic participation, and improved health. Second, there may be failures in the market for student loans that result in less borrowing than there otherwise would be. Finally, government intervention may alleviate inequalities in access to higher education between low-income and high-income students to the extent that they exist. On the other hand, critics point out that the positive spillover effects associated with education are large for elementary and secondary education, but small for post-secondary education where most of the returns are private. Furthermore, even if the spillover effects were larger, this would not necessarily imply that the government should choose policies that subsidize debt-financed higher-education over other types of policies that also alleviate under-provision.

Under the investment interest deduction limitation, tracing rules determine whether interest is associated with tax-exempt income and therefore not deductible. By contrast, some

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[10] For example, section 7872 treats below-market interest rate loans between family members as loans that bear interest at a market rate accompanied by a payment from the lender to the borrower, which may be a gift subject to the gift tax.

[11] See *Tax Treatment of Business Debt*.

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business taxpayers are subject to a pro rata rule for making this determination. The tracing rules applicable to households may be less effective at preventing tax arbitrage than the pro rata method applicable to businesses, resulting in more portfolio leverage than there otherwise would be.

Taxation of income from the discharge of indebtedness may affect the incentives of households to borrow. In principle, taxation of this income reduces the net benefit of filing for bankruptcy and reduces incentives to borrow. On the other hand, exceptions to the income inclusion rules reduce the cost of borrowing in certain circumstances.

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I. REASONS HOUSEHOLDS INCUR DEBT

In general

Households have many reasons to incur debt. A disparity between the timing of income and desired consumption is a principal reason that households incur debt. Consumers may borrow to smooth their consumption over time rather than subject their consumption to fluctuations in their current income.[12] That is, consumers may want to buy more goods and services in a given period than their income in that period would allow. To have the funds available to purchase those goods and services, consumers may choose to save, reducing consumption now to fund consumption later in excess of future income, or they may choose to borrow to fund consumption now in excess of current income.

Borrowing to fund an increase in consumption in the current period requires a greater reduction in future consumption as the borrower repays not only the principal amount borrowed but also interest. Households that wish to increase their consumption in a particular period can only borrow if others (savers) are willing to lend by reducing their consumption in the same period below their income in that period. Interest rates represent the price borrowers are willing to pay and savers are willing to accept to achieve the intertemporal substitution.

This smoothing of consumption over time is referred to as the "life cycle" theory of savings. Suppose that an individual expects to have low earnings while young, higher earnings as his productivity rises with more experience and more education, and lower earnings as he reduces hours worked in anticipation of retirement. Rather than subject his consumption to fluctuations in his earnings, the individual may wish to smooth out these fluctuations to have either a steady level of consumption or perhaps a constantly rising level of consumption throughout his life cycle. This smoothing may be accomplished in part by saving to fund consumption during retirement and in part by borrowing to finance consumption early in his working career. Interest payments are the price the borrower is willing to pay to experience his preferred pattern of consumption.

Consumers may also wish to align the timing of income and payment for consumption over a short time horizon. For example, a worker who is paid on a monthly basis may use a charge card or credit card to make purchases between paychecks and pay the bill in full when it is due each month after receiving the paycheck for that month. Credit cards may also serve as a convenience mechanism, for example, for payment for items purchased via the internet or otherwise, or in lieu of carrying around large amounts of cash. Beyond serving as a convenient payment mechanism, credit cards may also allow individuals to maintain a level of consumption following the loss of a job or the depletion of any savings.

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[12] Milton Friedman. *A Theory of the Consumption Function*, Princeton University Press, 1957. Alberto Ando and Franco Modigliani, "The 'Life Cycle' Hypothesis of Saving: Aggregate Implications and Tests," *American Economic Review*, 53:1, March 1963, pp. 55-84.

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Durable goods

Borrowing is often associated with the purchase of durable goods.[13] Examples of durable goods include motor vehicles, furniture, and appliances. These items may be too expensive for some consumers to purchase out of their current income. Consumers must then choose either to reduce current consumption to save for the purchase of the desired good in the future or to borrow the funds necessary to make the purchase now and reduce future consumption.

By their very nature, durable goods provide consumption benefits over a period of years. By borrowing, a household can purchase durable goods and align the period during which they pay for them with the useful life in which they provide consumption benefits. For example, consider the purchase of a washing machine that has a price of $1,000 and a useful life of 10 years. Alternatively, a consumer could wash clothes at the local laundromat for $208 per year ($2 per load at two loads of laundry per week). Buying the washer yields benefits of $208 per year to the consumer. If the consumer borrows the $1,000 payable over ten years at 10 percent interest, the payments are only $158.64 per year, and the timing of the payments more closely matches the timing of the benefits of the washing machine. In the absence of borrowing, the individual would be worse off.

For many consumers, their most significant borrowing finances the purchase of a home. Analogous to other durable goods, a home yields a stream of benefits over time. Borrowing allows a consumer to pay for those benefits over a time horizon that more closely matches the timing of the benefits. Even for a buyer with sufficient assets to purchase a home (or other durable goods) with cash, borrowing may make sense if the after-tax interest rate on the loan is below the after-tax rate of return the buyer could earn by investing the cash in some other asset. Even if the interest rate on the loan is above the rate of return on the alternative investment, an individual may borrow to maintain sufficient liquid assets as a precaution to fund emergencies.

Education

In addition to borrowing to smooth consumption over one's lifetime, individuals may borrow to make investments in education (human capital) to increase their future earnings and consumption possibilities.[14] An investment in education often involves both direct expenses such as tuition and the cost of forgone current earnings when individuals devote themselves to full-time study. Accordingly, individuals often need to borrow to cover living expenses as well as tuition and fees for education. Borrowing for education is analogous to borrowing for durable goods or for investment. Education may increase an individual's productivity and therefore an individual's earning potential, thus yielding a stream of benefits over an entire working career.

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[13] In economic data, durable goods are defined as those items that have an average useful life of at least three years. Bureau of Economic Analysis, U.S. Department of Commerce, NIPA Handbook: Concept and Methods of the U.S. National Income and Product Accounts, November 2010, available at http://www.bea.gov/natioual/pdf/NIPAhandbookch1-7.pdf.

[14] An additional year of education can increase earnings by between six and thirteen percent. David Card, "Estimating the Return to Schooling: Progress on Some Persistent Econometric Problems," *Econometrica*, 69(5): 1127-1160 (2001).

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Borrowing to finance education can serve to align the payment for education with the benefits in terms of this increased earning potential.

Evaluated purely as an economic investment,[15] an individual should invest in education if the present discounted value of the expected future increase in income attributable to education exceeds the present discounted value of the individual's immediately forgone earnings (from going to school instead of working) plus the present discounted value of future payments of principal and interest on the loans (or forgone earnings on savings). An individual should finance the education with borrowing if the present discounted value of payments on the loans is less than the present discounted value of education expenses and forgone earnings on savings. Like the homebuyer discussed above, an individual with sufficient savings to fund his education and to support current desired consumption without loans might still wish to borrow if the borrowing terms are sufficiently favorable.[16]

Portfolio leverage

Another form of leverage households may undertake is portfolio leverage, that is, individuals may borrow to finance the purchase of other portfolio assets, such as stocks or bonds. Portfolio leverage may make sense if the expected after-tax rate of return exceeds the after-tax cost of borrowing. Modern portfolio theory and the capital asset pricing model suggest investors should diversify and hold portfolios that achieve the highest rate of return for a given level of risk or minimize the amount of risk for a given rate of return.[17] Portfolios that maximize return for a given level of risk or minimize risk for a given rate of return are described as efficient portfolios. Investors would hold different efficient portfolios of risky assets depending on the tradeoff between risk and return that each investor desires. However, when investors may invest in a risk-free asset, such as a short-term U.S. Treasury bill, all investors can do better in terms of the risk-return tradeoff than before the introduction of the risk-free asset.

In fact, the theory implies that any investor seeking risk should hold the same diversified market portfolio of all *risky* assets (that is, all assets other than the risk-free asset),

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[15] Education may contain elements of consumption as well as investment. See, e.g., Joint Committee on Taxation, *Overview of Present Law and Issues Relating to Tax and Savings Incentives For Education* (JCX-12-99), March 2, 1999.

[16] Various government and private loan programs exist that may subsidize an individual's borrowing costs while pursuing an education, or forgive debt if the individual pursues specified careers or has income below specified levels. Employers may also offer additional compensation in the form of student loan repayments, subsidies that may not be available for education financed without borrowing, that further reduce the cost of borrowing relative to not borrowing.

[17] Harry Markowitz, "Portfolio Selection," *Journal of Finance*, vol. 7, no. 1, March 1952, pp. 71-91. William F. Sharpe, "Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk," *Journal of Finance*, September 1964, pp. 425-442. John Litner, "The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets," *Review of Economics and Statistics*, vol. 47, no. 1, 1965, pp. 13-37. Andre F. Perold, "The Capital Asset Pricing Model," *Journal of Economic Perspectives*, vol. 18, no. 3, Summer 2004, pp. 3-24. Eugene F. Fama and Kenneth R. French, "The Capital Asset Pricing Model: Theory and Evidence," *Journal of Economic Perspectives*, vol. 18, no. 3, Summer 2004, pp. 25-46.

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because the market portfolio of risky assets is an efficient portfolio that achieves the highest rate of return for the given level of risk.[18] Combinations of the risk-free asset and the market portfolio can be found that dominate any previous combination of risky assets that investors held before the introduction of the risk-free asset. That is, any prior portfolio of risky assets other than the market portfolio is no longer efficient. An investor can now hold a portfolio that achieves a higher rate of return for the given level of risk or the same level of return for a lower level of risk.

Investors who desire a different combination of risk and return than the market portfolio can achieve the desired combination either by investing some money in the risk-free asset rather than in the market portfolio or by borrowing to invest more in the market portfolio.[19] A more conservative investor willing to accept a lower rate of return with less risk effectively lends money by investing in the risk-free asset. Some extremely risk adverse investors may hold only the risk-free asset. An individual who desires more exposure to the market borrows to purchase more of the market portfolio. For example, an individual could achieve this result by investing $10,000 in one of several leveraged mutual funds or exchange traded funds that borrows an additional $10,000 at the fund level to invest $20,000 in the market portfolio, thereby magnifying market movements. Such leverage combined with holding the market portfolio of all assets allows the investor to achieve a higher rate of return for a given level of risk than would be available in the absence of a risk-free asset.

Business leverage

Households may also borrow to finance business operations. For example, they may do so as sole proprietors or when borrowing in their own name is less expensive than borrowing in the name of a business entity that they own. Borrowing can make sense in this context if the discounted present value of expected cash flows from the investment in the business is positive, that is, if the risk-adjusted expected returns from the capital investment in the business exceed the costs of the loan. Business leverage is the subject of a companion report.[20]

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[18] James Tobin, "Liquidity Preference as Behavior towards Risk," *Review of Economic Studies*, February 1958, pp. 68-85. The market portfolio may be effectively replicated by multiple different portfolios.

[19] The original formulation of the theory has investors borrowing at the risk-free rate so that the rate on borrowing and lending (by investing in the risk-free asset) were the same. However, for the market portfolio to be efficient, it is not necessary that investors be able to borrow at the risk-free rate. See, e.g., Fischer Black, "Capital Market Equilibrium with Restricted Borrowing," *Journal of Business*, July 1972, pp. 444-454.

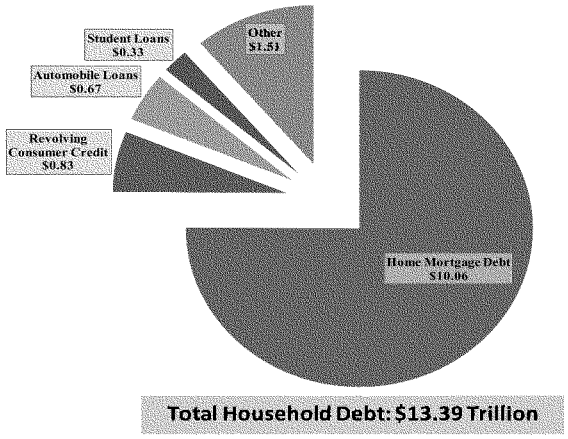
[20] See *Tax Treatment of Business Debt.*

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II. DATA ON HOUSEHOLD DEBT

Total credit market debt outstanding in the household sector at the end of 2010 was $13.386 trillion.[21] Of this amount, by far the largest category was home mortgage debt totaling $10.055 trillion. Total consumer credit liabilities, consisting of revolving and non-revolving credit were $2.435 trillion. Revolving credit (for example, credit cards) is credit that is extended up to pre-approved limits and may be used repeatedly, with the amount of available credit decreasing as borrowing increases and increasing as borrowed funds are repaid. Non-revolving credit (for example, auto loans) is credit that cannot be used again once repayment is made, and is usually repaid in predetermined installments. Of the consumer credit liabilities, non-revolving credit was $1.608 trillion, and revolving credit was $827 billion. Non-revolving credit liabilities consisted of, in part, automobile loans of $668 billion and student loans of $326 billion. The bulk of the revolving credit liabilities were credit card liabilities of $760 billion. For comparison, household sector financial assets in 2010 were $47.683 trillion. Figure 1 shows selected categories of household credit market debt for 2010.

Figure 1.—Outstanding Credit Market Debt, Household Sector, 2010
(Dollar Figures in Trillions)



Source: Board of Governors of the Federal Reserve System. Other category includes security credit, personal bank loans, commercial mortgages, and policy loans.

[21] The data reported in this section are from the Board of Governors of the Federal Reserve System and are available through the Board of Governors of the Federal Reserve System's data download program at http://www.federalreserve.gov/datadownload/. The reported data for the household sector includes nonprofit organizations. Calculations relating to the data, such as the ratios of the credit market debt to personal income, were made by the staff of the Joint Committee on Taxation.

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Table 2.–Credit Market Debt Outstanding, Household Sector

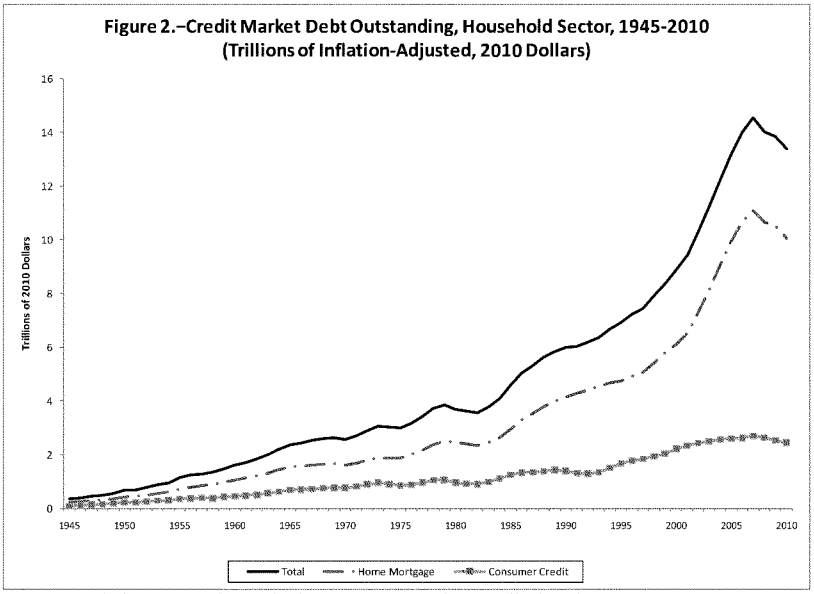
Millions of Current $

Year	Total	Home Mortgage	Consumer Credit		
			Total	Non-Revolving	Revolving
1945	27,958	18,596	6,774	6,774	-
1946	35,356	23,074	9,777	9,777	-
1947	44,147	28,239	13,298	13,298	-
1948	52,684	33,388	16,332	16,332	-
1949	60,514	37,717	19,374	19,374	-
1950	73,263	45,304	23,947	23,947	-
1951	81,781	51,745	25,350	25,350	-
1952	93,888	58,433	30,522	30,522	-
1953	106,085	65,950	34,614	34,614	-
1954	117,414	75,300	35,963	35,963	-
1955	137,953	87,878	42,949	42,949	-
1956	152,872	98,686	46,580	46,580	-
1957	165,306	107,317	49,217	49,217	-
1958	176,135	117,124	49,490	49,490	-
1959	198,076	130,044	57,213	57,213	-
1960	215,586	141,324	61,248	61,248	-
1961	232,277	153,976	63,435	63,435	-
1962	254,244	168,256	69,344	69,344	-
1963	281,148	185,054	77,870	77,870	-
1964	310,290	202,282	87,352	87,352	-
1965	338,732	219,397	97,489	97,489	-
1966	361,222	232,689	103,422	103,422	-
1967	384,167	245,857	108,567	108,567	-
1968	412,857	262,817	119,324	117,219	2,105
1969	442,680	278,575	129,231	125,511	3,720
1970	457,346	285,897	133,660	128,530	5,130
1971	499,394	309,404	149,243	140,714	8,529
1972	555,351	343,490	168,757	159,056	9,701
1973	624,790	382,154	192,980	181,270	11,710
1974	680,168	419,277	201,926	188,244	13,682
1975	734,128	459,028	206,996	191,976	15,020
1976	818,769	517,013	228,961	211,771	17,190
1977	946,680	602,953	264,892	225,618	39,274
1978	1,105,337	708,593	311,305	262,996	48,309
1979	1,275,273	826,675	354,616	297,679	56,937
1980	1,394,408	926,486	358,044	299,538	58,506
1981	1,504,674	998,221	377,882	313,075	64,807
1982	1,573,975	1,031,147	396,718	326,257	70,461
1983	1,728,508	1,116,227	444,878	361,076	83,802
1984	1,943,786	1,242,830	526,584	420,328	106,256
1985	2,277,702	1,449,561	610,574	479,021	131,553
1986	2,536,695	1,648,339	666,355	517,453	148,902
1987	2,754,552	1,827,851	698,640	529,001	169,639
1988	3,044,123	2,054,156	745,206	550,746	194,460
1989	3,319,091	2,259,465	809,285	586,990	222,295
1990	3,581,122	2,488,755	824,391	573,482	250,909
1991	3,769,529	2,666,968	815,581	538,492	277,089
1992	3,970,427	2,840,032	824,769	532,511	292,258
1993	4,210,459	2,998,729	886,169	561,158	325,011
1994	4,531,661	3,165,254	1,021,168	637,981	383,187
1995	4,841,248	3,318,894	1,168,160	703,213	464,947
1996	5,176,976	3,523,783	1,273,878	749,461	524,417
1997	5,478,392	3,739,252	1,344,165	788,632	555,533
1998	5,902,723	4,040,620	1,441,272	843,612	597,660
1999	6,394,789	4,416,260	1,553,622	926,155	627,467
2000	6,985,768	4,798,350	1,741,267	1,039,020	702,247
2001	7,657,593	5,305,406	1,891,827	1,156,734	735,093
2002	8,482,359	6,009,938	1,997,008	1,224,885	772,123
2003	9,508,862	6,894,521	2,102,932	1,312,544	790,388
2004	10,575,877	7,838,232	2,220,119	1,395,698	824,421
2005	11,763,740	8,877,272	2,320,555	1,463,872	856,683
2006	12,943,204	9,866,529	2,415,971	1,515,817	900,154
2007	13,805,640	10,540,176	2,555,304	1,582,069	973,235
2008	13,843,759	10,495,739	2,594,109	1,605,052	989,057
2009	13,611,187	10,342,073	2,478,855	1,584,859	893,996
2010	13,386,220	10,055,358	2,434,692	1,608,016	826,676

Source: Board of Governors of the Federal Reserve System.

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Figure 2, below, shows total credit market debt outstanding, as well as the subcategories of mortgage debt and consumer debt, from 1945 to 2010, in inflation-adjusted 2010 dollars. Table 2 shows the data behind Figure 2 in current dollars, and also shows the breakdown of consumer credit into revolving and non-revolving credit.



Source: Board of Governors of the Federal Reserve System and JCT Staff calculations.

The 2010 debt figures have fallen below the peak levels achieved in the middle of the decade. Total credit market debt outstanding in the household sector peaked at $13.844 trillion in 2008. Total consumer credit liabilities also peaked in 2008 at $2.594 trillion.[22] Home mortgage debt peaked a year earlier, in 2007, at $10.540 trillion.

The growth in credit market debt by itself does not give a sense of the growth of household debt relative to the size of the economy. To give a sense of the size of household debt in relation to the economy, it is common to express household debt in relation to annual disposable personal income, as is shown in Figure 3 and Table 3 below. Total disposable personal income in 2010 was $11.375 trillion. In 2010, total credit market debt outstanding in

[22] For comparison, total household sector financial assets peaked in 2007 at $50.6 trillion.

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the household sector equaled 117.7 percent of disposable personal income. Home mortgage debt alone was 88.4 percent of disposable personal income, while total consumer credit was 21.4 percent. Expressed as a percentage of disposable personal income, 2007 was the peak year for total credit market debt outstanding at 132.4 percent of disposable personal income, while home mortgage debt was 101.1 percent of disposable personal income. In contrast, total consumer credit liabilities peaked in 2003 at 25.1 percent of disposable personal income.

Table 3.–Credit Market Debt Outstanding, Household Sector, as Percentage of Disposable Personal Income

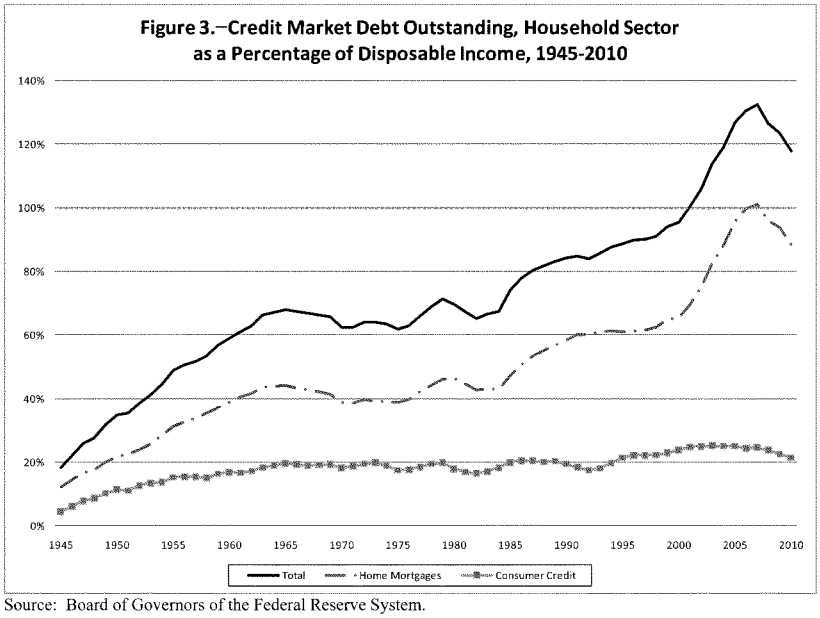
Year	Total	Home Mortgages	Consumer Debt
1945	18.4%	12.2%	4.5%
1946	21.9%	14.3%	6.1%
1947	25.8%	16.5%	7.8%
1948	27.7%	17.5%	8.6%
1949	31.8%	19.8%	10.2%
1950	34.9%	21.6%	11.4%
1951	35.4%	22.4%	11.0%
1952	38.6%	24.0%	12.6%
1953	41.1%	25.5%	13.4%
1954	44.5%	28.5%	13.6%
1955	48.7%	31.0%	15.2%
1956	50.5%	32.6%	15.4%
1957	51.7%	33.6%	15.4%
1958	53.3%	35.4%	15.0%
1959	56.6%	37.1%	16.3%
1960	59.0%	38.7%	16.8%
1961	60.9%	40.4%	16.6%
1962	62.8%	41.6%	17.1%
1963	66.2%	43.5%	18.3%
1964	67.1%	43.8%	18.9%
1965	68.0%	44.1%	19.6%
1966	67.2%	43.3%	19.2%
1967	66.8%	42.8%	18.9%
1968	66.1%	42.1%	19.1%
1969	65.7%	41.3%	19.2%
1970	62.2%	38.9%	18.2%
1971	62.3%	38.6%	18.6%
1972	63.9%	39.5%	19.4%
1973	63.9%	39.1%	19.7%
1974	63.5%	39.1%	18.8%
1975	61.8%	38.7%	17.4%

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Year	Total	Home Mortgages	Consumer Debt
1976	62.9%	39.7%	17.6%
1977	66.0%	42.0%	18.5%
1978	68.8%	44.1%	19.4%
1979	71.2%	46.2%	19.8%
1980	69.6%	46.3%	17.9%
1981	67.3%	44.6%	16.9%
1982	65.2%	42.7%	16.4%
1983	66.5%	42.9%	17.1%
1984	67.2%	43.0%	18.2%
1985	74.0%	47.1%	19.8%
1986	77.8%	50.6%	20.4%
1987	80.2%	53.2%	20.3%
1988	81.7%	55.1%	20.0%
1989	83.2%	56.6%	20.3%
1990	84.2%	58.5%	19.4%
1991	84.8%	60.0%	18.3%
1992	83.8%	60.0%	17.4%
1993	85.6%	60.9%	18.0%
1994	87.4%	61.1%	19.7%
1995	88.7%	60.8%	21.4%
1996	89.9%	61.2%	22.1%
1997	90.2%	61.6%	22.1%
1998	90.8%	62.2%	22.2%
1999	94.0%	64.9%	22.8%
2000	95.3%	65.5%	23.8%
2001	100.1%	69.4%	24.7%
2002	105.9%	75.0%	24.9%
2003	113.5%	82.3%	25.1%
2004	119.0%	88.2%	25.0%
2005	126.8%	95.7%	25.0%
2006	130.5%	99.5%	24.4%
2007	132.4%	101.1%	24.5%
2008	126.4%	95.8%	23.7%
2009	123.3%	93.7%	22.5%
2010	117.7%	88.4%	21.4%

Source: Board of Governors of the Federal Reserve System.

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Source: Board of Governors of the Federal Reserve System.

While debt as a percentage of disposable personal income has fallen below recent peak levels, it remains high by historical standards. The ratio of total credit market debt outstanding in the household sector to disposable personal income is roughly 20 percent higher in 2010 than it was in 2000, 40 percent higher than in 1990, and twice that of 1960. This growth is due largely to the growth in home mortgage debt. Corresponding figures for home mortgage debt are roughly 40 percent higher than 2000, 50 percent higher than 1990, and 230 percent higher than 1960. Growth in total consumer debt has been more modest, and as a percent of disposable personal income is today only 90 percent of what it was in 2000. However, the ratio of total consumer debt to disposable personal income in 2010 is still approximately 10 percent higher than in 1990 and 30 percent higher than in 1960.

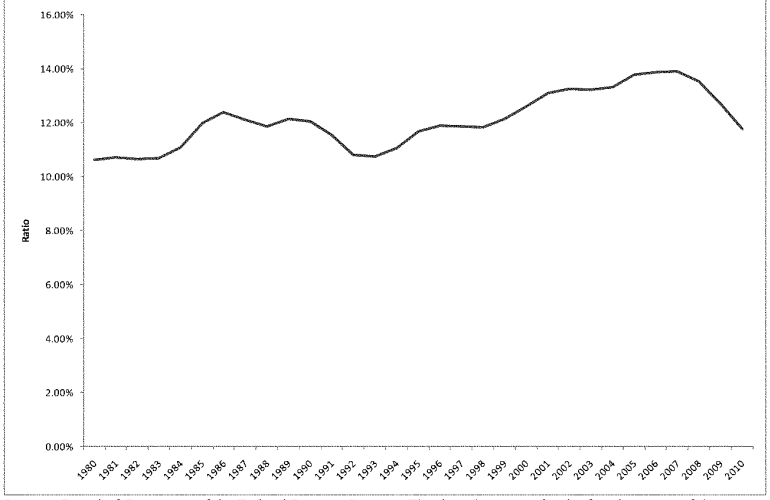
While credit market debt outstanding has grown considerably over the past decades, the cost of servicing such debt has grown less dramatically as a result of generally declining interest rates. The Board of Governors of the Federal Reserve System calculates a measure of the cost of debt service equaling the ratio of the estimated required debt payments to disposable personal income.[23] The debt payments considered for this estimate consist of the estimated required

[23] For revolving consumer debt, the Board of Governors of the Federal Reserve System uses an estimate of the required minimum payment on balances as the estimated required debt payment.

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payments on outstanding mortgage and consumer debt. Figure 4, below, shows this debt service ratio from 1980 to 2010.

Figure 4.–Debt Payments as a Percentage of Disposable Personal Income (Debt Service Ratio), 1980-2010



Source: Board of Governors of the Federal Reserve System. The data shown are for the fourth quarter of the relevant year.

The debt service ratio fluctuates with the aggregate amount of debt, changes in interest rates, and changes in disposable personal income. In the first half of the 1980s, the debt service ratio was generally between 10 and 11 percent. That is, approximately 10 percent of disposable personal income was required to cover the debt payments on mortgage and consumer debt. In the latter half of the 1980s and throughout the 1990s, the ratio was generally between 11 and 12 percent. The ratio rose through the 2000s from 12 percent to a peak of 13.95 percent in the third quarter of 2007. The ratio fell to 11.75 percent by the fourth quarter of 2010 as consumer and mortgage debt outstanding fell, mortgage rates declined, and aggregate disposable personal income continued to rise.[24]

[24] The Board of Governors of the Federal Reserve System also calculates a financial obligations ratio. For homeowners, the financial obligations ratio adds automobile lease payments, homeowners' insurance, and property tax payments to the debt service ratio. The financial obligations ratio follows a pattern similar to the debt service ratio, rising from 15 to 16 percent in the early 1980s to a peak, also in the third quarter of 2007 as for the debt service ratio, of 18.85 percent, and subsequently falling to 16.64 percent by the fourth quarter of 2010. The Board of

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A complete picture of the finances of the household sector needs to reflect the full balance sheet of households and consider assets as well as liabilities. Table 4, below, shows the balance sheet for the household sector. The net worth of the household sector in 2010 was $57.1 billion. The peak level of household net worth was $64.2 trillion in 2007.

Table 4.–Household Sector Balance Sheet: Selected Years 1980, 1990, 2000, and 2010 ($ in billions)[1]

Item	1980	1990	2000	2010
Assets	11,000	24,219	50,063	71,063
Tangible assets	4,442	9,722	16,782	23,380
Real estate	3,414	7,605	13,448	18,466
Households[2,3]	2,943	6,800	12,201	16,451
Consumer durable goods[4]	991	2,039	3196	4,618
Financial assets	6,558	14,497	33,280	47,683
Deposits	1,534	3,325	4,376	7,934
Credit market instruments	521	1,741	2,458	4,255
Corporate equities[2]	1,010	1,961	8,147	8,240
Mutual fund shares[5]	52	512	2,704	4,717
Security credit	16	62	412	694
Life insurance reserves	221	392	819	1,278
Pension fund reserves	970	3,310	9,171	13,092
Equity in noncorporate business[6]	2,154	2,939	4,813	6,642
Liabilities	1,446	3,703	7,375	13,948
Home Mortgage[7]	926	2,489	4,798	10,055
Consumer credit	358	824	1,741	2,435
Net Worth	**9,554**	**20,516**	**42,688**	**57,114**

(1) Includes farm households, domestic hedge funds, and nonprofit organizations.
(2) At market value.
(3) All types of owner-occupied honsing including farm houses and mobile homes, as well as second homes that are not rented, vacant homes for sale, and vacant land.
(4) At replacement (current) cost.
(5) Value based on the market values of equities held and the book value of other assets held by mutual funds.
(6) Net worth of noncorporate business and owners' equity in farm business and unincorporated security brokers and dealers.
(7) Includes loans made under home equity lines of credit and home equity loans secured by junior liens.

Source: Board of Governors of the Federal Reserve System.

Governors of the Federal Reserve System also calculates a financial obligation ratio for renters by including rental payments on tenant-occupied property.

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Table 5, below, shows, for the same years as Table 4, the real value (in 2010 dollars) of assets, liabilities, and net worth, as well real per capita net worth and the ratio of liabilities to assets, or leverage ratio. While net worth has risen in the aggregate over this period, real per capita net worth has declined somewhat since 2000. Leverage ratios have increased over this period, especially over the past decade, as the real value of liabilities has grown faster than the real value of assets.

Table 5.–Assets, Liabilities, Net Worth, and Per Capita Net Worth, in 2010 Dollars; and Leverage Ratios

	1980	1990	2000	2010
Assets (billions of dollars)	29,108	40,406	63,394	71,063
Liabilities (billions of dollars)	3,826	6,178	9,339	13,948
Net Worth (billions of dollars)	25,282	34,227	54,055	57,114
Per Capita Net Worth (thousands)	111	137	192	185
Ratio of Liabilities to Assets	0.13	0.15	0.15	0.20

Source: Board of Governors of the Federal Reserve Board; U.S. Census Bureau, and JCT staff calculations.

These aggregate level data on household assets and liabilities may obscure differences across segments of the population. The top panel of table 6 reports the leverage ratio for households by income and by age of the head of the household.[25] The bottom panel of Table 6 reports the income thresholds associated with the percentiles used to define the income groups in the table. The overall pattern of leverage ratios is stable across time, though it exhibits substantial variation across families. Leverage ratios rise and then fall as income increases. The ratio declines uniformly with age. This age pattern is consistent with the life-cycle hypothesis of savings discussed earlier in this document.

[25] Data come from Brian K. Bucks, Arthur B. Kennickell, Traci L. Mach, and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 95, February 2009, pp. A1-A56.

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Table 6.-Leverage Ratio by Income and Age

	Survey Year			
	1998	**2001**	**2004**	**2007**
All Families	14.2	12.1	15.0	14.9
Percentile of income				
Less than 20	12.7	13.5	15.1	13.5
20–39.9	14.4	14.5	19.4	18.5
40–59.9	20.6	19.2	23.2	24.3
60–79.9	23.1	18.0	21.7	25.3
80–89.9	20.1	18.1	22.8	23.4
90–100	8.9	7.4	9.2	8.4
Age of head of family (years)				
Less than 35	36.6	33.5	46.4	44.3
35-44	25.1	22.6	26.0	28.2
45-54	15.7	13.5	17.3	16.3
55-64	9.0	7.2	9.3	10.3
65-74	4.7	4.2	5.2	6.5
75 or more	2.2	1.8	4.0	2.2

Income Thresholds (nominal dollars)				
	Survey Year			
Percentile of Income	**1998**	**2001**	**2004**	**2007**
20	17,700	19,700	20,800	20,600
40	33,600	36,100	37,200	36,500
60	54,200	60,100	58,900	59,600
80	86,900	96,200	98,100	98,200
90	119,600	139,000	142,100	140,900

Source: Board of Governors of the Federal Reserve System, Survey of Consumer Finances.

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III. PRESENT LAW AND LEGISLATIVE BACKGROUND

The description below focuses on the Federal income tax rules applicable to households, which consist of individuals, apart from any business activities.[26]

A. Deductibility of Interest Expense of Households

1. Disallowance of deduction for personal interest

Present Law

Unlike business interest and investment interest, the personal interest of an individual taxpayer is not deductible. Personal interest includes all interest other than interest properly allocable to a trade or business (other than the trade or business of performing services as an employee), investment interest, certain home mortgage interest and education loan interest, and other types of interest.[27] For example, personal interest includes interest on a loan to purchase an automobile and credit card interest incurred, if such interest is not incurred or continued in connection with the conduct of a trade or business. Personal interest also includes interest on certain underpayments of individual Federal, State or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from the conduct of a trade or business.[28]

Because personal interest generally is not a cost associated with the production of income that is subject to tax, a deduction for personal interest would not accurately measure the taxpayer's income. The Federal income tax system generally does not include the economic income taxpayers receive from personal assets, even though the individual taxpayer may be considered as having received a measurable economic benefit from the personal asset.[29] Because

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[26] A sole proprietorship is a form of business entity that is disregarded as separate from its owner for Federal tax purposes. Taxpayers report income or loss from a business operated or a profession practiced as a sole proprietor on Schedule C of the taxpayer's Form 1040. The Federal income tax rules relating to business debt are discussed in *Tax Treatment of Business Debt*.

[27] Sec. 163(h)(2). This rule applies to taxpayers other than corporations. The other types of interest are: interest taken into account under section 469 in computing income or loss from a passive activity; and certain interest payable under an extension of time to pay estate tax.

[28] Temp. Treas. Reg. sec. 1.163-9T(b)(2)(i)(A). See *Allen v. U.S.*, 173 F.3d 533, 537 (4th Cir. 1999), in which the court stated, "[i]n plain English, interest on an unpaid income tax debt is never a cost of doing business, because no taxpayer may claim that he or she is in the business of not paying taxes"; *Alfaro v. Commissioner*, 349 F.3d 225 (5th Cir. 2003); *McDonnell v. U.S.*, 180 F.3d 721 (6th Cir. 1999); *Redlark v. Commissioner*, 141 F.3d 936 (9th Cir. 1998); *Kikalos v. Commissioner*, 190 F.3d 791 (7th Cir. 1998); *Miller v. U.S.*, 65 F.3d 687 (8th Cir. 1995). In the case of property tax, however, personal interest includes interest on underpayments of individual Federal, State, or local property taxes not properly allocable to a trade or business (other than the trade or business of performing services as an employee). With respect to interest on property tax, it can be ascertained whether the property subject to property tax is trade or business property or not.

[29] For example, the economic benefit of living in a home an individual owns, or of personal use of a car the individual owns, is not included in the individual's income. Nonetheless, the amount of the economic benefit the individual receives from living in his home, or using his car, can be measured: it is generally the rental value of a

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imputed personal income is excluded from the income tax, interest expense associated with the excluded income is not deductible as a general rule.[30]

Legislative Background

Prior to the Tax Reform Act of 1986 ("1986 Act"),[31] no limitation was imposed on the deductibility of interest on indebtedness of households. Interest incurred to purchase or carry consumption goods was deductible. For example, households could deduct interest on auto loans and credit cards as itemized deductions.

In 1985, a total of 101.7 million returns were filed. Among the returns filed, 39.8 million claimed itemized deductions of $405 billion in aggregate. Of the returns claiming itemized deductions, 36.3 million claimed $180 billion of itemized deductions for interest paid, of which 28.1 million claimed $115 billion of mortgage interest, 26 million claimed $12.2 billion of credit card interest, and 29 million claimed $52.8 billion of other interest (including mortgage points and investment interest).[32] By 1991, when the deduction for personal interest was completely phased out, of the 114.7 million returns filed for that year, 32.5 million claimed itemized deductions of $467.7 billion. Only 27.4 million claimed a deduction for any interest paid for total interest paid deductions of $213.7 billion. Of these 27.4 million returns, 27 million claimed $201 billion of mortgage interest, just under 2 million claimed $2.2 billion of deductible mortgage points, while 1.6 million claimed $10.3 billion of investment interest.[33]

The 1986 Act phased out the deductibility of consumer interest generally, while providing specified exceptions.[34] In enacting the personal interest limitation, Congress described a principal rationale as eliminating a disincentive to saving:

> Prior to the 1986 Act, the tax law excluded or mismeasured income arising from the ownership of housing and other consumer durables. Investment in such goods allowed consumers to avoid the tax that would apply if funds were invested in

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comparable house in a comparable neighborhood, or the rental value of a comparable car. The current Federal income tax system excludes from the measurement of an individual or household's income the imputed rental value of personal assets for a variety of reasons. For example, an individual does not receive the economic benefit in cash, but in kind, so the individual may not have means to pay the tax. In addition, the administrative burden of measuring and collecting such a tax could be outweighed by the simplicity of ignoring it. For these reasons and others, the custom since imposition of the income tax has been generally to exclude from the tax base imputed income from personal assets. See Part I, above, for a discussion of how households use debt to match the timing of the consumption of benefits to the timing of payments in the purchase of durable goods.

[30] Sec. 163(h)(1).

[31] Pub. L. No. 99-514.

[32] Internal Revenue Service, *Individual Income Tax Returns 1985*, Publication 1304 (Rev. 4-88).

[33] Internal Revenue Service, *Individual Income Tax Returns 1991*, Publication 1304 (Rev. 3-94).

[34] Pub. L. No. 99-514, sec. 511.

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> assets producing taxable income and to avoid the cost of renting these items, a cost which would not be deductible in computing tax liability. Thus, the tax system under pre-1986 law provided an incentive to invest in consumer durables rather than assets which produce taxable income and, therefore, an incentive to consume rather than save. Although Congress believed that it would not be advisable to subject the imputed rental income of consumer durables owned by the taxpayer to income tax, Congress nevertheless concluded that it is appropriate and practical to address situations where personal expenditures are financed by borrowing. ... By phasing out the deductibility of personal interest, Congress intended to eliminate a significant disincentive to saving.[35]

2. Deduction for home mortgage interest allowed

Present Law

Qualified residence interest is not treated as personal interest and is deductible, subject to limitations.[36] Qualified residence interest means interest on either acquisition indebtedness or home equity indebtedness.

Acquisition indebtedness

Acquisition indebtedness is indebtedness incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer.

Acquisition indebtedness is reduced as payments of principal are made and cannot be increased by refinancing. Thus, for example, if the taxpayer incurs $200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to $150,000, the taxpayer's acquisition indebtedness with respect to the residence cannot thereafter be increased above $150,000 (except by indebtedness incurred to substantially improve the residence). Refinanced acquisition debt continues to be treated as acquisition debt to the extent that the principal amount of the refinancing does not exceed the principal amount of the acquisition debt immediately before the financing.

The indebtedness must be secured by the qualified residence and is limited to $1 million ($500,000 for married persons filing a separate return). A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

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[35] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 263; S. Rep. No. 99-313, Report of the Senate Committee on Finance to accompany H.R. 3838, 99th Cong., 2d Sess., May 29, 1986, p. 804; H. Rep. No. 99-426, Report of the House Committee on Ways and Means on H.R. 3838, 99th Cong., 1st Sess., December 7, 1985, p. 297.

[36] Sec. 163(h)(2)(D) and (h)(3).

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Home equity indebtedness

Certain home equity indebtedness may give rise to deductible qualified residence interest. Home equity indebtedness, for this purpose, means debt secured by the taxpayer's principal or second residence to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

The amount of home equity indebtedness on which interest is treated as deductible qualified residence interest may not exceed $100,000 ($50,000 for married persons filing a separate return).

Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the indebtedness are used. For example, personal expenditures may include health costs and education expenses for the taxpayer's family members or any other personal expenses such as vacations, furniture, or automobiles. A taxpayer and a mortgage company can contract for the home equity indebtedness loan proceeds to be transferred to the taxpayer in a lump sum payment (e.g., a traditional mortgage), a series of payments (e.g., a reverse mortgage), or the lender may extend the borrower a line of credit up to a fixed limit over the term of the loan (e.g., a home equity line of credit).

The aggregate limitation on the total amount of a taxpayer's acquisition indebtedness and home equity indebtedness with respect to a taxpayer's principal residence and a second residence that may give rise to deductible interest is $1,100,000 ($550,000, for married persons filing a separate return).

Points

Points (prepaid interest) with respect to a home mortgage are treated differently for Federal income tax purposes depending on the circumstances in which they are paid. In general, points are capitalized and amortized over the period of the indebtedness.[37] This rule generally applies to points on a refinancing of a qualified residence of the taxpayer. An exception to this general rule, however, permits a current deduction for points on debt incurred for the initial purchase or improvement of the taxpayer's principal residence. This exception does not apply to the taxpayer's second residence. The deduction is allowable only to the extent the points would be deductible as qualified residence interest (if they were not prepaid).

Legislative Background

The deduction for home mortgage interest, like other consumer interest, generally was not limited prior to the 1986 Act. When the deduction for personal interest was phased out generally under the 1986 Act, deductibility was nevertheless retained for interest on debt on the taxpayer's principal residence and a second home. The Omnibus Budget Reconciliation Act of

[37] Sec. 461(g).

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1987 ("1987 Act")[38] modified this provision to permit a deduction for interest (not restricted to borrowing for educational or medical expenses) on home equity debt of up to $100,000, and on home acquisition debt of up to $1 million.

Congress described the reason for preserving a deduction for home mortgage interest as furthering the social policy goal of promoting home ownership:

> While Congress recognized that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, Congress nevertheless determined that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. Therefore, the personal interest limit does not affect the deductibility of interest on debt secured by the taxpayer's principal residence or second residence, to the extent of the basis of the principal residence (or second residence).[39]

3. Deduction for student loan interest

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit and an income phase out.[40] Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis certain educational institutions.[41] The cost of attendance is reduced by any amount excluded from gross income under the exclusions for qualified scholarships and tuition reductions, employer-provided educational assistance, interest earned on education savings

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[38] Pub. L. No. 100-203, sec. 10101.

[39] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 263; S. Rep. No. 99-313, Report of the Senate Committee on Finance to accompany H.R. 3838, 99th Cong., 2d Sess., May 29, 1986, p. 804; H. Rep. No. 99-426, Report of the House Committee on Ways and Means on H.R. 3838, 99th Cong., 1st Sess., December 7, 1985, p. 297.

[40] Sec. 221.

[41] Specifically, these are (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

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bonds, qualified tuition programs, and Coverdell education savings accounts, as well as the amount of certain other scholarships and similar payments.

The maximum allowable deduction per year is $2,500. For 2011, the deduction is phased out ratably for taxpayers with modified adjusted gross income between $60,000 and $75,000 ($120,000 and $150,000 for married taxpayers filing a joint return). The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of $5,000.

Effective for taxable years beginning after December 31, 2012, interest is deductible only during the first 60 months of required interest payments and the phaseout ranges revert to a base level of $40,000 to $55,000 ($60,000 to $75,000 in the case of a married couple filing jointly), but with an adjustment for inflation occurring since 2002.

Legislative Background

Prior to enactment of the personal interest deduction limitation in 1986, student loan interest was deductible without limitation. During the period for which the personal interest deduction limitation was phased in, 1987 through 1990, student loan interest was partially deductible under the phase-in rules.[42] From 1991 through 1997, student loan interest generally was not deductible.

In 1997, a general deduction for student loan interest was added to the Code.[43] It was effective for interest paid in taxable years beginning after December 31, 1997. Congress indicated it made the 1997 changes because it understood that many students incur substantial debt in the course of obtaining undergraduate and graduate education, and believed that permitting a deduction for interest on certain student loans would help ease the financial burden on those students.[44]

In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") temporarily increased the adjusted gross income phaseout ranges for the deduction and eliminated rules limiting deductibility of interest to the first 60 months of required interest payments.[45] Congress believed it was appropriate to modify the deduction to make it available to

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[42] The amount of personal interest disallowed during the phase-in period for the personal interest deduction limitation is the applicable percentage of the amount otherwise disallowed. The applicable percentage for 1987 is 35 percent; for 1988, 60 percent; for 1989, 80 percent; for 1990, 90 percent; and for 1991 and thereafter, 100 percent. Sec. 163(h)(5). For taxable years beginning in 1987, the 1986 Act personal interest limitation rules allowed a deduction for interest on debt secured by a qualified residence of the taxpayer and incurred to pay for qualified tuition and related expenses of the taxpayer, his or her spouse, or a dependent for attendance at specified types of educational institutions. 1986 Act, Pub. L. No. 99-514. The 1987 Act (Pub. L. No. 100-203) modified this provision to permit a deduction for interest (not restricted to borrowing for educational expenses) on home equity debt of up to $100,000 (as well as on home acquisition debt of up to $1 million).

[43] Taxpayer Relief Act of 1997, Pub L. No. 105-34, sec. 202.

[44] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, p. 21.

[45] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, sec. 412.

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more taxpayers.[46] In 2010, these modifications were extended when the EGTRRA sunset was extended by two years, from December 31, 2010, to December 31, 2012.[47]

4. Deductible investment interest expense limited to net investment income for individuals

Present Law

General rule

In the case of a taxpayer other than a corporation, the deduction for interest on indebtedness that is allocable to property held for investment (investment interest) is limited to the taxpayer's net investment income for the taxable year.[48] Disallowed investment interest is carried forward to the next taxable year.

Allowable investment interest is an itemized deduction that reduces income taxable at ordinary income rates. The adjusted net capital gain[49] of an individual, which is subject to tax at a maximum rate of 15 percent for taxable years beginning before January 1, 2013, is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation.[50]

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[46] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 107th Congress* (JCS-1-03), January 24, 2003, p. 47.

[47] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 101.

[48] Sec. 163(d).

[49] Under section 1(h), the adjusted net capital gain of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain, plus qualified dividend income. The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year. "Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies may not exceed the net section 1231 gain for the year.

[50] Sec. 1(h)(2).

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Net investment income

In general

Net investment income is investment income net of investment expenses.[51] Investment income generally consists of gross income from property held for investment,[52] and investment expense includes all deductions directly connected with the production of investment income (e.g., deductions for investment management fees) other than deductions for interest.[53] Investment income includes only so much of the taxpayer's net capital gain and qualified dividend income as the taxpayer elects to take into account as investment income.[54]

Interaction with two-percent floor on miscellaneous itemized deductions

The two-percent floor on miscellaneous itemized deductions allows taxpayers to deduct investment expenses connected with investment income only to the extent such deductions exceed two percent of the taxpayer's adjusted gross income ("AGI").[55] Miscellaneous itemized deductions[56] that are not investment expenses are disallowed first before any investment expenses are disallowed.[57]

For example, if an individual has $10,000 of gross investment income, $800 of investment expenses, and $700 of employee business expenses, the individual would have $1,500 of miscellaneous itemized deductions (i.e., $800 plus $700). Assume the taxpayer's AGI is $50,000. The taxpayer's two-percent floor is therefore $1,000, and the taxpayer is allowed only $500 of miscellaneous itemized deductions (i.e., $1,500 of deductions minus the $1,000 floor). Because expenses that are not investment expenses are disallowed first, all $700 of the employee business expense is disallowed, and only $300 of the $800 investment expenses is disallowed. The remaining $500 of the investment expenses is deductible. Thus, the taxpayer's

[51] Sec. 163(d)(4)(A).

[52] Sec. 163(d)(4)(B).

[53] Sec. 163(d)(4)(C).

[54] Sec. 163(d)(4)(B)(iii). A taxpayer may claim a deduction for investment interest expense by filing IRS Form 4952, which enables the taxpayer to elect how much qualified dividends and net capital gain to include in investment income.

[55] Sec. 67(a).

[56] The miscellaneous itemized deductions are defined in section 67(b) to include itemized deductions of individuals other than certain specific itemized deductions. Thus, miscellaneous itemized deductions generally include, for example, investment management fees and certain employee business expenses, but specifically do not include, for example, interest, taxes, casualty and theft losses, charitable contributions, medical expenses, or other listed itemized deductions.

[57] H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-154, Sept. 18, 1986 (Conf. Rep.) ("In computing the amount of expenses that exceed the 2-percent floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.").

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net investment income is $9,500 (i.e., $10,000 of gross investment income minus $500 of investment expenses).

Tracing interest on debt

In applying interest deduction limitations, either a tracing approach or a pro rata approach determines whether debt is associated with untaxed income. The tracing approach applies generally to interest deduction limitations applicable to taxpayers who are individuals.[58]

For purposes of the investment interest limitation, under the tracing approach, debt is allocated to expenditures in accordance with the use of the debt proceeds, and interest on the debt is allocated in the same manner.[59] Thus, generally, the disallowance of a deduction for investment interest depends on the individual's use of the proceeds of the debt. For example, if an individual pledges corporate stock held for investment as security for a loan and uses the debt proceeds to purchase a car for personal use, interest expense on the debt is allocated to the personal expenditure to purchase the car and is treated as nondeductible personal interest rather than investment interest.

Legislative Background

Prior to the 1986 Act,[60] in the case of a noncorporate taxpayer, deductions for interest on indebtedness incurred or continued to purchase or carry property held for investment were generally limited to $10,000 per year, plus the taxpayer's net investment income.

Investment income under pre-1986 law was income from interest, dividends, rents, royalties, short-term capital gains arising from the disposition of investment assets, and any amount of gain treated as ordinary income pursuant to the depreciation recapture provisions, but only if the income was not derived from the conduct of a trade or business.

In determining net investment income under pre-1986 law, the investment expenses taken into account were trade or business expenses, real and personal property taxes, bad debts, depreciation, amortizable bond premiums, expenses for the production of income, and depletion, to the extent these expenses were directly connected with the production of investment income. For purposes of this determination, depreciation with respect to any property was taken into account on a straight-line basis over the useful life of the property, and depletion was taken into account on a cost basis.

The investment interest limitation was modified in the 1986 Act to eliminate the $10,000 offset against noninvestment income, and to coordinate the investment interest limitation with

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[58] By contrast, the pro rata approach applicable to certain financial institutions and certain other businesses disallows interest deductions based on the percentage of a taxpayer's assets comprised of tax-exempt obligations.

[59] Temp. Treas. Reg. sec. 1.163-8T(c).

[60] Pub. L. No. 99-514.

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other limitations on deductions of individuals enacted in 1986, the personal interest limitation and the passive activity loss limitation rules.[61]

In modifying the investment interest deduction limitation in 1986, Congress expressed concern about income mismeasurement that resulted under the rules of prior law:

> Under prior law, leveraged investment property was subject to an interest limitation, for the purpose of preventing taxpayers from sheltering or reducing tax on other, noninvestment income by means of the unrelated interest deduction. Congress concluded that the interest limitation should be strengthened so as to reduce the mismeasurement of income which can result from deduction of investment interest expense in excess of current investment income, and from deduction of current investment expenses with respect to investment property on which appreciation has not been recognized.[62]

Congress noted at that time that under pre-1986 law, no part of long-term capital gains were included in net investment income for purposes of determining the investment interest deduction limitation. This was to prevent taxpayers from taking a deduction at higher rates than the rate at which the taxpayer's income was subject to tax. Congress concluded in 1986 that the continuation of this rule was inappropriate, because long-term capital gains were generally taxed at the same tax rate as ordinary income when the 1986 Act provisions were fully phased in. When those long-term capital gains and ordinary income tax rates were equalized in the 1986 Act, long-term capital gains were included in investment income for purposes of computing the investment interest limitation.

In 1990,[63] however, Congress raised ordinary income tax rates without increasing long-term capital gains rates, thereby reintroducing a rate differential. In 1993, a provision was added to the law excluding from long-term capital gains those amounts taken into account in determining investment income for purposes of the investment interest limitation, thus modifying the treatment under the 1986 Act when the rates were the same.[64]

In summary, the principal difference between the pre-1986 and the present-law investment interest limitation is that present law does not provide for the $10,000 offset of

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[61] Secs. 163(h)(1) and 469. The passive activity loss limitation was enacted to "curb the expansion of tax sheltering." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 210.

[62] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 263. See also Report of the Senate Committee on Finance to accompany H.R. 3838, S. Rep. 99-313, May 29, 1986, p. 803; compare Report of the House Committee on Ways and Means on H.R. 3838, H.R. Rep. 99-426, pp. 297-298.

[63] Omnibus Reconciliation Act of 1990, Pub. L. No. 101-508.

[64] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66. A similar exclusion for qualified dividend income (which is taxed at a 15-percent rate for taxable years beginning before January 1, 2013) was added in 2003, Pub. L. No. 108-27, sec. 302(b).

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investment interest against other income. In addition, the present-law investment interest limitation is coordinated with other rules restricting the deductions of individual taxpayers that were enacted in 1986, specifically the personal interest limitation and the passive activity loss limitation, and investment expenses are determined after the application of the two-percent floor on miscellaneous itemized deductions.

5. Debt with respect to certain insurance products

Present Law

In general

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[65] ("inside buildup").[66] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[67]

Present law imposes limitations on the deductibility of interest on debt with respect to life insurance contracts.[68] These limitations apply to all taxpayers, including individuals (households). An additional pro rata interest deduction limitation applies to taxpayers other than natural persons.[69] These limitations address the potential for arbitrage that could arise in the event that deductible interest expense relates to amounts excludable as inside buildup or as death benefits under a life insurance contract.

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[65] By contrast to the treatment of life insurance contracts, if a deferred annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract for purposes of determining income taxes, other than those imposed on insurance companies (sec. 72(u)).

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

[67] Sec. 101(a).

[68] Limitations on the deductibility of premiums also apply if the taxpayer is directly or indirectly a beneficiary under the policy or contract. Sec. 264(a)(1).

[69] If a business other than a sole proprietorship is directly or indirectly the beneficiary under a policy, such policy is treated as held by the business and not by a natural person. Sec. 264(f)(5). This rule is discussed further in *Tax Treatment of Business Debt*.

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Interest paid or accrued with respect to the contract in the case of individual taxpayers

Single premium contracts

No deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract (the "single premium" deduction limitation).[70] A contract is treated as a single premium contract if substantially all the premiums on the contract are paid within a period of four years from the date on which the contract is purchased or if an amount for payment of a substantial number of future premiums is deposited with the insurer.[71]

Four-out-of-seven rule

In addition, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[72] The deduction denial does not apply if no part of four of the annual premiums due during the initial seven-year period is paid by means of such debt.[73] A tracing approach applies to determine whether premiums are paid by means of such debt.[74]

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[70] Sec. 264(a)(2).

[71] Sec. 264(c).

[72] Sec. 264(a)(3).

[73] Sec. 264(d). Further exceptions are provided: (1) if the total amounts to which the provision would apply in taxable year does not exceed $100; (2) if the amounts are paid or accrued because of an unforeseen financial hardship; or (3) if the indebtedness is incurred in connection with the taxpayers trade or business. However, the section 264(d) exceptions are inapplicable in situations in which the general interest deduction disallowance rule of section 264(a)(4) applies. The general rule of section 264(a)(4) was enacted in its current form in 1996, subsequent to the rules of section 264(a)(3) and (d) which were enacted in 1964.

[74] For example, if an individual borrows amounts under a life insurance contract that he or she owns, the debt is considered to be incurred with respect to the contract. Treasury regulations explain "direct or indirect borrowing" under the 1964 rule limiting interest pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise). These regulations provide this example: "[t]hus, for example, if a taxpayer borrows $100,000 from a bank and uses the funds to purchase securities, later borrows $100,000 from a second bank and uses the funds to repay the first bank, later sells the securities and uses the funds as a part of a plan …to pay premiums on a contract of cash value life insurance, the deduction for interest paid in continuing the loan from the second bank shall not be allowed (assuming that none of the exceptions contained in paragraph (d) of this section are applicable)." Treas. Reg. 1.264-4(c)(2).

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General rule

Finally, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual (with an exception relating to key persons in the business context).[75]

Life insurance, endowment, and annuity contracts may permit borrowing of the cash value of the contract by the holder of the contract. Under the interest deduction limitation, if an individual purchases a life insurance, endowment, or annuity contract, and, for example, borrows under the contract pursuant to its terms, the interest on the borrowing is not deductible.[76]

Legislative Background

A limitation has applied to the deductibility of interest with respect to single premium life insurance contracts since 1942.[77] The "four-out-of-seven" interest deduction limitation was added in 1964, and an additional interest deduction limitation with respect to life insurance, endowment, and annuity contracts was added in 1986.[78] More recently, additional interest deduction limitations with respect to such insurance contracts were added in 1996 and again in 1997.[79] In general, these interest deduction limitations have been based in part on concern over the opportunity for arbitrage, that is, the deductibility of interest expense with respect to untaxed investment income (inside buildup) of the insurance contract.

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[75] Sec. 264(a)(4). This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. In the case of a taxpayer that holds policies or contracts insuring other individuals (generally in the business context), a key person exception applies. Sec. 264(e).

[76] In general, a tracing rule applies to determine whether debt is incurred with respect to a life insurance, annuity, or endowment contract, as exemplified by Treas. Reg. 1.264-4(c)(2).

[77] Current sec. 264(a)(2) (former sec. 24(a)(6) of the 1939 Code), enacted in the Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 798, sec. 129, 77th Cong., 2d Sess., October 21, 1942.

[78] Sec. 264(a)(3), enacted in the Revenue Act of 1964, Pub. L. No. 88-272, sec. 215, 88th Cong., 2d Sess., 1964; sec. 264(a)(4) and (e)(1) (subsequently modified), enacted in the Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 99th Cong., 2d Sess., October 22, 1986. As enacted in 1986, the sec. 264(a)(4) provision applied only to the extent that the aggregate amount of indebtedness with respect to policies covering an insured exceeded $50,000. This limitation was removed in 1996 (Pub. L. No. 104-191, sec. 501). In addition to interest deduction limitations, limitations are imposed on the deductibility of premiums with respect to life insurance, endowment and annuity contracts (sec. 264(a)(1)).

[79] These changes were directed primarily to business-owned life insurance. Current sec. 264(e), enacted in the Health Insurance Portability and Accountability Act of 1996, Pub. L. No 104-191, sec. 501, 104th Cong., 2d. Sess., July 31, 1996; and sec. 264(f), applicable to taxpayers other than natural persons, enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 105th Cong., 1st Sess., July 30, 1997.

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For example, in enacting the 1964 interest deduction limitation, Congress stated,

> The annual increase in the cash value of the insurance policy to reflect interest earnings, which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal or exceed the net interest charges the taxpayer pays. Thus, for taxpayers in higher brackets, where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured.[80]

6. Disallowance of deduction for interest incurred to purchase tax-exempt obligations

Present Law

In general

The interest income an individual or household receives from an investment in debt is generally taxable as ordinary income, and gain or loss on sale of debt held as an investment is capital gain or loss.[81]

Interest on bonds issued by State and local governments, however, generally is excluded from the recipient's gross income for Federal income tax purposes.[82]

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[80] Revenue Act of 1963, Report of the Committee on Ways and Means, H.R. Rep. No. 749, 88th Cong., 1st Sess., page 61, September 13, 1963. In enacting the most recent of these interest deduction limitations in 1997, Congress expressed concern about the tax arbitrage of deducting interest expense that funds untaxed income:

> In addition, the Committee understands that taxpayers may be seeking new means of deducting interest on debt that in substance funds the tax-free inside build-up of life insurance or the tax-deferred inside buildup of annuity and endowment contracts. The Committee believes that present law was not intended to promote tax arbitrage by allowing financial or other businesses that have the ongoing ability to borrow funds from depositors, bondholders, investors or other lenders to concurrently invest a portion of their assets in cash value life insurance contracts, or endowment or annuity contracts. Therefore, the bill provides that for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of any life insurance policy or annuity or endowment contract issued after June 8, 1997.

Revenue Reconciliation Act of 1997 (as Reported by the Senate Committee on Finance), S. Rep. No. 105-33, 105th Cong., 1st Sess., p. 187, June 20, 1997 (footnotes omitted).

[81] The amount of capital losses that a taxpayer may deduct, including on sale of debt held as an investment, is generally limited to a taxpayer's capital gain. Under section 1211(b), an individual, trust, or estate may deduct all capital losses (i.e., both short- and long-term capital losses) against all capital gains (i.e., both short- and long-term capital gains). If aggregate capital losses exceed aggregate capital gains, such taxpayers may deduct up to $3,000 of the excess against ordinary income ($1,500 in the case of a married individual filing a separate return).

[82] The interest on qualified private activity bonds is included in a taxpayer's alternative minimum taxable income ("AMTI"). A private activity bond is a bond issued by a State or local government for which the State or local government serves as a conduit, providing financing to nongovernmental persons (e.g., private businesses or individuals). The alternative minimum tax ("AMT") is the amount by which a taxpayer's tentative minimum tax

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Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax.[83] This rule applies to tax-exempt obligations held by individual and corporate taxpayers.[84] The rule also applies to certain cases in which a taxpayer incurs or carries indebtedness and a related person acquires or holds tax-exempt obligations.[85]

Tracing approach

In the case of households, the method for allocating interest on debt to tax-exempt obligations is generally a tracing approach.[86] Under the tracing approach, the disallowance of a deduction for interest depends on whether the taxpayer's borrowing can be traced to its holding of tax-exempt obligations. Thus, for example, interest on debt is disallowed if the proceeds of the debt are used for and are directly traceable to the purchase of tax-exempt obligations, or if tax-exempt obligations are used as collateral for the debt. In the absence of direct evidence, the interest disallowance rule applies only if the totality of facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempt obligations exists. In general terms, the tracing rule applies only if the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

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exceeds the taxpayer's regular income tax. The tentative minimum tax is computed based upon a taxpayer's AMTI, which is the taxpayer's taxable income modified to take into account certain preferences and adjustments. One of the preference items is tax-exempt interest on certain tax-exempt bonds issued for private activities (sec. 57(a)(5)). As a result, interest on qualified private activity bonds is taxable for taxpayers who pay the AMT. Because a tax-exempt qualified private activity bond is equivalent to a taxable bond for bondholders who pay the AMT, the yield on qualified private activity bonds is typically higher than the yield on equivalent tax-exempt governmental bonds.

[83] Sec. 265. An interest deduction generally is not disallowed to an individual if during the taxable year the average adjusted basis of the individual's tax-exempt obligations is two percent or less of the average adjusted basis of the individual's portfolio investments and trade or business assets. See Rev. Proc. 72-18, 1972-1 C.B. 740, sec. 3.05.

[84] For this purpose, tax-exempt obligations do not include tax credit bonds; present law provides that for Federal income tax purposes, the credit associated with the bond is treated as interest that is includible in gross income (sec. 54A(f)). The rules applicable to corporate taxpayers are discussed in a companion document. See *Tax Treatment of Business Debt.*

[85] Although Treasury regulations have not been issued, section 7701(f) provides that the Secretary of the Treasury will prescribe regulations necessary or appropriate to prevent the avoidance of any income tax rules that deal with the use of related persons, pass-through entities, or other intermediaries in (1) the linking of borrowing to investment or (2) diminishing risks. See *H Enterprises Int'l, Inc. v. Commissioner,* T.C.M. 1998-97, *aff'd.* 183 F.3d 907 (8th Cir. 1999) (Code section 265(a)(2) applied where a subsidiary borrowed funds on behalf of a parent and the parent used the funds to buy, among other investments, tax-exempt securities).

[86] The tracing approach applies to individual taxpayers (and thus to households). See Rev. Proc. 72-18, 1972-1 C.B. 740. A pro rata method applies to dealers in tax-exempt obligations, corporations that are not dealers, and banks. The pro rata approach disallows interest deductions based on the percentage of a taxpayer's assets comprised of tax-exempt obligations (sec. 265(b)).

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Legislative Background

The interest expense disallowance rules are designed to prevent taxpayers from engaging in tax arbitrage by using indebtedness that generates an interest deduction to purchase an asset that produces tax-exempt income.

The Federal income tax has excluded the interest on debt issued by States and their political subdivisions from the debt holder's gross income since the tax's inception in 1913.[87]

Section 265(a)(2) has remained largely unchanged since 1918.[88] The predecessor to section 265 was first enacted in the Revenue Act of 1917, which allowed a deduction for "all interest paid within the year on [a taxpayer's] indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation under this title."[89] The Revenue Act of 1918 contained a similar provision, allowing a deduction for all interest paid or accrued on indebtedness "except on indebtedness incurred or continued to purchase or carry obligations or securities…the interest upon which is wholly exempt from taxation under this title."[90]

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[87] The exception is now codified in sec. 103.

[88] Sec. 265(a)(2) states that no deduction shall be allowed for "[i]nterest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle."

[89] Revenue Act of 1917, sec. 1201(1), amending section 5(a) of the Revenue Act of 1916.

[90] Revenue Act of 1918, sec. 214(a)(2).

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B. Discharge of Indebtedness Income

1. Tax treatment of income from discharge of indebtedness

Present Law

Gross income generally includes income that is realized by a debtor from the discharge of indebtedness.[91] The amount of discharge of indebtedness income generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Exceptions to this income inclusion rule are provided for debtors in Title 11 bankruptcy cases,[92] insolvent debtors, certain farm indebtedness, certain real property business indebtedness, and certain principal residence indebtedness that is discharged before January 1, 2013.[93] The rules for excluding cancellation of indebtedness income are different for each of these exceptions. For example, a debtor in bankruptcy need not be insolvent to have discharged debt excluded, and there is no limit to the amount of the exclusion. In contrast, the amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent.

In cases involving income from a discharge of indebtedness that is excluded from gross income, taxpayers generally are required to reduce tax attributes (such as net operating losses, tax credits, and the basis of property) by the amount of the discharge of indebtedness income that is excluded.[94]

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[91] Sec. 61(a)(12).

[92] Title 11 of the United States Bankruptcy Code contains chapters which describe the rules and procedure for the filing of a petition for relief. For example, Chapter 7, which is available to individuals, is a straight bankruptcy in which a trustee liquidates a debtor's assets and distributes the proceeds to the creditors. Chapter 11 is typically used for business debt because it allows the debtor to retain possession of assets continue normal business activities while reorganizing its finances so that it may pay its employees, reduce obligations to its creditors and produce a return for its stock holders.

[93] Sec. 108.

[94] Secs. 108(b) and 1017(a). The amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount of cash or the fair market value of other property used to satisfy the debt. The adjusted issue price is usually the issue price including any accrual of original issue discount, reduced by any principal payments made before the discharge and bond issuance premium accrued. See Treas. Reg. sec. 1.1275-1(b); Prop. Treas. Reg. sec. 1.163-13(d)(5).

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Legislative Background

In 1931, the Supreme Court, in the case of *U.S. v. Kirby Lumber Co.*,[95] established that the gain or saving that a debtor realizes upon the reduction or cancellation of outstanding indebtedness for less than the amount due generally is income for Federal tax purposes.[96] In 1939, in response to the *Kirby* decision, Congress amended the Code to exclude the cancellation of indebtedness income of certain financially troubled taxpayers, provided that the taxpayer consents to a reduction in the basis of the taxpayer's other property.[97] The statutory rule generally requiring inclusion in income of discharge of indebtedness income became present-law section 61(a)(12) as part of the Internal Revenue Code of 1954.

The rule of inclusion was recodified with exceptions in 1986. Further exceptions have been added since 1986. For example, in 1993, Congress allowed noncorporate taxpayers restructuring a mortgage secured by real property used in a trade or business and worth less than the mortgage to reduce basis rather than recognize income from the discharge of debt,[98] and in 2007 added the exclusion for qualified principal residence indebtedness that is discharged before January 1, 2013.[99]

2. Exclusion of income from certain student loan forgiveness

Present Law

As described above, gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.[100] The professions to which the exception applies are medicine,

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[95] 284 U.S. 1 (1931).

[96] Prior to *Kirby*, an insolvent or bankrupt taxpayer had no income on a discharge of indebtedness and suffered no reduction in any tax attribute. See I.T. 1564, II-1 C.B. 59 (1923); Treas. Reg. 86, § 22(a)-14 (1935). See Rev. Rul. 69-43, 1969-1 C.B. 310 (declaring the 1923 ruling obsolete).

[97] The Revenue Act of 1939, Pub. L. No. 155, added sections 22(b)(9) and 113(b)(3) of the Internal Revenue Code of 1939, later codified as secs. 108 and 1017. Specific exceptions to the requirement of income inclusion were added (or in 1976, repealed) in legislation subsequent to 1939. In 1980, the Bankruptcy Tax Act, Pub. L. No. 96-589, significantly rewrote section 108. Additional specific exceptions to income inclusion were added in subsequent legislation in 1984, Pub. L. No. 98-369, as well as thereafter.

[98] Pub. L. No. 103-66, sec. 13150.

[99] Pub. L. No. 110-142, sec. 2(a). In 2008, the expiration date was changed from January 1, 2010 to January 1, 2013. Pub. L. No. 110-343, Division A, sec. 303(a).

[100] Sec. 108(f).

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nursing, teaching,[101] and the law.[102] The broad class of employers condition is intended to prevent the provision of loan forgiveness from serving as indirect compensation from a specific employer or employers.[103]

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation.

In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations), cancellation of the student loan must be contingent upon the student working in an occupation or area with unmet needs and such work must be performed for, or under the direction of, a tax-exempt charitable organization or a governmental entity.

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program or certain State loan repayment or loan forgiveness programs.[104]

Legislative Background

In 1976, Congress first made available an exclusion from gross income for certain student loan forgiveness.[105] The exclusion applied only to loans made pursuant to a government-

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[101] S. Rep. No. 98-169, p. 887 (1984); Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 1200.

[102] Rev. Rul. 2008-34, 2008-28 I.R.B. 76.

[103] An example of a loan requirement satisfying this condition is that a doctor work for any public hospital in any rural area of the United States. In contrast, a loan requirement that a doctor work for a specific hospital would not satisfy this condition. Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 1200.

[104] Sec. 108(f)(4).

[105] Tax Reform Act of 1976, Pub. L. No. 94-455, sec. 2117.

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sponsored program requiring the loan recipient to work for a certain period of time in certain geographical areas or for certain classes of employers.[106] The primary purpose for this exclusion was to assist States and cities that had had trouble recruiting doctors, nurses, and teachers to work in certain rural and low-income urban areas.[107] In 1997, the exclusion was expanded to include forgiveness of loans made by certain tax-exempt organizations under conditions comparable to those of the government-sponsored programs to which the exclusion already applied.[108] The exclusion was further expanded in 2004 to include loan repayments received under the National Health Service Corps loan repayment program and certain State loan repayment programs.[109] In 2010, the exclusion was again expanded to include any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas.[110]

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[106] As initially enacted, the exclusion was available only for loans forgiven prior to 1979. The exclusion was extended by four years in 1978, however, so that it was available for loans forgiven prior to 1983. Revenue Act of 1978, Pub. L. No. 95-600, sec. 162. In 1984, a permanent exclusion for certain student loan forgiveness was enacted that was similar to the prior, temporary exclusions; this exclusion applied to forgiveness occurring on or after January 1, 1983. Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 1076.

[107] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 1200.

[108] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 225; see also IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, sec. 6004(f) (clarifying that the 1997 change applies to refinancing loans made pursuant to a program of a tax-exempt organization requiring the student to fulfill a public service requirement).

[109] American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 320.

[110] Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, sec. 10908.

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IV. ECONOMIC INCENTIVES FOR HOUSEHOLDS UNDER PRESENT LAW

In general

The tax treatment of household debt has a number of potential consequences for both the efficiency of debt markets and the equity of treatment across borrowers and lenders in these markets. When borrowers and lenders face changes in the cost of acquiring and holding household debt as a result of new tax policies, they respond to these new costs by changing their demand for, or supply of, debt, distorting economic activity that would otherwise enhance the well-being of both lenders and borrowers (economists refer to this distortion as "efficiency loss"). On the other hand, if there are existing inefficiencies in the market (for example, due to spillover effects), taxes may reduce efficiency losses. Furthermore, if tax policies redistribute resources in a way that lawmakers believe to be more equitable, losses in efficiency due to the tax may be offset by a gain in equity. Also, the policies could trade off for a gain in simplicity of administration and compliance.

Deduction for home mortgage interest

The deduction for home mortgage interest reduces the after-tax cost of financing and maintaining a home. Because the Federal income tax allows taxpayers to deduct mortgage interest from their taxable income, but does not allow them to deduct rental payments, there is a financial incentive to buy rather than rent a home. Taxpayers are also allowed to exclude gains from the sale of their principal residences of up to $500,000 ($250,000 for married filing separately) from gross income. There is no such exclusion for other types of investments, further reinforcing the financial incentive to buy rather than rent a home.[111]

Homeowners also receive preferential treatment under U.S. tax law because the imputed rental income on owner-occupied housing (that is, the cost of rent which the taxpayer avoids by owning and occupying a home) is not taxed. Consider two taxpayers: one rents a home at a $1,000 monthly rate, and the other owns a home which carries a $1,000 monthly mortgage. All else equal, a renter pays taxes on a measure of income that includes the $1,000 used to pay rent and the homeowner pays taxes on a measure of income that does not include that same $1,000. If imputed rental income were included in income, it would be appropriate to allow a deduction for mortgage interest, property taxes, and depreciation as costs of earning that income. Because tax law allows taxpayers to deduct mortgage interest and property taxes to determine their taxable income but does not tax imputed rental income or allow them to deduct rental payment, it creates the incentive to buy rather than rent a home and to finance the acquisition with debt.

One study estimates that the mortgage interest deduction lowers the cost of capital for owner-occupied housing by seven percent.[112] Some researchers argue that this creates economic

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[111] There are also some tax incentives that may reduce the cost of renting relative to owning (for example, accelerated depreciation).

[112] James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review Papers and Proceedings*, vol. 96 (May 2008).

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distortions; the subsidized mortgage debt may lead households to demand houses that are larger and more expensive than would be demanded in the absence of the mortgage interest deduction. In markets where the marginal buyer itemizes, this increased demand for larger and more expensive homes leads to a rise in price for these homes above what the market dictates in the absence of the deduction. The mortgage interest deduction may also lower the cost of home mortgage loans relative to other types of debt. Households may increase their demand for owner-occupied housing instead of choosing from potentially higher pre-tax return investments in other sectors. Finally, if the mortgage interest deduction results in relatively lower cost of home mortgage debt, households may increase their holdings of home mortgage debt.

Supporters of the home mortgage interest deduction believe that this policy has a positive effect on the U.S. economy, encouraging homeownership and accompanying positive spillover benefits. They assert that homeowners are more likely to care about their neighborhoods and towns than those who rent. In principle, if this care increases civic involvement and local decision-making that prioritizes long-run investments leading to long-term gains in property values, then the mortgage interest deduction creates social and economic value that may justify the cost of the policy. However, some research fails to find evidence for correlations between home ownership and social benefits such as increased civic involvement and local decision-making that prioritizes long-run investments.[113] Other research questions whether the home mortgage interest deduction serves its intended purpose of encouraging homeownership, noting that the deduction disproportionately benefits high-income taxpayers, many of whom would be homeowners in the absence of any deduction.[114] Because money is fungible, it is also possible that these taxpayers use mortgage loans to increase other consumption rather than home purchases.

In addition to effects on efficiency, the home mortgage interest deduction carries distributional consequences. The average tax savings from the mortgage interest deduction increases as annual household income increases.[115] Furthermore, the average tax savings from the mortgage interest deduction varies within income groups. Consistent with the "life cycle" theory of savings in which younger households borrow more than older households in order to smooth consumption over the life cycle, research suggests that for households with greater than $75,000 of annual income, average tax savings from the mortgage interest deduction are largest for younger homeowners (ages 25 to 35). For households with less than $75,000 of annual income, average savings are largest for middle-aged homeowners (ages 35 to 50).[116] Within income groups, the largest benefits generally accrue to taxpayers who have higher loan-to-value

[113] Gary Engelhardt, Michael Eriksen, William Gale, and Gregory Mills, "What Are the Social Benefits of Homeownership?" Experimental Evidence for Low-Income Households," *Journal of Urban Economics* (September 2009).

[114] Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in James M. Poterba (ed.), *Tax Policy and the Economy* 17, Cambridge, Mass.: The MIT Press (2003).

[115] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010*-2014 (JCS-3-10), December 15, 2010, p. 60.

[116] Poterba and Sinai (May 2008).

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ratios, and to those taxpayers purchasing more expensive homes. Table 7 below shows the distribution of tax expenditures for the mortgage interest deduction by income class in 2009. The largest tax expenditures accrue to those households with the highest incomes as they are more likely to own homes, are more likely to itemize deductions, face higher tax rates, and have larger mortgages.

Table 7.–Distribution by Income Class of the Tax Expenditure for the Home Mortgage Interest Deduction at 2009 Rates and 2009 Income Levels

Income Class	Tax Expenditure for Home Mortgage Interest Deduction		
	Returns (thousands)	Amount ($ millions)	Average Per Return in Dollars
Below $10,000	(1)	(2)	-----
$10,000 to $20,000	311	88	283
$20,000 to $30,000	1,000	521	521
$30,000 to $40,000	2,023	1,292	639
$40,000 to $50,000	2,923	2,329	797
$50,000 to $75,000	7,603	9,332	1,227
$75,000 to $100,000	6,754	10,066	1,490
$100,000 to $200,000	10,594	30,261	2,856
$200,000 and over	3,424	22,768	6,650
Total	**34,632**	**76,656**	**-----**

[1] Fewer than 500 returns.
[2] Positive tax expenditure of less than $500,000.
Note: details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

Table 8 shows homeownership rates by household income in 2009. Unsurprisingly, homeownership rates rise with household income, ranging from 40 percent ownership rates for households with $5,000 to $9,999 annual income to 92 percent ownership rates for households with greater than $120,000 annual income. Given the fact that homeownership rates are not closer to zero at very low levels of income, this data is again consistent with the notion that younger households borrow when their incomes are relatively low in order to smooth consumption over the life cycle. Because higher income households are more likely to itemize deductions, it is also consistent with the claim that the home mortgage interest deduction disproportionately benefits higher income households.

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Table 8.–Homeownership Rates by Household Income

Household Income	Total Occupied Units	Owner Occupied Units	Homeownership Rate
Less than $5,000	5,849	2,539	43.4%
$5,000 to $9,999	4,683	1,884	40.2%
$10,000 to $14,999	5,963	2,788	46.8%
$15,000 to $19,999	6,062	3,123	51.5%
$20,000 to $24,999	5,961	3,110	52.2%
$25,000 to $29,999	7,637	4,507	59.0%
$30,000 to $34,999	5,966	3,600	60.3%
$35,000 to $39,999	5,593	3,482	62.3%
$40,000 to $40,999	10,290	6,852	66.6%
$50,000 to $59,999	8,654	6,328	73.1%
$60,000 to $79,999	13,780	10,535	76.5%
$80,000 to $99,999	10,073	8,409	83.5%
$100,000 to $119,000	6,840	6,007	87.8%
$120,000 or more	14,456	13,264	91.8%
Total	**111,806**	**76,428**	**68.4%**

Source: American Housing Survey: 2009, U.S. Census Bureau.

Deduction for interest on home equity loans

Deductions for interest on home equity loans contribute to lower after-tax costs to the borrower for home equity loans relative to other sources of loans. Because the use of proceeds is not restricted, this may create an incentive for households to borrow for any purpose, including for consumption or investment. For example, a home equity loan can be used to pay off other debt, purchase a car, or for medical or educational expenses. Some researchers believe restrictions on the tax-deductibility of non-mortgage interest payments have spurred home equity borrowing in the past. [117]

The increased ability to borrow attributable to home equity loans may allow households to smooth lifetime consumption more optimally. Also, households may be able to improve lifetime earnings if they reinvest the loans in ways that increase future earnings and wealth.

[117] Joyce Manchester and James Poterba, "Second Mortgages and Household Saving," *Regional Science and Urban Economics*, 19 (1989).

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Supporters of the deduction on interest for home equity loans point to these possibilities as ways to improve equity in the tax treatment of households. On the other hand, some researchers find a significant negative correlation between a household's stock of second mortgage debt and its net worth, consistent with the view that households primarily use home equity loans to increase consumption.[118]

Deduction for student loan interest

Commentators have made three main arguments for government intervention in education markets. First, there may be positive spillover effects associated with education. For example, higher education levels are associated with increased average productivity and wages,[119] lower crime rates,[120] increased civic participation,[121] and improved health.[122]

Second, there may be failures in the market for student loans that result in less borrowing than is optimal. That is, some students may benefit from attending college but are unable to do so due to the inability to borrow. Market failures occur because, unlike the market for car loans or home loans, the market for student loans is not collateralized. If a borrower defaults on a car or home loan, the lender may sell the car or the home and use the proceeds to offset some of the losses. However, if a borrower defaults on a student loan, the lender cannot practically liquidate the value of the student's education, and must absorb the entire loss. The lender may be unable to price this risk properly due to lack of information about the student's future earnings or the cost of collecting on other assets. The loan is therefore riskier for the lender. As a result, lenders may issue fewer loans than is optimal. This introduces inefficiencies in the market. That is, both lenders and borrowers may be less well off as a result of the under-provision of loans.

Finally, government intervention may alleviate inequalities in access to higher education between low-income and high-income students to the extent that they exist. Studies show an extra year of education increases wages by between six and 13 percent.[123] As a result, equal

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[118] *Ibid.*

[119] Enrico Moretti, "Estimating the Social Return to Higher Education: Evidence From Longitudinal and Repeated Cross-Sectional Data," *Journal of Econometrics* 121(1-2), (2004).

[120] Lance Lochner and Enrico Moretti, "The Effect of Education on Criminal Activity: Evidence from Prison Inmates, Arrests and Self-Reports," *American Economic Review* 94(1), (2004).

[121] Kevin Milligan, Enrico Moretti and Phil Oreopoulos, "Does Education Improve Citizenship? Evidence from the U.S. and the U.K.," *Journal of Public Economics* 88(9-10), (2004).

[122] Adriana Lleras-Muney, "The Relationship Between Education and Adult Mortality in the United States," *Review of Economic Studies* 72(1), (2005).

[123] David Card, "Estimating the Return to Schooling: Progress on Some Persistent Econometric Problems," *Econometrica*, 69(5): 1127-1160 (2001). Thomas Kane and Cecilia Rouse, "Labor-Market Returns to Two- and Four-Year College," *The American Economic Review*, 85(3): 600-614 (1995). Stephen Cameron and Christopher Taber, "Estimation of Educational Borrowing Constraints Using Returns to Schooling," *Journal of Political Economy*, 1(1): 132-182.

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access to higher education today may hold significant implications for the wage distribution as well as economic growth in the future.

Supporters of the student loan interest deduction note that the impact of credit market failures on lending is substantial in higher education. They suggest that the deduction for student loan interest mitigates this impact by reducing the cost of financing higher education. With lower cost of loans, more students apply for loans. If some of the cost of borrowing is subsidized by the government through an interest deduction, students are also willing to pay higher rates to borrow. Banks respond to this higher willingness to pay by increasing their volume of lending, alleviating some of the under-provision of loans in the market.

On the other hand, others point out that the positive spillover effects associated with education are large for elementary and secondary education, but small for post-secondary education where most of the returns are private. As a result, inefficiencies in the market may not be large in practice. Furthermore, even if the spillover effects were larger, this would not necessarily imply that the government should choose policies that subsidize debt-financed higher-education over other types of policies that also alleviate under-provision. Some researchers note that higher education finance policies are most effective when they target lower-income students as opposed to higher-income students, many of whom will attend college regardless of student loan costs. Other programs may be more effective at targeting those students who would not otherwise attend college.

Table 9 shows the distribution of tax expenditures for the student loan interest deduction by income class in 2009. This table shows the largest tax expenditures for student loan interest deductions accrued to households with greater than $50,000 of income annually.[124] For example, there were 1,129,000 households with $100,000 to $200,000 of income that claimed the deduction, a total of $203 million in expenditures for these households, for an average (per household) expenditure of $180. In contrast, households with less than $40,000 of income received an average expenditure of less than $100. Because of the subsidies for student loans, higher income families may be encouraged to borrow for education rather than pay cash. Because money is fungible, in doing so, they can increase consumption or other types of investment. This substitution can be made without increasing the level of education.

[124] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-20143* (JCS-3-10), December 15, 2010, p. 59.

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Table 9.–Distribution By Income Class of The Tax Expenditure For The Student Loan Interest Deduction at 2009 Rates And 2009 Income Levels

Income Class	Tax Expenditure for Student Loan Interest Deduction		
	Returns (thousands)	Amount ($ millions)	Average Per Return in Dollars
Below $10,000	22	2	91
$10,000 to $20,000	275	17	62
$20,000 to $30,000	635	51	80
$30,000 to $40,000	843	83	98
$40,000 to $50,000	771	94	122
$50,000 to $75,000	1,616	215	133
$75,000 to $100,000	1,161	136	117
$100,000 to $200,000	1,129	203	180
$200,000 and over	-----	-----	-----
Total	**6,452**	**801**	-----

Source: Joint Committee on Taxation.

Deductible investment interest expense limited to net investment income for individuals

When a taxpayer incurs debt to purchase property that generates tax-exempt income, such as bonds issued by State and local governments, limitations on interest deductions generally apply. The reason for such rules is that allowing taxpayers to deduct interest on money used to acquire property generating tax-exempt income does not accurately measure a taxpayer's taxable income and creates an opportunity for tax arbitrage.

Because money is fungible, it can be difficult to ensure that taxpayers are not using the proceeds of debt that generate deductible interest to purchase obligations generating tax-exempt income. In general, two alternative methods apply for determining the portion of debt (and interest thereon) that is associated with a particular asset. Under the tracing method, which applies to individual taxpayers, the taxpayer's use of debt proceeds determines whether the debt is associated with the asset. Under the pro rata method, which applies to financial corporations and certain business taxpayers, interest deductions are disallowed based on the percentage of a taxpayer's assets comprised of tax-exempt obligations. Determining a taxpayer's use of debt proceeds, given the fungibility of money, is inherently more complex than a mechanical pro rata rule. Consequently, the tracing rules may be less effective at preventing tax arbitrage than the pro rata method. The tracing rule may allow taxpayers to plan the use of debt proceeds so as to ensure the interest is deductible. Alternatively, in some cases, the tracing rule may prevent the

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deduction of otherwise deductible interest expense that is used to generate taxable investment income.[125]

Taxation of income from the discharge of indebtedness

Taxation of income from the discharge of indebtedness may affect the incentives of households to borrow. In principle, taxation of this income reduces the net benefit of filing for bankruptcy and reduces incentives to borrow.

Researchers are divided on the main causes of bankruptcy filings. Some studies claim that bankruptcy filings are primarily the result of adverse events (such as sickness, accidents, unemployment, divorce). Others claim that consumption patterns play a larger role.[126] If consumption patterns play an important role in households' decisions to file for bankruptcy, these filings may be strategic. That is, households may weigh costs and benefits in their decision to file. Furthermore, the availability of the option to file for bankruptcy can change households' consumption patterns if households are more likely to consume knowing they bear less than the full cost of consumption in the event of bankruptcy. Some research shows households do indeed behave strategically, filing for bankruptcy when the benefits of filing (for example, discharge of indebtedness) exceed the costs of filing (for example, forfeiture of assets).[127] Taxation of indebtedness income reduces incentives to borrow by reducing the net benefit of filing for bankruptcy. If adverse events are primarily responsible for bankruptcy filings, these incentives will have a smaller effect on actual borrowing. On the other hand, if consumption patterns are primarily responsible for bankruptcy filings, these incentives will have a larger effect on actual borrowing.

Some types of debt discharges are excluded from Federal income taxation. They include, for example: farm indebtedness, certain qualified real property business indebtedness, qualified principal residence indebtedness which is discharged before January 1, 2013, and certain student loan indebtedness. For these categories of debt, the exclusion from taxation reduces the cost of borrowing and therefore increases the incentives to borrow.[128]

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[125] For example, a taxpayer holding assets that produce taxable income may prefer to borrow to purchase a car even though the taxpayer may have sufficient investment assets to purchase the car with cash. The taxpayer may not want to liquidate those investments. Although the taxpayer borrows to purchase the car in order to continue to hold assets that generate taxable income, the interest expense on the borrowing nevertheless is disallowed because the debt proceeds are used to purchase the car.

[126] Ning Zhu, "Household Consumption and Personal Bankruptcy," *Journal of Legal Studies* 40 (2011).

[127] Scott Fay, Eric Hurst, and Michelle White, "The Household Bankruptcy Decision," *American Economics Review* 92 (2002).

[128] The circumstances under which forgiven student loan debt is excluded are quite limited. As a result, the expectation of excluding debt forgiveness likely has only a limited impact on the incentive for students to borrow.

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Economic incentives and trends in household debt

Though a comprehensive analysis of underlying causes of trends in household debt is beyond the scope of this document, an analysis of economic incentives together with the data in Figure 3 in Section 2 suggests the trends discussed in Section 2 above are not driven solely by Federal tax rules governing debt and interest on debt.

Figure 3 in Section 2 shows an increase in household debt over the last sixty years. The majority of this increase is due to an increase in household mortgage debt and a relatively smaller portion of the increase is attributable to more modest increases in consumer credit.

Over this period, the value of the mortgage interest deduction declined. This decline was partly due to declines in income tax rates. Also, the Tax Reform Act of 1986 and subsequent legislation imposed limits on deductions of interest related to acquisition indebtedness and on interest related to other debt secured by a taxpayer's home equity. The declining value of the home mortgage interest deduction created incentives for households to reduce their quantity of mortgage debt. However, the concurrent increase in the quantity of mortgage debt appears to indicate that the overall trend in mortgage debt holdings by households is not entirely explained by tax rules over this period.

Similarly, interest deductions on consumer credit were generally disallowed as a Federal income tax deduction starting after 1986. However, Figure 3 in Section 2 shows consumer credit did not decline after 1986. This appears to indicate that the tax rules by themselves do not explain the trends in household debt over this period. While each tax rule by itself creates relatively straightforward economic incentives, the interaction of these rules with each other and with macroeconomic factors leads to more complicated results.

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V. TAX TREATMENT OF HOUSEHOLD DEBT IN SELECTED COUNTRIES

A. Summary

There are both similarities and differences in the tax treatment of household debt across countries. A strict country to country comparison of these provisions is difficult because each country has distinct market institutions as well as a distinct set of policies (both tax and nontax) that may be similar in certain ways but dissimilar in others. A comprehensive analysis of foreign taxation of household debt is therefore beyond the scope of this publication. However, following is a brief overview of the similarities and differences in key tax provisions of household debt across seven countries: Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom. None of these seven countries allow deductions for consumer credit, such as credit card debt or auto loans. However, there is less uniformity in their treatment of other types of debt.

Deduction for interest on mortgage loans and home equity

Six of the seven countries do not allow a deduction of interest on residential mortgage loans that is comparable to the mortgage interest deduction under U.S. tax law.[129] However, three of these six countries provide somewhat related tax benefits.

Australia provides one-time grants of up to AU$7,000 (about US$7,485) to first-time home-buyers. France allows some limited tax credits on interest for residential mortgages. These tax credits equal 40 percent of the loan interest for the first year and 20 percent for each of the following four years on loans concluded between May 6, 2007 and January 1, 2011. The annual credits are capped at €3,750 (about US$5,423) for a single person and €7,500 (about US$10,845) for a couple. Finally, the United Kingdom provides a few exceptions to the disallowance of mortgage interest deductions. As a result, there are a few limited cases in the United Kingdom in which a tax benefit for mortgage interest is provided. Some examples of cases where mortgage interest deductions are allowed are: loans for the purchase of a caravan or houseboat that will be the only or main residence of the borrower; existing loans for life annuities (home income plans) where the annuitant is age 65 or over; and loans taken out before April 1988 for the purchase of a home for a dependent relative or a divorced spouse of the borrower.

In six of the seven countries, there is no explicit allowable deduction for interest on home equity loans.[130] This differs from the U.S. income tax law which allows deduction of interest on residential mortgage loans on amounts up to $1 million of debt as well as on interest on home equity loans on amounts up to $100,000 of debt.

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[129] Mexico allows for interest paid with respect to home mortgage loans to be deducted as long as the loan does not exceed 1.5 million investment units (approximately US$588,978).

[130] There is no information available on the deductibility of interest on home equity loans in Mexico.

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Deduction for interest on student loans

The tax treatment of student loans varies across these seven countries. Canada allows a deduction for all interest on student loans. Australia, France, Germany, Japan, Mexico, and the United Kingdom do not allow deduction of interest on student loans. However, of the six countries that do not allow student loan interest deductions, two countries provide a different tax benefit, and three countries provide nontax benefits for households that incur student loan debt. France provides a tax credit on loans obtained to finance non-tuition, education related costs. This credit is equal to 25 percent of the loan's interest for the first five years of the loan.[131] Mexico provides an income exclusion for yields on property held in trust when those yields are allocated to finance the education of straight-line descendants through the bachelor's degree level.[132] Germany offers cash grants and loans with little or no interest to low-income families. Australia offers interest-free government loans to domestic students and the United Kingdom subsidizes interest on certain government-provided loans. In addition, in a number of countries, wholly or partially subsidized tuition may be available for students eligible to attend a university. U.S. income tax law allows deduction of student loan interest, though this is phased out for taxpayers at higher income levels. However, it is difficult to compare incentives provided by other countries to the student loan interest deduction permitted under U.S. income tax law, because many other factors also differ across these other countries.

Deduction for debt incurred to finance investments

In five of the seven countries studied (as well as in the United States), interest and dividends earned on private investments are considered income in certain cases and the interest paid on money borrowed to earn this income is a deductible expense. There are two exceptions to this: France does not allow a deduction for debt incurred to finance investments but provides tax credits in particular cases; and Germany no longer allows deduction of this type of debt.[133]

Treatment of cancelled debt

In five of the seven countries (as well as in the United States), cancelled debt is generally treated as taxable income. However, the details of this treatment vary widely across countries. Variations among these countries' specific rules for cancelled debt create a spectrum of taxation across countries. For example, in Mexico, all cancelled debt is considered to be taxable income. On the other side of the spectrum, in the United Kingdom, cancelled debt is treated as income only in specific circumstances.[134]

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[131] For loans obtained between September 1, 2005 and December 31, 2008.

[132] Yields on property held in trust and allocated to finance the education of straight-line descendants are excluded from income.

[133] Effective January 1, 2009.

[134] Income arises only if the loan was employment-related, made to a shareholder of a closely held corporation, or involved a liability that had been previously been deducted.

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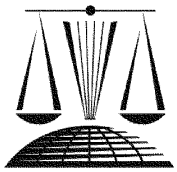
Two countries are exceptions to this treatment of cancelled debt as taxable income: Germany does not treat any cancelled debt as taxable income; and Japan treats cancelled debt as a gift which is subject to a gift tax.

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B. Law Library of Congress: Tax Treatment of Household Debt

Following is the Report for Congress, June 2011, Tax Treatment of Household Debt, prepared by the Law Library of Congress.

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The Law Library of Congress

REPORT FOR CONGRESS

June 2011

Global Legal Research Center
LL File No. 2011-005748

TAX TREATMENT OF HOUSEHOLD DEBT

This report describes the tax treatment of interest from personal loans in Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom. It focuses on the deductibility of interest for residential mortgages, student loans, and various consumer debts. It also deals with the deductibility of interest related to investment income and tax-exempt income, and with the tax consequences of the cancellation of a personal loan.

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AUSTRALIA

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Under Australian tax law, a general deduction provision allows interest costs to be deducted where they are incurred in gaining taxable income, provided that the expenditure is not of a capital, private, or domestic nature. The interest on loans used to finance income-earning investments, including rental properties and shares, will therefore be deductible. However, mortgage interest is not deductible where it relates to the purchase of a taxpayer's private residence. Programs are in place to provide assistance to first-time homebuyers. Deductions are not limited by the amount of income actually gained and can therefore offset other income. Deductions are not available if the interest costs relate to gaining exempt income.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

The Income Tax Assessment Act 1997 (ITAA 1997) provides for "general" and "specific" deductions.[1] There are no specific deductions that apply solely to household interest expenses. Whether interest is deductible will therefore generally depend on the application of section 8-1 of the ITAA 1997 to the particular circumstances. This provision sets out two tests for allowing general deductions, referred to as the positive and negative limbs. The positive limbs state that taxpayers can deduct from their gross taxable income[2] any expense to the extent that

(a) it is incurred in gaining or producing taxable income, or

(b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing taxable income.[3]

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[1] *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) Div 8, *available at* http://www.comlaw.gov.au/Details/C2011C00374. *See also* AUSTRALIAN MASTER TAX GUIDE 846 (CCH Australia, 47th ed. 2010).

[2] Gross taxable income is called "assessable income" in Australia. An Australian resident's assessable income includes income derived from all sources, including employment, business, investment, and foreign source income. Once deductions are taken out the net taxable income is then called "taxable income" in Australian tax law. For clarity, however, references to taxable income in this report are to gross taxable income only. *See What is Income?*, AUSTRALIAN TAXATION OFFICE (ATO), http://www.ato.gov.au/content/48101.htm (last visited June 1, 2011). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 364, 856.

[3] ITAA 1997 s 8-1(1).

The first positive limb "has been interpreted as applying to non-business taxpayers, whereas the second limb is seen as providing a less restrictive deduction principle applicable to businesses."[4]

The negative limbs provide that a taxpayer cannot deduct an expense to the extent that

- it is of a capital nature,
- it is of a private or domestic nature,
- it is incurred in relation to gaining or producing various categories of exempt income, or
- there is a provision in the legislation that prevents it from being deductible.[5]

Whether interest is deductible is therefore determined by looking at the purpose of the loan and the use to which it is put, although these two things will often coincide.[6] The tests mean that interest on residential mortgage loans that is incurred by an individual in relation to his own private residence is not deductible.[7] However, a deduction may be claimed for interest incurred on a mortgage loan for a residential investment property from which the person derives rental income.[8] Interest expenditure relating to other personal debts that does not satisfy the requirements of section 8-1, whether because the borrowing is private or domestic in nature or does not have the required connection to the production of taxable income (e.g., employment or investment income),[9] such as home equity loans, auto loans,[10] credit card debt, and student loans,[11] will also not be deductible.

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[4] Dr. Justin Dabner, *Interest Deductibility - Australia and Canada Compared*, 2(3) J. AUS. TAX. 172 (1999), *available at* http://www.austlii.edu.au/au/journals/JlATax/1999/15.html. *See also* R.L. DEUTSCH ET AL., AUSTRALIAN TAX HANDBOOK 531(2009). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 856.

[5] ITAA 1997 s 8-1(2). *See also* DEUTSCH ET AL., *supra* note 4, at 531.

[6] DEUTSCH ET AL., *supra* note 4, at 564.

[7] *Id.* at 553 and 565.

[8] *See id.* at 53 and 560. *See also* Tom Toryanik, *Australia – Individual Taxation* ¶ 1.8.1.1., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (AUSTRALIA), http://ip-online.ibfd.org/kbase/ (by subscription) (last visited May 27, 2011). The Australian Taxation Office (ATO) provides information about deducting mortgage interest in relation to investment properties at *Rental Properties – Claiming Interest Expenses*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/00113233.htm (last modified Mar. 26, 2009); *and* ATO, RENTAL PROPERTIES 2010, *available at* http://www.ato.gov.au/content/downloads/IND00237831 N17290610.pdf.

[9] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 956.

[10] Motor vehicle expenses, including interest on a car loan, are deductible if incurred in the course of deriving taxable income or in carrying on a business. *See* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 909-18.

[11] "Self-education expenses," including loan interest, are generally deductable under section 8-1 if there is a sufficient connection with the taxpayer's income-producing activities. *See* DEUTSCH ET AL., *supra* note 4, at 571, 548. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 927.

A particular item of expenditure "may have to be apportioned into its deductible and non-deductible components."[12] This may occur where, for example, "expenditure is incurred in deriving both assessable and exempt income, or where expenses are incurred partly for income-producing purposes and partly for private purposes."[13]

The ITAA 1997 does provide for a specific deduction for expenses incurred by a taxpayer in borrowing money to the extent that the borrowed money is used for the purpose of producing taxable income.[14] This provision applies only to the cost of borrowing and not to the interest on the loan.[15] The legislation also provides that expenses incurred in discharging a mortgage given as security for a loan that was used for the purpose of gaining taxable income are deductible.[16] This includes any penalty interest for early repayment of the loan.[17]

B. Incentives for the Lender

There do not appear to be any incentives provided to lenders under Australian tax law.

C. Related Tax Benefits or Subsidies

Australian state governments administer and fund a First Home Buyer Grant program in each state.[18] This program was introduced to offset the effect of Goods and Services Tax (GST) on home ownership. It provides a one-time grant of up to AU$7,000 (about US$7,485) to first-time homebuyers that satisfy the eligibility criteria.[19]

Individual states may also provide additional assistance to homebuyers. For example, in New South Wales a duty exemption of up to AU$17,990 (about US$19,240) is available under

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[12] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 856.

[13] *Id.* *See supra* note 2 for an explanation of the meaning of "assessable income" in Australia.

[14] ITAA 97 s 25-25. *See also* DEUTSCH ET AL., *supra* note 4, at 588. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 963. *See also* Toryanik, *supra* note 8, ¶ 1.8.1.1. Examples of borrowing expenses are procuration fees, loan establishment fees, mortgage protection insurance, legal expenses, stamp duty, valuation and survey fees, commissions paid to brokers, and underwriters' fees.

[15] DEUTSCH ET AL., *supra* note 4, at 589.

[16] ITAA 1997 s 25-30. *See also* DEUTSCH ET AL., *supra* note 4, at 587. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 963-64 (referring to Taxation Ruling TR 93/7).

[17] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 964.

[18] *First Home Owner Grant General Information*, FHOGONLINE, http://www.firsthome.gov.au/ (last visited May 24, 2011).

[19] *First Home Owner Grant Scheme*, NEW SOUTH WALES (NSW) OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/first_home/general/eligibility/ (last updated Dec. 3, 2010). *See also* NSW Office of State Revenue, Factsheet: First Home Owner Boost Scheme (Dec. 2010), http://www.osr.nsw.gov.au/lib/doc/factsheets/fs_fhob2.pdf.

the First Home Plus Scheme[20] and a $3,000 supplement is available for people that build or purchase new homes.[21]

In addition to the state programs, the federal government operates a First Home Saver Accounts program to assist people to save for their first home.[22] This program involves a low tax rate (15 percent) on the interest earned on money in the account as well as government contributions equal to 17 percent of personal contributions each year (up to a maximum of $935 for the 2010/11 financial year).[23] Withdrawals from these accounts are not subject to further tax if used for the purchase of a first home that will be used as a person's own residence.

Most domestic undergraduate students in Australia are required to pay only a contribution to the cost of their education, while the Australian federal government contributes the majority of the cost.[24] The federal government also operates student loan programs for domestic students to use in paying their student contributions or fees.[25] There is no interest rate charged on the loans. Instead, a person's debt is indexed annually to reflect changes to the Consumer Price Index.[26] The loans are repaid over time through the tax system, with the rate of repayment based on an individual's taxable income.[27] This means that repayments are deferred until a person is earning above a particular income threshold, at which point there will be compulsory minimum repayment percentages depending on the person's income level.[28] Voluntary repayments can

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[20] *First Home Plus*, NSW OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/first_home/general/fhplus/ (last updated July 9, 2010).

[21] *NSW Home Builders Bonus*, NSW OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/nbb/ (last updated May 12, 2011). *See also First Home Benefits*, NSW OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/first_home/ (last updated May 16, 2011).

[22] *First Home Saver Accounts*, THE AUSTRALIAN TREASURY, http://homesaver.treasury.gov.au/content/default.asp (last visited May 24, 2011). *See also First Home Saver Account – Home*, ATO, http://www.ato.gov.au/individuals/pathway.aspx?sid=42&pc=001/002/066 (last visited May 24, 2011).

[23] *Guide to First Home Saver Accounts – Benefits*, ATO, http://www.ato.gov.au/individuals/distributor.aspx?menuid=0&doc=/content/00250962.htm&page=1#P26_2695 (last modified Apr. 28, 2011).

[24] *Going to Uni – Undergraduate*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS, http://www.goingtouni.gov.au/Main/FeesLoansAndScholarships/Undergraduate/Default.htm (last visited May 31, 2011).

[25] *HELP Information for Payers*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/12115.htm&pc=001/002/008/013/001&mnu=0&mfp=&st=&cy (last modified Aug. 2, 2010). *See also Going to Uni – Paying For Your Studies (HELP loans)*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS, http://www.goingtouni.gov.au/Main/Quickfind/PayingForYourStudiesHELPLoans/Default.htm (last visited May 24, 2011).

[26] *Going to Uni – Interest and Indexation*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS, http://www.goingtouni.gov.au/Main/FeesLoansAndScholarships/LoanRepayments/Interest-Indexation.htm (last visited May 24, 2011). *See also Higher Education Loan Program (HELP) Indexation Rates*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/74307.htm&pc=001/002/008/014/002&mnu=&mfp=&st=&cy=1 (last modified May 18, 2011).

[27] *See HELP and HECS Repayment Thresholds and Rates*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/8356.htm (last modified Apr. 19, 2011).

[28] *Going to Uni – Compulsory and Voluntary Repayments*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS,

also be made and result in a 10 percent bonus being added to each repayment by the government.[29] Both compulsory and voluntary repayments are not tax deductible.[30]

II. Deductibility of Debt Incurred to Finance Investments

Income from investments, including dividends,[31] interest, royalties, and rent, is included in a person's taxable income.[32] Therefore, under section 8-1 of the ITAA 1997, expenses incurred in the course of gaining or producing this income can be deducted, to the extent that the expenditure is not of a capital, private, or domestic nature.[33] This means that, as noted above, an individual may claim a deduction for the interest incurred on a mortgage loan that relates to a rental property. Section 8-1 also means that interest incurred on money borrowed to purchase other income-producing investments, such as stocks and bonds, is ordinarily deductible.[34]

As section 8-1 is general in nature, there have been a number of determinations, rulings, and cases related to the deductibility of interest incurred in borrowing funds for different investment products and arrangements.[35] This has also resulted in a list of tests that the courts will use to assist in determining whether a particular interest expenditure is deductible or not.[36]

Some of the rulings led to amendments to the legislation in relation to "capital protected" products and borrowings.[37] Specific provisions apply to

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http://www.goingtouni.gov.au/Main/FeesLoansAndScholarships/LoanRepayments/Compulsory-Voluntary.htm (last visited May 24, 2011).

[29] *Id.*

[30] *Id.*

[31] Dividends paid to shareholders are taxed under an imputation system. Individuals that receive franked dividends include the amount of the dividend and the franking credits in their taxable income, with the franking credits able to be claimed as a franking tax offset. *See Refunding Franking Credits – Individuals*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/8651.htm&pc=001/002/002/013/005&mnu=44711&mfp=001/002&st=&cy= (last modified June 29, 2010).

[32] *See* Toryanik, *supra* note 8, ¶ 1.5.

[33] DEUTSCH ET AL., *supra* note 4, at 565. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 948.

[34] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 960; *see also* 948 and 955. *See also* DEUTSCH ET AL., *supra* note 4, at 561; ATO, D8 – Dividend Deductions, http://www.ato.gov.au/individuals/content.aspx?doc=/content/00222869.htm (last modified June 28, 2010).

[35] DEUTSCH ET AL., *supra* note 4, at 565, 568. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 960-62.

[36] *See* Grant Richardson & Ken Devos, *The Deductibility of Interest in Anglo-American Countries: A Comparison and Review of Policy*, 2 REV. L. J. 33 (1999), *available at* http://www.austlii.edu.au/au/journals/RevenueLawJl/1999/2.pdf. *See also* Karen Burford, *Going out on a Second Limb – An Analysis of the Deductibility of Interest by Recognising the Distinction Between the Positive Limbs of s 51(1)*, 5(1) REV. L. J 100 (1995), *available at* http://www.austlii.edu.au/au/journals/RevenueLawJl/1995/5.html; Dabner, *supra* note 4.

[37] *About Capital Protected Products and Borrowings*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/44515.htm&pc=001/002/013/009/004&mnu=44692&mfp=001/002&st=&cy (last modified July 25, 2008). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 960.

> investments in shares, units, stapled securities or beneficial interests in an entity holding such investments, where the investments (a) are listed on an approved stock exchange or in a widely held company or trust and (b) have a capital protection feature, that is a clause allowing the underlying investment to be sold for at least the invested amount.[38]

Interest costs incurred in borrowing funds used to purchase such investments may not be fully deductible: part of the interest costs are allocated to the capital cost of acquiring the option over the capital protected investment. This amount will be nondeductible "and will be taken into account in calculating a capital gain or loss on either the expiry of the option or disposal of the underlying investment in accordance with the capital gains tax rules."[39]

With regard to retirement savings and investments, the ITAA 1997 provides that the contributions of employers as well as personal contributions to pension funds are deductible, subject to limits.[40] Employers can also claim deductions for interest and borrowing costs connected with a contribution, but only if a deduction can be claimed for the contribution itself.[41] There is no similar specific provision for borrowing related to an individual's personal contributions.

A taxpayer can also deduct interest on money borrowed to pay a premium for a life insurance policy, but only if the risk component of the premium is the entire amount of the premium, and any amount that the insurer is liable to pay under the policy would be included in the taxpayer's taxable income.[42]

A. Annual Limits Relating to Investment Income

There does not appear to be an annual limit on deductions. To be deductible, "expenditure must be incurred, though not necessarily paid, in the year claimed."[43] The legislative provisions also mean that "the whole amount may be claimed in the year incurred even though the expenditure may help in the production of income in other years."[44] As long as expenditure is incurred in the course of gaining taxable income, "the Commissioner [of Taxation] cannot reduce the amount of the deduction simply because the expenditure is greater than the amount which would normally have been incurred by a prudent businessman."[45] However, where expenditure exceeds taxable income, or where it produces no income, this may mean that the reasons and motives of the taxpayer in incurring the expenditure will need to be

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[38] Tom Toryanik, *Australia – Corporate Taxation* ¶ 1.4.5., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (AUSTRALIA), http://ip-online.ibfd.org/kbase/ (by subscription) (last visited May 27, 2011). *See also* ITAA 1997 Div. 247.

[39] *Id.*

[40] ITAA 1997 ss 290-60, 290-150.

[41] *Id.* s 26-80.

[42] *Id.* s 26-85.

[43] Toryanik, *supra* note 38, ¶ 1.4.1. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 856.

[44] *Id.*

[45] *Id.* (referring to *Ronpibon Tin NL v. FCT; Tongkah Compound NL v. FCT* (1949) 4 AITR 236).

examined in order to determine whether it will be deductible. This exercise may lead to expenditure being apportioned "between that attributable to the pursuit of assessable income and that attributable to other aims."[46]

Negative gearing of investments is therefore possible in Australia[47] as long as borrowed funds are used for a genuine income-producing purpose, such as to obtain rent from an investment property, interest will be deductible even if it exceeds the actual income gained.[48] Any excess interest may therefore be used to offset other taxable income of the taxpayer.[49] However, if another purpose of the borrowing is established (such as a private purpose),[50] or where there is "no objective expectation that income will exceed interest over the life of the arrangement," interest will be not be deductible either as a whole or in part.[51]

B. Deductions for Exempt or Tax-Favored Income

The general rule contained in the second limbs of section 8-1 of the ITAA 1997, as set out above, means that "no deduction is available for interest on borrowings relating to the production of exempt income."[52] However, a deduction is allowed for interest incurred in relation to deriving foreign dividend income that is classified as non-taxable income under provisions relating to foreign non-portfolio dividends and dividends from previously attributed Controlled Foreign Corporation or Foreign Investment Fund income.[53]

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

A list of provisions that allow a tax offset (or rebate) for different income and personal situations is set out in section 13-1 of the ITAA 1997. This includes offsets arising from franked dividends[54] and foreign income tax offsets.[55] There do not appear to be specific rules denying or

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[46] *Id.* (referring to Taxation Ruling TR 95/33). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 857, 962. See *supra* note 2 for an explanation of the meaning of "assessable income" in Australia.

[47] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 955. *See also Rental Properties 2009-10 – Negative Gearing*, ATO, http://www.ato.gov.au/individuals/content.aspx?menuid=0&doc=/content/00237831.htm&page=17&H17 (last modified June 29, 2010).

[48] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 947, 962.

[49] Toryanik, *supra* note 38, ¶ 1.4.5. *See generally* Jim O'Donnell, *Quarantining Interest Deductions for Negatively Geared Rental Property Investments*, EJ. TAX. RESEARCH (2005), *available at* http://www.austlii.edu.au/au/journals/eJTR/2005/4.html#Heading9.

[50] Toryanik, *supra* note 38, ¶ 1.4.5 (referring to *Ure v. FCT* (1981) 11 ATR 484).

[51] *Id.* (referring to *Spassked Pty Ltd v. FCT (No 5)* (2003) 52 ATR 337).

[52] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 954. *See also* DEUTSCH ET AL., *supra* note 4, at 566 (referring to Taxation Ruling TR 2005/11). *See also* ITAA 1997 s 6-15 (notes).

[53] Toryanik, *supra* note 38, ¶ 1.4.5.

[54] *See You and Your Shares 2009-10: How Dividends Are Taxed*, ATO, http://www.ato.gov.au/individuals/content.aspx?menuid=0&doc=/content/00237927.htm&page=5&H5 (last modified June 29, 2010).

[55] *See Guide to Foreign Income Tax Offset Rules 2009-10*, ATO, http://www.ato.gov.au/content/00238031.htm (last modified June 29, 2010).

limiting these offsets where deductions are available in relation to borrowing to finance the investment.[56]

D. Other Limits on the Deductibility of Interest for Private Investments

In addition to general anti-avoidance provisions in the legislation,[57] there are various provisions that may limit the deductibility of interest.[58] However, in relation to debt deductions incurred in deriving investment income, it appears that the rules (for example, thin capitalization rules) primarily relate to income obtained through business activities.[59]

III. Special Treatment of Other Debt

It appears that there is no additional special treatment for either the borrower or lender in relation to other household debt.

IV. Treatment of Cancelled Debt

The Australian legislation contains debt forgiveness rules that relate to "commercial debt."[60] A debt is "commercial" if "part or all of the interest payable on the debt is, or would be, an allowable deduction."[61] The rules are targeted at remedying the effective duplication of tax deductions that might otherwise arise. Such duplication could occur because, for example, a creditor may be entitled to a deduction when a debt is forgiven, while the debtor is not taxed on any gain arising from the debt being cancelled and could continue to claim deductions relating to undeducted expenditures.[62]

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[56] *See, e.g.*, *You and Your Shares 2009-10: Allowable Deductions from Dividend Income*, ATO, http://www.ato.gov.au/individuals/content.aspx?menuid=0&doc=/content/00237927.htm&page=12&H12 (last modified June 29, 2010).

[57] *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) Pt IVA. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 878. These provisions mean that the Commissioner of Taxation may reduce the amount of a deduction otherwise allowable under s 8-1 where a tax avoidance scheme is involved. The High Court has found that the anti-avoidance provisions applied to disallow the tax benefits obtained under a split-loan arrangement, i.e., where a mortgage had been split into both a home loan for a private residence and an investment loan to refinance a rental property. Toryanik, *supra* note 38, ¶ 1.4.5 (referring to *Federal Commissioner of Taxation v Hart and Anor* [2004] HCA 26).

[58] *See* DEUTSCH ET AL., *supra* note 4, at 778-79. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 959.

[59] *See, e.g.*, *D16 – Other Deductions*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/00217609.htm (last modified June 29, 2010) (containing information on debt deductions relating to foreign income).

[60] ITAA 1997 Div 245. A debt is defined for these purposes as "an enforceable obligation imposed by law on a person to pay an amount to another person, and includes accrued interest." DEUTSCH ET AL., *supra* note 4, at 779.

[61] *CGT and Debt Forgiveness*, ATO, http://www.ato.gov.au/content/36559.htm (last modified May 18, 2011). *See also* DEUTSCH ET AL., *supra* note 4, at 779.

[62] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 980.

Under the debt forgiveness rules, the amount of debt that is forgiven is applied to reduce certain deductions of the debtor.[63] Specifically, a forgiven amount may reduce, in the following order: a taxpayer's prior income year revenue losses; net capital losses from earlier years; deductible expenditure; and cost base and reduced cost base of assets.[64]

The commercial debt forgiveness rules do not apply where the debtor is a shareholder of the company. The forgiveness of the debt in these situations results in an amount being deemed dividends and therefore included in the taxable income of the debtor.[65] The waiver of a debt will also result in an amount being considered taxable income where it constitutes a fringe benefit provided to an employee.[66] In most other cases, an act of debt cancellation will not result in the amount forgiven being treated as ordinary income of the debtor.[67]

The commercial debt forgiveness rules also do not apply if the debt is forgiven as a result of an action under bankruptcy law, in a deceased person's will, or for reasons of natural love and affection.[68]

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[63] DEUTSCH ET AL., *supra* note 4, at 779. *See also* ATO ID 2003/27, *Commercial Debt Forgiveness: Applying Total Net Forgiven Amount – Individual Debtor* (Feb. 14, 2003), *available at* http://law.ato.gov.au/atolaw/view.htm?docid=AID/AID200327/00001.

[64] *CGT and Debt Forgiveness*, ATO, *supra* note 61.

[65] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 126-27.

[66] *Id.* at 980.

[67] Such a result did occur in a case where a company's debt was forgiven and the resulting gain was deemed to be inextricably linked to the trading activities of the company, but this is not a common outcome. Roger Timms and Weiran Wang, *The Application of the Commercial Debt Forgiveness Provisions*, THE TAXPAYER (Jan. 18, 2010), *available at* http://www.taxpayersassociation.com.au/docman/small-business/debt-forgiveness-provisions/details.html (click on "Download" at bottom of page).

[68] *CGT and Debt Forgiveness*, ATO, *supra* note 61.

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CANADA

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Canada does not allow deductions to be taken for interest paid on mortgages or other personal expenditures, with an exception for certain student loans. Canada does not offer tax incentives to lenders to make personal use loans. Canada does have a Home Buyers' Plan that allows taxpayers to borrow money from their Registered Retirement Savings Plan and Registered Educational Savings Plan accounts, which is designed to encourage persons to purchase homes and pursue educational opportunities. Contributions to Registered Retirement Savings Plans and Registered Educational Savings Plans are limited, but the use of these plans can result in substantial tax savings.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

Deductions for interest paid for personal use purposes are not allowed in Canada,[1] with an exception for student loans, as discussed below.

1. Residential Mortgage Loans

Canada has never allowed interest paid on residential mortgage loans to be deducted in calculating taxable income. Former Prime Minister Joseph Clark planned to create a limited deduction in 1980, but his government was defeated before it could be implemented.[2]

2. Home Equity Loans

The Income Tax Act[3] (I.T.A.) does not contain any provisions for the deduction of interest paid on home equity loans.

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[1] *Line 221—Carrying Charges and Interest Expenses*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/221/menu-eng.html (last modified Jan. 5, 2011).

[2] Stephen Gordon, *Why Canadians Should Be Glad Joe Clark Lost the 1980 Election*, WORTHWHILE CANADIAN INITIATIVE (Feb. 25, 2009), http://worthwhile.typepad.com/worthwhile_canadian_initi/2009/02/why-canadians-should-be-grateful-that-joe-clark-lost-the-1980-election.html.

[3] Income Tax Act, R.S.C. ch. 1 (5th Supp. 1989), http://laws-lois.justice.gc.ca/eng/acts/I-3.3/index.html.

3. Auto Loans

Interest on auto loans is not deductible in Canada.

4. Credit Card Debt

Interest paid to credit card companies for personal purchases are not deductible in Canada.

5. Student Loans

In Canada, undergraduate tuition fees for Canadian residents vary from province to province and, to a lesser extent, from university to university and program to program. The range is from an annual low of approximately US$3,000 in Quebec to slightly over US$6,000 in Ontario for most resident undergraduates in most programs.[4]

Interest paid on a student loan received under the major student loan programs established by the federal and provincial governments in Canada is deductible.[5] If a taxpayer does not have income to offset in the year he or she pays interest on a student loan, he or she may carry the unclaimed amount forward for five years.[6] Interest on foreign student loans is not deductible,[7] however, and parents cannot deduct the interest they pay on their children's student loans.[8]

B. Incentives for the Lender

The I.T.A. does not contain special tax provisions designed to encourage lenders to make loans available for home mortgages, home equity investments, or autos. Credit card companies are not taxed at a special lower rate.

Student loan programs are government funded. Interest earned on student loans by federal and provincial governments is not taxed by those governments.

C. Related Tax Benefits or Subsidies

The major incentive Canada has to encourage home ownership is its Home Buyers' Plan (HBP). Under this plan, individuals can withdraw up to Can$25,000 (approximately US$25,556) from their Registered Retirement Savings Plan (RRSP) to "buy or build a qualifying home for

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[4] *Canada's Higher Education and Career Guide*, CANADIAN-UNIVERSITIES.NET, http://www.canadian-universities.net/Campus/Tuition-Fees.html (last visited June 1, 2011).

[5] *Line 319 – Interest Paid on Your Student Loans*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns300-350/319-eng.html (last modified Jan. 5, 2011).

[6] I.T.A. § 118.62.

[7] *Id.*

[8] CANADA REVENUE AGENCY, *supra* note 5.

[themselves] or a related person with a disability."[9] "Qualifying expenditures" are expenditures on housing units located in Canada or shares in a Canadian cooperative housing corporation.[10] Withdrawals from an RRSP must be repaid over a period of fifteen years.[11] Payments are in equal installments beginning with the second year following the withdrawal.[12] Failure to make an annual repayment will result in the amount due having to be declared as income because contributions to RRSPs, like contributions to Individual Retirement Accounts in the United States, are generally tax deductible up to certain limits.

The rules respecting RRSPs have become quite complex in recent years. The amount that a taxpayer can deduct from otherwise taxable income on account of contributions to an RRSP is called the taxpayer's "contribution room."[13] The Canada Revenue Agency calculates each taxpayer's contribution room for him or her. For 2010, the maximum RRSP deduction limit was Can$22,000 (approximately US$22,000).[14] However, unused contributions may be taken for the years 1991-2010 to greatly increase a taxpayer's contribution room.

Canada also has Registered Education Savings Plans (RESPs).[15] Under these plans, contributors or "subscribers" cannot deduct their contributions to a plan in the same manner that a taxpayer can deduct contributions to an RRSP. Income from the plans is paid to beneficiaries who are enrolled in a postsecondary school. This income, which may be in the form of interest, is taxable income to the beneficiary, but not to the subscriber.[16] Since most students do not pay income tax at high rates, RESP payments are usually subject to little, if any, income tax. Consequently, an RESP allows a parent, grandparent, or other older person to avoid taxation on income earned on money set aside for a child's education.

In addition, Canada has Registered Disability Savings Plans, which are generally similar to RESPs, but are only available to persons who are eligible for Canada's Disability Tax Credit.[17] Income earned by these plans is taxable in the hands of a beneficiary not when it is earned, but when it is paid out.[18] Again, the incentive is a tax savings through deferral rather than a reduction in tax on account of contributions, as in the case of an RRSP.

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[9] *Home Buyers' Plan (HBP)*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/hbp-rap/menu-eng.html (last modified Dec. 10, 2010).

[10] I.T.A. § 146.01.

[11] *Id.*

[12] *Repayments Under the Home Buyers' Plan (HBP)*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/hbp-rap/rpymnts/menu-eng.html (last modified Dec. 10, 2010).

[13] *How Much Can I Contribute and Deduct?*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/cntrbtng/lmts-eng.html (last modified Dec. 22, 2010).

[14] *Id.*

[15] I.T.A. § 146.1.

[16] *How an RESP Works*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/resp-reee/hw-eng.html (last modified Oct. 15, 2010).

[17] *Registered Disability Savings Plan*, CANADA REVENUE AGENCY, http://cwww.cra-arc.gc.ca/tx/ndvdls/tpcs/rdsp-reei/menu-eng.html (last modified Oct. 29, Oct. 29, 2010).

[18] I.T.A. § 146.4.

II. Deductibility of Debt Incurred to Finance Investments

Interest and dividends earned on private passive investment income must be included in income and is taxed at marginal rates unless it is received from a taxable Canadian resident corporation. Interest and dividends received from a taxable Canadian resident corporation are given a tax imputation credit on account of the fact that they have been paid out of after-tax earnings. The formulas for calculating tax imputation are very complicated, but their net effect is to tax interest and income received from taxable Canadian resident corporations at a rate that is very close to what the individual would pay if the income was a capital gain.[19] In Canada, 50 percent of capital gains must be included in income, and the total of other income and half of capital gains are taxed at marginal rates.[20]

Interest paid on money borrowed to earn passive income is a deductible expense.[21] Interest paid for the purpose of earning income from rental properties is a business expense and is also deductible. Interest on purchases that provide no income but can only produce a capital gain is not deductible.[22]

A. Annual Limits Relating to Investment Income

There are no limits on the amount of interest that can be deducted for the purpose of borrowing money to make passive investments to earn income.

B. Deductions for Exempt or Tax-Favored Income

As mentioned above, the interest on money borrowed to make passive investments to earn tax-favored eligible income is deductible.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

D. Other Limits on the Deductibility of Interest for Private Investments

N/A

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[19] *Line 120 – Taxable Amount of Dividends (Eligible and Other Than Eligible) from Taxable Canadian Corporations*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/rprtng-ncm/lns101-170/120/menu-eng.html (last visited June 1, 2011).

[20] *Capital Gains 2010*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/E/pub/tg/t4037/t4037-e.html (last visited June 1, 2010).

[21] *Carrying Charges and Interest Expenses*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/221/menu-eng.html (last visited June 2, 2011).

[22] *Id.*

III. Special Treatment of Other Debt

N/A

IV. Treatment of Cancelled Debt

Canada's I.T.A. provides that cancelled debts must be included in income in two situations. The first of these applies to forgiven employee loans.[23] The second applies to shareholders.[24] The rationale for the first rule is to "prevent employees from avoiding taxes by simply arranging to receive part of their wages or salary as fringe benefits rather than [as] cash remuneration."[25] The rationale for the shareholder inclusion also appears to be to prevent loan forgiveness to be used to avoid income tax.[26]

Aside from the two cases noted above, Canada does not have a general rule that forgiven loans must be included in the income of an individual taxpayer.

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[23] I.T.A. §§ 6(1)(a), 6(15).

[24] *Id.* § 15(1.2).

[25] Canadian Tax Reporter (CCH) ¶ 2303.

[26] *Id.* ¶ 4664c.

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FRANCE

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

French tax law has a marked preference for the use of tax credits instead of deductions. The French General Tax Code provides for limited tax credits on interest for residential mortgages and student loans. The 2011 Finance Law, however, abolished the tax credit granted in respect of interest incurred for loans obtained for the purchase or construction of the taxpayer's main residence. The abolition of this tax credit is not retroactive. It has been replaced by enhanced zero-interest loans for first-time homebuyers. The tax credit is granted instead to banks that provide this type of loan. Tax credits are granted for energy-saving equipment and equipment for disabled elderly persons purchased for the principal residence of the taxpayer. France also has two types of home savings plans that have substantial tax advantages, and a tax credit for school expenses. As a general rule, interest paid on debt incurred to finance investments is not deductable. Instead, tax credits are granted on a percentage of the amount of the capital invested in certain types of investments irrespective of whether the capital was borrowed.

The French General Tax Code enumerates eight categories of income that are taken into account to determine the taxable income of an individual: industrial and commercial; professional; agricultural; real estate; investment; wages, salaries, pensions, and annuities; remunerations paid to majority shareholders of certain business organizations; and capital gains.[1] Each category is subject to various rules for calculating adjusted gross income and the resulting sums are then added together. Adjusted income is reduced by a few specifically authorized deductions. French tax law has a marked preference for the use of tax credits instead of deductions.[2]

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

The French General Tax Code does not authorize an individual taxpayer to take a deduction for interest paid on the types of debts listed below. Instead, it provides for limited tax

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[1] CODE GENERAL DES IMPÔTS [C.G.I.] art. 1A, *available at* LEGIFRANCE, http://legifrance.gouv.fr/ (*Les codes en vigueur*).

[2] FRENCH TAX & BUSINESS LAW GUIDE (Sweet and Maxwell) ¶ 32310.

credits on interest for residential mortgage loans and student loans. In addition, since enactment of the 2009 Finance Law there is a general ceiling on the use of tax deductions, tax credits, and other tax benefits. For the taxation of 2011 income, the tax benefit limitation is the sum of the two following amounts: €18,000[3] plus 6 percent of the taxable income subject to the progressive rate schedule. This limitation applies per fiscal household.[4] Some tax benefits are excluded from that ceiling. They include those connected to the personal situation of the taxpayer or contributions made by the taxpayer out of disinterested generosity such as charitable gifts.[5]

1. Residential Mortgage Loans

Taxpayers are entitled to a tax credit for the initial five-year period of the loan on loans concluded between May 6, 2007, and January 1, 2011, for the acquisition or construction of their principal residence. The credit is equal to 40 percent of the loan interest for the first twelve months then 20 percent for each of the remaining years. This credit, however, is limited to €3,750 per year for a single person and €7,500 for a couple. It is increased by €500 per year for each dependent. These limits are doubled where one member of the family (the taxpayer, one of the spouses, or one of the dependents) is disabled.[6]

The tax credit rate is reduced from 40 and 20 percent to 30 and 15 percent respectively for a principal residence built or acquired between January 1, 2010, and January 1, 2011, that does not meet the low energy consumption building standards.[7]

The tax credit is raised to 40 percent of the interest paid over the initial seven years for a principal residence purchased or built on or after January 1, 2009, where the residence meets the low energy consumption building standards.[8]

The loans must have been obtained from a financial establishment located in France or in one of the member states of the Economic European Area (EU members, Iceland, and Norway) that have entered into a fiscal convention with France containing an administrative assistance clause to fight fiscal fraud.[9]

The 2011 Finance Law abolished the tax credit for interest incurred on loan offers issued on or after January 1, 2011, for the purchase or building of the taxpayer's main residence and, where the loan offer was issued before that date, for houses purchased after September 30, 2011. The abolition of the tax credit is not retroactive. The tax credit is replaced by enhanced

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[3] At the current exchange rate, €1 is equal to approximately US$1.44.

[4] C.G.I. art. 200-0 A.

[5] *Id.*

[6] *Intérêts des prêts contractés pour l'habitation principale*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/lienBrochure.html?ud_051.html#dgibro.ir2011.ud51.171.7 (last visited May 27, 2011); C.G.I. art. 200 quaterdecies.

[7] *Id.*

[8] *Id.*

[9] *Id.*

zero-interest loans (*prêt à taux zéro plus*) issued under strict conditions.[10] (See also Part I(C), "Related Tax Benefits or Subsidies.")

2. Home Equity Loans

No deduction is allowed for interest paid on home equity loans.

3. Auto Loans

No deduction is allowed for interest paid on an auto loan. (See also Part I(C), "Related Tax Benefits or Subsidies.")

4. Credit Card Debt

No deduction is allowed for interest paid on credit card debt.

5. Student Loans

Students in France do not pay any tuition at the university level. University students may nonetheless benefit from an education tax credit for loans they obtained to finance other costs related to their studies if they obtained the loan between September 1, 2005, and December 31, 2008, and they were twenty-five years old or under on January 1 of the year in which the loan was issued. The tax credit is equal to 25 percent of the loan's interest for the initial five-year period of the loan. This credit, however, is limited to €1,000 per year. The student must be registered at a university and domiciled in France during the years he or she requests the tax credit.[11] (See also Part I(C), "Related Tax Benefits or Subsidies.")

B. Incentives for the Lender

As seen above, the tax credit that was granted to individuals on their mortgage interest has been replaced by a tax credit granted to banks that provide mortgages for qualifying low-income borrowers purchasing their first home with a zero interest loan.

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[10] Loi n° 2010-1657 du 29 décembre 2010 de finances pour 2011 [2011 Finance Law] art. 90, *available at* LEGIFRANCE, http://legifrance.gouv.fr/affichTexte.do;jsessionid=6ACD821A554DA9CC6E58ED4B902537B9.tpdjo04v_1?cidTexte=JORFTEXT000023314376&categorieLien=id#JORFARTI000023315060.

[11] *Intérêts des prêts contractés par les étudiants*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/lienBrochure.html?ud_053.html#dgibro.ir2011.ud53.177.21 (last visited May 27, 2011); C.G.I. art. 200 terdecies.

C. Related Tax Benefits or Subsidies

1. Principal Residence

Energy Saving Equipment

Investments by individuals in their personal residence for qualifying major household equipment, such as energy-saving and energy-producing heating systems and thermal insulation, that are made over a consecutive five-year period between January 1, 2005, and December 31, 2012, give rise to a tax credit equal to 15, 25, or 50 percent depending on the nature of the equipment.[12] These rates are reduced by 10 percent for the taxation of 2011 income by the 2011 Finance Law. The tax credit is 15 percent for low-temperature heating devices, 25 percent for equipment used to connect to certain renewable energy or cogeneration sources, and 50 percent for equipment that produces energy from renewable energy sources or from certain heat pumps. The total credit amount, however, is limited to €8,000 for a single person and €16,000 for a couple. It is increased by €400 for each dependent.[13]

Equipment for Disabled or Elderly Persons

The acquisition of equipment for disabled and/or elderly persons for the taxpayer's principal residence purchased between January 1, 2005, and December 31, 2011, also gives rise to a tax credit. For expenses incurred during the year 2010, the tax credit is equal to 15, 25, or 30 percent depending on the equipment. The overall limits of the tax credit are €5,000 for a single person and €10,000 for a couple. The limit is increased by €400 for each dependent.[14]

Enhanced Zero-Interest Loans

Enhanced zero-interest loans (*prêt à taux zéro plus*) are reserved for first-time homebuyers. The term "first-time homebuyers" is understood as covering buyers who did not own their main residence within the two years preceding the loan request or who are disabled or were victims of a catastrophe. The loan may either finance the purchase of a new or old dwelling or the construction of the taxpayer's residence.[15]

These loans are subject to means testing. The annual income ceilings depend on the make-up of the household and the geographic zone where the property is located. The amount of the loan granted depends on several criteria including, for example, the age of the property, the

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[12] *Dépenses en faveur de la qualité environnementale de l'habitation principale*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/lienBrochure.html?ud_049.html#dgibro.ir2011.ud49.162.1 (last visited May 27, 2011); C.G.I. art. 200 quater & 18 bis de l'annexe IV.

[13] *Id.*

[14] *Dépenses d'équipement de l'habitation principale en faveur d'aide aux personnes*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2009/brochures_ir2009/ud_057.html (last visited May 27, 2011); C.G.I. art. 200 quater A.

[15] MINISTERE DE L'ECOLOGIE, DU DEVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT, LE PRET A TAUX ZERO (Jan. 2011), http://www.developpement-durable.gouv.fr/IMG/pdf/Plaquette_PTZ_.pdf.

income of the purchaser, and the make-up of the household. The repayment period depends on the income of the purchaser and can be from six years to twenty-two years. These loans are complementary funding and are granted as a supplement to the main mortgage loan. They are financed by credit establishments that have signed a convention with the state. The state grants the establishment a tax credit equivalent to the amount of the interest it would have earned.[16]

Home Savings Plans

The home savings plans (*plans compte d'epargne logement*) were established in 1965 to encourage private individuals to build up their savings for homeownership. There are two types of plans: the property savings account and the property savings plan.

- The property savings account is a deposit account with a deposit ceiling of €15,300. After eighteen months of saving, the holder of the account may obtain a loan of up to €23,000 with a below-market rate. The state also provides for a bonus of €1,144.[17]

- The property savings plan allows the holder to save up to €61,200 during four years at which time he may be granted a loan at a below-market rate for a maximum amount of €92,000.[18] The state also pays a bonus of €1,525.

In both cases, the below-market rate depends upon the rate of interest accrued during the period of saving. There is no tax payable on the interest that accrues while one is saving. This interest is also capitalized at the end of each year. If the amounts saved are then used for the intended purpose, they can be withdrawn free of income tax.[19]

2. Auto Loans

Taxpayers who acquire environmentally friendly cars are rewarded with a tax bonus of up to €5,000 (the amount depends on the CO_2 emission level) by way of a price discount.[20]

3. School Expenses

A tax credit for school expenses is granted to taxpayers residing in France whose dependent children are continuing their secondary or higher education. The amount of the tax

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[16] *Id.*

[17] *Compte épargne logement*, MINISTERE DU DE L'ECOLOGIE, DU DEVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT (Sept. 17, 2010), http://www.developpement-durable.gouv.fr/Phase-epargne.html.

[18] *Plan épargne logement*, MINISTERE DU LOGEMENT DE L'ECOLOGIE, DU DEVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT (Sept. 17, 2010), http://www.developpement-durable.gouv.fr/spip.php?page=article&id_article=17909.

[19] MINISTÈRE DU LOGEMENT DE L'ECOLOGIE, DU DÉVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT, *supra* notes 16 & 17.

[20] Marc Henderson, *France–Individual Taxation* ¶ 1.8.3.2, *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: EUROPEAN TAX ANALYSIS, http://online.ibfd.org/kbase/ (by subscription) (last visited Apr. 15, 2011).

credit is €153 for a student attending a high school and €183 for a child attending an establishment of higher learning.[21]

II. Deductibility of Debt Incurred to Finance Investments

Investment income (*revenus de valeurs mobilières*) is subdivided into two categories: dividends and interest. As a general rule, 40 percent of dividends received by an individual from a company subject to corporate income tax or equivalent tax whose registered office is located in France or in an other EU member state, or in a country that entered into a double taxation treaty with France containing an administrative assistance clause, is exempt from tax. An additional €1,525 for a single taxpayer or €3,050 for a married couple is also exempt from tax. The remaining dividends are subject to income tax at the ordinary tax rate. Expenses are not deductable. The taxpayer, however, may elect a 19 percent withholding tax.[22]

Interest on current accounts, loans, government and corporate bonds, and similar debt instruments are taxable at the ordinary tax rate. The taxpayer may also elect a 19 percent withholding tax. No further tax is due on dividends or interest where a withholding tax is paid. Interest on certain types of saving schemes—for example, home savings plans—are exempt from tax.[23]

France does not appear to favor the deduction of interest as an incentive for investment by individuals. It prefers instead to grant tax credits. Only the following instances of deductibility of interest for individual taxpayers could be found; some are borderline between investments and other categories of income:

- Part of the interest paid on a small business loan taken by an individual to purchase capital in a non-quoted company that gives the individual a majority of voting rights with the goal of allowing him/her to exercise the function of director. The General Tax Code allows the deduction of 25 percent of the interest up to €20,000 for a single person and €40,000 for married couples.[24]

- Interest on debts contracted for the conservation, acquisition, construction, reparation, or improvement of real property.[25] This deduction relates to the real estate income category.

- Interest on loans granted to French citizens for their reinstallation in France when returning from a stay abroad.[26]

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[21] C.G.I. art. 199 quarter F.

[22] *Id.* ¶ 1.5.1.

[23] *Id.* ¶ 1.5.2.

[24] *Intérêt d'emprunt pour reprise d'une société*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida 2011/ brochures_ir2011/ud_071.html (last visited May 27, 2011); C.G.I. art. 199 terdecies-0B.

[25] C.G.I. art. 31 I(d).

[26] *Id.* art. 156 II 1°.

- Interest paid in connection with loans taken for business purposes, which is deductable when accrued.[27] This deduction is found in the General Tax Code under industrial and commercial income.

A. Annual Limits Relating to Investment Income

There is no specific annual limit relating to investment income. As mentioned in Part I, there is a general ceiling on the use of tax deductions, tax credits, and other tax benefits. For the taxation of 2011 income, the tax benefit limitation is the sum of the following two amounts: €18,000 plus 6 percent of the taxable income subject to the progressive rate schedule. This limitation applies per fiscal household.[28]

B. Deductions for Exempt or Tax-Favored Income

N/A

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

Tax credits are granted on a percentage of the amount of the capital invested in certain types of investments irrespective of whether the capital was borrowed. Examples are provided below.

Small Business Investment Funds

Individuals are encouraged to invest in small business investment funds (*fonds d'investissement de proximité*) through a tax credit. These funds invest in small- or medium-sized enterprises within the geographic area specified by the mutual fund. The tax credit is equal to 25 percent of the amount invested in such funds, up to a limit of €12,000 for a single person and €24,000 for a married couple.[29]

Investments in Innovation Mutual Funds

The General Tax Code provides for a 25 percent tax credit to taxpayers who invest in specialized innovation mutual funds between calendar years 1997 to 2012. As above, the

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[27] *Id.* art. 39 I 1°.

[28] *Id.* art. 200-0 A.

[29] *Souscription au capital des FIP*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_068.html (last visited May 27, 2011); C.G.I. art. 199 tercedies OA, VI.

ceilings are €12,000 for a single person and €24,000 for a married couple. The taxpayer must hold his investment for at least five years to avoid recapture.[30]

Purchasing Shares in Certain Qualifying Small- and Medium-Sized Companies

Purchasing shares in certain newly created or already existing small- or medium-sized companies before December 31, 2012, entitles the taxpayer to a tax credit equal to 25 percent of the amount of his investment within an annual limit of €20,000 for a single person and €40,000 for a married couple. The taxpayer must hold his investment for at least five years or the credit will be recaptured.[31]

Similar tax credits are given for investments in overseas territories,[32] investments in residential premises intended for letting,[33] the purchase of shares in qualifying cinema and television production companies (SOFICAs),[34] the purchase of shares in finance companies for traditional fishing (SOFIPECHEs),[35] and investment in forests.[36]

IV. Treatment of Cancelled Debt

French tax law only contains debt forgiveness rules that relate to the industrial and commercial income category of the taxpayer. Under these rules, the taxpayer must include the amount of the debt forgiven in its profits.[37]

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[30] *Souscription au capital des FCIP*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_067.html (last visited May 27, 2011); C.G.I. art. 199 terdecies 0 A-VI bis, VI quater, VI quinquies.

[31] *Souscription au capital des PME*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_065.html (last visited May 27, 2011); C.G.I. art. 199 terdecies-OA-I to V.

[32] Henderson, *supra* note 20, ¶ 1.8.3.5.

[33] *Id.* ¶ 1.8.3.6.

[34] *Id.* ¶ 1.8.3.17.

[35] *Id.* ¶ 1.8.3.18.

[36] *Investissements forestiers*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_063.html (last visited May 27, 2011); C.G.I. art. 99 decies H.

[37] II LAMY FISCAL, IMPOTS SUR LE REVENU § 610 (Lamy 2011).

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GERMANY

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Currently, Germany does not treat any interest from a personal, non-business-related loan as tax-deductible. Germany does not grant income tax deductions for interest on residential mortgages, student loans, or consumer loans. Germany, however, provides other tax benefits and subsidies for homeownership and education.

For owner-occupied housing, portions of the acquisition or improvement costs can be deducted under an incentive program for retirement savings, and states and municipalities provide various subsidies for low-income housing.

For education expenses, some tax deductions are granted. For students from low-income families, generous cash grants and loans with little or no interest are available. Moreover, most universities charge little or no tuition.

Since January 1, 2009, passive investment income is taxed with a final withholding tax and no interest or other expenses can be deducted from this withheld tax.

Interest or other expenses cannot be deducted if they are attributable to the generation of tax-exempt income.

German law does not treat the forgiveness of a personal debt that is not related to the taxpayer's business as earned income.

Explanatory Remarks – Definition of Income

The German Income Tax Code defines the income of individual taxpayers by enumerating seven categories of income. Receipts obtained by individuals are taxed only if they fall within one of the following income categories:

1. Income from agriculture and forestry;
2. Income from trade or business;
3. Self-employment income;
4. Employment income;
5. Investment income;

6. Income from rents and royalties; and
7. Specified types of other income (including gains from annuities and from miscellaneous contractual relationships).[1]

Income is computed within each category according to different rules, and the deductibility of interest and other expenses varies within these categories.[2] An individual's taxable income is the sum of the income from the different categories, minus miscellaneous personal deductions.[3]

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

Interest paid on loans incurred for personal purposes is not tax-deductible, and this principle applies to residential mortgage loans, home equity loans, auto loans, credit card loans, and student loans. Expenses related to these private purposes fall into the category of living expenses for which no relief is granted to taxpayers,[4] unless the law specifically makes an exception from this principle.[5]

Until 1996, generous tax benefits for new homeowners were available. These, however, have been reduced over the last twenty-five years. (See Part I(C), below, "Related Tax Benefits or Subsidies"). Although student loans are not tax advantaged, relief for educational expenses is granted through tax deductions and other benefits. (See Part I(C), below, "Related Tax Benefits or Subsidies").

B. Incentives for the Lender

There are no specific tax advantages for the lenders of consumer loans, residential mortgages, or student loans.

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[1] Einkommensteuergesetz [EStG], *repromulgated* Oct. 8, 2009, BUNDESGESETZBLATT [BGBL.] I at 3366, *last amended by* Gesetz, Apr. 5, 2011, BGBL. I at 554, § 2.

[2] EBERHARD RICK ET AL., LEHRBUCH EINKOMMENSTEUER 89 (2006).

[3] Andreas Perdelwitz, *Germany – Individual Taxation*, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY SURVEYS, http://online.ibfd.org (by subscription) (last updated Apr. 1, 2011).

[4] EStG § 4(1).

[5] Deductible personal expenses are child care expenses; contributions to various social security or pension programs; contributions to various retirement savings programs (EStG § 4f & 10); donations to charity (EStG § 10b); and relief from various hardship situations, including educational expenses of dependants (EStG §§ 33–33b).

C. Related Tax Benefits or Subsidies

1. Housing

In the last twenty-five years, Germany has reduced the level of tax benefits and subsidies granted for individual homeownership. Significant income tax deductions were granted for the purchase or the construction of a taxpayer's home that was acquired before 1996. These amounted to a deduction of 6 percent of the cost of acquisition during each of the first four years following acquisition, and another 5 percent in each of the next four years, up to a maximum annual amount of approximately US$7,000 during the first four years and an annual maximum of approximately US$5,500 during the next four years.[6] Additional deductions were granted to homeowners with children.[7]

Under this scheme of granting tax relief to new homeowners, the deductibility of mortgage interest played a short and minor role for homes acquired between 1991 and 1994.[8] The provisions were restrictive and proved unpopular as compared to the other tax benefits that were available.[9]

In 1996, the tax benefits for homeownership were replaced by cash grants for lower- and middle-class homeowners.[10] Since January 1, 2006, the cash grant for homeowners is no longer given for new investments, but earlier investments will continue to enjoy the benefit until its scheduled termination after a maximum of eight years.[11]

Currently, income tax deductions are granted to homeowners who acquire or improve housing in urban planning areas or that qualify for historic protection. Over a nine-year period, close to one-half of such costs can be deducted.[12] In addition, tax credits or deductions for investments in owner-occupied dwellings are also granted within the framework of a subsidy program that encourages individuals to save for their retirement.[13] Altogether, these subsidies aim to replace, to some extent, the cash grants for homeownership that were abolished in 2006.[14]

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[6] Einkommensteuergesetz, in the repromulgated version of Aug. 8, 1961, and as in effect through April 28, 1997, § 10e; EStG § 52(14), as currently in effect.

[7] EStG, as in effect through Dec. 27, 1996, § 34e.

[8] EStG § 10e(6a).

[9] LUDWIG SCHMIDT, EINKOMMENSTEUERGESETZ 861 (27th ed. 2008).

[10] Eigenheimzulagengesetz [EigZulG], *repromulgated* Mar. 26, 1997, BGBL. I at 734, *as amended.*

[11] EigZulG § 9.

[12] EStG §§ 10f & 10g.

[13] Eigenheimrentengesetz, Aug. 1, 2008 BGBL. I at 1509. Currently, the deduction for retirement savings that can be used to deduct home acquisition costs is limited to a maximum amount of €2,100 (about US$3,040). *See* EStG § 10a.

[14] H. Nüssgens, *Selbst genutzte Wohnungsimmobilien werden in die Riester-Förderung einbezogen,* SOZIALE SICHERHEIT 259 (2008).

A few other federal subsidies are still being granted, among them, various opportunities to obtain subsidies for building savings contracts[15] that encourage potential homebuyers to save for several years before building or buying a home.[16] In addition, many states and local communities provide loans at subsidized interest rates for home purchases or improvements. These often employ preferences for young families; income limits and limits on the size of the subsidized housing also apply.[17]

2. Education

For several reasons the cost of higher education is less burdensome in Germany than in the United States. Most universities are owned and operated by the German states and they either charge no tuition or they limit tuition to about €500 (about US$650) per semester.[18] Moreover, a comprehensive federal program supports students from low-income backgrounds with cash grants and loans with little or no interest.[19] In addition, children qualify as dependents until age twenty-five if they are studying, and this grants to the parents an annual income tax-reducing allowance. Educational expenses for adults are also deductible up to certain limits.[20]

II. Deductibility of Debt Incurred to Finance Investments

Private investment income is taxable income.[21] Until 2009, expenses incurred in the process of generating private passive investment income were deductible from the investment income,[22] and interest was one of the deductible expenses.[23] Since January 1, 2009, however, private investment income from securities has been taxed with a final nonadjustable withholding tax, and investment-generating expenses can no longer be deducted.[24]

Since 2009, the only tax benefit that accrues to the private investor is an income-reducing allowance of €801 (about US$1,050) of the annual investment income. This allowance is

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[15] Fünftes Vermögensbildungsgesetz, Mar. 4, 1994, BGBL. I at 406, *as amended*, § 8.

[16] Gesetz über Bausparkassen, *repromulgated* Feb. 15, 1991, BGBl I at 454, *as amended*, http://www.gesetze-im-internet.de/bausparkg/BJNR020970972.html.

[17] For Munich, *see* MÜNCHEN REFERAT FÜR STADTPLANUNG UND BAUORDNUNG, GEFÖRDERTER WOHUNUNGSBAU IN MÜNCHEN (Jan. 2011), http://www.muenchen.de/cms/prod2/mde/_de/rubriken/Rathaus/75_plan/06_stadtsanierung/pdf/mbt_e_vi.pdf.

[18] Verwaltungsgerichtshof für Baden-Württemberg, Feb. 16, 2009, No. 2 S 1855/7, available by subscription at the German legal database JURIS; *Hessen schafft Studiengebühren wieder ab*, FINANCIAL TIMES DEUTSCHLAND (June 3, 2008), available by subscription at the German legal database JURIS.

[19] Bundesausbildungsförderungsgesetz, *repromulgated* Dec. 7, 2010, BGBL. I at 1852.

[20] EStG §§ 10, 32.

[21] Section 20 of the Income Tax Code (EStG § 20) lists as taxable income what appears to be all conceivable forms of income from capital interest, dividends, related distributions, annuities, and other unspecified returns on capital.

[22] EStG § 9.

[23] RICK ET AL., *supra* note 2, at 732.

[24] EStG § 20(9), *as enacted by* Unternehmenssteuerreformgesetz 2008, Aug. 14, 2007, BGBl I at 1912.

doubled in the case of spouses filing jointly. The allowance combines the previous allowance of €750 (about US$925) that aimed at encouraging savings and another allowance of €51 (about US$75) that formerly was a non-itemized lump sum deduction for investment-generating expenses.[25]

A. Annual Limits Relating to Investment Income

N/A

B. Deductions for Exempt or Tax-Favored Income

Section 3c of the Income Tax Code provides that expenses are not deductible if they are incurred in relation to tax-exempt income.[26] This provision, however, appears to have little relevance for personal, non-business debt because none of it is deductible.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

N/A

IV. Treatment of Cancelled Debt

The cancellation of a private debt is not taxable income.[27] It does not fall within one of the statutorily defined income categories. In particular, cancellation of a debt could not result in income if it could be considered a gift.[28]

An individual taxpayer, however, who is self-employed or operates a business, farm, or forestry enterprise realizes a taxable profit when a debt is cancelled that relates to these income-generating activities.[29] Technically, such a discharge from indebtedness must be entered on the books as a gain, to be included in the computation of the annual business profit.[30] Yet even the discharge of a business-related debt is not a taxable receipt if the creditor forgave the debt for personal reasons, such as family relations.[31]

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[25] SCHMIDT, *supra* note 9, at 1729.

[26] EstG § 3c.

[27] Bundesfinanzhof, Mar. 12, 1970, No. IV R 39/69, BUNDESSTEUERBLATT II 518 (1970).

[28] SCHMIDT, *supra* note 9, at 1848.

[29] *Id.* at 204.

[30] EStG § 4.

[31] Bundesfinanzhof, Mar. 12, 1970, No. IV R 39/69, BUNDESSTEUERBLATT II 518 (1970).

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JAPAN

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

A tax credit for interest paid on housing loans is available for homeowners in Japan who bought a home with a mortgage and moved into it between 1991 and 2013. Homeowners may also claim a tax credit for certain remodeling expenses and for qualified new homes.

With regard to debt incurred to finance investments, interest expenses on the acquisition of shares may be deducted from dividend income. Japanese law does not appear to provide for special treatment for other household debt or for debt cancellation.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

The deductions that are allowed in calculating the taxable income of individuals are listed in Japan's Income Tax Law,[1] and expenses not listed therein are not deductible. Consequently, interest is not deductible if it is paid for the following types of loans:

1. Residential Mortgage Loans
2. Home Equity Loans
3. Auto Loans
4. Credit Card Debt
5. Student Loans

For interest paid on mortgage loans, however, a tax credit is granted (See Part I(C), below, "Related Tax Benefits or Subsidies.")

B. Incentives for the Lender

Japanese tax laws do not provide incentives for the lender.

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[1] Shotokuzei hō [Income Tax Law], Law No. 33 of 1965, *last amended by* Law No. 71 of 2010, bk. 2, ch. 2, § 4 (arts. 72–88).

C. Related Tax Benefits or Subsidies

1. Residential Mortgage Loans

a. *Public Housing Financing System*

The Japanese government established its housing policy after the Second World War. As originally conceived, the policy had "three pillars":

(1) Homeownership promotion through low-interest loans provided by the Government Housing Loan Corporation (GHLC);

(2) Public rental housing for low-income people constructed by local governments with heavy subsidies from the central government; and

(3) Housing by the Housing Corporation for middle-income workers.[2]

The GHLC was abolished in 2007, and the Japan Housing Finance Agency (JHFA) was created and succeeded to GHLC's rights and obligations. The JHFA is an incorporated administrative agency owned by the government.[3] The JHFA does not provide loans directly to households except in special situations, such as houses rebuilt after a disaster.[4] Instead, it engages in the securitization business for housing loan products with a long-term, fixed interest rate, so that private financial institutions can more readily provide these loans.[5] Financial institutions that sell these housing loans are allowed to set their fee portions of the interest rates at their own discretion.

There are other public housing finance systems as well. Under the *Zaikei* (asset forming) Housing Savings System, workers who are employed by firms that participate in the System can make regular deposits to a participating financial institution for at least five years.[6] The deposit is made by the employer, who withdraws a set amount of money from the worker's salary and sends it to the financial institution.[7] Interest generated by the deposit is exempt from tax.[8] The deposit may be used only for the acquisition of a home. An eligible employee may borrow up to

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[2] Yosuke Hirayama, *Outline of Japanese Housing*, ASIA-PACIFIC NETWORK FOR HOUSING RESEARCH, THE JAPAN CHAPTER (Faculty of Human Development, Kobe University), http://www.edu.kobe-u.ac.jp/hudev-hiraken/apnhr/intro_apnhr.html (last visited May 27, 2011).

[3] JHFA has an English language website, at http://www.jhf.go.jp/english/index.html (last visited June 1, 2011).

[4] Dokuritsu gyōsei hōjin Jūtaku kin-yū shien kikō hō [JHFA Law], Law No. 82 of 2005, *last amended by* Law No. 79 of 2009, art. 13.

[5] *Id.*

[6] Kinrōsha zaisan keisei sokushin hō [Law to Promote Workers' Asset Forming], Law No. 92 of 1971, *last amended by* Law No. 26 of 2008, art. 6, para. 4.

[7] *Id.*

[8] Sozei tokubetsu soehi hō [Tax Special Measures Law], Law No. 26 of 1957, *last amended by* Law No. 12 of 2011, art. 4-2.

ten times the amount of the deposit (up to 40 million yen, or about US$490,000).[9] A public corporation, the Employment and Human Resources Development Organization of Japan (EHRD),[10] borrows money from participating financial institutions[11] and lends the money to the employers.[12] The employer then makes a loan contract with the employee. There are certain physical requirements for the home purchased.[13]

Local governments also provide housing loan support measures. In the past, many municipal governments had direct or indirect housing loan programs for eligible residents. It appears, however, that most of them abolished such programs due to financial difficulties.[14] There are still municipal governments that pay/reimburse a portion of housing loan interest for/to qualified residents, often for specific purposes. For example, in the 2011 fiscal year (ending March 31, 2012), the Tokyo Metropolitan government will pay 1 percent of the housing loan amount that was borrowed from designated financial institutions for ten years for qualified households that will demolish their homes in areas where homes made of wood are concentrated and rebuild fire-resistant homes.[15]

b. *Tax Credit*

i. Tax Credit for Housing Loan

A tax credit for interest paid on a housing loan is available for qualified homeowners who built or bought a qualified home and moved into it between 1991 and 2013.[16] The terms and maximum amounts of the tax credit vary depending on the year in which the homeowner moved in. The following requirements are based on the program applicable to homeowners who move into their homes during 2011. To qualify for the 2011 tax credit,

- the homeowner's taxable income must be 30 million yen (about US$370,000) or less;

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[9] Law to Promote Workers' Asset Forming, art. 9, para. 1; Kinrōsha zaisan keisei sokushin hō sekō rei [Enforcement Order of Law to Promote Workers' Asset Forming], Order No. 332 of 1971, *amended by* Order No. 58 of 2010, art. 33.

[10] The Organization does not have an English language website. Its website in Japanese is available *at* http://www.ehdo.go.jp (last visited June 1, 2011). Its *Zaikei* webpage is available *at* http://www.ehdo.go.jp/zaikei/zaikei.html (last visited May 27, 2011).

[11] Law to Promote Workers' Asset Forming art. 12.

[12] *Id.*

[13] *Id.*

[14] Jūtaku rōn jichitai yūshi tte? [What Is a Local Government Housing Loan?], Teishūnyū demo okane o tameru hōhō [Method to Save Money Even for Low-income People], http://money.fastingsky.com/2011/02/post_27.html (last modified Feb. 18, 2011).

[15] Heisei 23 nendo tōkyō to kojin jūtaku rishi hokyū josei no boshū [Opening of Housing Loan Interest Supplement by Tokyo Metropolitan Government], Tokyo Metropolitan Government, http://www.toshiseibi.metro.tokyo.jp/juutaku_seisaku/281buybuildB1.htm (last visited May 27, 2011).

[16] Tax Special Measures Law, Law No. 26 of 1957, *last amended by* Law No. 12 of 2011, art. 41, para. 1.

- the seller of the house may not be a spouse, family member, or other person who has a special relationship with the buyer/new owner;
- the homeowner must move into the house within six months from the date of purchase;
- the loan must be from a qualified loan provider;
- the term of the loan payment must be ten years or more; and
- the home must satisfy physical conditions that the Ministry of Finance Ordinance specifies.[17]

The amount of the tax credit is 1 percent of the amount of the loan as of December 31 of the applicable year, up to 400,000 yen (about US$4,900). The tax credit may be claimed for ten consecutive years as long as the owner continues living in the home and the taxable income of the owner is 30 million yen or less.[18]

There are variations to this tax credit system. When a person builds a house or buys a newly-built house that qualifies as a "long-lasting, high-quality home," more tax credit is available. This tax credit system varies by year. For example, if a person buys and moves into a qualified home during 2011, the amount of the tax credit is 1.2 percent of the amount of the home loan as of December 31 of the year, for a period of ten years. The maximum amount of the tax credit is 600,000 yen (about US$7,300) annually. This tax credit is available for people who buy a qualified home and move into it between June 4, 2009, and December 31, 2013. The amount of the tax credit will decrease for persons who move into a qualified home in 2012 and 2013 to 1 percent of the home loan.[19]

A tax credit is also available for certain housing loans for remodeling when the homeowner is fifty years old or older, needs daily living assistance, or is disabled, or lives with a family member who is sixty-five years old or older, needs daily living assistance, or is disabled and remodeling is undertaken to make these person's daily living easier (i.e., barrier-free).[20] Also, home insulation costs may be included in the remodeling fee if it is done at the same time as the barrier-free remodeling.[21] This tax credit is available for five years, and the amount of the tax credit is 2 percent of the loan of the first 2 million yen (about US$24,400) and 1 percent of the remainder, up to 8 million yen.

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[17] *Id.*

[18] *Id.* art. 41, para. 2, item 8.

[19] *Id.* art. 41, para. 5.

[20] *Id.* art. 41-3-2; Sozei tokubetsu sochi hō shikōrei [Tax Special Measures Law Enforcement Order], Order No. 43 of 1957, *last amended by* Order No., art. 26-4, para. 3.

[21] Tax Special Measures Law art. 41-3-2, para. 2; Tax Special Measures Law Enforcement Order art. 26-4, para. 7.

ii. Tax Credit for Housing Expense With or Without a Housing Loan

When a resident remodels his home to make it earthquake resistant or has an inspection of his home to measure how earthquake resistant it is under a local government's earthquake resistance project between April 1, 2009, and December 31, 2013, he or she may claim a credit against income tax of up to 200,000 yen (about US$2,440).[22]

When a person buys a newly-built home that qualifies as a "long-lasting, high quality home," 10 percent of the difference in cost (up to 10 million yen, or about US$122,000) between an ordinary home and a "long-lasting high quality home" may be deducted from income tax. When the person elects to claim a tax credit for the housing loan described in the previous section, the tax credit for newly-built homes cannot be applied, however.[23]

2. Home Equity Loans

N/A

3. Auto Loans

N/A

4. Credit Card Debt

N/A

5. Student Loans

N/A

II. Deductibility of Debt Incurred to Finance Investments

Interest expenses on the acquisition of shares may be deducted from dividend income.[24]

A. Annual Limits Relating to Investment Income

The amount of the interest expense deduction is limited to the amount of the investment income.[25] In other words, a taxpayer may not deduct a higher amount of interest than the annual income received from investments.

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[22] Tax Special Measures Law art. 41-19-2.

[23] *Id.* art. 41-19-4, para. 4.

[24] Income Tax Law, Law No. 33 of 1965, *last amended by* Law No. 71 of 2010, art. 24, para. 2.

[25] *Id.*

B. Deductions for Exempt or Tax-Favored Income

Japanese law does not have a provision that limits individual interest deductions on debt incurred to purchase or carry tax exempt income.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

It appears that there is no additional special treatment for either the borrower or lender in relation to other household debt.

IV. Treatment of Cancelled Debt

There is no provision in the Income Tax Law regarding treatment of debt cancellation. However, cancelled debt is treated as a gift under the Inheritance Tax Law, so a person may have to pay gift tax for a forgiven or cancelled loan.[26] Cancelled debt is not regarded as a gift if the debtor has lost assets and it is very difficult to pay off the debt.[27]

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[26] Sōzoku zei hō (Inheritance Tax Law), Law No. 73 of 1950, *last amended by* Law No. 6 of 2010, art. 8.

[27] *Id.*

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MEXICO

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Residential mortgage loans are deductible under Mexico's tax regime, but other types of consumer debt apparently is not. Starting in fiscal year 2011, tuition paid to private schools (preschool through high school) may be deductible provided that applicable requirements are met. No information could be located concerning incentives for lenders. However, Mexico promotes its real estate market with incentives applicable to eligible Real Estate Investment Trusts. Expenses incurred by individuals to generate dividend income are not deductible. Cancelled debt is taxable.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

1. Residential Mortgage Loans

The amount of interest that is paid with respect to home mortgage loans contracted with financial system entities is deductible, as long as the amount of the mortgage loan does not exceed 1.5 million investment units[1] (equal to approximately US$588,978 as of June 3, 2011). Investment units "provide for a flexible currency unit to account for inflationary adjustments to Mexican currency."[2] Mexico's Central Bank (*Banco de México*) publishes the investment unit values periodically.[3] Financial institutions must inform the taxpayer, by February 15 of each year, of the amount of the interest paid in the tax year.[4]

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[1] Arturo Pérez Robles, *Mexico – Individual Taxation* ¶ 1.8.1.1., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (MEXICO), http://online.ibfd.org/kbase/ (by subscription) (last visited June 1, 2011). *See also* Ley del Impuesto sobre la Renta [hereinafter, Income Tax Law] art. 176-IV, *as amended*, Diario Oficial de la Federación [DO], Jan. 1, 2002, available on the website of Mexico's House of Representatives *at* http://www.diputados.gob.mx/LeyesBiblio/pdf/82.pdf.

[2] Jaime González-Bendiksen et al., Mexican Tax Guide (CCH) ¶ 6285.20, http://intelliconnect.cch.com (by subscription) (last visited June 1, 2011).

[3] *Id.*

[4] Pérez Robles, *supra* note 1, ¶ 1.8.1.1.

2. Home Equity Loans

No information could be located on the deductibility of home equity loans.

3. Auto Loans

The website of Mexico's Tax Administration Service indicates that investments in automobiles for personal use are not deductible.[5]

4. Credit Card Debt

No information could be located on the deductibility of credit card debt.

5. Student Loans

No information could be located on the deductibility of student loans. However, starting in fiscal year 2011, tuition paid to private schools (preschool through high school) may be deductible, provided that applicable requirements are met.[6] In addition, Mexico's Income Tax Law provides the following income exclusion applicable to education expenses:

> Yields on property held in trust are not considered income to the extent such yields are allocated … to finance the education of straight-line descendants through the bachelor's degree level, provided that the studies have official recognition.[7]

Public universities are mostly free in Mexico, although some charge low fees.

B. Incentives for the Lender

No information could be located concerning incentives for lenders. However, Mexico provides incentives to eligible Real Estate Investment Trusts, as follows:

> To promote the Mexican real estate market, a number of incentives are granted to investments in Mexican real estate investment trusts, mainly:

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[5] *Al deducir sus gastos* [*The Deduction of Expenses*], GOBIERNO FEDERAL, SAT (Servicio de Administración Tributaria), http://www.sat.gob.mx/sitio_internet/asistencia_contribuyente/principiantes/errores/36_756.html (last visited June 1, 2011).

[6] Decreto por el que se otorga un estímulo fiscal a las personas físicas en relación con los pagos por servicios educativos [Decree granting a tax incentive to individuals with regard to payments for educational services], DO, Feb. 15, 2011, available on the website of Mexico Department of Treasury, *at* http://www.shcp.gob.mx/lashcp/MarcoJuridico/documentosDOF/2011/febrero/decreto_15022011.pdf. *See also Mexico Politics: Private Education Now Tax Deductible*, ECONOMIST INTELLIGENCE UNIT (Mar. 11, 2011), http://www.eiu.com/index.asp?layout=VWArticleVW3&article_id=957877680&region_id=1510000351&country_id=1520000152&channel_id=210004021&category_id=&refm=vwCh&page_title=Channel+Latest&rf=0 (by subscription).

[7] González-Bendiksen et al., *supra* note 2, ¶ 2505.80. *See also* Income Tax Law art. 106.

- Deferral on the income tax applicable on the capital gain resulting from contribution of real estate to the trust.
- The trust is not required to make estimated income tax payments.
- Foreign pension and retirement funds enjoy an exemption for income generated by the assets contributed to the trust and income from the sale of the participation certificates issued by the trust.
- Exemptions also apply for nonresidents and individuals who sell publicly traded participation certificates issued by the trust.[8]

C. Related Tax Benefits or Subsidies

The following services are exempt from Value Added Tax:

> Commissions and other payments made by the borrower to the lender under a loan secured through mortgage for the acquisition, extension, construction, or repair of real property destined to residential purposes, except for those payments arising after the corresponding loan has been granted and for payments from the borrower to third parties.
>
> ...
>
> Interest derived from mortgage credits or credits with a trust guaranty for the acquisition, extension, construction or repairing of real property intended for residential purposes.[9]

Mexico's federal government provides financial aid to eligible low-income individuals for the purchase or construction of a home.[10]

II. Deductibility of Debt Incurred to Finance Investments

Dividends

According to the International Bureau of Fiscal Documentation (IBFD), dividends are taxed as follows:

> Investment income is normally included in the individual recipient's taxable base. Dividends must be accrued as any other income for the individual. This person can credit against its annual income tax the income tax paid by the distributing company, provided that this income tax is considered accruable income and the individual has the certificate issued by the distributing company regarding the dividend.[11]

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[8] González-Bendiksen et al., *supra* note 2, ¶ 1330.10.

[9] *Id.* ¶ 5205. *See also* Ley del Impuesto al Valor Agregado [Value Added Tax Law] art. 15 (I), (X-d), *as amended*, DO, Dec. 29, 1978, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/77.pdf (last visited June 2, 2011).

[10] *Esta es tu Casa* [*This Is Your Home*], GOBIERNO FEDERAL, COMISIÓN NACIONAL DE VIVIENDA, http://www.conafovi.gob.mx/programas-estrategicos/tu-casa (last visited June 2, 2011).

[11] Ricardo León & Mariana Eguiarte, *Mexico – Individual Taxation* ¶ 1.5.1., IBFD: COUNTRY SURVEYS, http://online.ibfd.org/kbase / (by subscription) (last visited June 2, 2011).

The *Mexican Tax Guide* further states that

> No deductions are allowable against dividend income, which is includable with other ordinary income, on a gross basis. Dividends paid out by Mexican entities are subject to no withholding tax at all.[12]

Interest

With regard to the treatment of interest, the *Mexican Tax Guide* explains that

> Taxpayers are required to recognize as ordinary income the "real" interest received during the tax year and add it to all other ordinary income of the taxpayer generated in the tax year.[13]
>
> . . .
>
> When the inflation adjustment to determine the "real" interest … is greater than the interest received, the result is deemed a loss. The loss may be subtracted from the other ordinary income generated in the tax year, except for income from dependent personal services … and income from business and professional activities …. The part of the loss not subtracted in the tax year may be carried forward to the five following tax years until exhausted, adjusted for inflation … from the last month of the tax year in which incurred to the last month of the tax year in which applied, or from the last inflationary adjustment made to the last month of the tax year in which applied, as the case may be.[14]
>
> . . .
>
> Real interest is the amount by which the interest exceeds the inflationary adjustment….[15]
>
> . . .
>
> All corporations and individuals paying interest to individuals is required to withhold and pay in the tax withheld. …
>
> The tax withheld is considered an estimated payment.[16]

Income from Real Property

The IBFD provides the following guidance with regard to the taxation of income from real property:

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[12] González-Bendiksen et al., *supra* note 2, ¶ 3165.

[13] *Id.* ¶ 3060.10.

[14] *Id.* ¶ 3060.30.

[15] *Id.* ¶ 3065.10.

[16] *Id.* ¶ 3070.10.

Rental income is taxed on its net amount, i.e. the gross rent received less related expenses (including the amount of the local property tax paid during the same tax year, maintenance expenses, construction and improvements, insurance premiums for insurance covering the immovable property, interest on loans to finance the acquisition of the property or construction of improvements). However, individuals may elect to deduct 35% of the rent as "constructive expenses" instead of deducting the substantiated expenses. All taxpayers can deduct the amount of the local property tax paid during the same tax year.[17]

A. Annual Limits Relating to Investment Income

N/A

B. Deductions for Exempt or Tax-Favored Income

N/A

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

No information could be located on this topic.

IV. Treatment of Cancelled Debt

Pursuant to Mexico's Income Tax Law, "[t]he amounts forgiven by the creditor and the debts paid by a third party on the taxpayer's behalf"[18] are taxable income.[19]

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June 2011

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[17] León & Eguiarte, *supra* note 11, ¶ 1.5.2.

[18] González-Bendiksen et al., *supra* note 2, ¶ 3200.10.

[19] Income Tax Law art. 167(I).

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UNITED KINGDOM

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

There are very few tax deductions that are permitted for household debt in the United Kingdom. Residential mortgage interest relief was removed in 2000. There are limited circumstances in which interest from loans may be deducted for tax purposes.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

Tax deductions for interest paid in the United Kingdom (UK) have been severely restricted over the past twenty years. There are currently a very limited number of loans for which a deduction[1] may be taken on interest paid.[2]

1. Residential Mortgage Loans

The deduction for interest paid on residential mortgages (known in the UK as Mortgage Interest Relief) was withdrawn as of April 6, 2000.[3]

Individuals that own property that is rented out may deduct interest paid on the mortgage for that property as a business expense.[4]

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[1] Deductions, where applicable, are provided on the net income of the tax year in which the interest payment was made. Income and Corporation Taxes Act 1988, c. 1, § 353.

[2] BRITISH MASTER TAX GUIDE 2010-11, ¶ 1884.

[3] Telephone conversation with Inland Revenue, July 6, 2011, at 7:40am. *See also Mortgage Interest Relief*, HM REVENUE AND CUSTOMS, http://www.hmrc.gov.uk/stats/mir/intro.pdf (last visited May 11, 2011); Inland Revenue, *Withdrawal of Mortgage Interest Relief* (Mar. 1999), http://archive.treasury.gov.uk/budget/1999/nr/ir2.txt.

[4] Alan Holmans, Christine Whitehead & Kathleen Scanlon, Fiscal Policy Instruments to Promote Affordable Housing (Cambridge Centre for Housing and Planning Research, 2002), *available at* http://eprints.lse.ac.uk/29958/1/Fiscal_policy_instruments_to_promote_affordable_housing_%28LSERO%29.pdf. *See also* HM REVENUE AND CUSTOMS, *supra* note 3.

2. Home Equity Loans

There are no current tax deductions for interest paid on home equity loans. However, relief is provided for loans that were taken out before April 1988 for the improvement of a property that is the only, or main, residence of the borrower.[5]

3. Auto Loans

There are no tax deductions available for interest on loans taken out to purchase a personal vehicle.

4. Credit Card Debt

There are no deductions available for interest paid on credit card debt.[6]

B. Incentives for the Lender

There appear to be no tax incentives for lenders responsible for financing residential mortgage loans, home equity loans, auto loans, or credit card debt.

C. Related Tax Benefits or Subsidies

1. Student Loans

Student loans for UK students are provided through the Student Loans Company.[7] This is a Non-Departmental Public Body, which administers government funded loans on a not-for-profit basis to students across the UK.[8] The interest rate payable on these loans is subsidized by the UK government and set to the rate of inflation.[9] When these loans become due, they are payable through the tax system, and no tax deductions are permitted for either the interest or the payments.

2. Subsidies for the Purchase or Construction of a New Home

In terms of home ownership, the majority of tax incentives in the UK are geared towards ensuring that housing is affordable and accessible to all sectors of the population. For example, the transfer tax (known in the UK as Stamp Duty Land Tax), which applies to the purchase of a

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[5] HM REVENUE AND CUSTOMS, *supra* note 3.

[6] Her Majesty's Revenue and Customs, Helpsheet 340: Interest and Alternative Finance Payments Eligible for Relief on Qualifying Loans and Alternative Finance Arrangements 2 (2011), *available at* http://www.hmrc.gov.uk/helpsheets/hs340.pdf.

[7] Teaching and Higher Education Act 1998, c. 30, http://www.legislation.gov.uk/ukpga/1998/30/section/22; *Welcome*, STUDENT LOANS COMPANY, http://www.slc.co.uk/ (last visited May 18, 2011).

[8] *About Us*, STUDENT LOANS COMPANY, http://www.slc.co.uk/about%20us/index.html (last visited May 18, 2011).

[9] Teaching and Higher Education Act 1998, c. 30; *Welcome*, STUDENT LOANS COMPANY, *supra* note 8.

home, is waived if the home is below £125,000 (approximately US$160,000) for all home purchases, or £150,000 (approximately US$210,000) in specified disadvantaged areas.[10] First-time homebuyers are exempt from the transfer tax on properties up to £250,000 (approximately US$400,000) if purchased between March 25, 2010, and 25 March 2012.[11]

For the construction of new homes, as well as certain cases where buildings are converted or renovated, any Value Added Tax (VAT) (sales tax) that would be payable, which is currently rated at 20 percent, is zero rated. This applies to the labor and material costs used in constructing or renovating these buildings. VAT is chargeable at the standard rate of 20 percent if the home is to be used as a vacation home, or the buyer cannot live in it year round or use it as their private residence.[12]

Individuals that provide social housing may receive funding for the construction or purchase and rehabilitation of rental units from the Housing and Communities Agency,[13] a non-departmental government body, and Local Authorities (local government). These are funded by the central government and Local Authorities, respectively.

The government further offers a "Homebuy" program, through which a reduced fee loan provides for up to 30 percent of the value of a home for households that make under £60,000 (approximately US$96,000) per year and are either first-time homebuyers or are currently renting a council or housing association property and purchasing a house in a specified area.[14] This is known as an "equity loan" and becomes payable after five years. Fees are charged in the sixth year and are currently 1.75 percent of the loan's value, which increases each year by the Retail Price Index (RPI) plus 1 percent.[15]

II. Deductibility of Debt Incurred to Finance Investments

Income derived from dividends, interest, royalties, and immovable properties are all considered investment income, which is taxable under UK's income tax regime. According to the British Tax Guide, "income tax is charged on the full amount of the interest arising in the tax year. The person liable to tax is the person entitled to or receiving the interest."[16] Moreover, unless they are subject to a tax exemption, dividends and other distributions from a company are

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[10] Finance Act 2003, c. 14, § 57 & sch. 6. *See also Stamp Duty Land Tax Rates and Thresholds*, HM REVENUE AND CUSTOMS, http://www.hmrc.gov.uk/sdlt/intro/rates-thresholds.htm (last visited May 21, 2011).

[11] Finance Act 2010, c. 13, § 6.

[12] Her Majesty's Revenue and Customs, Notice 708: Building and Construction (Feb. 2008), http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000513#P341_32640.

[13] *Our Funding*, HOMES AND COMMUNITIES AGENCY, http://www.homesandcommunities.co.uk/ourwork/our-funding (last visited May 25, 2011).

[14] *Low-Cost Home Ownership Schemes – A Guide*, DIRECT.GOV, http://www.direct.gov.uk/en/HomeAndCommunity/BuyingAndSellingYourHome/HomeBuyingSchemes/DG_4001347 (last visited May 31, 2011).

[15] *Equity Loans – How They Work*, DIRECT.GOV, http://www.direct.gov.uk/en/HomeAndCommunity/BuyingAndSellingYourHome/HomeBuyingSchemes/DG_171504 (last visited May 31, 2011).

[16] RAY CHIDELL & TREVOR JOHNSON, BRITISH TAX GUIDE: INCOME TAX 2010 at 269 (2010).

"generally chargeable as savings and investment income,"[17] irrespective of whether the source is a UK or non-UK company.

Deductions on interest payments on loans procured, *inter alia*, for investment purposes are deductable, however, only "in respect of certain specified loans."[18] According to the International Bureau of Fiscal Documentation Country Analysis for the UK,

> Interest paid by an individual is allowable as a general deduction from income if it is:
>
> - Loan interest, whether annual interest or not, but excluding interest on a bank overdraft and credit card interest, and
> - For a specified purpose.[19]

Under Part 8, Chapter I of the Income Tax Act 2007 (ITA 2007),[20] the purposes of the loans for which interest expenses can be deducted are listed as follows:

- To buy plant or machinery for partnership use
- To buy interest in closed company
- To buy interest in employee-controlled company
- To invest in a partnership
- To invest in a co-operative
- To pay inheritance tax.[21]

Interest payments on a loan used to purchase a life annuity are also tax deductable where certain conditions are satisfied. These include, *inter alia*, where the borrower is age 65 or over, and where the loan was taken out before March 9, 1999.[22]

A. Annual Limits Relating to Investment Income (and Other Limits on the Deductibility of Interest for Private Investments)

There do not appear to be any annual limits on deductions for interest payments with respect to loans for investment purposes under UK's income tax regime. However, schedule 30

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[17] *Id.* at 282.

[18] Belema Obuoforibo, *United Kingdom–Corporate Taxation* ¶ 1.8.1.1., *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: EUROPEAN TAX SURVEYS, http://ip-online.ibfd.org/kbase/ (last visited May 31, 2011).

[19] *Id.*

[20] Income Tax Act 2007, c. 3, *available at* http://www.legislation.gov.uk/ukpga/2007/3 (last visited May 31, 2011).

[21] HM Revenue & Customs, Savings and Investment Manual – SAIM10010 – Relief for Interest Paid: Introduction, http://www.hmrc.gov.uk/manuals/saimmanual/saim10010.htm (last visited May 7, 2011).

[22] CHIDELL & JOHNSON, *supra* note 17, at 65.

of the Finance Act 2009[23] introduced rules to the ITA 2007 that aimed to deny tax relief for loan arrangements "if the main purpose of the arrangements is to avoid tax."[24] Under section 384A of the ITA, tax relief with respect to interest payments is disallowed where loan arrangements are

> very likely to produce a "post-tax advantage," and the arrangements seem to have been made in order to reduce what would have been the borrower's income tax or capital gains tax liability (or such liability of a person in similar circumstances to the borrower), had the arrangements not been made.[25]

According to the European law firm, Field Fisher Waterhouse, the restriction is aimed at

> … schemes structured to utilise tax relief for interest paid to ensure that the borrower investor is virtually guaranteed to make an after-tax profit. This can arise where, for example, arrangements give rise to a payment to the borrower which, together with the amount of the tax relief from the borrower's interest payments, is equal to or more than the amount needed to meet the borrower's obligations under the loan.
>
> The new restriction denies tax relief for interest paid where the loan in question is made as part of arrangements *"which appear very likely to produce a post-tax advantage."* A *"post-tax advantage"* will arise where an amount becomes payable to the borrower (or a connected person) or for the borrower's benefit which, taking into account the tax relief which would otherwise be available, equals or exceeds the borrower's obligations under the loan. The test is applied objectively and applies whether or not obtaining tax relief is a main purpose of the underlying transaction. Where the restriction applies, *no* interest deduction is allowed under section 383 ITA.[26]

Under section 384(2) of the ITA 2007, interest payments on a loan are also ineligible for deductions if they exceed a "reasonable commercial" amount. According to the British Tax Guide "a 'reasonable commercial' amount of interest on the loans for the relevant period is an amount which, together with any interest paid before that period (other than unrelieved interest) represents a reasonable commercial rate of interest from the date the loan was made to the end of that period."[27] The interest "representing the excess is not eligible for relief."[28]

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[23] Finance Act 2009, c. 10, sch. 30, *available at* http://www.legislation.gov.uk/ukpga/2009/10/schedule/30 (last visited May 31, 2011).

[24] CHIDELL & JOHNSON, *supra* note 17, at 57.

[25] Obuoforibo, *supra* note 19, ¶ 1.8.1.1.

[26] *Tax Update – Anti-Avoidance Targets 'Post-Tax' Advantages*, FIELD FISHER WATERHOUSE (May 2009), http://www.ffw.com/publications/all/alerts/anti-avoidance-targets.aspx (emphasis in the original).

[27] CHIDELL & JOHNSON, *supra* note 17, at 57.

[28] *Id.*

B. Deductions for Exempt or Tax-Favored Income

In the UK, "there is no general principle barring a deduction of expenses related to exempt income—it's all a matter of statutory interpretation for each category of income."[29] Nor does there appear to be any general rule that restricts deductions of interest expenses incurred to produce tax-advantaged income.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

There do not appear to be any rules under UK's income tax regime that would limit other tax benefits with respect to tax-exempt income.

III. Special Treatment of Other Debt

Other than the items specified above there appears to be no other special treatment for other debt in the UK.

IV. Treatment of Cancelled Debt

Under the UK's income tax regime, cancelled debt is treated as income only in specific circumstances. According to Ault & Arnold:

> The *United Kingdom* continues to have restrictive rules on cancellation of indebtedness income. In general, income arises only if the loan was employment-related, made to a shareholder of a closely held corporation, or involved a liability that had previously been deducted (e.g., in the business income context).[30]

Prepared by Clare Feikert-Ahalt, Senior Foreign Law Specialist
and
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June 2011

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[29] HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 292 (2010).

[30] *Id.* at 227 (emphasis in original).

Chairman CAMP. Thank you, Mr. Barthold.
Ms. Olson, you are recognized for five minutes.

STATEMENT OF PAMELA F. OLSON, PARTNER, SKADDEN, ARPS, SLATE, MEAGHER & FLOM, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Ms. OLSON. Thank you, Chairman Camp, Chairman Baucus, Senator Hatch, Mr. Levin, distinguished members of the committee. Thank you for inviting me to testify this morning.

I am appearing on my own behalf, and not on behalf of any client or other organization. And the views I express are solely my own, and are based on my experiences in both the private and the public sector.

My compliments, first, to the chairmen, for your decision to tackle tax reform on a bicameral and bipartisan basis. The tax code's treatment of debt and equity is one of many issues that should be considered carefully as Congress considers reform of the tax system.

It has been observed that the one law Congress cannot repeal is the law of unintended consequences. Individuals and businesses respond to economic incentives and disincentives, including those provided through the tax laws. It is important for the tax-writing committees to be cognizant of the tax system's incentives and disincentives, particularly with respect to the disparate treatment of debt and equity, so that potential consequences can be factored in as you consider reform of the tax system.

In its current form, as Mr. Barthold has observed, the Internal Revenue Code provides an incentive for businesses to raise capital through the issuance of debt, rather than equity. The incentive arises from the interplay of the two features of our tax system that he identified as well, the double taxation of corporate income, and the tax deductibility of interest payments.

Incurring debt serves as a straightforward means of mitigating the double tax on corporate income. It is worth noting that the disparate treatment of debt and equity has been the subject of numerous disputes between taxpayers and the Internal Revenue Service that continue today, and that there have been several failed efforts to draw a bright line between the two, both legislatively and administratively. Treasury and the IRS proposed regulations under Code Section 385 back in the 1980s that were subsequently withdrawn.

The impact of the Internal Revenue Code's preferential treatment of debt has been a concern for a number of years, and has led to proposals to neutralize or equalize the tax treatment of debt and equity. The disparate treatment of debt and equity, particularly the double tax on dividends, has also given rise to corporate governance concerns, which affected the Treasury Department's design of a dividend exclusion proposal that was included in the Bush administration's fiscal year 2004 budget.

Prior to 2003, the tax on dividends brought the top tax rate on corporate income distributed as dividends to nearly 60 percent, creating an opportunity for corporate managers to cite the tax inefficiency of dividend payments as a basis for reinvesting corporate profits, rather than distributing them as dividends.

The payment of dividends is a healthy financial discipline, because it requires free cash flow to fund the payment. But that discipline was dulled by the tax disincentive to paying dividends. Prior to 2003, the lower tax rate on capital gains made methods of delivering capital gains to shareholders, such as stock redemption, a more tax-efficient means of distributing excess cash to shareholders.

The 2003 dividend exclusion proposal would have brought a measure of transparency to corporate taxes as well, because divi-

dends would only have been excludible, to the extent they were paid out of earnings on which corporate tax had been paid. The attractiveness of tax-free dividends was seen as giving corporations an incentive to pay income tax, at least to the extent of dividends expected to be paid to shareholders, and shareholders an interest in the extent to which the corporation had paid tax. Thus, the proposal could have reduced the value of corporate tax incentives, by preventing the value of those incentives from flowing through to the shareholders.

There are simpler means of reducing or eliminating the double tax on equity, including the reduced rate Congress ultimately adopted, or making dividends deductible at the corporate level. A dividends paid deduction would have a significant effect on tax revenues, because it would have the effect of eliminating all tax on dividend income, where the stock is held by a tax-exempt entity, as is the case with interest income, where the indebtedness is held by a tax-exempt entity. Thus, a dividends paid deduction could result in the removal from the U.S. tax base of a significant amount of corporate income.

As the tax-writing committees consider tax reform options, one simple means by which to reduce the preference for debt financing is to lower the corporate tax rate. The preference for debt financing is a result of the ability to deduct interest payments from taxable income, and lowering corporate tax rates would reduce the value of the interest deduction, thus reducing the disparity in the taxation of debt and equity investments.

Besides reducing the distortion between debt and equity financing, lowering the corporate rate would have the benefit of more closely aligning our rate with rates of other countries, which have fallen in recent years.

Another reform option would be to integrate the corporate and individual tax systems, along the lines of the Bush administration's 2004 budget proposal, by eliminating the shareholder level tax on corporate income distributed as dividends. The dividend exclusion proposal could eliminate the debt financing incentive associated with double taxing the return to corporate equity investment.

You could also go for full parity between debt and equity, through the adoption of a comprehensive business income tax, which has also been studied by the Treasury Department.

In considering corporate tax reform, I encourage the committees to make sound policy the primary objective.

Thank you for the opportunity to testify. I would be pleased to respond to questions you may have.

[The prepared statement of Ms. Olson follows:]

Statement of Pamela F. Olson
to the
Committee On Ways & Means
United States House of Representatives
and the
Committee On Finance
United States Senate

"Tax Reform And The Tax Treatment Of Debt And Equity"

July 13, 2011

Chairman Camp, Chairman Baucus, Ranking Members Levin and Hatch, and distinguished members of the Committees, I appreciate the opportunity to appear this morning as the Committees consider the United States federal tax system's treatment of debt and equity in the context of tax reform. I am here today at the request of the Committees. I had the honor of serving as Assistant Treasury Secretary for tax policy from 2002 to 2004, and am currently a partner in the law firm Skadden, Arps, Slate, Meagher & Flom, LLP. I am appearing on my own behalf and not on behalf of any client or other organization. The views I express are solely my own and are based on my experiences in the private sector and in public service, particularly as Assistant Secretary.

I. Introduction

I applaud the Committees' decision to tackle tax reform jointly and for taking a detailed look at one of many issues that should be considered carefully as Congress considers reform of the tax system.

As the Committees consider tax reform, it is important to bear in mind certain fundamental principles. First, the goal in the design of a tax system should be a regime that promotes economic growth because economic growth is essential to job creation and increasing prosperity. Second, the tax system should raise the revenues necessary to fund the operations of the government with the least adverse impact on the economy. Third, all taxes distort decisions to work, save, and invest. Maximizing national income depends on investment dollars flowing to the activities where they produce the highest pre-tax returns. A well-designed system should minimize disincentives to work and save and avoid skewing investment decisions.

Individuals and businesses respond to economic incentives and disincentives, including those provided through the tax laws. The tax laws are only one of many such economic incentives and disincentives that affect economic decision-making. Nonetheless, it is important for the tax-writing committees to be cognizant of the tax system's incentives and disincentives, particularly with respect to the disparate treatment of debt and equity, so that potential consequences are factored in as you consider reform of the tax system. My testimony addresses the disparate treatment of debt and equity and concludes with a few observations about the potential for tax reform in this area.

II. Effect of the Tax System on Capital Structures

In its current form, the Internal Revenue Code provides an incentive for businesses to raise capital through the issuance of debt, rather than through the issuance of equity. The incentive arises from the interplay of two features of our tax system. The first is the double-taxation of corporate income, which flows from the choice to treat corporations and their investors as separate taxable units. Corporate earnings are taxed at the corporate level, and then again at the shareholder level when the corporation distributes earnings to shareholders. The second feature is the tax deductibility of interest payments made to creditors. While interest payments are deductible by the eorporation, distributions of earnings to shareholders are not.[1]

Incurring debt, thus, serves as a straightforward means of mitigating the double tax on corporate income because corporate earnings paid as interest are deducted from the corporation's gross income and are taxed only to the recipient of the interest income. All else equal, the disparity encourages corporate use of debt financing because it ensures the income is taxed only once. Substituting debt for equity reduces the maximum combined tax rate on corporate income from approximately 45 percent to 35 percent. Corporate earnings paid as interest may fall entirely outside the U.S. tax base if the interest recipient is a tax-exempt organization such as a pension plan or an endowment fund, or is a foreign person. Generally speaking, the Internal Revenue Code imposes a 30 percent withholding tax on payments of dividends or interest to non-U.S. taxpayers.[2] That 30 percent withholding tax is eliminated, however, if the interest payment qualifies as "portfolio interest;" it then leaves the U.S. tax base without incurring a tax.[3]

Even for non-portfolio interest, our income tax treaties often reduce interest withholding rates to a greater degree than dividend withholding rates, in some cases exempting treaty country residents' interest income from U.S. withholding tax altogether.[4] Although treaties often reduce the 30 percent withholding rate on dividends, with a few recent exceptions, none exempt dividends altogether. The first of the recent exceptions is the income tax treaty with the United Kingdom, which was signed in 2001 and exempts from withholding dividends paid to U.K. shareholders who have owned more than 80 percent of the voting power of the paying company for the previous 12 months.[5]

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1 The disparate treatment of debt and equity has been the subject of numerous disputes between taxpayers and the Internal Revenue Service over the years and to several failed efforts to draw a bright line distinction between the two.

1 I.R.C. § 871(a)(1), 881(a).

3 I.R.C. § § 871(h), 881(c).

4 *See, e.g.,* Convention Between the Government of the United States of America and the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Art. 10, 11 (providing for a maximum withholding rate of 15 percent on dividends, and for a 0 percent withholding rate on interest payments).

5 The Convention Between the Government of the United States and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, Art. 10.

The impact of the Internal Revenue Code's preferential treatment of debt has been a concern of the U.S. Treasury Department for a number of years and has led to proposals to neutralize or equalize the tax treatment of debt and equity. In 1992, for example, the Treasury Department described concerns about high debt service burdens and corporate bankruptcies and noted that "[t]he U.S. corporate tax system discourages corporations from financing investments with equity as opposed to debt."[6] Similarly, the Treasury Department issued a report in December of 2007 that stated that:

> excessive reliance on debt financing imposes costs on investors because of the associated increased risk of financial distress and bankruptcy. Firms in financial difficulty may be denied sufficient access to credit, suffer key personnel losses, and endure a diversion of management time and energy away from productive activity. Other costs include legal and administrative expenses associated with bankruptcy, uncertainty regarding the ultimate size of those expenses, uncertainty regarding the marketable value of the firm's assets under partial or full liquidation, and risks regarding the ultimate settlement of competing claims on those assets.[7]

The concern expressed in the Treasury report has been echoed by economists and business leaders. Jason Furman, formerly deputy director of the National Economic Counsel, stated that the "disparity between debt and equity financing encourages corporations to finance themselves more heavily through borrowing. This leverage in turn increases the financial fragility of the economy, an effect we are seeing dramatically today."[8] Similarly, Doug Holtz-Eakin, an economist who heads the American Action Forum, served as a senior advisor to Senator John McCain, and directed the Congressional Budget Office, stated to the *Washington Post* that "the tax code is interfering dramatically with the choice of how you finance and how you deliver returns in the corporate sector."[9] Gregory Mankiw, formerly Chair of the Council of Economic Advisers, wrote in the *New York Times* that, "because interest payments on corporate debt are deductible for corporate income tax calculations, this capital income is taxed only once. This asymmetric treatment of debt and equity finance induces companies to issue more debt than they otherwise would, increasing leverage and the economy's financial fragility."[10] The CEO of FedEx remarked in the *Wall Street Journal* that, "our national policies actively encouraged all this debt. The United States has a completely uncompetitive tax structure in general and it has a particularly onerous tax structure for firms that are asset-intensive."[11]

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[6] U.S. Department of the Treasury, *The Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, p. 16 (January, 1992).

[7] U.S. Department of the Treasury, *Approaches to Reform the U.S. Business Tax System for the 21st Century*, December 20, 2007.

[8] *See* Martin A. Sullivan, *Economic Analysis: Deleveraging the Tax Code*, 120 Tax Notes 1241 (Sept. 29, 2008).

[9] David Cho, *Look At Macy's: U.S. Tax Code Continues to Encourage Companies to Rack Up Huge Debt*, Washington Post, Aug. 8, 2010.

[10] N. Gregory Mankiw, *On Dividend Taxes, It's a Post-Partisan Race*, N.Y. Times , Sept. 6, 2008.

[11] Quoted in Stephen Moore, *Washington is the Problem*, Wall St. J., Oct. 25, 2008.

The disparate treatment of debt and equity, particularly the double tax on dividends, has also given rise to corporate governance concerns, which affected the Treasury Department's design of the dividend exclusion proposal included in the Bush Administration's fiscal year 2004 budget. Prior to 2003, the tax on dividends brought the top tax rate on corporate income distributed as dividends to nearly 60 percent, creating an incentive for corporate managers to cite the tax inefficiency of dividend payments as a basis for reinvesting corporate profits rather than distributing them as dividends. In the Treasury Department's description of the Bush Administration's fiscal year 2004 proposal to exclude dividends from tax, Treasury noted that the double tax on dividends "lessens the pressure on corporate managers to undertake only the most productive investments because corporate investments funded by retained earnings may receive less scrutiny than investments funded by outside equity or debt financing."[12] The payment of dividends is a healthy financial discipline because it requires free cash flow to fund the payment. That discipline was dulled by the disincentive to paying dividends. Prior to 2003, the lower tax rate on capital gains made methods of delivering capital gains to shareholders, such as stock redemptions, a more tax efficient means of distributing excess cash to shareholders, allowing shareholders to choose whether to take the cash at a lower tax rate or avoid the tax liability.

The Bush Administration's proposal would have brought a measure of transparency to corporate taxes because dividends would only have been eligible for the exclusion to the extent they were paid out of earnings on which corporate tax had been paid. The attractiveness of tax-free dividends was seen as giving corporations an incentive to pay income tax, at least to the extent of dividends to be paid to shareholders, and shareholders an interest in the extent to which the corporation had paid tax. Thus, the proposal could have reduced the value of corporate tax incentives by preventing the value of those incentives from flowing through to the shareholders.[13] Because the dividend exclusion was contingent upon payment of corporate tax, the proposal would have had the effect of reducing the benefit of corporate tax avoidance, as corporate income sheltered from tax would not have produced tax-free dividends.

Revenue constraints were taken into account in the Bush Administration's design of the dividend exclusion proposal. The elimination of the double tax on dividends could have been achieved by providing corporations with a deduction for dividends paid instead of a dividend exclusion. Providing a deduction for dividends paid, however, would have the effect of eliminating all tax on dividend income where the stock is held by a tax exempt entity, as is the case with interest income where the indebtedness is held by a tax exempt entity. Thus, a dividends paid deduction could result in the removal from the U.S. tax base of a significant amount of corporate income.

III. Reform Alternatives

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[12] The United States Department of Treasury, *General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals*, p. 11 (February 2003).

[13] The Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal*, JCS-7-03, p. 31.

Lower corporate tax rates. One fairly obvious means by which to reduce, although not eliminate, the preference for debt financing is to lower the corporate tax rate. The preference for debt financing is a result of the ability to deduct interest payments from taxable income. Lowering corporate tax rates would reduce the value of the interest deduction to corporations and reduce the disparity in the taxation of debt and equity investments.

Besides reducing the distortion as between debt and equity financing, lowering the corporate tax rate would have other important benefits. The U.S. corporate tax system is increasingly out of step with policies adopted by other countries, to the disadvantage of our economy and the jobs that might otherwise be created here. Our corporate tax rate, at 35 percent, is high relative to our economic peers. Foreign countries offer lower tax rates and investment incentives and, as a result, may provide a more attractive location for investment.

Eliminate the double taxation of corporate earnings. As I mentioned, as part of its 2004 budget proposal, the Bush Administration proposed to integrate the corporate and individual tax systems through a two-part dividend exclusion mechanism under which the shareholder-level tax on corporate profits would be eliminated. The proposal would allow corporations to distribute non-taxable dividends to shareholders to the extent the dividend was paid out of previously taxed earnings. Equivalent treatment of retained earnings would be achieved through an increase in shareholders' basis in their stock. This basis increase would reduce the amount of capital gain that the shareholder would otherwise recognize on disposition of the stock by the amount of the dividend that the shareholder would have received had the corporation distributed its previously taxed earnings. By eliminating the shareholder level tax on corporate income distributed as dividends, the dividend exclusion proposal would eliminate the debt financing incentive associated with double-taxing the return to corporate equity investment.

Full parity between debt and equity could be achieved through the adoption of a comprehensive business income tax similar to a proposal developed by the Treasury Department in 1992.[14] One of the benefits of a comprehensive business income tax is that it would raise revenue, which was estimated in 1992 to be sufficient to offset the revenue lost through corporate integration. There are downsides to such a proposal, as well, including the fact that the difficulties in taxing financial institutions under such a regime have not been satisfactorily resolved and there would be significant transition issues. Were Congress to consider expensing as part of broader reform, then limitations on the deductibility of interest similar to those contained in the comprehensive business income tax would have to be considered.

Consider an Alternative Tax Base. In my view, there are limits to our ability to generate additional revenue through our existing tax bases. Consequently, I urge the Committees to give consideration to the addition of an alternative tax base as part of tax reform, which could be coupled with lower rates on existing tax bases and a measure of corporate integration. One such

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[14] The United States Department of the Treasury, *A Recommendation for the Integration of the Individual and Corporate Tax Systems* (December 1992).

alternative is the value-added tax, which would have the advantage of decreasing the tax system's overall pro-leverage bias.

In 2005, the Bush Administration's Advisory Panel on Federal Tax Reform devoted a chapter of its report to consideration of a value-added tax.[15] The proposal the panel reviewed resembled a single-level retail sales tax collected at each stage of the production process. The plan combined this device with a income tax, which allowed the top individual income tax rate to fall to 15 percent and the top corporate income tax rate to fall to the same level.[16] Under this plan, entities providing taxable goods and services imposed and collected taxes on all sales.[17] To determine value-added tax liability, businesses multiplied total taxable sales by the tax rate and subtracted from that figure the amount of value-added tax paid for purchases of goods and services. Notably, interest income would not be included in the value-added tax base, and no deduction from the value-added tax base would be permitted for interest expenditures. Value-added taxes imposed in other countries generally follow the same approach.

For any given level of revenue, policymakers face a choice about whether to raise that revenue through the income tax or through an alternative base like a value-added tax. To the extent revenue is raised through a value-added tax rather than the income tax (in the form of higher tax rates, perhaps), the income tax's inherent bias in favor of greater leverage is less than it otherwise would be. On average, OECD countries collected almost 11 percent of tax revenue through consumption taxes in 2009, while such taxes account for only 4.4 percent of U.S. tax revenue.[18] If the United States raised as large a portion of total tax revenue through a value-added tax as do other OECD countries, the overall effect on the debt incurred by U.S. business could be substantial.

The Tax Reform Panel and commenters have noted other improvements that a value-added tax would bring. In particular, a broad-based value-added tax applied at a single level would offer certain efficiency advantages. The panel's report notes that such a system "generally does not distort consumers' choices among good and services . . . or distort the allocation of capital."[19] Further, according to the report, "[e]conomists agree that a well-designed VAT imposes a lower excess burden than most other taxes for any given amount of revenue raised."[20] For these reasons, introducing a value-added tax could reduce the overall distorting effect of the income tax system's treatment of debt and equity.

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[15] *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, President's Advisory Panel on Federal Tax Reform, Nov. 2005.

[16] *Id.* at 191.

[17] *Id.* at 193.

[18] Unweighted average calculated from data vailable at http://www.oecd-ilibrary.org/taxation/taxes-on-goods-and-services_20758510-table6.

[19] *Id.* at 200.

[20] *Id.*

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Budgetary constraints have dictated many legislative decisions in recent years, often to the detriment of sound policy. In considering corporate tax reform, I encourage the Committees to make sound policy the primary objective. Thank you for the opportunity to testify today. I would be pleased to respond to any questions you may have.

Chairman CAMP. Thank you very much.
Mr. Fleischer, you are recognized for five minutes.

STATEMENT OF VICTOR FLEISCHER, ASSOCIATE PROFESSOR OF LAW, UNIVERSITY OF COLORADO LAW SCHOOL

Mr. FLEISCHER. Thank you for inviting me to participate today. 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 shapes the structuring of deals, and so I will focus my testimony from that perspective today.

The main point that I want to make is that the debt equity distortion is costly on two levels. The first level of cost is obvious. Deals are restructured to reduce taxes, which erodes the tax base. This is the explicit cost of the debt-equity distortion.

The second level of cost is implicit. When a corporation restructures a deal to reduce taxes, the restructuring imposes an implicit cost on the corporations themselves. It adds complexity to their capital structure, distorts corporate governance, and even changes critical business decisions.

The debt-equity distortion imposes an additional implicit cost on the public, in the form of increased systemic risks, taxpayer bailouts, and the like. It also encourages a lot of wasteful tax planning. One can think of these implicit costs collectively as the collateral damage of the debt-equity distortion.

The best way to reduce this collateral damage is to eliminate the underlying distortion in the tax code. Legal distinctions in the tax code that have no basis in underlying economics are almost always a bad idea. The tax lawyers that I know are very, very clever. If you give them an economic incentive to turn equity into debt, or a corporation into a partnership, or ordinary income into capital gain, they will work tirelessly until you are convinced that a dog is properly treated as a cat for tax purposes.

With that introduction, I will briefly elaborate on the implicit cost of the debt-equity distortion. The first implicit cost is risky managerial behavior. As firms take on more debt, common stock behaves economically like a risky stock option, giving executives unlimited upside, but limited downside risk. With enough debt, it even becomes rational for executives to make negative expected value bets with company assets. The debt holders, not the executives, bear most of the downside risk.

The second cost is the social cost from increased bankruptcies and systemic risk. Excessive leverage fuels risky speculation that has repercussions, even for taxpayers that never engage in risky behavior themselves. The problem is especially acute with banks and other financial institutions, because the externalized social costs are larger than in other sectors.

The third cost is wasteful tax planning. In a world without tax distortions, corporations would make financing decisions based on market conditions, not a tax calculation. Instead, many corporations and financial institutions, in particular, issue new financial products to engage in regulatory arbitrage, exploiting the inconsistencies of two different regulatory regimes.

In the typical scenario, bank executives want to increase the amount of leverage in the firm to reduce taxes and to supercharge return on equity. But taking on too much debt runs afoul of banking regulations and the guidelines of credit agencies.

Platoons of lawyers and investment bankers then create complex new financial products that qualify as debt for tax purposes, and equity for financial accounting or credit agency purposes, or as tier one capital for bank regulatory purposes. These hybrid instruments allow financial institutions to appear safer by appearing to have greater equity capital. In fact, they mask an increase in debt. They are dogs that are treated as cats for tax purposes.

AIG, Lehman Brothers, Bear Stearns, and other failed institutions all had large amounts of these hybrid instruments on their balance sheets before the crash. These instruments did not perform well in the financial crisis. Because they typically contained ongoing obligations to make cash payments, the instruments were properly perceived by trading counterparties as debt obligations that would not provide a cushion in the way that real equity would. The resulting loss and instability was borne largely by the public, and not the banks themselves.

So, what is the bottom line? The best solution is a broader corporate tax reform effort that would eliminate the debt equity distortion all together. There are several different ways to do this, including eliminating the deduction for interest, allowing a deduction for corporate equity, or moving to a corporate cash flow or consumption tax system.

If Congress is interested in moving more immediately on the debt-equity distortion, my suggestion is to focus on financial institutions. Financial institutions are where the problem is, they have the most excessive leverage, 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 that debt-equity ratio exceeds five to one. The goal of such a limit 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.

I would be happy to answer any questions you may have, and I thank you for the honor of participating in this hearing.

[The prepared statement of Mr. Fleischer follows:]

TAX REFORM AND THE TAX TREATMENT OF DEBT AND EQUITY

JOINT HEARING

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

U.S. SENATE
COMMITTEE ON FINANCE

JULY 13, 2011

VICTOR FLEISCHER

ASSOCIATE PROFESSOR
UNIVERSITY OF COLORADO LAW SCHOOL

TAX REFORM AND THE TAX TREATMENT OF DEBT AND EQUITY

VICTOR FLEISCHER*

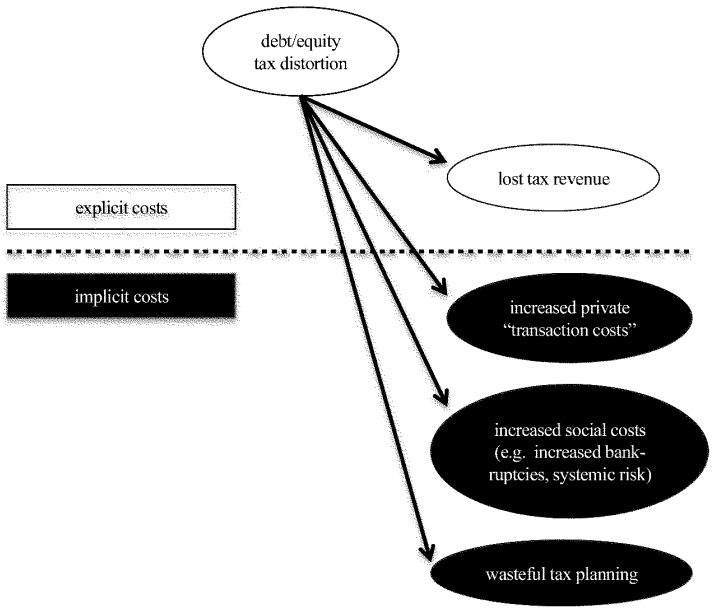
Thank you for inviting me to participate in this historic joint hearing on tax reform and the tax treatment of debt and equity. I am an Associate Professor of Law at the University of Colorado, where I teach Deals, Partnership Tax, and Tax Policy. My research focuses on how tax policy affects the structuring 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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* Associate Professor, University of Colorado Law School. I thank Erik Gerding for his comments and suggestions. I welcome comments and suggestions at victor.fleischer@gmail.com.

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 encourages 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. In the 1980s, 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 over the last two decades, 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 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 5 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.[1]

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[1] To keep it revenue neutral, the proposal could be coupled with an allowance (deduction) for corporate equity.

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.[2] 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

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

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.

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 ade-

quate 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. In the business context, tax policy generally 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 nondebt 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 manag-

ing 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.

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.

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.

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 generates 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.[3] 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

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[3] 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).

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 5 to 1 debt to equity ratio. The 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 5 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.

By itself, this limitation on the deductibility of interest would result in higher effective taxes on banks. If policymakers want to keep the proposal revenue neutral, Congress could couple the interest limitation with an allowance or deduction for corporate equity. The net result would be a shift in tax burdens from riskier banks (with excessive leverage) to less risky banks (who would benefit more, proportionately, from the allowance for corporate equity).

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 or financial accounting 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.

Chairman CAMP. Thank you very much, Mr. Fleischer.
Mr. Desai, you will be recognized for five minutes.

STATEMENT OF MIHIR A. DESAI, MIZUHO FINANCIAL GROUP PROFESSOR OF FINANCE, HARVARD BUSINESS SCHOOL

Mr. DESAI. Chairman Baucus, Chairman Camp, and members of the committees, it is a pleasure to appear before you today to dis-

cuss tax reform and the treatment of debt and equity. I am a professor of finance at Harvard Business School, professor of law at Harvard Law School, and a research associate of the National Bureau of Economic Research.

In my comments, I want to describe the fundamental problem raised by the current tax treatment of debt and equity, how changes in the economy and the tax system have raised novel complications to this underlying problem, and outline several alternative solutions. As an aside, I will comment on the possibility that the tax treatment of debt and equity contributed to the recent financial crisis.

My written testimony can be summarized in five points. First, a classical corporate income tax with an entity level and individual level taxation creates the potential for asymmetric treatment of debt and equity income. This asymmetric treatment can distort financing, organizational form, and investment decisions.

In the U.S. system, equity income is taxed twice, while debt income is taxed once, though assessing the actual relative tax burdens of equity and debt income is complicated by several factors. Indeed, the simple narrative that debt is tax favored is not necessarily true, nor is it borne out by recent patterns in the data, as I elaborate on in my recent testimony. In addition to distorting financing choices, the differential in tax treatment creates a host of opportunities for financial engineers to innovate around that distinction.

Second, this asymmetric treatment of debt and equity income has been complicated by three significant developments that any reform measure should grapple with. The first development is the rapid globalization of firms and capital markets. This development makes the tax treatment of multinational firms and transfer pricing concerns central to the corporate tax, creates situations where investor-level taxation now often involves foreign investors, and allows the possibility of allocating various headquarter and domicile functions across multiple jurisdictions.

The second development is that the simple characterization of entity-level taxation and taxable investors that is customary to use in these discussions does not reflect two very rapid—two very important developments: the rapid rise of pass-through entities for business income, and the rise of tax-exempt investors as major players in the capital markets.

The third development is that corporate tax is now largely for public corporations, where financial reporting incentives compete with tax obligations, and these incentives can compromise tax policy goals.

My third major point is that while excessive leverage is sometimes associated with the tax code because of a presumed debt bias for corporations, concerns over the role of tax policy in fostering the financial crisis appear unfounded. It is difficult to describe significant roles for tax incentives in the housing market or for financial institutions as primary or secondary actors in the drama of the financial crisis.

For the non-financial corporate sector, where the presumed debt bias is thought to exist, the startling fact is how unlevered that sector was, prior to the crisis. In particular, as Senator Hatch out-

lined, the rise of cash balances and the decline of net debt is the dominant corporate finance trend of the last decade.

A brief and remarkable burst in leverage buy-out activity that is not related to changed—to tax incentives is likely responsible for the perception of excessive leverage in the non-financial sector. The increased reliance on equity financing also speaks to the potential scope of the current bias towards debt. In my opinion, the excesses of financial-sector leverage, which are very important, are best addressed through regulatory approaches, rather than tax instruments.

Fourth, the corporate tax is ripe for reform for many reasons, but excessive leverage may not rank highly amongst them, in my view. In my testimony, I highlight three approaches to the debt equity distinctions: regulatory, structural, and rate solutions all can be deployed to correct perceived concerns regarding the debt equity distinction. Regulatory approaches which provide arbitrary limits to leverage must be crafted with care, as they can create added complexities with limited payoffs.

If the stripping of earnings by multinational firms is the concern, then new regulation should be integrated with current policy instruments that already target that problem, such as interest allocation rules and Section 163(j). Indeed, a lowered corporate rate is likely the best antidote to that behavior.

If firm leverage is the concern, then limits on interest deductibility must consider how highly-levered industries and organizational forms will be impacted, and the consequent effects on their cost to capital and investment levels. Given the uncertainty of the current debt bias, such regulations would appear to engender more tax planning than economic benefits.

Fifth, reforming the corporate tax structurally via comprehensive business income tax can provide a solution-based symmetric treatment of debt and equity, can undo distortions to organizational form decisions, and provide a first step towards fundamental tax reform.

A more modest approach to modernizing the corporate tax should couple a rate reduction with a move toward territoriality that is funded by better alignment of book and tax reporting, and by some taxation of non-C corporation business income.

As other countries have learned, reducing rates, simplifying international taxation, and broadening the base, are cornerstones of reforms that can improve the lives of American workers and the firms that employ them. Such reform efforts, rather than regulatory approaches that target excessive leverage, would best advance your admirable agenda of strengthening tax policy and America's economic future.

Thank you, and I look forward to any questions you might have.

[The prepared statement of Mr. Desai follows:]

Testimony
of
Mihir A. Desai
Miuzho Financial Group Professor of Finance
Professor of Law
Harvard University

before the
U.S. Senate Committee on Finance and the
U.S. House Committee on Ways and Means

July 13, 2011
9:00 a.m.

Chairman Baucus, Chairman Camp and members of the Committees, it is a pleasure to appear before you today to discuss tax reform and the treatment of debt and equity. I am a Professor of Finance at Harvard Business School, a Professor of Law at Harvard Law School and a Research Associate of the National Bureau of Economic Research.

In my comments, I want to describe the fundamental problem raised by the current tax treatment of debt and equity, how changes in the economy and the tax system have raised novel complications to this underlying problem, and outline several alternative solutions. As an aside, I will comment on the possibility that the tax treatment of debt and equity contributed to the recent financial crisis.

A summary of my comments follows:

1. A classical corporate income tax with entity level and individual level taxation creates the potential for asymmetric treatment of debt and equity income. This asymmetric treatment can distort financing, organizational form and investment decisions. In the U.S. system, equity income is taxed twice while debt income is taxed once though assessing the actual relative tax burdens of equity and debt income is complicated by several factors. Indeed, the simple narrative that debt is tax favored is not necessarily true nor is it borne out by recent patterns in the data. In addition to distorting financing choices, the differential in tax treatment creates a host of opportunities for financial engineers to innovate around that distinction.

2. This asymmetric treatment of debt and equity income has been complicated by three significant developments that any reform measure should grapple with. First, the globalization of firms and capital markets makes the tax treatment of multinational firms and transfer pricing concerns central to the corporate tax, increases the likelihood that investor level taxation considerations now involve foreign investors, and allows firms the opportunity to relocate headquarter functions and domiciles across jurisdictions.. Second, the simple characterization of entity level taxation and taxable investors is not consistent with the rapid rise of pass-through entities for business income and with the rise of tax-exempt investors as major players in the capital markets. Third, the corporate tax is now largely for public corporations where financial reporting incentives compete with tax obligations and these incentives can compromise tax policy goals.

3. While excessive leverage is sometimes associated with the tax code because of a presumed debt bias for corporations, concerns over the role of tax policy in fostering the financial crisis appear unfounded. It is difficult to ascribe significant roles for tax incentives in the housing market or for financial institutions as primary or secondary actors in the drama of the financial crisis. For the nonfinancial corporate sector where the presumed debt bias is thought to exist, the startling fact is how unlevered that sector was prior to the crisis. In particular, the rise of cash balances and the decline of net debt is the dominant corporate finance trend of the last decade. A brief and remarkable burst in leveraged buyout activity, that is not related to changed tax incentives, is likely responsible for the perception of excessive leverage in the nonfinancial sector. The increased reliance on equity financing also speaks to the potential scope of the current bias toward debt. For many reasons, the excesses of financial sector leverage are best addressed through regulatory approaches rather than tax instruments.

4. The corporate tax is ripe for reform for many reasons, but excessive leverage does not rank highly amongst them in my view. Regulatory, structural and rate solutions all can be deployed to correct the perceived concerns regarding debt bias. Regulatory approaches which provide arbitrary limits to leverage must be crafted with care as they can create added complexities with limited payoffs. If the stripping of earnings by multinational firms is the concern, then new regulations should be integrated with current policy instruments that already target that problem. Indeed, a lowered corporate rate is the likely best antidote to that behavior. If firm leverage is the concern, then limits on interest deductibility must consider how highly levered industries and organizational forms will be impacted and the consequent effects on their cost of capital and investment levels. Given the uncertainty over the current debt bias, such regulations would appear likely to engender more tax planning than economic benefits.

5. Reforming the corporate tax via a comprehensive business income tax can provide a structural solution to the asymmetric treatment of debt and equity, can undo current distortions to organizational form decisions, and provide a first step toward fundamental tax reform. A more modest approach to modernizing the corporate tax should couple a rate reduction with a move toward territoriality that is funded by better alignment of book and tax reporting and by some taxation of non-C corporation business income. Such reform efforts, rather than regulatory approaches that target excessive leverage, would best advance your admirable agenda of strengthening tax policy and America's economic future.

I. The Problem

The tax treatment of debt and equity claims on business income can distort the form of firm financing, the choice of organizational form and the nature and amount of investment. Tax systems that have entity level taxation of corporations (classical systems) create the possibility of distinctive treatments for the returns to debt and equity investors. Specifically, a corporate tax system which provides for a deduction for interest payments coupled with an individual income tax which taxes returns to debt and equity creates a double tax on equity income. Equity income is taxed twice – first at the entity level and then at the investor level while debt income is taxed only at the investor level. The magnitude of the bias toward debt financing is a function, unsurprisingly, of relative statutory tax rates on corporate income and individual capital income

streams and, more subtly, on situations when effective rates depart from statutory rates and the nature of the capital market equilibrium.

While relative statutory rates are clearly observed, effective tax rates and nature of the capital market equilibrium are not as easily observed. First, deferral of capital gains taxation and the treatment of capital gains at death create uncertainty over the tax burden on one part of the return to equity capital. Second, investors differ in their tax attributes creating the possibility that sorting, or clientele effects, will also partially undo this double taxation. The combination of these first two factors can create settings where equity income is untaxed at the individual level, allowing for the possibility of a tax system, depending on relative corporate and interest income tax rates, that is biased toward equity rather than debt. Third, losses at the corporate level can create situations where entity level taxation is not meaningful. Fourth, uncertainty over future tax rates can also cloud the interpretation of the effects of tax policy. Finally, the effects of the tax treatment of financing on investment is a function of what constitutes the marginal source of financing for investment, which is itself unobservable.

Detecting the effects of taxation on the debt-equity choice is complicated by the various unobservable factors described above and by the other considerations that go into financing decisions. Specifically, informational asymmetries between managers and capital providers make external finance costly, resulting in a preference for investment financed out of retained earnings. Similarly, issuance of equity is thought to be more expensive than issuance of debt because of the poor signal provided by selling ownership rather than a fixed claim. These informational asymmetries are thought to create a financing hierarchy of sorts where retained earnings are favored over debt issuance which is favored over equity issuance.

The current configuration of statutory rates certainly makes a pro-debt bias feasible. Moreover, equity income still generates considerable tax revenue suggesting that individual level taxation of equity income is operative. Nonetheless, tax losses at the corporate level are widespread given the recent crisis and more aggressive tax behavior by corporations. A simple empirical approach to the question of financing bias would show that the U.S. corporate non-financial sector appears remarkably underlevered by historical standards, as described in more detail below. One interpretation of the current situation is that the tax system still provides a pro-debt bias but other financial frictions have led to a reliance on equity capital that is unusual. An alternative interpretation would be that the tax system is neutral or pro-equity biased because of widespread corporate tax losses and the possibility that equity is more lightly taxed at the individual level than debt is.

In addition to distorting the choice of financing, the tax treatment of debt and equity creates another set of behavioral responses because of the difficulties in classifying capital flows as debt or equity. Textbook definitions of debt and equity as fixed obligations requiring repayment and ownership claims, respectively, falsely suggest a bright line distinction. In fact, standard options analysis makes it clear that capital income can be packaged in a nearly infinite variety to conform to arbitrary distinctions. Consequently, financial engineers are quite adept at gaming the artificial distinctions and tax authorities are inevitably catching up to the latest hybrid instruments that capitalize on this labeling problem. Given the tax preference for debt hypothesized above, this involves packaging equity or quasi-equity as debt for tax purposes. As described below, this gaming by managers and financial engineers around the tax treatment of debt and equity has risen in importance as financial reporting considerations are increasingly paramount. This rise has created added pressure to classify claims on corporate income both as

debt for tax purposes and equity for financial reporting purposes in order to allow for tax savings and enhanced reported income to shareholders.

II. The Complications

The underlying problem described above has been exacerbated by several developments in the economy and the tax system. These complications have grown in importance and any potential solutions should address these complications

II. 1. The globalization of firms and investors

The rise of global production networks within firms and the rise of emerging economies have distributed firm activity globally in a remarkable way. Capital market integration has also created an even greater set of portfolio capital flows so that U.S. investors routinely invest in non-U.S. firms and non-U.S. investors are now significant investors in U.S. firms. Mobility of firm activity and financial capital is also now accompanied by mobility of firms themselves as firms can be redomiciled through the market for corporate control or through private equity transactions. Firms also increasingly choose to decenter themselves and have multiple national identities for the purposes of a legal domicile, a financial home and a home for managerial talent. These developments impact any potential tax reform of the treatment of debt and equity in several ways.

First, the tax treatment of debt for the modern global firm must consider interest allocation rules which effectively allocate interest expenses to foreign source income based on ratios of measures of activity such as assets or sales. These interest allocation rules are central to how U.S. firms consider debt-equity choices and the location of that debt. Second, the globalization of firm activity, the rise of tax havens, and the increasing difference between U.S. statutory rates and other country statutory rates, has given rise to increased transfer pricing opportunities, including the location and pricing of intrafirm debt. Third, any effort to correct the bias toward debt through reforms at the shareholder level must address the fact that foreign shareholders of U.S. firms are increasingly important. Finally, any changes must address the fact entrepreneurs and managers are increasingly willing to alter their domiciles in response to tax rules, including the tax treatment of debt and equity.

II. 2. The rise of alternative organizational forms

Nearly half of U.S. business income is now not in the C-corporate form. The rise of alternative organizational forms has transformed the corporate tax into, largely, a tax on public U.S. corporations. As a consequence, the corporate tax is effectively a toll tax on going public. The rise of alternative organizational forms, particularly for financial firms and investment trusts, creates the possibility that large amounts of debt financing is happening for entities that are not subject to entity level taxation. More generally, it demonstrates that responsiveness on the margin of organizational form changes has increased. In a somewhat related vein, tax-exempt investors have transformed the capital markets landscape making assumptions about marginal taxable investors more tenuous. More generally, the presence of tax-indifferent investors can drive more tax arbitrage activities in capital markets.

II. 3. Heightened financial reporting incentives

The dominance of public corporations within the corporate tax has also meant that the corporate tax is paid by firms and managers with an acute focus on reported earnings to shareholders. Most capital markets observers conclude that the rise of high-powered incentives

in public corporations have heighted sensitivity to reported income over the last several decades. As a consequence, managers may resist value-enhancing opportunities created by debt financing as it would result in lower reported income. More generally, the flexibility provided by the arbitrary distinction between debt and equity takes on new value when financial reporting incentives are paramount.

III. An Aside on the Financial Crisis

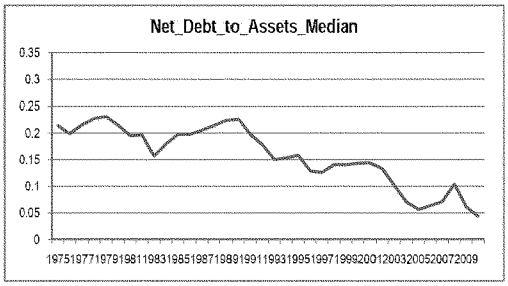
Excessive leverage was a cornerstone of the financial crisis. The forces that contributed to this excessive leverage are varied and it is natural to attribute blame to the tax system when a pro-debt bias potentially exists and when there is so much blame to go around.

III. 1. Taxes and the Financial Crisis

The tax system could have contributed to the financial crisis in three ways: (i) the tax preference for owner-occupied housing could have contributed to the sharp rise in housing values and the excessive leverage against those inflated values, (ii) the excessive leverage of financial institutions could have been caused by the tax system and (iii) the pro-debt bias could have created excessive leverage of non-financial corporations. This hearing is most clearly about iii) but it is useful to briefly comment on i) and ii). In short, the possibilities of i) and ii) are real but there is limited evidence for either nor is there reason to believe that changes in the tax system actually triggered the changes in houseful and financial sector leverage that proved so destructive. Moreover, there are many more compelling explanations for increased housing and financial sector leverage, most notably the insufficient supervision and the misplaced incentives of the financial sector created by monitors, investors and regulators. While the tax preference for owner-occupied housing is problematic for many reasons, it is difficult to ascribe a primary role in the financial crisis for it. Similarly, the leverage of financial institutions appears to have become problematic largely for reasons associated with prudential regulations rather than tax incentives.

III.2. Nonfinancial Corporate Leverage and the Crisis

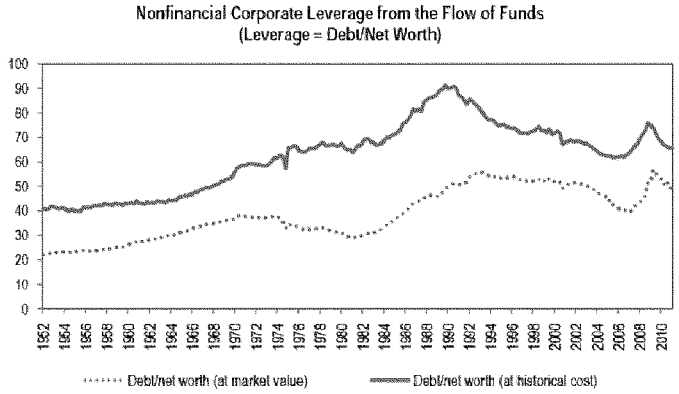
The most promising and relevant role for the tax system in creating current economic difficulties is in contributing to excessive leverage amongst non-financial firms where the debt-bias is thought to exist. Here, however, the evidence is clear. The leverage of the non-financial sector was not a contributing factor to the crisis and, in fact, the remarkable underleverage of the non-financial sector prior to the financial crisis was a saving grace in ensuring that the financial crisis was not nearly as severe as it could have been. The chart below created by my colleague James Zeitler provides the median ratio of net debt (debt minus cash) to assets for non-financial public firms from 1975 to 2010.



In order to measure leverage accurately, this figure portrays the evolution of debt minus cash as cash held by public corporations is most usefully considered negative debt. The median ratio of gross debt to assets for public corporations demonstrates a similar, though less pronounced, trend downard.

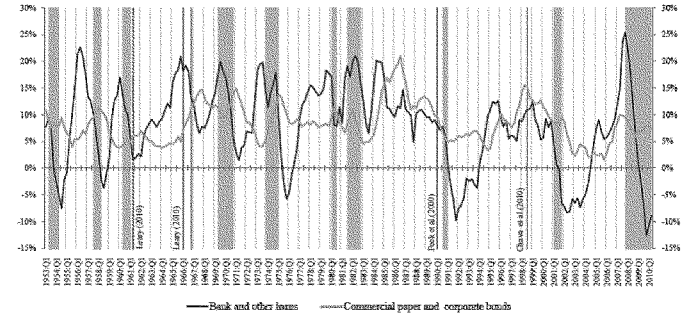
The rising cash balances of public corporations remains a defining feature of corporate finance within the early twenty-first. There are three competing explanations for this rising cash balance and the failure to invest or disgorge this cash – weak demand in product markets, regulatory and macroeconomic uncertainty that forces managers to hoard cash, and a coordination problem whereby managers are frozen into not spending. I have elsewhere proposed that if the third reason is operative, a two percent tax on excess cash balances, coupled with a reform of international tax rules that would allow firms to bring cash home, would help break this coordination problem.

This trend of delivering could be biased because of its focus on public companies or because of the inclusion of cash. In fact, a longer time series from the Federal Reserve's Flow of Funds data that excludes cash and is for all non-financial corporations, provided by my colleague Sam Hanson, verifies that the corporate sector is not highly levered by historic standards.



The trend upward in the latter half of 2007 would appear to reflect the onset of the crisis rather than serve as a possible cause of it. Finally, focusing entirely on issuance, my colleagues Bo Becker and Victoria Ivashina have provided this figure of issuance of bank loans, corporate bonds and commercial paper over the last sixty years.

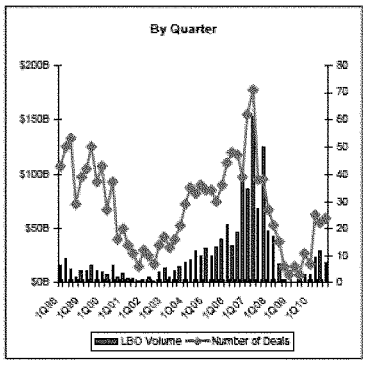
Figure 2
Volatility of corporate credit growth: Loans vs. Bonds
Figure 2 is compiled from quarterly United States Flow of Funds Accounts data (1953:Q1 -2010:Q2.) Each series corresponds to a four quarter rolling-window growth in nonfarm, nonfinancial corporate debt stock (Flow of Funds). *Bank and other loans* is the sum of Other Loans and Advances and Bank Loans Not Elsewhere Classified. *Commercial paper and corporate bonds* includes Commercial Paper and Corporate Bonds. Shaded areas indicate NBER recession periods. Dashed vertical lines indicate exogenous shifts in bank credit supply documented by the existing literature: (i) 1961 credit expansion following emergence of the market for certificate deposits (Leary, 2010); (ii) 1966 Credit Crunch (Leary, 2010); (iii) 1990 credit contraction following the burst of the Japanese real estate bubble (Peek and Rosengren, 2000); and (iv) 1998 credit contraction following the Russian debt crisis (Chava and Purnanandam, 2010).

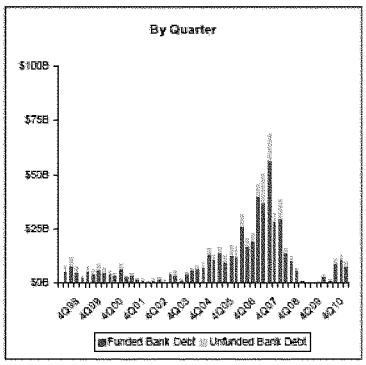


This figure illustrates that average credit growth during the last decade was not extraordinary and that with the exception of lending associated with the private equity boom years of 2006-2007, average lending growth was low relative to other business cycles.

III.3. Private Equity and Leveraged Buyouts

Indeed, the remarkable private equity boom of the mid-2000s may be the source of the perception that non-financial corporate leverage has grown so remarkably. The following two figures, provided by S&P, portray the growth in deal volume and in loan volume for leveraged buyouts.





There was a remarkable growth in leveraged buyout deals, deal sizes, and loan volumes through 2007, though this trend does not appear to have been large enough to move the aggregate figures above. More recently, this trend appears to have revived to a small degree though more recent transactions appear to rely less on debt. The waves of these transactions are hard to tie to tax incentives and more likely represent responses to credit spreads and borrowing rates.

III.4. Conclusions

A remarkable and underappreciated fact about the financial crisis remains that the evaporation of credit was not associated with widespread corporate bankruptcies – a happy outcome that seems to exonerate the debt bias of the tax system for non-financial firms as a major factor in the financial crisis. Indeed, as described above, the reliance on equity financing in aggregate today speaks to the magnitude of the current bias toward any one type of financing.

IV. The Solutions

Perceived problems with the tax treatment of debt and equity are varied. They include economy-wide incentives for excessive reliance on debt finance, favoritism toward firms or transactions (such as leveraged buyouts) where debt is used heavily, and abuses by multinational firms through related party transactions. Of course, each of these concerns are associated with revenue consequences which generate their own interest. And, sometimes, simply the promise of revenue is enough to generate interest, even in the absence of a specific problem.

There are three classes of solutions to these problems of the tax treatment of debt and equity. First, regulatory solutions target behavior deemed excessive and try to curtail that behavior. Second, structural solutions address the underlying problem with significant reforms. Third, rate solutions address the underlying problems but with reforms that dampen the incentives rather than removing them entirely.

IV. 1. Regulatory Reforms

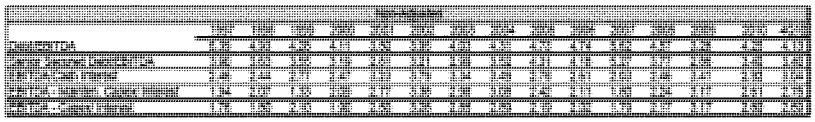
Regulatory solutions take on several forms. First, they can limit deductibility of interest when thresholds of balance sheet leverage ratios or cash flow ratios are exceeded for certain actors. Indeed, earnings-stripping rules such as Section 163 (j) are an example of such an effort with respect to multinational firms and their related parties. Recent proposals that deny deductibility of interest until repatriation are another such example targeted toward multinational firms. Broadening that effort beyond related parties was recently attempted by Germany which has created an "interest barrier" that disallows interest expenses when they exceed certain levels for a firm in aggregate. Similar, more general approaches can include global debt caps so that aggregate leverage cannot exceed predetermined levels.

In order for such approaches to be useful, excessive behavior must be clearly identifiable and regulations must anticipate the inevitable behavioral responses. Such rules may be gamed relatively easily by managers and, as we have learned, the innovative abilities of financial engineers should not be underestimated. Such rules have typically had exemptions for smaller firms, as in the case of Germany, which creates another bright line distinction that can be gamed. In the German case, they limited the interest expense to thirty percent of earnings before interest, taxes and depreciation and amortization. During the crisis, Germany revised the interest barrier as it was viewed as counterproductive during the economic downturn, lifting the exemption level and providing complex carryforward rules for net interest and the earnings against which it is measured. The complexity of such rules should not be underestimated. Moreover, reliance on

such approaches would appear at odds with the current situation where excessive leverage is not a problem in aggregate. Increased tax planning may well be the most easily anticipated reaction to such approaches.

If such rules were to apply to all firms, the treatment of the financial sector and the leasing sector would deserve special attention. Usually, the financial sector is exempt from such rules through specific carve-outs or because excessive interest is measured relative to a net interest margin. Of course, as we've learned, drawing a bright line between financial firms and non-financial firms in creating regulations is a non-trivial exercise. As one example of this, it is difficult to see how leasing firms would be integrated in such schemes without handicapping them considerably.

If one were targeting the leveraged buyout organizational form, one would want to know why this organizational form was worthy of particular note. This form, and the threat of it, offers a powerful antidote to the corporate governance difficulties created by diffuse ownership. There are reasons to question the organizational form – eg. the compensation arrangements of the private equity managers and their mediocre performance relative to reasonable benchmarks – but these presumably should be the concerns of the investors in those funds. In order to consider how the leveraged buyout organizational form would be impacted by such regulations, the chart below, compiled by S&P, provides some average metrics for LBOSs over the last two decades.



Most generally, it is difficult to understand why one would penalize borrowing when we appear to be going to extreme lengths through other policy instruments to ensure loan demand.

Regulations that would target earnings stripping of multinational firms would, presumably, add to the considerable arsenal of tools that already guard against such abuses including 163 (j) and interest allocation rules. Within the context of the remarkably complex regime for taxing foreign source income, the virtue of additional regulations would have to be weighed against their administrative costs and the degree to which they would make the U.S. a less attractive home for corporations to domicile themselves in.

IV. 2. Structural Reforms

Structural solutions take on the underlying issue either by eliminating entity level taxation via integration or through shareholder remedies such as imputation. Such solutions, in idealized settings, are quite powerful. Economic and administrative realities impinge on their desirability as the presence of foreign shareholders, as highlighted above, and tax exempt shareholders complicate such structural solutions to a large degree. Indeed, various countries with imputation systems have abandoned this approach given the difficulties created by foreign shareholders. More generally, transition issues are non-trivial in this setting as the capitalization of current expected taxes could allow for large windfalls if reforms are not designed appropriately.

Fundamental tax reform in various forms, including corporate cash flow taxes, can address such transition issues and the underlying issue created by entity level taxation. One

variant of particular interest is the Comprehensive Business Income Tax which would change the base of the corporate tax to be all business revenue from the sale of goods or real assets less wages, material costs and depreciation allowances for capital investments. All capital income would be taxed uniformly at the business level. Accordingly, the CBIT tax would remove the distortion to organizational form and financing choices. Finally, adding immediate expensing to the CBIT, along with a wage tax, would transform the tax base to consumption and afford the efficiency gains provided by such transitions.

Modernizing the corporate tax in the absence of fundamental tax reform would usefully focus on several critical dimensions of the current corporate tax rather than the debt-equity distinction. A reform that would preserve the corporate tax in its current form could usefully combine a significant rate reduction with a move toward territoriality and a reduced tolerance for the practice whereby corporations report profits to capital markets and losses to tax authorities. Pervasive examples of firms reporting large profits to capital markets and losses to tax authorities only serves to undercut the general sense of fairness of the income tax. Creating greater so-called book-tax alignment along with taxing the growing share of business income that is not subject to the corporate tax would provide for revenue that could compensate for the lower rates and the shift away from worldwide taxation that the rest of the world has already migrated toward.

IV. 3. Rate Reforms

Rate solutions are modest by comparison but have significant, ancillary benefits. There are many reasons to consider a significant rate reduction on U.S. corporate income. For these purposes, one of the most significant debt related difficulties currently is not excessive leverage in aggregate but with transfer pricing problems and earnings stripping using intrafirm debt, as described above. Reduced corporate rates in the U.S. would reduce the incentive for doing so given the relatively high U.S. statutory rates. The current corporate tax system has the worst of all worlds – high statutory rates and low average rates. Alternatively, relief for equity holders via rate changes can remedy the potential pro-debt bias of the current system.

IV. 4. Conclusions

The appropriate solution will, unsurprisingly, depend very much on the diagnosis of the problem. My perspective on these issues is that regulatory approaches are tempting in idealized settings and are politically salient but are also likely to be ineffective pragmatically and rife with unanticipated consequences. Structural approaches are worth pursuing but some variants of structural approaches are at odds with some important current realities. A step toward fundamental tax reform via a comprehensive business income tax or a corporate tax reform that cuts rates, moves toward territoriality, captures more business income and links definitions of income for tax authorities and capital markets is most desirable. Rate solutions are modest by comparison but provide some supplementary benefits. More generally, given the uncertainty over the magnitude of the current financing bias, it is useful to prioritize the promise of fundamental tax reform or modernizing the corporate tax for current global realities rather than the perceived ills of excessive leverage.

Chairman CAMP. Thank you, Mr. Desai.
Mr. Johnson, you are recognized for five minutes.

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, MASSACHUSETTS INSTITUTE OF TECHNOLOGY SLOAN SCHOOL OF MANAGEMENT, FORMER ECONOMIC COUNSELOR AND DIRECTOR OF THE RESEARCH DEPARTMENT AT THE INTERNATIONAL MONETARY FUND

Mr. JOHNSON. Thank you very much. I would like to speak about household debt, non-financial corporate sector debt, and financial sector debt as three separate issues for your consideration.

However, there is a common problem across all these kinds of debt which is now, I think, apparent to all American homeowners. If you buy a house that costs $1 million with only $5,000 down—so the rest is leverage—you are much more at risk when house prices go down than if you had put down $50,000 or $500,000. You also, of course, get great upside if house prices go up. You get a better return on your equity.

And the issue, I think, before us, certainly with regard to the previous financial crisis, and also with regard to what may happen in the future, is to what extent individuals or corporations create a spillover, an externality, a form of system risk when they choose to be over-leveraged, from a social point of view.

Now, looking at households, I am afraid—I think it is somewhat obvious—that the tax code has encouraged households, over a long period of time—and it wasn't the primary instigator of the crisis, but it encourages households to massively over-leverage, to take on a great deal of risk, which they may or may not fully understand themselves.

But, in any case, it creates really bad macroeconomic consequences when house prices go down. I would strongly urge you to consider phasing out the mortgage interest deduction over a long period of time, such as 20 years. This has been done in other countries. If handled properly, it would not be disruptive and dangerous. Obviously, I am not proposing to do it right away.

On the non-financial corporate side, I think we don't have a major problem. I agree with what the previous witnesses have said, with regard to the attractiveness of making the system more neutral between debt and equity. And I think there are a number of reforms you could do, either lower the tax of equity or lower the deduction for interest payments, or, even better, move to a new system, a more integrated system for corporate taxation, perhaps also with individual taxation.

That, I think, is not the pressing number-one issue, though, with regard to macro risks and financial stability. Those risks are about the financial sector. And Senator Baucus said it exactly right at the beginning. We had financial firms going into the crisis in 2008 with leverage of at least 40 to 1. And that was not—those are not isolated examples. We have tried for a long time, through regulation, to limit leverage, to have so-called capital requirements, which have a similar effect to leverage caps, and it hasn't worked.

Not only that, but the Basel III attempt to limit leverage, to require more capital, the major international response to the crisis, has also not had a dramatic effect, either now or in terms of what will happen later in the cycle, as firms want to take on more leverage.

For the financial sector, it is very clear that the top bankers and traders are paid on a return on equity basis. If they have less equity in the business, and things go well, they get nice compensation. If things go badly, there is a downside risk.

But who, I would ask you, bears that downside risk? It is largely borne by the rest of the economy, by the non-financial sector, by households, either—whether or not you are in favor of bail-outs, whether or not you think you will get a bail-out doesn't matter. You will get an awful recession, you will get devastating losses. You get an increase of debt to GDP, if you just want to think in fiscal terms.

As Mr. Levin pointed out, the debt level has gone up dramatically in the past few years in the United States, mostly because of the recession caused by the excessive leverage in the financial system. It makes no sense to have a tax code that encourages that leverage, at the same time as we try and pull it back rather ineffectively with regulation. At a minimum, the tax code should be neutral between debt and equity for financial sector firms.

I, though, would strongly advise you to follow the lead of some other countries in taxing excessive leverage. In the UK they now have a tax of 7.5 basis points on what they define as excessive leverage. That tax, I think, is actually rather low, if you consider that the International Monetary Fund and other organizations assess the value of being too big to fail, the funding advantage you get from being a mega-bank today—not just in the United States; in other countries, as well—that funding advantage is 50 basis points, half a percentage point. We should be taxing away that advantage.

I would actually suggest going—speaking to the points made by Mr. Hatch. If you want a fair, simple, and pro-growth system, you should tax excessive leverage in the financial system and use the revenue that generates to reduce corporate taxation for the non-financial sector, because the non-financial sector is what really got hit hard.

That is why the jobs aren't coming back.

That is why this has turned out to be such a painful recession. Thank you.

[The prepared statement of Mr. Johnson follows:]

Testimony submitted to the U.S. House Committee on Ways and Means and the U.S. Senate Committee on Finance, hearing on "Tax Reform and the Tax Treatment of Debt and Equity," July 13, 2011 (embargoed until 9am).

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; co-founder of http://BaselineScenario.com; member of the CBO's Panel of Economic Advisers; and member of the FDIC's Systemic Resolution Advisory Committee.[1]

Main Points

1) The US tax code creates a "debt bias" that encourages borrowing by households, the nonfinancial sector, and financial firms. Primarily because interest payments can be deducted as an expense when calculating taxes, homeowners borrow more relative to house prices, and firms finance themselves relatively more with debt and relatively less with equity.[2]
2) A high degree of leverage – more debt relative to assets – increases the upside return to equity when asset prices. But it also exacerbates the downside losses for equity when asset prices fall. This is true for firms and banks; it is also true for households – as many American families unfortunately discovered when house prices fell.
3) There is no evidence that a change in the tax code, or in its implementation and interpretation, played a major role in sparking the financial crisis of 2007-09. The incentives towards higher leverage for individuals and firms have largely been in place for decades.
4) However, the high leverage of households – and the risks this implied – clearly played a role in the dynamics of the crisis. The economy is growing slowly now, in part, because households are not finished "deleveraging", i.e., they are spending less and saving more in order to pay down their debts.
5) US nonfinancial firms were not particularly highly leveraged on average before the crisis. Relatively few of them were central to the housing/banking boom and bust, although there certainly has been considerable collateral damage – including for the small business sector, which is now reluctant to borrow and to hire.
6) The major tax-induced debt bias issue arising from the crisis is with regard to the financial sector. During the run-up to 2008, banks and other financial firms found ways to greatly increase their leverage (so debt increased relative to equity), including by moving assets "off-balance sheet" and through being allowed to set their own "risk-weights" for the purposes of calculating capital requirements.[3]
7) Banks and other financial firms create an externality – managers do not take into account the effect that the failure of their bank would have on other banks and the rest of the economy.[4]

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[1] This testimony draws on joint work with James Kwak and Peter Boone. Our updates and detailed policy assessments are available at http://BaselineScenario.com. The views expressed here are personal and not those of any other organization.

[2] The extent of tax-induced debt bias for firms depends on the tax treatment of investors and some other details – and not all nonfinancial firms choose to be leveraged – but the general statement holds.

[3] See Simon Johnson and James Kwak, *13 Bankers*, Chapter 5.

[4] In the United States, bankruptcy costs for the nonfinancial sector are generally small. The FDIC resolution process for small and medium sized banks is well-run and does not usually have large social

For highly leveraged banks that are large relative to the economy, the negative spillover effects on the rest of the economy are potentially very big.

8) Changes in the financial sector over the past two decades have created a new order of magnitude for system risk with negative macroeconomic implications in the United States.
9) To see the just fiscal impact of the finance-induced recession, consider changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to $5.1 trillion by 2018 (23% of GDP). As of January 2010, the CBO projected that over the next eight years debt will rise to $13.7 trillion (over 65% of GDP)—a difference of $8.6 trillion.
10) Most of this fiscal damage is not due to the Troubled Assets Relief Program – and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the "automatic stabilizers" in the United States are relatively weak); and another 14% is due to increased interest payments on the debt – because we now have more debt.[5]
11) In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget in the United States. It also damages the nonfinancial sector both directly – when there is a credit crunch, followed by a deep recession – and indirectly through creating a future tax liability.
12) Despite reform efforts since the crisis, including the Dodd-Frank legislation, big banks today still create major structural system risks.[6] Neil Barofsky, the Special Inspector General for the Troubled Assets Relief Program (TARP) summarized the situation well in his January 2011 report, emphasizing: "perhaps TARP's most significant legacy, the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are 'too big to fail.'"
13) As a result of the boom and the crisis, the remaining big financial firms became bigger and remain very powerful politically. The U.S. six largest bank holding companies currently have assets valued at just over 63 percent of GDP (end of Q4, 2010). This is up from around 55% of GDP before the crisis (e.g., 2006) and no more than 17% of GDP in 1995. With assets ranging from around $800 billion to nearly $2.5 trillion, these bank holding companies are widely perceived by the market as "too big to fail," meaning that they are implicitly backed by the full faith and credit of the US government. They can borrow more cheaply

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costs. And some kinds of financial firms can restructure their debts without big negative impact on the economy (e.g., the recent case of CIT Group). But the failure of large financial institutions can be very disruptive – as the experience of Lehman Brothers shows.

[5] See also the May 2010 edition of the IMF's cross-country fiscal monitor for comparable data from other industrialized countries, http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10 of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

[6] Andrew Haldane (Bank of England) and Anat Admati (Stanford University) both refer to system risk in this context as a form of pollution, i.e., a negative social spillover that should be discouraged by regulation and/or taxation.

than their competitors and hence become larger. The IMF and others have estimated this funding at advantage at around 50 basis points (half of a percentage point).

14) In public statements, top executives in these very large banks discuss their plans for further global expansion – presumably increasing their assets further while continuing to be highly leveraged. This is highly dangerous for society, particularly as there is no way to manage an orderly resolution process if a global megabank were to fail – there is no current or likely future cross-border agreement on bank resolution, including how various kinds of creditors would be treated.

15) In terms of policy priorities:

a. A reasonable goal would be to reduce the incentives for households to overleverage. The mortgage interest deduction could reasonably be phased out over 20 years, or it could be severely limited when there is little equity in the house. Home ownership would still be favored by the tax code, but homeowners would be encouraged to build up equity rather than borrow so heavily.[7]

b. Tax neutrality for the nonfinancial sector is also a sensible goal for longer-run reform, so that debt and equity are treated the same way for tax purposes. The deductibility of interest could be limited or there could be a deduction for payments to equity holders, in the form of an "allowance for corporate equity".[8]

c. The tax-induced debt bias in the financial sector has gone too far; neutrality between debt and equity would be a great improvement over the current situation. Given the externalities involved for the financial sector, there is a strong case for actively discouraging debt relative to equity financing, for example by taxing firms that are "thinly capitalized".[9] A steeply progressive tax on bank leverage would serve a similar purpose.[10]

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[7] Compared to other industrialized countries, the US stands out in terms of the extent to which it encourages households to leverage for house purchases. See, for example, Figure 1 on p.21 of International Monetary Fund, "Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy," 2009, http://www.imf.org/external/np/pp/eng/2009/061209.pdf.

[8] See Ruud de Mooij, "Tax Baises to Debt Finance: Assessing the Problem, Finding Solutions," International Monetary Fund, Staff Discussion Note, May 2011, http://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf. Abolishing the corporate income tax is less appealing, particularly as an increasing number of investors are tax-exempt, including pension funds and foreigners (such as sovereign wealth funds).

[9] Leveraged Buyouts can potentially contribute to system risk and a "thin capitalization" tax would address this.

[10] See Michael Keen, "The Taxation and Regulation of Banks," International Monetary Fund, mimeo, March 2011, http://www.law.nyu.edu/ecm_dlv2/groups/public/@nyu_law_website__academics__colloquia__tax_policy/documents/documents/ecm_pro_067915.pdf. There is useful background analysis in "Financial Sector Taxation: The IMF's Report to the G-20 and Background Material," http://www.imf.org/external/np/seminars/eng/2010/paris/pdf/090110.pdf.

Further Financial Sector Considerations: Why Regulation Is Not Enough

Thinking about debt bias in the financial sector is closely related to the debate on capital requirements for banks.

Capital is not something banks "hold" but rather refers to how they fund their loans – i.e., capital is on the liability side, not the asset side, of a bank's balance sheet.[11] Less capital means that loans made by banks are funded with more debt relative to equity. This puts the banks in greater danger of default. In contrast, more equity capital implies more safety – and less risk – for both the equity and the debt issued by the bank.

In principle, capital levels in the US banking system could be increased by regulation. But in practice such measures are unlikely to be sufficient. Partly this is because capital requirements are largely set in the international Basel process negotiations, where the lowest common denominator prevails.[12]

There is nothing in the Basel III accord on capital requirements – concluded in fall 2010 – that should be considered encouraging. Independent analysts have established beyond a reasonable doubt that substantially raising capital requirements would not be costly from a social point of view (see the work of Anat Admati of Stanford University and her colleagues).[13]

Arguments that equity is "expensive" for banks are either incorrect or self-serving. From a broader social perspective, banks and anyone else providing credit should be financed with relatively more equity and less debt. This would not reduce the availability and growth of credit – rather it would ensure that financial institutions have sufficient "loss-absorbing" capital on their balance sheets. This is what we need for sustainable growth and job creation.

In a free market system – without government guarantees – financial institutions fund themselves with a relatively large amount of equity (30 percent of total assets is not uncommon), because they need a strong buffer against losses. Investors are not willing to fund a bank that is prone to collapse.

But in a system with deposit insurance (and other forms of potential government protection for creditors), the downside risk for one class of investors – retail depositors – is limited or zero. This encourages banks and other financial firms to fund themselves with more debt relative to equity, which means little capital relative to total assets. This increases the upside payoff to equity – i.e., for a given return on assets, the return on equity is higher when things go well. But it also increases the downside returns on equity, creating more volatility and a higher probability that the bank will become insolvent – perhaps with major negative effects on the rest of the economy. Bank executives are paid primarily based on the return on equity, unadjusted for risk.

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[11] "Holding capital" is a common phrase that is completely misleading and often causes confusion in the debate – making people think that capital is an asset, rather than a liability.

[12] Credible reports indicate that in the Basel III negotiations, France, Germany, and Japan all wanted lower capital requirements than did the United States.

[13] Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive," http://www.gsb.stanford.edu/news/research/admati.etal.html.

In effect, big firms in modern financial systems receive a great deal of government-backed implicit insurance, without having to pay for the privilege. This is not only unfair to the nonfinancial sector and to everyone else in the economy, it is also very dangerous – we are subsidizing exactly the kind of behavior (excessively high leverage) that we should seek to discourage.

Rather than requiring banks become small enough, simple enough, or unimportant enough to fail, the Dodd-Frank Act gave regulators new resolution authority to protect the financial system from a collapsing financial institution in a crisis, hoping that fear of being "resolved" would be enough to deter financial institutions from taking excessive risks in the first place. While this is better than nothing, it is highly improbable that authority granted to U.S. regulators over U.S. institutions will be sufficient if a major global bank with subsidiaries in many countries is about to fail.

Dodd-Frank also gives regulators new preemptive weapons they can use against big banks, if they so choose. These include the ability to force banks to draw up plausible "living wills" and to shrink if these wills indicate an unacceptable risk to the financial system. But whether those weapons will ever be used remains a big question mark.

Taxing excessive leverage in the financial sector would be a sensible complement to capital regulation. There is generally no convergence in corporate tax systems across countries so – unlike with real or imagined constraints in the Basel III negotiations – we can set policy that makes sense for the United States.[14]

A number of European countries have already introduced new taxes on financial institutions – including the UK, for which the base is liabilities other than Tier 1 capital, insured deposits, and some other items.[15] The rate in the UK will initially be 0.04 percent, rising to 0.07 percent – which is definitely on the low side, if the goal is to tax away any "too big to fail" funding advantage.

Any such tax could go into general revenue and, if the goal is revenue neutrality, could reasonably be used to lower the effective corporate income tax for the nonfinancial sector – for example, by compensating for revenue lost due to the adoption of an allowance for corporate equity in the nonfinancial sector.

Financial crises have major negative consequences for the nonfinancial sector and imposing ad hoc penalties on the financial sector after any crisis is not workable – that is often the moment when banks are least able to pay. Encouraging less reliance on debt by the nonfinancial sector is one way to reduce the vulnerability of the real economy to future financial crises. But the top priority should be taxing excessive leverage in the financial sector.

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[14] In addition, taxation can reasonably target high leverage, i.e., excessive debt relative to total assets, which is really what causes systemic risk "pollution". The Basel process has instead pursued risk-weighted capital, which turns out to be a potentially misleading concept – for example, many European banks currently look fine in terms of their tier one capital, but only because they have a low or zero risk-weight on bonds issued by their own governments (which now prove to be very risky).

[15] See Michael Keen, "Rethinking the Taxation of the Financial Sector," International Monetary Fund, mimeo, October 2010, http://cesifo.oxfordjournals.org/content/57/1/1.abstract.

Chairman CAMP. Well, thank you, Mr. Johnson. We will now proceed with Member questions for witnesses. And due to the joint nature of today's hearing, questioning will alternate between members of the Senate, as recognized by Chairman Baucus, and members of the House, as recognized by myself, for a single round of questioning.

Senators will be recognized in an order consistent with rules and practices used at Senate Finance Committee hearings. House members will be recognized in an order consistent with rules and practices used at Ways and Means Committee hearings.

And each Member will have three minutes to question witnesses. I realize this is a little shorter than we are used to having in the Ways and Means Committee. But in order to accommodate everyone, we want to hold to the three minutes for each Member.

So, with that, let me invite Chairman Baucus to begin the questioning.

Chairman BAUCUS. Thank you, Mr. Chairman. I am curious about this question—the degree to which financial institution overleveraging and the ability of those companies to create an infinite number of financial products to affect their own needs should best be dealt with through the code, or best dealt with, as Mr. Desai said, through the regulatory regime. Or, is there some combination—are there some areas where maybe a tax change to the tax code is better? There is some general feeling lowering the rate, and trying to flatten the corporate tax code a little bit helps.

I only have three minutes. I would like to throw in the implication of pass-throughs, the rise of pass-throughs. What effect does the rise of pass-throughs have? I will see a little bit of difference between you, Mr. Johnson, and Mr. Desai and Mr. Fleischer. But if you could—the three of you—just briefly comment on that basic question. Which is more important, and what about pass-throughs?

Mr. FLEISCHER. So, on the question of whether we should try and address excessive leverage through the tax code or through regulatory responses, the answer is yes to both.

On the tax side, I think what is important is to remove the extra incentive to borrow. I don't think we should use the tax system to try and solve all of our issues in the bank regulatory area. The critical thing on the tax side is to try and make it more neutral.

On pass-throughs, I think the development of pass-throughs—it used to be that when you think of a partnership, you think of a small business. Now we see very large companies, including large financial institutions like hedge funds that are organized as partnerships. To me, that shows they are very sensitive to tax distortions, and will do—will go to great lengths to try and avoid the corporate tax.

Chairman BAUCUS. So what is the solution?

Mr. FLEISCHER. Well, as I said, I think the short-term solution, if you want something in the short run, would be to limit or cap the deductibility of interest by financial institutions, based on a leverage ratio. And I could talk more about comprehensive tax reform, but in the short run—

Chairman BAUCUS. Okay, thank you. Mr. Desai?

Mr. DESAI. So, you know, just briefly, to outline what the possibilities are, I think—within the tax policy realm I think there are several variants.

One is what would be called a financial transaction tax, which would be akin to kind of throwing sand in the wheels of financial markets, for the purpose of kind of disrupting excessive levels of transactions.

The second type would be financial activities taxes, where, you know, broadly, anybody involved in finance has a specific kind of tax.

One could have a too-big-to-fail kind of tax, which is if your assets are above some threshold level, then you have potentially to pay an extra tax.

You know, roughly speaking, I think that is the variance that one can have. And then, of course, one can limit interest deductibility.

So, you know, I think the first thing to realize is financial institutions are highly specialized. And understanding them is extremely difficult. And in situations like that, regulatory apparatuses are best used. That doesn't mean that we succeeded in the past, but it also doesn't mean that we should try a tax instrument in a very complex setting with highly responsive taxpayers and a lot of institutional detail.

So, that is why I am very skeptical about tax instruments to address financial leverage. Not because it is not a problem, but because I think there are better ways to do it. And I understand there has been a failure to do it, but there is little evidence that—in my mind—that these kinds of taxes are little more than kind of a representation of the vengeance that many of us feel—

Chairman BAUCUS. But Mr. Johnson says the financial planners just plan all around any financial regulations that you come up with. They are so clever—

Mr. DESAI. Well, indeed they are—

Chairman BAUCUS. And they are so driven to try to find a product that will yield the greatest return.

Mr. DESAI. Indeed they are, and they will do even more so when one tries to think about a tax instrument. And that just means that we need to strengthen regulatory approaches, where I think that specialized knowledge exists, where we can actually govern them in a much more thoughtful way than through the tax system.

And finally, I will just say that it is useful to remember that a lot of the leverage was hidden, right? So let's think about Lehman Brothers. I don't think anybody knew how levered they were. And that is a part of this crisis, which is there was behavior that was even beyond the realm that you might have imagined.

Chairman BAUCUS. Mr. Johnson, your thoughts?

Mr. JOHNSON. Whether you like it or not, Senator, the Code impacts the leverage choice these firms make. I think we all agree with what the JCT staff has determined, that this is a big bias towards debt, including for the financial sector.

It makes no sense to have regulation and tax code pointing opposite directions here. I work a great deal on regulation with regulators, and I am very supportive of what they are trying to do. But it is not enough. They are all so constrained, perhaps by their own choice, but they are constrained by international approach to regulation, including Basel III on capital, where the Japanese, the Germans, and the French were the—provided the lowest common denominator. So, why should we regard that as the last word, as the appropriate constraint on the extent—excessive leverage?

I agree with Mr. Fleischer. There are many appropriate ways to tax excessive leverage, including a version of a thin capitalization

tax, which is part of what he discussed. And the IMF made a very good report to the G–20 on exactly these issues that I commend to all of you.

Chairman BAUCUS. Thank you very much. Appreciate it. Thank you, Chairman.

Chairman CAMP. Well, thank you. Mr. Desai, you, in your testimony, say that a lower corporate tax would alleviate pressure on the tax bias in favor of debt over equity. Can you explain how a lower tax rate would address the sort of debt-equity bias that we have heard about?

Mr. DESAI. Sure. And I think Mr. Barthold made reference to this as well, which is the most simple version of this is that that entity-level taxation is part of the problem. And so, reducing that rate ends up taking away that distortion, to some degree.

But it kind of goes further than that, insofar as one of the problems here is not just debt in the aggregate for non-financial corporations, but the possibility that the corporate tax base is being eroded in the U.S. by earnings stripping, which I think is a widespread concern. And there, you know, lowering statutory rates is a very valuable thing to do, because it takes out that incentive for relocating profits outside of the United States.

So, I would say it is at two levels. It is at one level of the system, which is part of the reason why the system may be tax biased towards debt, is because of the high corporate tax rate, the high deduction. And once you take that away, you reduce that. And second, if we think that earnings stripping and reallocations of income, which are legitimate concerns today, given how easy it is to reallocate income, then lowering the rate has the additional salutary effect of taking away that incentive.

Chairman CAMP. There seems to be a general consensus that the federal tax code favors debt over equity for C-corporations and financial firms. And to the extent that you consider this a problem, is the solution to change the treatment of equity, or the treatment of debt? And how would any of those changes to the treatment of debt and equity affect taxpayers that take advantage of the current debt bias?

And if each of you would like to just briefly answer—I don't know if, Mr. Barthold, you really want to address that—but why don't we start with Ms. Olson and just quickly go down the line? And I know time is short.

Ms. OLSON. I think you can go either direction. I mean I think right now we have a little bit too much of a bias towards debt and against equity. And so I think you can go in either direction. You could go in the direction of reducing the double tax on corporate income, or you could go in the direction of some restrictions on interest.

I think if you go in the direction of some restrictions on interest, you need to first think about significantly reducing the corporate rate, and you need to think about transition, because there are capital structures in place that would be significantly affected by that kind of a change.

Chairman CAMP. All right. Mr. Fleischer?

Mr. FLEISCHER. I largely agree with that. My preference would be to limit the—on the interest side, to limit interest deductions.

And the big benefit there is that you could reduce corporate tax rates, which reduces all sorts of distortions and incentives to tax planning. Thank you.

Mr. DESAI. Just briefly I would say that, you know, I think this is an opportunity that one shouldn't squander, and there is the possibility of more comprehensive approaches. Mr. Rangel has put forward things, other folks have put forward things, and I think that is a very useful opportunity.

So, to try to fix this on the margin is not as advisable as something like the comprehensive business income tax, which I think would be very useful.

Chairman CAMP. Thank you. Mr. Johnson?

Mr. JOHNSON. My suggestion for the non-financial sector is to have an allowance for corporate equity, where you are allowed to deduct some of the dividends payments, based on an assessment of what is the normal rate of return on capital.

But for the financial sector, I think you have to go further. For the financial sector, I am proposing that you tax excessive leverage, because that is what generates the big negative—now, it is a form of pollution, a very bad form of pollution that doesn't hit you every year. But every 5 to 10 years you are going to have some very nasty consequence to this. And you should take that revenue and use that as general revenue, and use that to reduce tax rates on other parts of the economy. Because it is those parts of the economy that are going to be hit very hard when the banks go bad again.

Chairman CAMP. All right, thank you. Chairman Baucus?

Chairman BAUCUS. Thank you. We will experiment with this new regime here. Under Senate rules, we go according to a first come first served, early bird system. And the earliest bird that arrived from the Senate was Senator Hatch. You are next.

Senator HATCH. Well, thank you. Thank you, Mr. Chairman, and both of you.

Professor Desai, this is a question for you. And I would like it also to be answered by Ms. Olson and Mr. Barthold, if they could weigh in briefly on this question, as well.

Professor Desai, in your written testimony you said that "the current corporate tax system has the worst of all worlds: high statutory rates and low average rates." Could you please explain that a little bit more?

For instance, if—say the average rate is 17.5 percent, and say that the statutory rate is 35 percent, and the ratio of average rate to statutory rate would be 1 to 2, as I see it. Do you think there is some ideal ratio—one to one, maybe? Or would it actually be ideal to have a statutory rate somewhat lower than the average rate, if that could be accomplished?

And if you would, go weigh in on that and then, after that, Ms. Olson and Mr. Barthold.

Mr. DESAI. So, I guess what I was trying to get at there is a few things. The first is the statutory rate is high. And by "high," I mean by global standards the statutory rate is high.

When I said it was the worst of all worlds, if one is going to have a high statutory rate, one would like lots of revenue, presumably,

or at least there would be some benefit that would come from that. And we are living in a world where we are not getting that.

So, we have highly responsive taxpayers, we have very high statutory rates, which, on the margin, is distorting incentives, as we know marginal rates will do. And we are not collecting very much.

So, the promise of tax reform, of course, that other countries have embarked on and that I hope you embark on, is lower rates, broader base, and bringing together statutory and average rates in a way that is much more consistent with economic efficiency and, I should mention, is also more consistent with political viability. The corporate tax is now viewed—I think widely by the American people—as something that is not paid at all. And it discredits the overall tax system and, I think, has a wide series of repercussions. So, bringing those two back in line is, I think, a very worthy goal.

Senator HATCH. Thank you. Ms. Olson?

Ms. OLSON. I agree with Mr. Desai's comments. I do think that it would be much better if we had a lower statutory rate, and if we did some things to broaden the base, which would have the effect of increasing the effective rate, or bringing the effective tax rate closer to the statutory rate.

The differences now, I think, of the ways in which the tax code directs resources, as opposed to resources being directed on the basis of what produces the best pre-tax return. And we will maximize national income, and therefore, economic growth, if we remove some of those distortions.

Mr. BARTHOLD. Senator Hatch, I will probably just re-emphasize a point that Mihir Desai made. When we are looking at the statutory rate, we are usually thinking of it as the marginal tax rate that applies, and economists emphasize the importance of marginal tax rates. Because, at the margin, that influences the next investment that will be made, or the next financing choice that will be made.

And so, high marginal tax rates tend to distort choice. They could promote more debt than equity. They could promote tax shelter behavior. They can reduce incentives to invest, which reduces incentives for future growth. And so, that is why economists generally are always in favor of lower marginal tax rates. As to an optimal ratio of marginal to average, remember that average also reflects a number of other policy concerns that Members may have in the design of the tax code. And so, the optimality of that is your decision.

Senator HATCH. Well, thank you. My time is up, Mr. Chairman.

Chairman CAMP. Mr. Levin is recognized for three minutes.

Mr. LEVIN. Thank you, Mr. Chairman. Now, this has been, I think, interesting and, I hope, helpful. I do think that the complexities emphasize that as we approach these issues we kind of need to leave ideology at the door, and try to dig into these issues.

In a sense, it is easy to say lower the rates and broaden the base. The problem is when we start talking about how you broaden the base. And that is not at all easy. We have held hearings, for example, on transfer pricing. And it is not easy. We have held hearings on tax havens. And there is often disagreement about that.

By the way, let me just say quickly on the mortgage interest deduction—some of you have mentioned it—I just urge that we be

careful about our proposals. That—because that is one way to kind of lower the rate, but the impact, when you look at the distributional analysis of mortgage interest, it has been very much a middle-income tax provision. And I think most of us have to ask where we would be if it hadn't been in existence the last 40 years. And there are some problems of excess, but I think we have to be careful about not throwing out the baby with the bath water.

So let me, on corporate, ask each of you just directly—some of you have already expressed yourselves—do each of you favor taxation of excessive leverage in the corporate sector? Yes or no, or however you would like to modify that.

Ms. Olson, let's start with you. I won't ask Mr. Barthold.

Ms. OLSON. I would go in the direction of eliminating some of the bias between debt and equity. I don't think I would think that it would be a great idea to tax excessive leverage, because I am not sure how we would define it, or how we would apply it. I had some experience with Section 163(j) proposals when I was at the Treasury Department. We made an effort to try to cap interest deductions, and it didn't turn out very well.

Mr. LEVIN. All right. Mr. Fleischer, there are just 20 seconds left, I see here.

Mr. FLEISCHER. I favor removing the tax incentives to be excessively levered. Going beyond that, you have to proceed carefully. If you want to impose a kind of penalty tax on excessive leverage, I might support that. But you would have to be careful in the design.

Mr. LEVIN. Mr. Desai?

Mr. DESAI. No on very targeted things towards excessive leverage.

And on your point about revenue, you are absolutely right on broadening the base. There are two solutions in my testimony. One is the non-corporate business income, which has grown enormously, and then the second is the gap between book and tax income, which also, I think, can generate some revenue.

Mr. LEVIN. Mr. Johnson, I think you have already spoken, so—

Mr. JOHNSON. But if I could just add, the tax on excessive leverage is where European Union is heading, including the UK. London is our major competitor, vis-à-vis New York. So we are behind the curve on taxing excessive leverage, compared to major comparative countries.

Mr. LEVIN. Thank you. Thank you, Mr. Chairman.

Chairman BAUCUS. Okay. Next is Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. And, Chairman Baucus and Chairman Camp, let me thank you both for your bipartisan leadership in putting together this important hearing.

I believe that tax reform is now the major unused tool in the economic recovery toolshed. The Federal Reserve has cut interest rates repeatedly. The Economic Recovery Act was passed. Numerous initiatives are in place to help hard-hit homeowners. But bipartisan tax reform is now sitting, in effect ready, in the economic recovery toolshed. And I hope, as we consider this, we know that a variety of factors go into job creation, but the last time there was bipartisan tax reform, our country created 6.3 million new jobs in the 2 years after it was passed.

Now, on the debt equity issue specifically, Mr. Barthold, a question for you. Senator Coats of Indiana and I put in, as part of our broad tax reform, an idea that suggests that one way to make the tax code less tilted towards debt finance is to disallow a portion of the deduction for interest cost that is attributable to inflation. That would make the interest on debt a bit less deductible and, in turn, would make equity finance a bit more attractive.

Now, you all scored that, as part of our proposal, as raising $163 billion over 10 years. My question is—and see if we can put this into English—Mr. Barthold, wouldn't that mean that if you had broad tax reform, and you had that one feature in it, that means you would have that substantial sum—$163 billion—so you could cut rates for middle class folks, focus on creating jobs in our country, pay down the deficit? Isn't that what that score really means?

Mr. BARTHOLD. Senator Wyden, yes, sir. I mean our estimate was you had a proposal that would limit interest deductibility, and you chose to do that by measuring the inflation component annually.

As we noted in our report, there is a substantial amount of interest expense claimed annually by business. And so, a reduction in the deductibility of that is a substantial base-broadener, given the existing—the rest of the Internal Revenue Code.

Senator WYDEN. Thank you, and thank you for your professionalism always, for all the Members on both sides of the aisle.

Question for you, Mr. Fleischer, and we appreciate your involvement in this, as well. Jane Gravelle, of the Congressional Research Service, has found that in recent years, over the life of a loan, about half the value of the interest deduction is now inflation. Isn't that another argument for limiting the deduction to its non-inflation component?

Mr. FLEISCHER. I think it is. I think there are different ways to limit interest deductibility, and I think you want to think about inflation as one possibility. My own personal opinion would be for something closer to comprehensive business income tax, which I think would actually be simpler, along those lines. But yes, you are right.

Senator WYDEN. Thank you, Mr. Chairman. My time is up.

Chairman CAMP. Thank you. Mr. Herger is recognized for three minutes.

Mr. HERGER. Thank you, Mr. Chairman. Several of you mentioned in your testimony that the tax code's bias towards debt investment may encourage some businesses to take on an excessively risky amount of debt, increasing the risk of bankruptcy and the associated cost to society. Among the most serious of these consequences is a loss of jobs, resulting from major bankruptcies.

Since one of the most important issues facing Congress is the urgent need to create jobs, could you—maybe beginning with you, Mr. Fleischer—comment on whether reforming the tax treatment of debt and equity might help to create a better foundation for stable job growth?

Mr. FLEISCHER. I do think it would, and I think you will probably find some unanimity from the panel. The more simple, efficient, fair our corporate tax system is, the easier it is for busi-

nesses to make planning decisions, including hiring workers, going forward.

Mr. HERGER. Thank you. Mr. Desai?

Mr. DESAI. So, just two quick thoughts. You know, the first is, as I mentioned in my written testimony, it is remarkable that we have not had more corporate bankruptcies, given the nature of the credit crisis. And I think that is because the non-financial corporate sector is under-levered, relative to historic standards, and we should be happy and grateful for that nice outcome.

Would it have a salutary effect for kind of—if we kind of made debt not deductible? The one thing one has to keep in mind is that the cost of capital would rise, as a consequence of that.

So, some of the social spillover effects of bankruptcies that you are worried about would certainly be a benefit. The cost of capital would likely rise, as a consequence of that. And that would have some potentially offsetting effects, as well. So, I am not so sure it is quite easily a job-winner.

Mr. HERGER. Mr. Johnson?

Mr. JOHNSON. As long as we are putting this in the context of medium-term fiscal consolidation—so, over a 5 to 10-year horizon, until the financial markets believe you have credible plans for bringing down the deficit, controlling the deficit, and preferably bringing down the debt, then yes, I think that there is ample scope for measures that would encourage short-term job creation.

But I would strongly caution against focusing only on that. Experience in Europe, including in the last days and weeks, tells you that countries that previously thought that they had an impeccable credit rating can come under market pressure much more quickly. So, please, whatever you do, put it in the framework of medium-term, credible, committed fiscal consolidation.

Mr. HERGER. Ms. Olson?

Ms. OLSON. I think there is definitely some value in doing whatever we can to make the tax system more rational. And something along the lines of what you are talking about might well move in that direction.

Mr. HERGER. Thank you. Thank you, Mr. Chairman.

Chairman BAUCUS. Okay. Next is Senator Stabenow.

Senator STABENOW. Thank you very much, Mr. Chairman. And, first, a thank you to you and to Chairman Camp for doing what I hope will become more than just one meeting. I think this is really important to do, and congratulations.

As we talk about all of this—and we clearly are having important hearings and discussions on tax reform, which clearly needs to happen—and we look at how we need to create tax fairness for small businesses, as well as large, multinational businesses, how do we create incentives for investments in American jobs, and in this global economy, and how do we create incentives for American families to be able to plan themselves and achieve important goals for their families like home ownership which has, of course, been under attack, given what has happened with the fact that the majority of families think they were saving through equity in their home, and then we've seen what is happening in the housing market, and so on. And so, it has been very difficult, I think, obviously, for families, on a number of fronts.

But there is another area in the code where we encourage people to save, and that is through the Pension Protection Act of 2006. And I am wondering, Dr. Desai, if you might respond to the fact that Congress has allowed firms to auto-enroll employees into 401(k) plans, but allowing employees to then opt out if they desire. And the goal was to encourage savings.

However, the Wall Street Journal reported earlier this week that while more people were now contributing to 401(k) plans, many of them are making contributions that are actually less than what they otherwise would be with the typical 3 percent default.

So, I am wondering if you have suggestions or if any of you have suggestions on how we can improve this provision to encourage greater savings as we focus on pensions, which are another important part of, you know, economic security for families.

Mr. DESAI. So, Senator Stabenow, I think you are absolutely right to turn the discussion toward savings, in some sense, that is underneath it all, one of the most important metrics that we can measure our success by, especially given the history of the American citizen over the last several decades as being a "dis-saver".

So—and you are also right to kind of put your finger on pensions, which are an important piece of the savings picture.

So, just briefly, I think, you know, one of the revolutions in economics in the last decade or two decades has been about behavioral biases. And so, when you force people or rather, when you give them default options that allow them to save easily, that is an incredibly powerful device, it turns out.

So, I think, in the design of pensions, and in the design of legislation around pensions, paying attention to default provisions, and paying attention to making it extremely easy for a person to save, is a very important part of this.

Of course, one would be remiss without mentioning the broader point, which is the distortion to saving in the tax code that is primary is the nature of the income tax. And the opportunity for fundamental tax reform provides you an even bigger lever on that than would be otherwise available.

Senator STABENOW. Thank you very much. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Rangel is recognized for three minutes.

Mr. RANGEL. Thank you, Chairman Camp and Chairman Baucus. I don't remember the meeting in 1940, but—

[Laughter.]

Mr. RANGEL. But I certainly do welcome this meeting. Not only do we have Democrats and Republicans looking civil and acting civil, but we have the House and Senate coming together. And even though they are close by physically, people don't recognize how seldom we have a chance to see each other.

This panel is extraordinary. And I think all of us, especially our chair, is excited about the possibility of tax reform. And it takes this type of cooperation in order for us to move forward. And it takes a better understanding of equity and debt in order to develop a system that is fair and equitable.

Having said that, there is a big elephant in this room, and it is called debt ceiling. And until we get that out of the way, it will be

impossible for us to, in a bipartisan way, deal with this very serious problem that everyone admits is really dampening our economic growth, by not having a fairer system with lower corporate rates and closing loopholes.

Having said that, I wonder, Mr. Chairman, whether I would be out of order if I took advantage of the minds of our great panel here to ask them, is there anyone here that sees any connection at all in terms of increasing the debt ceiling, as we have 17 times to make certain that our great nation pays our debt, and the solution to the budget problem that we have which, of course, involves revenue and cut-back in spending?

As economists and people who understand these serious problems, is there anyone here that sees where there is any connection between dealing with reduction of our debt and authorizing the President to increase the debt ceiling? And if you do, I wish you could share it with me in 30 seconds.

Having seen no response—

Ms. OLSON. Mr. Rangel, I hope that the cooperation you are seeing here today sets the stage for the debt ceiling negotiations.

Mr. RANGEL. But you don't see any connection between increasing the debt ceiling with the President and dealing with our serious problem with the national debt, do you?

Ms. OLSON. They are all important steps towards getting—

Mr. RANGEL. I know that. God knows every day it is important. But really, as a professional that has worked with the Internal Revenue and served presidents in the past, do you see a connection between the two, except politics, which is not really why you are here?

Ms. OLSON. I think there are important policies that have to be addressed. You have got to address them on the spending side, and you have got to address them on the revenue side. It is very important for us to get our fiscal house in order across the board.

Mr. RANGEL. So you do believe that we can hold the question of debt and spending and revenues with denying the President the opportunity to pay our debts internationally? You do see a connection? What Administration did you serve under?

Ms. OLSON. President Bush.

Mr. RANGEL. Oh, okay. I have completed my questions, thank you.

Chairman CAMP. Thank you, Mr. Rangel.

Chairman BAUCUS. Okay. And I will recognize Senator Nelson from Florida.

Senator NELSON. I am afraid we are going to fritter away this opportunity to get tax reform done in this debt ceiling. But if we had our d'ruthers, the Senate Budget Committee has come out and said you could do a $4 trillion package and 2 trillion of revenues could come from just eliminating 17 percent of the tax expenditures over the next decade, which amount to $14 trillion.

So, if you were to whack 17 percent of those tax expenditures, where would you go first?

Mr. FLEISCHER. So I will start. I have written and testified previously about some loopholes, some of which might be characterized as tax expenditures. The carried interest loophole is the one

where I have testified before, and that is converting—when fund managers convert their labor income into capital gain.

There are other examples, including the—some of the treatment of the hybrid instruments that I talked about before that banks use to exploit the debt equity distinction. So I do think there is some low-hanging fruit in order to generate significant revenue.

Mr. DESAI. So just briefly I would say, you know, in general, in these discussions I am always loathe to characterize anything as a loophole, because that makes it sound like it is easy to get rid of. And I think tax administrators know that there is no free money hanging around here and we can just snap our fingers and close something and it will work.

What is at play, of course, are serious policy choices. And if you want to look at the expenditure side, the tax expenditure side—you know, I haven't looked at this in the last week or two, but my understanding, as I recall, is that the big numbers are going to be on owner-occupied housing, which is the mortgage interest deduction, and it is going to be on the preference for employer-provided health insurance.

And as, you know, people have written about, those are both significant sources of revenue. I think the distortion on health care choice that's created because the employer deduction on health insurance is significant, that would be a place to look. And, you know, of course, housing is hugely important. But you know, that—I don't think it has to do with leverage in the financial crisis. But the preference for owner-occupied housing is another place to look, where you can get the kind of money that you are talking about.

Mr. JOHNSON. Excessive leverage in the financial sector. You could be steeply progressive on this. It is the very biggest banks with their huge debts that pose a disproportionate risk to the system.

And this is an obvious thing to go after. It is completely consistent with the broader assessment from the right and from the left, with regard to the fact that too-big-to-fail has become a massive government subsidy operation. And while we have tried to deal with that in various ways, nobody is impressed. Standard & Poor's just ruled yesterday that they think the government would still have to come and support major financial institutions if they fail. That is a systemic risk. That is pollution. That is a negative externality you should be taxing on.

Chairman CAMP. Mr. Johnson is recognized.

Mr. JOHNSON of Texas. Thank you, Mr. Chairman. Ms. Olson, in your testimony you talk about reform alternatives that you believe could address this bias in the tax code. One of the reform proposals you mention is the lower corporate tax rate. In your view, what should that rate be? And how far would that proposal go toward addressing a bias?

Ms. OLSON. Mr. Johnson, I think that—I am not sure what the optimal corporate rate is. But I think one of the things we have to look at is what the rate has fallen to in other countries around the globe that are major trading partners. And that would suggest that a rate of somewhere around 25 percent would be about the top rate. Now, that would include the state and local rate, which adds

about four or five points to the overall rate. So you've got to take that into account, as well.

I think that companies use leverage for a lot of reasons besides the interest deduction. In fact, lots of times companies find that equity capital is less expensive than debt even taking into account the deduction of interest and the non-deductibility of dividends.

So, I think that bringing the corporate rate down would go a long ways towards eliminating the bias that currently exists.

Mr. JOHNSON of Texas. Well, we also eliminate the taxation of dividends as a measure of improving the system?

Ms. OLSON. I think that there has to be a connection between the two. And so, to the extent that you have got a high corporate rate, you need a lower rate on dividends, and vice versa. If you bring down the corporate rate, you don't need, perhaps, to reduce the rate on dividends quite as much.

But if you have too high a rate of tax on dividends, you will give companies a disincentive to pay dividends, and that has been a problem for us—

Mr. JOHNSON of Texas. Yes, that is kind of double taxation, isn't it?

Ms. OLSON. Yes.

Mr. JOHNSON of Texas. Okay. Mr. Barthold, the mortgage interest deduction, did it have a role to play in the tax underwriting standards? Should we do something about that? Could you elaborate on what tax incentives could reduce the cost of renting, as well?

Mr. BARTHOLD. The code currently provides several benefits for rental housing, to try and increase the supply of rental housing and reduce rents to moderate to low-income individuals. There are provisions in Section 42 to provide the low-income housing tax credit to expand the supply of rental housing to qualifying lower-income families.

Similarly, under Section 142 of the code, states may issue tax-exempt bonds to help finance at lower cost multifamily housing, again, targeted at lower income. So there are provisions in the Internal Revenue Code to help benefit the rental market.

But I don't think I am fully addressing your question, sir.

Mr. JOHNSON of Texas. Well, I have kind of run out of time, so—

Mr. BARTHOLD. Well, the chairman may—since I misspent it, maybe the chairman will grant an extra 30 seconds?

[Laughter.]

Mr. JOHNSON of Texas. Thank you, Mr. Chairman.

Chairman BAUCUS. Mr. Chairman, we have some votes that are going to start in the Senate fairly quickly. There are no more senators at this moment. I think Senator Carper is on his way. I suggest that you continue on your side. So—well, just continue on your side. When the vote does occur, the Senate will cross that bridge when we get there. And when Senator Carper comes, we can address him, too.

Is he here? Senator Carper? No, he is not here yet. Why don't you go ahead?

Chairman CAMP. All right, thank you. Mr. Neal is recognized.

Mr. NEAL. Thank you, Mr. Chairman. And actually, in the House we have done a pretty good job this year at the Ways and Means Committee of conducting a lot of hearings, in an effort to examine how we might revamp the code. But I think that it is also important to acknowledge today that, unless the presidential candidates next year take up the issue in earnest, it is going to be very hard for us, even having accumulated a great deal of evidence as to how the code might be altered, to, in fact, make it happen.

And I think insisting that after we come up with competing products, perhaps, or even one product, that the presidential candidates address the extensive hearings and evidence that we have assembled—now, Mr. Barthold has heard this question before, but I want to go back to it because of the hearings that the Select Revenue Subcommittee held last year.

One of the witnesses testified at that hearing that foreign-owned multinationals in the United States have a competitive advantage over U.S.-based corporations, with respect to certain U.S. investments. The witness stated, further, that the tax advantage afforded to inbound investors arises because of their ability to erode the U.S. tax base through base erosion payments, such as earnings or interest-stripping payments.

Maybe we might hear from Professors Fleischer or Desai as to what your thoughts are on whether foreign-owned U.S. subsidiary corporations engaged in earnings strippings on their debt-financed U.S. investments have a competitive advantage over U.S.-owned corporations. And should some of the tax rules related to debt financing rules be modified in order to prevent this competitive disadvantage for U.S.-owned corporations?

Mr. FLEISCHER. I am going to defer to Professor Desai on that.

Mr. DESAI. So I think there are a few things to say. The first is it is striking that the profitability of foreign multinationals in the U.S. is low, relative to American firms. And one explanation for that is, in fact, lots of earnings stripping by these foreign firms out of the U.S. base. There are alternative explanations, which is it is hard to make money in America versus American multinational firms.

But if, in fact, base erosion is the problem, then you have to ask the question, are they able to do something that American firms aren't able to do? And at first approximation, I would have thought that they are subject to the same regulations and the same rules that American multinational firms are.

So I understand the source of the concern, which is very low profitability of foreign firms in the U.S. And I understand the possibility that part of what is going on here is they are stripping all their earnings out. What I am less convinced of is the degree to which that represents earnings stripping or something else. And given that they face the same rules, it is a puzzle why they would be more capable, in some sense, than American firms.

Mr. NEAL. Professor Fleischer?

Mr. FLEISCHER. Well, just to add that there is two ways to look at that. One—

Mr. NEAL. Yes, there generally is, in tax policy.

Mr. FLEISCHER. Yes. I think Mihir is right. On the other hand, it also just shows that American multinationals are also very good at moving profits offshore through things like transfer pricing.

Mr. NEAL. Okay.

Chairman CAMP. Thank you, Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman CAMP. Mr. Tiberi is recognized.

Mr. TIBERI. Thank you, Chairman Camp and Chairman Baucus, for holding this hearing today. Great panel of witnesses, as well.

I first want to associate myself with the remarks by Mr. Levin with respect to the home mortgage interest deduction, and kind of piggyback on something that Mr. Johnson had said.

In addition, on the rental side, Mr. Barthold, you have rental owners that have the ability to not only take advantage of the mortgage interest deduction, but a series of other deductions that, in theory, would reduce, if taken away, their ability to keep rents lower, meaning if, through the tax code, you took away deductions from rental housing owners, they would have to increase the rent. That is not a question, just a comment.

The question I have is more on the business side to all of you. Joint Tax actually came out with a report that stated that the debt to equity issue concerning the Tax Code's preferential treatment for financing with debt doesn't really apply to owners of businesses that are pass-through entities.

As we have heard on this committee, more than half of American businesses are set up as pass-through entities. The Administration has suggested switching, or changing the way that pass-through entities are taxed to the corporate side, tax them as C-corps, instead. Wouldn't that have a negative effect on those pass-through entities today, and continue to exacerbate the debt-to-equity issue through the tax code? Starting with Joint Tax.

Mr. BARTHOLD. Well, thank you, Mr. Tiberi. I think the main point that you are raising is that the corporate income tax itself, at its simplest level, is a tax on the return of income to the equity owners.

Mr. TIBERI. Right.

Mr. BARTHOLD. And it is an extra tax. We have noted on the panel the double taxation.

So, if you were to make, by whatever criteria, entities that are currently pass-through entities subject to a second level of tax, and the tax were just on the return-to-equity owners, it would increase the relative burden on equity returns, and so would favor debt financing by those entities, just as we argued is the case for a C-corporation.

Mr. TIBERI. That is exactly my question. Ms. Olson?

Ms. OLSON. Yes. I agree with that, and I think it would be better to move in the opposite direction of integrating the corporate system with the individual system, rather than to push pass-throughs into the corporate system.

Mr. TIBERI. Thank you.

Mr. FLEISCHER. So I do want to note there are distortions from debt versus equity in the pass-through context. In a lot of partnerships they are very flexible vehicles, from a structuring perspective. And the interest deductions that you can generate by financing

with debt, those deductions can be moved around to a large extent to one partner or another, depending on which partner has the higher tax rate. So it doesn't always match up with the underlying economics.

So, you know, my preference here would be to move towards a system where pass-throughs and—where—I should say what are currently pass-throughs and what are currently C-corps are treated the same. I think doing that, it removes the penalty of operating in C-corp form, which, from an economic perspective, doesn't make much sense to me.

Mr. TIBERI. All right, thanks.

Chairman CAMP. Thank you. Thank you, Mr. Tiberi.

Mr. TIBERI. Thank you.

Chairman CAMP. Mr. Thompson is recognized for three minutes.

Mr. THOMPSON. Thank you, Mr. Chairman. Thanks for holding the hearing. And thanks to all of you for being here.

There has been—a number of you have mentioned that—the need to do the tax reform, and the whole idea of lowering the rate and broadening the base, which, I assume, suggests that you believe we should pay for any tax reform that we do. It should be revenue neutral, is that a good assumption? Start with Ms. Olson.

Ms. OLSON. I think it is important for the country to size its budget so that there is a better match-up between revenues and spending. But I think that we have made an awful lot of decisions throughout our recent history on the basis of our revenue constraints, and that has led to some bad policy.

Mr. FLEISCHER. So—

Mr. THOMPSON. Revenue-neutral tax reform?

Mr. FLEISCHER. Yes, revenue-neutral is—

Mr. THOMPSON. If we—because of the time, if you could, just tell me if revenue-neutral tax reform is the way we should be going.

Mr. FLEISCHER. I think it is the right starting point.

Mr. THOMPSON. Thank you. The rest of you?

Mr. DESAI. Yes. Yes.

Mr. JOHNSON. I think that is a minimum, Mr. Thompson, revenue neutrality. However, if you were taking on broader tax reform, including a switch away from an income tax towards a VAT-type system, then you have the option of being either revenue neutral, or raising significant revenue in a way that is not distorting, and doesn't hurt savings, doesn't hurt investment.

Mr. THOMPSON. Thank you. I just want to point out that on lowering the rate and broadening the base on the corporate stuff, if you do away with all the tax expenditures, it only gets you to about 28 percent, not the 25.

Ms. Olson, what I have been hearing most about here recently—and it deals with this debt ceiling debate, and I am hearing from people all over my district. Yesterday, 100-percent Vietnam—a disabled Vietnam veteran who says if he doesn't get his Social Security check he is living in his car. Farm credit folks were in yesterday, and they finance everything from grapes to rice to pears to walnuts in my district. And they tell me that it is going to be devastating for agriculture, and that we—it will take years, decades, to recover from the loss of not doing the debt ceiling.

Can you tell us how and what the priority would be for paying our debts, if we don't pass the debt ceiling?

Ms. OLSON. I am afraid that that is not within my area of expertise.

Mr. THOMPSON. So it would be—from your experience at Treasury?

Ms. OLSON. No, my experience at Treasury was all on the tax collection side, as opposed to paying out.

Mr. THOMPSON. Okay, thank you. Can anyone tell us what the fiscal impact would be if the debt ceiling is not raised? How many years would it take for us to recover from the hit, even if it is just a few days or a week or a month without raising the debt ceiling? I understand that this is a fiscal consequence that will haunt us forever. Mr. Johnson?

Mr. JOHNSON. Mr. Thompson, we don't know, exactly. We have never done it. We shouldn't do it. I hope we don't do it. It would be very bad for the economy, particularly at this point in time, for all the reasons that you have enumerated.

Chairman CAMP. All right. Thank you very much. Dr. Boustany is recognized. And because of the discrepancy in the number of Members, I will be recognizing two Republicans for one Democrat at this point. So, Dr. Boustany?

Dr. BOUSTANY. Thank you, Mr. Chairman. Let me first express my support for moving forward with fundamental tax reform, rather than trying to do this piecemeal with tax policy changes, because of the distortions that we will create if we try to do that.

Ms. Olson, in your testimony you mention the adjustments to the deductibility of interest expense would need to be considered in connection with any further moves toward expensing capital investments. And clearly, in recent years we have seen a number of efforts and laws enacted to spur economic activity by increasing accelerated depreciation provisions and moving toward more generous expensing for certain types of assets.

And at the same time, we have interest remaining as a deductible expense. So talk a little bit about the distortions that could be created. Could we, in effect, see negative effective tax rates and other types of distortions? I would like all of you to comment on that. Thank you.

Ms. OLSON. Yes. The short answer to your question is yes, we would see negative tax rates. You know, I think it is sort of one thing to do it on a temporary basis, where you are trying to spur some investment, accelerate some investment. It probably doesn't have the same impact. But certainly, if you are going to do expensing on a long-term basis as part of fundamental tax reform, then you do need to look at interest expense.

Mr. FLEISCHER. I agree. Any time that you are allowing borrowing to invest in an investment that is going to throw off tax-exempt income, you have created an opportunity and an incentive to engage in tax arbitrage. And as I said in my testimony, tax lawyers are very clever. And once they spot these opportunities, they are going to try and design structures to take the fullest advantage.

Mr. DESAI. I would echo what has been said. It is exactly the reason why one should move not towards incremental efforts, but

to think about this in a systematic way, precisely so we avoid these kinds of situations, where you can easily end up with negative effective tax rates.

Mr. JOHNSON. I agree also.

Dr. BOUSTANY. Thank you. I yield back, Mr. Chairman.

Chairman CAMP. Mr. Buchanan is recognized.

Mr. BUCHANAN. Thank you, Mr. Chairman, for the opportunity today. And I want to thank all the panelists, as well.

Let me just ask you. We are talking about the debt ceiling, getting people back to work. In the environment we find ourselves in today, do you think that raising taxes on individuals or small businesses makes sense, in terms of what is going on today? Do any of you feel that that makes some sense as a policy decision, here in Washington? Ms. Olson, I will start with you.

Ms. OLSON. Well, certainly on a near-term basis, I think we need to be very careful with anything we do that would raise taxes. I think one of the most important things we can do for the country is to get things set so that, for the long term, we know where we are going to stand. Because I think what we learned in 2001 was that it was the permanent changes that had the most impact.

Mr. BUCHANAN. Yes. Mr. Desai, because I'm short on time.

Mr. DESAI. Just briefly, I—

Mr. BUCHANAN. I am talking about individuals and small businesses. Does it make any sense in the near future to raise taxes on individuals or small businesses?

Mr. DESAI. To the degree that we want to take a shot at actually fixing our structural problems, then we are going to have to raise taxes on someone.

Mr. BUCHANAN. Okay.

Mr. DESAI. At some point. Clearly, there are short-run consequences of doing it right now.

Mr. BUCHANAN. Now, let me go to the other issue that we are talking about, debt and equity. And I have had the good fortune to have been in business for 30 years, and have been involved in a lot of leverage transactions.

But you look at the 1980s, what happened? I remember the "predators balls"—that happened with Milken and all those in the 1980s, and we ended up—in 1990, 1991—with S&L bank crises. Now we move forward, we find ourselves in this scenario, of having a lot of leverage.

But at the end of the day, what I find, if you don't have viable financial institutions, is that you put everything at risk. And what is happening—at least in Florida; I am sure around the country is that a lot of these banks that are leveraged 10 to 1, because they have been taking such a hit to their equity, they have had to shrink all the banks.

So, not only do you affect the companies that are trying to create jobs, but you affect a lot of good companies, where they come in, they scoop all their equity. And that is why it is so critical, in my experience, that you have sound financial institutions. And if you go back 100 years, we get in this trap every 10 or 15 years.

So, Mr. Johnson, do you agree that we have to take a look at the viability, long-term, of financial institutions, as it relates to small

businesses especially? It is nice to talk about equity, but it is hard to get equity for small business. And those are job creators.

Mr. JOHNSON. Absolutely, Mr. Buchanan. If you go back to when we had a real free market system around finance in this country, more than 100 years ago, before deposit insurance, before the Federal Reserve was created, banks at that time routinely had 30 percent equity. No risk adjustment in that calculation. Thirty percent equity, relative to their total assets. And they had big buffers against losses. And when you had a downturn, they didn't have to cancel all their other loans, all their good loans. They didn't squeeze out the small businesses.

We cannot go back to a system without deposit insurance, unfortunately. We have to recognize that regulation has encouraged and allowed banks to have too little capital for too long. If we are going to have big shocks in our economy, going forward, you need to be discouraging debt and encouraging equity in the heart of the financial—including big banks and small community banks.

Chairman CAMP. Thank you, Mr. Buchanan. Mr. Larsen is recognized for three minutes.

Mr. LARSEN. Thank you, Chairman Camp and Chairman Baucus, for being a part of this historic hearing. And this comes at a historic time for the nation.

I would like to know the opinion—we have received letters from more than 400 CEOs about the pending potential of default on the—our—the nation's debt. The CEOs, in their letter, outline—they say that even a technical—technical—default in this case would have catastrophic events. In 1979 this happened, even under the well intentions of Congress. It was late, resulting in interest rates that plagued the country for the next 10 years.

Given what is happening around the globe as we speak, what—Moody's downgrading of Ireland again today—what is your advice to the Congress in terms of acting, given the deadlines that Treasury Secretary Geithner has outlined?

Mr. JOHNSON. My advice, sir, would be simple, the same advice as Christine Legarde, the new director of the IMF, has given to the United States, which is you need to extend the debt ceiling. You cannot play games with something this serious. World financial markets are much more fragile than you might like to believe.

Mr. LARSEN. Mr. Desai?

Mr. DESAI. I would echo that. I think what is worth considering is exactly why. And one piece of that is the technical default, which is, you know, people may stop receiving their payments, which is extremely problematic.

But it can also become a broader manifestation of a system that appears broken to the rest of the world. And that is where we run into really significant problems. So, I am less—you know, have less of a position on exactly how we fix that, but I think it is very important that this particular deadline is not ignored, and taken—

Mr. LARSEN. With regard to the deadline, if I might just follow up quickly here, before the others respond, is this not the equivalent of knowing about Lehman Brothers? With all the other nations that we see in jeopardy, and knowing what we know, isn't it essential that we act now?

Mr. DESAI. It is essential that we act now. I would caution us to use parallels to private sector actors, only because the government is very special. And—

Mr. LARSEN. Point well taken.

Mr. DESAI. And—but I take your point that it is a very serious issue.

Mr. JOHNSON. I would use the Lehman example. Frankly, the situation in Europe right now is very bad. It is getting worse. The eurozone does not have control over the situation in Italy, in Spain, much more broadly. It is absolutely essential that the United States remain a beacon of safety and clarity to international investors. Otherwise, there will be consequences for all of us around the world.

Mr. LARSEN. Would you say what is at stake is the United States's reputation as a governing entity, both globally and domestically?

Mr. JOHNSON. Yes.

Chairman CAMP. Thank you very much. Mr. Smith is recognized.

Mr. SMITH. Thank you, Chairman Camp, Chairman Baucus, for holding this hearing today. We have heard a little bit about home mortgages and home ownership being a priority in our society, and certainly in the tax code. Could you, starting with Mr. Fleischer, reflect on the effectiveness of the mortgage interest deduction? How effective has that been, and are there any alternatives that you might propose?

Mr. FLEISCHER. Well, I think it has had an impact in putting more people into houses. And, from that perspective, that is good. But if you were to take a step back, and try and think about designing housing policy, it is hard to conceive that using an interest deduction, a mortgage interest deduction, would be the right way to accomplish that goal, particularly one that is not capped at a certain number.

So, for example, allowing it at all on second homes or on super-expensive homes doesn't make a whole lot of sense to me, if the goal is to get lower-class and middle-class people into houses.

Mr. SMITH. And would you propose an alternative in our public policy, in terms of encouraging home ownership?

Mr. FLEISCHER. Sure. I mean I think in the short run, limiting the mortgage interest deduction would be beneficial in the short run. In terms of what the other policy goals are, I guess I am not quite sure what you are getting at.

I think we do have a lot of people in houses, probably more than we need to, in fact. There are people that do move around a lot, and would benefit from some sort of equivalent subsidy to renters.

Mr. SMITH. Okay. Mr. Desai?

Mr. DESAI. You know, so briefly I would just say that there is a bit of a puzzle which is, given how large this preference is, it has not been easy to find evidence of its effects on behavior. So it is a very large preference.

And then, the question we have to ask—is maybe we like it, and we have to ask why we like it. And I can think of three reasons we like it. You know, one is we like it because home ownership is good. It creates good citizens, it creates good people. And that is

just what we believe. The second is that we believe the construction sector is very important. And we think that, in a cyclical recovery, it is potentially something that you want spur. And finally, maybe you think that it is just a vehicle for savings, and you want to preference it that way.

I think it is important to kind of nail down which of those we really believe. We have had very high levels of home ownership. And it is not clear that more home ownership is good. We should understand that there are chunks of the population for which renting is a really good thing to do.

Mr. SMITH. Okay. Mr. Johnson?

Mr. JOHNSON. We are not directly encouraging home ownership. We are encouraging leverage as part of home ownership. So we are encouraging households to take on these very large debt burdens. And there are absolutely other ways to encourage home—if you want to do it revenue-neutral, we could reduce the mortgage interest deduction and find other ways to encourage people to buy first homes, for example, if that is what you wanted to do, if the goal was home ownership.

I think you should be very clear. We encourage households to take on and believe in an enormous amount of leverage. And I think, frankly, many of them didn't understand the risks, the downside risks, that they now see in many parts of the country.

Mr. SMITH. Okay, thank you. I yield back.

Chairman BAUCUS. I will now recognize Senator Carper.

Senator CARPER. Hi, everybody. Up here, on the right.

Chairman BAUCUS. I see you down there.

Senator CARPER. Pretty big room, isn't it? This is bigger than the Senate, I think. Glad I found it. It is nice to be here with the chairman of the Ways and Means Committee. How are things in Detroit? Those Tigers are in first place in the American League Central, as we go to the all-star break. That was good to see, and to see another guy from Michigan, Carl Edwards's big brother. Sandy, nice to—very nice to be with you.

To our witnesses, thanks very much for joining us in what is really a unique setting. And it is kind of fun to do this.

One of the main reasons that tax reform has again become necessary is the proliferation of new tax breaks that we add to the tax code, it seems like, every year, as well as some of the increased use of the existing tax expenditures by taxpayers. I am told if you add up the cost of these tax expenditures, the total comes over the next 10 years to something like $15 trillion over the next decade. It is more than the Federal Government will spend on Social Security or, I believe, on national defense. No small amount of money.

Some of these tax incentives are for individuals. Some are for corporations. And some are pretty good policy. Others, less so. Many—I guess it probably just depends on where you sit, as to whether or not they make good policy sense. But many tax preferences are inefficiently designed. Some lose more revenue than is necessary and don't deliver benefits to the taxpayers who, arguably, need them the most.

And with those thoughts in mind, tax treatment of debt versus equity is certainly something that needs to be examined and, I think, closely. One of the keys to tax reform in 1986, when I served

in the House with some of these fellows here—including this fellow from Massachusetts, to my right—one of the keys to reforms that we adopted in 1986 was that Congress, working with the Reagan administration, partially cleaned up at least some of the tax preferences, in exchange for lower rates.

I would just like to ask each of our witnesses to take a couple of seconds and directly and frankly tell our committees which one policy change—one policy change—would do more than any other that you can think of to reduce the bias in favor of debt in the current tax code.

Let me say that again. Just take a couple of seconds and just tell our committees which one policy change do you think would do more than anything else you can think of to reduce the bias in favor of debt in our current tax code. Thanks.

Ms. OLSON. Greater integration of the corporate and individual tax systems.

Senator CARPER. Say that one more time.

Ms. OLSON. Greater integration of the corporation and individual tax systems.

Senator CARPER. All right. Thank you.

Mr. FLEISCHER. I agree. I think equalizing the treatment of debt and equity.

But I will take just a second to add that, you know, 1986 is kind of like the Holy Grail in the tax academy. It was an amazing achievement that broadened the base and lowered the rates. And one of the keys to that was sort of not focusing only on one thing at a time, but focusing on the system as a whole, and tackling a lot of different tax expenditures at the same time. I think that that was part of the magic of that reform.

Senator CARPER. All right, thank you.

Mr. DESAI. One version of the integration proposal would be the comprehensive business income tax, which—

Senator CARPER. I am sorry, were you saying—

Mr. DESAI. One version of the integration effort would be the comprehensive business income tax, and I think that is a very worthwhile way to go.

Senator CARPER. All right, thank you.

Mr. JOHNSON. I suggest that you tax excessive leverage in the financial sector, and use the proceeds of that to introduce some deductibility for dividends, therefore equalizing the treatment of debt and equity.

Senator CARPER. All right. That is an interesting idea. Thank you. Anybody else?

[No response.]

Senator CARPER. All right. Do—is my time expired? Let me just ask our chairs.

Chairman CAMP. It has.

Senator CARPER. Yes? Okay. Well, it was great. It was great while it lasted.

[Laughter.]

Senator CARPER. And it was great to see all of you. Thank you for those simple, direct answers.

Chairman CAMP. Thank you very much, Senator Carper. Ms. Jenkins is recognized.

Ms. JENKINS. Thank you, Mr. Chairman, and thank you for holding this hearing. Thank you all for being here.

In general, since 1945, household debt has steadily increased. There has been some decrease in the combined mortgage and consumer debt for households. But the total combined debt for 2010 is approximately 120 percent of disposable income. In particular, debt has rapidly increased since tax reform back in 1986, which eliminated the deduction for interest on personal credit.

So, my questions for the panel are, is this level of debt sustainable? Why has household debt increased when no deduction is available for interest on personal credit? And what is the appropriate private debt ratio for households, and how long do you think it will take for us to achieve that? Tom, do you want to start?

Mr. BARTHOLD. Well, thank you, Ms. Jenkins. You recited the statistics that we provided to the Members, which I think is—a first point shows that there is not an obvious link between our tax policy related to household debt and what has been going on in the household market.

Also, though, do remember that it is a reasonable and sound economic matter for households to incur debt. It can be a matter of when you are young and you are starting out, you purchase a home. So you carry a large debt load, which you gradually pay down, as you pay down the mortgage. You may borrow to purchase automobiles or to furnish the home or to buy other durable goods. It is part of what—you know, we use the jargon in the pamphlet that the economists like, of the life cycle theory of consumption.

So, what that doesn't answer is why has the overall debt load on households increased. And I don't have a good take on that. I will defer to my other panelists.

Ms. JENKINS. Ms. Olson?

Ms. OLSON. I think I should defer to the economists down at the end of the—

Ms. JENKINS. Okay.

Mr. FLEISCHER. I will just add one factor to the mix here, which is that—which is the housing bubble. So, as real estate prices were going up, people were able to increase household debt with larger and larger mortgages to finance current consumption. I think with the housing bubble burst, I think we are observing people de-leveraging in significant ways.

Ms. JENKINS. Okay. Mr. Desai?

Mr. DESAI. Well, two things. You know, the first is I think you are right to put your finger on what is a long-term process of leverage, and what is going to be a long-term process of de-leverage, as we move forward. The reasons for it can be cultural, and they can be economic.

And I think one thing to highlight here, of course, in the context of the tax code, is the absence of a consumption tax, or a value-added tax, or the—alternatively, the presence of an income tax which disfavors saving is a piece of that puzzle. How much of it is, it is hard to say. But certainly, if we think about the things that are within our domain and our ability to control, it is yet another reason to really think hard about whether the income tax we have now is the right one.

Chairman CAMP. Thank you. Mr. Marchant is recognized.

Mr. MARCHANT. Thank you, Mr. Chairman. Is it fair to say that the main takeaway from this hearing could be that a way to bring the equity and debt issue into focus is to devalue the value of the debt deduction in the code by simplifying the code and lowering the rate, and making that debt deduction less valuable?

Also, Mr.—I don't know if Mr. Fleischer or Desai—but I think one of you said that there were some hybrid debt instruments that were distorting the system. Could you identify what those hybrid debt instruments are?

Mr. FLEISCHER. Sure. On the first question, the goal is neutrality between debt and equity, broadly speaking. And so you can either do that by limiting interest deductibility, or what you called lowering the value of that interest deduction, or you could do it by allowing a deduction for corporate equity. So, looking at the amount of equity that a firm has, and allowing them an imputed deduction. Either of those approaches would achieve tax neutrality.

So, some of the hybrid instruments, I am thinking of things—they all have trade names that the investment banks come up with, but I am thinking of things like—Feline Prides was one of the first, and these are instruments that are part debt and part equity. And what they do is they get the—on the balance sheet, or for bank regulatory purposes, they look like they are equity, but they are deductible. So at one time these were referred to on Wall Street as tax-deductible preferred stock.

But, of course, it is not preferred stock. There are ongoing obligations that the banks have to make to pay to the people who buy these securities. And so, in the financial crisis, those—they cannot skip those payments, like you could with—on stock. So that added to the crisis.

Mr. MARCHANT. Could you limit the tax preference on those specific instruments without—or would that just—

Mr. FLEISCHER. Well, it is hard, because all you are doing, then, is kind of moving the line. So there—you can move the line a little bit, but you are going to see a lot of activity, then that just shifts to wherever you have moved the line. Again, tax neutrality would be the better solution.

Mr. MARCHANT. Okay.

Mr. FLEISCHER. And, failing that, a tax on excess leverage that reduces the value of the interest deduction, I think, would be a very good short-term solution.

Mr. MARCHANT. Okay. Mr. Desai?

Mr. DESAI. I would just underscore Vic's point about the futility of line-drawing in the context of managers and financial engineers, who can capitalize on that kind of line drawing.

Mr. MARCHANT. Okay.

Chairman CAMP. All right, thank you. Mr. Becerra is recognized.

Mr. BECERRA. Thank you all for your testimony. And in the three minutes that I have, let me see if I can focus a bit.

I know we have been talking quite a bit about the treatment of debt and equity for corporations, how we move forward with the tax code that tries to reform our system of taxation, and make us more competitive. But I think most eyes that are focused on the

Congress today, and on Washington, D.C., are still worried about the debt issues that confront us right now.

Mr. Barthold, perhaps you can give me an answer to this question. Does increasing the debt ceiling have anything to do with reducing future spending by the Federal Government?

Mr. BARTHOLD. Well, Mr. Becerra, I am not an expert on the overall fiscal position of the United States. The members of Congress vote on outlays and vote on revenues.

Mr. BECERRA. But in terms of future spending, spending next year, spending in 10 years, if we vote in Congress to increase the debt ceiling limit today, or before August the 2nd, does that have anything to do with what we will spend directly in 2020?

Mr. BARTHOLD. Well, sir, as a simple statutory matter, the two issues are separate.

Mr. BECERRA. Okay. And I know you have had a chance to speak a bit about this, and I know with the short amount of time—let me ask Mr. Johnson a question.

Should revenues be part of the debt limit discussion, as we start to discuss how we move forward in dealing with our deficits and our national debt? If you want to have an approach that resolves this issue of our national debt, should revenues be part of that conversation?

Mr. JOHNSON. In any situation where a fiscal adjustment is required, such as in the United States today, I would suggest that you look at both revenue and expenditures. So, yes, I would definitely include revenues in the discussion.

Mr. BECERRA. And if we are able to resolve these large deficits and this large national debt in a way that is comprehensive, long-term, does that help the private sector, our companies that are trying to do business both here, domestically, or abroad?

Mr. JOHNSON. Of course. The best thing you could do for the economic recovery at this point is to have a medium-term fiscal framework that is completely credible, people understand that the debt is on a sustainable trajectory. That will bring down long-term interest rates. That will encourage investment. That will boost job growth.

Mr. BECERRA. In the alternative, if we take the country to the brink and say August the 2nd we don't have any solution or resolution to the debt ceiling issue, what happens in the eyes of the business community?

Mr. JOHNSON. We don't know what happens, but we don't want to find out. Other countries that have tried to play these kinds of games with the financial markets usually end up being burned. The limited experience we had in the 1970s with the so-called technical default was it had an impact on base interest rates for a prolonged period of time. Why would you want to take that risk?

Chairman CAMP. Thank you. Mr. Berg is recognized.

Mr. BERG. Mr. Chairman, thank you. You know, obviously, I have been sitting here listening to a lot of analogies. One of the analogies is between personal household debt and the Federal Government debt.

And to me, maybe I look at it too simplistically. I think there is an analogy. People loaded up on residential debt because they need money. Inflation was driving values up, and people were able to

make that leveraged investment and get a higher return. I think our U.S. debt has soared out of control because it has been too easy to simply borrow the money and not make some of the difficult decisions that need to be made.

I truly think that if we don't take this issue seriously, and we don't look long-term and have a serious discussion about how to rebalance and get our country back on track, I think the private sector and financial markets will say, "Hey, Washington still does not get it. They are just going along."

You know, the fundamental question that we have got here, I think is, what is the impact of interest deductions? And, obviously, as we looked at this trend over the last 20-plus years, it hasn't had that big an impact. Although, in my sense of things, it is changing business decisions.

So, I have two questions. One question, are we clear that the deduction on interest is really not the right incentive, as we move forward? And if it were a revenue-neutral situation, what would you do with those tax dollars in another way? Would you just reduce, for example, the corporate rate? Would you eliminate the interest deduction and focus on the corporate rate? Or, what would you do with those dollars?

So—you look deep in thought, Tom, so we should start with you.

Mr. BARTHOLD. Well, I think you have asked the broad question of how to undertake major tax reform. I mean you could undertake a tax reform, and maintain deductibility of interest. You could undertake tax reform. You could create new preferences for equity. You could, as Ms. Olson has suggested, and Mihir Desai, integrate corporate tax with the individual tax, and change overall incentives. But that is—I mean, I assume that is part of the purpose of this hearing.

Mr. BERG. Well, maybe I asked too many questions. The first question is, should we keep the interest deduction, in your opinion on this panel?

And if we didn't have an interest deduction, would you be here advocating that we put one in?

Mr. BARTHOLD. Well, you know, sir, that I don't advocate before the committees, I work for the committees. So I will defer to my colleagues on the panel.

Ms. OLSON. There are certainly good arguments for limiting the interest deduction. But you can't, in my view, limit the interest deductions without taking into account a lot of ripple effects. I think that the interest deduction affects financing decisions. I don't think it dictates them. I think we make a mistake any time we think that the tax rules are the things that ultimately decide what people do. They have an impact on them.

And if we are going to limit interest deductions, then we have got to do it on a comprehensive basis. We ought to take a comprehensive look, and we have got to think about transition. Things like the comprehensive business income tax set up a system that is more like the treatment of equity. So you wouldn't have a deduction for interest on the business side, but on the recipient side, it wouldn't be taxable income. So you shift things around, much along the lines of the way consumption taxes operate.

Chairman CAMP. All right, thank you. Mr. Kind is recognized.

Mr. KIND. Thank you, Mr. Chairman. I want to thank our panelists today, an excellent panel. And, Mr. Chairman, I want to thank you and Chairman Baucus for this format. I think this is very helpful. I think it makes sense for us to, hopefully in the future, have more joint hearings like this, so that we can better coordinate the action in the House and the Senate, especially over something as important and crucial as comprehensive tax reform.

Mr. Johnson, let me start with you. I mean you have been an advocate for some time about taxing excessive leverage right now. But you had admitted earlier in your testimony in the Lehman case, and coming out of the financial crisis, that it was often difficult to be able to identify what excessive leverage looked like at the time.

Have we made improvements, in regards to—with the passage of Dodd-Frank or other steps coming out of the financial crisis—of having a better ability of identifying excessive leverage when it existed, as opposed to a retrospective look-back, and then identifying it?

Mr. JOHNSON. It was Mr. Desai who made the point about Lehman's leverage.

Look, the New York Fed and the SEC were living at Lehman for the last six months. I think they knew what the leverage was, and I am sure they could have told you what the excessive leverage was, if that was the framework. But, more broadly, taking on the—I think the spirit of your question, which is do we understand the risks that arise from this kind of leverage, do we know the damage that can be done, do we know who will be impacted, all the small businesses and small community banks will be devastated next time there is a big problem.

Or, if Italy were to run into serious debt problems today, no, we don't know. The Financial Stability Oversight Council, which was created for this purpose, as far as we can see from the outside, does not have a determination on this in any precise manner. These risks are huge, and they impact the rest of the economy. And they come directly and immediately from excessive leverage, particularly in our biggest financial institutions.

Mr. KIND. Well, let me ask the rest of the panel, maybe starting with you, Ms. Olson, that, obviously, there are capital structures that are in place right now, based on the current tax code as it exists. And we really haven't gotten into the transition period that we should be considering, when making these type of changes. But what type of time period do you think we should realistically be looking at, as far as a transition pace of tax reform?

Ms. OLSON. Well, that will be determined, at least in part, by the kind of change that you make, and how—whether it is very incremental, or whether it is much more comprehensive.

But even incremental change, I think, needs some transition period of, say, 5 years, 10 years—

Mr. KIND. Well, just the issue that we have been dealing with mainly today on debt, and the incentives for increased debt in the tax code today.

Ms. OLSON. Again, I think it would depend on how radical you want to be in making changes. If the changes are incremental, then

they could be phased in more quickly. But if they are more radical changes, then you would need a very long period of time to adjust.

Mr. KIND. Mr. Fleischer, you have an opinion?

Mr. FLEISCHER. I want to go back to the point on excessive leverage.

Mr. KIND. All right.

Mr. FLEISCHER. It is very difficult to determine even how much leverage there is, especially once you start thinking about the embedded leverage in derivatives, and the use of off-balance-sheet entities.

But the point that I would make is you don't have to get it exactly right to make things better. Right now, the tax system is tilted in the wrong direction. And so, any move towards neutrality is likely to make things much better, rather than worse.

Mr. KIND. Sure. Mr. Desai?

Chairman CAMP. Quickly, please.

Mr. DESAI. Again, I would echo Pam's comments, that the scope of the transition has to mirror the scope of the change. So you can imagine a narrow change that—which I would not support—but which could be done quickly, or you can imagine a broader change, which has to embrace the—

Chairman CAMP. thank you.

Mr. KIND. Thank you.

Chairman CAMP. Mr. Reed is recognized.

Mr. REED. Thank you very much, Mr. Chairman. I guess I am the newest member to the committee, so I get the last question.

I have really enjoyed the testimony—and I find it very informative—from the panel today. And I do want to focus on just a very limited area, if we could.

One thing I hear, as I go through my district, from a lot of younger folks is that the college tuition that they are facing—and the loan and the debt associated with that tuition burden—is going through the roof.

I would be interested in anyone from the panel offering their insight as to whether the subsidies that we provide through the tax code with the student loan deduction, what impact, if any, do you see them having in regards to tuition growth that has clearly been demonstrated over the past few years?

Mr. JOHNSON. I think you are raising a very important issue, Mr. Reed, and one that doesn't get enough attention. Obviously, the issue is what kind of education are you getting for the money that you are paying, and questions are increasingly being raised about some parts of the education sector.

And there are rules in place, as you know. If a sufficiently high proportion of graduates default on a loan, then that institution is no longer able to get these kinds of loans for its applicants. But these rules seem not to be particularly effective right now.

And perhaps we should consider, on a revenue-neutral basis, shifting away from this loan structure towards an alternative way of financing. For example, through using some form of grants that are based on—also on assessing people's means to pay for themselves.

Mr. REED. Any other comments from any of the panelist? Because I am really interested in seeing is the tax code itself, by al-

lowing the deduction for student loan interest, encouraging higher tuition costs because of the inflationary impact of that policy? Does anyone have any counterpoints, or any other information on that?

Mr. BARTHOLD. Mr. Reed, some people have raised that possibility, that the incidence—some of the benefit of the numerous provisions that we have enacted to benefit education may redound to the providers of education. But the economic evidence to this point couldn't be described as anything more than mixed.

Mr. REED. Okay.

Mr. DESAI. I would just echo that, and not just because I am in the higher education business. But it has been very difficult to find this out. And, in part, it has to do with the fact that pricing in higher education is a very curious practice. And part of what we have seen is increased list prices, and then lots of discounting with fellowships. So there is a whole market structure there, which is complicated.

I just want to echo Simon's point, though. A big part of this concern may be about the heterogeneity in the educational sector today, which didn't exist 20 years ago, where you have various different providers providing different kinds of quality. And that is worth looking at.

Mr. REED. Thank you. My time has expired.

Chairman CAMP. Thank you. Mr. Crowley is recognized.

Mr. CROWLEY. Timing is everything. I am the last man on the totem pole. But thank you, Mr. Chairman. I appreciate you holding this hearing, this historic joint hearing between the House and the Senate on a very important issue of debt in the tax code.

More pressingly, I think, as has been expressed by many of my colleagues, we should be talking about the overall issue of debt.

In three weeks, the U.S. will hit the so-called debt limit, which is like maxing out on a credit card. But while an individual with a credit card can stop paying—making future payments with the card once they hit their limit, the same can't be said for the U.S. Government.

The spending debt will be financed by debt limit increase—paying for past obligations, not future spending. For example, we just can't stop paying out Social Security. We just can't stop paying out veterans compensation and pensions. We just can't stop paying out military pay and benefits to our troops at war.

But if we do not increase the debt limit, that is exactly what will happen. Funds that were promised—and, in terms of Social Security, funds that were [sic] even the government's money, but the people's own money—will not be paid, because we won't have the funds to do so. Could you imagine if Social Security checks bounced? It is a real possibility, if Congress continues to play games on the budget, and if they continue, as the Senate Republican leader said yesterday, refuse to work with President Obama on the pressing problems of this country.

The number one job of this Congress should be to create jobs and get our fiscal house in order, not to play politics and bow to special interest groups. That is why I salute President Obama for continually extending his hand in cooperation and negotiation to work with Congress to ensure we can meet our obligations of paying out

Social Security on August 3rd, while also working for long-term debt reduction for our children and our great-grandchildren.

But any debt reduction plan will require a shared sacrifice. Seniors on Social Security, veterans who rely on their VA pensions, and the troops in battle should not have to lose their rightful benefits, while others do not meet that same sacrifice. And I will oppose a plan that does not involve shared sacrifice, but makes seniors and veterans and military families pay the bills created after a decade of fiscal irresponsibility.

It is amazing that we have people in this room who supported trillions in tax cuts and two unpaid-for wars, but now say it is up to veterans and the seniors and the troops to sacrifice a bit more so millionaires don't have to. This President is trying to work out returning our country to a policy of fiscal discipline last seen when President Bill Clinton was in the office, while ensuring we promote economic growth and stability. And I urge all of us to focus on this critical mission, and to stop playing politics and the blame game.

And with that, I yield back the balance of my time, Mr. Chairman.

Chairman CAMP. All right. Mr. Paulsen is recognized for three minutes.

Mr. PAULSEN. Thank you, Mr. Chairman. And I also want to compliment you for holding the hearing with the Senate, and for laying the foundation for what we heard from some of our colleagues and Senator Wyden, in particular, about this being an important foundation for tax reform for economic growth. And I think we have heard from our panelists the negative implications of the preference for debt financing, and ideas for equalizing the treatment between debt and equity.

And I guess I just want to go back to the design of what the tax system should look like—what the tax code should look like, what tax reform should look like—if we are going to promote economic growth, if we are going to promote jobs. I mean that should be our number one goal here, I think. Because, obviously, issues like spending and debt are a big issue. But we have to increase economic growth.

When you only have 18,000 jobs coming out in the last jobs report, that is pretty embarrassing. It is embarrassing, when you think we have got more college graduates probably in Minnesota than we have jobs coming out nationally.

So, knowing that that's the case, we want a tax code that is going to promote work, savings, and investment. What should be the focus on that, in the context of debt and equity? Ms. Olson?

Ms. OLSON. Well, I think there is a lot of economic literature that supports the notion of moving in the direction of a consumption tax. And there are lots of ways to get there. Something like a comprehensive business income tax would be one thing that Congress might look at to move in that direction.

Mr. PAULSEN. Yes. Mr. Fleischer, anything to add?

Mr. FLEISCHER. I largely agree with that. I mean I think the basic principles of what we are aiming for I think a lot of us agree on, that broad-based lower rates are the place to start. And to try and reduce the distortions in the code that lead not only to a reduction in tax revenue, but an incentive to engage in wasteful tax

planning, that from a long-term, economic perspective, it is not encouraging long-term growth.

Right. And we have had a lot of, I think, comments from the panelists about lowering the rate, broadening the base. And in the context of helping small businesses, too, please share if there is any thoughts on that, because that is a driver of the economy, is the small business economy.

Mr. DESAI. Right, absolutely. And I think the remarkable thing, of course, is the level of consensus on what, you know, tabula rasa, if we started the world, what a good tax code would look like. And there is a remarkable level of consensus on that, which is some notion of a consumption tax base, coupled with progressivity that can be achieved in a variety of ways.

So, in some sense, that is not the hard part. The hard part is, you know, where you said—you know, I think sitting where we sit, I think there is wide consensus about what the code should look like. But getting there is the harder part.

Mr. PAULSEN. And, Mr. Johnson, before my time runs out?

Mr. JOHNSON. I think you should focus on moving towards a value-added tax system. And you can make that as progressive or as not progressive as you want, and you can generate the same revenue or less revenue or more revenue. There is a variety of VAT systems around the world.

The U.S. system, taxing income, is always going to get in the way of your goals. You want to promote work, savings, and investment. Well, anything that is primarily—or as much income tax-based in our system is not going to do that. And I think I would echo—or encourage you to look at the specific proposals put forward by my colleagues here, and look at other proposals—for example, that the IMF has available—in terms of how countries can move and transition smoothly to a VAT system.

Chairman CAMP. All right, thank you.

Mr. PAULSEN. Thank you, Mr. Chairman.

Chairman CAMP. I want to thank our panelists this morning, all of you, for being here and for participating in the hearing. I also want to thank Chairman Baucus and the Senate Finance Committee, as well as their staff, for making this joint hearing possible.

This hearing is now adjourned.

[Whereupon, at 11:23 a.m., the committees were adjourned.]

[Questions for the Record follow:]

RESPONSE TO QUESTIONS FOR THE RECORD FROM SENATE FINANCE COMMITTEE MEMBERS SUBMITTED BY CHAIRMAN BAUCUS FOR MR. THOMAS A. BARTHOLD CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Question from Senato Hatch:

1. **Although the debt levels of corporations have roughly stayed the same over the decades, we see that both household debt and government debt have gone up considerably in recent years. I'm interested in what the relationship, if any, is between household debt and government debt.**

   One way to think of government debt is that it is simply deferred taxes. High government debt today simply means high taxes tomorrow. Thus, assuming that households behave in a rational fashion, one might think that high government debt, such as we have had, would lead households to save more so as to pay for the high government taxes down the road. But, despite high levels of government debt, we don't see households in fact saving much -- to the contrary, they are going ever deeper into debt.

   Do you have some thoughts on that? Does it surprise you at all that simultaneously household debt and government debt would both go up significantly? Had the government not run the significant deficits that it has in recent years, do you think it likely that households would have saved even less – that is, would household debt have been even more?

Economists since David Ricardo in the early 19th century have pondered the question of whether changes in private saving could moderate or eliminate the differences in the macroeconomic effects of tax-financed vs. debt-financed government spending on output, employment, interest rates, and saving. The notion of the equivalence of debt-financed and tax-financed government spending is known as "Ricardian equivalence." In general, equivalent macroeconomic effects would result from government spending regardless of whether the spending is debt or tax-financed if individuals recognize a future tax obligation when the government finances new spending with debt, and then save more to cover that future tax obligation. For this equivalence to hold exactly, strict conditions must be met. In addition to individuals needing to perceive that government debt means future taxes, they must care about future generations that will pay the tax, they must be able to borrow and lend freely, and new distortions must not occur from taxes levied under the debt-financed regime compared to those under a tax-financed regime. Most economists agree that conditions do not hold for exact equivalence, but disagree to the extent to which the predictions of the theory hold approximately.

As the economics profession is not in agreement on the extent to which government borrowing is offset by private saving, it is not a surprise that growth in government debt and household debt have occurred simultaneously. This of course does not mean that no individuals have increased their saving in response to expectations of future tax increases resulting from

current debt financed spending. Indeed, the personal saving rate has risen sharply since 2007, though we cannot conclude that individuals increased their saving rates in expectation of future tax increases. Also, the fact that growth in household debt has occurred simultaneously with growth in government debt is not necessarily inconsistent with Ricardian equivalence if taxpayers' net worth or expected future income is growing sufficiently to provide the desired resources for future tax increases. Aggregate household net worth has continued to grow over the past decade, though at a slower pace than previously. Additionally, most of the recent increase in household debt has not been the result of consumer debt, but is rather mortgage debt. In incurring mortgage debt to purchase or improve a residence, the individual's increase in debt is matched by an increase in assets, resulting in no change to net worth at the time of purchase or improvement.

In answer to your final question, it is possible that if the government had not run significant deficits in recent years that household debt would have been larger. Much of the deficits financed stimulus in the form of individual tax reductions, increased unemployment insurance benefits, etc., thereby making it easier for taxpayers not to cut consumption during the recession. Had the stimulus not been provided, taxpayers might have incurred more debt to maintain their consumption.

Questions from Chairman Baucus:

1. **Current tax law generally provides an incentive for corporations to capitalize with debt rather than equity since corporations can deduct interest but cannot deduct dividends. This tax benefit may be offset somewhat by the lower tax rates on dividends and capital gains compared to interest income.**

   There has been considerable commentary suggesting that as part of tax reform, tax rates should be reduced and the base should be broadened. Others believe the current 15 percent tax rate on dividends and capital gains could be increased. Let me ask each of you:

   a) **What do you believe have been the effects of the current lower rate for dividends? Has it resulted in more equity financing and less debt financing by corporations?**

According to researchers, a relatively straightforward before-and-after comparison of publicly traded corporations (excluding financial and utility companies) shows three main effects of the dividend tax cut enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003.[1]

First, the fraction of publicly traded companies paying dividends increased from 20 percent at the end of 2002 to almost 25 percent at the beginning of 2004. This was the result of a

[1] Jeffrey Brown, Nellie Liang, and Scott Weisbenner, "Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut," *NBER Working Paper No. 11002* (2004). Raj Chetty and Emmanuel Saez, "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Cut," *Quarterly Journal of Economics* 120(3): 791-833 (2005). Brandon Julio and David Ikenberry, "Reappearing Dividends," *Journal of Applied Corporate Finance*, 16 (2005).

surge in dividend initiations immediately following the reform and reversed a two-decades long downward trend in the fraction of companies paying dividends. Second, dividend-paying firms were more likely to increase their regular dividend payments after the reform. Third, the number of one-time, nonrecurring ("special") dividend payments also increased. One study estimates that a ten percent cut in the marginal tax rate (3.5 percentage points) induces a five percent increase in dividend payments.[2]

An examination of the heterogeneity of this response across firms shows certain types of firms were more likely than others to increase dividend payments. After enactment of the tax cut, the increase in dividends was concentrated in firms where top executives held more shares and fewer unexercised stock options. This fact indicates the importance of top executives' self interest in shaping corporate responses to taxation. Dividend increases were also more prevalent in firms that had large independent shareholders on the board of directors.

Because corporations may distribute profits to shareholders via dividends or share repurchases, one important question concerning the effect of lower dividend tax rates on dividends is whether any increase in dividend payouts is accompanied by a decrease in share repurchases. In other words, it is not entirely clear to what extent the increase in dividends is simply a relabeling of repurchases as dividends. Though there is not clear consensus on this question, researchers find that total payouts, including both dividends and share repurchases, increased post-reform. This appears to suggest that not all of the post-reform dividend increases are due to substitution away from share repurchases.

Data show that overall corporate debt as a percentage of GNP both increased and decreased from year to year between 2003 and 2010.[3] Similarly, there is no clear upward or downward trend in the ratio of debt to equity over these years.[4] Based on these aggregated data, we can neither confirm nor rule out an effect of tax policy on corporate debt financing.

b) Are there some industries that you think are especially affected by the different tax treatment of debt and equity? How?

As noted in our pamphlet prepared for the hearing, returns to debt investment are generally deductible while returns to equity investment are not. This tax distinction is particularly important to C corporations because only such entities are taxed at the entity level. Industries dominated by C corporations might be especially affected by the different tax treatment of debt and equity.

For 2008, while C corporations reported 55.1 percent of business net income overall, the percentage of net income reported by C corporations varies by industry. The following

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[2] Raj Chetty and Emmanuel Saez (2005).

[3] Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011, p. 58.

[4] *Ibid*, p. 60.

industries tend to have more net income reported by C corporations than average: utilities, manufacturing, information and media, finance and insurance, and holding companies. These same industries also tend to have a higher percentage of interest expense reported by C corporations than is reported by C corporations for all industries.

c) Are there some industries that rely more or less on debt than is good for the economy? If so, how much does it relate to the tax code and is it a major problem?

It is not clear what the optimal mix of debt and equity in firms' capital structures is for the economy overall. Even in the absence of tax considerations, each firm typically wishes to obtain capital at the lowest cost, while investors seek the highest rate of return (and thus impose a higher cost of capital) adjusted for the risk of the enterprise. Firms and investors balance these competing incentives, as well as other costs and benefits of various capital structures (such as direct and indirect bankruptcy costs) to determine the optimal mix of debt and equity.

d) Do you believe that the existing tax advantage for the use of debt by corporations is a problem that should be addressed as part of tax reform? If so, how would you suggest we address this tax bias? How would your proposed solution impact revenues?

The JCT staff usually refrains from making policy recommendations. However, the tax treatment of debt and equity by corporations could be made more equivalent in various ways with various effects on revenues. Consider a couple of simple options. For example, dividends could be made deductible at the corporate level and taxable at full ordinary income rates at the individual level, as is the treatment of interest under present law. This would tend to reduce revenues. Alternatively, the tax treatment of dividends and interest could be made more equal by denying the deductibility of interest. This would tend to increase revenues. The revenue impact of any particular proposal depends on the specific details of the proposal.

2. The Tax Code does not provide a definition of debt or equity, but rather a determination is made on the facts and circumstances of the interest in the entity. The lack of a uniform definition allows taxpayers to essentially choose the most beneficial tax treatment by structuring their deals as loans or equity.

a) Do you think this is a problem?

b) If yes, should a uniform definition be part of the Tax Code or regulations? What other ways could we provide a uniform and certain definition so that similar economic outcomes are taxed in the same way?

It is true that in the absence of statutory or regulatory standards, a substantial body of Federal common law is the principal source of guidance taxpayers have for distinguishing debt and equity. Although the Federal courts have identified various factors to consider, it is not our understanding that variation in the factors considered in any particular case or circuit is a problem for the classification of instruments as debt or equity for Federal tax purposes.

Our report notes that different Federal courts have identified slightly different lists of factors to consider as part of a debt versus equity analysis.[5] Despite minor variations across cases and courts, Federal courts generally agree that the proper characterization of an instrument requires a facts and circumstances analysis, the primary goal of which is to determine whether, in both substance and form, an instrument represents risk capital entirely subject to the fortunes of the venture (equity), or an unqualified promise to pay a sum certain on a specified date with fixed interest (debt). Courts make this determination by weighing the relevant facts and circumstances of each case, including the terms of the instrument, the economic circumstances of the particular issuer and holder, and the context of a particular investment or transaction. This type of balancing analysis necessarily requires a court to apply its judgment, both in weighing the factors and in deciding which factors to consider at all.

A statutorily prescribed, uniform list of factors to consider would likely accomplish little or no change from current practice. In any particular case, a court would still have to apply the law to the facts, and decide how to weigh the factors given the facts at hand. A court could consider a statutorily prescribed factor irrelevant on the facts presented and assign it no weight. On the other hand, if a statutorily prescribed list of factors precluded consideration of other factors, fixing the list could have the effect of preventing adaptation of common law analysis to new instruments.

In lieu of a balancing test of various factors, Congress could attempt to draft a certain definition of debt or equity. A statutory definition of debt and equity presents significant challenges. As noted in our report, Congress has previously attempted to define debt and equity by statute but ultimately abandoned the effort. Fifteen years later, Congress gave Treasury the authority to define debt and equity but Treasury also abandoned the effort. Neither failed for lack of trying. One explanation for this difficulty is the fact that pure debt and pure equity are the opposite extremes of a continuum of possible instruments, and "[t]here is nothing more complex than trying to draw a line which does not exist."[6]

Alternatively, Congress could attempt to define a statutory safe harbor definition of debt or equity, for example, by identifying certain features which, if included (or excluded), would cause an instrument to be classified in a particular way. Congress and Treasury have generally retreated from such efforts out of concern that defined safe harbors would lead to taxpayer abuse.

Some commentators note that the debt or equity distinction involves the classic rules versus standards trade off. Although rules clearly define what is permitted and what is not, bright-line rules allow for the possibility of activities consistent with the letter of rule, but inconsistent with its understood purpose. In contrast, a standards-based approach may thwart

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[5] *Present Law and Background Treatment Relating to Tax Treatment of Business* Debt (JCX-41-11), July 11, 2011, p. 16.

[6] William T. Plumb, Jr., "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax Law Review* 369 (1971), p. 619 (quoting Lanning, "Some Realities of Tax Reform," 1 Compendium of Papers on Broadening the Tax Base 19, p. 55 (Comm. Print 1959)).

line-toeing behavior by failing to provide the line, but standards are thereby more difficult to administer.

While it is true that taxpayers have considerable flexibility to design hybrid instruments intended to qualify as either debt or equity, taxpayers do not have unfettered discretion to choose their classification. Notwithstanding a taxpayer's intention, the ultimate classification of a disputed instrument may involve the IRS or the courts. However, in addition to these authorities, classification of an instrument will typically be an important consideration for financial market participants. For example, classification of an instrument will typically be an important consideration for both issuers and prospective holders. As noted in our report, issuers will often be constrained by factors beyond tax, including financial accounting, credit ratings, and regulatory constraints. Moreover, the design of a hybrid instrument ultimately affects the issuer's overall cost of capital. Similarly, prospective holders will often be constrained by factors relevant to their economic position and interests. Recharacterization of an instrument could have negative consequences for both issuers and holders, and inconsistent treatment by these parties must be disclosed to the IRS.

An alternative approach to resolving issues presented by the debt and equity distinction is to reduce or eliminate the significance of the distinction for Federal income tax purposes. The United States has a "classical" system of taxing corporate income in which an income tax is imposed on corporate earnings once at the corporate level and again upon distribution to shareholders. This system results in the so-called "double tax" on corporate earnings. It is not the case, however, that corporate earnings are always subject to the double tax. For example, corporate earnings may be taxed only once when corporate earnings are distributed as deductible interest payments to taxable debt holders, or not at all when deductible interest is paid to certain foreign or tax-exempt debt holders. Proposals to integrate the corporate and individual income tax generally attempt to impose a single level of tax (either at the corporate level or at the shareholder level) on corporate earnings. Such proposals could have the effect of reducing or eliminating some of the Federal tax benefits of debt relative to equity.

A number of methods could be used to achieve integration of the corporate and individual income taxes. One such method, the comprehensive business income tax, was proposed by the Treasury Department almost 20 years ago. As proposed, the comprehensive business income tax would, in effect, extend a dividend exclusion system to the payment of interest and deny a deduction for payments of interest, in order to equalize the treatment of debt and equity and treat tax corporate and noncorporate businesses in the same manner.[7] A determination whether to adopt a particular form of integration involves significant policy considerations including the passthrough of corporate business level tax benefits to individuals, the treatment of tax-exempt investors, the treatment of international transactions, and how to treat existing corporate equity structures. In addition, integration proposals can involve considerable complexity.[8]

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[7] See, e.g., U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once* (1992). This study presents and considers various corporate integration prototypes.

[8] For a more extensive discussion of the background and issues relating to integration, see Michael J. Graetz and Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxes* (Tax Analysts,

3. Would it be an improvement in our law if all corporations were subject to a statutory limit on the deductibility of interest, based on a ratio such as net interest expense to adjusted taxable income?

If so, should the limit for a given corporation be determined by looking at the relevant ratio for the worldwide affiliated group of corporations which includes the taxpayer (disregarding intra-group loans)?

The Federal income tax effect of imposing a statutory limit on the deductibility of interest for corporations, based on a ratio such as net interest expense to adjusted taxable income, would depend on the ratio and the measures selected. In considering whether such a change would be an improvement in our law, consideration should be given to the various tax and non-tax consequences that may accompany debt, and the intended purpose of the proposed change.

A limit based on a specified ratio of net interest expense to adjusted taxable income, such as the 50-percent limit of present law section 163(j)[9] (which applies to certain interest paid to or guaranteed by foreign and other tax-exempt related parties), might have the effect of limiting the corporate interest deductions taken for Federal income tax purposes in some cases. However, such a rule would not necessarily bear a relationship to the amount of debt that any particular corporation might reasonably be able to carry without risking financial distress, because the rule would not distinguish between the economic conditions of particular industries or taxpayers within industries.[10] Also, because debt and equity can be structured in such a way that the instruments carry similar economic burdens on the issuing corporation, such a limit would not necessarily limit the economic burdens faced by corporate issuers, and could perpetuate the pressure on the tax distinction between debt and equity, as taxpayers could be expected to maximize deductions on instruments characterized as "debt" to take advantage of the maximum

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1998); Joint Committee on Taxation, *Present Law and Background Relating to Selected Business Tax Issues* (JCX-41-06), September 19, 2006; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal* (JCS-7-03), March 2003.

[9] Present law section 163(j) limits interest deductions on certain debt owed to or guaranteed by certain tax-indifferent related parties. The rule is intended to impose a limitation on so-called "earnings stripping" transactions in which U.S. corporate interest deductions are taken on debt to foreign or tax-exempt related parties that are not subject to U.S. tax on the interest income. Such debt not only eliminates the U.S. corporate level tax on earnings paid as interest, it also avoids any U.S. tax to the extent the recipient is tax exempt (including through the benefits of U.S. law or treaty provisions that reduce the tax on such interest income received by a foreign related party). Present law limits the deduction of such payments to 50 percent of adjusted taxable income (generally, taxable income before interest, taxes, depreciation, and amortization). Section 163(j) primarily affects U.S. corporations that are foreign-owned. Section 163(j) does not directly limit interest deductions on unrelated party debt (except to the extent such debt is guaranteed by a foreign or other tax-exempt related party) though it does require a debt-to-equity ratio of no greater than 1.5 to 1 in order for interest on debt owed to or guaranteed by such a related party to be deductible. Absent related party debt or a guarantee or third-party debt, and a foreign or other tax-exempt related party, the rule imposes no limitations.

[10] As a simplified example, a regulated utility that is permitted to increase its rates to recover costs and that has a stable stream of income may be viewed as relatively secure, and debt may provide such a utility with a relatively low-cost method of financing. On the other hand, a corporation in a less stable industry might be able to support less debt, or the terms of debt might be more burdensome to the corporate issuer.

permitted interest deduction, while possibly carrying high-yielding or other "equity" instruments with conditions that might be financially burdensome. Such a rule alone also would not address any of the Federal income tax advantages of debt in non-corporate settings (e.g., the ability to deduct interest on debt that supports non-taxed income, the magnification of the tax effect of other tax deductions such as depreciation or credits for particular activities, and the ability to monetize asset value without recognizing taxable income).[11] And such a rule would bear no direct relationship to any of those specific issues even in the case of a corporation.

If nevertheless it were desired to attempt to limit the overall risk of a company being overleveraged by applying a specified, fixed percentage of adjusted taxable income limit (similar to the 50-percent limit of section 163(j) or some other fixed percentage), the rule could be applied based on the worldwide affiliated group's measure of adjusted taxable income and net worldwide interest expense (disregarding intra-group debt).[12] Applying such a limit on a worldwide affiliated group basis arguably may have some effect on the overall leverage of a group, but could nevertheless permit significant interest deductions by U.S. corporations on debt that arguably supports income of foreign affiliates not currently taxed in the United States. For example, a worldwide group's net interest expense may be well below the specified percentage limitation while a U.S. corporation that is a member of the worldwide group might have a relatively small proportion of the taxable income of the group but carry a disproportionately large share of the group's debt such that a proportionately large interest expense deduction in the United States would not be limited. In addition, a significant amount of the U.S. corporate debt might be intra-group debt from a foreign related party not subject to U.S. tax on the interest income (similar to the type of debt addressed by the "earnings stripping" rules of section 163(j)). Such debt would be disregarded in the new computation (though the rules of 163(j) could be retained).

Alternatively, a worldwide computation could be designed not to apply against a permitted specified, fixed deduction percentage, but rather as a method of addressing the concern that current interest deductions taken in the United States may reduce U.S. taxable income, while the debt generating the deductions arguably supports the production of foreign affiliate income that is not subject to current U.S. tax. Such a concern could become even more significant if the U.S. were to adopt a territorial system for taxing income earned abroad by U.S. controlled entities, because such income would be permanently exempt from U.S. tax. Rather than applying a specified percentage of adjusted taxable income to limit the deductibility of a worldwide group's net interest expense, a ratio of a group's worldwide net interest expense to the group's worldwide adjusted taxable income could be used as a limitation on a U.S. corporation's U.S. interest expense. Such a rule arguably provides more distinction between economic

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[11] The ability to increase partner basis in the partnership by partnership level borrowings, and to direct the incidence of such effects by various partner guarantees, enhances these aspects of debt in a partnership setting. These tax effects related to debt are discussed at Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Household Debt* (JCX-41-11) July 11, 2011, pp. 72-77.

[12] Any measure using net interest expense may provide some incentive to substitute interest generating investments instead of equity investments to reduce the effect of the limitation; however, if a gross interest measure was adopted, special rules may be necessary for the financial services industry.

conditions of individual industries or taxpayers by providing a unique limitation based on the group's overall leverage position. To the extent the group has similar activities and similar costs of borrowing in the U.S. and abroad (which may or may not be the case) such a rule limits the extent to which a taxpayer can take interest deductions in the U.S. for debt that supports deferred or non-taxed income earned abroad.[13] If it were desired to use this approach also to encompass the issue of interest deductions taken in the U.S. and paid to non-taxed or low-taxed related parties, it would be important to include interest on intra-group loans in computing the amount of the deduction allowed to the U.S. entity. For example, if a worldwide affiliated group's net interest expense is 35 percent of the group's worldwide adjusted taxable income, the U.S. corporation's interest deduction (including interest on intra-group loans) would be limited to 35 percent of its U.S. adjusted taxable income.

If it were deemed desirable to apply a worldwide comparison for purposes of limiting U.S. interest deductions, consideration could also be given to whether a ratio based on debt and assets might be more readily administrable than a ratio based on interest deductions and worldwide adjusted income.[14] Although U.S. based multinational groups may need to compute the earnings and profits of foreign affiliates for purposes of the present law controlled foreign corporation ("CFC") rules that impose tax in certain circumstances with reference to earnings and profits, it is not currently necessary to compute "adjusted taxable income" for foreign affiliates. In addition, it is not necessary to compute earnings and profits or adjusted taxable income for the foreign parent of a foreign controlled domestic corporation, or for any foreign related affiliates that are not CFCs. Such computations could require the imposition of additional U.S. tax rules in place of the rules used by the country in which the entity operates. By contrast, determinations relating to assets and debt might be easier for both corporations and the IRS to administer.

A number of countries do impose some type of interest deduction limitation, though the rules adopted vary significantly. For example, new thin capitalization rules were adopted by Germany in 2008. The new rules apply to resident and nonresident corporations and limit net interest expense (including intra-group debt) to 30 percent of taxable earnings before interest, taxes, and depreciation. The limitation does not apply if the net interest expense is less than €3 million (approximately $4.32 million), the corporation is not part of a consolidated group, or if the debt/equity ratio of the corporation is not greater than the overall debt/equity ratio of the entire group (generally determined using international financial reporting standards).

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[13] In the context of the present law foreign tax credit rules applying a similar test (based on assets rather than income), some contend that the failure of worldwide allocation rules (scheduled to become effective in 2021) to account for potentially different activities and borrowing costs in different jurisdictions still may lead to over or under allocation of interest expense against U.S. source income.

[14] This is similar to the present law approach used solely for foreign tax credit purposes. Under present law, the U.S. provides limitations on interest that can be deducted against U.S. income in determining the amount of "U.S. source" earnings compared to "foreign source" earnings. This allocation of interest is based on a ratio of U.S. to worldwide assets. The foreign tax credit rules currently do not provide for a full worldwide allocation based solely on the ratio of U.S. debt and assets to worldwide debt and assets, but are scheduled to permit the election of such a comprehensive allocation method starting in 2021.

The United Kingdom applies a worldwide debt cap to medium- and large-sized companies. Under the worldwide debt cap rules, a threshold test is applied to determine if the net debt of the U.K. taxpayer is greater than three quarters of the gross debt of the worldwide group. If the net debt exceeds this threshold, the U.K. company must apply more detailed rules to determine the portion of related party interest expense that is disallowed. This regime does not apply to financial services companies.

Canada limits the deductibility of interest paid by a Canadian corporation to certain nonresident shareholders if the debt of the Canadian corporation exceeds two times the equity of the Canadian corporation.

Senate Finance Committee and House Ways & Means Committee Hearing
"Tax Reform and the Tax Treatment of Debt and Equity"
Wednesday, July 13, 2011
Questions for Dr. Mihir A. Desai

Question from Senator Hatch:

1. Although the debt levels of corporations have roughly stayed the same over the decades, we see that both household debt and government debt have gone up considerably in recent years. I'm interested in what the relationship, if any, is between household debt and government debt.

   One way to think of government debt is that it is simply deferred taxes. High government debt today simply means high taxes tomorrow. Thus, assuming that households behave in a rational fashion, one might think that high government debt, such as we have had, would lead households to save more so as to pay for the high government taxes down the road. But, despite high levels of government debt, we don't see households in fact saving much -- to the contrary, they are going ever deeper into debt.

   Do you have some thoughts on that? Does it surprise you at all that simultaneously household debt and government debt would both go up significantly? Had the government not run the significant deficits that it has in recent years, do you think it likely that households would have saved even less – that is, would household debt have been even more?

   Optimizing households could have saved to offset the rising government debt but it is hard to imagine that this is what has happened. More generally, this notion of Ricardian Equivalence, as it is known, does not have a great deal of empirical support. My sense is that these are two distinctive phenomena. Rising fiscal problems reflect structural issues in our entitlement programs, expansion of defense and non-defense expenditures and the failure to raise taxes in parallel. Separately, debt-financed consumption by Americans reflects changed preferences for current consumption and policies that don't favor saving. So, I view these phenomena as distinct.

Questions from Chairman Baucus:

1. Current tax law generally provides an incentive for corporations to capitalize with debt rather than equity since corporations can deduct interest but cannot deduct dividends. This tax benefit may be offset somewhat by the lower tax rates on dividends and capital gains compared to interest income.

   There has been considerable commentary suggesting that as part of tax reform, tax rates should be reduced and the base should be broadened. Others believe the current 15 percent tax rate on dividends and capital gains could be increased. Let me ask each of you:

a) What do you believe have been the effects of the current lower rate for dividends? Has it resulted in more equity financing and less debt financing by corporations?

The lower rate for dividends has been shown to have stimulated a rise in dividend payments. I think this has been the primary effect of the lower rate of dividends. At the same time, it has likely also lowered the cost of equity financing and, therefore, changed the relative preference for equity.

b) Are there some industries that you think are especially affected by the different tax treatment of debt and equity? How?

Industries which use the most leverage are unsurprisingly the most affected. Typically, industries where business risk is low are most able to handle financial leverage. So, industries, with low business risk (eg. utilities) and those with the steadiest cash flows typically have the most leverage. Those industries are the most affected. The tax shields from taking on debt are thought to be significant for these firms as their businesses are simpler, there is more financial engineering on the right hand side of the balance sheet.

c) Are there some industries that rely more or less on debt than is good for the economy? If so, how much does it relate to the tax code and is it a major problem?

Industries and organizational forms (such as leveraged buyouts) that rely on leverage do benefit from the tax code's treatment. The costs to the economy are twofold – first, there are revenue losses. Second, there is the possibility of excessive leverage which has spillover effects. As I discussed in my written testimony, there is little evidence that the economy as a whole is overlevered or that the financial crisis was caused by the tax code.

d) Do you believe that the existing tax advantage for the use of debt by corporations is a problem that should be addressed as part of tax reform? If so, how would you suggest we address this tax bias? How would your proposed solution impact revenues?

In my written testimony, I elaborate on why I believe that excessive leverage is not one of the most important problems in the corporate tax today. Instead, I propose a comprehensive business income tax or, less ambitiously, a rate cut and a move to territoriality financed by a tax on non-C corporation business income and an alignment of book and tax income.

2. The Tax Code does not provide a definition of debt or equity, but rather a determination is made on the facts and circumstances of the interest in the entity. The lack of a uniform definition allows taxpayers to essentially choose the most beneficial tax treatment by structuring their deals as loans or equity.

    a) Do you think this is a problem? *Yes. My written testimony elaborates on the abilities of financial engineers to game these distinctions.*

b) If yes, should a uniform definition be part of the Tax Code or regulations? What other ways could we provide a uniform and certain definition so that similar economic outcomes are taxed in the same way?

The clearest path toward that would be a move toward comprehensive business income tax.

3. Would it be an improvement in our law if all corporations were subject to a statutory limit on the deductibility of interest, based on a ratio such as net interest expense to adjusted taxable income?

No. I think, as elaborate in my written testimony, that such regulations do not address a major problem in the corporate tax and such regulations are complicated by many realities on the ground that are non-trivial.

If so, should the limit for a given corporation be determined by looking at the relevant ratio for the worldwide affiliated group of corporations which includes the taxpayer (disregarding intra-group loans)?

[Submissions for the Record follow:]

Sen. Olympia J. Snowe, Statement

SENATE COMMITTEE ON FINANCE
Tax Reform and the Tax Treatment of Debt and Equity
Senator Olympia J. Snowe
July 13, 2011

Chairman Baucus, Chairman Camp, I thank you both for bringing Congress' two tax-writing Committees together for this historic hearing. Not since 1940 have both the Finance and Ways & Means Committees joined together to hold a joint tax hearing and I am proud to be a part of this momentous occasion.

I also wish to commend you for highlighting the critical issue of the treatment of debt and equity in our tax code as the subject for today's hearing, and also for asking the Joint Committee on Taxation to put its considerable resources to the task of analyzing the significant impact this seemingly obscure topic has on the larger economy.

Our tax code does have a built-in bias that favors the accumulation of debt, particularly relative to the use of equity, and I am troubled by the implications of this fact. By providing a tax deduction for the payment of interest on debt, we have sent a signal to the markets and to businesses that we consider interest payments to be a normal cost of doing business. And the markets have responded with their usual efficiency, as businesses turn to debt for financing, incentivized by the tax code to do so. It is not clear that this incentive effect *created* the financial crisis, but it certainly may have *deepened* that crisis. It is our duty to explore that today, and, if necessary, correct it as part of comprehensive tax reform.

We had a hearing back on March 30th on the ways in which our tax code sends such signals, and I am pleased to have the opportunity to examine one such signal in greater specificity today. Certainly, because the taxation of debt and equity has serious consequences for the economy and job creation, it needs to be given careful consideration in the context of tax reform. But I must ask, yet again, when are we going to proceed to undertake the monumental task of actually enacting comprehensive tax reform? We have had half a dozen hearings so far this year devoted to topics such as today's, all under the rubric of "tax reform," and I commend the Chairman for keeping this issue alive, but at some point we have to move beyond identifying issues to doing something about them.

I have been calling for tax reform for years now. In 2009, when we were invited to the White House for a "Fiscal Responsibility Summit," I chose to discuss tax reform; I pressed it then and I have been doing so ever since. I am disappointed that the Obama Administration has not yet given this critical topic its due attention. As we have

learned from our hearings on tax reform to date, presidential leadership was the lifeblood necessary for passage of landmark tax reform 25 years ago, and Congress has before it a very heavy lift in order to fill the void left us by the Administration and to achieve any kind of serious tax reform again.

To the extent the Administration has talked at all about tax reform, which has been little enough, at least Secretary Geithner and others have recognized that the high U.S. corporate tax rate encourages investors to look to other shores and creates a challenge for American businesses trying to compete in the fierce global marketplace. But with roughly 90 percent of all American businesses organized as flow-through entities, we can hardly focus solely on the narrow issue of corporate tax reform. Rather, we need *comprehensive* tax reform, and that means of necessity that individual rates, at which flow-through entities are taxed, must be part of the conversation. On this point I am pleased to add my voice to that of Chairman Camp, who is with us today and who has made this same argument. Like me, he knows that these businesses are our greatest job creators, providing at least two out of three new American jobs, and the uncertainty they face with looming tax increases after 2012, as the Administration proposes, remains perhaps the greatest and most damaging "signal" our tax system can send.

We hear that tax issues, or even some form of larger tax reform itself, may be a part of the eventual bargain on the debt ceiling issue. While I would welcome any improvements such tax changes may bring, I do not believe that we will benefit from rushed deliberations on taxes to cobble together a debt deal. The path to true and effective tax reform may be arduous but we need to walk that path. I also fear that revenue changes that might be well-suited to offsetting needed and beneficial tax code changes could be used to "pay for" part of the debt deal, making the task of comprehensive tax reform that much more difficult.

Mr. Chairman, the process of reforming the tax law in 1986 was largely possible only through bipartisan work in the Senate Finance Committee and only over the course of years. Thus, we need to start that process now, we cannot wait any longer. I appreciate the meaningful contribution today's analysis of debt and equity taxation will add to the discussion, but I urge us as a Committee to undertake the larger endeavor of comprehensive tax reform with care and deliberate speed. Our economy needs the boost that tax improvements will provide, and our fellow Americans need the jobs that will come with it.

National Association of Home Builders, Statement

STATEMENT OF

THE NATIONAL ASSOCIATON OF HOME BUILDERS

ON

"Tax Reform and the Tax Treatment of Debt and Equity"

July 13, 2011

Introduction

The National Association of Home Builders (NAHB) appreciates the opportunity to submit this statement on "Tax Reform and the Tax Treatment of Debt and Equity?"

Founded in 1942, NAHB is a federation of more than 800 affiliated state and local building industry associations. It is the voice of the housing industry in the United States. NAHB represents more than 160,000 builder and associate members throughout the country, including individuals and firms that construct and supply single-family homes, as well as apartment, condominium, multi-family, commercial and industrial builders, land developers and remodelers.

Access to household and business debt financing is critical for the operation of a modern economy. Debt enables individuals to finance the purchase of durable goods and to invest in long-term assets. In turn, durable goods and investments provide a stream of benefits over time, and the use of debt aligns the cost of these goods/investments with the flow of their benefits. For most households, the largest investment decision they make will involve the purchase of a home, which is both a durable good (in that it provides a flow of housing services) and an investment (in that it is a capital asset that must be maintained and can be sold for a gain or loss).

Housing's Economic Impact

Housing plays a central role in the economy. Housing contributes to gross domestic product (GDP) in two basic ways: through private residential investment and consumption spending on housing services. Historically, residential investment has averaged roughly 5 percent of GDP while housing services have averaged between 12 and 13 percent, for a combined 17 to 18 percent of GDP. These shares tend to vary over the business cycle. Residential investment includes construction of new single family and multifamily structures, residential remodeling, production of manufactured homes, and brokers' fees. Consumption spending on housing services includes gross rents (which include utilities) paid by renters, and owners' imputed rent (an estimate of how much it would cost to rent owner-occupied units), and utility payments.

Currently, because of the impacts of the Great Recession housing's total contribution to GDP stands at 14.9 percent. This is in large part due to the ongoing depression in the residential construction sector. Housing starts are down by more than 75% since their peak at the beginning of 2006, with more than 1.45 million jobs lost in the residential construction sector. Home prices are down approximately one-third from 2006 levels, wiping out trillions of dollars of wealth of the nation's 75 million homeowners. Until the nation's housing markets recover, there can be no robust economic recovery for the economy at large. Housing is linked to household wealth, consumer confidence, a healthy labor market (by enabling people to locate from city to city), and the direct jobs impact connected to the housing industry.

NAHB estimates the following economic impacts from home building and remodeling.[1]

Construction of an average single-family home:

- Creates 3.05 jobs and $145,422 in wage income
- Yields $85,866 in net business income
- Generates $89, 216 in federal, state and local tax revenue

Construction of an average multifamily unit:

- Creates 1.16 jobs and $54,938 in wage income
- Yields $31,771 in net business income
- Generates $33,494 in federal, state and local tax revenue

Investment of $100,000 of remodeling improvements:

- Creates 1.11 jobs and $52,709 in wage income
- Yields $29,958 in net business income
- Generates $30,217 in federal, state and local tax revenue

Debt Financing is Critical For Home Buyers

To produce these benefits, the housing sector must have reasonable access to debt, which facilitates both supply and demand. Home buyers provide both debt (a mortgage) and equity (cash in the form of a downpayment) when purchasing a home. Very few home buyers—only the wealthy and investors—are financially capable of providing all or most of the home purchase price in the form of cash. As a result, accessible and affordable mortgage financing of a home purchase is an essential element of a functional housing market.

Given these realities the use of debt to finance a home purchase is an unavoidable means. This is particularly true for younger, first-time homebuyers who have less accumulated wealth as they begin their working years. The Joint Committee on Taxation[2] demonstrated this effectively by noting that household leverage declined significantly for households headed by an individual aged more than 45. For household heads aged less than 35, the leverage ratio on average was 44.3 according to the 2007 Survey of Consumer Finances. For those aged 35 to 44, the average ratio fell to 28.2. And for those 45 or higher, the average leverage ratio was less than 16.3.

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[1] The Direct Impact of Home Building and Remodeling on the U.S. Economy. NAHB Economics Group. (http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311)

[2] Present Law and Background Relating to Tax Treatment of Household Debt. http://www.jct.gov/publications.html?func=startdown&id=3802

The Mortgage interest Deduction

The mortgage interest deduction (MID) is a cornerstone of American housing policy. Deductions for mortgage interest have been allowed for homeowners since the origins of the tax code in 1913. By reducing the after-tax cost of servicing a mortgage, the MID reduces the cost of ownership of a home. This is particularly true for homeowners in the early years of a mortgage, who are paying mostly interest and relatively little principal. For these homeowners, the MID is of great importance.

Under present law, homeowners may deduct interest from up to $1 million of acquisition mortgage debt and up to $100,000 of home equity loan debt. These limits were set in 1987 and were not adjusted for inflation. Mortgages connected to a primary residence and one other home qualify for the deduction.

The benefits of the MID are collected predominantly to the middle class. According to estimates from the Joint Committee on Taxation (JCT), nearly 70% of the tax benefits fall to those with economic income of less than $200,000.[3] It should be noted that economic income is a concept that generates incomes higher than adjusted gross income (AGI) (for example, it includes employer-paid health insurance premiums). These same taxpayers pay only 43% of the income tax paid, indicating that the MID is a progressive feature of the income tax (providing larger benefits to middle income taxpayers as a share of household income). In fact, using IRS data, NAHB has calculated that for taxpayers with AGI less than $200,000, the MID is worth on average 1.76% of AGI. For taxpayers with AGIs above $200,000, it is worth less, 1.5% of AGI. [4] 89% of MID beneficiaries earn less than $200,000 in economic income according to the JCT.

It is sometimes claimed that few homeowners claim the MID because itemization, or filing Schedule A in lieu of claiming the standard deduction, is required. This is false. The JCT estimates reveal that 34.6 million taxpayers claimed the MID for tax year 2009. While this number represents 22% of all tax returns, it is in fact 46% of all taxable returns and nearly 70% of itemizing returns.

The more relevant numbers are the shares of homeowners. There are 75 million homeowners in the U.S., so approximately half *in a given year* claim the MID. However, approximately 25 million of that 75 million own their homes free and clear of a mortgage. This means of homeowners with a mortgage, 70% claim the MID. Of those who do not, most are older homeowners in the later years of the mortgage when they are paying relatively more principal and relatively less interest. For these homeowners, the standard deduction is a better deal.

Using BEA data, NAHB estimates that over the last decade, 86% of mortgage interest paid has been claimed as a deduction on Schedule A. Take together, these numbers illustrate that over the tenure of homeownership, almost all homeowners will claim the MID for years at time, particularly as first-time homebuyers paying large amounts of interest.

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[3] Estimates of Federal Tax Expenditures for Fiscal Years 2010 – 2014.
http://www.jct.gov/publications.html?func=startdown&id=3718

[4] Who Benefits from the Housing Tax Deductions?
http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311

NAHB analysis of IRS Statistics of Income data in fact reveals that the deduction is most valuable for younger home homeowners.[5] 75% of the deduction is claimed by those under age 55. The largest nominal deductions for mortgage interest are claimed by those aged 35 to 45 (with the average deduction totaling nearly $14,000) and the largest deductions as a share of AGI being claimed by those under age 35 (totaling 12% of AGI).

Moreover, contrary to claims that the MID causes homebuyers to purchase a more expensive home, the data indicate that larger families deduct more mortgage interest because they require a larger home to house their families. NAHB analysis of SOI data confirms this.[6] Taxpayers with two dependents claimed on their tax return who claimed the MID had an average tax benefit of $1,500. Taxpayers with four dependents had an average benefit of approximately $1,950. In fact, the benefit increased correspondingly from one dependent to five-plus dependents, which is intuitive with the notion that larger families require larger homes. Moreover, the cost of living, particularly for housing, varies greatly from city to city, so what may appear to be a large deduction for a given home in one area, may in fact reflect a modest home in a high cost area. Indeed, the MID and the real estate tax deductions reflect one of the few elements in the tax code that account for differences in cost-of-living.

Public Opinion of the Mortgage Interest Deduction

It is not surprising given the important financial role that the MID plays that polling indicates that it is popular with the American public, homeowners and renters alike. NAHB commissioned a nationwide poll with a bipartisan teaming of Public Opinion Strategies and Lake Research Partners in May 2011. The poll found that 73% of likely voters thought it was reasonable to support housing through the tax code. With respect to the MID, 71% of the respondents opposed eliminating the deduction. And 63% of likely voters oppose any limitation of the present law rules. The support was consistent across party lines, with self identified Republicans, Democrats and independents all opposing limiting the MID by significant majorities.

Interestingly, support for the MID was also high among renters, who are often cited as a group who does not benefit from the deduction. However, this once again overlooks the lifecycle of housing tenure. Nearly 60% of renters opposed eliminating the MID, which makes sense given that 73% of renters aspire to own a home in the future. And despite the ongoing weakness in the housing sector, the poll reveals continued faith in the American dream, with 75% of the respondents reporting that owning a home was the best long-term investment and 95% of homeowners indicating that they were happy with their decision to become homeowners. This is good news for the long-term prospects of the nation's economy and the health of local communities, given the substantial research literature indicating

[5] Housing Tax Incentives: Age Distribution Analysis.
http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=137280&channelID=311
[6] Who Benefits from the Housing Tax Deductions?
http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311

significant, positive social and individual impacts that come from homeownership, including improved health, education, and civic outcomes.[7]

The New York Times also commissioned a poll that provides confirmation of the NAHB commissioned poll.[8] Regarding the mortgage interest deduction (MID), the Times reported that, "almost no one favors discontinuing the mortgage tax deduction, a prized middle-class benefit that has been featured on some budget-cutting proposals." Other findings of the Times poll indicate that 93% of people believe it is very important (63%) or somewhat important (30%) for the federal government to keep the MID in place.

Misconceptions of the Mortgage Interest Deduction

Another claim of some opponents of the MID is to link the deduction with the housing crisis. Given the worldwide increase in housing prices and the long historical use of the MID, this linkage clearly fails. In fact, the JCT in their report[9], comparing the changes in tax law and historical debt levels including the years prior to and during the Great Recession, note that "This appears to indicate that the tax rules by themselves do not explain the trends in household debt over this period."

In fact, eliminating or curtailing the MID would have the effect of increasing the cost of purchasing a home, thus reducing demand for homes and placing downward pressure on home prices, thus exacerbating the current economic crisis. Given what has happened the nation's housing markets, and its related and spillover consequences for that nation's economy, changing the rules with respect to home buyer demand and mortgage access is exactly what the economy does not need. Some critics of the MID claim that a reduction in house prices would "improve" affordability for home buyers. This claim assumes the homebuyer is using cash and no debt however. However, if the price of homes fell less than the after-tax increase in servicing the debt, affordability would be hurt by limiting the MID. Not to mention that this view ignores the impact declining prices has on the wealth of all the nation's current homeowners.

Others have suggested long-term phase-ins of various limits for the MID. However, these proposals would also have immediate and negative consequences for housing. The typical homebuyer remains in their home for approximately 10 years.[10] Given the long-term nature of a home purchase, changes that would become effective in two, five or even ten years would have the consequence of reducing housing demand, and prices, today. And these changes would affect not only potential homebuyers, but all existing homeowners in terms of generating a windfall wealth loss through housing price declines.

Other specific limitations that have been debated concerning the MID would also have harmful impacts. Some have suggested eliminating the deduction for a second home. Perhaps such a proposal calls to

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[7] The Social and Private Micro-consequences of Homeownership. Robert Dietz and Donald Haurin. Journal of Urban Economics. 2003. http://www.sciencedirect.com/science/article/pii/S0094119003000809

[8] http://www.nytimes.com/2011/06/30/business/30poll.html?_r=2&hp

[9] Present Law and Background Relating to Tax Treatment of Household Debt. http://www.jct.gov/publications.html?func=startdown&id=3802, page 48.

[10] How Long Buyers Remain in Their Homes. NAHB. http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=110770&channelID=311

mind expensive beach homes (regardless of whether such homes are more likely to be owned by higher-income families who own the home free and clear of a mortgage or rent out the home, with the mortgage interest expense a business deduction, not an MID). In practice, the second home deduction is important for many households who in fact do not think of themselves as owning two homes. For example, the second home deduction facilities claiming the MID during a period of homeownership transition, when a family may own two separate principal residences in a given tax year. Without the second home MID, this family would only be able claim an interest deduction on a portion of their total mortgage interest payment. Further, the second home MID rules allow up to 24 months of construction loan interest on a newly-constructed home to be claimed while the family resides in their existing principal residence. This rule provides parity for owner-built home building for which the eventual homeowners assumes the role of the builder and finances the cost of construction.

Overall, repeal of the second home MID rules would have negative economic consequences throughout the nation in terms of lost home sales, home construction, as well as price impacts. And those price declines would of course be more significantly realized in those areas of the country for which second home ownership is more common. The top areas with high numbers of second homes may be surprising; a preliminary NAHB analysis of American Community Survey data from the Census Bureau indicates, for example, that of the counties which has the largest stocks of homes that most closely match the tax code's definition of a second home (a broader definition than simply seasonally vacant properties) two are in Colorado, two are in Utah, and one each in Pennsylvania, Michigan, New York, Alaska, California and Massachusetts. This indicates that the scope of impact would be significantly larger than simply coastal beach homes, totaling 7 to 12 million homes.

Another element of the MID that has been criticized are the rules allowing an interest deduction for home equity loans. It is important to keep in mind that according to the 2009 American Housing Survey, half of all home equity loans are used for remodeling purposes. Remodeling is of course another form of housing investment which creates jobs and improves the nation's housing stock, particularly with respect to energy efficiency. Disallowing a deduction for interest for home remodeling provides a disincentive for homeowners to improve the nation's existing housing stock and hurts job creation in the remodeling industry.

Business Debt Tax Issues for Home Builders

The use of debt is also critical for the supply side of the housing market. The home building industry is dominated by small businesses. And small businesses in the residential construction sector depend on debt to finance business operations, make payrolls, and build and build or improve homes.

The median NAHB home builder member has 4 employees, constructs 3 homes per year, and reports less than $1 million in gross receipts. Approximately 80% of NAHB's membership consists of businesses organized as non C-Corporation entities (sole proprietorships, partnerships, LLCs and S Corporations). And very few of the 20% of members organized as C Corporations are publicly-traded corporations.

For such small firms, equity financing from Wall Street is simply not an option. The average NAHB member, be they a land developer, remodeler, or home builder, must seek business financing in the

form of debt from banks. For builders, this typically takes the form of Acquisition, Development and Construction (AD&C) loans. It is typical with such loans for small businesses to offer up personal guarantees (effectively using personal assets as collateral) in order to attract capital to small business.

For these reasons, the tax treatment of debt and the prospects for a recovery in housing and the economy as a whole are directly related. Policy actions that would increase the cost of debt for homebuyers and small businesses in the housing sector would prevent job creation, undermine emerging stability in housing prices, and weaken an already lagging economic recovery after the deepest recession since the Great Depression.

Small business lending is in a state of crisis, particularly for those firms in the residential construction industry. According to FDIC Statistics on Banking data, since the fourth quarter of 2007, loans outstanding for ADC home building purposes have fallen from $203 billion to $56 billion, a decline of nearly 74%. While some of this decline is explained by the fall in housing construction activity, during this same period total housing starts fell only 40%. A significant gap has opened between actual demand for new home building (housing starts are currently at a 560,000 seasonally-adjusted annual rate) and business lending available.

For those builders who are able to get debt financing, interest expense deductibility is critical. Limiting deductions for these loans would raise the cost of business for small firms and drive many out of business, reducing job creation and competition for the sale of new homes. And the alternative, equity financing, is simply impractical for small business.

A final note concerning multifamily developers and carried interest is important to make in the context of access to capital. A carried (or promoted) interest is a profits interest in a business deal that is larger as a share of the total return than the share of the initial equity investment. Under present law, if the income paid out as the carry is a capital gain, then the carry is taxed at capital gains tax rates (in general, up to 15%).

Despite the focus on the financial sector, the use of carried interest is actually quite common in real estate. A builder/developer will typically gain a carried interest in partnership with outside limited partners, who will invest a significant share of the initial equity for a project. The builder provides also provides some equity, but additionally acts as the entrepreneur and takes more of the economic risk. The return to the carry reflects this risk premium, and thus allows shifting the risk away from the limited partners and attracting capital to the deal.

For multifamily projects, the income due to a carry typically arises as profit from the sale of an apartment building, which is a depreciable, capital asset. As such, this profit originates as a capital gain. The proposal to tax carried interest would redefine such income as non-capital income and tax it at a higher rate.

NAHB analysis found that by placing downward pressure on the prices of apartment buildings and other commercial real estate, the proposal would reduce state and local property tax revenues by more than $1 billion per year and would eliminate more than thirty thousand jobs in multifamily construction and development. Given the ongoing weakness in the labor market and the potential for job creation in the multifamily sector, tax increases on apartment developers would be harmful for economic growth.

The Center for Fiscal Equity, Statement

Comments for the Record

Joint Hearing on Tax Reform and the Tax Treatment of Debt and Equity

House Committee on Ways and Means
Senate Committee on Finance

Wednesday, July 13, 2011

by Michael Bindner

The Center for Fiscal Equity

Chairmen Camp and Baucus and Ranking Members Levin and Sessions, thank you for the opportunity to submit my comments on this topic. We will leave the technical analysis of current law to the Joint Tax Committee Staff and focus our comments on how these issues relate to the Tax Reform options proposed by the Center for Fiscal Equity.

Those who have previously read our comments know that the Center has a four pronged tax reform proposal:

- Value Added Taxes (VAT) to fund domestic military and civil discretionary spending (in addition to other excises, such as the gasoline tax);
- VAT-like Net Business Receipts Taxes (NBRT) on labor and capital to fund non-pension entitlement spending which replace some payroll and most income taxation at both the individual and corporate levels;
- Old Age and Survivors Insurance (OASI) payroll taxes on employers and employees to fund old age and survivors insurance (retirees only) – with survivors insurance to non-retirees and disability insurance funded by the NBRT (and decoupled from income); and
- Income surtaxes on cash disbursements from all sources, including inheritance to fund overseas military and naval deployments, retirement of debt to the Social Security system and other trust funds, and net interest on the debt and any additional debt retirement.

We preface our analysis by noting that debt and equity are not taxed, per se. Instead, the interest on debt is taxed as income to the lender and their depositors or investors and is considered an expense to those who incur it for the purchase of capital or for home financing while dividends are taxed rather than equity. Indeed, equity cannot be federally taxed – only the dividend income earned as a result of holding such equity. State governments can, of course, tax equity under personal property tax provisions and it could potentially be taxed under a state level Equity Value Tax, which would operate on the same principal as a Land Value Tax on economic rent.

Two perspectives on taxing interest and dividends are important to note – the perspective of the producer/business owner and the perspective of the consumer. Identifying both points of view is essential to any analysis of the economic and equity impacts of tax reform on interest and dividend taxation

Under the VAT and NBRT elements of our proposal, interest paid would continue to be an expense while increases to equity would be considered a result of adding value and therefore subject to tax, whether paid out in dividends or not. The equity itself, however, is not taxed – rather the income which grows income is.

Under VAT and NBRT regimes, labor is also taxed while interest paid is not, however the return on equity and labor would ideally be taxed at the same rate – rather than taxing dividends at either a higher or lower rate than income, depending on the tax bracket of the taxpayer and their primary source of income.

An advantage to both VAT and NBRT is that they are potentially much simpler with regard to the tax treatment of interest expenses than the current personal and corporate income tax systems, although that simplicity is as much a function of how the tax laws are written as the inherent nature of these taxes.

Under our proposals, wages, interest income and dividend income for most households would not be taxed directly. In order to facilitate the payment of VAT, net income would increase by the same percentage as the VAT plus any adjustment due to receipt of refundable Child Tax Credits through NBRT, while gross income would decline to Net Income plus OASI taxes and for high income individuals and families, continued income surtax withholding.

For most families, taxation would occur through consumption rather than through wages. The loss of gross income would be for wages which were never paid anyway, as the responsibility for being an object of taxation shifts from the employee to the employer. Of course, economically, the consumer is the already the ultimate funder of all income taxes currently paid by both labor and capital under the current system.

There is extensive literature already in existence on the tax treatment of interest income to financial services firms. We will leave review and comment of this highly technical literature to those who are expert in it, as we believe it is beyond the purposes of this hearing. Such issues are important to consider when implementing legislation and regulation are in the drafting stage – and we surmise that this debate is no where near that point.

OASI contributions have no impact on the question of interest and dividends unless personal accounts are included as a feature. Whether such accounts are on the Cato Institute model, with diversified investment, or our model with insured investment in the employing company, equity would largely replace debt and value added to equity would be taxed as income under VAT and NBRT rather than as interest income to the financial institution making the loan.

High income individuals are more likely to be taxed both as consumers and as producers, however, their greater propensity to consume less of a percentage of income in any current period requires a separate surtax, especially if dividends are reinvested rather than spent and capital gains remain unrealized. In the short term, reinvestment or holding investments leaves this potential income outside the reach of taxation, creating real vertical equity issues that can only be resolved with the adoption of surtaxes on all income above a certain level.

Under our proposal, there would be no separate rate for interest, dividends, disbursements from inheritance or sale of inherited assets (unless the sale is to a qualified Employee Stock Ownership Plan), capital gains or wages. All income would be taxed at the same rate. For high income tax payers, all income is fungible. It matters not whether it comes from dividends or from interest on deposits loaned out to firms who pursue debt finance rather than equity finance.

We propose graduated rates from the $100,000 per year income level to the $550,000 per year level, as it is no more complicated to look up tax due on a tax table for graduated rates than for a single rate, so tax simplification concerns provide no justification for abandoning graduated tax rates. Indeed, such rates are necessary to compensate for the fact that at higher levels, families are more likely to defer spending for decades, if not generations, and may attempt to avoid taxation permanently. While in the long term, all income must eventually be spent to have any value, in the short term there are serious equity concerns from not taxing high income individuals at a higher rate because they are less likely to consume within a given period.

Without high income surtaxes, the pool of potential investment becomes more and more concentrated until the vast majority of the population is reduced to wage slavery alone. Indeed, the lowering of tax rates in the last three decades has produced such a result, with productivity gains going to an ever shrinking high income population at the top of the income distribution, while most workers see income levels rise only by the rate of inflation, even when they are the source of the increased productivity that is growing the economy.

Drawing this distinction is much more important than the impact of tax reform on debt finance versus equity finance.

Thank you for this opportunity to share these ideas with the subcommittee.

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