European Economic & Social Committee

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Key Points

- Recent U.S. Experience
- D/E & the capital markets?
- D/E & the broader tax law context
- Horror Stories
- The larger tax picture today

Some Recent U.S. History

Background on U.S. Regime

- No participation exemption, means double taxation of corporate earnings
- Has created strong preference for passthrough entities as compared to corporates
- Led to proposals for corporate integration for a single level of tax, in addition to proposals for eliminating debt/equity bias
  - Shareholder allocation form of integration,
  - Comprehensive business income tax form of integration,
  - Allow a shareholder level dividends received exclusion,
  - Allow a corporate level dividends paid deduction,
  - Eliminate all or a part of the corporate interest deduction, or
  - Allow a limited deduction for cost of capital allowance.

2016 Senate Finance Committee Hearing: Corporate Integration & Debt Equity Bias

- Prof Al Warren: "Integration, whether by shareholder credit or a dividend deduction with withholding, could substantially reduce many distortions and problems of current law.
  - "[C]ould reduce or eliminate important distortions caused by differences in the taxation of corporate debt and equity.
- JODY K. LURIE, CFA: cautions re outcomes from corporate integration:
  - Equalization of tax treatment of debt and equity may create an increased incentive for companies to return cash to shareholders over alternatives, such as debt repayment.
  - Diverse effects on companies in different industries.
  - Would likely encourage corporations to create complex organizations and financing instruments.

US Result, as of 2021

- *U.S. Congress ultimately declined to adopt a corporate integration system, instead adopting a more robust interest expense limitation rule in 2016.*
- *Biden proposals generally do not attempt to further restrict interest deductibility, and by raising the rate, make it more valuable*

Capital Markets & Debt v. Equity

Cost of Capital & Debt v. Equity

- Modigliani and Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, AER 48:3 (1958)
  - Corporate debt impacts the return on equity.
  - "Because firms may have different proportions of debt in their capital structure, shares of different companies, even in the same class, can give rise to different probability distributions of returns.
  - "[T]he shares will be subject to different degrees of financial risk or "leverage" and hence they will no longer be perfect substitutes for one another.
- *Takeaway: Mix of financing (debt & equity) has wide implications for shareholder return and markets, far beyond tax.*

Investors' Perspective

- Interest expense deductibility is but one factor in each of these theories that attempts to explain different firms’ preferences for debt v. equity financing
  - Pecking Order Theory
  - Trade-Off Theory
  - Capital Substitution Theory
- Even if the difference between the cost of debt v. equity capital decreases, companies will still see a benefit of one form of financing relative to the other, based on individual facts.
- Disparate impact across industries.
- A higher cost of debt capital might determine whether a capital project ultimately meets the targeted return on investment, i.e., whether it moves forward.
- *Takeaway: changing the return on debt financing relative to equity could impact investment decisions in much broader ways than anticipated.*

IRS Research

- Why do companies use equity at all, given big tax preference for debt?
- “significant nontax costs involved with debt financing” such as “standard costs of borrowing and risks of financial distress that fixed liabilities imply.”
- *George Contos, An Essay on the Effects of Taxation on the Corporate Financial Policy (Washington, DC: Internal Revenue Service, 2005).*

Searching for Debt in Today's Market

- Bond Analysts: There may not be enough corporate debt being issued to meet investor demand, particularly from pension funds
  - https://info.loomissayles.com/long-duration-fixed-income-market-conditions-and-implications-for-pension-plans-insurers
- "we expect continued interest in long-duration issues from pensions…
- we "expect that long-duration fixed income demand could continue …
- *Takeaway: increasing the cost of debt relative to equity could have widespread unintended effects in the capital markets, on investors such as pension funds*

Debt/Equity in an Overall Tax Regime

A Wider Picture

- Various tax factors might cause an investor to choose to invest in certain type of financial instrument, or a company to issue one or the other type of instrument:
  - Bias towards retaining earnings,
  - Tax treatment at investor level for income from interest, dividends, and gain from the redemption or sale of stock,
  - Limitations on use of corporate losses,
  - Different tax treatment of expensing of costs of creating intangible v. tangible assets,
  - Different tax treatment of U.S. v. foreign shareholders,
  - Different tax treatment of corporate v. individual taxpayers,
  - Different tax rates applicable to taxable v. tax-exempt investors.

Patricia Bryan, When Junk Bonds Go Bad. Protecting the Corporate Tax Base on Repurchases and Defaults, 42 FLA. L. REV. 645, 658-661 (1990)

Interaction with other Tax rules

- Interest expense deductibility interacts closely with other tax rules that can impact the value of the deduction.
- For example, interest expense deductions may not matter much for companies that expect operating losses in the future.
- Companies can substitute nondebt tax shields, for example, depreciation deduction, for debt tax shields.
  - *George Contos, An Essay on the Effects of Taxation on the Corporate Financial Policy (Washington, DC: Internal Revenue Service, 2005).*
- *Takeaway: Doesn't make much sense to talk about changing debt/equity rules in isolation, without considering incentives and deterrents created by other tax rules.*

Corporate v. Investor Tax Differences

- Corporate managers make decisions about the capital structure of a corporation based on both corporate level and investor level consequences of issuing debt or equity.
- A proposal that equalizes the corporate level consequences of debt and equity but doesn't equalize the investor level consequences could have unintended consequences.
- Investor level consequences of debt and equity can vary, for example, due to timing, character, and rate differences between taxation of bondholder interest, shareholder dividends, and stock gain.
  - *Katherine Pratt, The Debt-Equity Distinction in a Second-Best World, 53 Vanderbilt Law Review 1055 (2000) Available at: https://scholarship.law.vanderbilt.edu/vlr/vol53/iss4/1*

Debt/Equity in Context

- [A tax law change] although it might solve a specific problem, … might exacerbate others because it only moves in the direction of an ideal, but, by definition, does not reach it.
- Would it improve the current regime or make it worse?
  - *Deborah H. Schenk, Taxation of Equity Derivatives: A Partial Integration Proposal, 50 TAX L. REV. 571, 640 (1995).*
- *Takeaway: requires consideration of myriad of ripple effects*

Tales from the Dark Side

The Netherlands Antilles Treaty & the Eurobond Market

- In 1987 the U.S. Treasury Department terminated the United States-Netherlands Antilles Tax Treaty.
- Treasury saw this as a victory against tax abuse because the termination prevented use of that Treaty for treaty shopping.
- BUT … caused great disruption in the international bond market.
  - *Frith Crandall, The Termination of the United States-Netherlands Antilles Tax Treaty: What Were the Costs of Ending Treaty Shopping, 9 Nw. J. Int'l L. & Bus. 355 (1988-1989)*

The Background

- A tax law passed in 1984 ("DEFRA") repealed the 30% statutory withholding tax for all new Eurobonds, meaning that U.S. companies could now issue new bonds directly to foreign investors, rather than having to rely on subsidiaries in the Netherlands Antilles.
- The law explicitly preserved the tax treatment of pre-1984 bonds, and holders of pre-1984 bonds expected their bonds to remain tax-free.
- BUT … termination of the N-A Treaty immediately subjected pre-1984 bonds to the 30% withholding tax.

Costs of Termination

- Immediate cost:
  - “panic selling in the Eurobond market ensued, because the termination subjected the interest on approximately $32 billion of pre-1984 bonds issued through the Netherlands Antilles to the withholding tax.
- Also, many bond issues had provisions permitting the issuer to redeem the bonds if a withholding tax was imposed, allowing the issuers to call in the obligations at par value.
- Issuers who called their bonds and refinanced loans at lower rates received a windfall.

Context for Yet Another Change

Since 2015

- 15 BEPS Action Items, including:
  - Action 2: Anti-hybrid rules
  - Action 4: Interest expense limitation recommendation
- EU Directives
  - ATAD 1
  - ATAD 2, including
  - Interest expense limitations
  - Hybrid mismatches
- US: Tax Cuts & Jobs Act, including:
  - Interest expense limitation
  - Anti-hybrid Rules
- *Takeaway: Myriad of changes makes it hard to predict the effects of any one of them taken on a standalone basis, must consider the interaction.*

Latest Proposed Changes

- OECD: Global minimum tax: conforming a tax base
- U.S.: minimum tax base, interaction uncertain
- EU BEFIT proposals
- *Takeaway: How would restriction on deduction / new deduction impact the calculation of the minimum tax base?*