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# THE ZEN OF CORPORATE CAPITAL STRUCTURE NEUTRALITY

Herwig J. Schlunk\*

It is well understood that corporate capital structure affects tax collections. Most basically, corporate interest expense is deductible. With each interest accrual, the corporate tax base shrinks. Thus, there is a broad range of circumstances in which corporate managers are encouraged by the Internal Revenue Code (the "Code") to load their corporate capital structures with debt. But there is little support for the proposition that Congress desires corporations to adopt such debt-laden capital structures.<sup>1</sup> Indeed, much tax legislation suggests congressional displeasure with the achievable degree of corporate self-integration.<sup>2</sup>

On the other hand, corporate equity has its charms: shareholders are able to defer their gains essentially forever. Thus, in some circumstances the Code encourages corporate managers to load their corporate capital structures with equity. Based on the numerous provisions in the Code that depress the relative tax cost of equity, it is probably safe to conclude that Congress is more sanguine about equity than it is about debt.<sup>3</sup> But periodically, Congress tempers its enthusiasm.<sup>4</sup> And academicians as a group find the feature of equity deferral — the realization requirement — quite troubling.<sup>5</sup>

Given the current tax rate structure — where the marginal tax rate of some persons exceeds the corporate tax rate and the marginal tax rate of others is exceeded by it — corporations are generally well ad-

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1. As explained in Part VII below, the mere existence of a corporate interest deduction does not provide adequate support.

2. In the case of corporate interest expense deductions, see I.R.C. §§ 163(e)(5), 163(j), 163(l), and 279 (West Supp. 2000). In other contexts, see § 311(b), repealing *General Utilities v. Helvering*, 296 U.S. 200 (1935), and § 355(e), repealing *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966), and the recent expansions of § 1059.

3. See, e.g., I.R.C. §§ 351, 354-356, 368 (granting nonrecognition treatment to various types of exchanges); § 1014 (making nonrecognition permanent for those who die); § 1(h) (making recognition less painful for those who are forced to recognize).

4. See, e.g., I.R.C. § 302 (treating certain redemptions as giving rise to ordinary income); § 1091 (limiting the artificial acceleration of certain losses). In addition, there are many restrictions placed by the Code on nonrecognition. See, e.g., §§ 305(c), 351(g).

5. See, e.g., Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991); see also Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEXAS L. REV. 243 (1992).

vised to employ both debt and equity in their capital structures. The former will be held by low tax rate taxpayers and will serve to lower the effective aggregate tax rate<sup>6</sup> on the corporation's *taxable* income. The latter will be held by high tax rate taxpayers and will serve to keep low the effective aggregate tax rate on the corporation's *unrecognized economic* income (such as any increase in the value of corporate assets, including goodwill). From the vantage of the Fisc, this is, of course, the worst of all possible worlds.

This Article does not propose to do away with the infirmities of the current corporate tax regime by abolishing double taxation. For while Code § 11 may be the step child of federal income tax theory,<sup>7</sup> there currently appears to be no realistic prospect to repeal it.<sup>8</sup> At least in the case of publicly traded corporations — the most important class of double-taxed entities — Americans tend to view them either as a free good, which can be taxed with economic impunity, or as a proxy for the faceless rich, who are undertaxed in any event. Perhaps this will change in time, as the proliferation of 401(K) plans turns the hoards of middle class taxpayers into capitalists. But a change seems to be yet a good way off. And in any event, as I argue below, integration — at least in its commonly proposed forms — would not necessarily cure all that ails the current corporate tax system.

Thus, this Article takes double taxation as a given and as a challenge. It asks how, if at all, a double tax regime can be designed so that economic actors are powerless to use capital structure to influence tax collections. The linchpin to the answer, set forth in Part VI below, is that the Code cannot allow any nontrivial corporate deduction with respect to any returns earned by any corporate capital providers. In particular, and merely as one example, the corporate deduction for interest expense must be abolished.<sup>9</sup>

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6. The "aggregate" tax rate includes both the corporate rate and any relevant interest-holder tax rates.

7. That no academician seriously supports it is amply demonstrated by the ever-continuing spate of integration proposals. See Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265 (1995); Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 24 OHIO N.U. L. REV. 493 (1998); George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431 (1992).

8. Not even the managers of publicly held corporations, who would seem to be the most natural proponents of such repeal, show much support for the idea. Perhaps this is because integration would put pressure on such corporations to pay out more to shareholders than currently is their wont, and this would reduce the size of managerial fiefdoms.

9. Other scholars have, of course, long argued for the abolition of the corporate interest deduction. See, e.g., Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1603 (1974). More recently, as part of its Comprehensive Business Income Tax Prototype, the Treasury Department similarly proposed repealing the corporate interest deduction. See UNITED STATES DEP'T OF THE TREASURY, INTEGRATION OF INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 39, 40 (1992).

One immediate objection to such a suggestion is that it cannot adequately take into account the special needs of corporate financial intermediaries whose business it is, at least in part, to own highly leveraged interests in other corporations. Without interest deductions, so the argument goes, financial intermediation can not be profitable, and without such intermediation, capital deployment in the economy will become less efficient, with calamitous results. Although I leave to a subsequent article the full exposition of this problem, the short answer is that it need not be so. The question is indeed no different from any other question of consolidation — that is, the proper treatment of corporate capital instruments held by other corporations — and has, when so viewed, several relatively straightforward solutions.

A more powerful objection to my suggestion is that, given political reality and public choice, a capital structure neutral tax regime will never be enacted. Thus, the best one is likely to observe is a movement away from current inefficiencies toward future inefficiencies or, more bluntly, the replacement of one set of arbitrary and irrational lines with another. Whenever only a partial solution to an existing problem is possible, the relevant policy question must be whether there is a net gain from implementing that partial solution, taking into account that there will be both gains and losses.<sup>10</sup> I do not dwell on such tradeoffs because the goal of this Article is merely to provide a theoretical characterization of capital structure neutral tax regimes, not an ordering of second best non-capital structure neutral tax regimes.

Part I demonstrates how corporate capital structure *can* affect tax collections. It defines as “capital structure neutral” a tax regime in which corporate capital structure does not affect tax collections. Part II argues that a capital structure neutral tax regime is desirable. Part III shows that integrated corporate tax regimes are not necessarily capital structure neutral. Part IV gives some examples of possible capital structure neutral tax regimes. Part V develops a theoretical deconstruction of any corporate tax regime. This deconstruction forms the basis for the general description of all capital structure neutral tax regimes. Part VI is the proof that any capital structure neutral tax regime must have a certain form. Part VII describes some implications and, in particular, demonstrates that in a world with multiple interest holder tax rates, a corporate deduction for interest expense is incompatible with capital structure neutrality. Part VIII is a brief conclusion.

#### PART I — AN EXAMPLE AND A DEFINITION

Assume that the world is governed by certainty: cash flows and changes in the fair market value of assets are all certain. Reality, of

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10. See David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 J. LEGAL STUD. 71 (2000).

course, differs from this assumption. Nonetheless, the assumption is useful because it will make the examples that follow tractable. Moreover, the points illustrated hold under uncertainty as well. Any tax regime that cannot pass muster under the assumption of certainty does not have a chance in the more complex world of uncertainty.

I focus on a single corporation, X. Economically, X is owned in proportions of equal value by two interest holders, A and B. However, the legal form which A's and B's ownership interests will take is a variable to be determined.

I also focus on only a single period. This can be justified in part in that the collection of income taxes has historically been periodic. But more, it is a nod to the fact that once a tax code permits the tax on economic income to be deferred for even one year, it will generally be powerless to prevent subsequent replications of the deferral. The end result is that the tax, which is ultimately paid in the distant future, will have an arbitrarily low net present value. Thus, for modeling purposes, the tax rate in all periods but the present is assumed to be zero.

The tax rates imposed on X, A, and B are variables. They will be set so as to allow the Fisc to collect \$50 of tax directly or indirectly from the X business in a base case. The only arbitrary constraint I impose is that the tax rate on income taxed to A will be four times the tax rate on income taxed to B. This allows A to serve as a proxy for high-income taxpayers, and B as a proxy for low-income or tax-exempt taxpayers.

Finally, I assume that each of A and B invests \$1000 in the X business and that, in the year in question, X generates cash flow of \$200 and what I shall call "capital-structure-independent" taxable income of \$100. In addition, during the year, the X assets actually increase in value by \$200, rather than depreciating by \$100 as implied by the difference between cash flow and taxable income.

#### *Base Case: Common Equity with Current Payout*

Assume X intends to distribute annually all net taxable income (that is, taxable income remaining after payment of taxes). Under current tax principles, X would be taxed on \$100 of corporate taxable income. The Fisc would like to tax a certain amount of income "at the source," and so imposes a 33.33% tax rate on corporate income. (This rate is arbitrarily chosen (the first variable to be fixed); a different rate will simply require different shareholder rates.) Thus, the Fisc collects \$33.33 of tax. If X indeed distributes the \$66.67 of net income — \$33.33 each to A and B — the Fisc will need to impose additional shareholder-level taxes on A and B at rates of 40% and 10%, respectively, to achieve its stated aggregate tax collection objective of \$50.

### *First Variation: Deferral*

One way that A and B can keep at least a part of the Fisc's intended take is simply to have X retain its after-tax income. That saves \$16.67 of tax. While this is particularly effective under the instant facts — where future tax rates drop to zero — it is in fact an opportunity whenever the effective tax rate on implicit reinvestment in a business, by having such business retain its earnings, is lower than the effective tax rate of explicit reinvestment in the business (where interest holders receive distributions and must affirmatively reinvest them — after paying tax, of course).<sup>11</sup>

### *Second Variation: Base Erosion*

A and B are no fools. Thus, they each structure their ownership interests in X as partially debt — say \$500 of debt accruing interest at a 10% rate. This generates an aggregate \$100 of interest deductions for X, which zeroes out X's income and, of course, its payment to the Fisc. Since X has no taxable income, it distributes no net income to its shareholders. It does, however, pay \$50 of interest to each of A and B. A pays \$20 of tax on this interest; B pays \$5 of tax. The Fisc collects only \$25 of tax.

### *Third Variation: More Base Erosion*

A and B are not done. As a further iteration, A's entire interest is transmuted into a participating preferred stock (which is common stock for tax purposes) with an accruing 10% preferred return prior to

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11. As in the example in the text, assume that X can always earn a 5% taxable return on its assets. But ignore for the moment any other economic earnings; assume that 5% is all there is. Additionally, assume the fiction of having only a single year taxed is abolished, and that tax rates are invariant from one year to the next. Rather than focussing on one tax year, I now focus on two.

In year 1, X earns \$100 and pays \$33.33 of tax. If it holds onto its earnings and profits ("e&p"), X has an additional \$66.67 earning 5% in year 2. Thus, in year 2, it earns \$103.33. Paying tax at its 33.33% rate leaves it \$68.89 to distribute, in addition to the \$66.67 retained from year 1. Thus, \$135.56 flows out to A and B, and they pay tax on this at their blended rate of 25%. They are thus left with \$101.67.

If instead X distributes its e&p annually, A and B pay \$16.67 of tax in year 1, and thus have only \$50 to reinvest in X. Thus, in year 2, X earns \$102.50 and generates \$68.33 of e&p. When X distributes this amount to A and B, they pay 25% tax on it and so are left with \$51.25. Plus, they are entitled to a tax-free return of the \$50 of capital they invested just before the beginning of year 2. Thus, they have \$101.25 when the dust settles, which is less than in the case of implicit reinvestment.

The reason for the disparity is the same one that makes tax-free savings accounts — IRAs, 401(K)s, and the like — so taxpayer friendly. As in those cases, A and B have avoided a tax on what could have been current income, have reinvested such amount "tax-free," and only pay the piper once the amount is withdrawn from their "tax-free" account. Only here the account is not entirely tax-free: it is burdened with corporate income tax. But it is tax-free from A's and B's vantage, for it defers their individual liabilities.

*pari passu* treatment with any (other) common stock. In turn, B's entire interest is transmuted into a convertible debt instrument yielding 10% before conversion into common stock. Assuming X can successfully avoid Code Section 163(l) and similar provisions, X's taxable income is again zeroed out with interest expense, but now the entirety of the corresponding interest income is taxed to B (without, however, diminishing A's economic interest in any way). The Fisc's collections now shrink to \$10.

The iterations in this example demonstrate that, under the current corporate tax regime, taxpayers can — solely through the expedient of varying capital structure — reduce the amount of tax collected by the Fisc.<sup>12</sup> In the terminology of this Article, the corporate tax regime is not capital structure neutral.<sup>13</sup>

I define a scheme of corporate and interest-holder taxation to be capital structure neutral if corporate managers are powerless to design capital structures that systematically affect the aggregate tax collected by the Fisc directly or indirectly from such corporation.<sup>14</sup> This does not necessarily mean that the Fisc's expected tax collections from any one corporation will be fixed. Such collections may vary based on the tax rate mix of such corporation's interest holders. Thus, if all interests in one corporation are fortuitously held by tax-exempt investors, while all interests in an otherwise identical corporation are held by high tax rate investors, the Fisc will collect more tax directly and indirectly from the latter. But so long as the selection of investments by investors is truly fortuitous — so long as each corporation's managers cannot by design steer their corporation's capital interests into the hands of investors of any particular tax rate — the Fisc should be unconcerned by such variation. Economy-wide it will be fully protected: capital instruments of every type will be held on average by the average investor.

There are two distinct ways that managers can currently try to systematically alter — that is, reduce — the tax collections directly or indirectly from their corporations. First, they can create capital instruments that have inherent features that reduce tax collections. Thus, for

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12. If B were permitted to have a 0% tax rate — that is, to be a tax exempt person — the tax collections from the X business could be eliminated entirely.

13. Of course, taxpayers have a myriad of concerns, unrelated to tax, that affect their capital structure choices. In rare circumstances, these concerns may limit the ability to effectively manage capital structure from a tax perspective. More commonly, however, skillful drafting will permit nontax concerns to be addressed in instruments otherwise designed purely with tax in mind in such a way as not to alter the desired tax effect.

14. For purposes of this Article, capital structure does not merely take debt and equity into account, but includes all manner of financial instruments (even ones which do not nominally involve direct investment, such as derivatives). It further includes certain relationships — for example, employment relationships and leasing — that allow the interest holder (the counterparty) to participate in the success or lack thereof of the corporate business. Herwig J. Schlunk, *Do We Really Need Nonqualified Preferred Stock? A Rethinking of the Taxation of Corporate Capital*, 77 TAXES 64, 64-91 (1999) [hereinafter Schlunk, *NQPS*].

example, a corporation with positive taxable income may wish to issue a current-pay capital instrument with a given set of economic terms. If the corporation structures this instrument to be tax debt, then the tax collections by the Fisc will be lower than if the corporation structures the instrument to be tax equity (due to the corporation's interest deduction). Or, as a second example, a corporation without taxable income, but with plenty of economic income, may wish to issue a non-current-pay instrument with a given set of economic terms. If an instrument is structured to be tax equity, then the tax collections by the Fisc will be lower than if it is structured to be tax debt (due to a holder's not needing to accrue any yield into taxable income on a current basis).

The second way that managers can try systematically to reduce tax collections is by creating instruments that provide either the entity or its interest holders with an embedded option to do post-issuance tax planning. For example, under the Code, a corporation's decision to redeem an instrument or an interest holder's decision to sell it will generally affect tax collections. A capital structure neutral tax regime would not give taxpayers the ability to exploit post-issuance tax opportunities (and conversely would not burden taxpayers with the need to avoid post-issuance tax traps).

## PART II — WHY CAPITAL STRUCTURE NEUTRALITY?

Why should one care about capital structure neutrality? I have said a bit about this elsewhere.<sup>15</sup> Essentially, three points need to be made. The first is practical; the second is economic; the third is political. A fourth point — that tax regimes should be aesthetic and that this one is not — I will not belabor.

The first point is brief. A corporate tax is presumably intended to accomplish at least one thing: the raising of revenue. That there may be other or better ways to raise revenue is beside the point. However, as the example in Part I illustrates, the ability of a corporate tax to raise revenue may be severely impeded when a tax regime is not capital structure neutral. Accordingly, capital structure neutrality is desirable.<sup>16</sup>

The second point is that, as an economic matter, any number of inefficiencies and transaction costs creep into a tax regime that allows

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15. *Id.*

16. Even a tax regime that is not capital structure neutral — for example, ours — can and does raise tax revenues from corporations. Tax planners can and do set tax rates that take into account taxpayer attempts to avoid the corporate tax. But there is a constant game of cat and mouse, action and reaction. And, hence, a periodic need to either adjust rates or to protect the tax base from excessive diminution. A capital structure neutral regime would allow the government to set tax rates in a more straightforward and a more transparent manner.



tax collections to be manipulated based on capital structure. First and foremost, distortions can and will arise — relative to the baseline of any capital structure neutral regime — on questions as basic as “who will win the economic game.”<sup>17</sup> Indeed, the current competition among corporate tax managers to engage in so-called corporate tax shelters (many of which, in fairness, are not based on capital structure manipulations) powerfully illustrates the perceived ability of a tax system to have just such unintended real economic effects. In addition, a tax regime that encourages debt financing (or certain other financing with tax-deductible returns) increases economy-wide bankruptcy costs.<sup>18</sup> Finally, the tax advantages of debt financing can affect the types of projects that a corporation will accept. For example, projects with lower expected value but also with lower variance of returns are more effectively subsidized by the corporate interest deduction.<sup>19</sup>

In addition, the actual racing to the bottom — the zeroing out of corporate income and tax — has direct costs. To stay competitive, corporations must expend considerable amounts hiring professionals to craft ways to reduce their tax burdens. These professionals tend not to be dullards; if focused on socially useful activities it is anyone’s guess how much social output would increase.<sup>20</sup> In addition to the cost of brainpower, efforts craftily to minimize taxes also spawn a host of administrative-type costs. For example, structuring a capital instrument to accomplish various not wholly consistent economic and tax re-

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17. Ignoring taxes, a producer of a good or service in a competitive market can generally reduce his production costs only by reducing his consumption of various inputs of production. Reducing such consumption is a social good, for society can presumably put the saved and valuable inputs to other use. But if the producer finds a way to pay less tax, there is no similar resource windfall to society. Indeed, so long as the government’s revenue requirements have not changed, the producer has accomplished nothing at all save the imposition of incremental taxes on someone else.

Under certain assumptions, an argument can be made that a producer who economizes on taxes has indeed provided society with a benefit. If, for example, there is an absolute level (nominal rate) beyond which tax rates cannot be raised, and if tax rates are at that level (which would not currently appear to be the case in the United States), then finding a way to pay less taxes may be socially beneficial since the reduced availability of public sector funds should result in more efficient public sector expenditures and, in any event, in less rent-seeking activity.

18. Roger H. Gordon & Burton G. Malkiel, *Corporate Finance*, in HOW TAXES AFFECT ECONOMIC BEHAVIOR 131 (Henry J. Aaron & Joseph Pechman eds., 1981); William D. Andrews, *Tax Neutrality Between Equity and Capital Debt*, 30 WAYNE L. REV. 1057, 1058-64 (1984).

19. Michael S. Knoll, *Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking*, 38 VILL. L. REV. 1461, 1491 (1993); Schlunk, *NQPS*, *supra* note 14, at 67.

20. It should be fairly straightforward to place an upper bound on this amount. Since tax professionals presumably are economic actors pursuing their highest and best use, their aggregate income should provide a bound. But when the income of the tax bar, the tax portion of the accounting profession, the various investment bankers who indirectly practice tax by cooking up various shelter schemes, and the various persons employed in corporate tax departments is aggregated, the result is surely not trivial.

sults often requires threading a needle through a loophole of uncertain size. This invariably leads to more reporting complexity, more government audit expenditures, and more litigation than would a more straightforward structure. This in turn leads to more uncertainty, and ultimately less horizontal equity between taxpayers, with irrelevant factors like the quality of reviewing IRS agents, the negotiating tactics employed at appeals, and the luck with a given trier of fact affecting ultimate tax burdens and, again, determining the winners and losers in the economic game. There is much to be said for a simple unavoidable tax that simply hits you over the head.<sup>21</sup>

Finally, there are costs related to the inability ideally to accommodate interest-holder preferences. There are at least two aspects to these costs. First, taxpayers will craft capital structures to optimize the *combination* of their tax and nontax objectives. In general, this means that a capital structure that is ideal purely from an economic perspective can and will be jettisoned for sufficiently compelling tax considerations. If so, suppliers and users of capital will suffer a loss of “consumer” and “producer” surplus.<sup>22</sup> In a capital structure neutral world, such losses would disappear. Since all capital would, in every relevant sense, be taxed alike, no tax benefits could be secured by slightly or even radically altering capital instruments. Taxpayers could structure their instruments, free of worry as to tax classification, in whatever way maximized their utility based on nontax considerations.

A second and subtler cost associated with the lack of capital structure neutrality is the creation of tensions among holders of a single class of a corporation’s capital interests.<sup>23</sup> For example, consider the

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21. This Article by design focuses only on the effects of capital structure on corporate tax collections. In certain capital structure neutral tax regimes, opportunities unrelated to capital structure will remain to reduce the amount of corporate or even interest holder tax. Were such a capital structure neutral tax regime adopted, it is certainly to be expected that considerable resources would continue to be expended — wasted — in attempts to exploit such opportunities.

22. Consider, for example, the recently created tax classification of nonqualified preferred stock (“NQPS”). I.R.C. §§ 351(g) and 354(a)(2)(C) generally impose gain recognition on exchanges in which NQPS is received. As a result, NQPS will never be received. Rather, persons who would have liked to receive an instrument that would happen to be categorized as NQPS will accept instead a slightly altered instrument that defers their gain recognition. Schlunk, *NQPS*, *supra* note 14. But these altered instruments will by definition be less ideal than those they replace. Perhaps they will require their holder to retain somewhat more economic risk than such holder desired. Or perhaps the holder will need to engage in additional transactions — themselves costly — to hedge certain retained risk to the maximum extent achievable under the Code. Or perhaps the holder will need to engage in additional transactions — partial sales of the position — at times other than those most desired, in order to finance planned consumption. In any event, the transaction parties will suffer, but without any increment of benefit to the Fisc.

23. That tensions exist, even absent taxes, between various classes of *interest* holders is clear. Bondholders tend to like conservative business decisions; equity holders prefer management to roll the dice (precisely because they have bondholders to absorb a share of the potential losses). In a world with efficient markets and without the possibility of opportunist-

realization requirement for capital gains. When coupled with multiple interest-holder tax rates, this requirement can produce divisions among equity holders as to how to accomplish the generally agreed-upon goal of maximizing equity-holder wealth. Tax-exempt and other low tax rate equity holders will generally support any above-market taxable acquisition of their corporation; higher tax rate equity holders may not. Thus the most fundamental corporate decision — whether to sell the corporation — can become contested. Similarly, consider the cash method taxation of dividends. Tax-exempt and other low tax rate equity holders will generally be roughly indifferent as to a corporation's dividend policy; higher tax rate equity holders will not be. Again, an important corporate decision — earnings retention policy — can become contested. In both these cases, the tax culprit that causes the inconsistent preferences — the realization requirement for capital gains in the first case, the cash method for taxing dividends in the second — cannot be reconciled into a capital structure neutral tax regime. And indeed, no capital structure neutral tax regime would create these particular tensions.

I also promised to make a third point — a political point — about capital structure neutrality. Unlike certain Code provisions, which clearly manifest congressional intent to benefit some taxpayer or another, most of the opportunities and/or traps created by the Code with respect to corporate capital structure do not appear to reflect any coherent congressional intent. Consider, most importantly, the corporate deduction for interest expense. Some businesses, with very steady cash flows, have little difficulty issuing debt instruments. Other businesses, with more volatile cash flows, have great difficulty issuing debt instruments. The former can reduce the aggregate amount of taxes levied on their operations through the judicious use of debt financing; the latter cannot. Yet there is no evidence that Congress intended the corporate interest deduction to have this effect.<sup>24</sup>

Or consider the corporate compensation deduction upon the exercise of a nonqualified stock option. Since the amount of this deduction is determined at exercise, rather than at grant, it rewards most those corporations which have seen their equity perform particularly well. These corporations will also — all things being equal — be generating more income (relative to expectations) than will their poorly performing brethren. Thus, precisely those corporations with income to

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tic “mid-stream” policy changes, these tensions will be fully reflected in the price of the corporation's capital instruments, and so should be of little moment.

Taxes can affect *inter-class* relations in positive or negative ways. One might think that capital structures that expropriate from the Fisc would be liked by all — for the pie to be split by owners, be they debtholders or equity holders, increases. But it need not be so. Deductible dividends (if there were such) would expropriate from the Fisc, but since they would also diminish the bondholders' equity cushion, might fail to win the bondholders' blessing.

24. See *infra* Part VII.

shelter will be able to shelter it. Yet there is no evidence that Congress intended the corporate compensation deduction on the exercise of nonqualified stock options to be an additional reward to the already successful.

Finally, but much more broadly, there is no evidence that Congress intends to give corporations great latitude to use capital structure to determine how much tax, directly or indirectly, they want to pay. Indeed, a raft of Code complexity suggests precisely the opposite.<sup>25</sup>

### PART III — A SOLUTION: INTEGRATION, BUT ONLY SOMETIMES

It is easy to imagine capital structure neutral tax regimes. For example, imposing a tax *only* on corporate income, without any allowances based on capital structure, trivially results in a capital structure neutral regime.<sup>26</sup> Similarly, imposing a tax *only* on interest holders, but on a mark-to-market<sup>27</sup> basis, may result in a capital structure neutral tax regime. Since the only tax levied by such a regime would be measured by something — fair market value — that would in the aggregate be independent of capital structure, there would be no obvious way for taxpayers to game the Fisc.<sup>28</sup>

Both of the foregoing are classically integrated tax regimes. For purposes of this Article, a scheme of corporate and interest-holder taxation is “integrated” if it levies only a single level of tax on some coherently defined measure of income. The measure of income can be some variant of economic income, as in the mark-to-market example, or can be a purely tax-defined notion of income, such as federal taxable income. The important point is that, however taxable income is defined, no part of such income is taxed more than once.

As shall become clear in Part IV below, not all capital structure neutral tax regimes are integrated. Conversely, not all integrated tax regimes are capital structure neutral. Thus, an attempt to integrate our current corporate tax regime by allowing a corporate-level deduction for dividends paid — analogous to the interest expense deduction —

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25. For example, with respect to corporate interest deductibility, see the limitations found in I.R.C. §§ 163(e)(5), 163(j), 163(l), 279, 385.

26. Indeed, certain allowances for capital, as opposed to capital structure, could probably be tolerated. See, e.g., Edward D. Kleinbard, *Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System*, 67 TAXES 943, 957 (1989); Michael S. Knoll, *Designing A Hybrid Income-Consumption Tax*, 41 UCLA L. REV. 1791, 1850 (1994).

27. Mark-to-market taxation taxes interest holders annually on the change in value of the interests they hold. No “realization” is required.

28. See, e.g., Franco Modigliani & Merton H. Miller, *Corporate Income Taxes and the Cost of Capital*, 53 AM. ECON. REV. 433-43 (1963); Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261-97 (1958).

would generally not be capital structure neutral.<sup>29</sup> Among the impediments to capital structure neutrality that would remain are (1) the cash method (for example, as applied to dividends) and (2) the lingering effect of multiperiod basis recovery (for example, as applied to stock and other financial instruments).

### *The Cash Method (a.k.a. Realization)*

The cash method — which is the logical endpoint of the realization requirement — has considerable lay appeal as a touchstone for taxation. The amount of cash received is generally easy to measure; the availability of a medium with which to pay any tax imposed is not in doubt. However, the actual receipt of cash corresponds poorly to a taxpayer's economic income. This leaves taxpayers subject to the cash method with tremendous latitude as to when and how much to pay the Fisc.

The most basic problem with a necessarily cash method dividends paid deduction<sup>30</sup> is that taxpayers can elect accrual instead by arranging to have their stock pay out gains in cash on a current basis. For example, suppose in a two-period world that corporation X has equity capital of \$1000 that it invests in T-Bills yielding 10%. Suppose X's tax rate is 33.33%. Suppose all of X's equity will be owned by a single taxpayer, either A or B. A has a tax rate of 66.67%; B has a tax rate of 0%. (A bit later, I will allow X's equity to be owned partially by A and partially by B.) Finally, suppose that A or B, as the case may be, has no investment opportunities other than X's equity, so that any amounts paid out by X after the first period will be reinvested — after paying taxes of course — in X.

Figure 1 shows a representative sample of four different tax results achievable in a cash method deductible dividends regime. The first pair of results assumes that X pays no first-period dividend on its equity.<sup>31</sup> Thus, both X's deduction and its interest holder's income are

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29. In contrast, a regime that allowed a dividend exclusion for equity holders has a fighting chance of being made capital structure neutral. The key would be to recharacterize a portion of any capital gain as an excludable dividend to the extent of retained earnings. If that were done, the only lingering problem would be a disadvantage to debt to the extent that interest is accrued or paid by corporations having insufficient corporate taxable income. That, in turn, could be cured by making debtholder interest accruals tax exempt to the extent of any shortfall in corporate income.

Equivalently, Michael Knoll has suggested that taxing debtholders on periodic interest (that is, putting them on the cash method) and taxing equity holders on retained earnings, but with a basis adjustment, also results in a capital structure neutral integrated tax regime. See Knoll, *supra* note 19, at 1508-09. Again, provided one cures the disadvantage to debt under circumstances of insufficient corporate taxable income, this seems correct.

30. Unlike interest, which generally accrues as a legal matter, dividends or rights to dividends only arise if and when declared by the corporation.

31. Note that under § 305(c) the instrument described in the text is technically common stock, and so is outside of the current preferred stock OID rules. Indeed, the same interest

taxed when X redeems the instrument at the end of the second period. Under these facts, A would be left with \$68.88 of two-year after-tax income, and B would be left with \$206.67 of two-year after-tax income.

FIGURE 1

## 1. Earnings Retained

	X	A	X	B
<b>First Period</b>				
X's Income	100.00	-	100.00	-
X's Div'd Exp/A's Div'd Inc	-	-	-	-
<b>X's Net Income</b>	<u>100.00</u>		<u>100.00</u>	
X's Tax	(33.33)		(33.33)	
X's Retained Earnings	<u>66.67</u>		<u>66.67</u>	
<b>A/B's Income</b>		-		-
A/B's Tax		-		-
A/B's Reinvested Earnings		-		-
<b>Second Period</b>				
X's Income	106.67		106.67	
X's Div'd Exp/A's Div'd Inc	(206.67)	206.67	(206.67)	206.67
<b>X's Net Income</b>	<u>(100.00)</u>		<u>(100.00)</u>	
X's Tax	33.33		33.33	
X's Retained Earnings	<u>(66.67)</u>		<u>(66.67)</u>	
<b>A/B's Income</b>		<u>206.67</u>		<u>206.67</u>
A/B's Tax		(137.78)		-
A/B's After-Tax Income		<u>68.88</u>		<u>206.67</u>
A/B's Two-Period After-Tax Income		<b>68.88</b>		<b>206.67</b>

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holder tax treatment would follow under current law even for cumulative preferred stock, so long as such stock were issued with an unstated but clearly understood policy that X will neither currently declare nor currently pay the accumulating dividends.

## 2. Partial Dividend

	X	A	X	B
<b>First Period</b>				
X's Income	100.00		100.00	
X's Div'd Exp/A's Div'd Inc	(50.00)	50.00	(50.00)	50.00
<b>X's Net Income</b>	<u>50.00</u>		<u>50.00</u>	
X's Tax	(16.67)		(16.67)	
X's Retained Earnings	<u>33.34</u>		<u>33.34</u>	
<b>A/B's Income</b>		50.00		50.00
A/B's Tax		(33.34)		-
A/B's Reinvested Earnings		<u>16.67</u>		<u>50.00</u>
<b>Second Period</b>				
X's Income	105.00		108.33	
X's Div'd Exp/A's Div'd Inc	(155.00)	155.00	(158.33)	158.33
<b>X's Net Income</b>	<u>(50.00)</u>		<u>(50.00)</u>	
X's Tax	16.67		16.67	
X's Retained Earnings	<u>(33.34)</u>		<u>(33.34)</u>	
<b>A/B's Income</b>		155.00		158.33
A/B's Tax		(103.34)		-
A/B's After-Tax Income		<u>51.66</u>		<u>158.33</u>
A/B's Two-Period After-Tax Income		<b>68.33</b>		<b>208.33</b>

## 3. Full Dividend

	X	A	X	B
<b>First Period</b>				
X's Income	100.00		100.00	
X's Div'd Exp/A's Div'd Inc	(100.00)	100.00	(100.00)	100.00
<b>X's Net Income</b>	<u>-</u>		<u>-</u>	
X's Tax	-		-	
X's Retained Earnings	-		-	
<b>A/B's Income</b>		100.00		100.00
A/B's Tax		(66.67)		-
A/B's Reinvested Earnings		<u>33.33</u>		<u>100.00</u>
<b>Second Period</b>				
X's Income	103.33		110.00	
X's Div'd Exp/A's Div'd Inc	(103.33)	103.33	(110.00)	110.00
<b>X's Net Income</b>	<u>-</u>		<u>-</u>	
X's Tax	-		-	
X's Retained Earnings	-		-	
<b>A/B's Income</b>		103.33		110.00
A/B's Tax		(68.89)		-
A/B's After-Tax Income		<u>34.44</u>		<u>110.00</u>
A/B's Two-Period After-Tax Income		<b>67.77</b>		<b>210.00</b>

## 4. A/B sells X's equity at end of period 1 for \$980 (i.e., a loss of \$20)

	X	A	X	B
<b>First Period</b>				
X's Income	100.00		100.00	
X's Div'd Exp/A's Div'd Inc	(100.00)	100.00	(100.00)	100.00
<b>X's Net Income</b>	<u>-</u>		<u>-</u>	
X's Tax	-		-	
X's Retained Earnings	-		-	
<b>A/B's Income (includes loss of \$20)</b>		80.00		80.00
A/B's Tax		(53.34)		-
A/B's Reinvested Earnings		<u>46.66</u>		<u>100.00</u>
<b>Second Period</b>				
X's Income	104.67		110.00	
X's Div'd Exp/A's Div'd Inc	(104.67)	104.67	(110.00)	110.00
<b>X's Net Income</b>	<u>-</u>		<u>-</u>	
X's Tax	-		-	
X's Retained Earnings	-		-	
<b>A/B's Income (includes gain of \$20)</b>		124.67		130.00
A/B's Tax		(83.12)		-
A/B's After-Tax Income		<u>21.55</u>		<u>110.00</u>
A/B's Two-Period After-Tax Income		<b>68.22</b>		<b>210.00</b>

The second pair of results assumes that X pays out as a first period dividend only a portion — here 50% — of its first period earnings. Under such a pay-out strategy, A is worse off than he is when X retains all of its earnings because his tax rate is higher than X's tax rate. Thus, X's dividends-paid deduction saves X less tax than the corresponding dividend inclusion costs A.<sup>32</sup> However, the very same pay-out strategy benefits B. The reason is that B's tax rate is lower than X's. Thus, X's dividends paid deduction saves X more tax than the corresponding dividend inclusion costs B.

The third pair of results assumes that X pays out all of its first period earnings on a current basis. This leads to the same ordering of after-tax results as the partial pay-out strategy immediately above, and for exactly the same reasons. The results are worth noting separately, however, because they correspond to the most likely form of accrual accounting which could be applied. Thus, for example, if X's equity instrument were a mandatorily redeemable preferred stock subject to Code Section 305(c), and if dividends were deductible by X under the same accrual regime, the after-tax results would be those illustrated here, whether or not a first-period dividend was paid. More importantly, since this example corresponds to the tax results under accrual accounting, it demonstrates that taxpayers can achieve accrual accounting results with a cash method instrument simply by adjusting X's dividend policy.

Finally, the fourth pair of results assumes both that X currently pays out all first period earnings (or, equivalently, that X's instrument is subject to the accrual method) and that X's interest holder disposes of the instrument (and buys back an equivalent instrument) at the end

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32. When interest-holder tax rates exceed the corporate tax rate, the ideal strategy in an integrated world is maximum earnings retention on the part of the corporation. The benefit achievable is analogous to that provided by a tax-deferred savings plan such as an IRA or a 401(K) plan. Here, as there, there is a deferred increment of tax — the excess of the interest-holder rate on the inclusion of the dividend over the corporate savings on the deduction of the dividend — that is reinvested at a reduced tax rate (corporate rather than interest-holder) for a period of time.

One can view the deferred increment of tax as a "borrowing" of what is essentially the Fisc's money, but without any need ever to pay any interest on such borrowing. An interest charge can theoretically compensate for the interest-free borrowing from the Fisc. But it is far from clear which interest rate should be used. The Fisc will be whole so long as it is paid the rate at which it borrows (since it can cover any revenue shortfall by borrowing at such rate). But that will leave the borrower with a far better interest rate than the borrower would generally be able to achieve on his own. Using the borrower's borrowing rate should make the borrower indifferent, but determining such rate poses some practical difficulties. Finally, one could use whatever rate is implied by the borrower's actual investment results, providing the fungibility of money is suitably accounted for. While this approach might appear undesirably to link the Fisc's fortunes with those of the borrower, it is hard to argue that they are not already inextricably intertwined by the tax system as a whole.



of the first period at a \$20 loss.<sup>33</sup> In addition to the dividend income, A or B thus recognizes a \$20 first-period loss (and a corresponding \$20 second-period gain).<sup>34</sup> Under these assumptions, a fourth set of after-tax results — indeed those corresponding to a mark-to-market interest holder tax regime — is achieved.

Since identical economic fact patterns lead to different tax results, the proffered tax regime — integration by means of a dividends-paid deduction — is not capital structure neutral.<sup>35</sup> But could it easily be made so? Ignoring the additional complexities posed by dispositions (as in the fourth scenario above), one might think the answer is yes, provided only corporate and interest-holder tax rates were uniformly the same. For in that case, corporations could not increase the after-tax yield of their interest holders through opportunistic distribution decisions. Whatever tax collections the Fisc loses by virtue of a corporate distribution, it exactly recovers by virtue of an interest-holder income inclusion. Or phrased differently, whatever tax collections the Fisc gains by virtue of a corporate decision to retain earnings are exactly offset by the tax collections foregone with respect to the withheld dividend. So at all times, the capital available for interest holder investment is fixed; there is no way to “borrow” or “lend” incremental amounts from or to the Fisc.

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33. Since I still assume that X earns 10% on all of its invested capital, the explanation for the price decline is unlikely to be a global increase in interest rates. Rather, it is likely related either to X's credit quality or the liquidity of X's equity.

34. In this example, X's interest holder is treated as not being subject to any loss limitation rules, such as the wash-sale rules of § 1091 or the limit on the deductibility of capital losses of § 1211(b). The justification for this treatment is that in practice, such rules are generally easily avoidable, particularly in the context of an interest holder with a portfolio of investments. Such a holder can reacquire economically identical instruments, which are not, however, “substantially identical” within the meaning of § 1091. And he will typically have gains from the sales of other instruments which can absorb any selectively realized capital losses.

35. One could object to the analysis in the text on the basis of economic compulsion. If the corporate tax rate were lower than the average interest-holder tax rate, so that retention of earnings were a good thing, one would expect corporations to be capitalized with nothing but equity, and that equity would never pay dividends. Thus, in a sense, there would not be any choice as to capital structure. Conversely, if the corporate tax rate were higher than the average interest-holder tax rate, so that retention of earnings were a bad thing, one would expect corporations to be capitalized either with zero-coupon debt instruments or with current-pay debt or equity instruments. The choice would depend on whether there were an effective method of compelling reinvestment of distributed funds. But, again, the interest and/or dividend deduction would accrue currently, and so there would be no real choice as to capital structure.

A simple response to this is that a system is not capital structure neutral if it offers a smorgasbord of tax results, even if some are only chosen by the misinformed. Even the current tax system compels taxpayers to act in certain ways so as to minimize tax, and arguably any failure on the part of taxpayers to act in exactly such ways is in effect a voluntary payment to the Fisc by the misinformed. But whether one views the Code as presenting opportunities, traps or both, the fact remains that under both the cash method system discussed in the text and the horribly complicated system confronted in the real world, there is a need to be informed. Under a capital structure neutral tax regime, this need vanishes.

In the examples, assuming that A and B each own an identical share of X, corporate and *average* interest holder tax rates would be the same.<sup>36</sup> Since our tax system is — even post-1986 — staunchly progressive with different tax rates imposed on different interest holders, as well as with a cadre of interest holders who are blessed with tax-exempt status, this is the best one can presently hope for. But is it enough?

No, unless there is a way of forcing every interest holder to hold the average portfolio. Put differently, a progressive rate structure permits the targeting of capital instruments to taxpayers with specific tax characteristics (tax clienteles). Thus, sticking with the example above, suppose A and B each provide X with exactly half of its capital (thus guaranteeing that X's *average* interest holder has a tax rate of 33.33%, since the average of A's 66.67% tax rate and B's 0% tax rate is 33.33%). What would X do? It would issue two classes of equity instruments, one of which would be current-pay and one of which would not. A and B would then perfectly segregate themselves: A would purchase only noncurrent-pay instruments and B would purchase only current-pay instruments. Thus, contrary to hope and intent, the Fisc would not extract exactly the same amount of tax from a dividend inclusion as it loses from a dividend deduction. Moreover, so long as tax-exempt interest holders such as B were allowed to retain their tax exemption, there is no tax rate that could be imposed on the taxable interest holders that would effectively offset the tax savings from the corporate dividend deduction. That dooms any integration scheme based on a cash method dividends paid deduction.

#### *Accrual Methods*

An interesting question is whether the accrual method can save the day. The most honest answer is that it depends on what is being accrued. Thus, suppose accrual is based on expected returns, but with a true-up mechanism to conform the expected returns which have been taxed to the actual returns realized by an interest holder upon the occurrence of certain events (for example, the distribution of cash in excess of accruals and/or the disposition of the instrument).<sup>37</sup> Suppose further that expectations are rational, so that both the Fisc and all taxpayers know the expected returns that any financial instrument will generate.

Consider an equity instrument issued by X and having an expected return of 10%. If A, whose 66.67% tax rate exceeds X's 33.33% tax

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36. The average of A's 66.67% tax rate and B's 0% tax rate is 33.33%, which is X's tax rate.

37. Cf. Treas. Reg. § 1.1275-4(b)(6) (1999) (providing rules for the treatment of positive and negative adjustments under the noncontingent bond method).

rate, holds such instrument, the following optimal strategy will obtain: Suppose the actual return from the instrument, in a given period, exceeds 10%. X should nonetheless pay out no more than 10%. By hypothesis, for any pay out up to 10%, the pay out does not affect the tax accrual of 10%. A higher pay out, however, both increases X's deduction and increases A's dividend inclusion. Since A's tax rate exceeds X's, this is in effect a negative arbitrage. Phrased differently, a deferral opportunity will have been lost. Now suppose that the actual return from the instrument, in a given period, is only 5%. In that case, X should redeem the instrument. Such redemption will trigger a true-up for A, thus insuring that A is taxed only on the actual 5% return rather than on the hypothesized 10% return. X's deduction may or may not be adjusted likewise (that will depend on whether cancellation of indebtedness income ("CODI")-like tax rules were instituted to replace Code Section 1032), but even if so, the lost deduction would cost X less in tax savings than the reduced income inclusion would save A.

Now suppose B, with his 0% tax rate, holds X's equity instrument. If the actual return from the instrument exceeds the tax accrual of 10%, X should pay out the entire actual return. For, in that case, X's deduction for dividends paid saves more tax than B's corresponding dividend inclusion costs. If, however, the actual return from the instrument is less than 10%, X and B should simply do nothing; X's benefit from the phantom excess deduction exceeds B's detriment from the phantom excess income inclusion.

And, of course, if both A and B want to hold X's equity instruments, X should create two classes of an otherwise identical instrument, with one class predictably serving the best tax interests of A and the other predictably serving the best tax interests of B. A and B will segregate their ownership in the most advantageous way. And the Fisc, for all its accuracy in accruing expected returns, will nonetheless be fleeced by taxpayers. Why? Because the true-up effectively places taxpayers on the cash method with respect to any difference between actual returns and expected returns. Thus, all the opportunities and pitfalls of the pure cash method system for equity remain, but are simply calculated with respect to a new baseline expected return: the implicit 0% expected return accrual of the pure cash method system has been replaced with an economically correct expected return accrual.

What must be done to achieve capital structure neutrality? One must abolish the ability to do postissuance tax planning. There are essentially three ways to accomplish this. At one extreme, one could ignore all true-ups. Taxpayers would be taxed on what they were expected to earn, rather than on what they actually earned.<sup>38</sup> This

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38. Of course, Congress would be bombarded by pleas from underperformers and by requests for the blood of overperformers.

effectively turns the income tax into a wealth tax, and is further discussed in Part IV below.

Second, at the other extreme, one could require an annual true-up (assuming an annual measurement of income and an annual collection of tax). Thus, each period would end with an accurate measurement of economic income, and there would be neither unrealized income to defer nor unrealized losses to accelerate. This tax system is, of course, commonly referred to as mark-to-market, and is also discussed further in Part IV below.

Third, one can try a completely different tack, by accruing equity holder taxable income neither on the basis of an expected market rate of income (as in a wealth tax) nor on the basis of actual investment performance (as in a mark-to-market tax), but rather on the basis of corporate taxable income. That is, rather than imposing any tax at the corporate level, and thus making relevant differences between equity holder and corporate tax rates, one could allocate corporate income among corporate interest holders (with suitable basis adjustments). Current tax rules for the taxation of debt already have the feature of moving a portion of a corporation's taxable income into the hands of debtholders. If the remainder were transported into the hands of equity holders, capital structure neutrality could result.<sup>39</sup>

#### *Multi-Period Basis Recovery*

Another feature of current tax law that conflicts with capital structure neutrality is the host of different methods of multi-period basis recovery. As these would not necessarily be eliminated by all forms of corporate integration, it follows again that not all integrated tax regimes are capital structure neutral. In particular, simply adding a corporate dividends-paid deduction would not necessarily limit taxpayer choices with respect to basis recovery.

A short list of taxpayer basis recovery choices (not limited to corporate capital instruments) follows. Subchapter K, Subchapter S and "open transaction" treatment — which is still allowed for liquidating distributions from C corporations and in certain other unusual circumstances<sup>40</sup> — all allow basis recovery to precede income recognition. On the other hand, debt and equity instruments acquired for cash — the heart of Subchapter C — generally feature only basis recovery upon the disposition of the instrument. Along with these basis recovery first and last regimes, the Code contains some ratable recovery schemes as well. Thus, if a debt instrument is received in exchange for property, basis recovery is ratable to the expected "total contract price" set forth

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39. See Knoll, *Taxing Prometheus*, *supra* note 19, at 1508-09.

40. See generally Rev. Rul. 68-348, 1968-2 C.B. 141; Rev. Rul. 85-48; 1985-1 CB 126; see also Temp. Treas. Reg. § 15a.453-1(d)(2)(iii).

in the debt instrument, assuming the instrument otherwise provides for adequate interest.<sup>41</sup> But if the debt instrument is a contingent payment debt instrument, then depending on the nature of the contingency, basis may be recovered in proportion to the maximum potential payments, if such maximum is determinable, or equally over a set number of years, if the number of years over which payments may be received is determinable, or in fifteen equal annual installments, if neither the maximum selling price nor a maximum period for payments can be established.<sup>42</sup> Then there are the contingent payment OID regulations, which contain the so-called “noncontingent bond method,” pursuant to which a projected payment schedule with a predetermined yield is established, and basis is recovered in proportion to the principal payments under such schedule.<sup>43</sup> Finally, Code Section 1256 dispenses with all such nonsense for futures contracts and similar financial instruments, providing instead for full annual basis recovery (a.k.a. mark-to-market).

That the type of basis recovery scheme affects the desirability of a given capital instrument should be obvious from the history of the open transaction method, as well as from such recent abuses of the installment sales basis recovery rules as those found in *ACM Partnership v. Commissioner*.<sup>44</sup> But a brief example will nonetheless help make the point. Suppose A acquires for \$100 X's instrument which promises a cash flow of \$10 at the end of the first period and \$110 at the end of the second. A can and will reinvest his first period's after-tax cash receipt at the same implied 10% pre-tax rate. Assume A's tax rate is 40%.

The first part of Figure 2 illustrates some of A's possible after-tax results, depending on the basis recovery rule employed. Not surprisingly, A is better off the sooner he can recover his basis. Of course, current federal income tax law would not allow A the totally unfettered choice of basis recovery scheme. However, there are situations in which taxpayers can strategically choose from side-by-side basis recovery schemes. Moreover, such choice will continue to plague tax collections as long as there is no effective integration for tax purposes of all instruments held by a single taxpayer.

The second part of Figure 2 shows how the self-help of breaking a single instrument into two instruments affects A's tax results. Suppose the first instrument promises a cash payment of \$10 at the end of the first period, and the second promises a cash payment of \$110 at the end of the second. So long as the term structure of interest rates is flat

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41. I.R.C. § 453.

42. Treas. Reg. § 15a.453-1(c).

43. Treas. Reg. § 1.1275-4(b).

44. 157 F.3d 231 (3d Cir. 1998).

and there is a proper accrual for tax purposes of the yield on the second instrument, A gains nothing from his ploy. But neither of these conditions is likely to hold in practice. Thus, the second part of Figure 2 shows how a term structure that is not flat can and should affect tax collections. It also shows how the lack of proper accrual affects tax collections.<sup>45</sup>

FIGURE 2: PART 1  
BASIS RECOVERY SCHEMES — SINGLE INSTRUMENT

	Basis Recovered First	Basis Recovered Upon Disposition	Basis Recovered Ratably to Cash	Basis Recovered Equally Each Period
<b>First Period</b>				
Invested Amount	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
Total Basis	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
Cash Received	\$ 10.00	\$ 10.00	\$ 10.00	\$ 10.00
Basis Recovered	\$ 10.00	\$ -	\$ 8.33	\$ 50.00
Taxable Income	\$ -	\$ 10.00	\$ 1.67	\$ (40.00)
Tax Paid	\$ -	\$ (4.00)	\$ (0.67)	\$ 16.00
After-Tax Cash	\$ 10.00	\$ 6.00	\$ 9.33	\$ 26.00
Adjusted Basis	\$ 90.00	\$ 100.00	\$ 91.67	\$ 50.00
<b>Second Period</b>				
Invested Amount	\$ 110.00	\$ 106.00	\$ 109.33	\$ 126.00
Total Basis	\$ 100.00	\$ 106.00	\$ 101.00	\$ 76.00
Cash Received	\$ 121.00	\$ 116.60	\$ 120.27	\$ 138.60
Basis Recovered	\$ 100.00	\$ 106.00	\$ 101.00	\$ 76.00
Taxable Income	\$ 21.00	\$ 10.60	\$ 19.27	\$ 62.60
Tax Paid	\$ (8.40)	\$ (4.24)	\$ (7.71)	\$ (25.04)
After-Tax Cash	\$ 112.60	\$ 112.36	\$ 112.56	\$ 113.56

The foregoing effects may be magnified when the corporate tax — even a corporate tax integrated with a dividends paid deduction — is taken into account. The reason is that a debt instrument's precommitment to a certain stream of cash flows restricts the ability of the parties to alter basis recovery schemes. Thus, suppose now that X corporation pays tax at a 33.33% rate. It predictably earns \$10 before taxes. Its interest holder, A, who pays tax at a 66.67% rate on all income (including capital gains, so that the capital gains preference makes no difference) wants to maximize the after-tax return from X's distribution of X's after-tax income. Suppose A's initial basis in its X instrument is \$100, and that the value of that instrument climbs dollar-

45. This could occur, for example, if the instruments in question were equity instruments and if the "promised" cash flows were not sufficiently promised to invoke the preferred stock OID rules. What the bifurcation amounts to is a successful dividend strip.

for-dollar from \$100 by the amount of X's after-tax earnings. If A receives a payment from X either as interest on a debt instrument or as a dividend on stock, the amount received is \$10 (since I am assuming dividends are deductible). A pays \$6.67 of tax and retains \$3.33.

FIGURE 2: PART 2  
BASIS RECOVERY SCHEMES — TWO INSTRUMENTS

	Term Structure Not Flat* YTM Taxation		Term Structure Not Flat* Proper Taxation		Successful Dividend Strip	
	Instru- ment #1	Instru- ment #2	Instru- ment #1	Instru- ment #2	Instru- ment #1	Instru- ment #2
<b>First Period</b>						
Invested Amount	\$ 9.26	\$ 90.74	\$ 9.26	\$ 90.74	\$ 9.09	\$ 90.91
Total Basis	\$ 9.26	\$ 90.74	\$ 9.26	\$ 90.74	\$ 9.09	\$ 90.91
Cash Received	\$ 10.00	\$ -	\$ 10.00	\$ -	\$ 10.00	\$ -
Basis Recovered	\$ 9.26	\$ -	\$ 9.26	\$ -	\$ 9.09	\$ -
Taxable Income	\$ 0.74	\$ 9.16	\$ 0.74	\$ 7.26	\$ 0.91	\$ -
Tax Paid	\$ (0.30)	\$ (3.67)	\$ (0.30)	\$ (2.90)	\$ (0.36)	\$ -
After-Tax Cash	\$ 9.70	\$ (3.67)	\$ 9.70	\$ (2.90)	\$ 9.64	\$ -
Adjusted Basis*	\$ 6.04	\$ 99.90	\$ 6.80	\$ 98.00	\$ 9.64	\$ 100.00
<b>Second Period</b>						
Invested Amount	\$ 6.04	\$ 98.00	\$ 6.80	\$ 98.00	\$ 9.64	\$ 100.00
Total Basis	\$ 6.04	\$ 99.90	\$ 6.80	\$ 98.00	\$ 9.64	\$ 90.91
Cash Received	\$ 6.78	\$ 110.00	\$ 7.63	\$ 110.00	\$ 10.60	\$ 110.00
Basis Recovered	\$ 6.04	\$ 99.90	\$ 6.80	\$ 98.00	\$ 9.64	\$ 90.91
Taxable Income	\$ 0.74	\$ 10.10	\$ 0.83	\$ 12.00	\$ 0.96	\$ 19.09
Tax Paid	\$ (0.30)	\$ (4.04)	\$ (0.33)	\$ (4.80)	\$ (0.39)	\$ (7.64)
After-Tax Cash	\$ 6.48	\$ 105.96	\$ 7.30	\$ 105.20	\$ 10.21	\$ 102.36
	112.44		112.50		112.58	

\* First period interest rate is assumed to be 8%; second period interest rate is therefore 12.24%.

\*\* This assumes that taxes with respect to the two-period instrument are paid from the proceeds of the one-period instrument.

If A holds stock, but not if A holds debt, A can change this result. In that case, X could pay no dividend, but could instead use its after-tax income to repurchase a bit of A's stock. In such case, X would have after-tax cash of \$6.67 (\$10 of income less \$3.33 of corporate tax) and would redeem 6.25% of A's stock (\$6.67 out of \$106.67). A would be entitled to a basis offset of \$6.25 (6.25% of A's total basis of \$100). Thus, A would pay tax of 66.67% only on a gain of \$0.42 (\$6.67 minus \$6.25), for a tax payment of \$0.28. When the dust settles, A is left with \$6.39 (\$6.67 sales proceeds less \$0.28 of taxes), which is considerably

more than in the case of receipt of an explicit dividend. Tax rules thus favor equity. And the net effect is that capital structure is not neutral.<sup>46</sup>

Thus, economically identical corporate capital instruments can yield disparate tax results solely due to the possible availability of different schemes of multi-period basis recovery. To achieve capital structure neutrality, such differences cannot be tolerated. There are two basic solutions. First, one could dispense with basis recovery altogether — that is, basis is *never* recovered — as one would do, for example, under a wealth tax.<sup>47</sup> Part IV below discusses such schemes. Alternatively, one could recover basis, in its entirety, every period. This is essentially what a mark-to-market income measure accomplishes. This, too, is discussed in Part IV below.

#### PART IV — A SOLUTION: DECOUPLE THE TAXES

The lesson of the prior Part is that integration does not guarantee capital structure neutrality. The converse is true as well: capital structure neutrality does not require integration. For example, consider a tax regime in which a corporate tax is imposed on some definition of corporate income, but without any deductions (or other adjustments) in respect of items determined or affected by a corporation's capital structure. Thus, corporate tax collections can neither be decreased nor increased by virtue of capital structure. Under such a regime, a CFO will be unable to generate wealth for the corporation's interest holders at the expense of the Fisc, *unless* such CFO structures the corporation's capital interests so that such interests, in and of themselves, generate tax opportunities for their holders.

Current law taxes corporate interests in ways that create precisely such opportunities. Most equity instruments (and even some debt instruments) provide their holders with elective deferral. In addition, most equity instruments allow their holders to characterize economic gains as capital gains, which are subject to reduced tax rates. Finally, all instruments — by virtue of the realization requirement — allow holders strategically to dispose of them to accelerate losses (subject, of course, to certain ineffectual limitations such as the wash sale rules and the annual limitation on net losses).

I do not know of any easily comprehensible intuitive way to characterize all possible interest-holder tax regimes that do not create any such tax opportunities. Professors Auerbach, Bradford, and Strnad

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46. The differences between the Code § 1032 regime for reacquired equity and the Code § 108 and Treas. Reg. § 1.163-7(c) regime for reacquired debt will magnify the benefits of equity in cases of falling value.

47. The retroactive capital gains taxation scheme set forth in Auerbach, *supra* note 5, is another example of a scheme with no basis recovery.



have each developed formulations for such regimes.<sup>48</sup> Applying such formulation to create actual usable tax rules, however, is another matter entirely. I will not attempt a universal formulation. Rather, I will give a series of more-or-less easily comprehensible solutions. They include excise taxes, wealth taxes, consumption taxes and accretion taxes. Which, if any, of such taxes can linguistically, economically, constitutionally or otherwise be fairly termed *income* tax is a question for another day.

#### A. Excise Taxes

By excise tax I mean any tax imposed on an interest holder merely by virtue of his status as such, but not necessarily measured by any economic feature of his capital holdings. Thus, for example, a tax regime could extract a uniform tax — \$1 — from any holder of any capital instrument. If such tax were imposed simply on the privilege of ownership, and did not multiply when a holder held more than one capital instrument, there would be nothing either a CFO or an individual who wished to invest in capital instruments could do to diminish the tax.

Less trivially, one could impose an excise tax on an interest holder's invested capital. Such a tax, which has a whiff of franchise tax about it, could be based on any of a myriad of different measures of capital, ranging from the amount of invested capital such interest represented at the time it was issued (that is, how many dollars actually went into the corporate coffers), to the amount of invested capital plus retained entity-level earnings such interest represents currently (based on some capital structure neutral allocation scheme of such earnings), to the fair market value of such interest (this last being also what I call a wealth tax, and hence being dealt with in Section B below).<sup>49</sup> So long as all types of capital are treated equally — for example, so long as debt-financing is made equally subject to such tax — there will be no ability on the part of corporations or their interest holders to tinker with the amount of such tax.<sup>50</sup>

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48. See Auerbach, *supra* note 5; David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency, and Correctness in the Taxation of Financial Instruments*, 50 TAX L. REV. 731 (1995); Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569 (1994).

49. Some superficially similar measures, such as the amount the holder actually paid for the interest in the secondary market, will not accomplish the goal. For example, such a basis-type measure would introduce realization-type rules into the system. Thus, a taxpayer will have an incentive never to exchange an instrument he acquired at a low cost; he will be "locked in." (This is a form of deferral!) Using the terminology previously developed, post-issuance taxpayer behavior would affect aggregate tax collections, in violation of the dictates of capital structure neutrality.

50. At least one of the metrics arguably allows some tinkering: If the corporation pays out a higher fraction of its earnings, there would appear to be a smaller tax base in the event

### B. *Wealth Taxes*

On the most simple level, and assuming away valuation problems, an interest-holder tax based on wealth offers little prospect for gamesmanship. Few CFOs and fewer interest holders will purposely create capital structures that depress the value of their corporations.<sup>51</sup>

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of an excise tax imposed on the sum of invested capital plus retained earnings. But such appearance is deceptive. Provided interest holders did not change their consumption/investment patterns on the basis of dividend policy, and provided further that the excise tax applied equally to investments in all manner of entities (including, for example, partnerships), any incremental dividend pay outs would be reinvested in another entity, and so would still attract the excise tax.

51. Of course, one can not exclude such behavior entirely. For example, corporate capital structures are sometimes designed to accomplish such noneconomic goals as preserving family ownership, and in such cases might depress the aggregate value that the corporation's capital interests would have under a more ideal capital structure. (Private ownership may, in some cases, actually increase value. For example, a private company will escape certain costly reporting requirements. In addition, the dearth of public information about a private company may give it certain competitive advantages. Since such increases in value will presumably be reflected in the company's earnings, they should easily be accounted for in valuation.)

Fundamentally, a depressed value for a private corporation's capital interests may result from either of two causes. First, the management which is entrenched by the capital structure may be woefully inefficient. Second, the capital structure itself may cause the corporation's capital interests to be illiquid. A fair wealth tax would *not* make allowances for such depressions of value (i.e., it would be imposed on the higher value the corporation would have if it had better management and/or more liquid interests).

Eradicating the collateral wealth tax benefits of inefficient management may seem analogous to taxing individuals on the basis of their potential, rather than on their actual, earnings (or equivalently, to taxing leisure). And it is. But unlike in the case of leisure, where one quickly runs into issues sounding of human dignity, involuntary servitude, and the like, in the case of corporations the question is more-or-less squarely one of optimal (non-human capital) asset deployment. (Not entirely, of course, since the inefficient deployment of the manager's human capital is involved, and perhaps too that of other nepotistically-hired employees.) And whatever society may think about the pursuit of happiness, it need not and should not think the same about the wasteful deployment of assets.

Moreover, a host of intangible benefits — power, prestige, satisfaction, whatever — generally flow from dynastic ownership. Economically, these are additional items of “income” accruing to the owners of the capital interests to which the benefits attach. If a corporation's owners are rational, the “private” value represented by such benefits must at least compensate for the foregone “market” value resulting from inefficient asset management. Fairness dictates that a wealth tax should not countenance any discount for a capital structure that reduces “market” value for the sake of creating such “private” value.

Accounting for liquidity issues in a wealth tax may pose different concerns, but not in the case of self-imposed restraints on alienation. Those, at least, are pure examples of temporarily destroying market value for the sake of creating private value. And indeed, most valuation methodologies can easily accommodate the inclusion of the intangible ownership benefits created by illiquid structures. In particular, any methodology that takes as a starting point a measure of value, and then applies a discount — blockage, liquidity, lack of marketability, or however else denominated — can be used. One simply does not apply the discount.

More problematic are cases where an illiquid interest is acquired at a discount to what would have been its value if it were liquid. Generally, to compensate for illiquidity, the purchaser will require a higher expected rate of return than is available from liquid assets. Since the wealth tax under discussion is intended to be a substitute for an income tax, and since the expected return from an asset is arguably a better measure of income than is some preordained fraction of the asset's value, one can make a compelling argument for even ignoring

What might a suitable periodic wealth tax look like? There seem to me two general approaches. First, one could tax a fraction of an individual's net worth, determined at the beginning of the tax period.<sup>52</sup> This approach is equivalent to imputing an expected return at a fixed rate on the individual's assets, and imposing a tax on such expected return. That such a tax is capital structure neutral is relatively obvious. The amount of tax paid by any interest holder is fixed before he makes his investment decisions, and is independent of such decisions. Thus, his investment decisions will reflect his tax-independent risk and reward preferences. Accordingly, whether his tax rate is high or low, his investment decisions will not change. And nothing a CFO can do to design instruments with different risk-reward profiles will successfully steer any such instruments (e.g., high expected return instruments) systematically into the hands of taxpayers of any one tax rate (e.g., a low tax rate).

The second broad approach to a wealth tax — albeit one quite impractical to implement — is to tax an individual on the expected return from his specific mix of assets.<sup>53</sup> This approach is to some extent hinted at in the OID rules.<sup>54</sup> And it is also, to some extent, the approach advocated by certain scholars.<sup>55</sup> It is not entirely clear, however, that this approach is still capital structure neutral. Here's why.

Any corporation (in particular one in a world imposing a corporate-level tax that is unaffected by capital structure) is economically a

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the discount in this case. For example, suppose an asset would sell for \$100 if liquid, and would offer a 10% perpetual expected return. If it is illiquid, it might sell for \$50. But the nominal return would be the same, and so the asset now offers a 20% expected return. If a wealth tax were based on a fixed percentage of an asset's value — for example, 1% — the person holding the liquid asset would pay twice as much tax as the one holding the illiquid asset, even though their expected "incomes" would be the same.

52. A variant would be to base the tax on an individual's end-of-period net worth. Such a tax is equivalent to a combination of a wealth tax imposed on beginning-of-period wealth and a tax on the period's mark-to-market income. This latter type of tax is discussed in Section D below.

Note, in addition, that the periodicity of tax collections means that, under a steady state assumption regarding tax rates, a wealth tax based on beginning-of-period wealth would function (in all periods except the first and the last) exactly like a tax on end-of-period wealth. This for the more-or-less obvious reason that the second period's beginning-of-period wealth tax collection is identical to the first period's end-of-period wealth tax collection, and so on. Hence any wealth tax, including the one measured on the basis of beginning-of-period wealth discussed in the text, includes an implicit tax on mark-to-market gains. I will not take account of this subtlety in the discussion of the potential investment effects occasioned by a "pure" wealth tax.

Finally, other metrics for a wealth tax — such as a period's average wealth, or its minimum or maximum wealth — are easily imagined. Taxes based on such metrics are more complicated to analyze, and produce no discernable benefit. Accordingly, they will be ignored.

53. Such an approach would moot the question posed *supra* note 51, of whether liquidity discounts should be taken into account in the wealth tax base.

54. See Treas. Reg. § 1.453-4.

55. See, e.g., Shuldiner, *supra* note 5.

set of random cash flows. Any state of the world — which will occur with some probability — carries with it one such cash flow. By hypothesis and/or Modigliani & Miller, capital structure does not affect such cash flow. The corporation's capital structure determines entitlements of interest holders to the cash flow, however. By definition, the capital structure must exhaust the cash flow: every dollar belongs to some interest holder; no dollar belongs to more than one interest holder. It follows that the expected value of a corporation's aggregate cash flows across all states of the world must equal the sum of the expected values of the cash flows of the corporation's various capital interests.<sup>56</sup> Moreover, the expected return from the corporation's aggregate asset mix must equal the weighted sum of the expected returns from its various capital interests.<sup>57</sup>

That being the case, a tax imposed *at a uniform rate* on the expected returns of a corporation's capital instruments can not be manipulated by varying capital structure. Create instruments with low expected returns, and some high expected return stub instruments will remain. Sum the products of the beginning-of-period values of the instruments by their expected returns and the result will *always* be the product of the corporation's beginning-of-period value and its expected rate of return. And this equality will, of course, continue to hold if each of the products is in turn multiplied by the prevailing uniform tax rate. Thus, if interest holders are taxed at a uniform rate on their expected returns, the amount of wealth tax to be collected from the holders of capital interests of any given corporation is preordained. It can not be manipulated.

But if a tax is imposed, as is ours, at a variety of tax rates, the equality may break down. That is, a corporation can create a variety of capital instruments with different (but mathematically related) risk-reward relationships. If high tax rate investors systematically gravitate to the low expected return instruments, and low tax rate investors systematically gravitate to the high expected return instruments, the Fisc may yet be whipsawed.

For example, suppose X has \$1000 of capital earning an after-corporate-tax expected return of 10% or \$100. If A, with his 66.67%

56. This is because "expected value," which is just a type of integration, is a linear function.

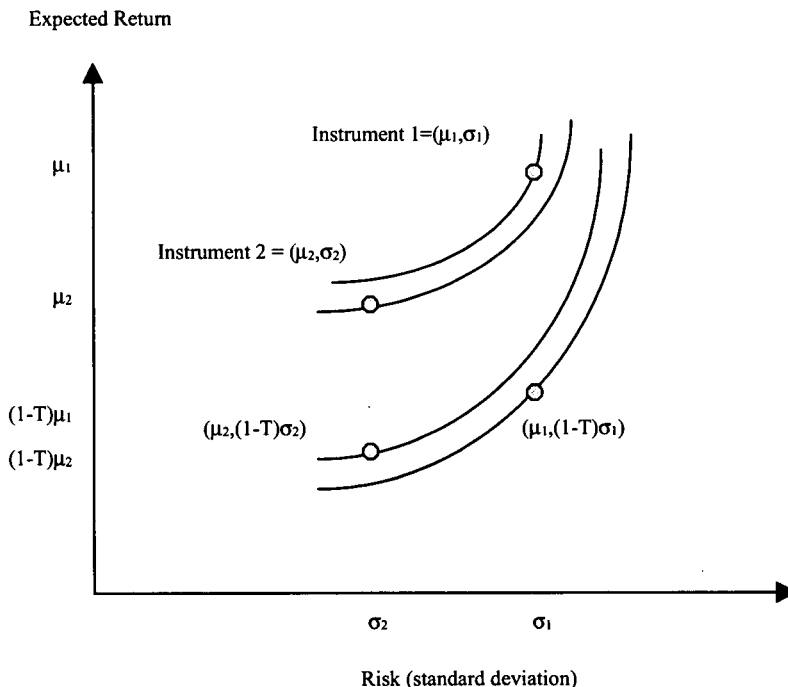
57. Let  $V(0)$  be the value of the entity at the beginning of the given period. Assume two financial interests, A and B, with initial values  $VA(0)$  and  $VB(0)$ . Thus,  $V(0) = VA(0) + VB(0)$ . The linearity of expected values means that end of period expected values must satisfy  $\text{Exp}V(1) = \text{Exp}VA(1) + \text{Exp}VB(1)$ . Expressing this as an expected rate of return yields  $[\text{Exp}V(1) - V(0)]/V(0) = [\text{Exp}VA(1) + \text{Exp}VB(1) - V(0)]/V(0)$ . Substituting  $V(0) = VA(0) + VB(0)$  in the numerator of the right hand side and breaking such side into two fractions yields the modified right hand side:  $[\text{Exp}VA(1) - VA(0)]/V(0) + [VB(1) - VB(0)]/V(0)$ . But such terms can then be rewritten in the form  $[\text{Exp}VA(1) - VA(0)]/VA(0) * VA(0)/V(0)$ . Taken all together, this yields  $\text{ExpRet}(\text{Corporation}) = VA(0)/V(0) * \text{ExpRet}(A) + VB(0)/V(0) * \text{ExpRet}(B)$ .

tax rate, and B, with his 0% tax rate, each hold half of X's capital, total tax collections are \$33.33. Suppose, however, that X can break its capital into two instruments, a safe instrument with an \$800 principal amount paying an expected 8% return and a risky instrument with a \$200 "principal" amount paying an expected 18% return. If A were to gravitate exclusively to the safe instrument, he would earn an expected \$40 per year. The Fisc's wealth tax collection from A would accordingly be \$26.67. Since no additional wealth tax would be forthcoming from B, the Fisc would be a net loser as a result of X's change of capital structure.

But is there any reason to expect that taxpayer preferences might be such as to create this fiscal quandary (or conversely, to create a fiscal bonanza)? Sadly, the answer is yes.<sup>58</sup> The harder question is

58. Assume investor preferences for an investment are fully determined by such investment's expected return and risk (as measured, for ease of presentation, by the standard deviation of the investment's returns, though the analysis is identical if the measure is the investment's covariance with the "market" portfolio). A wealth tax imposed at a rate of T on an instrument's *expected returns* will reduce the expected return of the instrument from the pre-tax ExpRet to  $(1 - T) * \text{ExpRet}$ . But it will leave the standard deviation of the instrument's returns unchanged.

It is possible to conceive of investor preferences that will switch the ordering of investments after taking an expected-returns-based wealth tax into account. Under the preferences illustrated, high risk-reward instruments will migrate into the hands of low tax rate taxpayers:



whether tax policymakers can safely ignore such possible second-order effects.

### C. Consumption Taxes

Consumption taxes are the next installment in the march towards something that might fairly be termed an interest-holder *income* tax. As in the case of wealth taxes, they arguably fit the bill, since a robust consumption tax scheme, at least when viewed over a long enough time horizon (that is, the lifetime of the taxpayer), taxes exactly the entirety of a taxpayer's economic income.

For purposes of this article, I define a consumption-tax scheme as any scheme which allows for the tax deferred receipt of any corporate capital income, provided such income is reinvested in other corporate capital instruments (with the reinvestment option being as broadly or as narrowly defined as desired).<sup>59</sup> Thus, in a loose sense, such schemes reverse the usual academic inclination (typified by calls for mark-to-market taxation) to conform the taxation of corporate equity to rules somewhat akin to those currently applied to corporate debt.<sup>60</sup> In contrast, a consumption-tax scheme is one that allows a holder of a corporate debt instrument the same deferral opportunities as holders of equity instruments currently enjoy. The paradigm for such taxation is the IRA account. Such an account effectively allows the taxpayer to neutralize the effects of various realization rules, and thus allows the holder of a debt instrument to benefit from the same reinvestment of "undistributed" earnings as the holder of an equity instrument enjoys.

I will say little about possible implementation of consumption-tax schemes. One could think of allowing taxpayers to designate one or more accounts which would be taxed as a single aggregate equity investment under current tax rules. At one extreme, the accounts could be narrowly tailored to include a single instrument, such as a corporate bond, and to allow reinvestment merely in identical instruments. At the other extreme, the accounts could be very broad, comprising a taxpayer's entire portfolio of investments. In either case, however, no tax consequences would adhere so long as economic returns, whether interest accruals, cash interest and dividend receipts, or proceeds from security dispositions, were reinvested in the same account. However, if and when the taxpayer withdraws funds from the account, he would be

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As pictured,  $u(\mu_1, \sigma_1) > u(\mu_2, \sigma_2)$ , but  $u((1-T)\mu_1, \sigma_1) < u((1-T)\mu_2, \sigma_2)$ . Thus, tax exempt investor B prefers Instrument 1, while taxable investor A prefers Instrument 2.

59. It is immaterial for my purposes whether, as in many consumption tax proposals, a deduction is allowed to the taxpayer at the time of his initial investment in a corporate capital instrument. Thus, under my definition, both a nondeductible IRA account and a regular IRA account represent a consumption-tax scheme.

60. In particular, the OID rules.

taxed on such withdrawal — notionally such withdrawal would be a “dividend.” And upon dissolution of the account, gain or loss could be tallied and taxed.<sup>61</sup>

For such a scheme to be capital structure neutral, no post-issuance strategic behavior on the part of either an issuing corporation or an interest holder can affect tax collections. That the corporation’s hands are tied follows from the fact that its capital instruments are buried in accounts, with interest holder tax results attaching solely to interest holder actions with respect to such accounts. Thus, for example, a strategic redemption of a capital instrument will not have any tax effect without additional action on the part of the interest holder.

Eradicating interest holder gamesmanship is therefore the issue. That is, for a consumption tax scheme to work, one might think that one needs to attend to such matters as preventing the interest holder from benefiting from strategic dissolutions and reformations of his accounts to accelerate losses.<sup>62</sup> But one does not, for such dissolutions and reformations are independent of the existence of any specific type of corporate capital in the given account. That is, the mere moving of capital instruments into accounts which are taxed as accounts will without more neuter any interest holder tax benefits based on the corporate creation of any specific type of corporate capital.

#### D. Accretion Taxes

An accretion tax bases tax collections on actual investment performance during the period in question. It is exemplified by “economic accrual” or “mark-to-market” taxation. But it would also include, as noted in footnote 52, a “wealth” tax measured on the basis of end-of-period wealth.

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61. As noted, it does not generally matter whether contributions to an account are tax deductible. If they are, a certain simplicity obtains, since there is no need for a basis recovery scheme to be applied to nonliquidating or liquidating distributions. If they are not, a basis recovery scheme would need to be chosen. But so long as any such scheme creates no opportunity for corporate-interest holder manipulation, and it generally will not, which scheme is chosen is irrelevant.

62. One simple way to accomplish this (that is, without excessive tracking of investments and without the implementation of complexities such as the current straddle rules or wash sale rules) is to have the sum total of all of an interest holder’s investments treated as a single portfolio. Or, depending on one’s tolerance of attempted arbitrages across broad classes of assets, one might go less far. Thus, one might allow a taxpayer to designate multiple portfolios so long as such portfolios *sufficiently* minimize the ability to behave strategically. Portfolios based on type of issuer could accomplish this. Thus, a taxpayer might have a portfolio containing capital instruments issued by C corporations, another containing capital instruments issued by single-taxed entities, a third containing government bonds, a fourth containing municipal bonds, a fifth with residential real estate, and so on. It should be noted that capital structure neutrality could be relatively closely approximated without applying a portfolio tax approach to any but the first such portfolio.

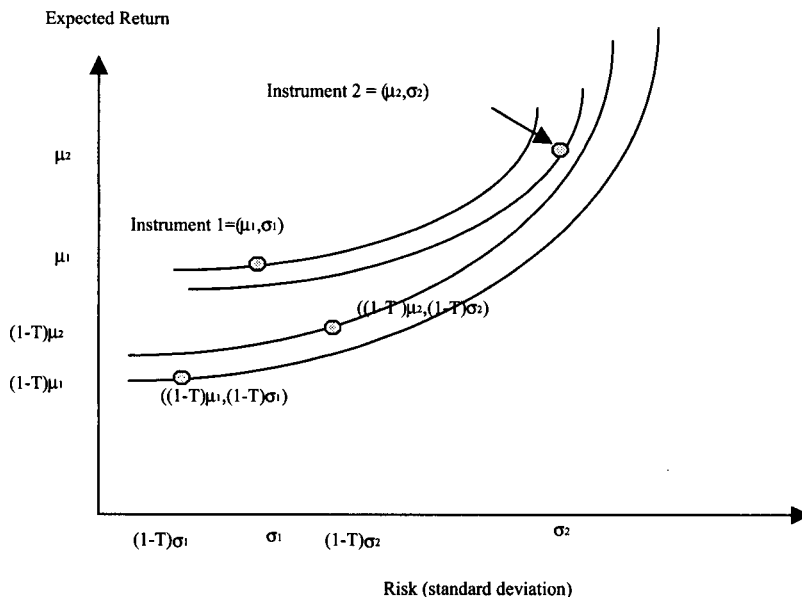
Much has been written about the benefits of such taxation.<sup>63</sup> For purposes of this Article, however, the key point is that an interest-holder tax based on accretion can under certain assumptions be part of a capital structure neutral corporate taxation scheme. That an interest holder can not manipulate such a tax should be obvious. For short of voluntarily sabotaging his actual investment performance (as opposed to his performance as reflected on a tax return under a tax system such as ours), there is nothing he can do to reduce the sting of such a tax, provided, as always, that accurate measurement of fair market value is possible.

But the analysis is not complete unless there is also nothing a CFO can do either to steer high expected return instruments into low tax rate hands, or inadvertently to cause high expected return instruments to migrate into high tax rate hands. Unfortunately, as was the case with a wealth tax, there may be.<sup>64</sup> Again, the harder question is

63. See, e.g., David J. Shakow, *A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986); see also Shuldiner, *supra* note 5.

64. Assume, as in footnote 58, that investor preferences for an investment are fully determined by such investment's expected return and the standard deviation of such return. A tax imposed at a rate of  $T$  on an instrument's *actual returns* will reduce the expected return of the instrument from the pre-tax  $\text{ExpRet}$  to  $(1 - T) * \text{ExpRet}$ . It will also reduce the standard deviation of the instrument's returns from  $\text{StDev}$  to  $(1 - T) * \text{StDev}$ .

It is possible to conceive of investor preferences that will switch the ordering of investments after taking a mark-to-market tax into account. For example, as pictured, high risk-reward instruments may migrate into the hands of high tax rate taxpayers. Again, and contrary to intent, capital structure matters.



As pictured,  $u(\mu_1, \sigma_1) > u(\mu_2, \sigma_2)$ , but  $u((1-T)\mu_1, (1-T)\sigma_1) < u((1-T)\mu_2, (1-T)\sigma_2)$ . Thus, tax exempt investor B prefers Instrument 1, while taxable investor A prefers Instrument 2.



whether such second order effects — even if they could be identified — should drive the design of a tax system.

#### PART V — A DECONSTRUCTION OF THE CORPORATE TAX SCHEME

It is always fun to begin with a tautology. Mine is that any corporate and interest-holder taxation scheme has a deconstruction into the sum of three separate tax levies:

**Levy #1** is a pure corporate-level tax, computed on capital-structure-independent corporate income. Thus, it is the tax imposed on corporate income computed without any deductions or other allowances for items which economically represent a return or payment to any interest holder with respect to such interest holders' invested capital. Note that this levy, viewed in isolation, is by definition capital structure neutral.

**Levy #2** is a corporation interest-holder tax interface, composed of the combination of any corporate tax effect — generally a *reduction* in tax — occasioned by capital structure and any directly corresponding interest-holder tax effect — generally an *increase* in tax — occasioned by the same capital structure feature. For example, a corporation's tax savings arising from the corporate interest expense deduction falls within this levy, while the interest holder's tax on the corresponding interest income may or may not. That is, in order to isolate the effects of capital structure, the interest holder portion of this levy should be limited to interest holder taxes which would not have been collected, *but for* the capital structure feature that occasioned the corresponding corporate tax effect. Thus, if the corporation's interest expense deduction is for a cash interest payment, no interest holder tax should be included (provided the interest holder would have paid a like amount of tax on a dividend), while if the corporation's interest deduction is for an OID accrual, the interest holder's tax on such accrual should be included (unless a like tax would have been imposed on an equity accrual).

**Levy #3** is the residual interest-holder tax, which — to qualify this deconstruction as a tautology — must include all other tax collected from interest holders with respect to such holders' investments in the corporation. For example, since corporate taxes are not generally effected by dividend payments or shareholder capital transactions, any tax collected on shareholder dividend income or capital gains will be part of this levy.

An example will help illustrate this deconstruction. Consider a corporation X with only debt and equity in its capital structure. X's earnings before interest and taxes are \$100. Assume the corporate tax rate is 33.33%. Then, the amount of tax X would pay on its income — computed in a capital-structure independent manner — is \$33.33 (that is, 33.33% of \$100). This is levy #1.

Suppose, however, that interest is deductible, and that X pays \$40 of interest. This payment saves X \$13.33 of tax (that is, 33.33% of \$40). Thus, levy #2 is tentatively -\$13.33. In order to determine whether anything more need be taken into account, other tax rules must be known. Suppose that the interest payment is includible in the income of X's bondholders. Suppose such bondholders pay tax on such interest at a blended 25% rate. Then \$10 of tax is collected as a result of the interest payment (that is, 25% of \$40). It is tempting to say that levy #2 should be the combination of these two pieces, hence -\$3.33 (that is, a loss of \$13.33 of corporate tax revenue and a gain of \$10.00 of interest-holder tax revenue). However, the goal is to isolate the effects of the corporate interest expense deduction. Thus, suppose that X's interest holders pay tax at a blended 10% rate on any dividends received from X. In that case, they would have paid \$4 of tax with respect to the interest receipts, even if such receipts had been denominated a dividend. Thus, the effect of the corporate capital structure decision — to denominate the payment as interest instead of dividend — is an incremental \$6 of tax collected from the interest holders. So viewed, levy #2 is -\$7.33 (i.e., a corporate tax savings of \$13.33 with respect to interest expense, and a bondholder tax increase of \$6 with respect to interest income).

Finally, suppose that X pays out its entire income after interest and taxes as a dividend. Such dividend would be \$40 (that is, \$100 of income before interest expense, less \$40 of interest expense, less \$20 of taxes on the remaining \$60 of taxable income). Since this payment did not affect the corporate tax collection, it has no implications for levy #2. Rather, its effects are limited to levy #3. Suppose, as noted above, that shareholders pay tax at a blended 10% rate on dividends. Then the dividend payment results in \$4 of tax (that is, 10% of \$40). But recall that a part of the tax on interest receipts was excluded from levy #2, since such part would have been collected whether the payment was denominated interest or dividend. This part totaled \$4 as well, and since it has not previously been taken into account in the deconstruction, it is also definitionally a part of levy #3. Finally, assume all other interest holder taxes are \$0 (for example, there is no capital gains tax on dispositions of interests). Then levy #3 is \$8 (that is, \$4 of tax collected on a \$40 dividend payment, and \$4 of tax collected on the \$40 interest payment).

#### PART VI — ALL SOLUTIONS ARE DECOUPLED

In Part IV above, I sketched a number of capital structure neutral tax regimes. When deconstructed, they have two features in common:

1. Levy #2 — that is, the sum of the corporate-level tax effects occasioned by capital structure and any directly corresponding interest-holder tax effects from those very same items — is

identically zero. This is because in each capital structure neutral tax regime sketched in Part IV, there is *no* corporate-level tax effect from capital structure at all. Thus, trivially, there is no corresponding interest-holder tax effect.

2. In each capital structure neutral tax regime sketched in Part IV, levy #3 — that is, all interest-holder taxes other than those included in levy #2 — is itself capital structure neutral. That is, ignoring all corporate-level tax effects (levies #1 and #2), there is no bias in any illustrated tax regime in favor of one financial instrument over another.

More, however, is true.

***Theorem: Every capital structure neutral corporate tax regime must have a deconstruction into three levies — as set forth in Part V — that additionally has the two features — items 1 and 2 above — just posited. That is, it must have a deconstruction wherein (1) levy #1 is capital structure neutral, (2) levy #2 is identically zero, and (3) levy #3 is capital structure neutral.***

The intuition is simple. The sum of things that are capital structure neutral will itself be capital structure neutral. And if something is globally capital structure neutral, and one breaks off a subpart which is capital structure neutral, the remaining piece will be capital structure neutral as well.<sup>65</sup>

More formally, consider any proffered capital structure neutral tax regime. Since every step of the deconstruction process is well-defined, such regime will have a unique deconstruction of the form set forth in Part V above. That is, it will have a derivable levy #1, which is simply that unique amount of tax which would be collected from the corporation if its taxable income were computed without allowing any effects related to its capital structure.<sup>66</sup> And it will have a derivable levy #2,

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65. Cf. Alvin C. Warren Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993). The centerpiece of the article uses put-call parity to deconstruct a fixed return as the sum of three random returns. The same can be done here. It is clearly possible to deconstruct a capital structure neutral tax regime as a sum of tax regimes which are not themselves capital structure neutral, so long as their failures in that regard perfectly offset one another. The proffered deconstruction, by lumping together pieces which need to offset one another, simply brings to light whether the necessary offsets need to be made.

66. It may appear to have multiple such deconstructions. For example, suppose a tax regime approaches the taxation of debt and equity by deeming debt to have an accrual rate of 8% and equity to have an accrual rate of 13%. Assume that both interest and dividend accruals are deductible and includible. Thus, the corporation accrues deductions at 8% or 13%, depending on the type of capital in its capital structure, and the holders accrue income at the same rate.

There appear to be two natural deconstructions of the resulting tax regime. First, one could look at the tax rules and decide that the capital structure independent tax — levy #1 — is whatever tax would be imposed if one ignored both the interest and the dividend deductions. Levy #2 would then include the tax effects of both such deductions and presumably also the tax on the 5% incremental dividend inclusion. Levy #3 would presumably include

which is the unique sum of (i) any corporate-level tax effect caused solely by its capital structure and (ii) any directly corresponding interest-holder tax effect which would not have existed but for this same item of capital structure. And it will have a derivable levy #3, which is the unique amount of any residual interest-holder taxes.

Since levy #1 is definitional — and is definitionally capital structure neutral — it is uninteresting. Suppose levy #2 is not identically zero. Without loss of generality, suppose for some capital structure that levy #2 is negative. This would be the case, for example, if interest deductions cost more corporate-level tax revenue than the corresponding *incremental* interest inclusions generate in interest holder tax collections. A CFO can take advantage of this disparity by placing the favored form of capital in his capital structure. In a world where nothing but taxes matters, he will do so, unless the benefit of doing so is outweighed by *other* incremental taxes.

Turn now to levy #3. If this levy provides a relative tax advantage to the same type of capital as levy #2, the CFO has his mandate, the corporation's capital structure will be loaded up with such capital, the tax world will not be in equilibrium, and quite clearly, contrary to assumption, the tax regime is not capital structure neutral. All the same is true if levy #3 is itself capital structure neutral. And indeed, all the same is true if levy #3 disfavors the type of capital favored by levy #2, provided it does not disfavor it to such an extent as to outweigh the benefit derived from such capital under levy #2. Finally, if the type of capital favored by levy #2 is subjected to such a great disadvantage under levy #3 that the disadvantage actually outweighs the tax saved by such capital under levy #2, the CFO will, or in any event should, turn tail and load the corporation's capital structure with the type of capital disfavored by levy #2. For in that case, on an aggregate basis, the corporation and its interest holders will be better off.

So the only tax regimes which nullify the CFO's shenanigans are those in which any benefit achieved by any type of capital with respect

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the tax on an 8% accrual by interest holders regardless of the nature of the corporate instruments they hold.

But this deconstruction would be incorrect. Instead, one needs to observe that the corporation receives an 8% allowance with respect to its invested capital, regardless of the nature of such capital. Thus, levy #1 should be the tax on corporate income measured *after* taking this allowance into account. (The allowance is equivalent to a reduction in the base corporate tax rate.) In that case, levy #2 would only include the tax reduction from the incremental 5% accruing deduction for equity in excess of debt, as well as the tax on the 5% incremental income inclusion with respect to equity holdings. And levy #3 would still be the tax on the 8% across the board accrual with respect to corporate instruments.

Note that the second — and correct — deconstruction is not made untenable merely because different corporations employ different *amounts* of capital, and so will have different “base” tax rates. Capital structure neutrality does not require that there be no differences in taxation resulting from the *amount* of capital employed by a corporation, but only that whatever that amount of capital, there is no difference in taxation based on the tax character of such capital.

to levy #2 is *exactly* offset by a detriment caused by such type of capital with respect to levy #3. But in such case, it is a trivial matter to properly identify the incremental detriment with respect to levy #3 as being directly related to the capital causing the incremental benefit with respect to levy #2, and so to rewrite the deconstruction with levy #2 as including both the detriment and the benefit and so as being identically equal to zero. And once so rewritten, what remains as levy #3 must be capital structure neutral, for otherwise there will again be opportunities for the CFO, and this time without any remaining tax impositions to offset such opportunities. Thus, any capital structure neutral tax regime must have a deconstruction of the proffered type. QED.

#### PART VII — IMPLICATIONS FOR THE CORPORATE INTEREST DEDUCTION

Subject to a myriad of exceptions, Code Section 163(a) allows any taxpayer — entity or individual — a deduction for “all interest paid or accrued within the taxable year on indebtedness.” This provision has been a part of the Code since the inception of the modern income tax in 1913.<sup>67</sup> No explanation for the original provision was provided; presumably none was needed.

Although predating the Haig-Simons definition of *personal* income, the deduction for interest expense squares neatly with such definition.<sup>68</sup> An amount paid or accrued to a third party creditor is hard to shoehorn into consumption (although if the borrowing was to finance consumption, such an argument can be attempted) and is impossible to shoehorn into wealth accretion. Indeed, for an individual conducting a trade or business, any payment or accrual to any third party provider of *labor or capital*, however denominated, constitutes neither consumption (except perhaps in a disguised gift context) nor wealth accretion, and so should be a Haig-Simons deduction.

But while this makes perfect sense for individuals, it makes not a whit of sense for corporations.<sup>69</sup> A corporation as such neither engages in consumption nor possesses any wealth, accreting or otherwise. Instead, what appears to be its wealth is merely a reserve against the unliquidated claims of various capital providers.<sup>70</sup> Some of the capital

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67. Section II(G)(b) of the Income Tax Act of 1913.

68. HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 61-62 (1938).

69. That the corporate analysis of interest deductions does not track the individual analysis was already clear when the original corporate interest deduction of 1913 was enacted; the deduction for interest expense was limited to an amount of interest accrued and paid on debt representing one-half of the capitalization of the corporation. *See* Section II(G)(b) of the Income Tax Act of 1913.

70. These claims include those of involuntary capital providers such as tort creditors.

providers appear higher on the right side of the balance sheet than others; some are left off altogether. But ultimately it is they, and not the corporation, who own the corporation's apparent wealth, and so it is to them that any accretion in such wealth belongs. Thus it is at best a mystery why income tax regimes have generally allowed corporations to treat payments or accruals to creditors in a fundamentally different — and inconsistent — way from payments or accruals to equity providers.

This is not to say that a capital structure neutral tax regime cannot contain an interest deduction. It can. The more salient question is whether it should. An example will help illustrate. Suppose that a tax regime is implemented that extracts tax at a rate of 33.33% on corporate income and further extracts tax at a uniform rate of 25% on all interest holders' mark-to-market gains. Suppose that the goal is to institute a corporate interest expense deduction that does not deprive the regime of capital structure neutrality. Accordingly, all necessary adjustments will be undertaken to retain such neutrality.

In a given year, assume that corporation X has \$100 of capital structure independent income and \$300 of unrealized appreciation.<sup>71</sup> As the tax legislator, I begin with a deconstruction of X's tax results as set forth in Part V above. Thus, levy #1 is a corporate tax of \$33.33 (that is, 33.33% of \$100). Levy #2 is tentatively zero, both because it must be so in order to have capital structure neutrality and because X's capital structure has not yet been set. Finally, levy #3, the interest-holder tax, is \$91.67 (that is, 25% on \$366.67 of appreciation, where the \$366.67 is itself composed of \$66.67 of X's after-tax taxable income and \$300 of X's unrealized appreciation).

My goal as tax legislator is to give X an interest deduction. So suppose that X pays \$50 of interest to A and that such payment is deductible. Suppose further that A is taxed at a 25% rate on the interest received, either as an application of the general mark-to-market tax or in lieu of the mark-to-market tax. The tax effects are as follows. X's taxable income declines from \$100 to \$50, so the Fisc's tax collection from X falls from \$33.33 to \$16.67. In addition, A pays \$12.50 of tax on the interest received (that is, 25% of \$50).

What are the implications for the deconstruction? Levy #1 is capital structure independent, and so is unchanged at \$33.33. Levy #2 is now negative \$16.67, representing X's tax savings of \$16.67 in respect of its interest deduction. Note that A's tax payment of \$12.50 on his interest income is not included in levy #2, since such tax payment is not affected by the fact of X's interest payment. Rather, A pays a 25%

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71. The unrealized appreciation is assumed to be an after-corporate tax number, so that the interests of X's capital providers increase in value by exactly this amount. Perhaps the simplest way to think about this is as the increase in value of X's goodwill, which for purposes of the example, X will never alienate.

tax on the \$50 in question whether such amount represents a deductible interest payment, a nondeductible dividend payment, or even just unrealized appreciation in A's instrument. Thus, A's \$12.50 tax payment on his interest income is part of the general interest holder tax in levy #3. And accordingly, levy #3 is \$95.83, which is the sum of the tax collection of \$12.50 from A on his interest receipt and a tax collection of \$83.33 from X's equity owners with respect to the appreciation in the value of their X stock (that is, 25% of \$333.33, which is now composed of \$33.33 of X's income after interest and taxes and \$300 of X's unrealized asset appreciation).

This taxation scheme is not capital structure neutral. Specifically, although levy #3 satisfies the requirements for a suitable interest holder tax, levy #2 does not. Fortunately, as the tax legislator, I can easily "fix" this tax regime. I simply impose an *incremental* interest holder tax of 33.33% on interest income. If this were done, A would pay an incremental \$16.67 in respect of the interest received (33.33% of \$50). Levy #2 would then be zero, as required. That almost restores capital structure neutrality, but not quite. If A is still required to pay the mark-to-market tax on the entire \$50 of interest received, debt will be over-taxed relative to equity. Thus, the mark-to-market tax must include an allowance (a deduction) for the incremental tax paid on interest income. Thus, A's income with respect to the interest payment for mark-to-market tax purposes is only \$33.33, representing the \$50 of interest received less the incremental \$16.67 of taxes paid in respect of such interest. So refined, levy #3 would pick up \$8.33 of taxes from A (that is, 25% of \$33.33 of net interest receipts) and \$83.33 of taxes from X's equity holders (exactly as above). This is exactly the same net result as in the capital structure neutral regime I started with, but now in a world with a corporate interest deduction.

Before one shouts hallelujah at the saving of the corporate interest deduction — although query whether one should want to go through such contortions to save it — it should be noted that true salvation is not to be had. At least not if the model is complicated by allowing for interest holders with multiple tax rates.

For example, assume that X has two "equal" interest holders, A, with a 40% tax rate on mark-to-market income, and B, with a 10% tax rate on such income. Merely having interest holders with such multiple tax rates does not in and of itself scuttle capital structure neutrality. For so long as each taxpayer, whatever his tax rate, has no tax-related preference for one type of corporate capital instrument over another, the tax regime can still be capital structure neutral. The problem is to ensure that taxpayers will be indifferent.

To properly model B as a quasi-proxy for a tax-exempt taxpayer, it is critical to further assume that A's incremental tax rate with respect to deductible corporate interest income is also higher than B's: assume also four times higher than B's. Since the average rate for the incre-

mental tax must be 33.33%, A's tax rate must be 53.33% and B's must be 13.33%. This rate structure would produce a neatly capital structure neutral tax regime, provided either that A's and B's relative preferences for X's securities are identical, or that there is otherwise a mechanism to force each of A and B to hold identical portfolios of X's securities. Since the second alternative is anathema to a free market, one must hope to rely on the first. But one can not.

If A were the sole owner of all of X's securities, X would issue only equity securities. This is because the effective tax rate on corporate income paid to A as a debt holder is 53.33%, while the effective tax rate on corporate income paid to A as an equity holder is only 33.33%. On the other hand, if B were the sole owner of all of X's securities, X would issue — to the extent possible — only debt securities. This is because the effective tax rate on corporate income paid to B as a debt holder is 13.33%, while the effective tax rate on corporate income paid to B as an equity holder is 33.33%. Thus, in a world peopled with both A and B, A will purchase (to the extent possible) only equity securities and B will purchase (to the extent possible) only debt securities.<sup>72</sup> And so the blended incremental tax rate on the interest paid by the debt securities will not be 33.33% as required, but something much lower (and, in the limit, 13.33%).

Moreover, this same conclusion will hold whenever the incremental tax on interest income is imposed at a non-uniform rate. To those who pay an incremental tax at a rate above the corporate tax rate (that is, are subject to a negative tax arbitrage with respect to the corporation's interest payments), X will offer equity instruments with a lower yield than its debt instruments, but with a higher after-tax return. And to those who pay an incremental tax at a rate below the corporate tax rate, X will offer debt instruments both with a higher yield than its equity instruments, and with a higher after-tax return. So tax clienteles will form. And capital structure will most decidedly not be neutral.

Unless, of course, one discards the assumption that the incremental tax is imposed at a non-uniform rate. That is, the unraveling of capital structure neutrality in the world with a corporate interest deduction resulted solely from the assumption that all of A's tax rates had to be higher (indeed, four times higher) than those of B. If, instead, I had

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72. An alternative way to see this is as follows: Since X pays a 33.33% tax on income distributed to equity holders but a 0% tax on income distributed to debt, it is indifferent between issuing a preferred stock paying 10% or some junior debt paying 15%. If A purchases the preferred stock, he pays tax of 25% and so has an after-all-tax yield of 7.5%. If he purchases the debt, he pays both an incremental tax of 53.33% and the mark-to-market tax of 25% and so has an after-all-tax yield of 5.25%. Thus, he prefers the equity. Conversely, B's after-all-tax yield on the equity is 9% and his after-all-tax yield on the debt is 11.7%. Thus, he prefers the debt.



imposed a blanket tax of 33.33% on all interest receipts, whether those of A or of B, capital structure neutrality would be restored.

But this precisely demonstrates the silliness of incorporating a corporate interest deduction into a capital structure neutral tax regime. In a capital structure neutral world with multiple interest holder tax rates, a corporate interest deduction must be exactly reversed by an incremental *single-rate* interest holder tax on interest income. Thus, there can be a corporate interest deduction in form only, not in substance. And since having such a deduction does little for the virtues one wants from a tax system — simplicity, transparency, aesthetics, easy collectibility — one should simply dispense with it.

And one should dispense with its kin as well. That is, whenever a corporation is allowed a deduction in respect of a return — explicit or implicit — to any capital interest holder (broadly defined), all of the foregoing analysis applies.<sup>73</sup> Prominent examples include deductions for interest-like accruals imbedded in lease payments or deferred compensation arrangements and deductions for participation disguised as compensation (e.g., employee stock options) or as royalties.

#### PART VIII — CONCLUSION

Having seen what is required — structurally — to achieve a capital structure neutral corporate tax system, it remains to demonstrate briefly that a change to such a system would be worthwhile. Part II above enumerated certain benefits of having such a system. But the biggest benefit, I think, would be the potential tax rate reductions that could accompany a change to a capital structure neutral tax system. In the following paragraphs, I assume that such a tax system would combine a corporate-level tax on corporate taxable income (as currently defined, but without allowances based on capital structure) and an interest holder tax on mark-to-market capital income.

It is an empirical question as to exactly how low the corporate tax rate could go if one wanted to preserve at current levels corporate tax collections in a regime of — or more likely approaching — capital structure neutrality. The first iteration — the denial of a corporate deduction with respect to interest expense — would have increased the corporate tax base by \$771 billion, or 120%, in 1996.<sup>74</sup> The actual tax base, \$640 billion, generated \$224 billion in taxes, before taking credits into account. Thus, the corporate tax rate could have been reduced

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73. For the breadth of term capital interest holder, and the variety of forms that such returns can take, see Schlunk, *NQPS*, *supra* note 14.

74. INTERNAL REVENUE SERVICE, STATISTICS ON INCOME (1996). The percentage is as measured against income subject to tax, which totaled \$640 billion.

from 35% to 16% *without any loss of revenue to the FISC.*<sup>75</sup> Such a significant reduction in the corporate marginal tax rate should without more have the salutary effect of spurring corporate economic activity. It would further have the effect of reducing the marginal benefit of corporate tax shelters, and hence their prevalence.

Similarly, it is an empirical question as to how low interest holder tax rates could go if one wanted to preserve current interest holder tax collections, but in a mark-to-market setting.<sup>76</sup> The first iteration would observe that personal interest (not all of which is corporate) and dividend receipts totaled \$270 billion, or 10.5% of AGI, in 1996.<sup>77</sup> Taxes on this amount totaled \$69 billion.<sup>78</sup> Net realized capital gains, in turn, totaled \$252 billion, and at a presumed 20% tax rate generated \$50 billion of tax revenues. Assuming, admittedly arbitrarily, that realized capital gains on average reflect 50% of annually accrued capital gains, the tax base for mark-to-market capital gains would have been \$504 billion in 1996. Thus, a single individual interest holder tax rate of 15% on mark-to-market corporate capital income could have been imposed without any net revenue loss to the Fisc.<sup>79</sup> Taxing all corporate capital returns at such rate, rather than taxing some such returns at markedly lower (0%) or higher (39.6%) rates, should generally prove beneficial to the economy, and at the very least, would eliminate heroic attempts both to achieve deferral and to convert ordinary income into capital gain.

But, finally, a word of caution. Given political realities, it is unlikely that a move all the way to capital structure neutrality is feasible. If only a partial move is made — for example, abolishing the corporate interest expense deduction or taxing publicly-traded securities on a mark-to-market basis — there will be a need to compare the benefits of the move against its costs. In particular, such a partial move, by re-

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75. This rate reduction is meant to be provocative; the actual reduction would be lower (albeit still significant). I mentioned at the outset that consolidation issues would not be taken into account in this Article, but here they need to be. Thus, if the goal is to tax corporate income once and only once, then any consolidation scheme must insure that interest paid by one corporation to another has no net effect on the corporate tax base. Thus, the amount of the interest expense deduction which is relevant is not the entire \$771 billion, but merely the portion of such amount paid to persons other than domestic C corporations.

76. Cf. Weisbach, *supra* note 10 (discussing the possibility of taxing different types of income — for example, mark-to-market returns with respect to publicly traded instruments and more traditional returns with respect to nonpublicly traded instruments — at different rates, with the goal of taxing each at the same effective rate).

77. Internal Revenue Service, Statistics on Income — 1996. I have backed \$252 billion of capital gains out of taxable income of \$3090 billion, leaving \$2838 billion of non-capital gain taxable income.

78. This assumes that tax receipts from interest and dividend income are proportional to tax receipts from other types of income. In fact, they are probably somewhat higher.

79. 15% of \$272 billion of interest and dividends and \$504 billion of capital gains equals the actually collected tax of \$119 billion.

taining inefficiencies, would have costs that may or may not outweigh the benefits of the move. It is my sense that the benefits would swamp the costs, but a more thorough analysis would need to be undertaken to confirm this.