RESPONSE TO QUESTIONS FOR THE RECORD FROM SENATE FINANCE COMMITTEE MEMBERS SUBMITTED BY CHAIRMAN BAUCUS FOR MR. THOMAS A. BARTHOLD CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Question from Senato Hatch:

1. **Although the debt levels of corporations have roughly stayed the same over the decades, we see that both household debt and government debt have gone up considerably in recent years. I'm interested in what the relationship, if any, is between household debt and government debt.**

   One way to think of government debt is that it is simply deferred taxes. High government debt today simply means high taxes tomorrow. Thus, assuming that households behave in a rational fashion, one might think that high government debt, such as we have had, would lead households to save more so as to pay for the high government taxes down the road. But, despite high levels of government debt, we don't see households in fact saving much -- to the contrary, they are going ever deeper into debt.

   Do you have some thoughts on that? Does it surprise you at all that simultaneously household debt and government debt would both go up significantly? Had the government not run the significant deficits that it has in recent years, do you think it likely that households would have saved even less – that is, would household debt have been even more?

Economists since David Ricardo in the early 19th century have pondered the question of whether changes in private saving could moderate or eliminate the differences in the macroeconomic effects of tax-financed vs. debt-financed government spending on output, employment, interest rates, and saving. The notion of the equivalence of debt-financed and tax-financed government spending is known as "Ricardian equivalence." In general, equivalent macroeconomic effects would result from government spending regardless of whether the spending is debt or tax-financed if individuals recognize a future tax obligation when the government finances new spending with debt, and then save more to cover that future tax obligation. For this equivalence to hold exactly, strict conditions must be met. In addition to individuals needing to perceive that government debt means future taxes, they must care about future generations that will pay the tax, they must be able to borrow and lend freely, and new distortions must not occur from taxes levied under the debt-financed regime compared to those under a tax-financed regime. Most economists agree that conditions do not hold for exact equivalence, but disagree to the extent to which the predictions of the theory hold approximately.

As the economics profession is not in agreement on the extent to which government borrowing is offset by private saving, it is not a surprise that growth in government debt and household debt have occurred simultaneously. This of course does not mean that no individuals have increased their saving in response to expectations of future tax increases resulting from current debt financed spending. Indeed, the personal saving rate has risen sharply since 2007, though we cannot conclude that individuals increased their saving rates in expectation of future tax increases. Also, the fact that growth in household debt has occurred simultaneously with growth in government debt is not necessarily inconsistent with Ricardian equivalence if taxpayers' net worth or expected future income is growing sufficiently to provide the desired resources for future tax increases. Aggregate household net worth has continued to grow over the past decade, though at a slower pace than previously. Additionally, most of the recent increase in household debt has not been the result of consumer debt, but is rather mortgage debt. In incurring mortgage debt to purchase or improve a residence, the individual's increase in debt is matched by an increase in assets, resulting in no change to net worth at the time of purchase or improvement.

In answer to your final question, it is possible that if the government had not run significant deficits in recent years that household debt would have been larger. Much of the deficits financed stimulus in the form of individual tax reductions, increased unemployment insurance benefits, etc., thereby making it easier for taxpayers not to cut consumption during the recession. Had the stimulus not been provided, taxpayers might have incurred more debt to maintain their consumption.

Questions from Chairman Baucus:

1. **Current tax law generally provides an incentive for corporations to capitalize with debt rather than equity since corporations can deduct interest but cannot deduct dividends. This tax benefit may be offset somewhat by the lower tax rates on dividends and capital gains compared to interest income.**

   There has been considerable commentary suggesting that as part of tax reform, tax rates should be reduced and the base should be broadened. Others believe the current 15 percent tax rate on dividends and capital gains could be increased. Let me ask each of you:

   a) **What do you believe have been the effects of the current lower rate for dividends? Has it resulted in more equity financing and less debt financing by corporations?**

According to researchers, a relatively straightforward before-and-after comparison of publicly traded corporations (excluding financial and utility companies) shows three main effects of the dividend tax cut enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003.[1]

First, the fraction of publicly traded companies paying dividends increased from 20 percent at the end of 2002 to almost 25 percent at the beginning of 2004. This was the result of a

[1] Jeffrey Brown, Nellie Liang, and Scott Weisbenner, "Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut," *NBER Working Paper No. 11002* (2004). Raj Chetty and Emmanuel Saez, "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Cut," *Quarterly Journal of Economics* 120(3): 791-833 (2005). Brandon Julio and David Ikenberry, "Reappearing Dividends," *Journal of Applied Corporate Finance*, 16 (2005).

surge in dividend initiations immediately following the reform and reversed a two-decades long downward trend in the fraction of companies paying dividends. Second, dividend-paying firms were more likely to increase their regular dividend payments after the reform. Third, the number of one-time, nonrecurring ("special") dividend payments also increased. One study estimates that a ten percent cut in the marginal tax rate (3.5 percentage points) induces a five percent increase in dividend payments.[2]

An examination of the heterogeneity of this response across firms shows certain types of firms were more likely than others to increase dividend payments. After enactment of the tax cut, the increase in dividends was concentrated in firms where top executives held more shares and fewer unexercised stock options. This fact indicates the importance of top executives' self interest in shaping corporate responses to taxation. Dividend increases were also more prevalent in firms that had large independent shareholders on the board of directors.

Because corporations may distribute profits to shareholders via dividends or share repurchases, one important question concerning the effect of lower dividend tax rates on dividends is whether any increase in dividend payouts is accompanied by a decrease in share repurchases. In other words, it is not entirely clear to what extent the increase in dividends is simply a relabeling of repurchases as dividends. Though there is not clear consensus on this question, researchers find that total payouts, including both dividends and share repurchases, increased post-reform. This appears to suggest that not all of the post-reform dividend increases are due to substitution away from share repurchases.

Data show that overall corporate debt as a percentage of GNP both increased and decreased from year to year between 2003 and 2010.[3] Similarly, there is no clear upward or downward trend in the ratio of debt to equity over these years.[4] Based on these aggregated data, we can neither confirm nor rule out an effect of tax policy on corporate debt financing.

b) Are there some industries that you think are especially affected by the different tax treatment of debt and equity? How?

As noted in our pamphlet prepared for the hearing, returns to debt investment are generally deductible while returns to equity investment are not. This tax distinction is particularly important to C corporations because only such entities are taxed at the entity level. Industries dominated by C corporations might be especially affected by the different tax treatment of debt and equity.

For 2008, while C corporations reported 55.1 percent of business net income overall, the percentage of net income reported by C corporations varies by industry. The following

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[2] Raj Chetty and Emmanuel Saez (2005).

[3] Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011, p. 58.

[4] *Ibid*, p. 60.

industries tend to have more net income reported by C corporations than average: utilities, manufacturing, information and media, finance and insurance, and holding companies. These same industries also tend to have a higher percentage of interest expense reported by C corporations than is reported by C corporations for all industries.

c) **Are there some industries that rely more or less on debt than is good for the economy? If so, how much does it relate to the tax code and is it a major problem?**

It is not clear what the optimal mix of debt and equity in firms' capital structures is for the economy overall. Even in the absence of tax considerations, each firm typically wishes to obtain capital at the lowest cost, while investors seek the highest rate of return (and thus impose a higher cost of capital) adjusted for the risk of the enterprise. Firms and investors balance these competing incentives, as well as other costs and benefits of various capital structures (such as direct and indirect bankruptcy costs) to determine the optimal mix of debt and equity.

d) **Do you believe that the existing tax advantage for the use of debt by corporations is a problem that should be addressed as part of tax reform? If so, how would you suggest we address this tax bias? How would your proposed solution impact revenues?**

The JCT staff usually refrains from making policy recommendations. However, the tax treatment of debt and equity by corporations could be made more equivalent in various ways with various effects on revenues. Consider a couple of simple options. For example, dividends could be made deductible at the corporate level and taxable at full ordinary income rates at the individual level, as is the treatment of interest under present law. This would tend to reduce revenues. Alternatively, the tax treatment of dividends and interest could be made more equal by denying the deductibility of interest. This would tend to increase revenues. The revenue impact of any particular proposal depends on the specific details of the proposal.

2. **The Tax Code does not provide a definition of debt or equity, but rather a determination is made on the facts and circumstances of the interest in the entity. The lack of a uniform definition allows taxpayers to essentially choose the most beneficial tax treatment by structuring their deals as loans or equity.**

a) **Do you think this is a problem?**

b) **If yes, should a uniform definition be part of the Tax Code or regulations? What other ways could we provide a uniform and certain definition so that similar economic outcomes are taxed in the same way?**

It is true that in the absence of statutory or regulatory standards, a substantial body of Federal common law is the principal source of guidance taxpayers have for distinguishing debt and equity. Although the Federal courts have identified various factors to consider, it is not our understanding that variation in the factors considered in any particular case or circuit is a problem for the classification of instruments as debt or equity for Federal tax purposes.

Our report notes that different Federal courts have identified slightly different lists of factors to consider as part of a debt versus equity analysis.[5] Despite minor variations across cases and courts, Federal courts generally agree that the proper characterization of an instrument requires a facts and circumstances analysis, the primary goal of which is to determine whether, in both substance and form, an instrument represents risk capital entirely subject to the fortunes of the venture (equity), or an unqualified promise to pay a sum certain on a specified date with fixed interest (debt). Courts make this determination by weighing the relevant facts and circumstances of each case, including the terms of the instrument, the economic circumstances of the particular issuer and holder, and the context of a particular investment or transaction. This type of balancing analysis necessarily requires a court to apply its judgment, both in weighing the factors and in deciding which factors to consider at all.

A statutorily prescribed, uniform list of factors to consider would likely accomplish little or no change from current practice. In any particular case, a court would still have to apply the law to the facts, and decide how to weigh the factors given the facts at hand. A court could consider a statutorily prescribed factor irrelevant on the facts presented and assign it no weight. On the other hand, if a statutorily prescribed list of factors precluded consideration of other factors, fixing the list could have the effect of preventing adaptation of common law analysis to new instruments.

In lieu of a balancing test of various factors, Congress could attempt to draft a certain definition of debt or equity. A statutory definition of debt and equity presents significant challenges. As noted in our report, Congress has previously attempted to define debt and equity by statute but ultimately abandoned the effort. Fifteen years later, Congress gave Treasury the authority to define debt and equity but Treasury also abandoned the effort. Neither failed for lack of trying. One explanation for this difficulty is the fact that pure debt and pure equity are the opposite extremes of a continuum of possible instruments, and "[t]here is nothing more complex than trying to draw a line which does not exist."[6]

Alternatively, Congress could attempt to define a statutory safe harbor definition of debt or equity, for example, by identifying certain features which, if included (or excluded), would cause an instrument to be classified in a particular way. Congress and Treasury have generally retreated from such efforts out of concern that defined safe harbors would lead to taxpayer abuse.

Some commentators note that the debt or equity distinction involves the classic rules versus standards trade off. Although rules clearly define what is permitted and what is not, bright-line rules allow for the possibility of activities consistent with the letter of rule, but inconsistent with its understood purpose. In contrast, a standards-based approach may thwart

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[5] *Present Law and Background Treatment Relating to Tax Treatment of Business* Debt (JCX-41-11), July 11, 2011, p. 16.

[6] William T. Plumb, Jr., "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax Law Review* 369 (1971), p. 619 (quoting Lanning, "Some Realities of Tax Reform," 1 Compendium of Papers on Broadening the Tax Base 19, p. 55 (Comm. Print 1959)).

line-toeing behavior by failing to provide the line, but standards are thereby more difficult to administer.

While it is true that taxpayers have considerable flexibility to design hybrid instruments intended to qualify as either debt or equity, taxpayers do not have unfettered discretion to choose their classification. Notwithstanding a taxpayer's intention, the ultimate classification of a disputed instrument may involve the IRS or the courts. However, in addition to these authorities, classification of an instrument will typically be an important consideration for financial market participants. For example, classification of an instrument will typically be an important consideration for both issuers and prospective holders. As noted in our report, issuers will often be constrained by factors beyond tax, including financial accounting, credit ratings, and regulatory constraints. Moreover, the design of a hybrid instrument ultimately affects the issuer's overall cost of capital. Similarly, prospective holders will often be constrained by factors relevant to their economic position and interests. Recharacterization of an instrument could have negative consequences for both issuers and holders, and inconsistent treatment by these parties must be disclosed to the IRS.

An alternative approach to resolving issues presented by the debt and equity distinction is to reduce or eliminate the significance of the distinction for Federal income tax purposes. The United States has a "classical" system of taxing corporate income in which an income tax is imposed on corporate earnings once at the corporate level and again upon distribution to shareholders. This system results in the so-called "double tax" on corporate earnings. It is not the case, however, that corporate earnings are always subject to the double tax. For example, corporate earnings may be taxed only once when corporate earnings are distributed as deductible interest payments to taxable debt holders, or not at all when deductible interest is paid to certain foreign or tax-exempt debt holders. Proposals to integrate the corporate and individual income tax generally attempt to impose a single level of tax (either at the corporate level or at the shareholder level) on corporate earnings. Such proposals could have the effect of reducing or eliminating some of the Federal tax benefits of debt relative to equity.

A number of methods could be used to achieve integration of the corporate and individual income taxes. One such method, the comprehensive business income tax, was proposed by the Treasury Department almost 20 years ago. As proposed, the comprehensive business income tax would, in effect, extend a dividend exclusion system to the payment of interest and deny a deduction for payments of interest, in order to equalize the treatment of debt and equity and treat tax corporate and noncorporate businesses in the same manner.[7] A determination whether to adopt a particular form of integration involves significant policy considerations including the passthrough of corporate business level tax benefits to individuals, the treatment of tax-exempt investors, the treatment of international transactions, and how to treat existing corporate equity structures. In addition, integration proposals can involve considerable complexity.[8]

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[7] See, e.g., U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once* (1992). This study presents and considers various corporate integration prototypes.

[8] For a more extensive discussion of the background and issues relating to integration, see Michael J. Graetz and Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxes* (Tax Analysts,

3. **Would it be an improvement in our law if all corporations were subject to a statutory limit on the deductibility of interest, based on a ratio such as net interest expense to adjusted taxable income?**

   If so, should the limit for a given corporation be determined by looking at the relevant ratio for the worldwide affiliated group of corporations which includes the taxpayer (disregarding intra-group loans)?

The Federal income tax effect of imposing a statutory limit on the deductibility of interest for corporations, based on a ratio such as net interest expense to adjusted taxable income, would depend on the ratio and the measures selected. In considering whether such a change would be an improvement in our law, consideration should be given to the various tax and non-tax consequences that may accompany debt, and the intended purpose of the proposed change.

A limit based on a specified ratio of net interest expense to adjusted taxable income, such as the 50-percent limit of present law section 163(j)[9] (which applies to certain interest paid to or guaranteed by foreign and other tax-exempt related parties), might have the effect of limiting the corporate interest deductions taken for Federal income tax purposes in some cases. However, such a rule would not necessarily bear a relationship to the amount of debt that any particular corporation might reasonably be able to carry without risking financial distress, because the rule would not distinguish between the economic conditions of particular industries or taxpayers within industries.[10] Also, because debt and equity can be structured in such a way that the instruments carry similar economic burdens on the issuing corporation, such a limit would not necessarily limit the economic burdens faced by corporate issuers, and could perpetuate the pressure on the tax distinction between debt and equity, as taxpayers could be expected to maximize deductions on instruments characterized as "debt" to take advantage of the maximum

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1998); Joint Committee on Taxation, *Present Law and Background Relating to Selected Business Tax Issues* (JCX-41-06), September 19, 2006; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal* (JCS-7-03), March 2003.

[9] Present law section 163(j) limits interest deductions on certain debt owed to or guaranteed by certain tax-indifferent related parties. The rule is intended to impose a limitation on so-called "earnings stripping" transactions in which U.S. corporate interest deductions are taken on debt to foreign or tax-exempt related parties that are not subject to U.S. tax on the interest income. Such debt not only eliminates the U.S. corporate level tax on earnings paid as interest, it also avoids any U.S. tax to the extent the recipient is tax exempt (including through the benefits of U.S. law or treaty provisions that reduce the tax on such interest income received by a foreign related party). Present law limits the deduction of such payments to 50 percent of adjusted taxable income (generally, taxable income before interest, taxes, depreciation, and amortization). Section 163(j) primarily affects U.S. corporations that are foreign-owned. Section 163(j) does not directly limit interest deductions on unrelated party debt (except to the extent such debt is guaranteed by a foreign or other tax-exempt related party) though it does require a debt-to-equity ratio of no greater than 1.5 to 1 in order for interest on debt owed to or guaranteed by such a related party to be deductible. Absent related party debt or a guarantee or third-party debt, and a foreign or other tax-exempt related party, the rule imposes no limitations.

[10] As a simplified example, a regulated utility that is permitted to increase its rates to recover costs and that has a stable stream of income may be viewed as relatively secure, and debt may provide such a utility with a relatively low-cost method of financing. On the other hand, a corporation in a less stable industry might be able to support less debt, or the terms of debt might be more burdensome to the corporate issuer.

permitted interest deduction, while possibly carrying high-yielding or other "equity" instruments with conditions that might be financially burdensome. Such a rule alone also would not address any of the Federal income tax advantages of debt in non-corporate settings (e.g., the ability to deduct interest on debt that supports non-taxed income, the magnification of the tax effect of other tax deductions such as depreciation or credits for particular activities, and the ability to monetize asset value without recognizing taxable income).[11] And such a rule would bear no direct relationship to any of those specific issues even in the case of a corporation.

If nevertheless it were desired to attempt to limit the overall risk of a company being overleveraged by applying a specified, fixed percentage of adjusted taxable income limit (similar to the 50-percent limit of section 163(j) or some other fixed percentage), the rule could be applied based on the worldwide affiliated group's measure of adjusted taxable income and net worldwide interest expense (disregarding intra-group debt).[12] Applying such a limit on a worldwide affiliated group basis arguably may have some effect on the overall leverage of a group, but could nevertheless permit significant interest deductions by U.S. corporations on debt that arguably supports income of foreign affiliates not currently taxed in the United States. For example, a worldwide group's net interest expense may be well below the specified percentage limitation while a U.S. corporation that is a member of the worldwide group might have a relatively small proportion of the taxable income of the group but carry a disproportionately large share of the group's debt such that a proportionately large interest expense deduction in the United States would not be limited. In addition, a significant amount of the U.S. corporate debt might be intra-group debt from a foreign related party not subject to U.S. tax on the interest income (similar to the type of debt addressed by the "earnings stripping" rules of section 163(j)). Such debt would be disregarded in the new computation (though the rules of 163(j) could be retained).

Alternatively, a worldwide computation could be designed not to apply against a permitted specified, fixed deduction percentage, but rather as a method of addressing the concern that current interest deductions taken in the United States may reduce U.S. taxable income, while the debt generating the deductions arguably supports the production of foreign affiliate income that is not subject to current U.S. tax. Such a concern could become even more significant if the U.S. were to adopt a territorial system for taxing income earned abroad by U.S. controlled entities, because such income would be permanently exempt from U.S. tax. Rather than applying a specified percentage of adjusted taxable income to limit the deductibility of a worldwide group's net interest expense, a ratio of a group's worldwide net interest expense to the group's worldwide adjusted taxable income could be used as a limitation on a U.S. corporation's U.S. interest expense. Such a rule arguably provides more distinction between economic

[11] The ability to increase partner basis in the partnership by partnership level borrowings, and to direct the incidence of such effects by various partner guarantees, enhances these aspects of debt in a partnership setting. These tax effects related to debt are discussed at Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Household Debt* (JCX-41-11) July 11, 2011, pp. 72-77.

[12] Any measure using net interest expense may provide some incentive to substitute interest generating investments instead of equity investments to reduce the effect of the limitation; however, if a gross interest measure was adopted, special rules may be necessary for the financial services industry.

conditions of individual industries or taxpayers by providing a unique limitation based on the group's overall leverage position. To the extent the group has similar activities and similar costs of borrowing in the U.S. and abroad (which may or may not be the case) such a rule limits the extent to which a taxpayer can take interest deductions in the U.S. for debt that supports deferred or non-taxed income earned abroad.[13] If it were desired to use this approach also to encompass the issue of interest deductions taken in the U.S. and paid to non-taxed or low-taxed related parties, it would be important to include interest on intra-group loans in computing the amount of the deduction allowed to the U.S. entity. For example, if a worldwide affiliated group's net interest expense is 35 percent of the group's worldwide adjusted taxable income, the U.S. corporation's interest deduction (including interest on intra-group loans) would be limited to 35 percent of its U.S. adjusted taxable income.

If it were deemed desirable to apply a worldwide comparison for purposes of limiting U.S. interest deductions, consideration could also be given to whether a ratio based on debt and assets might be more readily administrable than a ratio based on interest deductions and worldwide adjusted income.[14] Although U.S. based multinational groups may need to compute the earnings and profits of foreign affiliates for purposes of the present law controlled foreign corporation ("CFC") rules that impose tax in certain circumstances with reference to earnings and profits, it is not currently necessary to compute "adjusted taxable income" for foreign affiliates. In addition, it is not necessary to compute earnings and profits or adjusted taxable income for the foreign parent of a foreign controlled domestic corporation, or for any foreign related affiliates that are not CFCs. Such computations could require the imposition of additional U.S. tax rules in place of the rules used by the country in which the entity operates. By contrast, determinations relating to assets and debt might be easier for both corporations and the IRS to administer.

A number of countries do impose some type of interest deduction limitation, though the rules adopted vary significantly. For example, new thin capitalization rules were adopted by Germany in 2008. The new rules apply to resident and nonresident corporations and limit net interest expense (including intra-group debt) to 30 percent of taxable earnings before interest, taxes, and depreciation. The limitation does not apply if the net interest expense is less than €3 million (approximately $4.32 million), the corporation is not part of a consolidated group, or if the debt/equity ratio of the corporation is not greater than the overall debt/equity ratio of the entire group (generally determined using international financial reporting standards).

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[13] In the context of the present law foreign tax credit rules applying a similar test (based on assets rather than income), some contend that the failure of worldwide allocation rules (scheduled to become effective in 2021) to account for potentially different activities and borrowing costs in different jurisdictions still may lead to over or under allocation of interest expense against U.S. source income.

[14] This is similar to the present law approach used solely for foreign tax credit purposes. Under present law, the U.S. provides limitations on interest that can be deducted against U.S. income in determining the amount of "U.S. source" earnings compared to "foreign source" earnings. This allocation of interest is based on a ratio of U.S. to worldwide assets. The foreign tax credit rules currently do not provide for a full worldwide allocation based solely on the ratio of U.S. debt and assets to worldwide debt and assets, but are scheduled to permit the election of such a comprehensive allocation method starting in 2021.

The United Kingdom applies a worldwide debt cap to medium- and large-sized companies. Under the worldwide debt cap rules, a threshold test is applied to determine if the net debt of the U.K. taxpayer is greater than three quarters of the gross debt of the worldwide group. If the net debt exceeds this threshold, the U.K. company must apply more detailed rules to determine the portion of related party interest expense that is disallowed. This regime does not apply to financial services companies.

Canada limits the deductibility of interest paid by a Canadian corporation to certain nonresident shareholders if the debt of the Canadian corporation exceeds two times the equity of the Canadian corporation.