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UNITED STATES SENATE, COMMITTEE ON FINANCE

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To Chairman Hatch, Ranking Member Wyden, and the other members of the Committee, thank you for allowing me to present my thoughts on the potential effects to the capital markets with the implementation of corporate integration.

- Recent events have highlighted issues related to the double taxation of corporate income.
- At the same time, the current structure appropriately promotes debt repayment over dividend distribution.
- As a positive, corporate integration could result in a rally in the equity markets.
- Further review of some of the unintended consequences from corporate integration may be warranted.

Introduction

For decades, the American tax system has grappled with issues related to the double taxation of corporation income. While most of the witnesses today and in last Tuesday's hearing testified on retirement accounts, international tax law, and specific issues around stocks and dividends, the focus of my testimony is the effect of corporate integration on bonds and interest.

Under the current tax system, corporations receive a deduction for interest payments on debt securities (such as bonds), resulting in only one layer of tax on the debt side. Since a corporation does not receive a deduction for dividend payments, the system promotes debt financing over equity financing, all else equal. While corporate integration in theory could equalize the treatment between equity and debt, it may also cause unintended consequences and should be examined with caution.

I have identified seven outcomes that are likely to occur from corporate integration. First, the equalization of the tax treatment of debt and equity may create an increased incentive for companies to return cash to shareholders over alternatives, such as debt repayment. Second, equity market valuations may rise, though companies may alter their dividend policies. Third, corporate integration would have diverse effects on companies in different industries. Fourth, the potential reduction in the debt markets may lead to job cuts. Fifth, corporate integration would likely encourage corporations to create complex organizations and financing instruments. Sixth, corporate integration may be impractical for the current corporate bond trading system, and could impose substantial compliance costs from an execution standpoint. Seventh, corporate integration may not address the real issue at hand, which is whether comprehensive entity tax reform would help the economy.

Debt and Equity Are Different

Many tax theorists have argued that there is no inherent difference between debt and equity; therefore, the two types of securities should be treated the same under the tax code. Even if this were true from a tax perspective, the capital markets extend beyond tax implications. The basic distinctions between debt and equity are widely known throughout the capital markets. In Finance 101, we learn that shareholders and lenders have different goals.

A shareholder purchases an equity security with the potential of unlimited growth and returns on his investment at the cost of higher risk. In contrast, a lender who buys a straight bond has limited upside potential, but with lower risk versus an equity. While some lenders invest for capital appreciation (i.e., the price of the bond rising), many seek income returns equal to the market rate and their principal repaid in full at maturity.

[1] Please note that my written and oral comments today represent my views, and not necessarily the views of Janney Montgomery Scott LLC. I would like to acknowledge the help of my supervisors, colleagues, and friends.

Corporate management typically aligns with the goals of the equity investors. Executive compensation is usually tied to equity performance via stock options and warrants, so management has a personal interest in increasing the equity value and, with that, paying dividends. Additionally, activist equity investors can seize control of a corporation's board of directors and institute policies that quickly bolster returns. Increasing dividends or share buybacks are both negative events for lenders, particularly when financed with debt.

Since the cards are already stacked against lenders, I see it as reasonable for the tax system to incentivize companies to repay their lenders before making discretionary dividends to their shareholders. The current tax system, which favors interest payments over dividends, does this. Equalizing the tax treatment of debt and equity may incentivize corporations to pay large dividends rather than save cash for other purposes, like debt repayment or long-term capital investments.

Shareholder Returns

Corporate integration has similarities in taxation of pass-through entities, which are not taxed at the corporate level, but at the shareholder level. Recent events related to pass-through entities can provide a case study for corporate integration in practice. In particular, these events suggest that a withholding tax and dividend paid deduction may encourage companies to distribute, rather than retain, earnings to their shareholders.

MLPs as an Example

The formation of businesses as alternative structures (such as partnerships, RICs, REITs, S corporations, and LLCs) to avoid double taxation is well known, and speaks to inefficiencies of the current tax system. That being said, recent events suggest that a move towards corporate integration may result in adverse effects.

Master limited partnerships ("MLPs"), as an example, are a type of publicly traded partnerships ("PTPs"). As background, MLPs are required to generate 90% of their income through a qualified source, such as natural resources-related activities, so the majority of MLPs are involved in the energy sector. Most MLPs pay out to equity unitholders all income not needed for core businesses via cash distributions (i.e. dividends). As pass-through entities, MLPs pay no taxes, but rather the individual partners pay taxes on the entity's income. As a result, MLPs are incentivized to have high capital expenditures because with high capital expenditures come deductions that are passed on to the individual unitholders.[2]

As I will explain in more detail shortly, we can learn many lessons from recent events in the MLP space. Before the collapse in energy prices, MLPs, like REITs, became a preferred alternative for individual investors looking for income in the current low interest rate environment. Since fall 2014, however, most MLPs and their oil & gas and metals & mining peers have come under pressure due to the fall in energy and commodity prices. While there have only been a handful of MLP bankruptcies—two prominent firms filed for Chapter 11 bankruptcy protection this month—the outsized credit risk in the industry is notable.

Industry cyclicality is perhaps inevitable, but what is not is a tax policy that favors companies paying out a substantial portion of their cash so that they do not have the necessary cushion during a down market. Years of feast are often followed by years of famine, and tax policy should not encourage gorging during feast only to be followed by starvation during famine. During the years after the 2008-2009 recession and before the 2014 erosion in energy prices, MLPs benefited from sector-wide expansion with technological advancements in the US and heightened demand for domestic oil, natural gas, and liquids. Market participants utilized the debt and, to a lesser extent, equity markets to finance capital expenditures, while at the same time promising unitholders distributions with yields that were competitive with

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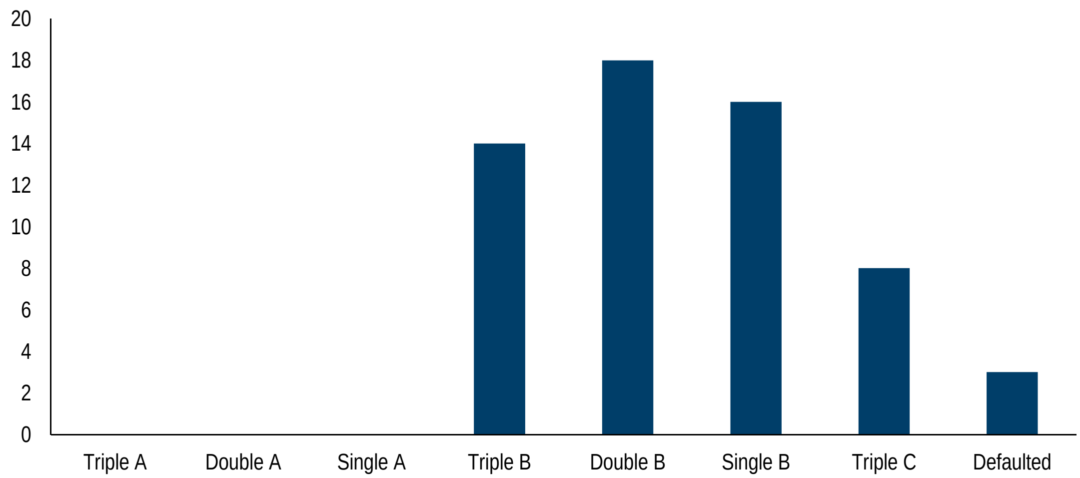
[2] Jody Lurie, *Janney Fixed Income Weekly,* "Credit: Masters of Their Own Design (MLP Overview)," http://www.janney.com/File%20Library/Fixed%20Income%20Weekly/April-30-2012.pdf, (April 30, 2012)

high yield corporate bonds. Even before the drop in energy prices less than two years ago, these companies operated with minimal cash balances, providing sizable returns to their equity unitholders via distributions.

Ratings of MLPs Are Skewed Towards the Lower End of the Ratings Spectrum[3]



When the energy market crashed, MLPs began to cut back on capital expenditures, but only reduced or eliminated their equity distributions as a last resort due to market perception related to dividend cuts. Several MLPs experienced credit ratings downgrades, and the current landscape of MLPs is skewed towards the lower end of the ratings spectrum. Of the 114 MLPs and energy-related publicly traded partnerships, about half are not rated, and over a third are high yield (i.e. double B or lower) rated by Moody's and/or S&P. Many MLPs operated before the fall in energy prices with minimal cash on hand and high levels of debt and leverage, so when the fall in prices occurred these MLPs had few financing options. Two prominent MLPs filed for Chapter 11 bankruptcy protection this month. It is likely the bankruptcy tally among MLPs will rise, as predicted by both Moody's and S&P.[4]

A pass-through structure does not necessarily decrease a company's appetite for an overleveraged credit profile, but rather encourages a company to spend all available earnings on short-term shareholder returns as opposed to saving some cash to ensure the long-term viability of the entity. While an equalization of debt and equity taxation could lead to additional equity offerings over debt issuance, the dilution effect for the company would remain a deterrent, as it was for MLPs during their expansion era, so debt issuance would stay the preferred method coupled with a focus on shareholder returns. MLPs are an example of a publicly traded entity that is taxed only once—at the unitholder level—so the recent history of MLPs serves as a cautionary tale on corporate integration.

Favoring Shareholders, While Ignoring Long-Term Investments

Since the 2008-2009 recession, corporate cash balances have reached record levels. At year-end 2015, non-financial corporate liquid assets totaled $1.95 trillion.[5] The low rate environment has encouraged borrowing, though many companies have shifted their debt profiles away from less short-term debt like commercial paper and towards long-term debt like corporate bonds. I have published multiple articles on the corporate cash balance topic, noting that the

[3] Bloomberg (May 17, 2016); does not include non-rated companies; classification based off the lower of Moody's and S&P's ratings when available; triple C includes double C as well; some companies are PTPs and not MLPs, per Bloomberg classifications, but are viewed as such from a market perspective

[4] Moody's Investors Service, *April Default Report*, (May 9, 2016), and Standard & Poor's Financial Services, *Default, Transition, and Recovery: The Global Corporate Default Tally Climbs To 62 Issuers So Far In 2016*, (May 12, 2016)

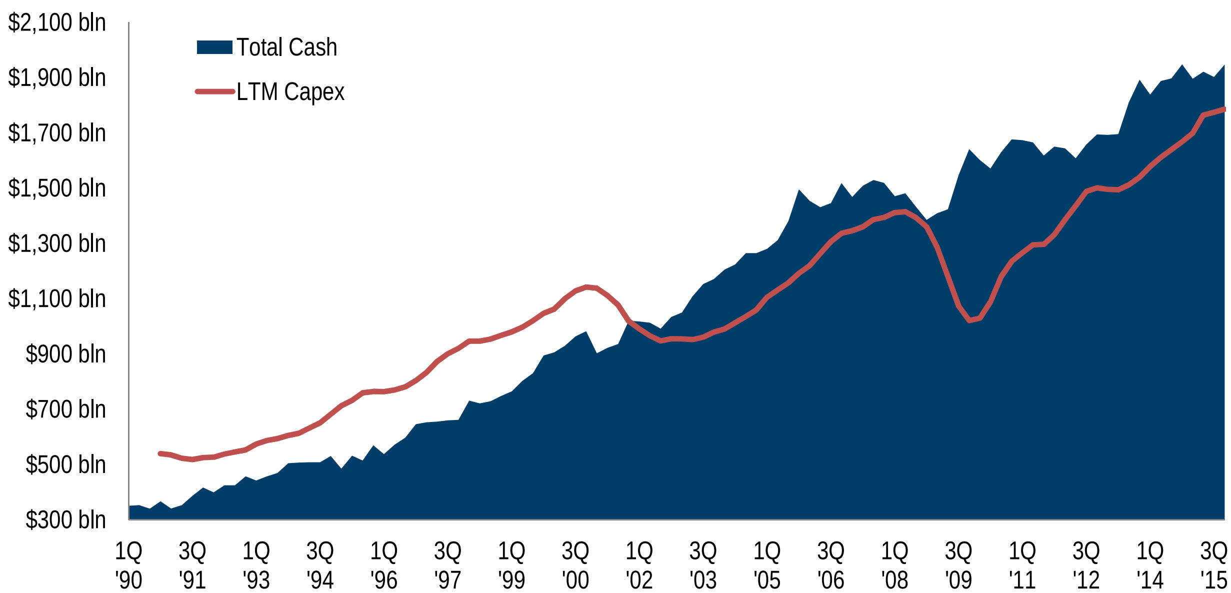
[5] Board of Governors of the Federal Reserve System, "Financial Accounts of the United States," http://www.federalreserve.gov/releases/z1/current/z1.pdf, (March 10, 2016)

largest companies in the US represent an outsized portion of corporate cash, and that a notable amount is locked up overseas due to high repatriation costs. Companies have utilized the debt markets to finance robust shareholder remuneration plans, as debt financing costs are significantly below the 35% tax rate on repatriating deferred foreign income. Unless the cost to issue debt equals the repatriation cost or until there is a way for companies to access the cash through a less costly method, companies will continue to use the debt markets to finance short-term equity returns.

When reviewing corporate liquidity trends, another issue that arises is the reduced amount of capital expenditures relative to available cash. While non-financial corporate liquidity peaked at year-end 2015, the trailing twelve month amount of capital expenditures has not kept pace. In fact, since the recession, capital expenditures have been tracking well below corporate cash levels. Companies are not investing in organic growth projects, but rather opting for short-term measures to keep shareholders happy. Part and parcel to this issue is the increase in mergers & acquisitions, through which some companies have pursued tax inversions. Rather than invest in a new project (such as expanding a product line or building a new plant) that may take years before realizing a return, companies are looking at share buybacks, dividends, mergers & acquisitions, and tax minimization to bolster shareholder returns.

Although the proposed tax changes may alter certain corporate behavior, it is likely we will continue to see a lack of long-term capital investments, and domestic capital investments are significant contributors to economic and job growth. Corporate integration may put even more pressure on corporations to pay outsized dividends to shareholders, which could lead to even less long-term capital investment.

In Recent Years, Companies Have Kept More Cash on Hand than Spent on Capital Expenditures[6]



A Rise in Equity Capital Markets

Corporate integration would likely lead to a rise in equity capital market valuations because it would encourage dividend payments. As I commented previously, equity indices broke record highs in recent years, thanks in part to economic stimulus and improving credit profiles at large corporations. It is likely that, with a decreased cost of equity capital through a change in the tax treatment of equity, the equity markets would respond positively. The more cash being spent on shareholders, in theory, could reenter the economy. Empirical studies have shown that companies with consistent and increasing dividend plans see greater total returns over the long run than companies that do not pay or

[6] Board of Governors of the Federal Reserve System, "Financial Accounts of the United States," http://www.federalreserve.gov/releases/z1/current/z1.pdf, (March 10, 2016); data pulled from Bloomberg

that cut their dividends. Part of this trend is the result of perceived company stability by investors. That said, it is unclear as to whether the new policy would encourage consistent or lumpy dividends, as the return amount would ultimately be based on the optimal rate to benefit from a dividend paid deduction and could vary with income levels each quarter.

Cost of Capital

An equalized treatment of equity and debt from a tax perspective is unlikely to cause companies to view equity and debt financing equivalently. After all, as a security falls further down the capital structure, investors demand an additional premium to take on the security's risk. It is likely, however, that the difference between cost of debt capital and cost of equity capital will decrease, companies will still see the benefit in debt- over equity-financing. What's more, certain industries may benefit more or less from the new regulation. Banks, for example, will likely benefit as lenders underlying the bank loans through the withholding tax and credit system. At the same time, it is unlikely banks would dramatically change their financing profile due to their desire to borrow cheaply and charge a spread on lending. Moreover, banks have regulatory requirements, and try to optimize the capital structure based on such guidelines. Regulated utilities, however, which operate with consistent cash flow streams, may look at the policy favoring dividends as a positive. Like REITs, they may see the dilution effect as less of a factor because they can increase their dividends with each equity issuance. At the same time, a higher cost of debt capital, though potentially marginal, could be the determinant between whether a capital project will meet the required return on investment or not.

Shrinking Fixed Income Capital Market

The US capital markets are the largest in the world, offering some of the most complex and diversified solutions for financing and investing. Debt capital markets, more affectionately known as "fixed income" capital markets, represent 60% of the $66.5 trillion total US capital markets, while equity capital markets represent the remaining 40%, as of year-end 2015.[7] Corporate debt, including bonds, bank loans, and commercial paper, represents 20% of the US fixed income capital markets.[8] The Federal Reserve's monetary policy since the recession resulted in a rise in both equity and debt market valuations. Stock indices set new highs, and the low interest rate environment led to a yield-grabbing mentality by investors. In terms of corporate debt, a handful of companies broke records in terms of issuance size with their bond offerings in recent years, and an increased number of issuers entered into the primary market to capture the low rates. Both domestic and international companies seized the opportunity, and we saw a record number of issues and issuance amount by international companies enter into the US corporate bond market. A change in the tax policy could lessen the appeal of issuing debt in the US markets, especially now that interest rates are lower overseas.

As experts suggest, it is possible that the debt markets could shrink due to the equalizing of debt and equity with the proposed tax system. Per the Bureau of Labor Statistics, over 900,000 people work in the securities industry, and the headcount has risen in the post-recession era.[9] Anecdotally, however, we have witnessed shrinking headcount in the equity markets with the advent of electronic trading platforms and regulatory changes. While technological advancements have also affected the fixed income markets, the heterogeneity of debt securities has prevented the wholesale industry change that is occurring in the equity markets. What's more, the low rate and low growth environment in which we operate has led to further headcount reduction by industry participants looking to cut costs and bolster margins. A less profitable or less active fixed income market could add further job losses to a challenged situation.

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[7] Securities Industry and Financial Markets Association, Data sourced from Federal Reserve, Bloomberg, Federal Agencies, NYSE, and NASDAQ, (May 19, 2016)
[8] Securities Industry and Financial Markets Association, "US Bond Market Issuance and Outstanding," http://www.sifma.org/research/statistics.aspx, (May 3, 2016)
[9] Bureau of Labor Statistics, "Securities, Commodity Contracts, and Other Financial Investments and Related Activities: NAICS 523," http://www.bls.gov/iag/tgs/iag523.htm, (May 19, 2016)

Creative Engineering and Further Tax Avoidance

As history shows, companies always look for ways to minimize taxes. A corporate integration system, while improving certain issues facing C corporations and their constituents today, may not prevent companies from pursuing creative structures to limit tax liabilities. Companies may create complex structures, including commercial mortgages, sale leaseback transactions, or various other formats, to avoid paying withholding tax on debt and equity. These unintentional outcomes are inherently hard to predict.

Costly Execution

My firm and other broker-dealers and financial institutions already face the hurdle of complex and costly trading platforms. Adding an equivalent to a shareholder credit or dividend paid deduction system on the debt side will likely translate to additional expenses and implementation challenges. The proposed tax changes are not as straight-forward and easy to administer as one might think.

Conclusion

Given recent events around corporate inversions, I view this discussion as timely and notable. Among the many challenges that may be created by the potential new tax regime are the incentives that would arise for companies to give back to shareholders over creditors or long-term capital investments, as the latter use of cash would have a better economic multiplier on job creation and long-term expansion. Identifying a way to encourage companies to invest long-term in domestic projects would likely better support the economy than would providing inroads into dividend distribution. Recent events related to MLPs provides a good case study when considering how companies may change their behavior through the equalized tax treatment of debt and equity. Further, relative to other fixed income securities, corporate debt may provide more attractive yields for certain investors, so the combination of reduced attentiveness to balance sheets and higher yields could cause an imbalance in individual investors' portfolio allocation and could expose them to unforeseen credit risk.