Statement of Pamela F. Olson
to the
Committee On Ways & Means
United States House of Representatives
and the
Committee On Finance
United States Senate

"Tax Reform And The Tax Treatment Of Debt And Equity"

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Chairman Camp, Chairman Baucus, Ranking Members Levin and Hatch, and distinguished members of the Committees, I appreciate the opportunity to appear this morning as the Committees consider the United States federal tax system's treatment of debt and equity in the context of tax reform. I am here today at the request of the Committees. I had the honor of serving as Assistant Treasury Secretary for tax policy from 2002 to 2004, and am currently a partner in the law firm Skadden, Arps, Slate, Meagher & Flom, LLP. I am appearing on my own behalf and not on behalf of any client or other organization. The views I express are solely my own and are based on my experiences in the private sector and in public service, particularly as Assistant Secretary.

I. Introduction

I applaud the Committees' decision to tackle tax reform jointly and for taking a detailed look at one of many issues that should be considered carefully as Congress considers reform of the tax system.

As the Committees consider tax reform, it is important to bear in mind certain fundamental principles. First, the goal in the design of a tax system should be a regime that promotes economic growth because economic growth is essential to job creation and increasing prosperity. Second, the tax system should raise the revenues necessary to fund the operations of the government with the least adverse impact on the economy. Third, all taxes distort decisions to work, save, and invest. Maximizing national income depends on investment dollars flowing to the activities where they produce the highest pre-tax returns. A well-designed system should minimize disincentives to work and save and avoid skewing investment decisions.

Individuals and businesses respond to economic incentives and disincentives, including those provided through the tax laws. The tax laws are only one of many such economic incentives and disincentives that affect economic decision-making. Nonetheless, it is important for the tax-writing committees to be cognizant of the tax system's incentives and disincentives, particularly with respect to the disparate treatment of debt and equity, so that potential consequences are factored in as you consider reform of the tax system. My testimony addresses the disparate treatment of debt and equity and concludes with a few observations about the potential for tax reform in this area.

II. Effect of the Tax System on Capital Structures

In its current form, the Internal Revenue Code provides an incentive for businesses to raise capital through the issuance of debt, rather than through the issuance of equity. The incentive arises from the interplay of two features of our tax system. The first is the double-taxation of corporate income, which flows from the choice to treat corporations and their investors as separate taxable units. Corporate earnings are taxed at the corporate level, and then again at the shareholder level when the corporation distributes earnings to shareholders. The second feature is the tax deductibility of interest payments made to creditors. While interest payments are deductible by the corporation, distributions of earnings to shareholders are not.[1]

Incurring debt, thus, serves as a straightforward means of mitigating the double tax on corporate income because corporate earnings paid as interest are deducted from the corporation's gross income and are taxed only to the recipient of the interest income. All else equal, the disparity encourages corporate use of debt financing because it ensures the income is taxed only once. Substituting debt for equity reduces the maximum combined tax rate on corporate income from approximately 45 percent to 35 percent. Corporate earnings paid as interest may fall entirely outside the U.S. tax base if the interest recipient is a tax-exempt organization such as a pension plan or an endowment fund, or is a foreign person. Generally speaking, the Internal Revenue Code imposes a 30 percent withholding tax on payments of dividends or interest to non-U.S. taxpayers.[2] That 30 percent withholding tax is eliminated, however, if the interest payment qualifies as "portfolio interest;" it then leaves the U.S. tax base without incurring a tax.[3]

Even for non-portfolio interest, our income tax treaties often reduce interest withholding rates to a greater degree than dividend withholding rates, in some cases exempting treaty country residents' interest income from U.S. withholding tax altogether.[4] Although treaties often reduce the 30 percent withholding rate on dividends, with a few recent exceptions, none exempt dividends altogether. The first of the recent exceptions is the income tax treaty with the United Kingdom, which was signed in 2001 and exempts from withholding dividends paid to U.K. shareholders who have owned more than 80 percent of the voting power of the paying company for the previous 12 months.[5]

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[1] The disparate treatment of debt and equity has been the subject of numerous disputes between taxpayers and the Internal Revenue Service over the years and to several failed efforts to draw a bright line distinction between the two.

[1] I.R.C. § 871(a)(1), 881(a).

[3] I.R.C. § § 871(h), 881(c).

[4] *See, e.g.,* Convention Between the Government of the United States of America and the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Art. 10, 11 (providing for a maximum withholding rate of 15 percent on dividends, and for a 0 percent withholding rate on interest payments).

[5] The Convention Between the Government of the United States and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, Art. 10.

The impact of the Internal Revenue Code's preferential treatment of debt has been a concern of the U.S. Treasury Department for a number of years and has led to proposals to neutralize or equalize the tax treatment of debt and equity. In 1992, for example, the Treasury Department described concerns about high debt service burdens and corporate bankruptcies and noted that "[t]he U.S. corporate tax system discourages corporations from financing investments with equity as opposed to debt."[6] Similarly, the Treasury Department issued a report in December of 2007 that stated that:

> excessive reliance on debt financing imposes costs on investors because of the associated increased risk of financial distress and bankruptcy. Firms in financial difficulty may be denied sufficient access to credit, suffer key personnel losses, and endure a diversion of management time and energy away from productive activity. Other costs include legal and administrative expenses associated with bankruptcy, uncertainty regarding the ultimate size of those expenses, uncertainty regarding the marketable value of the firm's assets under partial or full liquidation, and risks regarding the ultimate settlement of competing claims on those assets.[7]

The concern expressed in the Treasury report has been echoed by economists and business leaders. Jason Furman, formerly deputy director of the National Economic Counsel, stated that the "disparity between debt and equity financing encourages corporations to finance themselves more heavily through borrowing. This leverage in turn increases the financial fragility of the economy, an effect we are seeing dramatically today."[8] Similarly, Doug Holtz-Eakin, an economist who heads the American Action Forum, served as a senior advisor to Senator John McCain, and directed the Congressional Budget Office, stated to the *Washington Post* that "the tax code is interfering dramatically with the choice of how you finance and how you deliver returns in the corporate sector."[9] Gregory Mankiw, formerly Chair of the Council of Economic Advisers, wrote in the *New York Times* that, "because interest payments on corporate debt are deductible for corporate income tax calculations, this capital income is taxed only once. This asymmetric treatment of debt and equity finance induces companies to issue more debt than they otherwise would, increasing leverage and the economy's financial fragility."[10] The CEO of FedEx remarked in the *Wall Street Journal* that, "our national policies actively encouraged all this debt. The United States has a completely uncompetitive tax structure in general and it has a particularly onerous tax structure for firms that are asset-intensive."[11]

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[6] U.S. Department of the Treasury, *The Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, p. 16 (January, 1992).

[7] U.S. Department of the Treasury, *Approaches to Reform the U.S. Business Tax System for the 21st Century*, December 20, 2007.

[8] *See* Martin A. Sullivan, *Economic Analysis: Deleveraging the Tax Code*, 120 Tax Notes 1241 (Sept. 29, 2008).

[9] David Cho, *Look At Macy's: U.S. Tax Code Continues to Encourage Companies to Rack Up Huge Debt*, Washington Post, Aug. 8, 2010.

[10] N. Gregory Mankiw, *On Dividend Taxes, It's a Post-Partisan Race*, N.Y. Times , Sept. 6, 2008.

[11] Quoted in Stephen Moore, *Washington is the Problem*, Wall St. J., Oct. 25, 2008.

The disparate treatment of debt and equity, particularly the double tax on dividends, has also given rise to corporate governance concerns, which affected the Treasury Department's design of the dividend exclusion proposal included in the Bush Administration's fiscal year 2004 budget. Prior to 2003, the tax on dividends brought the top tax rate on corporate income distributed as dividends to nearly 60 percent, creating an incentive for corporate managers to cite the tax inefficiency of dividend payments as a basis for reinvesting corporate profits rather than distributing them as dividends. In the Treasury Department's description of the Bush Administration's fiscal year 2004 proposal to exclude dividends from tax, Treasury noted that the double tax on dividends "lessens the pressure on corporate managers to undertake only the most productive investments because corporate investments funded by retained earnings may receive less scrutiny than investments funded by outside equity or debt financing."[12] The payment of dividends is a healthy financial discipline because it requires free cash flow to fund the payment. That discipline was dulled by the disincentive to paying dividends. Prior to 2003, the lower tax rate on capital gains made methods of delivering capital gains to shareholders, such as stock redemptions, a more tax efficient means of distributing excess cash to shareholders, allowing shareholders to choose whether to take the cash at a lower tax rate or avoid the tax liability.

The Bush Administration's proposal would have brought a measure of transparency to corporate taxes because dividends would only have been eligible for the exclusion to the extent they were paid out of earnings on which corporate tax had been paid. The attractiveness of tax-free dividends was seen as giving corporations an incentive to pay income tax, at least to the extent of dividends to be paid to shareholders, and shareholders an interest in the extent to which the corporation had paid tax. Thus, the proposal could have reduced the value of corporate tax incentives by preventing the value of those incentives from flowing through to the shareholders.[13] Because the dividend exclusion was contingent upon payment of corporate tax, the proposal would have had the effect of reducing the benefit of corporate tax avoidance, as corporate income sheltered from tax would not have produced tax-free dividends.

Revenue constraints were taken into account in the Bush Administration's design of the dividend exclusion proposal. The elimination of the double tax on dividends could have been achieved by providing corporations with a deduction for dividends paid instead of a dividend exclusion. Providing a deduction for dividends paid, however, would have the effect of eliminating all tax on dividend income where the stock is held by a tax exempt entity, as is the case with interest income where the indebtedness is held by a tax exempt entity. Thus, a dividends paid deduction could result in the removal from the U.S. tax base of a significant amount of corporate income.

III. Reform Alternatives

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[12] The United States Department of Treasury, *General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals*, p. 11 (February 2003).

[13] The Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal*, JCS-7-03, p. 31.

Lower corporate tax rates. One fairly obvious means by which to reduce, although not eliminate, the preference for debt financing is to lower the corporate tax rate. The preference for debt financing is a result of the ability to deduct interest payments from taxable income. Lowering corporate tax rates would reduce the value of the interest deduction to corporations and reduce the disparity in the taxation of debt and equity investments.

Besides reducing the distortion as between debt and equity financing, lowering the corporate tax rate would have other important benefits. The U.S. corporate tax system is increasingly out of step with policies adopted by other countries, to the disadvantage of our economy and the jobs that might otherwise be created here. Our corporate tax rate, at 35 percent, is high relative to our economic peers. Foreign countries offer lower tax rates and investment incentives and, as a result, may provide a more attractive location for investment.

Eliminate the double taxation of corporate earnings. As I mentioned, as part of its 2004 budget proposal, the Bush Administration proposed to integrate the corporate and individual tax systems through a two-part dividend exclusion mechanism under which the shareholder-level tax on corporate profits would be eliminated. The proposal would allow corporations to distribute non-taxable dividends to shareholders to the extent the dividend was paid out of previously taxed earnings. Equivalent treatment of retained earnings would be achieved through an increase in shareholders' basis in their stock. This basis increase would reduce the amount of capital gain that the shareholder would otherwise recognize on disposition of the stock by the amount of the dividend that the shareholder would have received had the corporation distributed its previously taxed earnings. By eliminating the shareholder level tax on corporate income distributed as dividends, the dividend exclusion proposal would eliminate the debt financing incentive associated with double-taxing the return to corporate equity investment.

Full parity between debt and equity could be achieved through the adoption of a comprehensive business income tax similar to a proposal developed by the Treasury Department in 1992.[14] One of the benefits of a comprehensive business income tax is that it would raise revenue, which was estimated in 1992 to be sufficient to offset the revenue lost through corporate integration. There are downsides to such a proposal, as well, including the fact that the difficulties in taxing financial institutions under such a regime have not been satisfactorily resolved and there would be significant transition issues. Were Congress to consider expensing as part of broader reform, then limitations on the deductibility of interest similar to those contained in the comprehensive business income tax would have to be considered.

Consider an Alternative Tax Base. In my view, there are limits to our ability to generate additional revenue through our existing tax bases. Consequently, I urge the Committees to give consideration to the addition of an alternative tax base as part of tax reform, which could be coupled with lower rates on existing tax bases and a measure of corporate integration. One such

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[14] The United States Department of the Treasury, *A Recommendation for the Integration of the Individual and Corporate Tax Systems* (December 1992).

alternative is the value-added tax, which would have the advantage of decreasing the tax system's overall pro-leverage bias.

In 2005, the Bush Administration's Advisory Panel on Federal Tax Reform devoted a chapter of its report to consideration of a value-added tax.[15] The proposal the panel reviewed resembled a single-level retail sales tax collected at each stage of the production process. The plan combined this device with a income tax, which allowed the top individual income tax rate to fall to 15 percent and the top corporate income tax rate to fall to the same level.[16] Under this plan, entities providing taxable goods and services imposed and collected taxes on all sales.[17] To determine value-added tax liability, businesses multiplied total taxable sales by the tax rate and subtracted from that figure the amount of value-added tax paid for purchases of goods and services. Notably, interest income would not be included in the value-added tax base, and no deduction from the value-added tax base would be permitted for interest expenditures. Value-added taxes imposed in other countries generally follow the same approach.

For any given level of revenue, policymakers face a choice about whether to raise that revenue through the income tax or through an alternative base like a value-added tax. To the extent revenue is raised through a value-added tax rather than the income tax (in the form of higher tax rates, perhaps), the income tax's inherent bias in favor of greater leverage is less than it otherwise would be. On average, OECD countries collected almost 11 percent of tax revenue through consumption taxes in 2009, while such taxes account for only 4.4 percent of U.S. tax revenue.[18] If the United States raised as large a portion of total tax revenue through a value-added tax as do other OECD countries, the overall effect on the debt incurred by U.S. business could be substantial.

The Tax Reform Panel and commenters have noted other improvements that a value-added tax would bring. In particular, a broad-based value-added tax applied at a single level would offer certain efficiency advantages. The panel's report notes that such a system "generally does not distort consumers' choices among good and services . . . or distort the allocation of capital."[19] Further, according to the report, "[e]conomists agree that a well-designed VAT imposes a lower excess burden than most other taxes for any given amount of revenue raised."[20] For these reasons, introducing a value-added tax could reduce the overall distorting effect of the income tax system's treatment of debt and equity.

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15 *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, President's Advisory Panel on Federal Tax Reform, Nov. 2005.

16 *Id*. at 191.

17 *Id.* at 193.

18 Unweighted average calculated from data vailable at http://www.oecd-ilibrary.org/taxation/taxes-on-goods-and-services_20758510-table6.

19 *Id*. at 200.

20 *Id*.

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Budgetary constraints have dictated many legislative decisions in recent years, often to the detriment of sound policy. In considering corporate tax reform, I encourage the Committees to make sound policy the primary objective. Thank you for the opportunity to testify today. I would be pleased to respond to any questions you may have.