THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

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TO THE
COMMITTEE ON WAYS AND MEANS

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Mr. Chairman, members of the Committee, I am Norman B. Ture, president of the Institute for Research on the Economics of Taxation (IRET). IRET is a public policy research organization, exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code. The testimony I am presenting to the Committee today represents my views and are not necessarily those of IRET, its Board of Directors, contributors, or others associated with the organization.

What Is At Issue?

I am pleased to have the opportunity to present my views concerning the tax policy implications of corporate acquisitions, mergers, and leveraged buyouts (permit me to use the term "corporate restructuring" - abbreviated herein as CR - as a shorthand substitute designating all such changes in corporate ownership and identity). Many of these CRs have proved to be very dramatic events, capturing the media's attention, hence that of a much wider audience than the financial market participants who are directly or indirectly involved in them. One consequence is that the issues have tended to become somewhat blurred, and this has, in turn, tended to confuse the question of why the public policy interest should be engaged by CR activity. If this Committee is to determine whether public policy action within its jurisdiction should be undertaken, I respectfully submit, it should be at pains to identify the issues that are presented by CRs.

CRs' Alleged Capital Offenses

CRs have been widely and frequently indicted on a long list of alleged economic offenses. The usual litany starts with the assertion that a CR is undertaken by greedy persons in pursuit of the financial gain they seek to obtain from acquiring ownership and managerial control of the target business. These persons, allegedly, grossly disregard the profitability, efficiency, and growth of the acquired company, sacrificing these long-term goals in the interest of maximizing their own short-run gains. The consequences of the pursuit of short run gains by the new management, it is claimed, include plant closings or divestitures, massive personnel layoffs and pay cuts, sharp cutbacks on research and development and on investment for

expansion and modernization, less productive uses of the company's labor and capital resources, hence increases in production costs.

Because CRs are generally implemented by substantial increases in the target company's debt:equity ratio, the customary charge is that this results in a very large increase in the share of the company's cash flow that needs to be devoted to debt service, thereby eroding the income available for the shareholders of both the acquired and acquiring corporations. The increased leverage, it is claimed, also weakens the ability of the company to withstand business reverses, hence exposes them to a greater risk of bankruptcy. This enhanced riskiness, it is asserted, is quickly reflected in a lower bond rating, hence higher interest rates to be paid by the company on any new debt financing it may have to undertake subsequently.

The more widespread the CR activity, it is claimed, the more aggregative are these adverse effects. Thus, it is frequently claimed that CRs are at least partly responsible for rising interest rates, economy-wide job losses, inadequate growth in productivity, hence impairment of the competitive position of American businesses in the world market, and a gravely weakened capacity of the whole private sector to ride through the next recession. Perhaps the least serious charge that is commonly made is that CRs entail a highly wasteful use of the nation's saving at the expense of growth-generating capital formation.

Opposing Views About CRs

I won't attempt in this testimony to examine these charges in detail. As the Committee is well aware, there is an extensive and growing literature that, on both analytical and empirical grounds, challenges the views that CRs are, in their very nature, economically dangerous or damaging. Indeed, much of this literature points strongly in the opposite direction, arguing that CRs or the threat thereof result in better management, more productive use of the company's resources, expanded employment opportunities and greater returns to shareholders.[1] Several of these investigations have quantified the substantial gains realized by shareholders of the target company, noting that these greatly outweigh the losses to bondholders.

The data measuring the aggregate performance of the economy, moreover, give no credence to the views that the increasing number and magnitude of CRs have damaging economy-wide effects. Nor do the data support the view that the extensive leveraging relied on to implement CRs has significantly affected the financial structure of U.S. corporate business. From the early 1960s through 1987, for example, no statically significant trend in corporate debt:equity ratios is to be found when debt is measured at par and equity is measured at its current book value.

In fact, the ratio in 1987 was only slightly higher than in the late 1960s and early 1970s. Using market valuations of both debt and equity, a statically significant but very slight rising trend in the ratio of debt to equity (about 1.1 percent a year) is found, but the current level of the ratio is well below that of the years 1974-79, inclusive.[2]

It is indeed true that interest costs have increased as a fraction of the gross income of nonfinancial corporations. The increases in recent years, however, are best seen as the continuation of a very long-standing trend. From 1948 through 1987, net interest as a fraction of the gross domestic product of nonfinancial corporate businesses in the United States increased on the average by 0.1 percentage points a year; this trend rate of growth is statically highly significant.[3]

I do not mean to suggest that these findings urge that public policy should be structured so as to promote CRs, leveraged or not, but unless a convincing case, well supported by solid facts and analysis, can be made that CRs are per se economically damaging, neither should public policy be structured to impede CRs. By the same token, unless it can be convincingly demonstrated that institutional flaws, whether in our tax laws, regulatory provisions or procedures, or financial market arrangements systematically induce a volume of CR activity that would not otherwise occur, public policy makers would be well advised to allow the operations of the financial market and the decisions of the market's participants to determine the amount and character of this CR activity.

Federal Income Tax Factors, High-Yield Bonds, and CRS

It is quite commonly asserted that there is, indeed, a flaw in the federal income tax that has contributed substantially to CR activity. The prevalent view is that CRs depend critically on so-called "junk bond" financing and that the extensive use of highly-leveraged financing to implement CRs in turn depends on the tax subsidy of debt financing by allowing the deductibility of interest. It is this view that gives the Committee on Ways and Means governance in this matter. The critical issue for the Committee, therefore, is whether there is in fact any such tax subsidy of debt as opposed to equity financing that affords an unnatural impetus for CRs.

There is little question, I believe, that the availability of "junk bond" financing and the marketability of these instruments have facilitated the financing of CRs. Some observers appear to have put a twist on this relationship, implying that CRs are the product of the financial institutions that have developed and seek to market high-yield bonds, that CRs are undertaken only to provide the occasion for recapitalization of

the restructured firms and to provide a market for these high-yield bonds. No such implication is warranted, in my judgment.

The firms that have developed and are marketing these bonds have, as a group, apparently made a great deal of money from this activity, but the successful marketing of these bonds clearly depends on investors' assessment of the capacity of the company on whose behalf they are issued to service them. If investors believe that the risk of partial or complete default outweighs the high yield these bonds offer, the bonds won't be purchased, and if the CR depends on this financing, it will prove to be abortive. Unless one believes that financial market participants are all gullible fools, incapable of evaluating earnings prospects or are in the pockets of high-rolling CR activists and their brokerage firm allies, the notion that CRs occur solely at the behest of high-yield bond dealers is simply untenable.

Tax Subsidy of Debt Financing or Tax Penalty on Equity?

If CRs are made possible only by the availability of high-yield bonds to finance them and if this financing, in turn, depends on tax subsidization of debt, this subsidy should be removed, no matter what would happen to CR activity. The critical question, to repeat, is whether the differential income tax treatment of the returns on debt and equity contracts subsidizes debt finance.

The Tax Bias Against Equity

The answer is quite the opposite. It is, I believe, well established and widely accepted that the income tax is inherently biased against saving and in favor of current consumption. Income is taxed when it is earned and realized; if after-tax income is used for current consumption, no additional income tax is imposed. If the after-tax current income is saved, however, the returns on the saving are subject to another round of income tax. In addition to this basic nonneutrality, numerous provisions of the present income tax law also distort the relative prices or costs of differing uses of saving. [4]

One of the greatest culprits is the corporate income tax that imposes double taxation of saving committed to a corporation by an equity contract. As a general rule, this additional violation of tax neutrality is avoided in the case of debt contracts, because the interest paid by the debtor, corporate or otherwise, is deductible.

In effect, the income tax imposes a selective excise on equity investment in a corporation but does not impose it on debt incurred by the corporation. This differential treatment should certainly not be characterized as affording a subsidy for debt finance, but as imposing a negative subsidy or tax penalty on

equity financing. If an excise tax were imposed at a given rate on, say, all consumer durables except, say, refrigerators that were taxed at a lower rate, one certainly wouldn't assert that refrigerators were subsidized by the excise tax; indeed, purchases of refrigerators would be penalized relative to purchases of non-durables and services on which no excise is levied.

The Tax Distortion of Corporate Finance

The differential income tax treatment of returns on debt and on equity must indeed distort the composition of financing, hence business capitalization, not because debt is subsidized but because equity is penalized more than debt. The degree of bias exerted by this differential treatment depends on the level of the tax rates in both the corporate and individual income taxes. The higher the tax rates, clearly, the greater the distorting influence of the differential tax provisions.

In this connection, it must surely have been called to the Committee's attention that the very substantial rate reductions enacted in the Tax Reform Act of 1986 significantly reduced the effective tax bias in favor of debt and against equity financing. The elimination of the reduced rate of tax on capital gains offsets that favorable effect in some degree, but it is reasonable to assume that the net effect of the 1986 legislation is a less severe tax bias against equity compared with debt than had earlier prevailed. Insofar as debt:equity ratios have increased since 1986, whether or not as a result of CRs, tax policy can hardly be held to be responsible. On the contrary, tax policy has moved toward reducing the anti-equity bias in the income tax, thereby reducing the impetus for debt as opposed to equity financing.

Tax policy does not seem to have been a significant influence in the development and increasing use of high-yield bond financing. If CRs, as often asserted, depend on the availability of such financing, one must conclude that tax policy has exerted a decreasing influence, if any, on CR activity. Other factors and developments should be sought to explain the increase in this activity.[5]

This is certainly not to suggest that the differential tax treatment of debt and equity returns should be a matter of no concern to the Committee. It is difficult to discern any acceptable goal of tax policy that is effectively pursued by penalizing equity financing, certainly nothing that would warrant incurring the costs this penalty imposes.

The Tax Penalty on Equity and the Cost of Corporate Capital

One of the more damaging of these costs is the increase in the cost of capital that results from this tax treatment. Because dividends are not deductible, the corporate income tax is an incremental tax withdrawn from the earnings on the equity investment in the corporation. The fact of this additional tax does not persuade equity investors to accept a lower reward for saving in this form. Instead, it results in their requiring a higher pretax return on their investment so that their after-tax return will be maintained.

This cost increase is not confined to capital financed by equity. Shifting to debt finance to avoid the tax penalty on equity tends to increase the cost of the company's debt service. Debt finance, too, is made more costly than otherwise.

The increase in the amount of debt in the company's capitalization and the greater cost of servicing that debt, moreover, increases the risk that returns on equity will be eroded. This impels shareholders to seek higher pretax returns on their investment than would otherwise be needed. If corporate management fails to use the firm's resources in such a way as to provide the additional return, the market value of the company's shares will fall until the required risk-adjusted rate of return is achieved. In short, the tax distortion of the relative costs of debt and equity generally leads to higher costs of both.

Eliminating, or at least reducing, the tax bias against equity should not be sought by imposing the same sort of penalty on debt financing that is currently borne by equity financing. It is not a "level playing field" per se that should be the policy objective, but a playing field all parts of which are correctly configured. The way to eliminate the differential tax treatment of refrigerators and all other consumer durables, in the example above, is not by imposing or raising the excise tax on refrigerators but by eliminating or reducing the tax on consumer durables generally.

Economic Effects of Limiting Interest Deductibility

Irrespective of the way in which it is achieved, limiting the deductibility of interest should be counted on to have highly undesirable economic effects. It would certainly raise the cost of capital confronting all businesses, regardless of the type of financing relied upon. If any part of the interest payment is to be subject to tax by the payer, the capital the acquisition of which is debt financed would have to produce a higher pretax return than otherwise. If it did not, either the yield afforded the bondholders would have to be reduced or the after-tax return on the equity would fall. Nothing about exposing bond interest to tax in the hands of the interest payer would induce bondholders to accept a lower yield; if anything, the tax-induced increase in the cost of servicing the debt by the borrower would enhance the

risk of holding the bond and lead lenders to require higher pretax yields in order to assure the same risk-adjusted rate of return on their bond holding.

By the same token, nothing about the limitation of interest deductibility would in itself increase the return on equity capital or induce shareholders to accept a lower rate of return for the same amount of holdings. Insofar as debt financing were deemed to be essential, the tax-induced increase in the cost of debt service would reduce the amount of earnings available for rewarding equity capital and increase the risk of equity investment. This would impel equity investors to seek higher pretax returns to restore the returns on their investment and to compensate for the greater riskiness of their investment.

Selectively Limiting Interest Deductibility

These adverse consequences, moreover, could not be avoided by imposing limitations on interest deductibility selectively. One suggestion is to confine the limitation to high-yield bonds, presumably because they have been so extensively used in CRs. The objective of this selective curb on interest deductibility presumably is to reduce the extent of CR activity without adversely impinging on other "legitimate" uses of debt financing. In addition, such a curb, presumably, would prevent the run up of interest costs that allegedly imperil the leveraged firm relying on these high-yield instruments and that erode its taxable income and lose the Treasury tax revenue. I do not believe that either of these objectives is appropriate.

As indicated earlier in my testimony, I do not believe that the vote is in on the goodness or badness of CRs, however they may be financed. There is, as yet, at any rate, no persuasive body of evidence to urge that CRs, no matter how heavily debt financed, entail adverse economic consequences that call for public policy efforts to limit them.

The level of the yields on the debt instruments used to finance CRs certainly doesn't represent deliberate efforts on the part of the borrowers to pay "excessive" amounts of interest, despite the fact that these very large interest costs may drastically reduce the restructured company's taxable income and tax liability. Unless the marginal tax rate were 100 percent or higher, after all, each dollar of interest cost leaves the company poorer, not richer. The level of these yields, instead, reflects investors' assessments of the risk of committing funds to the borrower. It is difficult to see why public policy should interfere, seek to alter investors' judgments, or prohibit investors from willingly accepting these risks.

Revenue considerations certainly should not be determining factors. For one thing, a strong argument can be made that CRs

have been revenue raisers, particularly after the effective date of the Tax Reform Act of 1986. The most signal feature of CRs has been the very substantial increase in the market value of the target company's equity. The capital gains realized when the restructuring is implemented results in revenue gains that, at worst, are only partially offset by the increase in interest deductions net of the increase in interest income resulting from the increased leverage of the restructured business.

In any event, whether CRs leveraged with high-yield bonds result in revenue gains or losses is not the relevant question; the appropriate concern is whether there is any reason, based on fundamental tax principles, to question the legitimacy of the interest deduction. **I know of no principle of taxation that argues for determining the deductibility of interest by reference to the rate at which it is paid.**

Even disregarding these objections, it is difficult to see what kind of narrowly-focused limitation could be designed that would be workable. What other than perfectly arbitrary dicta would delineate the characteristics of a debt instrument the interest on which would qualify as deductible? At what level would the yield on any given debt issue be deemed to be "too high?" What meaningful criteria could be adduced to determine the "right" yield? What tax policy principle could be identified, indeed, to validate curbing the deductibility of interest on any debt the terms of which are determined in the market?

Attempting to curb the deduction of interest on some kinds of debt but not on others would confront formidable problems of identification and definition. The complexity and costs of compliance and enforcement that would attend attempts to distinguish among differing types of borrowing should themselves deter moving in this direction, even ignoring the adverse economic consequences. I am sure that other witnesses, particularly Secretary Brady, have called the Committee's attention to these problems.

Another approach that has received some attention would focus on rigorously defining debt and differentiating it from equity. The objective, presumably, would be to disallow the deduction of interest on those instruments that were deemed to be more nearly equity than debt contracts.

In a dynamic financial system that accommodates the financing demands of an enormously diverse business community, a very wide variety of financing devices is to be expected. It would be truly astonishing if the result were not a great number of similarities as well as distinctions among these devices. The need for sharp distinctions among them does not arise from unwarranted or overly generous treatment of those debt instruments that may be thought to be on the borderline between

debt and equity; it is impelled, instead, by the punitive treatment of equity. Obviously, if payments in service of equity contracts were treated the same way as debt service, i.e., correctly, there would be no occasion for attempting to make these often very difficult distinctions.

Even were it possible to implement this approach without adding appalling complexity to an already frighteningly complex tax law, the result would be damaging. Implementation would mean that some payments now treated as deductible interest would instead be subject to the corporate income tax. As shown above, this would raise the cost of capital to the affected companies.

Any limit on interest deductibility sought allegedly in the mistaken interest of leveling the playing field would, in fact, seriously tip the playing field in one major respect. However effective any such limit might be in inhibiting debt financing of CRs, and ostensibly in reducing the extent of CR activity by U.S. citizens, it would be largely if not entirely ineffective in constraining foreign persons' use of debt financing to restructure American companies. I do not believe that foreigners should be prevented from acquiring businesses in the United States, but neither do I see any reason to advantage foreigners in competition with Americans for the ownership of U.S. businesses.

Across-the Board Limits on Interest Deductibility

Possibly in response to these difficulties of definition and identification, a number of proposals have emerged for imposing some across-the-board limitation on the deductibility of interest. One such proposal is to disallow the deduction of some fraction of a company's interest costs and devote the resulting increase in tax revenues to offset the revenue lost by allowing the company to deduct some fraction of its dividends.

This Solomon-like cut-the-baby-in-two approach is simply misfocused. The deficiency in the tax law is not that interest may be deducted but that dividend payments may not be. Ignoring the various provisions in the present law that limit interest deductibility in certain situations, the present law in general affords the correct tax treatment of interest. This treatment should not be sacrificed on "level-the-playing-field" grounds, if this means leveling up to the tax rate on dividends. The focus, instead, should be on removing the present law's penalty on equity financing.

Implementing this 50-50 approach, moreover, would have particularly harsh results for new and for small, rapidly-growing companies that often depend on borrowing to obtain the financing they require. The higher costs of borrowing they would face would not be significantly offset by the lower cost of more nearly

correct treatment of equity. Such companies would, therefore, confront relatively and absolutely higher costs of capital. This certainly would not be a sought-after result.

Reducing the Tax Penalty on Equity

Instead of seeking ways to limit interest deductibility, the Committee would do well, I believe, to look for means of reducing the excessive tax on the returns to equity. Eliminating the double taxation of dividends by allowing them to be deducted in computing a corporation's taxable income is an appropriate objective. The income tax law generally observes a basic income tax principle that calls for allowing deductions for payments made for production inputs. Corporate businesses, accordingly, are permitted to deduct the payments they make for labor services; they are also allowed to deduct their payments to **lenders** for capital services. Deductibility should be extended for payments made to shareholders for capital services.

Making dividend payments fully deductible would probably entail a significant loss of tax revenue, as conventionally estimated, that is without taking account of feedback effects on economic activity. It is likely that this static revenue estimate overstates the revenue loss, even disregarding feedback effects, because it fails to take into account the increase in the market value of outstanding equity that would result and, therefore, the increase in capital gains tax revenue obtained when these gains were realized. In any case, in this era of great concern about federal budget deficits, extending deductibility to all dividend payments may well appear to be an unrealistic proposal.

Partial Deduction of Dividends on Net New Common Stock

A significant step in the right direction, however, can be taken at a much lower cost of tax revenues to the Treasury. This step would be to allow a deduction for some fraction of the dividends paid on net new common stock issues. The revenue effect of this change in the tax law clearly would depend on the increase in total corporate capitalization. This increase would occur in response to the lowered cost of equity capital that, in turn, would result from a reduced tax barrier to dividend payout and a larger volume of dividend distributions. In all, it is likely that the revenue loss, even measured on a static revenue basis, would be quite small.

Reduce the Capital Gains Tax Rate

A companion measure would be to reduce the tax on capital gains, at least those realized on the sale of corporate equity shares. The equity investor in a corporate business obtains the returns on this investment either in the form of dividends or, alternatively, by realizing capital gains upon the sale of his

shares. These capital gains are largely generated by the corporation's retention of profits remaining after payment of the corporate income tax. If these retentions are invested in assets at least as productive as those that produced the current income stream, the market's valuation of the equity will increase in an amount equal to the present value of the expected increase in the corporation's earnings after corporate tax. Reducing the tax on such capital gains, therefore, reduces the double taxation of income generated in corporate businesses. For this reason, reducing the capital gains tax rate would raise the market value of capital assets.

The effects of reducing the capital gains tax rate on the cost of corporate equity capital closely parallel those from providing for the deductibility of dividends. In essence, either tax change would reduce the pretax yield on equity investment required by equity investors to obtain an after-tax yield sufficient to warrant their making the investment.

There has been much debate about the revenue effects of reducing the capital gains tax rate. Much of the dispute has centered on the effect of the rate reduction in unlocking long-held capital assets. This transaction effect may well be quite substantial, at least in the short term, but it embraces only a part of factors that would affect the revenue flowing into the Treasury.

As noted, reducing the capital gains tax rate would very promptly raise the market value of capital assets. Tax revenue changes, therefore, would reflect not only the increase in capital asset transactions but the larger capital gains realized in these transactions. Furthermore, because reducing the capital gains tax rate would reduce the cost of capital, the ultimate effects to be expected include a larger stock of capital and a higher capital:labor ratio, greater labor productivity and higher real wages and employment, hence greater output and a larger tax base than would otherwise prevail. These long-term gains for the economy should weigh at least as heavily in policy makers' considerations as the near term effects on tax revenues in evaluating these proposed changes in the tax law.

Conclusion

In conclusion, I respectfully urge the Committee to reject proposals for any sort of limitation on the deductibility of interest. A persuasive case has not been made that CRs have injurious effects on the economy and therefore require changes in public policy to limit CR activity. Much evidence has been amassed and presented to this Committee and others that CRs contribute to more efficient corporate management and more productive uses of the resources at corporations' disposal. Should the Committee concludes that CR activity is a matter for

it to address, I strongly recommend that it focus on reducing the existing income tax penalties imposed on equity financing rather than attempt to impose those penalties on debt financing, as well.

[1] A partial listing of important contributions to this literature is provided in the attached bibliography.

[2] Data are from the Board of Governors, Federal Reserve System.

[3] The trend change in this ratio was computed using an ordinary least squares regression of the annual ratios of net interest to gross domestic product on time, from 1948 through the third quarter of 1988. Data on gross domestic product of nonfinancial corporations and their net interest payments are in **Economic Report of the President**, January 1989, Table B-12, page 322.

[4] For an extended discussion of these propositions, see Norman B. Ture and John B. Egger, **Corporation's "Fair Share" of Federal Taxes**, A Study Prepared for the National Chamber Foundation (Washington, D.C., 1988), pages 25 -39 and 42 - 45.

[5] For identification of some of these other influences, see Stephen Kaplan, "Management Buyouts: Efficiency Gains or Value Transfers?" paper presented at the New York University's Salomon Brothers Center, Conference on Financial-Economic Perspectives on the High-Yield Debt Market, December 8-9, 1988.