Seeking True Financial Reform: Ending the Debt-Equity Distinction

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SEEKING TRUE FINANCIAL REFORM: ENDING THE DEBT-EQUITY DISTINCTION

ABSTRACT

This Note identifies the failure of Congress to address tax incentives for leverage as a principal cause of the recent financial crisis and a fundamental flaw of recent financial reform legislation. Specifically, the Internal Revenue Code provides substantially disparate tax treatment for debt and equity financing by allowing firms to deduct interest payments on indebtedness, but not providing an equivalent deduction for equity funding. This “debt-equity distinction” artificially reduces the cost of capital for debt financing relative to equity financing and encourages firms to over-employ leverage in their capital structure. This in turn increases financial distress costs and externalities to the economy and increases the volatility of capital markets. Though some scholars have proposed to allow firms a deduction for dividends paid, such a scheme would create additional distortions and introduce the potential for corporate managers to substantially manipulate their taxable income. This Note offers an alternative solution by proposing: (1) that the deduction for interest on business indebtedness be eliminated, and (2) that policymakers return to the idea of the Cost-of-Capital-Allowance (COCA). A COCA deduction better aligns the incentives of firms with those of capital markets and economies writ large, and encourages managers to seek out the absolute cheapest sources of capital while removing tax shelter considerations from the decision-making process.
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INTRODUCTION

On March 16, 2008, J.P. Morgan made an emergency purchase of the entire firm of Bear Stearns for $2 a share, although the price had once been as high as $211 a share.\(^1\) Bear Stearns had been operating with a leverage ratio of 30:1, forcing the Federal Reserve to back the purchase in an attempt to stave off a broader financial market collapse.\(^2\) On September 14, 2008, Lehman Brothers filed for Chapter Eleven bankruptcy protection after several failed attempts to find a buyer.\(^3\) The firm employed a controversial accounting technique known as “Repo 105” to trim $50 billion in liabilities from its balance sheet in the months leading up to the bankruptcy filing, artificially lowering the amount of leverage reported to investors.\(^4\) That same week, Bank of America purchased Merrill Lynch in a “shotgun” deal arranged with government assistance, and AIG received a huge infusion of federal government cash valued at $85 billion.\(^5\) Both companies also maintained large leverage ratios whereby relatively small amounts of equity capital supported vast quantities of financial assets.\(^6\)

This Note proposes a method that would limit the necessity of such drastic actions by removing the tax incentives of firms to engage in over-leveraging. All the firms described in the preceding paragraph collapsed in part due to skyrocketing leverage ratios and undertaking vast amounts of debt to finance their operations. When asset valuations fell below the amount of their liabilities, lenders and trading parties began to doubt whether these firms could cover their obligations and began a flight to liquidity.\(^7\) Traders began short-selling their stock, investors attempted to liquidate positions, and lenders issued margin calls on their loans in a frenzied attempt to recover their capital.\(^8\) The margin calls forced these firms to liquidate their own positions at fire-sale prices, incurring losses of

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2 Id. at 11, 210.
5 Eric Dash, Purchase of Merrill Fulfils Quest for a Bank, N.Y. TIMES, Sept. 15, 2008, at A18; see also KELLY, supra note 1, at 219; Sorkin, supra note 3.
6 See KELLY, supra note 1, at 11, 217, 219.
7 Id. at 217–19; see also Sorkin, supra note 3.
8 See SEBASTIAN MALLABY, MORE MONEY THAN GOD: HEDGE FUNDS AND THE RISE OF A NEW ELITE 179 (2010).
increasing magnitude.\textsuperscript{9} Heavy reliance on leverage increases the amount of assets that must be sold as the firms require increasing amounts of capital to meet the margin calls.\textsuperscript{10}

During the first half of the Obama administration, policymakers, scarred by the public reaction to bailouts and loan guarantees, focused on crafting a new regulatory framework to prevent the need for such an overwhelming federal response in the future. On July 15, 2010, Congress passed the Dodd-Frank financial reform bill, granting regulators more powers to regulate risky financial practices on Wall Street and imposing costly new reporting requirements on capital market participants.\textsuperscript{11} Notable provisions include: (1) the Volcker Rule, which mandates that regulators set guidelines limiting the amount of capital that banks can risk in proprietary trading and investments with private equity and hedge funds; (2) guidelines dictating the regulators’ ability to break up dangerously large financial firms as a last resort before allowing markets to collapse; and (3) a last-resort clause allowing regulators to impose emergency 15:1 leverage ratios on specific financial firms if necessary to prevent “grave threats[s] to the financial system.”\textsuperscript{12}

With respect to preventing future meltdowns, Dodd-Frank relied heavily on granting greater power to regulators to prohibit high-risk financial practices; however, the legislation did not alter the incentives that originally encouraged firms to engage in such practices. Financial reform that targets such incentives should focus primarily on the tax deduction for interest on business indebtedness. Section 163(a) of the Internal Revenue Code (IRC) allows businesses and individuals to deduct all interest payments “paid or accrued within the taxable year on indebtedness,”\textsuperscript{13} as long as such interest payments relate to business activities.\textsuperscript{14} The deduction

\textsuperscript{9} Id.
\textsuperscript{10} Id.
\textsuperscript{12} U.S. SENATE BANKING COMMITTEE, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 4–5 (2010), available at http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf [hereinafter DODD-FRANK WALL STREET REFORM]. Due to space constraints, this Note will only touch briefly on a few aspects of the Dodd-Frank reform bill.
\textsuperscript{13} I.R.C. § 163(a) (2006).
\textsuperscript{14} Id. § 163(h) (disallowing deductions for all interest payments on personal indebtedness for individuals). A major exception to this rule is interest on a mortgage or home equity loan related to an individual taxpayer’s personal residence, which is fully deductible. Id. § 163(h)(3).
reduces the effective after-tax cost of employing leverage (indebtedness) in the capital structure of a firm.\textsuperscript{15} Moreover, the IRC contains no equivalent deduction for employing equity capital, which raises the cost of equity relative to debt financing.\textsuperscript{16} IRC Section 311(a) disallows any deduction for corporate distributions of property, generally known as dividends, and the corporation receives no beneficial tax treatment from the dilution of ownership interest that occurs with equity fundraising.\textsuperscript{17} This difference in tax treatment is commonly known as the “debt-equity distinction,” and is widely believed to create distortions in capital markets that lead to negative economic consequences.\textsuperscript{18}

This Note argues that Congress committed a potentially serious error in its attempt to prevent future financial panics by failing to directly address the debt-equity distinction. The deduction for business interest should be disallowed and replaced with a Cost-of-Capital-Allowance (COCA) deduction that makes no distinction between debt and equity at the level of the corporate entity.\textsuperscript{19} Through this tax reform, the extreme difference in tax treatment between debt and equity disappears, and the incentives of corporate managers evolve to pursue means of financing that carry the lowest absolute cost of capital, thus removing tax considerations from the decision-making process.

Part I will discuss the tax treatment of leverage and equity at both the entity level and the investor level. Part II will analyze the impact of leverage on the economy at both the micro and macro levels, illustrating how the financial activities of one firm can send shockwaves throughout the entire economy. Part III will briefly describe recent attempts and proposals

\textsuperscript{15} See Adam O. Emmerich, Comment, Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation, 52 U. Chi. L. Rev. 118, 131 (1985) (noting that a firm can reduce its after-tax cost of capital if it succeeds in re-characterizing equity as debt).

\textsuperscript{16} See id. at 118 (explaining that this disparate treatment of debt and equity is well-settled in tax law, though it lacks a clear rationale).

\textsuperscript{17} See I.R.C. § 311(a). Corporations must recognize gain and pay tax on appreciated property distributed as dividends, though again no loss may be recognized on the distribution of depreciated property. Id. § 311(b).

\textsuperscript{18} See Ilan Benshalom, How to Live with a Tax Code with Which You Disagree: Doctrine, Optimal Tax, Common Sense, and the Debt-Equity Distinction, 88 N.C. L. Rev. 1217, 1222 (2010) (noting the debt-equity distinction “aggravated the recessionary impact of the financial meltdown on the real economy because firms operating with low equity cushions are very dependent on their ongoing access to credit”); Katherine Pratt, The Debt-Equity Distinction in a Second-Best World, 53 Vand. L. Rev. 1055, 1056 (2000) (“This Article discusses the time-honored but outdated tax law distinction between corporate debt and equity. Economists and legal commentators and the Treasury Department have made various proposals to eliminate the debt-equity distinction.”).

\textsuperscript{19} See Pratt, supra note 18, at 1139–45 (describing the COCA proposal).
for reform of financial practices, including Dodd-Frank and other proposals from legal scholars. Part IV will put forth the main thesis of ending the deduction for interest payments, with an emphasis on designing the tax code changes to promote economic growth. The conclusion will list concrete steps to be taken over the next couple of years to achieve the best possible outcome.

In advancing its thesis, this Note will operate under two analytical frameworks designed to improve the final proposal and broaden its appeal. First, any changes to the tax code should be designed to promote, not hinder, long-term economic growth. The tax code contains several distortions, and simply removing one distortion will not improve economic efficiency if tax reform is designed improperly and other distortions arise. In a 2004 law review article, Peter Orszag and William Gale listed several guidelines that tax reform plans should follow to promote growth: (1) the change must be either revenue-neutral or be contemporaneously matched with corresponding spending changes; (2) the change must be designed to encourage new economic activity, not to reward existing activity; and (3) the change should reduce resources directed towards tax avoidance. This Note will aim to follow these guidelines elsewhere described as the theory of the “second-best” and strive to account for additional distortions in the IRC while devising a solution for the debt-equity distinction.

Second, this Note will operate within the framework of agency theory and the modern corporation. Specifically, this Note will acknowledge the divergence in economic interests between the shareholders and managers of a firm when discussing a firm’s decision-making process. This theory

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20 See id. at 1056 (“The theory of the second-best posits that eliminating an economic distortion does not necessarily increase efficiency if other economic distortions remain.”).


22 See id. at 1192–94. See generally Paul Sullivan, Confusion over the Dormant Estate Tax Keeps Advisers Busy, N.Y. Times, June 12, 2010, at B6 (describing the efforts of wealthy individual taxpayers to take advantage of the one-year absence of the estate tax in 2010).

23 See Edward J. McCaffrey, A New Understanding of Tax, 103 Mich. L. Rev. 807, 849–50 (2005) (“Tax, because of its incentive effects and the limited information of government policymakers—not to mention administrative concerns—is in a deeply ‘second-best’ situation. There is simply no a priori way to say that welfare would improve [by substantially altering the tax code].”) (emphasis added).

24 See Pratt, supra note 18, at 1056.

25 See Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288 (1980) (“Economists have long been concerned with the incentive problems
is relevant due to the different impact the debt-equity distinction has on both shareholders and corporate managers. Therefore, an optimal solution to this tax distortion must account for the divergence in economic interests between shareholders and managers to be successful.  

I. TAX TREATMENT OF DEBT AND EQUITY

The tax treatment of debt and equity financing instruments is complex, and for corporations this treatment varies significantly depending on whether the shareholder or the corporate entity is considered. This section describes the taxation of each form of financing in the context of corporate double taxation, first at the corporate entity level and then at the investor level.

A. Treatment at the Entity Level

The debt-equity distinction is most apparent at the entity level of taxation. IRC Section 163(a) allows businesses to deduct interest payments on indebtedness, regardless of whether the interest is related to short-term financing of current operations or the long-term financing of capital projects and expansion.  

This deduction is taken against both ordinary and capital gain income for corporations, and the amount of interest that may be deducted per tax year is limited only through the net operating loss provisions in IRC Section 172. Given the corporate marginal tax rate of 35%, this deduction effectively reduces a firm’s cost of capital on debt financing by over one-third. Corporations use this tax shield heavily to increase after-tax net income; a Department of Commerce report con-

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26 See discussion infra Parts I.A, I.B.
28 See id. § 1211(a) (applying capital loss limitations only on losses due to sales or exchanges of capital assets).
29 Both corporate and individual taxpayers may carry a net operating loss in the current tax year back two years to wipe out previous tax liabilities. If any current losses remain, they may be carried forward to offset tax liabilities for the next twenty years until exhaustion. See id. § 172.
30 Id. § 11(b). Corporations pay a marginal tax of 34% on all income between $75,000 and $10,000,000, with all excess income taxed at a 35% rate. Personal service corporations pay a tax of 35% on all income earned in the tax year. Id. § 11(b)(2).

Financing operations with equity, however, does not provide corporations with a corresponding tax deduction for their cost of capital. IRC Section 311(a) disallows corporations from recognizing any losses or deductions on the distribution of dividends or the repurchase of stock.\footnote{I.R.C. § 311(a).}

Thus, if a corporation raises $100 of equity capital and pays out $10 in dividends each year, the after-tax cost of the dividends is the full $10. If the corporation raises the same $100 in bonds at a 10% interest rate, the corporation still owes $10 in interest payments each year. The corporation can reduce its taxable income by the same $10, however, and therefore reduce its tax liability. The after-tax cost of the interest payment is thus only $6.50, given a 35% marginal corporate tax rate.

The stark contrast in tax treatment of debt and equity at the corporate level encourages firms to attempt to construct transactions that exhibit the form of debt financing but contain the substance of equity financing.\footnote{See Benshalom, supra note 18, at 1221–22.} Debt financing brings better tax treatment, but equity financing potentially carries fewer restrictions on the flexibility of corporate managers;\footnote{See generally Pratt, supra note 18, at 1061–64 (providing an overview of the different tax treatments and benefits of debt and equity financing).} an instrument that combines both of these qualities is thus highly valuable. Though IRC Section 385(a) authorizes regulations to clarify this issue of “line-drawing,”\footnote{I.R.C. § 385(a); see also Benshalom, supra note 18, at 1222.} the Treasury Department has so far left responsibility for deciding close calls to the judiciary.\footnote{See Benshalom, supra note 18, at 1235. Section 385(b) provides courts with five factors to consider when determining whether an instrument is equity or debt: (1) written, unconditional promises to repay; (2) any subordination or preference to the indebtedness of the firm; (3) the leverage ratio of the firm; (4) convertibility from debt to stock; and (5) the relationship between bondholders and shareholders of the firm. I.R.C. § 385(b).}

\subsection*{B. Treatment at the Holder Level}

Taxation of debt and equity instruments at the investor level partially offsets the distortion at the entity level;\footnote{See Pratt, supra note 18, at 1090 ("[T]he corporate level tax advantages of using debt in the capital structure are offset to some degree because of investor level tax consequences.").} however, the taxation of instru-
ment-holders carries less weight in the capital structure decision-making process for corporate managers than the taxation of the corporate entity. Bondholders are taxed at the generally higher marginal rates of ordinary income for interest received; currently, the highest marginal rate on ordinary income for individuals is 35%. Bonds may be bought and sold for purposes of speculation, however, and any gain on such sales can be classified and taxed as a capital gain to the extent the gain is not due to original issue discount.

Conversely, shareholders currently receive favorable tax treatment on their instruments relative to ordinary income. Most individual shareholder-taxpayers pay a low 15% marginal rate on dividends received as a result of the Bush-era tax cuts passed in 2003. Furthermore, individual shareholders pay the same low rate of 15% on capital gains on most equity instruments held for more than one year. Losses on the sale of equity instruments, regardless of how long the taxpayer held the instrument, can offset short-term capital gain, long-term capital gain, and $3,000 of ordinary income.

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38 See id. at 1092–93 ("Even in light of all of the potential offsets to the tax advantages of corporate debt, the consensus view of economists is that corporate debt is significantly tax favored over corporate equity.").

39 I.R.C. § 64 (defining ordinary income as all income which is not the result of a sale or exchange of capital property as defined in Section 1231(b)).

40 Id. § 1. This marginal rate for individuals in the highest tax bracket is set to persist through 2012 as a result of a December 2010 tax compromise between Republicans in Congress and President Obama. See Jim Kuhnhenn, Obama Salutes Spirit of Compromise, Signs Tax Bill, BOSTON.COM (Dec. 17, 2010), http://www.boston.com/business/taxes/articles/2010/12/17/obama_salutes_spirit_of_compromise_signs_tax_bill/.

41 I.R.C. § 1271 (requiring amounts received in retirement of the bond’s principal or in exchange for the right to receive the bond’s principal to be classified as a capital exchange); Id. § 1272 (excluding gains attributable to original issue discount from the definition of a capital exchange).

42 Id. § 1(h)(11). This tax rate is set to continue through 2012, again as a result of the December 2010 tax compromise between congressional Republicans and President Obama. See Kuhnhenn, supra note 40. Tax-exempt entities pay no tax on dividends received from equity investments, whereas corporations may take advantage of a dividend-received deduction to eliminate any tax liability arising from the receipt of dividends themselves. See Michael Doran, Managers, Shareholders, and the Corporate Double Tax, 95 VA. L. REV. 517, 527 (2009) (citing I.R.C. § 243 (West 2008)).

43 I.R.C. § 1(h)(1) (2006). The marginal tax rate for gains on the sale of equity securities held for less than one year is the ordinary income tax rate of the taxpayer. Id. § 1222(11). If the taxpayer’s marginal tax rate for ordinary income is 15% or less, the taxpayer enjoys a 0% tax rate on capital gains income. Id. § 1(h)(1)(B).
income per tax year.\textsuperscript{44} The shareholder can carry forward any unused losses to future tax years until exhaustion.\textsuperscript{45}

One may reasonably assume that the favorable tax treatment of equity at the shareholder level compensates for the reverse treatment at the entity level. The interests of the managers running the firm diverge from those of shareholders, however, and therefore shareholder taxation is likely a relatively minor consideration of corporate managers when making financing decisions.\textsuperscript{46} Scholar Michael Doran has argued that corporate shareholders support tax changes that “increase the value of existing capital,” whereas corporate managers prefer to lower the tax burden on new investment.\textsuperscript{47} Moreover, managers can persuade shareholders that increased leverage will provide a higher valuation of the firm than will equity financing due to the tax shield, and this higher valuation will increase the value of the investors’ holdings.\textsuperscript{48} Therefore, the distinction in taxation at the entity level likely carries significantly more weight in the capital structure decision-making process.

II. IMPACT OF LEVERAGE

A firm’s strategy in building its capital structure and financing operations can have a tremendous impact on the success of the firm, both in the short- and long-term. This section describes a few consequences of capital structure strategies, beginning with an extremely basic overview of the

\begin{itemize}
\item \textsuperscript{44} Id. § 1211(b).
\item \textsuperscript{45} Id. § 1212(b).
\item \textsuperscript{46} See Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323 (1986) (noting that whereas shareholders desire cash payouts from the firm, managers desire to grow the resources of the firm, leading to common clashes of interest).
\item \textsuperscript{47} Doran, supra note 42, at 532–33. Doran made these observations in the course of advancing his argument that, though shareholders support corporate tax integration, corporate managers are at best ambivalent and possibly even against full integration despite the likelihood of overall welfare benefits to the economy. See id. at 528–34 (citing U.S. DEPT. OF THE TREASURY, REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992)). An additional analogy to illustrate this divergence is found in the different tax consequences of a property tax versus an income tax. Shareholders would prefer lower property taxes, because that reduces the tax burden on their existing capital; managers would prefer lower income taxes to increase the gains to their future projects.
\item \textsuperscript{48} See Michael S. Knoll, Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk Taking, 38 VILL. L. REV. 1461, 1469, 1481–82 (1993) (“C]orporations trying to maximize their value will choose a capital structure that minimizes total taxes ....”).
\end{itemize}
analytical framework for judging a firm’s capital structure decisions. The section then notes a few of the advantages and disadvantages of the use of leverage, both on a micro- and macro-economic scale.

**A. Capital Structure of a Firm**

Firms generally finance their activities with a combination of equity and debt, with the optimal structure constituting the formula that meets all financing needs with the lowest possible cost of capital.\(^49\) The Modigliani-Miller Theorem, famous in the field of corporate finance, held that given a tax-free environment, the exact mix of debt and equity is irrelevant to a firm’s valuation.\(^50\) Taxes do impact the market, however, and debt receives a tax shield from the deductibility of interest payments.\(^51\) Thus, the value of a leveraged firm is equal to the value of the firm unleveraged plus the tax shield the firm receives from leverage.\(^52\) Therefore, assuming no marginal change in interest payments, a firm’s optimal capital structure may theoretically be all debt and no equity, because as leverage increases, so does the tax deduction.\(^53\)

Such a heavy reliance on leverage has drawbacks, especially in the form of financial distress costs. These costs include bankruptcy costs, higher costs of raising new debt, and higher transaction costs in normal business operations.\(^54\) Lenders require higher interest rates in return for the risk inherent in lending to an already highly-leveraged firm.\(^55\) Additionally, due to provisions in the tax code limiting the ability of corporations to take advantage of the full amount of operating losses in a single tax year,\(^56\) the value of the interest payment tax shield is limited to the extent of the firm’s annual pre-tax net income. Many scholars have thus observed the

\(^{49}\) Id. at 1467 (“Choosing the capital structure that minimizes the corporation’s cost of capital is desirable because it maximizes the value of the corporation.”).


\(^{53}\) Id.

\(^{54}\) See generally id. at 1061–62 (listing several costs of financial instability that may result from a firm’s heavy reliance on leverage in its financial structure).

\(^{55}\) Villamil, *supra* note 50, at 3.

interest deduction tax shield has a declining marginal value as the leverage of a firm increases.\(^57\)

A more advanced version of the Miller-Modigliani Model accounts for these financial distress costs, though firms do not fully internalize some of these losses.\(^58\) The new model subtracts the costs from the value of a leveraged firm; otherwise equal to the value of the firm unleveraged plus the tax shield from debt.\(^59\) Some forms of financial distress costs, such as costs from bankruptcy, can be devastating to the firm and possibly end the life of the corporation.\(^60\) Due to the limited liability of the shareholders and management of a corporation, however, corporate managers have reduced incentives to caution against high-risk projects disproportionately financed with debt.\(^61\) Moreover, the phenomenon of “too-big-to-fail” firms presents problems of moral hazard, encouraging managers to act over-aggressively with the knowledge that a significant share of any resulting losses will be passed on to the taxpaying public.\(^62\)

### B. Benefits of Debt

Debt offers benefits to individual firms through avenues other than the tax code. Increasing leverage to raise overall after-tax net income improves several key financial metrics that stock analysts and investors often scrutinize, a move that favors existing shareholders and managers. Return on equity (ROE), an important financial metric for equity shareholders,

\(^{57}\) Knoll, *supra* note 48, at 1473–75.

\(^{58}\) See Pratt, *supra* note 18, at 1089 (“The failing businesses’ failures to make interest payments may cause a domino effect in the economy, as creditors of the failing businesses in turn find themselves unable to service their debt.”). See generally Knoll, *supra* note 48, at 1475–77 (observing a firm’s financial distress imposes indirect costs on employees, suppliers, and customers).

\(^{59}\) See Krawiec, *supra* note 52, at 1061–69.

\(^{60}\) See Knoll, *supra* note 48, at 1475–81 (describing the direct and indirect costs of bankruptcy).

\(^{61}\) See id. at 1478–79.

\(^{62}\) See generally Daniel K. Tarullo, Governor, Fed. Reserve, Address at the Exchequer Club in Washington, D.C. (Oct. 21, 2009), http://www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm (“The management and shareholders of the too-big-to-fail institution ... may thus be motivated to take greater risks with the cheaper funds... If the risky projects pay off, the shareholders profit famously. If the results are bad, the government may keep the institution afloat, thereby preserving at least some value for shareholders.”).
measures the proportion of a firm’s net income relative to its total equity. The ratio can increase sharply as a result of a corporation selling bonds to finance profitable expansion, as the numerator of net income increases while the denominator of total equity remains constant. The same effect is present in the financial metric of earnings-per-share (EPS), which divides net income by outstanding shares of common stock. Financing profitable expansion with debt increases EPS more than if both equity and debt financing are employed equally in the baseline capital structure, as debt financing alone does not change the denominator of outstanding shares of common stock.

Additionally, shareholders may prefer debt because of the restrictions and oversight that loan covenants place on firm managers. Raising capital through equity offerings carries few restrictions on the flexibility of corporate managers, increasing their ability to manipulate the financial indicators of the firm to their advantage. Inherent to bond offerings, however, is a promise to pay out interest payments in a specified amount on a certain date. The mandate to pay out interest and eventually repay the principal motivates managers and employees to ensure operations perform at a level sufficient to meet these obligations. Additionally, loan agreements with large banks often include requirements and covenants as a condition of lending to the firm. These characteristics allow debt to reduce agency costs in the shareholder-manager relationship, providing

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63 See generally Anthony Currie & Peter Thal Larsen, Morgan Stanley Makes Progress, N.Y. TIMES, Apr. 22, 2010, at B2 (illustrating the importance of return on equity to investment bank analysts).
65 See Jensen, supra note 46, at 324.
66 Id. (“Managers with substantial free cash flow can increase dividends or repurchase stock and thereby pay out current cash that would otherwise be invested in low-return projects or wasted.”). The author does note reductions in the expected dividend payment are often penalized through reductions in the share price of the firm. Id.
67 Id.
68 Id.
69 See Michelle M. Hamer, Corporate Control and the Need for Meaningful Board Accountability, 94 MINN. L. REV. 541, 560 (2010) (“These contracts, however, can and often do grant creditors the right to veto fundamental corporate transactions, receive financial information, observe board meetings, and appoint one or more directors or convert the debt into equity under certain circumstances.”).
managers with more incentive to act in the best interests of the shareholders of the firm.\textsuperscript{70}

A final benefit of the effective use of leverage is the potential to substantially increase gains from trading and speculation. Author and journalist Sebastian Mallaby describes how early hedge funds in the 1950s–60s employed leverage to gain a sizable advantage over more risk-averse investors.\textsuperscript{71} Mallaby cites an example of a sophisticated speculator practicing certain hedging techniques who borrows an amount equal to his original pool of capital.\textsuperscript{72} Through leverage, the investor further diversifies his portfolio, and thus both decreases net exposure to the market and increases overall profitability.\textsuperscript{73}

Another example of leverage increasing rates of return can be found in the housing market prior to the recent recession. A “Seeking Alpha” article provides an example of an individual purchasing a home for $100,000.\textsuperscript{74} One option is for the individual to buy the home entirely with his own capital; if the home appreciates $10,000 in value, the purchaser has experienced a 10% rate of return.\textsuperscript{75} If the individual instead puts down only $10,000 of his own capital and borrows the remaining $90,000 at 6% interest, he is leveraged 10:1 and must pay $5,400 in interest in the current year.\textsuperscript{76} If the house experiences the same $10,000 appreciation in value, however, the purchaser has now experienced a 65% rate of return: the $10,000 appreciation divided by the sum of the $10,000 down payment and the $5,400 interest payment.\textsuperscript{77} Of course, a movement in price in the opposite direction has the reverse effect of wiping out the entirety of the taxpayer’s equity and placing the house on the verge of going underwater.

\textsuperscript{70} See Jensen, supra note 46, at 324 (“Thus debt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers.”).
\textsuperscript{71} MALLABY, supra note 8, at 23–28.
\textsuperscript{72} Id. at 24–28.
\textsuperscript{73} Id. at 24–25. Mallaby’s example imagines a traditional investor with $100,000, investing $80,000 in stocks and $20,000 in safe government bonds. A leveraged investor practicing hedging techniques borrows another $100,000, increases his long investment in stocks to $130,000, and exchanges his safe bonds for a short position in stocks worth $70,000. The leveraged investor has thus reduced his net exposure to the market from $80,000 to $60,000 while increasing his overall positions.
\textsuperscript{75} Id.
\textsuperscript{76} Id.
\textsuperscript{77} Id.
Finally, Mallaby describes the story of the 1990s hedge fund Long Term Capital Management (LTCM). LTCM, a firm founded by former Salomon Brothers vice chairman John Meriwether, employed advanced financial engineering techniques to greatly enhance profits on minimal amounts of equity. The firm employed complex “value-at-risk” calculations to gauge potential losses, and built an incredibly diversified portfolio of uncorrelated trades and positions to substantially minimize risk—at least in theory. Though the firm achieved a mere 2.45% return on total assets in 1995, through leverage this number transformed into a 42.8% return on contributed equity. This formula worked wonderfully for the hedge fund for several years; however, as this Note describes below, dual financial crises in East Asia and Russia in 1998 exposed the extreme vulnerability of high leverage and caused LTCM to blow up.

C. The Danger of Debt

The downside to these methods is that fantastic success through leverage quickly becomes a colossal failure if either asset prices fall or the risk managers leave a variable out of their calculations. Ezra Klein, in a 2010 blog post for the Washington Post, captured the vulnerability of leverage to falling prices through a graph comparing leverage ratios to the propensity of a firm to go underwater. For a firm without any leverage, only a complete loss of value in all assets will sink the firm. This results from pursuing a strategy of full capitalization and not investing beyond its means. A firm with a leverage ratio of 2:1, financing half of its investments with borrowed funds, requires a 50% drop in asset values to go underwater. This process of leverage increasing volatility continues to grow until a firm leveraged 40:1, right above the level of Bear Stearns immediately before its collapse, requires a drop in asset values of only 2.5% to have its entire original investment wiped out.

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78 MALLABY, supra note 8, at 221–44.
79 Id. at 221–22.
80 Id. at 227–28.
81 Id. at 227.
82 Id. at 233–42.
84 Id.
85 Id.
86 Id.
Both falling asset values and incomplete risk modeling contributed to the swift fall of LTCM. In May 1998, the firm began to experience setbacks due to the market volatility arising out of financial crises in Indonesia, Japan, and Russia. In the span of one week in the middle of August, LTCM lost 15% of its capital: $550 million. LTCM reacted with hurried attempts to raise money, but the sales pitches only panicked other market participants even more, which in turn cost the fund more capital. LTCM then received margin calls from lenders seeking payment of interest, principal, and posting of extra collateral; this forced the fund to dump assets at fire-sale prices, leading to further drops in asset values. The downward spiral continued until most of the major investment banks on Wall Street stepped in with an industry bailout to prevent the panic from spreading, foreshadowing the government bailout ten years later.

Encouraging debt over equity has consequences other than increased volatility. The distinction also shifts investment capital away from innovative, high-risk startup companies and towards relatively safer and more stable firms in established industries. Michael Knoll, Co-Director of the Center for Tax Law and Policy at the University of Pennsylvania Law School, points out that high-risk startup firms have less capacity for leverage in their capital structure because they do not have a consistent earnings history or steady cash flow. More established companies are in better positions to employ the interest deduction in devising their capital structure, substantially lowering their cost of capital. The overall cost of capital of a firm can act as a “hurdle rate” for judging new ventures and projects; managers and investors will pursue only those projects with an expected rate of return above the cost of capital. The interest deduction thus encourages greater investment in stable firms past their rapid growth period, increasing competition for startups in acquiring capital.

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87 MALLABY, supra note 8, at 233–34.
88 Id. at 234.
89 Id. at 235–36.
90 Id. at 236.
91 Id. at 244.
92 Knoll, supra note 48, at 1465–66 (“Thus, traditional technologies and industries are encouraged at the expense of emerging technologies, new production methods and high-tech industries.”).
94 Knoll, supra note 48, at 1486–88.
95 Id. at 1488–89.
96 Id.
This distinction between high and low debt capacity firms causes several distortions in the broader economy. The first and most obvious distortion is slower rates of innovation and development of new technologies and products.\textsuperscript{97} Second, the deduction distorts markets through the encouragement of inefficient mergers between firms that separately have volatile cash flows.\textsuperscript{98} Mergers between firms with uncorrelated earnings cycles can increase diversification and reduce volatility in future cash flows, allowing for higher debt capacity.\textsuperscript{99} This higher debt capacity allows the merged firm to utilize the interest deduction tax shield on a greater scale.\textsuperscript{100} Mergers have high failure rates, however, as many combinations do not produce higher shareholder value or increase rates of return.\textsuperscript{101} The interest deduction therefore encourages more mergers than are efficient by providing for the potential of greater tax savings.\textsuperscript{102}

Finally, the tax shield for leverage distorts the economy through slower rates of job creation. A recent 2010 study by economists John Haltiwanger, Ron Jarmin, and Javier Miranda argues that the common claim from politicians that “small businesses” are the primary engine of job growth is misleading.\textsuperscript{103} The study found a relatively small causal relationship between the small size of a firm and net job growth rates.\textsuperscript{104} Rather, the authors determined that the more robust and disproportionate engines of job growth are young startup firms, despite their small share of the overall U.S. labor market.\textsuperscript{105} Though young firms also have high rates

\begin{footnotes}
\item[97] Id. at 1492–95. Knoll observes that these high-risk, high-reward assets are more likely to be intangible and created as the result of long R&D processes requiring steady investment. Id. at 1495.
\item[98] Id. at 1493.
\item[99] See Knoll, supra note 48, at 1493.
\item[100] Id. at 1466.
\item[101] See Kevin Voigt, Mergers Fail More Often than Marriages, CNN: WORLD BUSINESS (May 22, 2009), http://edition.cnn.com/2009/BUSINESS/05/21/merger.marriage/index.html. A 2004 study by consulting firm Bain & Company found that 70% of mergers did not realize an increase in value to shareholders. Id.
\item[102] Knoll, supra note 48, at 1493–94 (“Thus, the corporate interest deduction encourages inefficient conglomerate mergers. This reduces national income.”).
\item[104] Id. at 29. The authors conclude the “inverse relationship between [job] growth rates and [firm] size remains but is not overwhelming.” The authors speculate part of the cause behind the wide use of “small firm job creation” claims are “measurement issues” in the most often used data set, which “can lead to misleading inferences about the role of firm size in job creation.” Id.
\item[105] Id. at 30 (“Business startups account for roughly 3% of U.S. total employment in any given year.”).
\end{footnotes}
of job destruction, successful small startups tend to have rapid growth rates due to the “up-or-out” dynamic. Specifically, startup firms constitute 20% of gross job creation, which is more than six times their proportion of the overall employment market at 3%. In contrast, older and larger firms constitute 40% of job creation, but this number is less than their overall share of the labor market, which is around 45%.

Young, dynamic startup firms with a disproportionate contribution to job creation rates in the United States are precisely the firms harmed through the investment distortion arising out of the interest deduction. These firms produce jobs both through the original startup process and, for those lucky few startups that achieve success, the rapid growth trajectory to mature firm status. Startups are much more likely to have low or nonexistent capacities for debt early in their lifecycle, and therefore they cannot take full advantage of the easy tax shield inherent in the interest deduction. Therefore, the interest deduction of the tax code slows job growth by directing investment away from those firms most likely to rapidly increase employment.

106 Id. at 29–31.
107 Id. at 31.
108 See Who Creates Jobs, supra note 103, at 30–31. The authors define older, larger firms as being in business for longer than ten years and employing more than 500 workers. Id.
109 Id. at 25 (describing the “up-or-out” dynamic among young, high-risk startup firms).
110 Knoll, supra note 48, at 1486–95.
111 See id. at 1496.
112 Innovative, technology-based companies often receive other tax benefits that, in some cases, more than compensate for the disadvantage inherent in their capital structure. Recent newspaper and magazine articles have pointed out that companies in the biotechnology, drug, and internet industries pay the lowest marginal corporate tax rate in the U.S. as a whole, with the capital-intensive utility and oil industries at the other end of the spectrum. Reasons cited for the disparity include tax breaks for research and development spending, as well as favorable tax rates on income earned overseas. See David Leonhardt, The Paradox of Corporate Taxes, N.Y. TIMES, Feb. 2, 2011, at B1 (noting the United States imposes one of the highest corporate tax rates in the world, yet collects a relatively small percentage of overall revenue through the tax); Derek Thompson, Who “Wins” Under Our Bizarre and Complicated Corporate Tax System?, THE ATLANTIC MONTHLY (Jan. 28, 2011, 12:52 PM), http://www.theatlantic.com/business/archive/2011/01/who-wins-under-our-bizarre-and-complicated-corporate-tax-system/70428/ (“Companies with high R&D spending or a large overseas presence pay very little, and companies that do business mostly inside the U.S. pay very high.”). A possible argument in support of the distortion in favor of established companies is that young startup firms have high failure rates and thus lead to job destruction, in addition to robust job creation. This characteristic of young startup firms plays a valuable role in our economy, however, allowing human and physical capital to move from inefficient products and firms to more efficient
III. RECENT ATTEMPTS AT FINANCIAL REFORM

The federal government has been tremendously active in recent years regarding matters of financial regulation and banking oversight. Further, legal scholars have proposed several additional measures to address the debt-equity distinction. As will be discussed below, however, these proposals do not adequately address the incentives behind the dangerous financial practices that caused the recent financial panic. A brief discussion of these proposals will help illuminate the case for substituting the interest deduction with a COCA deduction.

A. Dodd-Frank Financial Reform Bill

The Dodd-Frank bill aimed to prevent, among other things, several of the problems common to over-leveraged companies discussed above.\(^{113}\) The comprehensive legislation contains several major provisions dealing with disparate aspects of the financial system, ranging from consumer credit practices to shareholder input on executive pay to limits on banks investing with hedge funds.\(^{114}\) As mentioned in the introduction, the bill further provides federal regulators with several powers of last resort, including the imposition of a strict leverage ratio cap and the ability to break up firms posing systemic risk to the financial system.\(^{115}\) The “Volcker Rule,” limiting proprietary trading, has angered investment banks which had previously wildly profited from the activity.\(^{116}\) Additionally, the new consumer financial regulations have raised the ire of credit card companies and consumer mortgage lenders.\(^{117}\)

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\(^{113}\) See DODD-FRANK WALL STREET REFORM, supra note 12.

\(^{114}\) Id.; see also Dennis, supra note 11.

\(^{115}\) DODD-FRANK WALL STREET REFORM, supra note 12, at 4.

\(^{116}\) See Floyd Norris, Volcker Rule May Work, Even if Vague, N.Y. TIMES, Jan. 21, 2011, at B1 (“[Bankers] had hoped for clear rules that could be complied with—or evaded, if you want to be cynical.”).

\(^{117}\) See Damian Paletta, Fight over Consumer Agency Looms as Overhaul Is Signed, WALL ST. J., July 22, 2010, at A1 (“The new consumer regulator will be funded by the Federal Reserve and have independent powers to write and enforce rules governing how
More relevant to this Note, however, are provisions giving Federal Reserve regulators the discretionary power to impose a 15:1 hard leverage cap on financial firms conclusively judged to be a grave threat to the health of the financial system. Several policymakers argued that giving experienced regulators the discretion to impose this relatively stringent leverage ratio will be an effective tool in preventing future financial panics. As journalist Sebastian Mallaby points out, however, the traditional leverage ratio is a blunt metric with several failings. First, the ratio “fail(s) to account for swaps and options,” financial instruments that played a substantial role in the financial crisis. Second, the ratio fails “to distinguish between hedged bets and unhedged ones,” though the former pose relatively little risk to the health of a firm if structured properly. Finally, the ratio compares only total assets to capital—not potential losses to capital—though the latter ratio is more indicative of a firm’s threat to the financial system.

As a last resort against a meltdown, Dodd-Frank may ultimately be a tremendous improvement from the regulatory apparatus in place before the recent financial crisis. However, as a means of preventing the need for such a strong government response in the future, Dodd-Frank does little to alter the incentives for large banking firms to pursue risky capital structure and financing strategies.

The bill employs strict regulation of the financial and investment practices of banking and investing institutions. Nonetheless, the prospect of large profits remains on the other side of the new regulations. Thus, financial firms will have strong incentives to water down the new rules through lobbying and complex legal, accounting, and financial methods designed

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118 DODD-FRANK WALL STREET REFORM, supra note 12, at 4.
119 See Dennis, supra note 11.
120 MALLABY, supra note 8, at 228.
121 Id. See generally MICHAEL LEWIS, THE BIG SHORT 29 (2010). Lewis describes a credit default swap as essentially “an insurance policy” on a bond, whereby the buyer of the swap receives a payout from the seller exponentially higher than the purchase price if the bond issuer defaults. At its peak, AIG had insured approximately $50 billion worth of credit default swaps on consumer loan securities, 95% of which constituted subprime mortgages. Id. at 90.
122 MALLABY, supra note 8, at 228.
123 Id. Mallaby notes LTCM employed a metric that accounted for some of these disadvantages in the 1990s. Id.
124 See DODD-FRANK WALL STREET REFORM, supra note 12, at 4–5, 8 (recommend-
to give the appearance of compliance. Additionally, the question of whether market conditions have sufficiently deteriorated to warrant imposing the tough new measures may not be anything more than a judgment call,\(^\text{125}\) and banking executives are certain to exert some influence over this decision.

**B. Dividend Deduction Proposal**

Some scholars have recently renewed a proposal for allowing corporations a deduction for dividends paid to mirror the interest payment deduction.\(^\text{126}\) The argument for a dividend deduction is similar to that of the dividend tax cut contained within the tax cut legislation of 2003.\(^\text{127}\) Both approaches attempt to mitigate the debt-equity distinction through reducing the relative tax burden on equity financing while leaving the interest deduction untouched.\(^\text{128}\) The dividend tax cut falls on the shareholder level of the corporate double tax, whereas the dividend deduction affects the taxation of the corporate entity.\(^\text{129}\) An advantage of the dividend deduction is that it avoids the problem of agency through targeting managerial decision-making directly.\(^\text{130}\) On the other hand, the dividend deduction retains many problems of the dividend tax cut, and adds significant, unique disadvantages that make the proposal more problematic than removal of the interest deduction.\(^\text{131}\)

Reuven Avi-Yonah and Amir C. Chenchinski argue for a dividend deduction primarily to integrate the corporate and individual tax systems,\(^\text{132}\) but they cite mitigating the debt-equity distinction as a secondary bene-

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\(^{127}\text{See Jobs and Growth Tax Relief Reconciliation Act of 2003, H.R. 2, 108th Cong. § 301(a)-(c) (2003). The legislation reduced the maximum capital gains rate to 15% and moved most dividends into the capital gains category.}\)

\(^{128}\text{See Pratt, supra note 18, at 1133–35.}\)

\(^{129}\text{See id. at 1133.}\)

\(^{130}\text{See Avi-Yonah & Chenchinski, supra note 126, at 8 (describing how the dividend deduction automatically affects both managers and shareholders).}\)

\(^{131}\text{See Pratt, supra note 18, at 1134–35 (outlining several drawbacks to a corporate level dividend deduction, including loss of tax revenue, increasing net operating loss distortions, and inverting the debt-equity bias towards equity).}\)

\(^{132}\text{See Avi-Yonah & Chenchinski, supra note 126, at 4 (“The right form of integration, we would argue, is dividend deduction.”).}\)
These scholars argue that a dividend deduction achieves the desired result of reducing the tax bias against corporations, but that it is designed more narrowly than similar proposals. This is because the deduction directly affects only management behavior with no impact on the taxation of shareholders. Further, they argue that the dividend deduction fully addresses the inherent bias of corporate managers towards retaining earnings to increase share price, whereas other proposals only partially compensate for this bias at best. Finally, they state that the proposal will create “true debt/equity parity” without disallowing a deduction for interest expense, which they claim is “a legitimate cost of doing business.”

Regarding the bias towards retention, the dividend deduction will be problematic regardless of whether the proposal achieves the intended effect. On one hand, the proposal may suffer from pitfalls that scholars identified with the 2003 dividend tax cut and not generate enough new activity. Steven Bank and Katherine Pratt argue separately that the large increase in dividends immediately after passage of the 2003 tax cut was likely a result of the temporary nature of the change; under the 2003 legislation, tax rates on dividends were scheduled to increase back to their previous levels in 2011. Companies distributed record amounts of dividends to shareholders to take advantage of a temporary decrease in tax rates, but did not make fundamental changes in dividend policy. A permanent change in the tax treatment of dividends would not strongly impact the dividend policy of corporations, as the tax code would not provide a “limited time only” windfall on which firms could capitalize.

\[133\] Id. at 2–3.
\[134\] Id. at 9.
\[135\] The authors compare a dividend deduction against proposals for a comprehensive business income tax and exemption of dividends received at the holder-level. Id. at 8–10.
\[136\] Id. at 8.
\[137\] Id. at 9 (“The bias against retention is only partially addressed by dividend exemption and imputation, because distribution decisions are taken by managers who may not care very much about the shareholder tax.”).
\[138\] See AVI-YONAH & CHENCHINSKI, supra note 126, at 10.
\[140\] Bank, supra note 139, at 534. S&P 500 companies paid out a record $202 billion in dividends in 2005, followed by another predicted $225 billion in 2006. Id.
\[142\] Bank, supra note 139, at 557–58.
\[143\] Id.
fore, a temporary dividend deduction would mitigate the retained earnings bias only to a limited extent.

Conversely, if the dividend deduction does permanently alter the dividend policies of firms, this will result in a huge windfall for existing shareholders. This conflicts with several of the tenets put forth by Gale and Orszag regarding designing tax changes to encourage economic growth.\textsuperscript{144} Large shareholders would enjoy great increases in dividends despite not altering their economic behavior from before the tax change.\textsuperscript{145} Gale and Orszag argue this windfall will lower the increase in efficiency arising as a result of the tax change, especially when coupled with the increase in government interest costs arising from the additional deficit financing.\textsuperscript{146}

The deficit plays an important role in another drawback of Avi-Yonah’s proposal. The federal government would experience a potentially significant loss of revenue if firms could deduct dividend payments;\textsuperscript{147} to prevent increased deficits, Congress must enact corresponding spending reductions and tax increases. If Congress follows the path of the 2003 tax cut, long-term budget deficits for the federal government will increase substantially.\textsuperscript{148} Pratt lists several costs associated with larger government deficits, including: (1) crowding out of private investment, (2) higher interest rates, and (3) diversion of government resources from programs designed to support growth in favor of interest payments on the debt.\textsuperscript{149} Pratt has questioned whether increasing total dividends will generate enough positive economic growth to overcome such heavy costs.\textsuperscript{150}

\textsuperscript{144} Gale & Orszag, supra note 21, at 1192–94.
\textsuperscript{145} See generally Bank, supra note 139, at 557 (describing a commonly held view among commentators that reducing taxation of equity via dividend policy “would be a one-time windfall to existing investors”).
\textsuperscript{146} See Gale & Orszag, supra note 21, at 1194–96 (stating an increase in government deficits “will reduce income and raise interest rates significantly in that year and future years and hence will make the environment for long-term growth more difficult”).
\textsuperscript{147} S&P 500 firms paid out $202 billion in dividends in 2005 and were expected to pay out another $225 billion in 2006. See Bank, supra note 139, at 534. Assuming a 35% corporate tax rate, allowing a dividend deduction would result in a $70.7 billion revenue loss in 2005 and a $78.75 billion revenue loss in 2006 for the federal government from S&P 500 firms alone.
\textsuperscript{148} See Pratt, supra note 139, at 539 (noting that Congress financed the 2003 dividend tax cut entirely through deficit financing).
\textsuperscript{149} Id. at 540. Pratt also cites increased dependence on foreign investors as another cost of government borrowing. Id.
\textsuperscript{150} Id. at 543 (“Economists have concluded the 2003 dividend tax cut could promote long-term growth only if it were not deficit-financed.”). Pratt would also include another requirement for tax cuts to meet before they are judged to be economically beneficial.
Finally, the dividend deduction has one significant problem that it does not share with a dividend tax cut. Allowing a deduction for dividends provides managers a tool to substantially manipulate tax liabilities through increased or decreased distributions. A firm’s dividend policy may have no rational connection to the firm’s overall performance during the year in terms of gross income and ability to pay a dividend.  

Because the task of setting dividend policy is generally within the exclusive control of management, managers can alter the amount of dividends paid to manipulate the after-tax net income the firm reports to the IRS and to shareholders. This manipulation can partially mask a firm’s weaknesses, thereby both reducing the incentives of managers to make substantive improvements to the business and potentially misleading investors. Such potential consequences of tax liability manipulation weigh strongly against the implementation of the dividend deduction proposal.

IV. DISALLOW THE DEDUCTION FOR BUSINESS INTEREST

A. Eliminating the Interest Deduction

The most direct path to both equalizing tax treatment of debt and equity and removing incentives for managers to over-leverage is to abolish the corporate interest deduction. The decision of whether to finance operations and expansion with equity or debt should be made pursuant to the business nature of the undertaking, not the tax code. The reform of Section 163(a) will place equity on equal terms with leverage regarding taxation of the corporate entity through removal of the large tax shield associated with...
leverage. Managers lose the tax incentive to increase leverage beyond normal business considerations, and the continuing legal fight over how to classify ambiguous “hybrid” instruments into certain categories mostly comes to an end.

One likely criticism of this proposal is Avi-Yonah’s statement that “interest is a legitimate cost of business,” and should therefore be deductible from net income. Avi-Yonah singles out financial institutions in particular, arguing that to eliminate the interest deduction is to “effectively tax them on gross interest income.” The question of the true nature of interest is more complicated, however, than Avi-Yonah’s statement suggests. Interest payments are a cost of capital equivalent to dividend payments, rather than an operating cost such as cost of goods sold, depreciation, or overhead. The amount of interest paid is often more closely connected to the financing arrangements the firm makes with lenders and bondholders, not the economic performance of the firm during a given period. The comparison is similar to the distinction between variable costs and fixed capital costs: the former are deductible as they are incurred and/or paid out, but the latter must be capitalized and deducted over the useful life of the underlying asset. A deduction for interest, therefore, is not necessary for the firm to obtain an accurate picture of net income.

The incurring of interest is thus a consequence of choosing to acquire capital through leverage, and not necessarily a constant fact of life for an ongoing business. This is not to argue that a firm should not be allowed a

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154 See id. at 1136 (observing that eliminating the corporate interest deduction would remove the “tax-advantaged” status of debt financing).
155 See Emmerich, supra note 15, at 119 (“An analysis of the debt-equity classification problem demonstrates that any attempt to draw a principled distinction between the two will be fruitless.”).
156 Avi-Yonah & Chenchinski, supra note 139, at 10. In the event of a repeal of Section 163(a), policymakers and tax attorneys may believe it necessary to include a provision specifically disallowing a business deduction for interest in light of Section 162(a), which allows a deduction for ordinary and necessary business expenses. I.R.C. § 162(a) (2006).
157 Avi-Yonah & Chenchinski, supra note 139, at 10.
159 Id. at 795 (noting the tax shelter opportunities available when borrower and lender agree to a repayment schedule allowing for the “mismatching of ... interest payments with the income they help generate”).
160 I.R.C. § 263(a) (2006) (disallowing deductions for capital expenditures); id. § 167(a) (allowing a reasonable deduction for depreciation in value of property used in a trade, business, or production of income).
deduction for its cost of capital; the point, rather, is that IRC-granted deductions should not be based on the mere choice of one form of capital over another, especially when the tax-favored choice can impose heavy externalities on the broader economy.\textsuperscript{161} The interest deduction should therefore be eliminated and replaced with a deduction that does not provide either method with an undue tax advantage.

B. The COCA Replacement

Allowing firms a fixed deduction for their cost of capital completes the proposal for ending the debt-equity distinction. As suggested in the subsection above, merely repealing Section 163(a), thereby disallowing deductions for interest, may create another distortion as it corrects the distortion of encouraging over-leverage.\textsuperscript{162} One potential problem is that the change is effectively a large tax increase on corporations at a moment when the United States is attempting to improve its economic competitiveness in the global marketplace.\textsuperscript{163} Second, disallowing a deduction for interest may swing the debt-equity pendulum too far in the other direction. Differential tax treatment between debt and equity would remain for shareholders in the form of lower tax rates on capital gains and dividends.\textsuperscript{164} This may over-encourage investment back towards startup corporations and firms with higher reliance on equity, generating a bubble similar to the “dot-com” craze of the late 1990s.\textsuperscript{165}

Encouraging heavier reliance on equity at the expense of leverage may be beneficial for the economy. Shareholders may have incentives to be more judicious regarding their investments, and equity does not have the same potential for heavy social costs as debt. Regardless, firms should be allowed some form of a deduction for their cost of capital to ensure their taxable income reflects profits earned, and not absolute gross income. Therefore, the interest deduction should be replaced with a COCA deduction applied to the entire capitalization of the corporation.\textsuperscript{166}

\textsuperscript{161} See generally Benshalom, supra note 18, at 1222 (“The debt-equity distinction problem is unique because of the huge social costs it imposes ....”).
\textsuperscript{162} See supra Part IV.A.
\textsuperscript{163} See Pratt, supra note 18, at n.398 (citing U.S. DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 544 tbl.863 (118th ed. 1998)). U.S. corporations deducted $2.085 trillion in interest payments in 2007, which translates into a $729.75 billion revenue loss for the government at the current 35% corporate tax rate.
\textsuperscript{164} I.R.C. § 1(h).
\textsuperscript{165} See Pratt, supra note 18, at 1138.
\textsuperscript{166} See generally id. at 1139–45 (describing the COCA proposal).
Under Pratt’s definition, the amount a firm may deduct as a COCA equals a fixed percentage of the corporation’s “aggregate capitalization,” including both equity and debt.\footnote{Id. at 1139–40. Pratt suggests setting the fixed percentage at a level sufficient to either: (1) make the COCA-for-interest substitution revenue neutral, or (2) track the risk-free interest rate on Treasury bonds. Id. at 1140.} Congress, possibly with the help of the Treasury Department, will have the responsibility of setting the COCA percentage, and can make further adjustments depending on the economic situation and the market rate for capital. Thus, if a firm has $50 million of capital including $20 million of equity and $30 million of debt, the amount of interest the corporation pays on the debt is irrelevant for tax purposes. However, if the fixed COCA percentage is 10%, the firm can deduct $5 million ($50 million x 10%) from gross income as a COCA deduction. This permitted deduction will stay constant if the firm converts equity into debt and vice versa.

\section*{C. The Second-Best Justification}

Substituting COCA for the interest deduction allows firms to continue to deduct a significant portion of their cost of capital, yet removes the tax incentives that encourage managers to over-leverage. Continuing the theory of the second-best, other distortions remain in the form of beneficial tax treatment accorded to shareholders relative to bondholders.\footnote{See id. at 1056.} This distinction at the holder-level may encourage managers to over-finance with equity. Replacing the interest deduction with a COCA deduction remains justified, however, for several reasons.

First, the lingering distinction for shareholders will likely cause less distortion than the current tax treatment due to the divergence in economic interests between shareholders and corporate managers.\footnote{See Fama, supra note 25, at 288.} As mentioned above,\footnote{See supra Part I.B.} shareholders have the incentive to support tax reform that maximizes the value of their investments, whereas managers prefer a tax reform that lowers the cost of new investments.\footnote{Doran, supra note 42, at 532–33.} Managers may consider several other factors in a financing decision, including which method has a lower overall cost of capital, before considering the tax treatment of investors.\footnote{See generally Pratt, supra note 18, at 1155 (arguing that corporate managers would likely oppose any proposals that create a bias against retained earnings, regardless of any}
bondholders alone will likely have a smaller distortionary impact than the current distinction for the corporate entity.

Second, a distinction favoring equity is less likely to inflict heavy externalities on the broader economy than the current tax code. Both debt and equity investments can be wiped out if the underlying asset goes under, representing a loss of capital to the economy. Shareholders do not contribute equity to a corporation with the obligation that the firm repay the funds on a specific date. Instead, shareholders receive ownership in the firm as well as a right to receive any dividends that the firm pays out.\textsuperscript{173} The firm takes full possession of the equity proceeds to employ at their discretion, reducing the risk that the firm will fail to meet its obligations and descend into insolvency.\textsuperscript{174}

Third, the proposal benefits innovative startup firms, which often must rely more heavily on equity. As discussed above,\textsuperscript{175} innovative startup firms with less predictable cash flows and higher proportions of intangible assets have lower debt capacities than established firms with fungible, tangible assets.\textsuperscript{176} Raising the cost of capital for leverage relative to equity should encourage more investment in firms with heavier reliance on equity, which will benefit high-risk startup firms. Further, the recent Haltiwanger study discussed above\textsuperscript{177} indicates such firms contribute to job growth rates disproportionately to their overall share of the private sector labor market, as success at this early stage often brings rapid growth.\textsuperscript{178} Therefore, lowering the relative cost of equity could increase opportunities for rapid job creation.

Fourth, allowing a deduction of only a fixed percentage of a firm’s cost of capital may act as a soft cap on “too-big-to-fail” banks. The current tax code allows firms to deduct the full amount of the increased interest costs from high leverage, provided the firm has net income to offset. If the

\textsuperscript{173} See generally David P. Hariton, Distinguishing Between Equity and Debt in the New Financial Environment, 49 Tax L. Rev. 499, 500 (1994) (“Equity permits an investor to participate in corporate profits in exchange for assuming corporate risk. Debt, on the other hand, permits an investor to avoid risk, in so far as that is possible, in exchange for forgoing participation.”).

\textsuperscript{174} See generally Kelli A. Alces, Revisiting Berle and Rethinking the Corporate Structure, 33 Seattle U. L. Rev. 787, 789–90 (2010).

\textsuperscript{175} See supra Part II.C.

\textsuperscript{176} Knoll, supra note 48, at 1486–88.

\textsuperscript{177} See supra Part II.C.

\textsuperscript{178} Who Creates Jobs, supra note 103, at 29–31 (describing the “up-or-out” dynamic among young, high-risk startup firms).
deduction is limited to a fixed percentage, managers will have no incentive to push leverage beyond the point at which actual interest equals the fixed percentage. \(^{179}\) Knoll writes that the optimal capital structure of a firm is the point “when the additional tax shield benefits equal the additional financial distress costs at the margin.” \(^{180}\) Capping the tax shield benefits available to a firm lowers the optimal amount of leverage for the firm. Therefore, firms will have less incentive to continue ever-greater expansion through leverage beyond the point at which their failure can be absorbed by natural market forces, reducing the likelihood of future government bailouts.

Finally, swapping a lopsided tax preference in favor of debt for a minor tax preference towards equity meets the criteria for promoting economic growth set forth by Gale and Orszag. \(^{181}\) The first criterion is that of revenue-neutrality: tax reform should not increase the deficit so as to increase interest costs and crowd out private investment. \(^{182}\) The satisfaction of this standard will be the responsibility of Congress upon setting the fixed percentage of capital allowable to firms as a COCA deduction. Second, Gale and Orszag advise that tax reform should encourage changes in economic activity and not merely provide “windfall” benefits to taxpayers for engaging in activity that they would have undertaken regardless of the change. \(^{183}\) This proposal encourages corporations to curtail funding operations with high-interest leverage and to instead pursue financing with the lowest absolute pre-tax cost of capital, including financial distress costs. Equity funding will become more valuable relative to debt, encouraging new equity investment and satisfying the above second criteria.

The proposal meets the third and final criterion, as a fixed COCA deduction reduces the need for firms to direct substantial resources towards tax avoidance. \(^{184}\) A firm may now deduct no more than a fixed, statutory

\(^{179}\) See Pratt, supra note 18, at 1139–40.

\(^{180}\) Knoll, supra note 48, at 1482.

\(^{181}\) See supra note 22 and accompanying text.

\(^{182}\) See Gale & Orszag, supra note 21, at 1194–96 (describing the effects of the 2001 and 2003 tax cuts on deficits and private investment).

\(^{183}\) See id. at 1196–97 (describing the significant “income effects” of the 2001 and 2003 tax cuts which “will reduce labor supply, saving, and investment”).

\(^{184}\) See id. at 1193 (arguing that reducing resources directed towards tax avoidance “can improve the allocation of resources and hence raise economic growth even without increasing the level of labor and capital inputs”); see also David Kocieniewski, At G.E. on Tax Day, Billions of Reasons to Smile, N.Y. TIMES, Mar. 25, 2011, at A1 (noting General Electric incurred no tax liability in 2010, despite reporting worldwide profits of $14.2 billion and domestic profits of $5.1 billion).
percentage of its total capitalization as its COCA deduction. Increasing the cost of capital beyond this percentage drains from the after-tax net income of the firm and provides no extra tax shield. Therefore, firms have an incentive to pursue financing solely on the basis of the lowest absolute pre-tax cost of capital.

CONCLUSION

This proposal has the potential to have as dramatic an impact on capital markets as any provision in the recent Dodd-Frank financial reform bill. Therefore, it is important for Congress to implement this proposal or similar tax reform legislation gradually and incrementally. Immediately disallowing a deduction for business interest could constitute a large hit on the bottom line of many financial firms, possibly destabilizing capital markets once again. Moreover, an immediate change may trigger a broad deleveraging process in the corporate ranks similar to the trend among American consumers over the past few years. Such deleveraging removes potential spending and investment from the national economy and constitutes a drain on economic growth. Congress can mitigate these possible effects by dragging out the implementation of the deduction switch over multiple years and providing a roadmap to taxpayers at the beginning of the process.

This Note does not argue that Dodd-Frank is inefficient and should be repealed, nor does this Note support Dodd-Frank in all its manifestations. Rather, this Note argues that recent financial reform is incomplete as long as the incentives of corporations to engage in risky financial behavior do not change. Replacing the business interest deduction with a COCA deduction represents a big step towards reducing the likelihood of a second round of the expensive and morally troubling federal government interventions of 2008–2009 in the near future.

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185 See supra Part IV.B.
187 Id. (“This would be fine if someone else were taking up the slack. But what’s actually happening is that some people are spending much less while nobody is spending more—and this translates into a depressed economy and high unemployment.”).

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