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COMMENTS ON “TAX NEUTRALITY BETWEEN EQUITY CAPITAL AND DEBT”

DOUGLAS A. KAHN†

Professor Andrews' proposals are aimed at eliminating a tax bias that affects a corporation's choice of a method of raising additional capital. Professor Andrews believes that the current tax system favors a corporation which raises capital internally by accumulating its income (or by borrowing) rather than by issuing stock. Professor Andrews seeks a neutral system that permits the choice of the manner in which capital is raised to be made on economic grounds without influence of the tax laws.

A reference to tax neutrality sometimes is confusing because tax neutrality is used to refer to two entirely different concepts. As used herein, the term refers to a tax system which has no impact on the resolution of certain financial issues.* If we were in a tax-free world, economic behavior might be different from what now exists because, by imposing taxes, we create a bias in favor of one type of behavior over another. Professor Andrews' proposals are on the assumption that, at least insofar as financial affairs are concerned, it would be desirable to eliminate that bias so that market decisions can be made free of any outside influence.

It is worth noting that the establishment of an income tax system necessarily introduces a bias that affects market behavior. That is not a happy consequence, but it is inevitable. Since it is not possible to prevent the tax law from causing market distortion, the elimination of a distortion in a specific area is not a sufficient justification for a proposed change in the tax law. That is, the mere identification of a tax bias is not sufficient; it is necessary to demonstrate that the distortion in question causes problems of such substantial magnitude that it warrants taking steps to eliminate it. This determination rests on considerations of economic, political, and social values. In the final analysis, the question of the desirability of altering the tax law rests on value judgments rather than on an absolute principle of tax neutrality. Professor Andrews presumably has weighed economic factors and determined that they warrant taking the action he recommends. It would

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* A different use of the term "neutrality" refers to a tax treatment that conforms with a model or ideal tax structure. See Blum, Accelerated Depreciation: A Proper Allowance for Measuring Net Income??, 78 Mich. L. Rev. 1172 (1980).
be helpful to have him spell out his reasons for deeming neutrality in this circumstance to be of such significance.

As previously noted, elimination of a tax bias operates only as to certain specific market choices where it is deemed to be important for policy reasons that the tax law not influence the selection process. But, by eliminating a bias as to certain choices, it is possible to introduce a tax bias that will influence choices in other market areas. It is quite possible that Professor Andrews' proposal will have that consequence. For example, consider the following simplified illustration of the application of his proposal.

Before Andrews' proposal was adopted, X corporation had $500,000 in stated capital and was paying dividends at a 2% rate. Thus, X was paying dividends of $10,000 each year. After the adoption of Andrews' proposal, the corporation determines that it needs to raise an additional $100,000 of capital in order to finance a new project. X does not have accumulated income or other funds available, so it must either borrow the needed funds or issue new stock. The interest rate then payable on corporate borrowing is 12%. So, if the corporation borrows $100,000, it will have to pay interest annually of $12,000, and all of those payments will be deductible.

If, instead of borrowing the needed funds, X raises $100,000 of capital by issuing new shares of stock and if X continues to pay dividends at a 2% rate, its cost will be only $2,000 per year. Under Andrews' proposal, the corporation will not only be granted a deduction for the $2,000 of dividends paid on the recently issued stock, it will also be granted a deduction for the $10,000 of dividends it pays on the stock that was previously issued. The ceiling on the amount of dividend deduction permitted to X is the product of multiplying the newly acquired capital ($100,000) times the normal bond rate (which I have assumed in this illustration to be 12%).

This would seem to create a tax bias in favor of raising capital through issuing new stock rather than by borrowing, at least where the dividend rate is less than the interest rate that would be payable. The lower dividend rate can be attributable to the equity interest obtained through stock ownership. By granting a corporation a deduction for dividends which it is already committed to pay if it raises capital by issuing new shares, it appears that the proposed tax law would skew the corporation's decision away from borrowing.

Another bias that might be created by the adoption of this proposal was noted by Professor Andrews himself in his report on the ALI Study. If the amount of dividends that are being paid by a corporation is less than the maximum amount that can be deducted, there is an incentive for the corporation to increase the amount of its dividends. The creation of a new distortion in market decision-making is inconsistent with Professor Andrews' goal of tax neutrality.
Let us now turn to another item of Professor Andrews' proposal—the excise tax on nondividend distributions (i.e., liquidating distributions and stock redemptions). In his oral presentation, Andrews gave two reasons for imposing this tax—(1) that by removing the distributed assets from corporate solution, the shareholder is thereby escaping the double tax incidence that the future income stream from the assets otherwise would have suffered, and (2) that it is a proxy for the discount price that the shareholder would have suffered if he had sold his stock to a third party. I will address the merits of both of those concerns.

First, consider the question of whether a cost should be imposed on such distributions to compensate for the loss of a corporate income tax on income earned from the assets after the distribution date. The desirability of compensating for an escape from a double tax incidence turns on whether a double tax itself is an appropriate imposition. The justification for a separate corporate tax might be: an excise tax on the privilege of doing business in corporate form, or as a necessary step to prevent the use of the corporate form to defer the recognition of income. When assets are withdrawn from the corporation pursuant to a nondividend distribution, that would seem to terminate whatever justification there might be for the double tax on the future income from those assets. That is, the assets are no longer enjoying the tax benefits provided for the corporate form, and the opportunity for deferral of recognition of the future income stream from those assets no longer exists. Thus, there seems little reason for anguish that the future income stream from such assets will escape double taxation. I will return to this issue at the end of this comment.

Professor Andrews' point that an excise tax would be a useful device to equalize the amount realized by a shareholder from a nondividend distribution with the amount that he would have realized on a sale of the stock is extremely interesting, but perhaps it proves too much. He offers the following example to illustrate his point.

Y corporation owns ten bonds of a face amount and value of $1,000 each. The bonds pay interest at a 12% rate which provides an annual return of $120 from each bond. Y has no other assets and has no liabilities. Y has ten equal shareholders of whom B is one. M, a third party, wishes to purchase B's stock in Y. Since this stock represents a 10% interest in Y and since Y owns ten $1,000 bonds, it would appear that B's stock is worth $1,000 (assuming no discount for holding only a minority interest). However, M will not pay $1,000 for B's stock even though he would pay $1,000 for a 10% interest in the ten bonds that Y holds. If an individual owned one of those bonds outright, he would receive income of $120 per year. But, because the bonds are held by the corporation, a corporate tax is payable thereon, and the shareholder will receive $120 less the amount of that corporate
tax. If Y were in a 46% tax bracket (which it is not), only $64.80 would be available to distribute to each shareholder. M therefore will discount the amount he is willing to pay for B's stock and will likely pay approximately $540 for that stock.

If instead of selling his stock to M, B has his stock redeemed by Y, he would receive $1,000—i.e., 10% of Y's assets which have a value of $10,000. The redemption thus provides B with a greater amount than he could obtain in a sale to a third party. If, instead of Y's giving B $1,000 for his stock, the corporation were to give B only $540 on the ground that that is the market value of B's stock, then the remaining shareholders would enjoy a windfall through the increased value of their share of the corporation's assets—that is, the liquidating interest of each surviving shareholder would equal 1/9 times $9,460 which equals $1,051.11, an increase for each shareholder of $51.11 over the value of his liquidating interest prior to the redemption of B's stock.

The perplexing aspect of this illustration is that it raises the question of why anyone would place assets into corporate form if to do so would immediately reduce the value of the shareholder's property. In other words, immediately after contributing property, the stock received in exchange therefore would be discounted because of the double tax on the subsequent income stream of the contributed property. The apparent answer is that the corporate form provides compensating benefits so that the hypothetical discount for the double tax incidence does not arise. If there were not compensating benefits, corporations would not be formed.

In his paper, Professor Andrews states that an excise tax on nondividend distributions is necessary to achieve tax neutrality between debt and equity capital. Presumably, this is the basis of his concern that nondividend distributions remove future income from double taxation. But the discussion above of the second ground for imposing an excise tax (which ground is not mentioned in Professor Andrews' article) suggests that the adoption of an excise tax may merely substitute one tax bias for another. As noted above, new corporations are formed despite the theoretical depression of the value of corporate stock that is attributable to the double tax system. The compensating benefits of a corporate form, which benefits include the current treatment of nondividend distributions, are sufficient to outweigh the detriment of a potential double tax. An excise tax on nondividend distributions would increase the cost of doing business in a corporate form and will influence the decision whether to incorporate. In all likelihood this would affect only closely held corporations. I would not hazard a guess as to whether such an additional tax cost would significantly reduce the number of businesses that are incorporated, especially in light of the mitigating proposal of Professor Andrews to grant a deduction for a certain amount of dividend distributions. The effect on incorpora-
tions will depend upon numerous factors, such as: the size of the excise
tax, the size of the aggregate tax cost imposed on the corporate form,
and the marginal tax brackets of the shareholders. I merely note the
obvious: that any meaningful change in the effective tax rate imposed
on corporations will be taken into account in determining the form in
which a business will be conducted.

Even if it were determined that an excise tax is warranted, there is
a question as to whether all nondividend distributions should be sub-
jected to that tax. For publicly held corporations, any anticipation of
the liquidation of the corporation typically is so speculative and for
such a distant future date that it will have little or no effect on market
decisions. There is no reason, therefore, to impose a tax on liquidating
distributions of publicly held corporations. Similarly, stock redemp-
tions are not commonplace for public corporations. For one reason,
there are substantial transactional costs in redeeming widely held
stock. In the absence of a showing that stock redemptions play a sig-
nificant role in the decision to accumulate income, it would appear
that their current tax treatment does not create a bias of any
magnitude.

As to closely held corporations, it is simpler for them to liquidate
or to redeem their stock. Even as to closely held corporations, how-
ever, a liquidation is a sufficiently serious step that it is unlikely to be
employed for a short term purpose. A disproportionate redemption of
stock that qualifies for capital gain treatment constitutes a meaningful
change of ownership of the corporation, thus the antitipation of the
possibility of such a redemption is not likely to influence the decision
whether to accumulate income. It is true that the anticipation of a li-
quidation at some undetermined future date may influence the corpo-
rations's decision to accumulate its income, but typically the dis-
counted value of a speculative future benefit will not be given great
weight. In any event, if the excise tax were not imposed on publicly
held corporations, one might not wish to impose a higher tax rate on a
non-abusive closely held corporation than is imposed on publicly held
corporations.