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How to Live with a Tax Code with Which You Disagree: Doctrine, Optimal Tax, Common Sense, and the Debt-Equity Distribution

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HOW TO LIVE WITH A TAX CODE WITH WHICH YOU DISAGREE: DOCTRINE, OPTIMAL TAX, COMMON SENSE, AND THE DEBT-EQUITY DISTINCTION*

ILAN BENSHALOM**

The current financial crisis and recession demonstrate the overwhelming social cost of high leverage. While many factors contributed to the development of the crisis, one factor is frequently overlooked—the tax incentive for excessive debt financing. This Article explains how the debt–equity distinction in the tax code provides corporations with incentives to rely on highly leveraged finance structures. It then asserts that even though there is little justification for the tax code to favor debt over equity investment, this bias is deeply rooted and hard to overcome. Given the political difficulty in eliminating the distinction, policy makers and academics should develop a debt–equity distinction with lower social costs. However, both doctrine and academic literature fail to address this problem because the current legal discourse responds to rules that were developed in the first half of the twentieth century. In those days, the corporate tax was primarily imposed on private and closely held corporations, there was a huge difference between individual and corporate tax rates, financial engineering was limited, and the vast majority of investors and corporations were United States tax residents. None of these conditions applies today, and, as a result, the tax rules distinguishing debt from equity unnecessarily increase the social costs of compliance, and, more importantly, the costs of financial distress. Remarkably, the current rules are ineffective even in preventing tax revenue loss because they fail to recognize the weakest link in terms of tax erosion—interest payments made to foreign investors. These payments may escape

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United States taxation altogether because they are deductible from the corporate tax.

This Article develops a more practical and easily administrable distinction between debt and equity based on two easy-to-observe and difficult-to-manipulate characteristics—voting power and duration. This new distinction should be used to classify the holdings of domestic investors in public corporations. Further, the analysis of the debt–equity distinction triggers a broader theoretical inquiry over the principles that should guide tax policy makers in line-drawing problems. As a theoretical matter, these problems arise where there is a need to distinguish between two transactions which result in dramatically different tax consequences even though they could be economically very similar.

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INTRODUCTION

“How to live in a world with which you disagree?”¹

When Milan Kundera posited the question of how to live in a world with which you disagree, he was not thinking about tax. However, tax policy makers face this question every day when they confront real-world line-drawing problems caused by various inconsistencies in the Internal Revenue Code (the “Code”). When it comes to tax, failure to adequately reconcile these inconsistencies is very costly in terms of economic distortion, compliance cost, and tax revenue.

Some of these inconsistencies have haunted the Code for so long that they seem almost beyond reform, despite the high costs associated with them. These inconsistencies result from the very different tax treatment that tax legislation assigns to transactions that are to some extent substitutable. To illustrate the significant harms caused by this general problem of inconsistent tax treatment, this Article evaluates one of the most ancient and pernicious problems in the Code—the debt–equity distinction. This distinction lies at the heart of three important debates in contemporary tax-policy literature: the income tax treatment of financial instruments,² the

1. MILAN KUNDERA, *IMMORTALITY* 257 (Peter Kussi trans., Grove Weidenfeld 1991) (1990).

2. The inherent deficiency of the income tax regime and the excessive use of innovative financial instruments for tax avoidance purposes seem to compel considerations of fundamental reforms in the income tax treatment of financial instruments. See generally David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 COLUM. L. REV. 1886 (2004) (providing an argument and a proposal for such a fundamental reform). The rapid flow of financial innovation highlights the vulnerability of many income tax conventions because it allows for an infinite number of different intangible instruments, which do not have a finite useful life or a fixed location and can be tailored to perform different functions to different parties. The income tax system, on the other hand, “works by describing a finite number of idealized transactions and attaching to each a set of operative rules” and assumes that once a financial product is classified, it “fill[s] the same financial role for all taxpayers in all circumstances.” Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1320, 1354 (1991). The tension between the economic reality in financial markets and the tax rules classifying instruments is evident: most innovative financial instruments are unlikely to perfectly fit any of these idealized transactions, rendering their appropriate tax treatment unclear. Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569, 570 (1994). This vagueness, along with the mobility, fungibility, and contractual flexibility of financial assets, allows sophisticated tax planners to take advantageous positions with regard to issues of timing-realization, ownership, character (as income or capital gains), and with respect to whether the income should be considered as derived from business activities in the United States. See Jeffrey M. Colón, *Financial Products and Source Basis*

need for corporate shareholder income tax integration,³ and the taxation of income derived from capital.⁴ Moreover, the murkiness of

Taxation: U.S. International Tax Policy at the Crossroads, 1999 U. ILL. L. REV. 775, 789–807 (elaborating on how financial instruments can defeat the various source rules); Mark P. Gergen & Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States: 1981–1997*, 52 TAX L. REV. 119, 120 (1997); Yoram Keinan, *United States Federal Taxation of Derivatives: One Way or Many?*, 61 TAX LAW. 81, 84 (2007); Michael S. Knoll, *Financial Innovation, Tax Arbitrage, and Retrospective Taxation: The Problem with Passive Government Lending*, 52 TAX L. REV. 199, 200 (1997); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1057, 1058–93 (2000) (discussing how financial contract innovation illustrates the costs associated with the debt–equity distinction); Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643, 652–53 (1995) (explaining how financial derivatives allow taxpayers to overcome risk-based rules to determine ownership by allowing taxpayers to create synthetic instruments with similar cash flows to other instruments); Alvin C. Warren, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 492 (1993) (stressing that the existing concept of realization does not seem adequate to deal with innovative financial contracts). See generally Daniel I. Halperin, *Interest in Disguise: Taxing the “Time Value of Money,”* 95 YALE L.J. 506, 519 (1986) (explaining the concept of deferral and the time value of money). Even though these problems are not unique to financial instruments, the current income tax system pushes them to their very extreme because of its inconsistency and incomprehensiveness. See Shaviro, *supra*, at 652. As a result, the income tax treatment of financial instruments is price-distortive, inequitable, loaded with arbitrage opportunities, and a source for disproportional compliance and administrative costs. See Ilan Benshalom, *The Quest to Tax Financial Income in a Global Economy: Emerging to an Allocation Phase*, 28 VA. TAX REV. 165, 193–95 (2008); see also Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX L. REV. 571, 573–79 (1995) (“[T]he lack of universality and consistency in the tax treatment of equity derivatives results in inefficiencies and inequities.”).

3. In essence, the debt–equity frictions result directly from the corporate income tax regime, in which corporations are taxed separately from their shareholders and where interest payments are deductible while dividends are not. David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95, 115 (1999). Accordingly, the debt–equity distinction is interesting because it predated modern financial theory. See Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 170 (2002) (describing the origins of the double tax on corporations). As such, the debt–equity distinction touches on the broader policy question of whether or not a separate corporate income tax is justified at all. The opinions on this matter vary considerably. While most tax scholars regard the separate corporate income tax as an utterly inequitable and inefficient tax, others find some justification for preserving it in one form or the other. For criticism of the corporate tax, see Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 328–31 (1995) (reviewing the strong academic and policy consensus over the inequitable nature of the corporate tax); Michael J. Graetz & Alvin C. Warren Jr., *Integration of Corporate and Individual Income Taxes: An Introduction to the Issues*, in *INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS* 3, 25–26 (Michael J. Graetz & Alvin C. Warren Jr. eds., 1998). For arguments favoring some form of separate corporate tax, see Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 946–47 (2006) (offering moderate support for the corporate tax as a way to take into account capital lock up); Terrence R. Chorvat, *Apologia for the Double Taxation of Corporate Income*, 38 WAKE FOREST L. REV. 239, 242–43 (2003) (explaining why, in a pure income

the debt–equity distinction and the different tax treatment of debt and equity have a huge effect on our economy because they incentivize firms to leverage their financial structure by financing their activities with debt rather than equity investments. As this Article explains, corporate managers and shareholders have a tax incentive to finance corporate activities through instruments classified as debt for tax purposes so that the payments made according to them are deductible.⁵ This leveraged financial structure allows corporations to show shareholders higher after-tax profits, which supports claims for higher manager compensation. It also increases corporations' bankruptcy risk as well as other costs of financial distress and makes corporations dependent upon an ongoing flow of credit to continuously refinance their activities.

The current distinction between debt and equity relies on vague rules. Over time, tax lawyers have learned to exploit its vulnerabilities in order to help corporate taxpayers increase their interest deductions by eroding the definition of equity in favor of debt.⁶ Tax planners' ability to avoid equity characterization obviously resulted in a revenue loss to the Treasury. It also allowed equity investors to shift

tax, a higher tax rate on the return for corporate equity would actually encourage investment in those relatively risky assets); Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, But to Save It*, 56 TAX L. REV. 329, 335–62 (2003) (providing a different justification for a much broader corporate tax base); Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax* 29–46 (Mich. Law & Econ. Research, Paper No. 04-006, 2004), available at <http://ssrn.com/abstract=516202> (arguing for the retention of the corporate tax).

4. The debt–equity distinction also reflects the broader question of whether the income tax is justified at all, or whether it should be replaced with an alternative consumption tax. In this context, commentators often use problems such as the debt–equity distinction as an example for how difficult it is to tax income generated from capital. See William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1118–19 (1974) (arguing that the current income tax has not been effective in terms of taxing wealth or wealth accumulation and that it would be difficult to make it so, suggesting instead that if wealth should be taxed, wealth transfer taxes are a more appropriate device); Daniel N. Shavero, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91, 95–106 (2004) (surveying the literature justifying the shift to a consumption tax); Shavero, *supra* note 2, at 647–48, 708 (pointing out the difficulty of relying on risk-based rules—such as the rules distinguishing between debt and equity—and suggesting that one alternative is to stop taxing income from capital). See generally HENRY J. AARON ET AL., TAXING CAPITAL INCOME (Henry J. Aaron et al. eds., 2007) (providing a thorough collection of articles on the topic).

5. See discussion *infra* Part I.A.

6. See *infra* notes 208–11 and accompanying text (discussing the creation and use of Monthly Income Preferred Stocks (“MIPS”)).

into more debt-like investment instruments and corporations to rely on a more highly leveraged financial structure.⁷

There is no better time to discuss the long-term harmful effects of this leverage incentive than in the midst of the current financial crisis. In times of financial crisis, when credit markets are believed to be inefficient and overly risk-averse, this high leverage rate reduces managers' flexibility, requiring them to either raise capital at very high finance costs or to cut back on their business activities. The difference in tax treatment of debt and equity gave financial intermediaries, such as investment banks and mortgage providers, incentives to over-leverage their activities, which in turn increased their chances of bankruptcy and failure.⁸ It also 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 to run their basic operations. While the difference in tax treatment of debt and equity is probably not the primary reason for the current financial crisis, its existence substantially contributed to the development of the crisis and worsened its outcomes. As a result, we face one of the worst recessions in modern history, which may have devastating effects on human welfare and political stability worldwide.

The debt-equity distinction problem is unique because of the huge social costs it imposes, which is why this Article seeks to analyze and help resolve it. However, as a theoretical matter, it is part of a broader problem of line-drawing where tax professionals are required to distinguish between similar transactions and to classify them according to different statutory categories.⁹ These line-drawing problems are an inherent part of the Code. Dealing with them becomes more difficult as taxpayers take advantage of the Code's

7. It also allowed the countereffect of debt investors shifting to more equity-like investments without obtaining equity characterization. For a more elaborated discussion on this point, see *infra* note 61 and accompanying text.

8. See discussion *infra* Part I.A.

9. Such examples include the distinction between an employee and an independent contractor, between capital assets and assets the sale of which gives rise to ordinary income, and between deductible and capitalized expenses. Another example, which has triggered a considerable amount of scholarly writing, is the distinction among nonrecognition transactions. See Joshua D. Blank, *Confronting Continuity: A Tradition of Fiction in Corporate Reorganizations*, 2006 COLUM. BUS. L. REV. 1, 19-44 (pointing to the artificiality of the continuity of interest doctrine developed by courts to distinguish genuine tax-free corporate reorganizations from taxable transactions); Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397, 411 (1987) (discussing the lack of concrete purpose of in-kind property exchange transactions).

increasing complexity to structure tax avoidance transactions.¹⁰ To date, both legal doctrine and academic scholarship have provided only partially satisfying solutions to this vexing line-drawing problem.¹¹

It is unreasonable to wait for a fundamental tax reform to eradicate these inconsistencies. If history is any indication, tax legislation is typically the producer of frictions and inconsistencies rather than a mechanism for eliminating them.¹² Accordingly, one should adopt a moderately skeptical position about addressing the debt–equity distinction or other line-drawing problems through legislation. Therefore, devising good intermediary regulatory policy solutions to rectify imperfect (yet politically stable) tax legislation is an important task because it involves real problems that impact real people and has substantial revenue and efficiency stakes that affect our society.

To understand the tension at the core of the debt–equity distinction, one has to adopt a broader framework for analyzing the line-drawing problems within the Code. Creating sustainable regulatory solutions requires three types of analyses. First, we must understand why the rules we have were originally enacted. Second, we must judge how the economic reality in which these rules operate has changed over the course of time. Finally, and most importantly, it is not enough to say that specific immutable rules require arbitrary line-drawing. After determining why the current rules do not work, it is important to see what objectives they *can and should* achieve.

The debt–equity distinction is a real-world problem that academics simply cannot ignore. However, this Article asserts that analysis of the debt–equity distinction also offers important insights for the broader line-drawing problem underlying the Code. The distinction is a familiar line-drawing problem and several tax scholars have adopted a second-best approach for addressing it.¹³ Apart from

10. These are often referred to as tax arbitrage transactions, which allow taxpayers to attain certain economic positions while avoiding unfavorable tax treatment associated with those positions.

11. See discussion *infra* Part IV.

12. See generally Michael J. Graetz, *Tax Reform Unraveling*, 21 J. ECON. PERSP. 69 (2007), available at <http://www.atypon-link.com/AEAP/doi/abs/10.1257/jep.21.1.69> (discussing generally how the legislative process adds to tax law complexity).

13. See Pratt, *supra* note 2, at 1115, 1117–18; discussion of Weisbach articles *infra* Part IV.B; see also Anthony P. Polito, *A Modest Proposal Regarding Debt-Like Preferred Stock*, 20 VA. TAX REV. 291, 295 (2000) (exploring the applicability of the risk-and-return framework to preferred stock to exclude it from being characterized as equity for corporate tax purposes).

its huge social impact and its relation to other fundamental tax controversies, two attributes make the debt–equity distinction an ideal line-drawing case study. First, it is relatively well known and not too technically complicated. This Article focuses on one key difference between the tax treatment of debt and equity instruments—that interest payments are deductible from the corporate income tax and dividends are not.¹⁴ Hence, this policy inquiry requires only a very basic framework and can be made without first delving into long technical explanations about tax rules (not suited for the faint-hearted). The debt–equity distinction thus provides a rare opportunity to examine why current academic and doctrinal attempts to approach real-world tax problems often fall short.

Second, the debt–equity distinction is an ideal line-drawing case study because it seems to be politically immutable. Reforms that would have affected the tax treatment of debt and equity have been frequently proposed over the years.¹⁵ However, all historic attempts to overcome this problem have failed,¹⁶ and most of the (politically plausible) tax-reform proposals intend to leave the debt–equity distinction in place.¹⁷

Regardless of one’s opinion on these reform proposals, a few issues are hardly in dispute. First, despite its old age, this century-long tax controversy of how to distinguish debt from equity is neither close to being solved nor likely to be reformed.¹⁸ Second, the stakes of the debt–equity line-drawing problem are so high that they should not be

14. See I.R.C. §§ 163, 311(a) (2006).

15. Pratt, *supra* note 2, at 1117–58 (providing a comprehensive explanation of the different reform proposals); see also Kleinbard, *supra* note 2, at 1363–68 (suggesting a radical reform that taxes most investment on an accrual basis of expected return with modifications upon realization); Knoll, *supra* note 2, at 219–20 (summarizing some of the deficiencies of the different approaches dealing with the tax arbitrage problem in relation to financial instruments); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 246 (1992) (developing a general framework for the timing of financial instruments under a realization-based income tax); Strnad, *supra* note 2, at 569–72 (summarizing the principles of an ideal system); Warren, *supra* note 2, at 473–77 (discussing several workable tax policy responses to the fixed versus contingent returns distinction).

16. See generally Graetz & Warren, *supra* note 3 (describing both the Treasury and American Law Institute (“ALI”) proposals—neither of which were ever executed).

17. See generally Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified in scattered sections of 26 U.S.C.) (including a change in the tax rate on dividend income, but not eliminating the debt–equity distinction).

18. See David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1637–39 (1999) (discussing failed attempts to distinguish between debt and equity and the lack of congressional guidance on the distinction).

ignored any longer.¹⁹ Third, the lack of a coherent debt–equity distinction poses an immediate threat to the viability of the corporate tax base as a fiscal instrument²⁰ and distorts investment decisions.²¹ It is also one of the most frequently litigated tax controversies, which generates huge administrative, compliance, and uncertainty costs.²²

Interestingly, the rules distinguishing debt from equity are appropriate for dealing with the line-drawing problems they were intended to address. However, they were generated at a time when many of the corporations subject to the corporate tax were closely held private family corporations, only a limited number of financial instruments were offered in financial markets, there was a sharp difference between the individual and corporate tax rates, and almost all corporate and individual taxpayers affected by the rules were United States residents.²³ To be sure, even though the rules distinguishing debt–equity instruments may have functioned reasonably well in the first half of the twentieth century, the distinction itself probably made little sense even then. Given a blank sheet on which to rewrite the corporate tax law, we probably would not include it. However, the tax rules that were generated to draw the line between debt and equity were suitable to deal with the problems that emerged out of the business reality in which they were written—problems of shareholders lending money to their controlled corporations to avoid paying both the corporate tax and the high individual income taxes on dividend payments.²⁴

Financial markets have developed and proliferated dramatically since then. Today, firms employ modern financial engineering to issue financial instruments that do not fit into the categories determined a century ago.²⁵ The corporate tax effectively has become a tax on the

19. See Mark P. Gergen, *Apocalypse Not?*, 50 TAX L. REV. 833, 840–41 (1995) (accepting that the debt–equity distinction is a threat to the integrity of the corporate tax base).

20. *Id.* (expressing skepticism about the extent that other financial instruments could really be used to avoid taxes); Strnad, *supra* note 2, at 604 (stating that the inconsistency in the tax treatment of debt and equity allows financial engineers to use the overlap between those categories to designate the same transactions as equity or debt for tax purposes).

21. See *infra* notes 53–57 and accompanying text; see also Alvin C. Warren, *The Relation and Integration of the Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717, 721–30 (1981) (explaining the distortions of the double tax structure in pre-1986 tax rates).

22. Nathan R. Christensen, Comment, *The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion*, 74 U. CHI. L. REV. 1309, 1310 (2007).

23. See *infra* Part II.B.

24. See *infra* Part II.B.

25. See David A. Weisbach, *Tax Responses to Financial Contract Innovation*, 50 TAX L. REV. 491, 494–500 (1995).

access to public markets rather than a tax on limited liability because most entities with limited liability are no longer subject to the corporate tax.²⁶ There has also been a substantial change in the corporate and individual income tax rates.²⁷ Most importantly, however, corporations issue instruments to a varied and dispersed body of investors, many of whom are tax-exempt or foreigners.²⁸ These interest payments are “efficient” from a tax planning perspective because they reduce the corporations’ tax liabilities, but foreigners receiving these interest payments are typically subject to only very low liabilities in the country in which they were paid.

All of the above changes are institutional phenomena unlikely to be reversed. This means that as long as we distinguish between debt and equity for tax purposes, we should make sure that the distinction operates within what can reasonably be achieved within this new reality. Put differently, given that the tax law distinguishes between debt and equity, we should make this distinction in a way that minimizes the social costs associated with it. This Article argues that the current rules are inappropriate for a number of reasons. First, they were developed primarily to deal with evidentiary difficulties of what the “real” transactions were between controlling shareholders and their private, closely held corporations.²⁹ This is no longer an issue because most of the instruments we are concerned with today are issued on the public markets and, therefore, in most situations, have very clear terms.³⁰ Second, as long as investors are United States residents, the revenue difference between the debt and equity characterization in the current tax rate structure is not very significant.³¹ Third, the real potential for a revenue loss arises only when foreign investors achieve debt classification, but there are better ways to address this problem.

26. See *infra* note 86 and accompanying text.

27. See *infra* notes 93–112 and accompanying text.

28. Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, 50 WM. & MARY L. REV. 115, 130–32 (2008) (making an assessment that sixty percent of the investors in private equity firms are foreigners or tax exempt).

29. See *infra* notes 130–33 and accompanying text.

30. See *infra* notes 138–39 and accompanying text.

31. This is a result of changes in the tax rate structure that happened over the course of the last twenty years. These changes include the low effective tax rate on corporations, the historically low top marginal tax rate on individual income, and the special 15% tax rates on dividends. See I.R.C. § 1(h)(11) (2006). There may, however, be some other factors that may be significant, such as the different timing rules for interest and dividend payments and the ability to withdraw principal without tax in the context of debt instruments.

This means that even though the debt–equity distinction is difficult to change politically, its main objective today should not be to distinguish “true” shareholders from creditors, so much as it should be to reduce distortions, compliance costs, and administrative costs. I propose to replace the current convoluted rules for determining whether a specific hybrid instrument should be treated as debt or equity with a rule that involves two easy-to-observe and difficult-to-manipulate factors—duration and voting rights.

This Article’s approach tries to make academic tax policy discourse more practical and the real-world line-drawing debate more policy oriented. As such, it offers a nuanced understanding of how line-drawing problems should be approached. The impact of this Article extends beyond the debt–equity distinction of the line-drawing problem because it reminds us that tax academics should not and cannot be insulated from real-world problems. It demonstrates that academic work does not have to rely on abstract, over-simplified models, nor does it have to excessively analyze complex tax law technicalities to participate in real-world tax debates. In more concrete terms, this Article’s analysis of the debt–equity distinction suggests that academics should at least think about how their work can be translated into real-world changes—that is, they should account for the fact that radical legislative tax reforms are rare and that most short-term progress could and should be sought through incremental regulatory changes.

The unavoidable conclusion of the debt–equity distinction analysis is that while tax scholars cannot offer a bright-line rule for all real-world line-drawing problems, they should try to develop a more uniform methodology for addressing those problems. Put differently, academics who care about issues of efficiency and redistribution cannot live in a world in which “proper” tax-law academic work deals primarily with abstract issues, and real-world tax practice is anything but theoretical. Accordingly, this Article makes three contributions: it offers a realistic option for reforming a costly and unresolved friction in our tax system; it points out the limitations of what policy makers can hope to achieve through the use of doctrinal analysis and abstract economic models; and it shows that even though many parts of the Code are arbitrary, one can still adopt a general policy-oriented methodology to approach them. This approach may not resolve all the inconsistencies and arbitrary distinctions in our tax law, but it would allow us to endure them and “live” better with a tax law with which we disagree.

Part I lays out and explains the stakes of the debt–equity distinction and the doctrinal answer to it. Part II then examines how the circumstances have changed from the time in which the law distinguishing debt and equity was developed until today. It then demonstrates why the doctrinal answer fails to provide a better policy to distinguish debt and equity. Part III explains how the debt–equity line-drawing problem should be approached. Part IV uses the debt–equity distinction to generalize some broader principles of how arbitrary line-drawing frictions in the tax law should be addressed. It provides a general theoretical framework to evaluate the line-drawing problem and explains the Article’s approach in a more general context. This Part then demonstrates why other approaches, such as the one offered by Professor David Weisbach, are not by themselves sufficient to help policy makers solve line-drawing problems.³² The last Part offers some short conclusions. It emphasizes that a reduction in the social costs of the debt–equity distinction is feasible if policy makers adopt a fresh and sober perspective on how to best address the matters at stake.

I. THE DEBT–EQUITY DISTINCTION

This Part seeks to familiarize the reader with the debt–equity distinction by explaining its tax consequences and the doctrinal approach to determining whether an instrument is debt or equity.

A. *The Tax Advantage of Debt*

This sub-Part explains the stakes of the debt–equity distinction under current tax law. It illustrates that while debt and equity instruments may be economically similar in many ways, their tax treatment is radically different. The analysis focuses on how this distinction operates with regard to instruments issued to the public even though the rules governing the distinction do not categorically distinguish between private and public corporations.

Corporations want to raise money and raise it cheaply. Investors, on the other hand, are interested in maximizing returns while minimizing their risk. When issuing to the public, corporations do not distinguish between different sources of capital contributions—they aim to invest all capital productively and promise both equity and

32. See David A. Weisbach, *Thinking Outside the Little Boxes: A Response to Professor Schlunk*, 80 TEX. L. REV. 893, 908 (2002).

debt investors a return, without assigning them property rights in the assets accumulated by the corporations.³³

The prototypes of debt and equity instruments are easy to distinguish. Equities are instruments that have no fixed maturity date and grant owners voting power and a right for a residual profit that is subordinated to all other claims against the corporation.³⁴ Debt instruments are funds transferred in return for a reasonable expectation of repayment within a fairly short and well-defined period.³⁵ They frequently provide their holders with fixed periodical interest payments until repaid. The expected return on equity is usually different than on debt because the investors' returns are contingent on many unforeseeable factors related to the success of the firm's business strategy.³⁶ This contingency is typically perceived to make the equity investments riskier than investments in bonds (which are debt instruments), and, as a result, equity investors typically demand a higher return for their investments.

There is a wide spectrum of risk-return combinations, and many considerations impact how issued instruments are designed and whether they bear greater resemblance to classic debt or equity. It is important to remember, however, that corporations and investors do not care so much for the abstract legal classifications of their actions, but rather they care about the price they are expected to pay, the risk they undertake, and the nominal amount and timing of their potential returns.

Given the above, the "functional similarity" between debt and equity is clear—both are instruments through which corporations raise money by offering investors a return that correlates with the risk of their investments.³⁷ Despite this functional similarity, most income tax regimes treat proceeds of debt and equity instruments differently,³⁸ resulting in different tax consequences on both the

33. Cf. David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499, 501 (1994) (noting the many possible corporate objectives for raising capital).

34. Anthony P. Polito, *Useful Fictions: Debt and Equity Classification in Corporate Tax Law*, 30 ARIZ. ST. L.J. 761, 770–71 (1998).

35. The return for debt investment is not completely insulated from the firm's business success. However, the firm's commitment to periodic interest payments and the relatively short term of many debt transactions make the repayment contingent on fewer factors.

36. RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 147–49 (8th ed. 2006).

37. TIM EDGAR, *THE INCOME TAX TREATMENT OF FINANCIAL INSTRUMENTS: THEORY AND PRACTICE* 93 (2000).

38. *Id.* at 40.

corporate and investor levels.³⁹ Most importantly, interest payments are generally deductible from corporate income while dividends are not.⁴⁰ For example, let us assume a corporation earns \$200 of gross income in a given year and has to pay \$100 to an investor. If the corporation pays the investor \$100 in interest, it would reduce its taxable income to \$100. Accordingly, if the corporate tax rate is 35%, it would have to pay \$35 in taxes. If it pays the investor \$100 in dividend payments, it would still be required to pay the corporate tax on \$200 and would have a tax liability of \$70. This is the essence of the double tax on equity investments. Corporations are artificial entities, so the tax is ultimately born by individuals. If part of the corporate tax is born by investors, there is double tax because the return of equity investors is taxed twice—once by the corporate tax and once when the dividends are paid.⁴¹

There are two other main differences between dividends and interest payments.⁴² First, investors pay tax on interest payments they receive at ordinary (progressive) income rates whereas in the fiscal years of 2003–2009, investors had to pay only (lower) capital gains rates on the dividends they received.⁴³ If the corporation refrains from distributing dividends, its stock appreciation would be taxed when sold by the investor and would be subject to a capital gains tax if held for more than a year. Second, there is a timing difference. Dividends, which are considered volatile and uncertain payments, are realized by

39. For a comprehensive list of those differences, see Pratt, *supra* note 2, at 1059–60; Margaret A. Gibson, Comment, *The Intractable Debt/Equity Problem: A New Structure for Analyzing Shareholder Advances*, 81 NW. U. L. REV. 452, 454–55 (1987); see also Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 889–92 (2003) (explaining how financing through convertible debt reduces the tax valuation of equity-based compensation of managers in venture capital corporations).

40. This Article deals only with “C corporations,” meaning corporations that are subject to the corporate tax under I.R.C. § 11 (2006), and not “S corporations,” which in most cases are not subject to a separate entity tax. See I.R.C. § 1363(a). Virtually all publicly traded companies are C corporations. See *infra* note 86 and accompanying text. For an exception, see Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 106–07 (2008) (explaining the tax planning strategy which allowed Blackstone to issue its shares to the public as a pass-through partnership).

41. See generally DANIEL N. SHAVIRO, *DECODING THE U.S. CORPORATE TAX* (2009) (discussing the concept, operation, and potential objectives of the corporate tax).

42. Pratt, *supra* note 2, at 1061. There are, of course, many other differences, including those in the sourcing rules for interest and dividends. See I.R.C. § 861(a). These rules determine where interest and dividend payments should be for international tax purposes. *Id.* However, these are less important for the purpose of this Article’s analysis.

43. See I.R.C. §§ 1(a), 1(h)(11) (revealing how certain qualified dividends are taxed at the preferred long-term capital gains rate of 15%, while maximum federal tax rates for individuals on other sources of income can go as high as 35%).

the investors only when actually received. In contrast, because interest is considered to be an obligation likely to be fulfilled, investors are required to include (and corporate issuers are allowed to deduct) interest payments as they accrue—even if the issuer is not obligated to transfer any payment to the investor.⁴⁴

In most cases, the above characteristics provide corporate managers with a clear incentive to finance corporations through debt rather than equity.⁴⁵ The interest deduction provides them with a tax shield that increases after-tax earnings, and the timing rules allow them to deduct interest sooner and to relish the time value of the taxes saved.⁴⁶ Furthermore, the effective tax rate on interest payments would typically be lower than the effective tax rate on dividends so that from a (pure) tax perspective, investors would prefer interest payments over dividends as well.⁴⁷

44. See I.R.C. § 163(e). Consider the (simplified) example of a bond with a two-year maturity period in which the corporation promises to pay \$121. The risk associated with this promise is priced by the market as justifying a 10% annual interest rate, which means that the bond would be sold for \$100. At the end of the first year, the issuer would be permitted to deduct \$10 of deemed interest payments, and the investor, if subject to U.S. tax laws, would be required to include those payments in its gross income. At the end of the following year, the issuer would transfer \$121 to the investor out of which \$21 are interest payments. Since \$10 of interest payments have already been accrued in the previous year, the issuer will only get to deduct \$11 from its income and the investor will only be required to include this same amount.

45. I.R.C. § 243 generally allows domestic corporate shareholders a deduction for a portion of dividends they receive from their subsidiaries. The amount of the deductible portion is a function of the investment position held by the corporate shareholder. However, when those dividends are eventually paid to non-corporate investors, they are subject to any investor level taxes on those dividends.

46. The time value of accelerating the deductions could be understood in the following manner: when the corporation is allowed to take a deduction sooner, it is able to reduce its tax liability. It could then take the money it saved from reducing its taxes and invest it in a short-term U.S. Treasury bill, which is considered a risk-free debt instrument, and gain some interest on it, which reflects the value of “renting” the money. On deferral, see MICHAEL J. GRAETZ & DEBORAH J. SCHENK, *FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES* 303–08 (3d ed. 1995).

47. In the current rate structure, the statutory corporate tax rate is 35%, exactly the same as the maximum individual tax rate and somewhat lower than the top effective marginal rate on equity investments. I.R.C. § 11. The top real tax rate on equity investments, which includes the tax rate on both the corporate level and on the (domestic) shareholder level and assumes both of them are borne solely by the shareholders, is 44.75%. To understand the higher real tax rate on equity investments, let us assume that a corporation earns \$1000 and pays all of its gains as dividends. The corporate income tax is 35%, so the corporation would pay \$350 of corporate income tax and would distribute \$650 to investors, who would have to pay 15% tax on the dividends, leaving them with \$552.50. Alternatively, assume that the corporation would not distribute any dividends but instead retains the earnings—so that the value of the corporate share would increase by \$650. If the investors sell the shares, they would be subject to a 15% tax on the \$650 appreciation. In this scenario, the effective tax rate on the equity investor is therefore

The key tax advantage of debt is, however, anchored in the deductibility of interest payments on the corporate level. The tax paid by investors on interest and dividends may vary significantly depending on their annual income,⁴⁸ residency (for tax purposes),⁴⁹ and tax status (many key investors are either tax-exempt⁵⁰ or tax-indifferent⁵¹). Calculating the tax rate that investors in corporate equity face at the shareholder level is therefore a complicated matter, and this Article will address this issue in the Parts that follow.

There is, therefore, an inherent inconsistency between the economics of the debt–equity distinction and its tax treatment. From an economic perspective, debt and equity instruments are two ends of a risk–return continuum—the difference between them is a matter of degree. Their binary tax classification, however, suggests that they are two mutually exclusive categories subject to non-linear tax treatment—one deductible and the other not.⁵²

44.75%. This calculation of the “real” tax rate on equity assumes that all the corporate tax is borne by investors. There is, however, much controversy over the incidence of the corporate tax—some of which is borne by employees, suppliers, and consumers. *See generally* Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know* (Nat’l Bureau of Econ. Research, Working Paper No. 11686, 2005), *available at* <http://www.nber.org/papers/w11686.pdf> (providing a literature review of the question of who bears the burden of the corporate tax).

48. I.R.C. § 1.

49. For example, foreign taxpayers are subject to a 30% statutory rate on all the dividends and interest payments they receive from United States persons. *See* I.R.C. §§ 871(a), 881(a). However, double-tax treaties tend to significantly reduce the statutory rate. Double tax treaties are bilateral, and the tax rates are subject to negotiations between countries. However, as a general matter, the tax rates on dividends tend to be higher (taxes on dividends tend to range from 5 to 15%) than those rates imposed upon interest payments (taxes on interest payments tend to range from 0 to 5%). *See* Ilan Benshalom, *The Quest to Tax Interest Income: Stages in the Development of International Taxation*, 27 VA. TAX REV. 631, 664–67 (2008).

50. The tax paid on pension funds and certain foreign portfolio investors that invest in debt instruments may vary. These taxpayers are defined in I.R.C. §§ 503, 881(c).

51. Financial institutions whose income is computed with reference to all of their earnings (including the appreciation and depreciation in the values of unrealized assets) are generally tax-indifferent. These types of financial institutions are defined in I.R.C. § 475.

52. To the extent that any tax advantage should be provided by debt, it is not clear that it should be provided in an “all-or-nothing” manner. Instead of completely disallowing the deduction of dividend payments, the tax advantage could have been provided in a gradual continuous manner which would have correlated the advantage to the instrument’s position on the hypothetical debt–equity continuum. Some returns from hybrids could be recognized as dividends and some as interest payments. A good example of such hybrids is preferred stock. *See infra* note 212 and accompanying text.

The Code's clear bias in favor of debt is believed to be one of the main "tax" factors that led to the current financial crisis.⁵³ That financial firms have an incentive and a tendency to over-leverage their activities in order to lower their costs of capital is well known.⁵⁴ However, one of the reasons the current crisis has moved from the financial sector to the real economy is that the basic tax incentive to leverage exists for all corporations. For years, the double corporate tax system has encouraged investors to increase their leverage, which thereby increases their long-term costs of financial distress, in order to deduct their interest payments and maximize their short-term after-tax income.⁵⁵ Additionally, it has been persuasively argued that the interest deduction discourages investments in potentially high-yield, yet risky, ventures involving research and development and intangibles that do not have the stable earnings pattern required for a corporation to manage high debt capacity.⁵⁶ This discouragement runs against the general economic convention that governments should encourage these types of activities and perhaps even subsidize them.⁵⁷

Since the classification of an instrument as debt or equity may entail significant tax advantages, corporate issuers and investors have an incentive to design instruments that fall under a favorable tax classification. Therefore, financial markets may show high demand for hybrid instruments that are classified as debt but have many equity characteristics.⁵⁸ This type of tax arbitrage raises serious efficiency, equity, and revenue concerns because the resources

53. Martin A. Sullivan, *Deleveraging the Tax Code*, 120 TAX NOTES 1241, 1241 (2008). The other main tax factor was the deduction for mortgage interest payments. See I.R.C. § 163(h). There were, of course other non-tax factors, including loose monetary and financial regulatory regimes, financial accounting that provided managers with incentives to maximize income-per-share, and lack of consumer protection regulation to prevent imprudent borrowing and lending.

54. Sullivan, *supra* note 53, at 1242.

55. This fact has not escaped the Treasury. See DEP'T OF THE TREASURY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY 81 (2007), available at http://www.ustreas.gov/press/releases/reports/hp749_approachesstudy.pdf; DEP'T OF THE TREASURY, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS BACKGROUND PAPER 25 (2007), available at <http://www.ustreas.gov/press/releases/reports/07230%20r.pdf>. A similar analysis was provided nearly two decades ago by the Joint Committee on Taxation. See J. COMM. ON TAXATION, 101ST CONG., FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES 53–58 (Comm. Print 1989).

56. Michael S. Knoll, *Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking*, 38 VILL. L. REV. 1461, 1465–66, 1492–93 (1993).

57. This view is reflected in other I.R.C. sections. See, e.g., I.R.C. §§ 41, 1235.

58. Knoll, *supra* note 2, at 203 (providing an example for how such a tax arbitrage could easily be achieved). Less frequently, investors may use hybrids to attain the opposite results—so that an instrument with debt characteristics would be classified as equity.

invested are geared solely to provide (privileged) taxpayers a tax advantage at the expense of other taxpayers. These resources are therefore wasteful from a macro-social perspective and inequitable.⁵⁹

This tax-planning activity also helps corporations substitute their traditional equity instruments for more debt-flavored instruments that qualify as debt for tax purposes. This substitution increases corporations' leverage and the negative externalities associated with it—namely the risk of bankruptcy.⁶⁰ However, it is important to note that the ability of corporate issuers to attain debt classification via tax planning does not dictate a higher leverage rate. Corporations may use their ability to attain debt classification through tax planning to issue more equity-flavored instruments instead of their traditional debt instruments.⁶¹ For the purposes of this Article, it is not necessary to resolve the empirical question of whether tax planning increases or decreases corporations' risk of bankruptcy and financial distress. It is enough to note that nothing in the vague debt–equity classification is designed to curtail tax planning that increases corporate leverage or to promote tax planning that reduces it.

To be sure, even if the distinction between debt and equity were clear, the preferred tax treatment of debt is bound to somewhat increase corporations' reliance on debt financing. Some of the negative effects of high corporate leverage are therefore inherent to the deductibility of interest payments.⁶² However, taxpayers' ability to design hybrid instruments that qualify for debt classification allows corporations to stretch their reliance on these instruments to finance their operations, which results in a significant erosion of the corporate tax base.⁶³

59. Scott Marc Kolbrenner, *Derivatives Design and Taxation*, 15 VA. TAX REV. 211, 281 (1995); David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. CAL. L. REV. 1339, 1351–54 (2000); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 222–25 (2002).

60. See *infra* notes 208–11 and accompanying text.

61. The ability to invest in hybrid instruments may attract investors that otherwise would invest in equity and increase the negative consequences of excessive leverage. On the other hand, these instruments may also attract investors that otherwise would invest in debt, which means that the equity components of the hybrid instrument may actually reduce some of leverage's negative consequences.

62. See Sullivan, *supra* note 53, at 1242–43.

63. Lee A. Sheppard, *Wall Street Rules: Feline PRIDES Get IRS Imprimatur*, 100 TAX NOTES 619, 619–20 (2003) (arguing that Rev. Rul. 2003-97 allows tax planners to carve a debt instrument out of every instrument and that this unduly erodes the corporate tax base); Adam O. Emmerich, Comment, *Hybrid Instruments and the Debt–Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118, 121 (1985) (“If the Service always allowed these hybrid instruments to be treated as debt for tax purposes, most distributions eventually would be made pursuant to these instruments, and the use of

B. *The Doctrinal Answer*

While the different tax treatment is explicitly stated in the Code,⁶⁴ the legislative guidance on how to distinguish debt from equity is brief. After failing to enact detailed comprehensive legislation that would have better defined these two categories,⁶⁵ Congress enacted Code section 385, which implicitly assumes that there is a distinction between debt and equity.⁶⁶ Section 385 does not clearly state the distinction but, instead, assigns broad authority to the Treasury to enact regulations to make this distinction⁶⁷—stating only a few factors that the regulations *may* include.⁶⁸ The Treasury published such regulations in 1980, but they were quickly withdrawn.⁶⁹

Due to this lack of legislative guidance,⁷⁰ much of the debt-equity distinction is based on federal common law. Over the years, it seems as though courts have been reluctant to prescribe any benchmarks that taxpayers and the Internal Revenue Service (the “IRS”) could use to clearly make this distinction. Instead, courts have dealt with the need to distinguish debt and equity instruments on a case-by-case basis while relying on an amalgam of factors generated over the years by common law wisdom. Courts have sought to

‘ordinary’ equity would decline sharply. As a result, the corporate income tax would be reduced to little more than a tax on retained earnings.”).

64. See, e.g., I.R.C. § 163(a) (2006) (granting deductions for interest payments but not for dividends).

65. See Internal Revenue Code of 1954, Pub. L. No. 83-591, 68 Stat. 730. The House’s version of the 1954 Internal Revenue Code contained definitions designed to indicate precisely what instruments would qualify as debt. The Senate dropped these definitions, however. See *id.*

66. This was added as part of the Tax Reform Act of 1969. See Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified at 26 U.S.C. § 385 (2006)).

67. I.R.C. § 385(a).

68. I.R.C. § 385(b) (“(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money . . . , (2) whether there is subordination to or preference over any indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether there is convertibility into the stock of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.”).

69. Withdrawal of Treasury Decision 7747 Relating to Debt and Equity, 48 Fed. Reg. 31,053, 31,053 (July 6, 1983) (codified as amended at 26 C.F.R. § 1 (2009)). For a description of this failed regulatory endeavor, see Polito, *supra* note 34, at 783–90; Emmerich, *supra* note 63, at 128–33.

70. There are some more narrowly tailored Code provisions dealing with the classification of specific instruments. For example, I.R.C. § 163(l), which denies the deduction for interest paid or accrued on indebtedness that is payable in stock of the issuer. A few other examples where the Code recharacterizes or limits the tax benefit associated with either a debt or equity classification are I.R.C. §§ 163(e)(5), 249, 279, 351(g), and 356(e).

determine the character of an investment according to the nature of the issuer-investor relationship⁷¹—defining the stockholder as taking part in the “corporate adventure” and the creditor as a party that is entitled to receive payments “independently of risk and success [of the corporation].”⁷²

This judicial inquiry has gained understandable notoriety due to its convoluted mix of factors and inconsistent outcomes.⁷³ Courts, followed by the IRS in revenue ruling procedures,⁷⁴ have identified numerous criteria to weigh in determining whether a given instrument should be classified as debt or equity. These criteria include: the parties’ intent; whether the investors operate under a dual capacity of both shareholders and creditors and their role in managing the corporation; the availability of equivalent funding sources from third parties; the level of corporate leverage and the risk associated with the corporation’s line of business; the formal title of the instruments; subordination to other corporate debt in cases of bankruptcy; voting power; the provision of fixed payments and their contingency; the source of the payments; a fixed maturity date; and whether the corporation has the option of buying back the instrument.⁷⁵ Courts, however, have not confined themselves to any list of factors and have been reluctant to determine any decisive factors.⁷⁶ Some commentators have argued that courts actually use many more factors.⁷⁷ Further complicating the distinction, every federal circuit has developed a slightly different list of factors.⁷⁸

Clearly, the sheer number of factors allows an infinite number of possible combinations, making it extremely difficult to determine in

71. David P. Hariton, *The Taxation of Complex Financial Instruments*, 43 TAX L. REV. 731, 768–69 (1988) (referring to this approach as the “traditional approach”).

72. See, e.g., *Comm’r v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935).

73. Weisbach, *supra* note 18, at 1638.

74. Rev. Rul. 2003-97, 2003-2 C.B. 380; David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499, 503 (1994) (citing the list of factors distinguished by I.R.S. Notice 94-47, 1994-1 C.B. 357, which closely resembles the list of common law factors singled out by the courts).

75. Polito, *supra* note 34, at 781; Pratt, *supra* note 2, at 1068.

76. *John Kelley Co. v. Comm’r*, 326 U.S. 521, 533–34 (1946) (Rutledge, J., concurring in part and dissenting in part); *Dixie Dairies Corp. v. Comm’r*, 74 T.C. 476, 493–94 (1980).

77. See, e.g., Gibson, *supra* note 39, at 463.

78. Christensen, *supra* note 22, at 1313–14 (providing a comprehensive list of the different factors that each circuit relies upon for making this distinction—for example, the Tenth Circuit is the only one that considers ability to liquidate the loan, the First Circuit is the only one that considers use of customary loan documentation, and the Third Circuit considers a number of “unique” factors: e.g., timing of the advance with reference to the organization of the corporation, provision for redemption at the option of the holder, provision for redemption by the corporation, and contingency on the obligation to repay).

advance how courts will classify a given hybrid on the debt–equity continuum. For example, how could investors know what a “reasonable” rate of leverage is? How should one classify a hybrid instrument which grants its owner an option to convert the instrument into a common share but until conversion pays a fixed periodic interest rate and has a predetermined termination date? Would the classification of this hybrid instrument change if some of the payments were contingent on the entity’s performance, the S&P 500 Index, or the fluctuation of the interest rates? What will happen if the instrument’s payments would be contingent on a complicated formula that involves all three factors?

To prevent granting sophisticated taxpayers a roadmap for avoidance, both the courts and the IRS have been careful to avoid creating any safe harbors or clear lines to distinguish between debt and equity.⁷⁹ Uncertainty, therefore, was not the problem of the debt–equity distinction—it *was the solution* chosen by courts and the IRS and endorsed by Congressional silence. This uncertainty came at a substantial price, however. The reliance of many Code provisions on the classification of an investment as debt or equity and, most importantly, the material financial consequences the classification often involves⁸⁰ make the debt–equity distinction one of the most frequently litigated issues in tax law.⁸¹

II. CORRECTLY IDENTIFYING REAL-WORLD PROBLEMS—A PREREQUISITE

This Article argues that to reform reality tax policy makers should first identify why the current rules were promulgated and determine whether these reasons are still applicable. Only after understanding what function the rules *were intended* to perform should policy makers try to determine what function the rules *can and should* have in relation to contemporary challenges. This “historical” inquiry should not be perceived as a purely academic exercise. Rather, in order to avoid the problem of policy makers’ path dependency, the inquiry should be a critical and reflexive process that tries to identify the conventional origins by which we operate today. This problem occurs when policy makers embrace a set of explicit or implicit assumptions used in the past without first critically examining whether these assumptions are still valid. This Part explores why the

79. Pratt, *supra* note 2, at 1068.

80. Christensen, *supra* note 22, at 1311.

81. *Id.* at 1310.

rules distinguishing debt and equity were reasonable when they were adopted, why they are incompatible with the problems they are required to solve today, and how the tension between what they are supposed to be doing and what they actually achieve is reflected in the doctrinal analysis.

A. The Brave New World of Corporate Investments

The rules distinguishing debt and equity rely on conceptions generated at the beginning of the twentieth century, when Congress instated the double tax on corporate investment.⁸² Since then, the rules have been essentially stagnant, developing only through relatively minor incremental changes.⁸³ Economic reality, however, has dramatically changed.

Today's financial investment markets are ever changing. A number of phenomena that distinguish contemporary markets from those of the first half of the twentieth century are of particular relevance for this inquiry: the change in corporate and individual tax rates; the growing role of portfolio investment in public corporations; and the rise of derivative financial instruments. The impact of these changes is difficult to overstate. It means that we distinguish debt from equity using rules that are not only incoherent and obsolete but also were designed to deal with completely different investment vehicles.

The debt–equity distinction has been profoundly affected by the changing role of private versus public corporations in the modern economy. Many of the corporations in the beginning of the previous century were closely held private corporations incorporated primarily to attain limited liability. Today, limited liability is available in a variety of entities—most of them not subject to the corporate tax (e.g., limited liability companies (“LLCs”), which are taxed as pass-through partnerships).⁸⁴ Following the Treasury’s “check-the-box” regulations,⁸⁵ which allow taxpayers to choose the tax classification of

82. Steven A. Bank, *The Story of Double Taxation*, in BUSINESS TAX STORIES 153, 153–76 (Steven A. Bank & Kirk J. Stark eds., 2005) (explaining the political dynamics that led to the double tax on corporate investment during the late 1930s).

83. See *supra* note 70 (discussing Code provisions that, though narrowly tailored, seek to classify certain instruments).

84. See RICHARD L. DOERNBERG, HOWARD E. ABRAMS & DON A. LEATHERMAN, FEDERAL INCOME TAXATION OF CORPORATIONS AND PARTNERSHIPS 473–83 (4th ed. 2009).

85. See I.R.C. § 7704(a) (2006) (prescribing that with few exceptions publicly traded partnerships be taxed as corporations); Treas. Reg. § 301.7701-2, -3 (as amended in 2009).

most non-publicly traded entities, the corporate tax now raises revenues primarily from large public corporations and should be perceived as a tax on the access to public markets.⁸⁶

A new pattern of portfolio investments and dispersed corporate ownership accompanied the shift in the types of corporations subject to the corporate tax.⁸⁷ Portfolio investments are made by individuals and corporations seeking a diversified portfolio of financial assets and a high (net) return on their investments—not control of a specific entity.⁸⁸ These investments are volatile, mobile, and dispersed among various types of investors—many of which are not United States taxpayers.⁸⁹ More importantly for tax purposes, most corporations subject to corporate tax are public, thus their debt and equity securities are liquid. This has a fundamental effect on the debt–equity distinction. Unlike the investors of solvent but closely held corporations, where minority shareholders are always concerned that controlling shareholders will not distribute the profits, the investors in instruments issued by corporations such as IBM and Microsoft care much less about the timing of distributions. The available secondary markets take account of corporations’ retained earnings and allow investors to easily sell their investments.⁹⁰ Additionally, even though dividend payments are supposed to be paid from the corporations’ residual profits, publicly traded firms have fairly strict dividend

The regulations allow most entities to choose whether they are taxed as a corporation or a pass-through entity/partnership. *Id.*

86. Pratt, *supra* note 2, at 1057, 1111–13 (stating that the Treasury enacted the “check-the-box” regulations which allow most privately owned business entities to elect to be taxed as a partnership and to avoid the double tax even if they have limited liability and other corporate features). See generally TAX POLICY CTR., TAX ITEMS 1998–2006 (2009), http://www.taxpolicycenter.org/taxfacts/Content/PDF/corp_taxitems.pdf (showing that even though the returns of large corporations, which are defined as corporations with annual receipts exceeding \$250,000, account for only about 0.1% of the total corporate tax returns, they account for more than 85% of the corporate tax revenues).

87. Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 542–45 (2003) (detailing the growth of U.S. taxpayers’ portfolio investments since the beginning of the 1990s); Pratt, *supra* note 2, at 1057. Portfolio investors are investors that seek to diversify their investment in order to minimize the risk of investing in only a few firms and industries. These investors tend to buy small amounts of shares and securities issued by a wide variety of firms, and do not try to exercise any control over them. This often results in a dispersed ownership structure of many publicly traded corporations—that is when no shareholder or group of shareholders have a control block in the corporation.

88. Graetz & Grinberg, *supra* note 87, at 547–54 (outlining the key distinctions between direct and portfolio investments, and arguing that the latter are more volatile, short-term, and responsive to bottom-line returns and financial markets).

89. *Id.*

90. Hariton, *supra* note 71, at 770.

payment policies.⁹¹ Legally, corporations can deviate from their pronounced dividend policy and not pay the dividends. However, the management of public corporations tends to make extreme efforts to avoid such a move because it would disrupt the market's pricing of their equity shares.⁹²

Changes in the tax rate structure since the inception of the corporate tax are also relevant to the debt–equity distinction. In the last quarter-century, there has been a material change in the top marginal tax rates for corporations and individuals.⁹³ From the late 1930s until the 1980s, there was a substantial gap between the corporate tax rate (most of this period between 40–50%) and the individual tax rates (the top marginal rate was never below 70% and was more than 80–91% for a period of about 20 years).⁹⁴ The non-deductibility of dividends from the corporate tax rate imposed a potentially high “real” tax rate on equity investments, which could reach up to about 96% when the proceeds of such investments were distributed in the form of dividends.⁹⁵

Despite the tax penalty on the distribution of dividends, it is important to recognize that incorporation was a tax-favored investment vehicle for most of the twentieth century. The relatively low corporate tax rate made the practice of retaining earnings in corporations an effective tax-deferral mechanism—allowing income to compound and accumulate while being subject to significantly lower statutory and effective tax rates. It also provided shareholders with incentives to seek other non-dividend forms of distribution (e.g., redemption, liquidation),⁹⁶ which typically were subject to a lower capital gains rate (for most of that period, between 12.5–35% on assets held for long periods of time).⁹⁷ Accordingly, before the 1980s, equity-flavored debt that allowed the deduction of interest payments would have potentially exposed investors to high individual income tax rates on those payments. Hence, investors were less concerned

91. See BREALEY, MYERS & ALLEN, *supra* note 36, at 415–18.

92. Cf. *id.* at 428–29 (discussing how publicly traded companies pay dividends to stockholders). The drop in share price may result in ownership change and the growing readiness of shareholders to replace management. *Id.*

93. See *infra* Appendix A.

94. See *infra* Appendix A.

95. In 1960, the corporate tax rate was 52% and the top marginal income tax rate for individuals was 91%. See *infra* Appendix A. This meant that the real tax would have been roughly 96% $(1 - (1 - .52) \times (1 - .91) \approx .96)$. For a detailed discussion of the real corporate tax rate, see *supra* note 47.

96. See, e.g., I.R.C. §§ 302, 304, 331, 332, 334, 336 (2006).

97. See GRAETZ & SCHENK, *supra* note 46, at 565–68 (providing an account of the historic development of the very complex capital gains rate structure).

about using deductible interest payments to avoid the corporate tax because the corporate tax mechanism, along with the low capital gains rates imposed on non-dividend distributions, *was the tax shelter*.⁹⁸ This legal tax shelter provided taxpayers a secure way to avoid paying high individual income taxes on their corporate investments.⁹⁹ For example, in 1954, investors subject to the high individual marginal tax rate who undertook a five-year corporate investment with a pre-tax return of 10% could have increased their nominal after-tax returns by 285%–650% if, instead of receiving dividends and interest payments, they retained corporate earnings and liquidated their holdings at the end of the period.¹⁰⁰

This rate structure has irrevocably changed, however. The greatest change occurred as part of the 1986 Tax Reform Act,¹⁰¹ which significantly reduced the gap between the high marginal statutory tax rates on individuals and corporations.¹⁰² Up until that period, the top individual marginal tax rates were almost always significantly higher than the top corporate tax rates.¹⁰³ However, in 1988, when the new rates came into effect, the top individual tax rate (28%) was actually lower than the top corporate tax rate (34%).¹⁰⁴ Since the Jobs and Growth Tax Relief Reconciliation Act of 2003,¹⁰⁵ top marginal tax rates for individuals and corporations have been set identically at 35%, and the statutory tax rate on dividend payments and most capital gains has been at 15%.¹⁰⁶ The “real” tax rate on the dividend proceeds of equity investment is now limited to about 45%,¹⁰⁷ although the actual real effective tax rate is probably much

98. For a numerical example, see Warren, *supra* note 21, at 723.

99. Calvin H. Johnson, *The Incredible Shrinking Domain of Corporate Stock*, 103 TAX NOTES 871, 871 (2004) (pointing out that individual tax rates were so high in the 1970s that the combination of corporate and capital gains tax would be two to three times better “than a single individual tax for a long-haul investment”).

100. See *infra* Appendix B. This example assumes that the interest and dividend payments would have been re-invested in the corporate solution.

101. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified at 26 U.S.C. § 1 (2006)).

102. *Id.* § 101, 100 Stat. at 2096.

103. See *infra* Appendices A, B.

104. See *infra* Appendices A, B.

105. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified at 26 U.S.C. § 1 (2006)).

106. *Id.* §§ 105, 301, 117 Stat. at 755, 758.

107. Real tax rate = $1 - (1 - \text{corporate tax rate}) \times (1 - \text{dividend tax rate}) = 1 - (1 - 0.35) \times (1 - 0.15) = 0.4475$.

lower (around 36%), given that the effective average tax rate on corporations is estimated to be 26%.¹⁰⁸

In essence, the changes in the corporate tax rates during the 1980s metamorphosed the double corporate tax system. Before 1988, it was a tax shelter. After 1988, however, it became a tax penalty. Since the 1988 rates came into effect, the real tax rate on equity investments has been greater than the high marginal tax rate imposed on individuals.¹⁰⁹

In the post-1988 years, where the top statutory corporate and individual tax rates are roughly similar,¹¹⁰ individual investors subject to United States income tax *prefer* to pay the individual tax rate on interest payments than to pay higher real rates on equity investments.¹¹¹ For example, investors now subject to the highest individual marginal tax rate, undertaking a five-year corporate investment with a pre-tax return of 10%, could increase their after-tax returns by 117% if they received the returns in the form of interest payments and refrained from retaining corporate earnings.¹¹²

108. CONG. BUDGET OFFICE, TAXING CAPITAL INCOME: EFFECTIVE RATES AND APPROACHES TO REFORM 7–9 (2005), *available at* <http://www.cbo.gov/ftpdocs/67xx/doc6792/10-18-Tax.pdf> (suggesting that the combined tax rate on equity investments is 36% and that the average tax rate on investment in corporations is about 26%). *See* STEVE MAGUIRE, CONG. RESEARCH SERV., AVERAGE EFFECTIVE CORPORATE TAX RATES: 1959–2002, at 4 (2003) (showing that in the period of 1988–2002 the average federal corporate tax rate exceeded 27% only in the years 1999 and 2000); *see also* DEP'T OF THE TREASURY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM, *supra* note 55, at 82 (reaching a slightly different figure of 39.7%, instead of 36%, for the real effective tax rate on corporate investment). For additional estimates, *see* ROBERT CARROLL, TAX FOUND., COMPARING INTERNATIONAL CORPORATE TAX RATES: U.S. CORPORATE TAX RATE INCREASINGLY OUT OF LINE BY VARIOUS MEASURES 3 (2008), *available at* <http://www.taxfoundation.org/files/ff143.pdf> (suggesting that the effective tax rate on marginal corporate investments is around 24%); ROBERT MCINTYRE & T.D. COO NGUYEN, CITIZENS FOR TAX JUSTICE & THE INST. ON TAXATION & ECON. POL'Y, CORPORATE INCOME TAXES IN THE BUSH YEARS 19–28 (2004), *available at* www.ctj.org/corpfed04an.pdf (providing data that suggests that the top 275 United States multinationals paid an average effective tax rate of 17.3% in the years 2001–2003 and that in some industries the rates were below 15%); *see also* JOEL FRIEDMAN, CTR. ON BUDGET & POL'Y PRIORITIES, THE DECLINE OF CORPORATE INCOME TAX REVENUES 7 (2003), *available at* <http://www.cbpp.org/10-16-03tax.htm> (providing some further information as to how corporations are able to attain these low tax rates); Arlen & Weiss, *supra* note 3, at 342–46 (demonstrating how corporations are able to reduce their effective tax rates through tax subsidies for new investments in the form of accelerated depreciation and investment credits).

109. *See infra* Appendices A, B.

110. *See infra* Appendices A, B.

111. For a concrete numerical example, *see infra* Appendix B.

112. *See supra* notes 105–08 and accompanying text.

In the current tax rate structure, deductible interest payments frequently offer only a relatively minor tax benefit to taxpayers subject to the top individual marginal tax rate.¹¹³ These benefits may be outweighed by other potential advantages of equity (e.g., higher returns). However, it is also important to note that many investors have tax-exempt status or are foreigners.¹¹⁴ These taxpayers may be subject to a 0%, or otherwise very low, effective tax rate on interest payments paid to them by a corporation that is a United States resident.¹¹⁵ If the interest payment is deducted by the corporation and not taxed at the investor level, then the return on the investment is effectively free from United States income tax.

Another point of disconnect between the current rules and the modern economy relates to the role of financial engineering. In 1909, when the corporate tax was first imposed,¹¹⁶ the tax law distinction was made in reference to a well-identified business law distinction between debt and equity.¹¹⁷ Up until the early 1970s, investment vehicles issued to the public were limited to a number of familiar categories, which correlated the investment experience with a certain amount of risk.¹¹⁸ While the list of categories gradually expanded to include investment vehicles other than debt and equity—e.g., futures in certain commodities and basic put and call options—the risk and return positions of the parties that owned publicly issued instruments were relatively straightforward and easy to categorize. This fundamentally changed as Wall Street started to explore the boundaries of modern finance theory and to experiment with

113. CONG. BUDGET OFFICE, *supra* note 108, at 7–9 (calculating that the average effective tax rate on equity investment—which combines the corporate tax and the shareholder tax—is 36%). Although there is still some tax benefit associated with retaining corporate earnings, the corporate tax offers little tax benefit to corporations that retain earnings instead of paying dividends. *See infra* Appendix B.

114. Knoll, *supra* note 28, at 131.

115. *See supra* notes 49–50 and accompanying text.

116. *See* Payne-Aldrich Tariff Act of 1909, ch. 6, 36 Stat. 11 (repealed 1913). Some earlier versions of the civil war income tax included shareholders' investment in corporate entities and certain dividend payments in the individual income tax base. *See generally* Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447 (2001) (discussing whether different theories about the corporate nature really had a significant impact on the development of the corporate tax).

117. Polito, *supra* note 34, at 778.

118. Pratt, *supra* note 2, at 1075–77; Warren, *supra* note 2, at 460. For a somewhat different view, see generally Michael S. Knoll, *The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage* (Univ. Pa., Inst. for Law & Econ., Working Paper No. 04-11, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=555972 (suggesting that while many consider financial innovation modern, it can be traced back hundreds of years).

financial engineering. Financial experts realized that financial assets represent intangible rights with respect to a potential stream of cash flow—and therefore, unlike the real economy, could be divided in an infinite number of ways.¹¹⁹ Through a process that may strike laypersons as alchemy, debt and equity instruments can be decomposed and recombined resulting in an array of instruments that allow investors and issuers to establish different risk-cost-return exposures,¹²⁰ to obtain favorable accounting and credit-rating treatment, and to benefit from tax and regulatory arbitrages.¹²¹ Slicing and dicing the debt–equity bundle of rights produces hybrid instruments (which have both debt and equity characteristics);

119. Pratt, *supra* note 2, at 1056–57.

120. George C. Howell III & Cameron N. Cosby, *Exotic Coupon Stripping: A Voyage to the Frontier Between Debt and Option*, 12 VA. TAX REV. 531, 533–50 (1993) (providing examples for how different derivatives can be issued from what was once considered to be a single debt coupon issuing debt instrument).

121. The ability to exploit arbitrages emerges out of the inconsistent treatment of equivalent cash flows. The most common and easiest way to illustrate this point is to examine how equivalent cash flows could be generated through the simple use of the put-call parity theorem.

The theorem holds that given any three of the following four financial instruments—a zero-coupon bond with a face value of E , $PV(E)$, a share of stock, S , a call option on the share that matures when the bond matures and that has a strike price equal to the face value of the bond, C , and a put with the same maturity and strike price as the call, P —it is possible to synthesize the fourth. The most intuitive means of writing the theorem expresses the bond in terms of the other three instruments:

$$PV(E) = S + P - C \quad (1)$$

Focusing on tax characterization only, and ignoring timing for the moment, the bond produces interest, which is taxable as ordinary income, whereas the portfolio consisting of the stock, the held put, and the written call produces capital gain. Currently, the maximum federal tax rate on ordinary income is 39.6%, whereas the maximum federal tax rate on capital gains is 28%. Thus, the two sides of the transaction are taxed differently: For taxpayers in the top bracket, the left side of Equation 1 is taxed at a higher rate than the right.

The tax arbitrage possibility arises because the taxpayer can borrow using the left side of Equation 1, by issuing the bond, and using the proceeds to purchase the portfolio on the right side. The taxpayer will never have a net pretax cash flow from this arrangement because the cash flows on the opposite sides of the transaction offset one another. Because the taxpayer's interest deductions are deductible at a higher tax rate (39.6%) than the rate at which her gain is taxed (28%), she will generate a positive after-tax cash flow (11.6% of the amount borrowed).

Knoll, *supra* note 2, at 203–04 (citations omitted); see also EDGAR, *supra* note 37, at 21–25 (discussing how the put–call parity can achieve financial equivalence and through it tax planning objectives); Shaviro, *supra* note 2, at 652–53 (same); Warren, *supra* note 2, at 465–67 (same).

option-embedded instruments—those with an ability to convert, buy, or sell a certain asset at a certain price in a given time;¹²² and “NOT” instruments, which can be classified as neither debt nor equity.¹²³

Even more interesting is the fact that investors can buy different slices *from different issuers* to create synthetic positions that mimic the cash flow of debt or equity instruments.¹²⁴ In the past, investors interested in investing in a corporation had to buy instruments issued by it, but the explosive development of new types of financial instruments allowed investors to buy different positions which entailed options with respect to any company from any counterparty.¹²⁵ Furthermore, investors were no longer limited in making those bets with regard to any specific company and could rely on market indices.¹²⁶ Taxpayers’ ability to construct these synthetic instruments is far-reaching because it makes it possible to replicate cash flows and risks associated with a certain asset through the use of derivatives—thus avoiding the need to actually own them. This ability makes it considerably more difficult for tax authorities to develop risk-based ownership rules to determine if a taxpayer “owns” a position with respect to a specific corporation.¹²⁷ Taxing synthetic positions is difficult because tax authorities, and indeed even the taxpayers themselves, may find it difficult to identify related positions in complicated diversified portfolios and to match them with each other.¹²⁸

B. *Why the Doctrine Fails—the Ghost of Dual Capacity*

The criteria for distinguishing between debt and equity originate in case law. The second-best reality agenda seeks to promote a politically realistic solution. It therefore assumes the immutability of

122. A particularly interesting thing about these instruments is that there is no theoretical explanation for why the option should be bundled and not sold separately. See generally Edward D. Kleinbard, *Taxing Convertible Debt: A Layman’s Perspective*, 56 SMU L. REV. 453 (2003) (criticizing Strnad’s explanation for why convertible debt exists); Jeff Strnad, *Taxing Convertible Debt*, 56 SMU L. REV. 399 (2003) (providing an explanation for the existence of convertible debt under the signaling theory).

123. Michael S. Farber, *Equity, Debt, NOT—The Tax Treatment of Non-Debt Open Transactions*, 60 TAX LAW. 635, 636–37 (2007).

124. Pratt, *supra* note 2, at 1083; Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt–Equity Distinction?*, 80 TEX. L. REV. 859, 861 (2002); Weisbach, *supra* note 25, at 495.

125. Pratt, *supra* note 2, at 1076, 1078.

126. Kleinbard, *supra* note 2, at 1326–27 (explaining how indexes are used in equity swaps).

127. See EDGAR, *supra* note 37, at 33; Weisbach, *supra* note 25, at 506.

128. Weisbach, *supra* note 25, at 502–06.

the debt–equity distinction but often does not spend enough time understanding why the rules were generated in a specific way. The claim in this sub-Part is that the debt–equity distinction is a clear historic example of the law of unintended consequences. The rules, which were originally developed to address the problem of controlling shareholders financing their privately held corporations through debt to avoid higher taxes on dividends, now impede public issuings, without helping the Treasury to achieve any tax-revenue or efficiency goals.

A short review of the leading cases in the debt–equity jurisprudence and in those cases in the leading corporate taxation textbooks¹²⁹ (through which tax professors introduce students to this problem) yields some interesting observations. All of the cases involve transactions that were made prior to 1986—when the tax rate structure was completely different than the one we have today.¹³⁰ All of the cases involved private, closely held corporations, which in most cases were family corporations.¹³¹ In those cases, both the corporation and the investors were United States residents for tax purposes.¹³² Most importantly, the lenders in each case were part of a control group of shareholders and were therefore acting under a dual capacity of both equity holders and creditors.¹³³

129. See DOERENBERG, ABRAMS & LEATHERMAN, *supra* note 84, at 104–12 (providing as an example *Bauer v. Comm’r*, 748 F.2d 1365 (9th Cir. 1984) which deals with loans made by two controlling shareholders, a father and son-in-law, to their wholly owned corporation); STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 142–50 (2008) (providing *Fin Hay* as an example); ROBERT J. PERONI ET AL., CASES AND MATERIALS ON TAXATION OF BUSINESS ENTERPRISES 159–61 (3d ed. 2006) (providing as an example *Scriptomatic, Inc. v. United States*, 555 F.2d 364 (3d Cir. 1977), which refers to *Fin Hay*); BERNARD WOLFMAN & DIANE M. RING, FEDERAL INCOME TAXATION OF CORPORATE ENTERPRISE 50–63 (2008) (providing *Fin Hay* as an example). See generally *John Kelley Co. v. Comm’r*, 326 U.S. 521 (1946) (trying to determine if “debt” instruments issued by closely held corporations were actually debt); *Plantation Patterns, Inc. v. Comm’r*, 462 F.2d 712 (5th Cir. 1972) (trying to determine the true nature of loans made by two controlling shareholders, a husband and wife, to their closely held corporation); *Fin Hay Realty Co. v. Comm’r*, 398 F.2d 694 (3d Cir. 1968) (trying to determine the true nature of transfers of capital by two controlling shareholders to their wholly owned corporation in return for promissory notes); *Gilbert v. Comm’r*, 248 F.2d 399 (2d Cir. 1957) (dealing with a husband and a wife who claimed bad debt deductions for advances they made to their wholly owned corporations).

130. For example, see Dominic L. Daher & Salvador D. Aceves, *Interest Expense Deductions*, 536-3RD TAX MGMT. PORTFOLIOS A-19, A-20–24 (2007) (providing an overview of the topic directed toward practitioners, citing numerous cases, all of which predated the 1986 Tax Reform Act).

131. See *supra* note 129 and accompanying text.

132. See, e.g., *Bauer v. Comm’r*, 45 T.C. 910, 911 (1983), *rev’d on other grounds*, 748 F.2d 1365 (9th Cir. 1984).

133. See, e.g., *id.*

As explained above, wealthy individuals had a strong tax incentive to shelter the profits in the corporation and engage in non-dividend distribution.¹³⁴ However, when deferring the distribution of profits was costly,¹³⁵ shareholders would have preferred to use related-party debt to receive interest rather than dividend payments.¹³⁶ Accordingly, all of these cases involved transfers of funds to the entity through a transaction characterized by the controlling shareholders as debt—a characterization that was later challenged by the IRS on the grounds that the transfer was really an equity investment.¹³⁷

Therefore, the doctrinal rules were set to distinguish debt from equity in the context of related debt transactions, where most of the relevant debt instruments under scrutiny would have been regarded as not much more than “a piece of paper.”¹³⁸ In those cases the contractual terms may not have reflected the “real” credit exposure of the related-party lender and may not have increased the corporation’s risk of bankruptcy in the same way debt instruments issued to third parties would have. In fact, there may not have been any “real” economic essence to the transaction because shareholders were basically transferring money to themselves. The objective of these investors was to supply the corporation they held with capital without losing control over it, borrowing the money, or locking their investments. Additionally, since these transactions were merely a transfer of funds between related parties, one would expect to find that they involved little efficiency costs, other than revenue and compliance costs.¹³⁹

To deal with these dual capacity scenarios, the rules had to depend on multiple factors so as to create vagueness and deprive

134. See *supra* notes 93–100 and accompanying text.

135. Distribution of profits might have been costly for a number of reasons: perhaps because the shareholders were not subject to high marginal tax rates or because of liquidity reasons, which were quite common given the lack of a secondary market for illiquid, private, corporate assets.

136. The term related-party debt defines borrower-creditor relationships between taxpayers that are related to each other—family members, a corporation, and controlling shareholders.

137. See *supra* note 129.

138. See H. David Rosenbloom, Address, *Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt*, 26 SYDNEY L. REV. 17, 17 (2004) (examining tax treatment of related-party debt).

139. The legal label that private related parties assign to their transfer of funds should have little or no economic meaning. For example, since a controlling shareholder is considerably less likely to force its controlled corporation into bankruptcy because of its failure to pay the debt, the corporation has no enhanced risk of bankruptcy costs as a result of borrowing the debt.

sophisticated tax planners the benefit of certainty. Furthermore, in these scenarios, where the written contract offered only weak evidence of the real essence of the transaction, the attempt to distinguish between debt and equity through analogy had to fall on petty, almost smell-test distinctions, no matter how big the tax consequences were. Hence, although it may be difficult for some to admit, the doctrinal rules distinguishing debt and equity instruments probably offered an adequate solution in the context of the problems they were originally meant to solve—investments by dual capacity shareholders in closely held corporations.

Yet these rules fail miserably today because most of the corporate tax base is comprised of large public corporations that have dispersed ownership.¹⁴⁰ Those companies issue liquid instruments to a group of anonymous investors that care only about cash flow and do not care at all about directly controlling the operations of the corporation. Hybrid instruments classified as debt produce deductible payments but also impose a real efficiency cost because, like debt, they may increase corporations' bankruptcy risk.

Most importantly, in the current rate structure, it seems as though tax authorities should not care so much about the erosion of the corporate tax base by deductible interest payments as long as those interest payments are subject to federal income tax on the individual level. Therefore, tax authorities should be primarily concerned with those cases in which interest is deductible on the corporate level but untaxed on the investor level—meaning mainly when the investors are not United States residents for tax purposes.

III. FINDING SOLUTIONS THAT WORK: POLICY MAKING AND COMMON SENSE

Policy makers face two options: look for an organizing principle that prescribes what a reasonable tax system should aim to achieve in a constrained reality or avoid looking for any broad policy solution and limit their inquiry to a case-by-case analysis.¹⁴¹ Even advocates of the case-by-case analysis are pessimistic about its ability to alleviate the line-drawing problem.¹⁴² Hence, this Article turns to evaluate what an organizing principle in a constrained reality would require, while bearing in mind the shortcomings of the doctrinal approach.

140. See discussion *supra* Part II.A.

141. Strnad, *supra* note 2, at 604–05 (echoing this approach in his conclusion).

142. See *id.* at 605.

To first start analyzing how we would like to distinguish debt from equity we have to determine the relevant group of taxpayers and its characteristics. The key notion is that from a policy perspective the solution should primarily seek to resolve those questions which involve the highest social costs (e.g., costs resulting from the loss of revenue, the cost of tax distortions on the efficient allocation of resources, and compliance costs). Accordingly, while problems related to the debt–equity distinction may appear in numerous settings, the proposed solution should not necessarily seek to solve all of them, but rather only those that are the most important. As mentioned above, virtually all of today’s corporate tax revenues come from large public corporations,¹⁴³ and those corporations also claim most of the interest deductions.¹⁴⁴ Therefore, problems of distinguishing debt from equity in this group of taxpayers should be the core of the analysis.¹⁴⁵ Hence, this Article seeks to determine only those rules that should govern the characterization of instruments issued by corporations on public markets. At the same time, given that the current doctrine-based rules offer a reasonable solution in the case of private closely held corporations,¹⁴⁶ the rest of the analysis assumes these rules should continue to govern in that context.

Once the relevant group of taxpayers has been identified, it is important to examine the sources of the problem. In the context of public corporations, there are four main problems: the ability of tax planners to use financial theory to design hybrid instruments with similar cash flows but with different characterization, erosion of the corporate tax base by deductible interest payments which are not taxed on the shareholder level, the distortion these tax rules have on firms’ financial structure, and the vagueness of the rules and their enormous compliance costs. Interestingly, the rules we use today were not designed to deal with any of these problems but with problems of dual capacity that are irrelevant in the case of portfolio investors. For example, the difficulty of determining the “real transaction” exists only in a dual-capacity scenario and is completely unnecessary in the context of public corporations, where the debtor and the issuer are unrelated and the terms of issued instruments are clear and credible.

143. See *supra* note 86 and accompanying text.

144. TAX POLICY CTR., *supra* note 86, at 8 (showing that 87% of the interest deductions against corporate income are claimed by large, mostly public, corporations).

145. See Gergen & Schmitz, *supra* note 2, at 122–23; Michael S. Knoll, *An Accretion Corporate Income Tax*, 49 STAN. L. REV. 1, 43 (1996).

146. For a different type of solution, see Gibson, *supra* note 39, at 490–91.

Obviously, vagueness may still cause public corporations to take more cautious positions when issuing new financial instruments, but vagueness has its own set of social costs. Moreover, it seems likely that corporate tax planners are in a superior position relative to the IRS to exploit this vagueness to achieve favorable tax treatment. Additionally, other than compliance costs, shareholder lending in dual-capacity scenarios had little efficiency costs because of the low credit risk associated with related-party lending. This again is not the case with public corporations—where debt instruments are issued to anonymous, unrelated parties, and where the credit risk associated with these obligations is real. Therefore, the tax incentive for a leveraged financial structure in this setting results in great inefficiency costs.

After determining what the problems are, the next step is to determine what our limitations are. In this scenario, two limitations constrain our decision making. First, we cannot eliminate the debt–equity distinction, and second, we cannot eliminate the ability of taxpayers to hybridize debt and equity instruments—meaning that we can limit but not eliminate tax planners’ ability to engineer instruments with nearly equivalent cash flows that appear contractually different.

The next step is to determine, in light of the above, what policy makers’ objectives *can* and *should* be with regard to drawing the line between debt and equity in the contemporary setting. The attribute that emerges immediately is that the debt–equity distinction does not matter so much in terms of revenues when it comes to domestic shareholders.¹⁴⁷ This may be subject to change, but the likelihood that the corporate tax rate will increase is relatively low because of international tax competitive pressures.¹⁴⁸

Because interest payments are deductible, the return on the investment in corporate tax is essentially not subject to the double corporate tax regime but taxed only at the investor level. The

147. As explained above, the real effective tax rate on most equity investments is 36%, which is only slightly higher than the top marginal tax rate of 35% set for individuals. See *supra* note 107 and accompanying text. Given that most of the investments are made by wealthy individuals who are likely to face high marginal tax rates (if they are United States residents), the difference is not dramatic and may not justify the difficulty of vigorously enforcing the debt–equity distinction.

148. See Graetz, *supra* note 12, at 84–86. The real question is whether future tax increases will come in the form of higher taxes on dividends, higher income taxes, or some other fiscal instrument (most likely a value-added consumption tax). For a detailed proposal advocating a value-added tax, see Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261, 282–99 (2002).

interesting consequence is that the debt–equity distinction is mainly relevant when the investors are not subject to United States tax—meaning when they are foreigners or tax-exempt entities.¹⁴⁹ In this scenario the interest payments made by the corporation reduce their United States tax liability, but those same interest payments that would be subject to tax if they were paid to a United States person are exempt (or otherwise very lightly taxed) because they are paid to a party that is not subject to United States tax. Accordingly, it seems as though the IRS should not be worried about thin corporate capitalization¹⁵⁰ per se but should be primarily concerned with debt investment in thinly capitalized companies by foreigners and, to a lesser extent, by tax-exempt institutions or low-income taxpayers, a practice which in the United States is called earnings-stripping.¹⁵¹ Policy makers therefore have to ask whether the debt–equity distinction is the best way to deal with earnings-stripping or whether there are other, more direct, ways to deal with that problem.¹⁵²

149. See *supra* notes 114–15 and accompanying text.

150. The term “thin capitalization” refers to corporations that have a very high debt–equity ratio.

151. Individuals subject to low federal tax rates and tax-exempt institutions enjoy this status because of a conscious policy decision. The former pay low income taxes because they are assumed to have a lower ability to pay the income tax. The tax exemption of charitable institutions is typically justified by the theory that they supply otherwise underprovided public goods. See generally Ilan Benshalom, *The Dual Subsidy Theory of Charitable Deductions*, 84 IND. L.J. 1047 (2009) (discussing and criticizing the theory that the tax subsidy for charities is justified on the account that they provide otherwise undersupplied public goods). It is important to note, however, that if the marginal corporate tax rate is higher than the income tax rate of individuals, the overall transaction will result in a revenue loss to the Treasury. For example, if a corporation is subject to a marginal tax rate of 35%, and it gets to deduct \$100 due to interest payments, the interest deduction saved it \$35 in taxes. If that \$100 is paid to an individual subject to a 15% tax rate or to a tax-exempt institution subject to 0% rate, the overall transaction would result in a \$20 or \$35 loss to the Treasury. While this is a genuine problem, it is important to recognize that at its core it is not associated with the debt–equity distinction and the ability to deduct interest payments, but rather with the progressive tax system. In a progressive tax rates structure, taxpayers subject to high marginal rates will be able to deduct certain payments even if they make them to low-tax individuals who are taxed on the gains at lower rates. As long as these payments are not part of an income-shifting scheme (e.g., between family members), this is not abusive because the payments represent a real cost to the payer, and the low income tax imposed on the payee reflects its low ability to pay the tax.

152. In previous articles, I have argued for some policy solutions to the earnings-stripping problem. See Ilan Benshalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm’s Length Allocation Method*, 28 VA. TAX REV. 619, 632–45 (2009) [hereinafter Benshalom, *Taxing the Financial Income of Multinational Enterprises*] (offering a proposal for how multinational enterprises’ financial income should be allocated); Benshalom, *supra* note 2, at 193–95 (exploring the difficulties associated with taxing multinational enterprises’ financial income); Benshalom, *supra* note

However, one does not have to accept my solutions to conclude that using the debt–equity distinction as a last line of defense to problems of earnings-stripping seems to be an over-inclusive and costly alternative to dealing with this problem. If the problem of earnings-stripping is addressed directly,¹⁵³ policy makers would still be required to distinguish between debt and equity investments but may be more flexible in doing so given that the tax revenue stakes of this determination would not be so high.

If the tax revenue loss associated with the debt–equity distinction could be better addressed by other means that directly deal with the problem of earnings-stripping, the main policy objective should be to deal with the remaining problems of compliance, uncertainty, and efficiency costs.¹⁵⁴ To deal with these problems, it is important to clarify the potential political constraints in which this analysis operates. First, even if it makes no sense, some instruments, such as common stock, would be classified as equity, and others, such as short-term coupon-yielding bonds, as debt. Second, the tax treatment of those categories would be different. Third, financial engineering would allow tax planners to create a lot of in-between hybrid instruments.

These three assumptions suggest that to reduce compliance and efficiency costs we first need to establish which easy-to-observe and difficult-to-manipulate criteria would help us make the distinction. These criteria would be arbitrary because the debt–equity distinction is arbitrary. Nevertheless, they would have to be in line with what debt and equity instruments actually are. For example, although we can say, theoretically, that every financial instrument contract written on a white piece of paper is debt and every contract written on a yellow paper is stock, this position would be politically implausible.

49, at 674–700 (providing a theoretical analysis of the earnings-stripping problem and a critique of the anti-earnings-stripping arrangements adopted by the Code; this article also provides an analysis of why other mechanisms designed to tax interest income, including withholding taxes and limitation of treaty benefits clauses, are inadequate to tax interest income).

153. Earnings-stripping could be dealt with directly by eliminating or amending the portfolio interest income withholding tax exemption and by reducing the ability of foreign multinational enterprises (“MNEs”) to engage in disproportionately leveraged foreign direct investments (“FDIs”) in the United States. See Benshalom, *Taxing the Financial Income of Multinational Enterprises*, *supra* note 152, at 632–36 (offering a solution for disproportional leverage by MNEs); Benshalom, *supra* note 49, at 667–70 (explaining the problem of the portfolio interest income withholding tax exemption).

154. Christensen, *supra* note 22, at 1311–18 (suggesting that the compliance costs associated with the debt–equity distinction impose significant compliance and tax-administration costs on taxpayers, the IRS, and the courts).

Accordingly, the distinction we need to develop has to be observable and has to correspond with what the general public and their elected representatives perceive debt and equity to be. Out of the various criteria mentioned by the doctrine, two factors—voting power and duration—stand out as easily observable and intuitively correct indicators of equity investment.

Voting power is one of the only characteristics that cannot be hybridized by financial engineering. Purchasing it indicates the willingness of the investor to spend money to buy the opportunity to benefit from control of the corporation. This can be either a direct benefit, which a large institutional investor may seek, or it can be an indirect benefit—e.g., the ability to get compensated for selling the voting power in a takeover scenario—which even small portfolio investors may seek. In a world where corporations can issue hybrid debt–equity instruments, and investors can purchase synthetic debt and equity positions by buying different debt–equity and option combinations, most of the attention about financial engineering has naturally focused on the cash flow equivalence of certain positions.¹⁵⁵ Voting power, however, is something that has not been bifurcated and typically cannot be bought separately—meaning from a party other than the issuing corporation. In fact, it is the only attribute that financial engineering cannot really manipulate, that only the issuing company can sell, and which suggests a deeper potential involvement in the corporation.¹⁵⁶

Put differently, investors wishing to enjoy the benefits associated with voting power have little alternative to buying common stocks or instruments with an embedded option of purchasing common stocks. Hence, these investors are in a very different position, and, therefore, should be far less tax-sensitive, when compared to the majority of investors, which are portfolio investors interested solely in risk–cash flow positions. Unlike investors who are interested in controlling the corporation’s activities, portfolio investors can seek this position through different hybrid instruments and synthetic positions, which

155. See, e.g., Schenk, *supra* note 2, at 574 (raising the issue of cash flow equivalence in the context of equity derivatives); Strnad, *supra* note 2, at 573 (discussing cash flow equivalence for innovative financial products).

156. This, of course, is subject to change. Since corporate law is developed by states, there is a long tradition of states “engineering” corporate law investment structures that offer investors a (federal) tax advantage. The best example for this is Wyoming’s development of the LLC—a limited liability company that for tax purposes is treated as a partnership. Hence, it is not inconceivable that a similar dynamic will develop with regard to voting rights if this Article’s proposal is adopted.

may be functionally different but are almost economically identical in terms of cash flow.

Duration of a financial contract is also an important factor. It is impossible to accurately project the long-term creditworthiness of a corporate issuer. Accordingly, investors purchasing an unsecured debt instrument with a forty-year maturity date are tying their return to the corporation's business performance and are taking part of the risk typically associated with holding equity. Time, more than anything else, is a continuum, and there is no specific point where a debt instrument starts bearing the equity risk.¹⁵⁷ Given that it is all a matter of degree, any distinction would be arbitrary. Nevertheless, the timeline dividing debt and equity should be clear and be determined with reference to the policies the rules seek to promote.¹⁵⁸ For example, an attempt to reduce the bankruptcy risk associated with corporations' need to refinance their activities by rolling short-term debt may dictate that only very long-term debt instruments would be considered as equity.

To make the debt–equity distinction easier to administer, the definition of equity should include all instruments with embedded options that grant the investor the option to convert its assets into vote-holding instruments¹⁵⁹ and those instruments embedded with options (to either the investor or the issuer) for extending the time frame of the instrument. This is a somewhat crude rule, but it is necessary given that the IRS lacks a solid doctrinal or theoretical background to efficiently determine the validity of a convertible instrument. Moreover, the IRS has limited resources to commit to this costly, case-by-case enforcement endeavor.

Two examples may help clarify how this new debt–equity classification would work. In these examples, the duration period after which an instrument would be considered as equity would be ten years. Assume a corporation issues two-year bonds, which could be converted into non-voting preferred shares. The bonds carry no voting rights and would not do so even if their conversion option is exercised. However, even though the debt instrument is only issued for two years, the conversion element would provide the investors

157. Even the most short-term equity contract bears the risk of counterparty default, which essentially means that the creditor takes over the equity rights of the borrower's assets.

158. One option is to determine this clear line with reference to David Weisbach's optimal line-drawing theory. *See infra* notes 186–200 and accompanying text.

159. This means that cash-settled derivative positions would not be considered as equity.

with preferred shares, which have no maturity date until the corporation agrees to redeem them or chooses to liquidate. Accordingly, these convertible bonds should be characterized as equity investments and their proceeds should be classified as dividends.

Assume another scenario, in which the corporation issues a collateralized interest paying forward. According to the contract, investors would be required to buy stock of the corporation for a predetermined price five years from the day of the issuance. Forwards are pure financial bets and do not typically pay any proceeds until the date when the future transaction is executed. In this case, however, the issuing corporation conditions the sale of the forward on the payment of collateral. Investors are therefore required to secure the future payment for the forward contract with money paid on the day of the issuance to the issuing corporation. Since the corporation would be able to use the cash in the meantime, it would have to compensate the investors for the time value of their money and for bearing its own credit risk of default.¹⁶⁰ The question would be whether those payments should be regarded as interest payments. The main issue is that the payments coming out of the collateral and the forward contract are not independent instruments, because the collateral would not have been paid absent the forward. The forward contract to buy the corporate stock is in a sense an obligation to buy a voting common-share with an indefinite duration period. The future contract and its collateral are therefore equity, and the payments produced by the collateral should be classified as dividends.

There may be some other indicators that investors in nominal debt instruments are taking part of the equity risk—e.g., high interest rates such as in the case of junk bonds¹⁶¹ and payments that are contingent on the company's performance.¹⁶² I am not arguing that

160. This could be done through actual periodic cash payments or it could be done through deemed payments. The investors would take into account whether the collateral yields any cash payments and would discount the amount they are willing to put as collateral if the instrument would not provide them with such cash payments.

161. The term “junk bonds” refers to bonds issued by high-risk firms that pay a high rate of interest, which compensates investors for the high risk of default.

162. For such examples, see Hariton, *supra* note 74, at 522 (arguing that determining the character of a position by the risk associated with it is difficult since an entity such as a utility could issue equity that is “less risky than the senior debt of a venture corporation”); Hariton, *supra* note 71, at 771 (describing what he calls the modern approach as the approach advocated by the Treasury regulations issued, and later withdrawn, under I.R.C. § 385 (2006), which treats a payment as a return on equity if its amount varies with factors relating to the issuer's business); Schlunk, *supra* note 124, at 887–90; David V. Ceryak,

these indicators should be disregarded altogether, but only that the prime indicators of the debt-equity character should be based on either voting power or duration. Other considerations relate to the measurement of risk and may be dynamic and more costly to observe. For example, the actual way in which an instrument insulates the investor from the risks associated with the issuer's success would depend on the capital structure of the issuer and the overall nature of its business. It is impossible to weigh each of those considerations, and they are subject to change over time. These risk-related considerations should therefore be taken into account only as part of supplementary anti-abuse rules.¹⁶³ These anti-abuse rules are necessary so that taxpayers and the IRS could classify the character of the vast majority of instruments with a relatively high level of confidence, while giving the IRS a tool to counter cases of evident abuse.

To be clear, in the current state of affairs, when no effective remedy to the earnings-stripping problem has yet been adopted, the debt-equity distinction of instruments traded on public markets *should not* primarily depend on their duration and on whether they assign voting power. Adopting this Article's proposal today, when there is no adequate mechanism to deal with problems of earnings-stripping, would result in a huge, inequitable revenue loss.¹⁶⁴ However, it is important first to recognize that the assumption that the debt-equity distinction is immutable does not entail that other arrangements—such as the earnings-stripping regime—cannot be reformed. The distinction between debt and equity is an inherent part of the double corporate tax regime, which is a delicate status quo that involves many taxpayers with conflicting interests and lobbying powers.¹⁶⁵ In contrast, the earnings-stripping problem involves primarily foreign investors, so that reforming it may generate considerably less political opposition than an overall corporate tax reform.

Note, *Using Risk Analysis to Classify Junk Bonds as Equity for Federal Income Tax Purposes*, 66 IND. L.J. 273, 283–84 (1990).

163. These rules should prevent abusive “mixed deals” where shareholders are simultaneously issued pro-rata debt and equity instruments that are proportional to their holding in the corporation. While mixed deals are not abusive per se, taxpayers may construct sophisticated contractual mechanisms that effectively prevent investors from selling their debt and equity instruments separately. A general anti-abuse rule would be necessary to prevent this type of planning.

164. See I.R.C. § 163(j); see also Benshalom, *supra* note 49, at 686–700 (describing and criticizing the current earnings-stripping arrangement).

165. See Arlen & Weiss, *supra* note 3, at 328–35.

The core of the challenge is to best reconcile the need to make a distinction between debt and equity with the notion of financial equivalence of different positions. Much of the compliance costs, pricing disorders, and avoidance opportunities we face today emerge from the attempt of the current rules to defy the notion of financial equivalence. This Article offers an alternative approach, which calls for recognizing the capacity of financial engineering to attain financial equivalence by using different instruments that are taxed differently and to try to deal with it to the extent that we can do so reasonably.

Some commentators have expressed skepticism about taxpayers' actual ability to use financial innovations to substantially avoid or reduce their taxes.¹⁶⁶ Simple tax-avoidance transactions that work in theory do not necessarily work in practice.¹⁶⁷ The low availability of certain instruments (e.g., long-term options), the difficulty in mimicking issuers' credit risk (especially in light of the current crisis in the credit default swap markets), and the tendency of tax authorities to act quickly to tackle certain abusive transactions that allow such reductions,¹⁶⁸ all make it difficult for taxpayers to generate perfect substitutes to traditional debt-equity positions. This criticism may be true, and, especially in times of financial crises where taxpayers' readiness to experiment is low and when they already have plenty of losses to offset their gains, it may be difficult to see how financial innovations could be flexibly utilized to avoid taxes. It is, however, reasonable to assume that over time technology would reduce transaction costs and make financial innovation available to a wider range of taxpayers. If there is money to be made, markets will develop to increase the availability of tax-favored positions that can substitute more traditional debt-equity positions.

To deal with the long-term implications of financial-engineered substitution, policy makers should try to think about which easy-to-observe attributes are difficult to substitute via financial innovation and try to make the debt-equity distinction primarily dependent upon them. Accordingly, even if one doubts whether the debt-equity distinction and other difficulties in taxing financial instruments significantly erode the income and corporate tax bases today, one should be prepared to admit that technology may make this problem more significant in the future. Hence, it is appropriate to adopt this

166. Gergen, *supra* note 19, at 841–44; Kleinbard, *supra* note 2, at 1332–33; Weisbach, *supra* note 32, at 908.

167. Gergen, *supra* note 19, at 841–44; Kleinbard, *supra* note 2, at 1332–33; Weisbach, *supra* note 32, at 908.

168. For example, see I.R.C. §§ 1091, 1092.

Article's proposal, which identifies those difficult-to-manipulate attributes of financial instruments.

The Article does not aim to offer a panacea solution to the debt-equity distinction. As with any criteria set forward to try and consistently classify financial instruments in a non-ideal reality, the voting and duration criteria could be manipulated and avoided through tax-driven financial engineering.¹⁶⁹ While there are basically infinite avoidance opportunities, it is important to bear in mind two key notions when evaluating this Article's contribution. First, current tax law provides tax policy makers with some legal tools to confront this type of planning.¹⁷⁰ The intellectual foundations of these tools are not always rigorous, and they are very difficult to enforce comprehensively.¹⁷¹ Nevertheless, despite these difficulties, tax authorities have developed ways to partially deal with these tax avoidance problems.¹⁷² Second, one has to remember that, even though the ability to manipulate this Article's proposal raises concerns, the relevant point of reference for evaluating it is by comparing it to the rules currently governing the debt-equity distinction and to other non-ideal alternatives. As detailed in the following Part, my aim is not to provide a flawless solution in an ideal reality, but rather to offer an expedient and practical alternative in a reality in which current tax law arrangements do not seem to operate

169. For example, investors seeking equity classification can insist on having an embedded legal option in the instrument, which is legally valid but economically worthless (because it is "out of the money"). Alternatively, investors seeking debt classification can break a loan instrument into separate instruments to avoid the need for a duration extension option or to avoid having voting rights taint their entire investment as equity.

170. See generally Jeff Strnad, Commentary, *Taxing New Financial Products in a Second-Best World: Bifurcation and Integration*, 50 TAX L. REV. 545, 548 (1995) (describing a variety of approaches to taxing financial instruments); Weisbach, *supra* note 25 (advocating bifurcation as the best theoretical approach to taxing financial instruments).

171. See Strnad, *supra* note 170, at 548; Weisbach, *supra* note 25, at 492-95.

172. When there are concerns for tax avoidance, tax authorities can determine the "correct" tax result by a variety of methods. First, tax authorities can disregard worthless options. See Rev. Rul. 2003-97, 2003-2 C.B. 380 ("[I]f the characterization of an instrument or a transaction for federal income tax purposes either depends on, or could be affected by, the existence of a person's legal right or option to elect a certain course of action, the tax consequences often depend on whether the exercise (or nonexercise) of the right or option is economically compelled based on all the facts and circumstances."). Second, tax authorities can separate single hybrid positions into different positions. See Treas. Reg. § 1.446-3(f) (as amended in 1994) (explaining how notional principal amount arrangements, also known as swaps, could be bifurcated so that non-periodic payments and deemed non-periodic payments would be recognized in an appropriate manner). Lastly, tax authorities can integrate different instruments into a single position. See I.R.C. §§ 1091, 1092, 1258, 1259.

properly and in which there is no foreseeable political support for an overall reform of the corporate tax system. This Article's proposal provides a *better* solution—a solution that is clearer, more difficult to manipulate, and that results in less economic distortions.

In conclusion, policy makers need to first determine what functions the rules were meant to serve, what functions they currently fulfill, and what policy objectives they can reasonably achieve. The debt–equity distinction may be an immutable characteristic of our current tax system, but it does not follow that we need to charge it with achieving functions which may have been relevant thirty years ago but are now completely obsolete. Moreover, even though there may not be a good reason why tax law should distinguish the tax treatment of debt and equity, once tax rules contain this distinction, tax policy makers cannot disregard the revenue and huge efficiency stakes (manifested in the current economic crises) associated with the inadequacy of the debt–equity distinction. In terms of revenue, the real issue at stake involves only the category of hybrid debt instruments issued by public corporations, which are held by investors that are not subject to United States income tax. Once this is recognized, we can see that making the debt–equity distinction for many other instruments could be greatly simplified.

IV. THE DEBT–EQUITY DISTINCTION AND THE LINE-DRAWING PROBLEM

This Part explains some of the recent academic interest in the debt–equity classification. As demonstrated through the debt–equity example, tax doctrine can be messy and almost anti-intellectual because courts' reliance on lists of factors and their reluctance to prioritize them renders much of the doctrinal inquiry a “smell-test” rather than an analytical inquiry.¹⁷³ Not surprisingly, for many years academics have been unwilling to confront this issue.¹⁷⁴

Tax academics' recent writing on this topic came not because they recognized that there is a better solution, rather it came as part of the recognition that the problem is so deeply rooted in the federal

173. Another example of this type of inquiry is the “substance over form” doctrine first adopted in *Knetsch v. United States*, 364 U.S. 361, 364–66 (1960).

174. Weisbach, *supra* note 18, at 1627 (claiming that since the William Plumb summary of the case law in 1971, no academic article has addressed the subject). See generally William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971) (summarizing the law at the time with respect to the debt–equity distinction).

tax system that (politically) it is almost beyond solving.¹⁷⁵ This recognition teased out an interesting policy inquiry of how tax policy makers should best “draw the line” between debt and equity instruments when the notion of different treatment is disconnected from the underlying economic reality.

This Part draws on this literature to situate the inquiry about the debt–equity distinction within a broader theoretical context. It first explains the line-drawing problem and the highly theorized optimal line-drawing approach that is represented by David Weisbach’s work. This Article then compares, contrasts, and evaluates its own approach with the approach of the optimal line-drawing theory.

A. *The Line-Drawing Problem*

Tax law relies on legal fictions to operate.¹⁷⁶ Indeed, in many ways the teaching and studying of tax law is a process to indoctrinate new potential members into a professional community that accepts the validity of those fictions.¹⁷⁷ Unavoidable as these fictitious classifications are, the frictions they create impose enormous costs on both tax authorities and taxpayers. Taxpayers are likely to take actions to seek tax arbitrage by switching from one classification to another—especially when switching is inexpensive and the body of law regulating it is unclear and inconsistent—so that the tax savings are potentially very high.¹⁷⁸ Such manipulation obviously erodes the tax base and inequitably allocates the tax burden.¹⁷⁹ Hence, tax authorities would be inclined to develop anti-avoidance rules to try and prevent it. These rules tend to be complex and to involve high administrative, compliance, and litigation costs.¹⁸⁰ The non-viability of the doctrinal distinctions and general anti-avoidance rules, along with their substantial enforcement costs, suggest the proper endeavor is to

175. For examples of other articles that try to provide a theoretical analysis in a constrained reality in the context of the income tax treatment of financial instruments, see generally Schenk, *supra* note 2 (arguing for a partial integration approach); Schizer, *supra* note 59 (exploring the tax attributes of convertible preferred stock).

176. Such fictions include the distinctions between capital assets and ordinary assets, taxable transactions and tax-free reorganizations, and corporations and partnerships. See I.R.C. §§ 351, 368, 1001, 1221; Treas. Reg. §§ 301.7701-2, -3 (as amended in 2008).

177. See Rosenbloom, *supra* note 138, at 20–22.

178. Strnad, *supra* note 2, at 573.

179. See Weisbach, *supra* note 59, at 222–25 (making the even stronger claim that tax planning is inefficient from a macro-social perspective and should be viewed as a negative externality of some taxpayers imposing extra costs on others).

180. See I.R.C. §§ 1091–1092 (dealing with this problem—the wash-sale and straddle rules—which impose a lot of penalties and require a great amount of monitoring that is unrealistic in the case of taxpayers with complicated portfolios).

attempt to reduce the costs and distortions associated with these frictions instead of trying to eliminate them altogether.

To be precise, while it is hard to think of a fictions- and frictions-free tax system, many of the fictions currently embedded in our income tax system are wasteful and unnecessary—they could be significantly reduced by a better-designed system. However, those fictions also involve many tradeoffs, so that changing them can alter the status quo significantly—inevitably resulting in many potential winners and losers.¹⁸¹ Even if there is broad agreement that a certain fiction is harmful, these types of changes require legislative reform that could be generated only if backed by a strong political will.¹⁸² The attempt to find real-world solutions does not endorse the frictions in the Code but recognizes the need to develop solutions that would minimize those frictions in the absence of a major legislative reform.¹⁸³ Hence, this type of inquiry assumes an imperfect tax system with some embedded fictions and frictions that are politically immutable.¹⁸⁴ Put differently, the line-drawing inquiry recognizes that a certain distinction may be economically arbitrary and that every line-drawing criterion would have to be arbitrary as well. However, it also recognizes that, despite the inherent arbitrariness of the criteria set forward, it is policy makers' obligation to make the distinction in a way that reduces the associated social costs to the extent possible.

There is of course a tension between “good” tax policy and “good” line-drawing policy because the former seeks to promote a tax system with fewer problems while the latter only seeks to reduce the various symptoms of those problems. Accordingly, “good line-drawing” reduces the pressure on legislators to eliminate arbitrary distinctions in the Code. This line of objection does not directly confront the need for a better line-drawing agenda. It merely suggests that there may be considerable disagreement about whether a specific distinction should be viewed from a practical perspective as being politically immutable. However, if it is clear that the elimination of certain arbitrary tax distinctions is not going to be part of any tax reform agenda in the foreseeable future, then it is tax policy makers'

181. See generally Arlen & Weiss, *supra* note 3 (explaining why, as a matter of political economy, corporate managers benefit from the double tax on dividends).

182. See David A. Weisbach, *An Efficiency Analysis of Line-Drawing in the Tax Law*, 29 J. LEGAL STUD. 71, 73 (2000) (arguing that even the most significant major tax reform in the last three decades—the 1986 Tax Reform Act—only shifted the lines between different classifications rather than eliminated some of the harmful distinctions).

183. For examples of articles that try to find policy solutions in a second-best reality scenario, see Schenk, *supra* note 2, at 579–90; Strnad, *supra* note 170, at 553–69.

184. See, e.g., Weisbach, *supra* note 182, at 74–75.

responsibility to find ways to reduce the social costs associated with the distinction, until it is eventually reformed.

B. The Optimal Line-Drawing Approach

Arbitrary distinctions, such as the debt–equity distinction, have little if any justification for why they should be enforced but for the fact that they are “in the Code.” With this type of shaky *why*, it is no wonder that practitioners devote most of their time to questions of *how*, while academics find it more attractive to solve abstract problems with intellectually “cleaner” solutions. For the most part, thoughtful scholarly works prefer to develop general models based on simplified assumptions.¹⁸⁵ The strength of these models is also the source of their weakness, however. They rely on simplified assumptions that provide meaningful intellectual insights but often cannot help policy makers resolve actual line-drawing problems because they do not take into account nuanced features of the problems they need to resolve. This Article demonstrates that, by themselves, these models offer little guidance to policy makers. Furthermore, this Article suggests that if these models were to be made a more effective tool, they would have to be supplemented in a way that would allow them to take account of the real-world constraints in which they operate.

This Article addresses the optimal line-drawing theory as it is represented in two leading articles written by David Weisbach.¹⁸⁶ It focuses on the optimal line-drawing theory because it is the most persuasive and comprehensive theoretical approach that ties the debt–equity distinction to the more general problem of line-drawing and because it represents a broader realm of law and economic literature which highlights the importance of efficiency considerations within tax law. Those articles stipulate that certain tax classifications are, or at least should (for all practical purposes) be, perceived as fixed—even when there is no clear justification for the different tax treatments and the distortions associated with them.¹⁸⁷ Such politically fixed distinctions require policy makers to draw a line on a continuous range of transactions between these fixed points to determine the tax treatment of a specific transaction. Taxpayers, in

185. See, e.g., Weisbach, *supra* note 18, at 1649–79.

186. See generally Weisbach, *supra* note 182 (providing a model for efficient line-drawing that suggests that an item should be taxed like its closest substitute); Weisbach, *supra* note 18 (arguing that tax line-drawing should be based on the efficiency of competing rules rather than on doctrine or efficiency).

187. See, e.g., Weisbach, *supra* note 18, at 1640.

turn, observe this line-drawing and may alter their behavior when the costs associated with the change are smaller than its perceived tax advantages.¹⁸⁸

Through reference to the optimal commodity taxation literature, Weisbach advocates and models a solution that is broad, clear, and intuitively appealing.¹⁸⁹ This solution relates to those cases in which tax policy makers are constrained by difficult-to-change legislation to classify a new transaction according to two (or more) immutable and mutually exclusive categories that carry different tax consequences. Given the inevitability of the inefficiencies and inequities associated with the frictions between the immutable categories, tax policy makers are left with the obligation to minimize the damage. In this case, where no middle path is available, policy makers should first determine through positive empirical research which of the existing categories the new transaction more closely resembles. Put differently, they should determine whether the new transaction substitutes one category more than another.¹⁹⁰ After this has been determined, they should tax the transaction like its closest substitute. This would minimize the distortions associated with the “substitution effect,” which is a change in taxpayers’ behavior motivated by a tax-driven price change.¹⁹¹ By taxing the new type of transaction as its closest substitute, tax policy makers would minimize the number of taxpayers that change their behavior to seek the result of a particular tax classification.¹⁹²

The lucidity of this solution and its broad applicability are impressive. Weisbach is, however, careful to constrain his proposal. First, he observes that policy makers should avoid providing a disadvantageous tax treatment to high-elasticity transactions.¹⁹³

188. *Id.* at 1631.

189. See Weisbach, *supra* note 182, at 75; Weisbach, *supra* note 18, at 1631.

190. See discussion of MIPs *infra* notes 208–12 and accompanying text.

191. See LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS 87–90 (2008).

192. Weisbach acknowledges that doctrinal analysis could be viewed as an attempt to make such determinations in the absence of adequate empirical information but expresses skepticism about the likelihood that doctrinal criteria offer a good measure for substitution. See Weisbach, *supra* note 182, at 92.

193. These transactions are transactions in which a small increase in price may result in a huge decline in demand. Accordingly, if, as a result of the tax, these transactions are taxed too heavily, the demand for them may drop sharply and may result in a huge welfare (dead-weight) loss and a huge revenue loss. To avoid this, Weisbach concludes that “we should tax the transaction like its closest substitute (to take into account the substitution costs), but should not tax the high-elasticity transaction too much (to take into account the direct costs).” Weisbach, *supra* note 18, at 1663.

Second, he is aware that to fully evaluate his proposal one should take into account its revenue and distributional effects.¹⁹⁴ Third, he argues that tax policy makers should take into account the costs of taxpayers' attempts to avoid the rules.¹⁹⁵ Finally, and most importantly for the purposes of this paper, Weisbach acknowledges that determining the starting point for reform is very difficult.¹⁹⁶ Especially in the financial world, identifying the "true" prototypes of transactions may be difficult given the fungible nature of capital resources, the highly responsive industry of financial innovations, and the impact of taxes on the design of these instruments.¹⁹⁷ Even though Weisbach fully realizes the importance of determining the core immutable points of tax reform, he addresses this issue only in an abstract and partial manner.¹⁹⁸

Weisbach uses two examples to contextualize his optimal line-drawing analysis: the tax distinction between business entities subject to a separate corporate tax and the debt-equity distinction. With regard to the debt-equity distinction, he notes that "[d]ebt and equity are fundamentally similar methods of financing a business yet are treated differently for tax purposes"¹⁹⁹ and concludes that "we should tax a security like its closest substitute, but should be a little more

194. If a new transaction is taxed like its closest substitute and, as a result, the tax base is eroded, in order to compensate for this revenue loss, the government would have to raise other taxes. *Id.* at 1665. The efficiency gain associated with the attempt to reduce the substitution effect should be weighed against the inefficiencies associated with the taxes levied to compensate for the revenue loss. *See id.* In the same manner, if policy makers wish to attain a certain distributional outcome, they should take into account efficiency costs associated with the additional taxes and subsidies necessary to attain this distributional outcome. *Id.*; *see also* Schlunk, *supra* note 124, at 882-83 (implicitly criticizing Weisbach's theory on this point by arguing that courts apply a methodology that is akin to the one advocated by Weisbach and the optimal-commodity-tax literature of finding the closest substitute).

195. A complete assessment of efficiency considerations requires assessing all the costs incurred by private parties. These costs are inefficient from a macro-social perspective and should be weighed against the potential efficiency gains of drawing the line in one place rather than the other. Weisbach, *supra* note 18, at 1669-72 (explaining that this problem may occur in low-elasticity transactions where a tax-driven change in price will motivate only a few taxpayers to seek substitutions but for which there are substantial social costs for every taxpayer that shifts his behavior).

196. *Id.* at 1669.

197. *Id.*

198. *Id.* (providing that rather than looking at the form of a transaction, policy makers should try to determine whether taxes distort the ability of taxpayers to attain their desired risk and return).

199. Weisbach, *supra* note 32, at 893.

generous for debt than for equity [because the demand for equity is more elastic and sensitive to tax costs].”²⁰⁰

The policy justifications for taxing corporations as separate entities are shaky.²⁰¹ As a result, it is difficult to determine how normative arguments can contribute to the analysis of real-world problems.²⁰² The optimal line-drawing theory, which highlights the value of efficiency considerations, offers such normative guidance in a setting in which normative considerations seem to play little (if any) role.²⁰³ However, the assertion that we should rely on empirical research to determine whether hybrid financial instruments should be classified as debt or equity falls short of providing a meaningful solution to the problem.²⁰⁴ On the practical level, it seems unhelpful to suggest that policy makers should rely on empirical research to resolve a problem so frequently litigated.²⁰⁵ Financial innovation does not require deploying assets or special technological advancement so

200. Weisbach, *supra* note 18, at 1663. For many, this conclusion may seem surprising given Weisbach's strong, long-standing objection to the separate corporate income tax, which he regards to be an inefficient and inequitable fiscal instrument. *Id.* at 1637–38. One would think that given his firm position against the corporate tax, Weisbach would be in favor of broadening the classification of debt without any limits, which would erode the corporate tax base. However, in the context of a second-best reality, in which the separate corporate income tax exists, Weisbach argues that treating hybrid instruments that are better substitutes to equity as debt would have devastating consequences. Weisbach, *supra* note 182, at 80. Equity investors would start investing in those new hybrids, and this would “increase . . . the costs of financial distress and the reduction in tax revenues.” *Id.*

201. See discussion *supra* note 3.

202. See generally Saul Levmore, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, 136 U. PA. L. REV. 1019, 1061–65 (1988) (“Positive theories and normative values are sometimes fairly separable. This is especially, or even uniquely, true in corporate tax law where rules and decisions are almost necessarily devoid of a normative foundation and are especially arbitrary. Corporate tax law is arbitrary because, like most of American tax law, it requires a specific recognition event before it taxes appreciation in asset values and because it regards corporations as taxable entities that are distinct from their shareholders. These features are best labeled arbitrary, rather than unfair or inefficient, because it is not entirely clear that alternative rules would be any more efficient or fair. The point is not to ‘defend’ the fundamental rules of the tax system as merely arbitrary, but rather to note that because these rules are arbitrary, it is virtually impossible to develop normative arguments about questions that arise as a result or in the shadow of these basic starting points. The nature of corporate tax law often defies normative argumentation.”).

203. Most importantly, Weisbach's analysis provides an interesting and persuasive argument about how to reconcile efficiency objectives with revenue and distributional concerns in a constrained reality.

204. See *supra* notes 183–92 and accompanying text.

205. See generally Christensen, *supra* note 22 (analyzing, in light of longstanding and frequent litigation on the issue, the circuit courts of appeals' continued split over the proper standard of review of a trial court's determination of debt or equity status).

new instruments can be issued with little cost.²⁰⁶ Given the low cost of generating innovative financial instruments, it would be costly (in terms of time and resources) for taxpayers and tax authorities to provide reliable empirical data so that courts can assess the character of those instruments. The solution is rendered even more impractical given courts' questionable expertise in assessing complicated empirical data and economic research.

The optimal line-drawing theory is also problematic because, as any analysis that deals with second-best solutions, it has to commence with a conscious filtering process that determines which parts of reality it embraces and which it wishes to challenge. This process requires deciding what the acceptable limits of practical political considerations are and designating them as the boundaries of the analysis. Because these boundaries depend on dynamic human practices, there is a genuine difficulty of determining the starting point, and any determination is inherently contestable. As a second-best theory, determining the boundaries is the Archimedean point on which the optimal line-drawing theory relies.²⁰⁷ Nevertheless, this issue is not addressed at all in the optimal line-drawing theory analysis. Accordingly, to offer a viable vehicle to address real-world problems, the line-drawing theory should be refined, or rather supplemented, with a starting point that would help policy makers identify the fixed points that they should compare.

The best illustration of why the line-drawing theory is insufficient as a stand-alone theory is provided in its discussion of the debt–equity distinction and the presentation of the Monthly Income Preferred Stocks (“MIPS”) case study.²⁰⁸ MIPS were designed as instruments that would qualify as debt for tax purposes but would count as equity for other purposes—most importantly for financial accounting,²⁰⁹ credit rating, and (bank) capital adequacy regulatory purposes.²¹⁰

206. See Schlunk, *supra* note 124, at 861–62.

207. For those readers unfamiliar with the concept, an “Archimedean point” is a theoretical position from which one can objectively analyze the totality of the subject under observation. See Michael Shermer, *The Really Hard Science*, SCI. AM., Oct. 2007, at 44, 46, available at <http://www.scientificamerican.com/article.cfm?id=the-really-hard-science&ref=rss>.

208. See Weisbach, *supra* note 18, at 1673–74.

209. In May 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 150, which limited the ability to treat MIPS as equity for financial accounting purposes. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 150 app. A, at A4, A5 (2003).

210. See Gergen & Schmitz, *supra* note 2, at 141; Weisbach, *supra* note 182, at 79; Weisbach, *supra* note 18, at 1673; Robert Willens, *Are 'Maximum Contingent' Instruments Debt?*, 112 TAX NOTES 607, 607 (2006). MIPS were essentially long-term debt instruments

MIPS were an almost perfect substitute for preferred stock, which is considered equity for tax purposes, and their (tax) characterization as debt essentially eliminated the issuance of non-MIPS preferred stock (which were considered equity for tax purposes). According to the optimal line-drawing theory, the IRS should have classified MIPS as equity for tax purposes. When it instead did not challenge the classification of MIPS as debt, this classification resulted in a shift of investors from preferred stock to MIPS—a shift that led to revenue loss and an increase in their exposure to bankruptcy risk.²¹¹

Posing the question of whether MIPS are better substitutes for publicly issued preferred stocks or for publicly issued bonds overlooks that, given the changes in corporate investment practices over the last half century, preferred stocks in publicly owned companies *may not be fundamentally different from certain unsubordinated long-term bond investments*, so that the optimal line-drawing theory's basic point for comparison may not be valid.²¹² This

(typically issued for a period of more than ten years). They were “equity-flavored” because they were subordinated to the claims of all other creditors, and, because, even though the payments were fixed, issuers had a unilateral ability to defer them for extended periods, so long as no dividend payments were made. Weisbach, *supra* note 182, at 79.

211. See Weisbach, *supra* note 18, at 1673–74.

212. Preferred stock offers passive investors a fixed return from corporate profits (so that they do not have claims over the corporation's residual profit) which can be deferred. It provides investors with priority over equity shareholders in cases of liquidation and with regard to dividend payments. Owners of preferred stock generally have no voting power. The main difference between them and bondholders is that they do not have a right for the return of the principal on a designated date, or the right to compel payment even when the corporation has not generated any profits. In the case of long-term debt instruments, the right to receive the principal is heavily discounted because of the vagueness of the issuer's creditworthiness when the debt reaches maturity. For some companies, which are either especially risky or stable in their earnings, the right to compel payments only from profits may also not be of huge economic significance. In public companies with stable earnings, the fact that preferred stock has priority over dividend payments is taken into account by the secondary markets in which the instruments are traded. This means that investors could cash out their investment at no or low discount even if they could not compel payments. In the case of risky corporations, the right to compel payments only from profits is not different from the positions of many creditors. For example, many risky corporations issue “junk bonds” which are bonds that pay no coupons. Given the high risk associated with those investments the bonds are sold for much less than face value—meaning that their interest rate is very high. Investors buying these bonds are de facto in a position very similar to that of equity investors because chances are that the company would only be able to pay its debt if it is profitable. The difference between the type of risk undertaken by preferred stock and debt holders may have been significantly different when dealing with illiquid, closely held, private corporations, which were somewhat opaque to non-controlling shareholders. Accordingly, the initial characterization of preferred stock as equity made a lot of sense when made years ago. This characterization should be questioned, however, given the dramatic changes in the corporate tax base terrain—most importantly, that the corporate tax is now imposed almost exclusively upon

critique does not suggest the optimal line-drawing theory is wrong. However, it does suggest that employing a methodology that merely compares empirical data about the substitution of two instruments is not enough to provide an answer to the line-drawing problem because it lacks an Archimedean point. In the same way policy makers can ask whether MIPS are a closer substitute for debt or preferred stock, they can ask whether preferred stock is a better substitute for stock or debt. Furthermore, assuming that once MIPS have been classified as debt, when tax planners engineer a new instrument that on the debt–equity continuum lies between MIPS and preferred stock, what would be the appropriate question to ask? Would we have to check whether the new instrument is a better substitute for classic debt or equity? MIPS? Preferred stock? From an analytical perspective, there is no *a priori* reason to prefer one category of instruments over another.

By Weisbach's own account,²¹³ the optimal line-drawing theory does not seek to address the broader real-world problem associated with policy makers' difficulty in correcting their classifications as circumstances change.²¹⁴ However, to enable policy makers to use the optimal line-drawing proposal to generate sensible solutions, one first needs to provide them with a recognition rule of what should be a sensible classification. Put differently, even if for tax purposes policy makers should take as a given the necessity of distinguishing between debt and equity instruments, they should not assume that every distinction made in the past still makes sense today. Accordingly, when they come to employ the optimal line-drawing theory to determine whether a new instrument is a better substitute for debt or for equity, they should first examine the premise of whether what they are comparing could still be perceived as a relevant distinction.

public corporations. Accordingly, Weisbach's assumption that the debt–equity distinction is immutable, and thus exogenous, combines two related yet analytically different notions. First, he assumes that a certain group of investment assets in corporations should be classified as either debt or equity—meaning that there is no possibility for any third classification. Second, he seems to assume that this distinction should be based on business norms that are more than fifty years old. While the first notion is the essence of his second-best reality inquiry, the implications of his second notion are somewhat overlooked.

213. Weisbach, *supra* note 32, at 903 (admitting that his optimal line-drawing theory is not sensitive to problems of path dependency and decision making correction, but arguing that this in essence is a problem of decision making in general and not unique to line-drawing).

214. See generally Schlunk, *supra* note 124 (arguing that Weisbach's theory does not account for problems of path dependency).

C. Principles for Real-World Line-Drawing Solutions

This sub-Part extrapolates a general approach to line-drawing from this Article's inquiry of the debt-equity distinction. The attempt to derive more general conclusions is necessary to clarify this Article's contribution to policy making regarding line-drawing problems. This Article develops an approach comprised of a series of questions that tax policy makers should ask themselves upon trying to determine their policy regarding a specific line-drawing problem. Instead of proposing a new theory of line-drawing, this approach tries to meaningfully impact policy makers' decisions by identifying what should be the matters at stake—or what should be the starting point and framework of the analysis.

This Article takes the position that real-world problems like the debt-equity distinction are too important to be academically ignored because leaving them undertheorized has too many real-world costs (in terms of revenue, efficiency, and compliance). This Article should be seen as part of an ongoing academic attempt to examine how to provide a more policy-oriented approach to an admittedly disarrayed reality embedded with many non-theoretical real-world problems that tax legislation requires us to address. This attempt may require an undertaking most tax academics may not like—looking at individual, technically complicated problems. However, even though every line-drawing problem requires a specifically tailored solution, some general conclusions can be inferred regarding how to approach those issues. Therefore, the ambition is not to provide a clear-cut solution to every line-drawing problem but to develop a methodology of how line-drawing problems should be approached.

The need for this approach arises because, as the case study of the debt-equity distinction demonstrates, traditional doctrinal analysis has typically produced poor outcomes. Rather than helping policy makers create more thoughtful distinctions, the old analysis typically constrains them to a set of arbitrary tests that merely complicate the analysis, making tax planning more expensive and distortive.²¹⁵ Furthermore, tax doctrine rarely succeeds in providing comprehensive rules that prevent taxpayers from exploiting loopholes, allowing revenue leakage and the inequitable distribution of the tax burden.

Through the debt-equity framework, I introduced how such an inquiry should be approached. First, the cases that impose the highest

215. See discussion *supra* Part II.

social costs and the relevant group of taxpayers should be identified. In this context, policy makers should give special heed to the fact that many of the tax conventions were determined during an era when markets were by and large domestic and that the process of global economic integration has opened new avenues of abuse that are frequently overlooked.²¹⁶

After determining the relevant group of taxpayers and cases, the original purpose of the rules should be determined. This step is important because policy makers' analysis often suffers from unconscious path dependency—focusing on how old rules should be enforced instead of on what reasonable outcomes they should seek to promote. Then, with reference to the changing circumstances, a set of plausible objectives of what the rules can achieve should be determined. It is important to stress that there may not be any strong connection between the original objectives and those that could reasonably be pursued. Policy makers should be aware of this possible friction and try to avoid the legacy of old mistakes.

Finally, the notion that some aspects of the legislative reality are difficult to change does not mean that all related aspects of legislation are immutable. Policy makers should therefore be careful in picking their battles to try and promote changes in those areas which are likely to produce maximum benefits at minimum costs. This is important because enacting legislation to prevent avenues of abuse that involve primarily international taxpayers may generate considerably less opposition than those involving domestic taxpayers.

CONCLUSIONS

Academics engaging in inquiries of realistic tax law problems cannot offer any panacea that solves all problems across the board. Nevertheless, engaging in policy-oriented inquiries about how real-world problems should be addressed offers the middle way, allowing policy makers to simultaneously avoid both the tyranny of past follies and the futility of utopian inquiries. In the context of the debt-equity

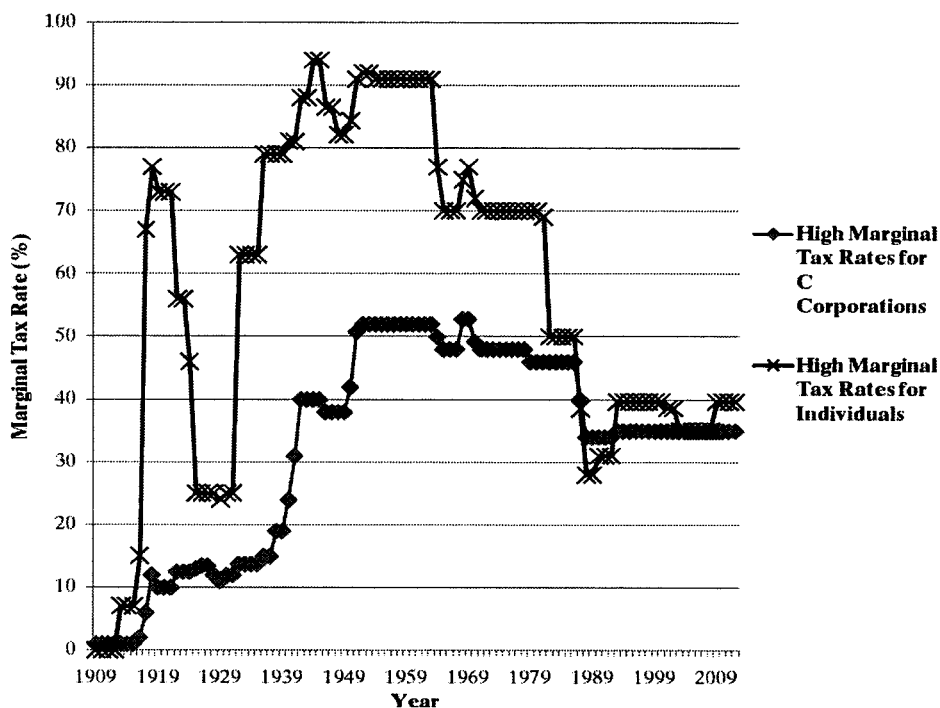
216. See, e.g., Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 455–56 (2005) (discussing the international implications of the check-the-box regulations); Weisbach, *supra* note 18, at 1628 (supporting his proposal by providing an additional example involving the check-the-box regulations that replaced the four-factor test that used to govern whether an entity should be characterized as a corporation for tax purposes—the rules resulted in an enormous simplification of the corporate tax law but had the unintended consequences of allowing multinationals to completely avoid anti-deferral legislation in international taxation and to substantially reduce their tax liability).

distinction, this Article encourages tax policy makers to take a fresh look at the potential sources of revenue loss. It claims that the problem today is not the erosion of the corporate tax base through thin capitalization. Instead, it argues that, in the context of public corporations, the revenue loss problem is a result of the low effective tax rate on debt investment of foreigners. Once policy makers recognize that this is the main problem in terms of revenue, they may recognize that there are ways to deal with it other than through the debt–equity distinction. Since the revenue costs of the debt–equity distinction in the context of individuals that are United States tax residents are much lower, much of the complexity and distortion of the debt–equity distinction would be eliminated if it were based on the two difficult-to-manipulate characteristics of voting power and duration.

This Article suggests that tax academics do not have the luxury of neglecting issues on the grounds that they are normatively unsettled or intellectually unclean. People who care about tax equity cannot just wait for the system to sort itself out via a case-by-case analysis and should not give up on creating a better system just because a perfect one is unavailable. Instead of asking how to create a flawless tax system, this Article emphasizes the need to make the existing system less imperfect.

The debt–equity distinction is a concrete example of how common sense may assist good policy-making insights, which can help refine tax law doctrines as well as law and economic models. This type of inquiry is especially relevant in the context of the income tax treatment of financial instruments where the amount of frictions, fictions, distortions, arbitrage opportunities, and compliance costs are overwhelming. The analysis of the debt–equity distinction provided by this Article is but a first step in that direction.

APPENDIX A. TOP BRACKET CORPORATE AND INDIVIDUAL
STATUTORY TAX RATES, 1909–2012²¹⁷



217. See, e.g., TAX FOUND., TAX DATA: FEDERAL CORPORATE INCOME TAX RATES, INCOME YEARS 1909–2009 (2009), <http://www.taxfoundation.org/taxdata/show/2140.html>; TAX FOUND., TAX DATA: U.S. FEDERAL INDIVIDUAL INCOME TAX RATES HISTORY 1913–2009 (2009), <http://www.taxfoundation.org/taxdata/show/151.html>; cf. OBAMA'08, BARACK OBAMA'S COMPREHENSIVE TAX PLAN 4–6 (2008), http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf (suggesting top individual income tax rates of 36% and 39.6%, and broadening of the corporate tax base).

APPENDIX B. EFFECTIVE TAX RATES ON DIFFERENT CORPORATE INVESTMENTS

After-tax returns for different corporate investments under top marginal statutory income tax rates for individuals and corporations in the years 1954, 1979, 1988, 1999, 2008, and 2010 (estimated tax rates).²¹⁸

Assumptions

	Time (years)	Annual Rate of Return				Investment (USD)
	5	0.1				10
Tax rate structure (top marginal rates)						
	1954	1979	1988	1999	2008	2010
Corporate	0.54	0.46	0.34	0.35	0.35	0.35
Individual	0.91	0.7	0.28	0.39	0.35	0.4
Individual Dividends	0.91	0.7	0.28	0.39	0.15	0.2
Individual Capital Gains	0.455	0.2	0.28	0.2	0.15	0.2
After-tax money for different investment strategies						
	1954	1979	1988	1999	2008	2010
Corporate Debt Investment	10.46	11.59	14.16	13.45	13.70	13.38
Corporate Investment Paying Dividend	10.21	10.84	12.61	12.15	13.09	12.88
Corporate Investment with Retention	11.37	12.41	12.71	12.96	13.15	12.96
			highest return			
			lowest return			



highest return

lowest return

How much greater is the strategy yielding the highest after-tax rate of return than the strategy yielding the lowest rate of return (%)?

1954	1979	1988	1999	2008	2010
658.41	287.594	159.105	160.5492	120	117.2

218. See, e.g., TAX FOUND., TAX DATA: U.S. FEDERAL INDIVIDUAL INCOME TAX RATES HISTORY 1913–2009, *supra* note 217; cf. TAX. FOUND., TAX DATA: FEDERAL CORPORATE INCOME TAX RATES, INCOME YEARS 1909–2009, *supra* note 217 (providing rates from 1909 to 2009, and providing a framework that suggests what the corporate rates for 2010 might be).

