CHOICES OF CAPITAL: REDUCING THEIR IMPACT ON TAXPAYERS AND THE GOVERNMENT

*Channing E. Brackey**

I. INTRODUCTION

Just like any raw material that a business needs to produce a finished product, all capital must be acquired for a price.[1] A simple proposition, but one that is unrecognized by the Internal Revenue Code (Code).

Instead, the Code myopically focuses on only one form of capital and allows corporations to deduct only the cost of debt — interest — as a business expense.[2] The cost of newly-issued stock, retained earnings or some hybrid form of debt and equity, very common forms of capital, are all but ignored. This is the source of tremendous problems, not only to the tax system, but also to society. At worst, the Code's bias in favor of debt must carry some blame for the 1980s wave of leveraged buyouts and corporate recapitalizations that substituted debt for equity, many of which are now falling apart in a flaming heap of "junk" bond-inspired bankruptcies. At best, the Code can be viewed as easily exploited by sophisticated financiers to produce tremendous advantages in world capital markets.

In either case, it is obvious that the Code's concept of the cost of capital has fallen far behind the times. A corporation's interest expense is rarely the amount of interest stated on its debt obligations.[3] Corporations hedge their debts with options, fu-

---

* Visiting Professor of Law, University of Pittsburgh. B.A., 1972, University of Notre Dame; J.D., 1974, Florida State University; LL.M., 1986, Georgetown University. The author is employed as a tax law specialist in the Office of the Chief Counsel of the Internal Revenue Service. The author, however, is speaking solely for himself and not for the Office of the Chief Counsel, the Internal Revenue Service or the United States Treasury Department.

1 The cost includes the cost of equity capital. Robert N. Anthony, *Recognizing the Cost of Interest on Equity*, HARV. BUS. REV., Jan.-Feb. 1982, at 91, 95-96.

2 *Id.* at 91. The general statutory provision addressing interest deductions is I.R.C. § 163 (West Supp. 1991).

3 Neither the Internal Revenue Code nor the Income Tax Regulations define interest. According to the Supreme Court, the term "do[es] not refer to some esoteric concept derived from subtle and theoretic analysis." Old Colony R.R. v. Commissioner, 284 U.S. 552, 561 (1932). Rather, the term "interest," said the Supreme Court, is well understood and needs no further definition. John Kelley Co. v. Commissioner, 326 U.S. 521, 530 (1946) (citations omitted). Nevertheless, although the

tures, interest rate swaps and the like — all transactions and financial instruments which the Code requires taxpayers to ignore in calculating interest expense.[4] In such a case, the true interest expense of the borrower is not the rate specified on the debt, but rather the converted rate plus the cost of hedging. Except for foreign credit tax purposes, the tax law does not recognize the gain or loss from liability management as interest expense.[5]

In addition, during the 1980s new financial products that hedged over $1 trillion dollars in debt, currency and stock portfolios were traded.[6] These instruments are neither debt nor equity, but hybrids of the two. Astoundingly, despite the volume and importance of these new financial products, the Code is not clear in accounting for these products. In large part, this is due to whether the products are characterized as debt because debt is the only form of capital which gives rise to a legitimate business expense. Consequently, it is necessary to determine whether any new financial product may properly be treated, in whole or part, as debt.

To change this system and to bring it in line with an international economy which fosters the creation of new financial products, commentators have proposed a new methodology of accounting for capital. The Cost of Capital Allowance (COCA) system would more accurately reflect the actual cost of capital,

Court initially concluded that "interest" equalled the rate of interest stated on a bond and not the bond's effective rate, the Court has since concluded that a bond's original issue discount is the equivalent of interest. United States v. Midland-Ross Corp., 381 U.S. 54 (1965).

4 Hedging is generally defined as any transaction entered into in the normal course of business to minimize the risks of interest rate, price or currency fluctuations with respect to current or future property, debt or obligations. I.R.C. § 1256(e) (West 1988). A debtor may hedge its borrowing and consequently convert it from a fixed to an adjustable rate. An interest rate swap agreement can be used to achieve this objective. A swap agreement allows two parties to exchange payments based on a notional principal amount. In an interest rate swap agreement, one party to the agreement can alter its fixed-rate liability on a debt instrument by agreeing to pay a floating rate to the other party to the swap agreement. In return, the party with the floating rate liability will receive a fixed-rate payment obligation. Its liability is thus converted from floating rate to a fixed rate. For an extensive discussion of swap transactions, see ANDREA S. KRAMER, TAXATION OF SECURITIES, COMMODITIES AND OPTIONS, ch. 5A (1986 & Supp. 1989).

5 Losses on financial products which alter the effective cost of borrowing, e.g., an interest rate swap, are apportioned in the same manner as interest expense. Gains on such instruments reduce the interest which is subject to apportionment provided the taxpayer identifies the financial product as a liability hedge. Temp. Treas. Reg. § 1.861-9T(b)(6) (as amended in 1989).

6 Henry T.C. Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 337 (1990).

with the ultimate effect of reducing a corporation's tax liability, regardless of the kind of capital the corporation holds.[7] Instead of a company deducting only its interest expense, as is currently allowed, the COCA system would permit a tax deduction based on a percentage of all of the company's capital, whether it be stock, debt, retained earnings or any of the myriad of new financial products. The COCA deduction would be equal to the product of the firm's capital and a statutorily determined rate.[8] The proposal is alleged to be a simple system which would remove the Code's bias in favor of debt.[9]

Clearly, the COCA proposal will improve the present system. But it will not be as simple a system as its proponents expect. For instance, a firm's capital for COCA purposes will not equal the sum of its debt, equity, retained earnings and other financial products, as COCA proponents suggest.[10] Instead, tax policy will require that certain items be excluded from capital when a firm calculates its COCA deduction. Moreover, the COCA rate, i.e., the percentage by which a firm's capital is multiplied to determine its COCA deduction, will have to be adjusted annually if COCA is to be revenue neutral. The COCA system proponents do not anticipate this element, which will complicate the system's administration. More importantly, the COCA proposal will not entirely resolve the problem with the Code's handling of debt. The COCA system will not eliminate the tax distinction between debt and equity because the system promotes the retention of earnings. Because retained earnings are part of a corporation's total capital, corporations which retain their earnings will receive a tax benefit via an increased COCA deduction. In addition, the proposal will not eliminate the tax benefit of debt. A corporation will still be able to reduce the taxes levied against itself and its shareholders by borrowing to purchase its own stock. The redemption can increase the remaining shareholder's return on equity.

II. The Current Problem

Because interest is deductible, there is an advantage to any business that issues debt instead of stock to raise capital. Yet investors often want more than just debt. Thus, the financial wiz-

---

[7] Edward D. Kleinbard, *Beyond Good and Evil Debt (And Debt Hedges): A Cost of Capital Allowance System*, 67 Taxes 943, 955 (1989).

[8] *Id.* at 957-58.

[9] *Id.* at 957.

[10] *Id.*

ards on Wall Street are constantly cooking up elaborate new financial products that contain a bit of debt and a dash of equity.[11] These hybrids, which can take some pretty exotic forms, are designed to raise capital while preserving the interest deduction.[12]

Under the current system, when a hybrid debt-equity product is issued, the Internal Revenue Service (IRS) has to scramble to decide whether the new product is debt, equity or both.[13] The determination of what portion of an instrument is debt, what portion is equity and what portion is something else, e.g., an option, is difficult.[14] The IRS has been unable to provide clear rules

---

[11] For a discussion of the long-term trends in corporate financing, see ROBERT A. TAGGART, SECULAR PATTERNS IN THE FINANCING OF CORPORATIONS (1981).

[12] Examples of financial instruments which do not fit neatly within the molds of debt or equity are Adjustable Rate Convertible Notes (ARCNs) and notional principal amount contracts. For a discussion of ARCNs, *see* Rev. Rul. 83-98, 1983-2 C.B. 40. For a description of notional principal contracts, *see* Kleinbard, *supra* note 7, at 944 n.3. A comprehensive discussion of notional principal contracts tax treatment is provided in Note, *Tax Treatment of Notional Principal Contracts*, 103 HARV. L. REV. 1951 (1990).

[13] Periodic payments made with respect to an instrument are deductible as interest under the Code. I.R.C. § 163 (West Supp. 1991). Whether an instrument is debt or equity for federal income tax purposes depends on the facts and circumstances of each case. John Kelley Co. v. Commissioner, 326 U.S. 521 (1941). No particular fact is conclusive in making this determination. *Id.* At least thirty-eight factors have been considered by the courts when classifying an instrument as debt or equity. Robert S. Holzman, *The Interest-Dividend Guidelines*, 47 TAXES 4 (1969).

An underlying principle in the debt-equity cases was stated by the Court of Appeals for the Second Circuit in Commissioner v. O.P.P. Holding Corp., 76 F.2d 11 (2d Cir. 1935). There the court stated that the material distinction between the shareholder and the creditor is that

> [t]he shareholder is an adventurer in the corporate business; he takes the risk, and profits from success. The creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives.

O.P.P. Holding Corp., 76 F.2d at 12. This view ignores that the creditor is also an adventurer in the corporate business. If the corporation does not have sufficient revenue, the creditor will not be paid. Witness the experience of the creditors of the many failed savings and loans.

Not all instruments are structured as debt. Corporate holders of instruments prefer to hold stock to receive the dividends-received deduction. *See infra* notes 71 & 73 and accompanying text for a discussion of the dividends-received deduction. In addition, stock, but not debt, may be received tax-free under certain reorganization provisions. I.R.C. § 354(a) (West Supp. 1991). Finally, premium and discount are not created on the issuance of stock.

[14] *See* William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 370-71 (1971) (the Supreme Court and Congress have declined to tackle this issue, the latter instead delegating the task to the Treasury Department).

on how to characterize such instruments.[15] Consequently, the issue must be resolved on a case by case basis, with the IRS levying a tax in some instances, but not in others. This haphazard approach undoubtedly results in a loss of revenue to the federal government.

One way to resolve the debt-equity distinction problem would be to draw a line in the sand and define debt. For tax purposes, the IRS could allow deductions for instruments which provide unconditionally for a return of principal and the payment of interest at a fixed rate or an adjustable rate based on an objective interest index.[16] The interest payments would be required on a specified date or dates. Under this definition, anything else would not be treated as debt.[17]

While this methodology has the benefit of distinguishing between debt and equity to clearly identify what portion of payments will be deductible as interest expense, it is lacking in several respects. First, it does not alter the premise that only interest is a legitimate cost of capital. Second, the definition would raise the cost of capital by excluding some instruments which are currently treated as debt. Third, it has as a premise that the cost of debt is the amount paid to the creditor. The actual cost, by contrast, includes the price of any hedging instruments that the company has purchased to reduce its debt exposure.

---

[15] Section 385 of the Code authorizes the Treasury to prescribe regulations to determine whether an instrument is debt, equity or part debt and part equity. I.R.C. § 385(a) (West Supp. 1991). Section 385 regulations were enacted on December 31, 1980. T.D. 7747, 1981-1 C.B. 141. The effective date of the regulations was delayed, however, and the regulations were withdrawn on August 5, 1983. T.D. 7920, 1983-2 C.B. 69.

[16] Section 1275-5(b) of the Proposed Income Tax Regulations defines an "objective interest index" as:

> (1) A rate which, as of the issue date of the debt instrument, is made known publicly and offered currently to unrelated borrowers in private lending transactions by a financial institution, or
>
> (2) A rate reflecting an average (based on a statistically significant sample) of current yields on a class of publicly traded debt instruments.

Prop. Treas. Reg. § 1.1275-5(b), 51 Fed. Reg. 12094 (1986). Examples of objective interest indices include designated financial institution's prime rates and the London Interbank Offered Rate (LIBOR).

The IRS could supplement this regulation with an *in terrorem* regulation. This regulation would provide that taxpayers who classify instruments incorrectly would be bound by the characterization at the option of the IRS. The IRS would be free to impose a different characterization for the holder and issuer in those cases where instruments are improperly characterized.

[17] Note, however, that instruments excluded under this definition would not necessarily be considered equity instruments.

These three shortcomings are serious. Economically, the tax distinction between debt and equity is unfounded.[18] Clarifying what is debt and what is equity does not alleviate the tax distinction but makes the distinction more critical than before. As more financial products are created and traded, it is apparent that a firm's capital consists of more than its debt, and that the cost of capital should consist of more than the firm's interest expense.

If the suggested limited definition of debt is implemented, some financial products which are now taxed as debt will no longer be considered such. As a result, more taxes will be collected from corporations. Any proposal which increases federal revenues must be received warmly, given the federal budget deficit. If additional federal revenue is to be raised from corporations, however, it should not be raised by increasing the cost of new capital.[19] Such measures may result in less investment and

---

18 Each financing method has a cost. Anthony, *supra* note 1, at 91. The cost of debt is the interest which the corporation must pay to the debt holder, adjusted by the gains and losses on financial instruments used to manage the debt. For example, if bonds are issued by the corporation at a premium, excluding any portion which is attributable to a conversion feature, the premium reduces the interest expense stated in the debt instrument. The premium, excluding the portion attributable to the conversion feature, must be prorated or amortized over the life of the bond. Treas. Reg. § 1.61-12(c)(2) (1991). If the bonds are issued by the corporation at a discount, the discount increases the interest expense which is stated in the debt instrument. The discount is deductible over the life of the bonds unless certain exceptions apply. I.R.C. § 163(e), (f), (i) (West Supp. 1991).

Because the cost of a firm's new equity is not deductible, the cost of new equity is the return expected by a firm's shareholders (r) divided by 1 minus the firm's marginal tax rate (t), or r/(1-t). The cost of retained earnings is less than the cost of new equity because earnings which are retained are not taxed at the shareholder level. Thus, the shareholders receive a deferral of taxation and do not require as great a distribution in order to receive the return which is expected.

In addition, the cost is reduced further because the retained earnings are reflected in the increase in the value of the stock, which is taxed at a capital gain rate when the stock is sold rather than the higher ordinary income rate for dividends. For expressions of the cost of retained earnings and the cost of new equity, see MERVYN KING, PUBLIC POLICY AND THE CORPORATION 235-40 (1977) and Alan J. Auerbach, *Wealth Maximization and the Cost of Capital*, 93 Q.J. ECON. 433, 442.

A firm's market capitalization rate is the return expected by its shareholders over the next year and equals the expected dividend per share plus the expected price appreciation per share, both of which are divided by the price of the equity at the start of the year. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 49 (3d ed. 1988).

19 The cost of capital is the full cost of hiring or renting a capital good, taking into account depreciation, interest, inflation and taxes. An increase in taxes reduces the capital which can be invested to produce revenue. If there is less investment, the nation's economy will not sustain its growth rate. This in turn will slow the growth in the national standard of living.

This decline may be exacerbated if the increase in the cost of capital results in less use of technology and a greater use of labor. A greater use of labor will result eventually less growth in national productivity.[20]

Ideally, a corporation should be able to account for its capital costs so that its taxable income can be accurately determined.[21] Included within the cost of a corporation's capital would be the cost of equity, newly-issued stock, retained earnings and the cost of debt adjusted by the gains or losses from liability management tools. The cost of equity could be determined in a number of ways. For example, the corporation could be allowed a deduction for any dividends it paid. This deduction would accurately reflect the decrease in the corporation's net worth occasioned by the payment. Consequently, the corporation's taxable income would be accounted for properly. Moreover, the corporate deduction for the dividend payment would be offset when the corporation's shareholders accounted for the receipt of the dividend.[22] The deduction would, however, result in partial integration of corporate and shareholder levels of tax and a substantial loss of revenue.[23] In addition, the dividends-paid deduction

---

in fewer dollars being available for investment because corporations will have greater labor costs. The increased income for the labor force may not spur further investment because individuals invest less than corporations.

If a greater use of labor results in additional individual income, government revenue would increase. But it is conceivable that the increased cost of capital would result in fewer high-paid employees to operate or manage the technology that was not purchased or maintained. In such a case, federal revenue would be adversely affected and would offset the revenue derived by increasing the cost of capital.

20 From an environmental standpoint, such a result may be welcome. The national standard of living may ultimately be reduced if capitalism impedes the replenishment of renewable natural resources.

21 Some of its capital costs should be excluded in calculating the firm's taxable income. *See infra* notes 32-56 and accompanying text.

22 There would not be a matching of the amount. Some of the shareholders would be corporations entitled to the dividends-received deduction. These corporate shareholders would be able to exclude, at a minimum, 70% of the dividend-received. I.R.C. § 243(a) (West Supp. 1991).

23 Other forms of integration have been proposed and debated. Double taxation of distributions of corporate earnings can be eliminated or reduced under several methods. Corporations could be taxed like partnerships or could be given a deduction for the dividends they paid. Alternatively, instead of eliminating the corporate tax, the shareholder tax could be eliminated by giving shareholders a tax credit for their share of corporate taxes paid. For a summary of these proposals, see Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717 (1981).

As this article was being prepared for publication, the U.S. Department of Treasury issued a report concerning the integration of the individual and corporate tax systems. The report defines four integration prototypes and calls for a debate on the desiribility of integration. While not in response to the report, this article, which examines the COCA system, will hopefully contribute to the debate.

would not address how investors should be taxed.[24]

III. The COCA System Alternative

A proposed alternative to tax integration, dubbed the Cost of Capital Allowance (COCA) system, diminishes the distinction between debt and equity. The COCA deduction would be an amount equal to a firm's capital multiplied by a revenue neutral statutory rate.[25] Because the allowance would be based on a firm's total capital, debt and equity would be treated similarly. No deduction would be allowed for interest expense, nor would gain or loss from liability management tools be recognized.[26]

Proponents of the COCA system allege that it can be structured to be revenue neutral and that the system eliminates the distinction between debt and equity.[27] Consequently, firms will be indifferent about how they are capitalized. In addition, COCA's advocates argue that the proposal does not increase the cost of new capital.[28] Moreover, it is alleged that the COCA system reflects the true cost of a corporation's capital more accurately than the present system, which only allows a deduction for interest expense.[29] Finally, its supporters claim that the COCA system would provide a systematic means for taxing new financial products which hedge corporate liabilities.[30] Thus, the COCA system would allegedly cure each of the shortcomings of the current regime for accounting for the cost of capital.

Under the proposed method, a corporation's capital would equal the monthly average of its assets over the course of the

---

24 The COCA proposal repeals the dividends-received deduction, but does not otherwise alter how taxpayers are taxed on corporate distributions.

25 If the allowance is based on a firm's average cost of debt, it should be based on the weighted average of its pre-tax cost of debt. The cost of a firm's equity cannot be calculated reliably. Equity, however, generally costs more than debt. This is because there is a risk premium for equity capital of approximately two to four percent. In addition, the cost of equity is non-deductible.

26 Gain or loss on liability management tools would not be recognized because the gains or losses, as hedges, offset the firm's interest expense. All of a firm's hedging instruments would presumably be liability management tools, unless the taxpayer identified the instrument when acquired as associated with its assets. *See* Temp. Treas. Reg. § 1.861-9T(b)(6) (as amended in 1989); Kleinbard, *supra* note 7, at 959.

27 Kleinbard, *supra* note 7, at 960. A distinction between debt and equity would still exist for investors, although, under the COCA scheme, the dividends-received deduction would be repealed.

28 *See, e.g.*, George N. Hatsopoulos, et al., Overconsumption: The Challenge to U.S. Economic Policy 16 (Am. Business Conference 1989).

29 *Id.*

30 Kleinbard, *supra* note 7, at 961.

fiscal year.[31] This definition of capital has the advantage of inclusiveness. Because all of a corporation's assets are included in the definition of capital, it is not necessary to distinguish between the debt and equity instruments of a corporation.

This inclusive definition of capital under COCA, however, is also its defect. This section examines the impact which COCA's definition of capital has on various tax provisions.

A. *Current Liabilities*

For accounting purposes, capital refers to a corporation's equity. For financial purposes, capital refers to a corporation's equity and long term debt.[32] Excluded from both of these definitions are a corporation's current liabilities, e.g., accrued income taxes, accounts payable, and short term debt. Except for the purpose of calculating a corporation's foreign tax credit or a corporation's alternative minimum tax, federal income taxes are not

---

[31] Using the monthly average of a corporation's capital will prevent a firm from artificially increasing its COCA by obtaining an artificial infusion of capital. That is, a corporation will not be able to borrow a stated sum near the end of the period for which COCA will be calculated, repay it shortly after the calculation of the COCA and receive a COCA deduction in excess of its interest cost.

For example, a firm might borrow $1,000,000 at a ten percent interest rate on December 15 of a given year. If the COCA rate were just one-half of the interest rate, the portion of the firm's COCA deduction attributable to the debt would cover the interest expense on the loan for six months. If the firm repays the loan prior to six months, it will have received the benefit of a deduction for a cost which it did not incur. (The portion of the cost it did not incur depends on when it repays the loan.)

If a firm's capital is based on its average throughout the year rather than its year-end amount, the COCA deduction will be more accurately calculated. For instance, if COCA is based only on the capital a firm has held for the entire taxable year, a firm could obtain an infusion of equity during the middle of its tax year, but receive no COCA deduction for it. Its cost of capital would not be reflected accurately. Similarly, a firm which suffers a large loss at the end of the year and a corresponding decrease in shareholder's equity would not receive the full COCA deduction it would receive if its COCA was calculated based on the average of its capital for each month of the year. Finally, basing a firm's COCA deduction on a monthly calculation of its capital rather than a yearly calculation will result in the firm having more flexibility in choosing when to dispose of its capital without losing the benefit of a portion of its COCA.

In the case of asset valuation for purposes of interest allocation, the income tax regulations provide for a yearly computation. Temp. Treas. Reg. § 1.861-9T(g)(2)(i) (as amended in 1989). If yearly valuation would result in distortion, however, calculation using a method which would clearly reflect asset values is required. *Id.*

Because the debit and credit sides of the balance sheet must balance, that is net to zero, it does not matter which side is used.

[32] Accounting terms and methods need not be adopted for tax purposes. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979).

taken into account in determining a corporation's taxable income.[33] If the COCA system's definition of capital includes a corporation's accrued income taxes, then a partial deduction will be provided for a corporation's federal income taxes. If federal income taxes were the only item excluded from the definition of capital for purposes of COCA, then perhaps this deviation from income tax policy could be permitted for the sake of simplicity. There are other items, however, which should be excluded from the COCA system's definition of capital.

To the extent that businesses do not pay interest on current liabilities, such liabilities should not be included in their capital for determining the COCA deduction. That is, if the COCA deduction is to replace the cost of debt and equity, liabilities which do not have a cost should not be included when calculating the deduction. This conclusion recognizes that some liabilities do not have an express interest component, e.g., accrued employees' compensation, and allows a deduction only when interest is stated or when debt is discounted.[34]

If the COCA system is to be revenue neutral, defining capital to include all current liabilities will result in capital intensive firms receiving less of a COCA deduction than they would if the definition excludes current liabilities on which there is no interest charge.[35] But, if current liabilities that have no interest charge are not considered a component of a firm's capital, firms will have an incentive to have a minimum interest charge on such liabilities. For instance, a firm could benefit by agreeing to pay an interest charge on its accounts payable.[36] Because the govern-

---

[33] For foreign tax credit purposes, a corporation may take, as a credit against its United States income tax, the lesser of the United States tax imposed on its foreign source income or the foreign tax imposed on such income. I.R.C. §§ 27, 901, 904 (West Supp. 1991). The credit is provided to prevent a United States taxpayer from being taxed twice on the same income. It is not designed as a deduction to determine what the taxpayer's taxable income is.

[34] This conclusion also recognizes that although no current obligation to pay a dividend exists with respect to stock, the shareholders of a corporation have a claim on a corporation's retained earnings. Thus, it is not illogical to exclude debt on which there is no interest charge, yet to include equity.

[35] If COCA is revenue neutral, firms with a greater percentage of accounts payable as part of their liabilities and shareholders' equity will receive a larger COCA deduction than a more capital intensive firm, i.e., a firm with more funds committed to capital investments and with a smaller percentage of accounts payable.

[36] By way of example, assume a firm has $1,000 of accounts payable. Interest is charged at the rate of 4% if paid within 30 days, and 10% if paid after 30 days. The taxpayer pays its accounts payable on the 30th day, but accrues additional accounts payable so that it maintains a balance throughout the year of $1,000. Its interest expense for the year is $40. If the COCA rate is 5%, the firm will receive a COCA

ment would be paying, in effect, the interest in the form of a COCA allowance to the corporation, the definition of capital could be modified to exclude any liability that bears a rate of interest that is less than the COCA rate.[37]

This rule however, carries too high a cost because it continues the current necessity to distinguish between debt and equity.[38] Moreover, the rule is inconsistent with the COCA system's premise that the cost of all debt and equity should be recognized.

B. Straddles

The capital of a firm may consist of offsetting positions with respect to actively traded property, i.e., straddles.[39] Loss on one of these positions is recognized only to the extent that gain is recognized on an offsetting position.[40] In addition to disallowing losses on straddles which are not offset, the Code disallows the deduction of interest expense and other carrying charges allocable to actively traded personal property which is part of a straddle.[41] The charges are disallowed to prevent taxpayers from reducing their taxable income by entering into transactions which lack substance because there is no economic risk.

When the property is sold, however, the interest expense and other carrying charges are added to the basis of the property for which the charges were incurred. Thus, there is a matching

deduction of $50, which is equal to the increase each month in the firm's capital times the COCA rate. Thus, under COCA's definition of capital the firm would have an additional $10 deduction than would exist under current taxing schemes.

37 Not only will circumvention be deterred by excluding from the definition of capital any liability which bears a rate of interest that is less than the COCA rate, but because liabilities such as these would carry a minimal interest charge, a firm's COCA deduction will be more accurately calculated if they are excluded from capital.

38 For instance, common stock bears no interest charge, yet should be included as part of a firm's capital. Should preferred stock, which pays a fixed dividend, be treated like common stock or debt if it pays a dividend which is less than the COCA rate? For its part, the Internal Revenue Service has decided to treat Dutch Auction Preferred Stock as equity. Rev. Rul. 90-27, 1990-1 C.B. 50, 51.

39 A taxpayer holds a straddle "if there is a substantial diminution of a taxpayers risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind)". I.R.C. § 1092(c) (West Supp. 1991).

40 I.R.C. § 1092(a)(1)(A) (West Supp. 1991).

41 I.R.C. § 263(g)(1) (West Supp. 1991). Such charges are disallowed to the extent they exceed the sum of the dividends and interest income or interest equivalent income allocable to the personal property. I.R.C. § 263(g)(2) (West Supp. 1991).

of expense and recognition of income, if any.[42] This matching policy should be continued after the COCA system is implemented. To the extent that capital is used to purchase personal property which is part of a straddle, it should not be included in the COCA calculation.

C. *Section 263A*

Matching of income and expenses is also required by section 263A of the Code. Section 263A provides that the direct and indirect costs allocable to inventory, real property and tangible personal property produced by the firm may not be currently deducted.[43] Interest is among the costs required to be capitalized.[44] Replacement of the interest deduction with the COCA deduction should not alter this fundamental concept of accounting. To clearly reflect the income of a firm, the COCA deduction attributable to the tangible personal property produced by the taxpayer and to the property used to produce such property should be added to the adjusted basis of such property.[45] If income from the property is accounted for during the tax year, then such property should be included as part of the firm's capital. If such property is not included, then the COCA calculation should be made without regard to it.

---

42 Because the transaction is a straddle, there may be minimal gain. Moreover, because the COCA rate will most likely be less than the taxpayer's cost of borrowing, the taxpayer's interest expense will exceed the COCA allowance. Consequently, a taxpayer will have no tax incentive to enter into a straddle transaction.

43 I.R.C. § 263A(a), (b) (West Supp. 1991). In the case of inventory, the costs must be included in the cost of inventory. § 263A(a)(1)(A). With respect to the other property to which section 263A is applicable, the costs must be capitalized. § 263A(a)(1)(B). Capitalized costs are recovered through depreciation, amortization or as an adjustment to basis when the property is used, sold or disposed of by the taxpayer.

44 Interest is required to be capitalized if it is paid or incurred during the property production period and is allocable to real property or tangible personal property produced by the taxpayer and which has: (i) a long useful life, (ii) an estimated production period exceeding two years, or (iii) an estimated production period exceeding one year and a cost exceeding $1,000,000. I.R.C. § 263A(f)(1) (West Supp. 1991). Interest must also be capitalized when it is allocable to property used to produce such property. I.R.C. § 263A(f)(3) (West Supp. 1991).

45 Section 263A(f)(2) of the Code provides the rules for allocating interest. To the extent that debt is specifically attributable to property, interest on the debt is allocated to the property. If the taxpayer has additional debt, the interest on such debt is allocated to property produced by the taxpayer to the extent that interest expense could be reduced if the production expenditures had not been incurred. Temp. Treas. Reg. § 1.263A-1T(b)(2)(iv)(B)-(D) (1987).

D. *Passive Activity Losses*

Section 469 of the Code, also a timing provision, suspends the deduction of passive activity losses to the extent that the losses exceed passive activity income for the year.[46] As a result, taxpayers are prevented from sheltering their salary and portfolio income gleaned from passive activity.[47] A portion of passive activity losses may consist of the interest expense which is allocable to the passive activity. If interest expense is suspended, the debt or portion thereof to which it is attributable should be excluded from the calculation of COCA if the full impact of the passive activity rules is to be retained.[48]

E. *Tax Exempt Income*

Section 265(a)(2) of the Code disallows the deduction of interest on indebtedness to the extent it is allocable to tax-exempt income.[49] Without section 265, a firm could profit by deducting the interest expense incurred from borrowing to purchase tax-exempt bonds. But for the deduction of interest expense, the transaction would not be profitable.

The implementation of the COCA system will reduce, but not eliminate, the need for section 265. Because the COCA rate will generally be less than a firm's cost of debt, the differential between the tax-exempt interest rate and the cost of the firm's debt will have to decrease in order for the firm to profit by borrowing to purchase tax-exempt securities.

Currently, under the "purpose test," it is necessary to show that debt was incurred or continued for the purpose of purchasing tax-exempt securities. A firm which is entirely equity fi-

---

46 I.R.C. § 469(d) (West Supp. 1991).

47 Passive activity is any activity involving "the conduct of any trade or business, and in which the taxpayer does not materially participate." I.R.C. § 469(c)(1) (West Supp. 1991).

48 Rules for identifying the interest component of a passive activity loss are contained in Temp. Treas. Reg. § 1.861-9T(c)(4)(ii) (as amended in 1989). Sections 263(g), 263A, 265 and 469 of the Code, among others, contain rules for disallowing the deduction of interest expense. Before the interest expense is disallowed, debt must be allocated to a specific activity. The methods of allocation differ depending on the Code section involved. It is suggested that the allocation of COCA be based on the fungibility of money. Thus, unless debt was secured by particular property, a taxpayer's debt would be allocated to a taxpayer's property in proportion to its value. Consequently, if a taxpayer owned tax-exempt bonds and was indebted, a portion of the taxpayer's interest expense would not be deductible regardless of whether the debt was incurred or continued to acquire or carry the bonds.

49 I.R.C. § 265(a)(2) (West Supp. 1991).

nanced will have incurred no debt for the purpose of purchasing tax-exempt bonds. On its face it would appear that such a firm should be entitled to its full COCA deduction. Under the COCA system, however, the equity financed firm is no different than the firm which is financed primarily by debt. If the financing is of equal value, each firm should be entitled to the same COCA deduction. If each acquires tax-exempt bonds with capital acquired or continued for the purpose of purchasing tax-exempt bonds, the COCA deduction allowed to each should be the same, regardless of whether debt or equity is used to purchase the tax exempt bonds.

A question remains, however, as to whether the purpose test can be applied to retained earnings. Clearly, a firm's objective in earning income is not for the purpose of acquiring tax-exempt bonds. Earning income is an end in and of itself. Thus, section 265 should not apply to tax-exempt bonds purchased with retained earnings. Nonetheless, the policy of section 265 is good and should be continued. Therefore, for purposes of calculating the COCA deduction, a corporation should not be allowed to include any debt or equity carried or acquired for the purpose of purchasing tax-exempt bonds.

F. *Prepaid Expenses*

Prepaid expenses may also result in an inaccurate representation of a firm's capital. For accounting purposes, when a firm prepays expenses, the amount of its cash, an asset on the balance sheet, is reduced; but the amount recorded as prepaid expenses, also an asset, is increased. For the recipient of the funds, cash is increased, and a liability, unearned income, is created or increased. The effect of these accounting procedures is to maintain the payor's capital and to increase the recipient's capital, and concurrently the recipient's liabilities, during the period the income is unearned. Consequently, when expenses are prepaid aggregate corporate capital is artificially increased.

If the COCA deduction is viewed in isolation, the government is adversely affected because of the decrease in taxable income.[50] To prevent this, either the firm which prepaid its expenses should be precluded from including the prepaid ex-

---

50 Note that prepayment will not affect the government's revenue as much if the COCA deduction is based on a firm's capital at the end of the year rather than on an average of a firm's monthly capital. This is because the recipient will adjust its records at the end of the accounting period to reflect the portion of the unearned income which has been earned.

penses in its COCA computation, or the recipient must be prevented from including the unearned income as part of its capital.[51] If viewed in a larger context, however, the government is not adversely affected by the impact of prepaid expenses on a company's COCA deduction. An accrual basis payor is disallowed a deduction for expenses that are prepaid until such times as the expenses are incurred, while the accrual basis recipient of the unearned income must include the payments in income.[52] Because the corporate income tax rate typically will exceed the COCA rate, absent hyperinflation, the government will benefit from prepayments of expenses because the corporate tax liability on the recipient's increased income will offset the COCA deduction. Accordingly, prepayment of expenses should not be discouraged by excluding either prepaid expenses or unearned income from COCA's definition of capital.

G. *Affiliated Groups and Financial Institutions*

There are two types of taxpayers for whom the definition of capital will have to be modified: affiliated groups and financial institutions. An affiliated group should be treated as a single taxpayer for COCA purposes. Section 1504 defines an affiliated group as one or more chains of includible corporations which are connected through eighty percent voting stock and equity ownership by a common parent corporation, which is itself an includible corporation.[53] The group's capital would consist of the sum

---

51 In determining whether the capital of the payor or recipient should be subject to a special rule, one should consider whether there will be more payors or recipients who will utilize COCA. If more recipients will utilize COCA, then their capital should not be increased upon the receipt of unearned income for the simple reason that COCA must be revenue neutral in order to be enacted. Similarly, if payors are in the majority, then the payors should be subject to the special rule.

52 Section 461(h) of the Code provides that, except with respect to recurring items, the all events test is not satisfied for an accrual basis payor until economic performance occurs. I.R.C. § 461(h) (West Supp. 1991). An accrual basis recipient of unearned income must account for it when it is earned. Schlude v. Commissioner, 372 U.S. 128, 137 (1963). *Cf.* Prop. Treas. Reg. § 1.446-3(e)(1), (3), 56 Fed. Reg. 31350 (1991) (An accrual basis taxpayer who is a party to a notional principal contract must account for non-periodic payments received as they economically accrue).

53 I.R.C. § 1504(a)(1)-(2) (West Supp. 1991). An includible corporation is defined in section 1504(b) of the Code. Certain corporations may not be members of the affiliated group for purposes of filing a consolidated return. Among these corporations are foreign corporations, insurance companies and section 936 corporations. I.R.C. § 1504(b) (West Supp. 1991). They are excluded because they are subject to different rules of taxation than the typical corporation. Because these excluded corporations do not join in the filing of a consolidated return, their interest expense is deductible only with respect to their income. With respect to the

of the capital of each of its members, with the exception that neither stock nor debt of one member held by another would be counted. If a corporation ceased to be a member of the group during the year, its capital would be included as part of the affiliated group for the portion of the year it was affiliated. Thereafter, the corporation would be entitled to its own COCA deduction, based upon its capital balance for the remainder of the year.[54]

Excluded from the group would be financial corporations.[55] These corporations would be excluded because of the necessity to define capital differently. Financial institutions show profits or losses depending upon the spread that exists between the weighted average interest rate on the loans they have made and the weighted average interest rate on their borrowings. Consequently, a financial institution's income is not accurately reflected unless the financial institution is allowed to deduct its interest expense from its interest income. The COCA deduction to which a firm is entitled, however, will not necessarily equal its interest expense. In fact, for firms with large debt-to-equity ratios, the COCA deduction to which they will be entitled will be less than their interest expense. Accordingly, COCA should not apply to a financial institution's debt or liability management tools.[56]

IV. Determining the COCA Rate

Defining the COCA rate, a statutory figure, is critical to the proposed system. The COCA rate can be a rate equal to a firm's average pre-tax cost of debt, a weighted average cost of capital for all firms or a rate tied to the applicable federal rate (AFR).

---

determination of the foreign tax credit of an affiliated group, however, these corporations are included to accurately determine the allocation of the affiliated group's interest expense. Temp. Treas. Reg. § 1.861-11T(b)(1), (d)(1)-(4), (d)(6) (1988). In determining the allocation of an affiliated group's COCA deduction, a similar rule should be applied.

54 For example, if the corporation was unaffiliated for one-half of the year, its COCA deduction would be only one-half of the COCA deduction it would have received if it had been unaffiliated for the entire year.

55 Financial corporations are defined to include banks, domestic building and loan associations, and savings and loan (and similar) associations which engage in business with other than their customers or entities related to the financial corporation, and which are required by law to operate separately from other non-financial institutions. Temp. Treas. Reg. § 1.861-11T(d)(4)(ii) (1988).

56 If banks are allowed to engage in non-banking activities, those activities should be segregated and the bank allowed a COCA deduction for such activities.

Whatever method is chosen, the rate can be designed to be revenue neutral.

A. *Using the Pre-tax Cost of Debt*

The advantage of using a firm's pre-tax cost of debt is that the cost closely approximates the firm's actual cost of capital, which is the weighted average of the after-tax debt and equity costs.[57] This is advantageous because COCA will not provide an advantage to the more credit-worthy firms.[58] Every firm will be able to deduct a specified percentage of its cost of capital.

If the COCA deduction, however, is to be based on a firm's average pre-tax interest cost, and every firm is permitted to deduct 100% of its cost of capital, the corporate tax rate would have to be increased to offset the loss of revenue which would occur as a result of COCA.

For example, assume X Corporation has $100,000 of debt, $100,000 of equity and an internal rate of return equal to 15%. Further, assume X's pre-tax debt cost is 10% and its gross income is $30,000. Using the pre-tax cost of debt definition, X's deduction would equal $20,000 and its taxable income would be $10,000.[59] To receive the $6,800 in corporate tax it would have received prior to COCA,[60] the government must impose a 68% rate of tax. If X's debt-to-equity ratio is less than 1:1, then a higher tax rate must be imposed. If X's debt-to-equity ratio is 0.735:1, the corporate tax rate would have to be increased to 73.19%, other variables remaining constant.[61]

Allowing an equity capital deduction equal to a firm's pre-tax cost of borrowing would result in government revenue loss even if corporate tax rates were increased. This is because the corporation is entitled to other deductions. These deductions, in addi-

57 Robert N. Anthony, *Equity Interest — Its Time Has Come*, J. OF ACCT., Dec. 1982, at 76, 82. This approach has been implicitly adopted, in CAPITALIZATION OF INTEREST COST, Financial Accounting Standards Statement of No. 34 (Fin. Accounting Standards Bd. 1979).

58 To the extent that credit-worthiness and debt-to-equity ratios are related, however, COCA could encourage firms to have high ratios.

59 X's total capital ($100,000 debt + $100,000 equity) times X's pre-tax debt cost (10%) yields a COCA deduction of $20,000 (assuming that 100% deduction of cost of capital is allowed).

60 Based on a corporate tax rate of 34% and assuming no other deductions, gross income ($30,000) less interest costs ($100,000 x 0.10) yields a tax liability of $6,800.

61 Debt-to-equity ratios may be calculated using current liabilities and long-term liabilities or only long-term liabilities. The value of equity may be its book value or its value as adjusted for inflation. BREALEY & MYERS, *supra* note 18, at 318-19.

tion to COCA, would result in little or no corporate income subject to tax.[62]

Moreover, basing the COCA deduction on a firm's average pre-tax cost of interest would enable taxpayers to avoid taxes. A firm would have an incentive to agree to pay a higher interest rate than could have been negotiated in an arms-length transaction. Further, the lower the firm's debt-to-equity ratio, the greater the tax incentive to pay a higher interest rate. Although a COCA-based scheme could provide the IRS with sufficient authority to police borrowing transactions, this authority would be useful only in cases in which the taxpayer clearly agreed to an excess interest charge. In most instances it would be difficult, if not impossible, for the IRS to determine if a taxpayer agreed to pay several basis points more for a loan. Yet, for a large corporation, those few basis points would add up to substantial corporate taxes avoided and, for the IRS, substantial revenue lost.

B. *Using a Weighted Average Rate*

To avoid the tax manipulation which could result from basing the COCA calculation on a firm's pre-tax cost of borrowing, the COCA rate could be calculated based on the most recent debt-to-equity ratios and the most recent lending rates. A rate calculated in this manner has the benefit of being applied to firms which have no debt, i.e., no pre-tax cost of borrowing.

Because the COCA rate would, in effect, be a weighted average of the cost of capital, those firms with a cost of capital less than the weighted average would be able to deduct a greater percentage of their cost of capital than those firms with a higher cost of capital. Thus, this rate would benefit the more credit-worthy firm. In addition, a firm with higher costs of capital, i.e., with a larger interest expense, will receive a smaller COCA deduction in subsequent years because its additional interest expense will prevent it from accumulating as much capital as a similar firm with a lesser interest expense.

A COCA rate based on current debt-to-equity ratios and interest rates may have to be calculated annually because of the

---

62 An alternative to using a corporation's pre-tax cost of borrowing is to allow every corporation to use its pre-tax rate for borrowing, but only for a specified percentage of its capital. This alternative has the advantage of tying the COCA deduction to a firm's cost of borrowing. In addition, for the COCA system to be revenue neutral, the percentage of capital can be adjusted so that the corporate income tax rate would not have to be increased.

difficulty of calculating the rate on a more frequent basis.[63] Frequent adjustments of the COCA rate may be difficult because of the difficulty of acquiring the current ratios and rates. A calculation on an annual basis is also problematic. While a firm's actual cost of capital might increase during the year due to market changes, the COCA rate would lag behind because it is determined by the prior year's figures. Consequently, the firm would not receive as large a deduction as it should. Conversely, if market rates declined the firm would receive a larger deduction than it merits.

C. *Using a Federal Rate*

Instead of basing the COCA rate on current debt-to-equity ratios and interest rates, the COCA rate could be tied to a federal rate. The federal rate could be determined from the federal interest rates for short-, mid- and long-term federal securities, with a weighted average based on the current mix of all corporations' publicly-held debt. The benefit of such a rate is that the rate would change in tandem with the typical corporation's actual cost of capital because a corporation generally borrows at an interest rate higher than the rate the government pays.[64]

A major disadvantage of basing the COCA rate on the proposed federal rate is that the COCA rate would not account for the different costs of capital for different corporations. Firms with lower costs of capital would receive the same COCA deduction as firms with higher costs of capital, even though the firms are similar in every other way. Thus, more credit-worthy firms would benefit more if the COCA rate is tied to a federal rate, than if the COCA rate is based on debt-to-equity ratios and interest rates.

To the extent that credit-worthiness is related to a firm's debt-to-equity ratio, tying the COCA rate to a federal securities-based rate would provide an incentive for firms to reduce their

[63] *But see*, Kleinbard, *supra* note 7, at 959. Alternatively, instead of using a weighted average based on the current mix of all corporations' publicly-held debt, the weighted average could be based on a mix of securities which would encourage long-term investment and research. These objectives can be furthered by lowering the cost of capital and treating equity and debt the same. Because the COCA system treats debt and equity the same, the first step is accomplished. Lowering the cost of capital could be achieved by including more long-term bonds in the mix of securities, without lowering the percentage of capital to which the mix applied. The provision would not be revenue neutral, however.

[64] To remain revenue neutral, the weighted average rate would have to be multiplied by a percentage of the corporation's capital.

debt with no corresponding reduction in the firm's tax deductions.[65] In any event, there would be no tax incentive for being highly leveraged.[66] An additional benefit of tying the COCA rate to the federal rate is that the rate can be applied to all firms, even those which have no debt, i.e., no pre-tax cost of borrowing. Further, the rate cannot be manipulated as can a COCA rate based on a firm's pre-tax cost of borrowing. Because it has all the benefits of a COCA rate based on current debt-to-equity ratios and interest rates, plus the benefit of adjusting with a firm's actual cost of borrowing, the federal securities-based rate should be used to calculate the COCA rate.

V. WHO GETS THE COCA DEDUCTION?

Another issue which must be addressed in the proposed COCA system is the type of business entities entitled to receive a COCA deduction. COCA should not apply to individuals or entities that are not treated as subchapter C-corporations.[67] Otherwise, it would be necessary to determine for each business, e.g., sole proprietorship, partnership, or S-corporation, whether the business was overcapitalized because individuals could place their personal assets within the framework of their businesses to receive a larger COCA deduction. In effect, these individuals would obtain the benefit of a partial interest deduction without having paid any interest or any corporate level tax on interest income.[68] Moreover, the cost of an individual's capital is what he could have earned on the capital in the market if he had not utilized it in his business. Thus, no deduction should be allowed because the taxpayer is not required to include in income the same amount, i.e., the potential, but unrealized, income.

COCA should not apply to regulated investment companies (RICs), real estate investment trusts (REITs) or real estate mort-

[65] Credit-worthiness and debt-to-equity ratios are not inextricably bound. A firm with a reliable income flow sufficient to cover its debt cost may be more credit worthy than another firm with no debt but with an unproven income stream.

[66] A disadvantage of providing an incentive for a corporation to reduce its debt is the loss of government revenue which could be collected from the corporation's creditors. Substitution of equity for debt will not increase a corporation's tax because the corporation will be entitled to the same COCA deduction.

[67] For a description of the characteristics of a corporation for tax purposes, see Treas. Reg. § 301.7701-2 (as amended in 1989). *See also* I.R.C. § 7704 (West Supp. 1991).

[68] A deduction for personal interest is generally disallowed under the Code. I.R.C. § 63(h) (West Supp. 1991). This provision would be circumvented with respect to personal assets placed within a business.

gage investment conduits (REMICs).[69] None of these entities is taxed if their income is passed through to the shareholders. Because Congress does not want to tax these entities unless they retain their income, COCA should not apply to them. The dividends-paid deduction and the interest deduction more accurately reflect the taxable income of these entities.[70]

VI. THE IMPACT OF COCA

A. *The Dividends-Received Deduction*

If X Corporation "invests" in Y Corporation by loaning Y $100,000 and by purchasing $100,000 of Y Corporation stock, why should the interest received by X on the loan be treated any differently than the dividends? Whether the "investor" is entitled to a fixed stream of payments or is entitled to payments from the earnings and profits of the corporation, after creditors have been paid, does not provide a reason to treat the income differently.

The distinction is warranted because of the current disparate treatment under the Code of debt and equity. The interest payments by Y Corporation are deductible, whereas the dividends paid are not. Because of the non-deductibility of dividends and

---

69 A REIT is broadly defined as an entity which garners most of its gross income from real estate investments and transactions. *See* I.R.C. § 856 (West Supp. 1991). A REMIC is an entity which is permitted to hold pools of mortgages and to issue multiple classes of interests. I.R.C. § 860D(a) (West Supp. 1991). They are not subject to tax. I.R.C. § 860A(a) (West Supp. 1991). Rather, income is allocated to the holders of the interests in the REIT. I.R.C. § 860A(b) (West Supp. 1991).

Included within the definition of a RIC are corporations or trusts registered under the Investment Company Act of 1940 as management companies or unit investment trusts. I.R.C. § 851(a)(1) (West Supp. 1991). Also included are common trust funds maintained by a bank and certain companies established prior to 1936 that are exempt from registration. I.R.C. § 851(a)(2) (West Supp. 1991). Most of a RIC's gross income must be derived from dividends, interest, payments with respect to securities loans and gains from securities transactions. I.R.C. § 851(b)(2) (West Supp. 1991).

70 A RIC is not taxed if it distributes 90% of its investment company taxable income and 90% of the excess of its tax-exempt interest income over any interest expense disallowed by section 265. I.R.C. § 852(a)(1) (West Supp. 1991). The RIC is taxed on any net capital gain which it does not distribute. I.R.C. § 852(b)(3)(A) (West Supp. 1991). REITs are not taxed if they pass their income through to their members, except to the extent the dividend is attributable to net income from foreclosure property or to the extent income is derived from prohibited transactions. I.R.C. §§ 857(b)(2)(B), (d); 857(b)(4); 856(b)(6) (West Supp. 1991); *see also* I.R.C. § 857 (b)(5) (West Supp. 1991). REMICs are not taxed except on certain prohibited transactions, income from foreclosure property and gains on distributions of property with respect to any regular or residual interest. I.R.C. §§ 860F(a)(1), 860G(c) and 860F(c) (West Supp. 1991).

the separate taxation of a corporation and its shareholders, dividend income is substantially reduced as it is distributed from one corporation to another, unless the dividends-received deduction is applicable.[71]

The greater the percentage of ownership that one corporation has of another, the greater the reason to allow a dividends-received deduction. When the ownership is 100%, a parent and a subsidiary may be considered as a single economic unit and may be treated as if the subsidiary is a branch of the parent. When the percentage of ownership is less than 100%, a portion of the income will not remain in the economic unit, but will be distributed to minority shareholders. When dividends are received from members of an affiliated group, a deduction of 100% is allowed.[72] For corporations which are not affiliated, the deduction is less than 100%.[73]

The Internal Revenue Code permits the filing of consolidated returns by affiliated corporations when an 80% value and control test is satisfied.[74] Although 80% is an arbitrary value, it is sufficiently high to regard two or more corporations as a single economic unit. This standard has been deemed appropriate for excluding any inter-company income of the affiliated group from taxation. It is the standard which is currently utilized for eliminating 100% of the dividends received from members of the affiliated group from consolidated taxable income.[75] COCA does

71 Generally, the dividends-received deduction provides the receiving corporation with a deduction ranging from 70% to 100% of the amount received. I.R.C. § 243(a) (West Supp. 1991). The dividends-received deduction ameliorates the impact of corporate taxation of multiple levels of corporations.

72 Corporations that elect to file a consolidated return are economically treated as one entity which is taxed only on income received from outside the group. In addition, the income and losses of the affiliated corporations are netted against each other. Affiliated corporations that do not elect to file a consolidated return do not receive this tax treatment. They may elect, however, to receive the 100% dividends-received deduction. I.R.C. § 243(b) (West Supp. 1991). If the dividends-received deduction is repealed for corporations which own 80% or more of the stock of other corporations, but which do not elect to file consolidated returns, more corporations will elect to file consolidated returns. As a result, not only will dividends not be included in income, but other intercompany income will be excluded as well. Consequently, there will be a revenue loss with respect to these corporations.

73 A corporation that is not entitled to a 100% dividends-received deduction is entitled to either an 80% or a 70% deduction depending on the degree to which it controls the corporation paying the dividend. I.R.C. § 243(a)(1), (c) (West Supp. 1991). This deduction may be reduced to the extent that the stock holding is financed with debt. I.R.C. § 264A(a) (West Supp. 1991).

74 I.R.C. § 1504(a)(2) (West Supp. 1991).

75 Although a corporation may own 80% of another corporation, it is not enti-

not require alteration of the 80% standard.[76] If this standard is continued, the inter-company income of affiliated corporations will not be affected by the implementation of COCA.[77]

With respect to dividends received by a corporation from non-affiliated corporations, the impact of COCA will depend upon whether the dividends-received deduction is retained.[78] If the dividends-received deduction is repealed, corporations that previously took the 80% deduction will be more adversely affected than corporations that had obtained a 70% dividends-received deduction. For every dividend dollar it receives, the corporation that was entitled to an 80% dividends-received deduction will have to take into income ten cents more than a corporation that was entitled to the 70% dividends-received deduction. Consequently, with the repeal of the dividends-received deduction, corporations approaching the 80% ownership requirement for affiliation, without achieving it, will be treated

---

tled to a 100% dividends-received deduction unless the dividend is received from a member of its affiliated group or is received by a small business investment company operating under the Small Business Investment Act of 1958. I.R.C. § 243(a)(2), (3) (West Supp. 1991). Not all corporations are eligible to be members of an affiliated group, and the Code specifies which corporations may be members of an affiliated group for purposes of the dividends-received deduction. I.R.C. § 243(b)(2), 1504 (West Supp. 1991).

76 Regardless whether or not the COCA system is implemented, the definition of an affiliated group for purposes of the 100% dividends-received deduction should be modified. Foreign corporations may not be members of an affiliated group. I.R.C. § 1504(b)(3) (West Supp. 1991). There may be valid reasons for not allowing such corporations to file a consolidated return, e.g., to prevent a foreign corporation from utilizing its foreign source losses to offset U.S. source income of affiliated members. These reasons, however, do not justify preventing foreign corporations which are 80% owned by domestic corporations from being treated as members of an affiliated group for purposes of the 100% dividends-received deduction with respect to dividends attributable to income effectively connected with the United States. Because these dividends are subject to multiple levels of U.S. tax, because the degree of affiliation required for a 100% dividends-received deduction exists, and because the paying corporation will not receive a COCA deduction, the recipient of the dividends should be entitled to a 100% dividends-received deduction.

77 Of course, to the extent that the COCA deduction is less than the interest deduction, an affiliated group's pre-COCA consolidated taxable income will differ from its consolidated taxable income after COCA.

78 If the deduction is eliminated, the impact of COCA will depend upon the COCA rate, a corporation's capital structure and the amount of dividends received by the corporation. Corporations with COCA deductions which exceed the interest deduction they would have received without COCA will be able to offset the additional dividend income for which they must now account. If the difference between the COCA deduction and the interest deduction exceeds the additional dividend income, then the implementation of COCA and the repeal of the dividends-received deduction will be beneficial from the corporation's viewpoint.

the same as corporations which own only one percent of other corporations.

Nevertheless, if debt and equity are to be treated similarly for tax purposes, the dividends-received deduction should be repealed. Otherwise, a tax preference for equity will exist and COCA will not achieve one of its objectives of eliminating the need to determine whether an instrument is debt or equity.[79] Conversely, if the dividends-received deduction is not allowed, income of a corporation will be subject to more than one level of corporate tax.[80] This concern is minimized, however, because COCA allows a deduction for capital invested in stock, regardless of whether dividends are received. No additional deduction is warranted when dividends are received. Moreover, for corporations which are a single economic unit, e.g., affiliated groups, repeal of the dividends-received deduction will not result in multiple levels of corporate tax with respect to dividends received from affiliated corporations.

If the dividends-received deduction is repealed when the COCA system is implemented, a corporation which receives a dividend from a non-affiliated corporation will assume a portion of the tax burden of the corporation which pays the dividend. This is because prior to COCA, the paying corporation is entitled to no deduction for a dividend it pays to another corporation. For tax purposes, its equity capital has no cost. A corporation which receives a dividend, however, receives the benefit of a dividends-received deduction. Conversely, after COCA is instituted, the paying corporation will be entitled to a deduction for the capital contributed by the receiving corporation, but the receiving corporation will no longer be entitled to a deduction for dividends received. For example, assume that a parent corporation's

[79] There still remains the difficulty of defining stock. Under section 1504, a parent corporation must have at least 80% of the value and voting power of its subsidiary. A financial instrument or instruments satisfying the value and voting requirements would seem to qualify as stock. Consider a firm, however, which owns ordinary common stock that provides it with 75% of the value and 80% of the voting power of its subsidiary. The common stock does not equal 80% of the value of the subsidiary because the subsidiary has issued a financial instrument that is labeled preferred stock but that has many attributes of debt. If the instrument labeled preferred stock is equity, the taxpayer is entitled to the 100% dividends-received deduction. If it is not, the taxpayer does not qualify. Because a taxpayer wants to qualify, however, the corporation will have an incentive to create instruments which the IRS will classify as equity.

[80] The dividends-received deduction does not prevent multiple taxation. It only reduces the rate of taxation by excluding from income a portion of dividends received.

capital consists of $100,000 of debt and $100,000 of equity. Assume further that interest on the debt accrues at ten percent per annum and that the corporation contributes $100,000 to a non-affiliated corporation. The parent earns $20,000 from its business and the subsidiary also earns $20,000, which is distributed to the parent corporation. Prior to COCA, the parent is entitled to an 80% dividends-received deduction of $16,000 plus an interest deduction of $10,000. The parent's taxable income thus is $14,000, while the taxable income of the subsidiary is $20,000. After COCA is implemented, the taxable income of the parent, based on a revenue neutral 8.66% COCA rate, will increase to $22,666 and the taxable income of the subsidiary will decrease to $11,333.[81]

This shifting of tax burdens is not reason enough to retain the dividends-received deduction. The equity of the paying corporation has a cost for which it should receive a deduction. The dividend received by the recipient corporation should be accounted for, just as all other income is recognized. Implementation of the COCA system, with a concurrent elimination of the dividends-received deduction, results in a clearer reflection of the taxable incomes of the two corporations. Therefore, with the system in place, the dividends-received deduction should be disallowed and only dividends received from affiliated corporations should be excluded from income.

B. *Elimination of Preference for Debt over Equity*

It is questionable whether the COCA system can be structured to eliminate a tax preference for debt or equity. On its face, equality can be achieved by allowing a deduction to a corporation equal to a stated percentage of the corporation's capital. If the percentage is ten percent, a firm with capital of $1,000,000 will receive a COCA of $100,000, regardless of how much of the capital is debt or equity. Thus, it would appear that the COCA deduction will not depend upon the capital structure of the firm.

Nevertheless, a firm's value is related to the firm's net income.[82] That is, the more a firm earns and has to pay to shareholders, the greater its value. A firm that retains its earnings will have more capital and will receive a larger COCA deduction in

---

[81] The COCA rate of 8.66% was chosen so that COCA would be revenue neutral with respect to the corporate taxes of these two corporations.

[82] *See* BREALEY & MYERS, *supra* note 18, at 63-64.

> The value of a business is usually computed as the discounted value of free cash flows out to a valuation horizon (H), plus the forecasted val-

succeeding years than a firm that is similar in all other respects but which distributes its earnings. The COCA system provides a tax incentive for firms to retain their earnings.[83]

Example one compares two firms which operate under a COCA system. The firms have the same amount of capital in year one. Because Corporation X distributes its earnings, however, X's capital in year two is less than Corporation Y, which retained its earnings. Consequently, X's COCA deduction is less in year two. Moreover, the after-tax earnings of the shareholders of Corporation Y are greater than the after-tax earnings of Corporation X shareholders because Corporation Y receives a larger COCA deduction in year two than Corporation X, and because the inversion of tax rates does not outweigh the tax benefit that Corporation Y receives by retaining its earnings.

EXAMPLE 1

CORPORATION X

	YEAR ONE	
Contributed Equity:	$100,000	
Retained Earnings:	$100,000	
Debt:	$100,000	
Interest Rate:	10%	
Internal Rate of Return:	10%	
COCA Rate:	3.33%[84]	
Gross Income:	$30,000	($300,000 x 10%)
COCA Allowance:	$10,000	($300,000 x 3.33%)
Taxable Income:	$20,000	($30,000 - $10,000)
Corporate Tax:	$6,800	($20,000 x 34%)[85]

ues of the business at the horizon, also discounted back to present value. . . .

Valuation horizons are often chosen arbitrarily. . . .

Id.

Free cash flow is cash which is not retained nor reinvested in the business. Thus, free cash flow equals revenue minus costs and investment. *Id.* at 59.

83 Firms try to minimize all taxes paid on corporate income, including personal income taxes. Consequently, an objective is to arrange the firm's capital structure so that after-tax income is maximized. *Id.* at 413. Currently, a firm can maximize after-tax income by distributing earnings and issuing debt. Although the COCA system provides firms with a tax incentive to retain earnings, this incentive will be diminished by the tax disincentive created by the inversion of the corporate and individual rates of tax.

84 This figure is based on the average debt-to-equity ratio and interest rate if and when COCA is instituted. It is assumed that the average debt-to-equity ratio and interest rate are the same as Corporation X's. The actual rate is 3.333333% but is expressed as 3.33%.

85 I.R.C. § 11 (West 1991).

Earnings Available to Shareholders:	$13,200	($20,000 - $6,800)
Tax on Earnings Distributed:	$4,092[86]	($13,200 x 31%)
Net Earnings to Shareholders:	$9,108	($13,200 - $4,092)
	YEAR TWO	
Contributed Equity:	$100,000	
Retained Earnings:	$100,000	
Debt:	$100,000	
Interest Rate:	10%	
Internal Rate of Return:	10%	
COCA Rate:	3.33%[87]	
Gross Income:	$30,000	($300,000 x 10%)
COCA Allowance:	$10,000	($300,000 x 3.33%)
Taxable Income:	$20,000	($30,000 - $10,000)
Corporate Tax:	$6,800	($20,000 x 34%)
Current Earnings Available to Shareholders:	$13,200	($20,000 - $6,800)
Tax on Earnings Distributed:	$4,092[88]	($13,200 x 31%)
Net Earnings to Shareholders:	$9,108	($13,200 - $4,092)
After-tax Shareholder Income on Year One Distribution:	$628	($9,108 x 6.9%)[89]
Total to Shareholders:	$18,844	($9,108 + $9,108 + 628)

CORPORATION Y

	YEAR ONE	
Contributed Equity:	$100,000	
Retained Earnings:	$100,000	
Debt:	$100,000	
Interest Rate:	10%	
Internal Rate of Return:	10%	
COCA Rate:	3.33%[90]	
Gross Income:	$30,000	($300,000 x 10%)
COCA Allowance:	$10,000	($300,000 x 3.33%)
Taxable Income:	$20,000	($30,000 - $10,000)

[86] The income is taxed at a 31% rate. There is no dividends-received deduction. In order to maximize the return to the shareholders when earnings are distributed, it is assumed that no shareholders are corporations.

[87] See *supra* note 84.

[88] See *supra* note 86.

[89] *Id.* It is assumed the shareholders receive a 10 percent return on the year one distribution.

[90] See *supra* note 84.

Corporate Tax:	$6,800	($20,000 x 34%)
Current Earnings Available to Shareholders:	$13,200	($20,000 - $6,800)
	YEAR TWO	
Contributed Equity:	$100,000	
Retained Earnings:	$113,200	($100,000 + $13,200)
Debt:	$100,000	
Interest Rate:	10%	
Internal Rate of Return:	10%	
COCA Rate:	3.33%[91]	
Gross Income:	$31,320	($313,200 x 10%)
COCA Allowance:	$10,440	($313,200 x 3.33%)
Taxable Income:	$20,880	($31,320 - $10,440)
Corporate Tax:	$7,099	($20,880 x 34%)
Cumulative Earnings Available to Shareholders:	$27,421	($13,200 + $14,221)
Tax on Earnings Distributed:	$8,501[92]	($27,421 x 31%)
Net Earnings to Shareholders:	$18,920	($27,421 - $8,501)
Total to Shareholders:	$18,920	($27,421 - $8,501)

Currently, a firm can increase its after-tax earnings by increasing its debt and redeeming its equity because the cost of the debt is tax deductible, but the cost of the equity is not. Although COCA will eliminate the tax preference for debt over equity, there will still be a financial preference for debt among firms which operate at a profit. This is because the firm can increase its market capitalization rate by redeeming stock and issuing debt.[93] Moreover, a lender's rate of return is fixed and therefore, a firm which expects to grow will benefit from borrowing instead of issuing new stock and sharing unlimited appreciation with the new investor.[94] Therefore, COCA should not result in a large reduction in the amount of debt which firms generally carry.

---

91 *Id.*

92 See *supra* note 86.

93 If the firm operates at a profit, the yield on its borrowings will exceed the cost of its debt. As long as the firm receives this yield, additional borrowing or a reduction in equity will increase the return on equity.

94 A firm which anticipates such growth will attempt to price its stock so that firm value is not shifted from old shareholders to new shareholders. If management is aware of favorable information which is not available to the market, however, investors may be unwilling to purchase stock at an inflated price which reflects management's expected increase in firm value. Consequently, some firms which want to issue equity will have to issue debt instead.

C. *Revenue Neutrality*

Proponents of the COCA system allege that if the COCA deduction for corporations is based on debt-to-equity ratios and interest rates, then COCA will be revenue neutral.[95] For instance, if the market value of debt issued by nonfinancial corporations is 70% of the market value of the equity issued by such corporations, debt comprises 41.18% of their total capital. If the cost of the debt averages 11% and all of the debt is deductible, then COCA proponents allege that a COCA rate of 4.5% (11% times 41.18%) may be implemented without any government loss of revenue. Factors in addition to debt-to-equity ratios and interest rates, however, will determine whether the proposed system is revenue neutral.

The amount of corporate and personal taxes collected by the government depends on the aggregate capital structures of firms. In the first year in which the COCA system is instituted, the taxes collected from firms will not differ from the taxes collected prior to COCA, assuming the COCA rate is based on current debt-to-equity ratios and current interest rates. Thereafter, the pre-COCA taxes which would have been collected will not differ from the taxes collected with the COCA system only if: (1) the debt-to-equity ratio and the average interest rate remain the same; and (2) if the capital held by firms prior to COCA is the same amount as is held after COCA is implemented.

Example 2 demonstrates this principle.

EXAMPLE 2

CORPORATION X (PRE-COCA)

	Year One	
Contributed Equity:	$100,000	
Retained Earnings:	$100,000	
Debt:	$160,000	
Interest Rate:	10%	
Internal Rate of Return:	15%	
Gross Income:	$54,000	($360,000 x 15%)
Taxable Income	$38,000	($54,000 - $16,000)
Corporate Tax:	$12,920	($38,000 x 34%)
After-tax Earnings:	$25,080	($38,000 - $12,920)
	YEAR TWO	
Contributed Equity:	$100,000	

95 HATSOPOULOS, *supra* note 28, at 16.

Retained Earnings:	$113,600[96]	
Debt:	$170,880	
Interest Rate:	10%	
Internal Rate of Return:	15%	
Gross Income:	$57,672	($384,480 x 15%)
Taxable Income:	$40,584	($57,672 - $17,088)
Corporate Tax:	$13,799	($40,584 x 34%)
After-tax Earnings:	$26,785	($40,584 - $13,799)
	YEAR THREE	
Contributed Equity:	$100,000	
Retained Earnings:	$128,481[97]	
Debt:	$182,784	
Interest Rate:	10%	
Internal Rate of Return:	15%	
Gross Income:	$61,690	($411,265 x 15%)
Taxable Income:	$43,412	($61,690 - $18,278)
Corporate Tax:	$14,760	($43,412 x 34%)
After-tax Earnings:	$28,652	($43,412 - $14,760)

CORPORATION Y (COCA)

	YEAR ONE	
Contributed Equity:	$100,000	
Retained Earnings:	$100,000	
Debt:	$160,000	
Interest Rate:	10%	
Internal Rate of Return:	15%	
COCA Rate:	4.4%[98]	
COCA Allowance:	$16,000	($360,000 x 4.44%)
Gross Income:	$54,000	($360,000 x 15%)
Taxable Income	$38,000	($54,000 - $16,000)
Corporate Tax:	$12,920	($38,000 x 34%)
After-tax Earnings:	$25,080	($38,000 - $12,920)
	Year Two	
Contributed Equity:	$100,000	
Retained Earnings:	$113,600[99]	
Debt:	$170,880	
Interest Rate:	10%	
Internal Rate of Return:	15%	

96 The debt-to-equity ratio of the firm is .80. This ratio is maintained in years two and three by allocating the after-tax earnings from years one and two accordingly.

97 *Id.*

98 This figure is based on the debt-to-equity ratio and the interest rate. *See also supra* note 84. The actual rate is 4.444444% but is expressed as 4.44%.

99 The debt-to-equity ratio of the firm is .80. This ratio is maintained in year two by allocating the year one after tax earnings of $25,080 accordingly.

COCA Rate:	4.44%[100]	
COCA Allowance:	$17,088	($384,480 x 4.44%)
Gross Income:	$57,672	($384,480 x 15%)
Taxable Income:	$40,584	($57,672 - $17,088)
Corporate Tax:	$13,799	($40,584 x 34%)
After-tax Earnings:	$26,785	($40,584 - $13,799)
	YEAR THREE	
Contributed Equity:	$100,000	
Retained Earnings:	$128,481[101]	
Debt:	$182,784	
Interest Rate:	10%	
Internal Rate of Return:	15%	
COCA Rate:	4.44%[102]	
COCA Allowance:	$18,278	($411,265 x 4.44%)
Gross Income:	$61,690	($411,265 x 15%)
Taxable Income:	$43,412	($61,690 - $18,278)
Corporate Tax:	$14,760	($43,412 x 34%)
After-tax Earnings:	$28,652	($43,412 - $14,760)

After the implementation of COCA, if a firm substitutes less debt for equity (because of the elimination of the Code's preference for debt) or retains more earnings (because of the tax incentives for retention) a firm will have more capital to invest without having to obtain or increase its external financing. Assuming that the internal rate of return does not decline, the firm will produce more revenue. As a result, the government will collect more taxes from the firm than it would have collected without the implementation of the COCA system. Moreover, the firm's tax liability will increase in every succeeding year.

If the elimination of the tax preference for debt results in less issuance of debt, the additional taxes collected from corporations will be offset by a decrease in taxes from corporate bondholders. Moreover, the magnitude of the decrease in taxes collected from corporate bondholders is much larger than the increase in corporate taxes which will result from a corporation increasing its capital by retaining more of its earnings and paying less interest.

Example 3 demonstrates how much income will be produced by a hypothetical firm with the COCA system in place and how much tax will be collected from it assuming the corporation retains its earnings, redeems its debt and issues equity in its stead.

---

100 *See supra* note 98.

101 The debt-to-equity ratio of the firm is .80. This ratio is maintained in year three by allocating the year two after tax earnings of $26,785 accordingly.

102 *See supra* note 98.

EXAMPLE 3

CORPORATION X (EARNINGS RETAINED)

	YEAR ONE	
Contributed Equity:	$260,000	
Retained Earnings:	$100,000	
Internal Rate of Return:	15%	
COCA Rate:	4.44%[103]	
COCA Allowance:	$16,000	($360,000 x 4.44%)
Gross Income:	$54,000	($360,000 x 15%)
Taxable Income:	$38,000	($54,000 - $16,000)
Corporate Tax:	$12,920	($38,000 x 34%)
After-tax Earnings:	$41,080	($54,000 - $12,920)
	YEAR TWO	
Contributed Equity:	$260,000	
Retained Earnings:	$141,080	
Internal Rate of Return:	15%	
COCA Rate:	4.44%[104]	
COCA Allowance:	$17,826	($401,080 x 4.44%)
Gross Income:	$60,162	($401,080 x 15%)
Taxable Income:	$42,336	($60,162 - $17,826)
Corporate Tax:	$14,394	($42,336 x 34%)
After-tax Earnings:	$45,768	($60,162 - $14,394)
	YEAR THREE	
Contributed Equity:	$260,000	
Retained Earnings:	$186,848	
Internal Rate of Return:	15%	
COCA Rate:	4.44%[105]	
COCA Allowance:	$19,860	($446,848 x 4.44%)
Gross Income:	$67,027	($446,848 x 15%)
Taxable Income:	$47,167	($67,027 - $19,860)
Corporate Tax:	$16,036	($47,167 x 34%)
After-tax Earnings:	$50,991	($67,027 - $16,036)
Dividends paid:	$137,839	
Tax on dividends:	$44,756[106]	
Total available to shareholders:	$93,082	

A comparison of Corporation X in example 2 and Corporation

---

103 *Id.*

104 *Id.*

105 *Id.*

106 The tax on dividends is computed based on the assumption that 49% of the corporation's shareholders are corporations, that none of the shareholders are entitled to a dividends-received deduction (eliminated under COCA) and that individual shareholders are taxed at a 31% rate.

X in example 3 reveals that the government will collect more corporate taxes under COCA if corporations reduce their debt ($43,350) than under current law ($41,501). This increase in corporate taxes, however, does not nearly offset the $15,924 in taxes which would have been collected on the interest paid to bondholders if COCA had not been implemented.[107] The pre-COCA decrease in taxes collected from bondholders exceeds the post-COCA enactment increase in corporate taxes because the corporation's COCA deduction is not reduced by its substitution of equity for debt. To the contrary, the corporation's COCA deduction will increase in subsequent years because of the interest expense which does not exist.

Under the COCA system, the disparity between the increase in corporate taxes and the decrease in bondholder taxes may be offset by taxes on shareholders. Whether the taxes collected from shareholders will be sufficient to make COCA revenue neutral will depend upon several factors. First, the repeal of the dividends-received deduction under COCA will significantly affect the amount of the taxes collected from shareholders.[108] On its face, the repeal of the dividends-received deduction would automatically result in significant additional taxes from shareholders because the government will receive more revenue from shareholders for each dollar distributed by a corporation. But because COCA provides an incentive for firms to retain their earnings, fewer dividends will be distributed. Nevertheless, it is not likely that the dividend flow will cease or be substantially curtailed because dividends have been distributed during other periods when there have been tax incentives for retention of earnings. In the late 1960's, the tax rates on ordinary income were much higher than today. There was a special capital gains rate which created a decided benefit to receiving income in the form of capital gain. Yet, many taxpayers and firms preferred income in the form of dividends, i.e., regular income, and therefore dividends continued to be distributed.[109] For this reason, even under the COCA system, dividends will continue to be paid.

A third factor affecting the amount of taxes collected from shareholders under the COCA system is that the shareholders' percentage of the firm's capital will increase. That is, the debt of a corporation can be replaced with equity without a tax cost to the

---

[107] In example 2, Corporation X paid $16,000 in interest charges in year one, $17,088 in year two and $18,278 in year three. If taxed at a 31% rate, the bondholders would pay $15,924 in taxes.

[108] *See supra* notes 71-81 and accompanying text.

[109] For a case study of shareholder preference for dividends, *see* Carol J. Loomis, *A Case for Dropping Dividends*, FORTUNE, June 15, 1968, at 181.

corporation. With respect to the equity thus issued, the government will collect less taxes from the distributions to the shareholders than would have been collected from the corporation's creditors. This results because interest received by a bondholder is currently taxed at 31%, assuming the highest personal tax rate.[110] Equity is also taxed at 31% if equity income is entirely in the form of dividends and there is no dividends-received deduction.[111] If equity income is entirely in the form of capital gains, however, that tax rate is 28% and the taxpayer is entitled to reduce the amount realized by the taxpayer's basis in the stock. Because some equity income generated by substituting stock for debt will be taxed at the lower capital gains rate, the government will receive less revenue than if the substitution had not occurred. In addition, the amount of dividends paid on the equity issued to replace debt will not equal the interest which would have accrued on the replaced debt.[112]

For COCA to be revenue neutral, the COCA rate will have to decrease if the government collects less revenue because of decreased taxes collected from bondholders or the retention of earnings.[113] If COCA results in revenue loss because corporations carry less debt or retain more earnings, an alternative to reducing the COCA rate is to impose a tax on retained earnings. In lieu of imposing a direct tax on retained earnings, revenue may be raised by denying a corporation a COCA deduction for retained earnings.[114]

---

110 I.R.C. § 1 (West Supp. 1991).

111 *See supra* notes 71-81 and accompanying text.

112 Certain interest, original issue discount, is taxed as it accrues regardless of the accounting method of the taxpayer. *See* I.R.C. §§ 163(e) & 1272 (West 1991). Dividends are not subject to these special rules. Unless the dividends paid equal the interest which would have accrued, the government will collect less taxes because less income will be made available to a firm's shareholders than was made available to its creditors.

113 Correspondingly, although the federal deficit compels the opposite conclusion, the COCA rate should be increased if the government collects more taxes from the implementation of the COCA system and the repeal of the dividends-received deduction. Otherwise, one of the COCA system's objectives of eliminating the tax preference for debt without increasing the cost of capital will be undermined.

In either event, the COCA rate must be based on more than current debt-to-equity ratios and interest rates. Rather, adjustment of the COCA rate will have to account for not only the taxes collected from corporations, but also the taxes collected from a corporation's shareholders and bondholders.

114 As an alternative to disallowing the COCA deduction to the corporation, the shareholders of the corporation could be taxed on that portion of the COCA deduction that is attributable to the retained earnings. This will insure that the COCA deduction is included in the shareholders' income during the same taxable year that the deduction is deductible by the corporation. It will not raise as much revenue, however, because of the higher corporate tax rate. Moreover, if the inclu-

The COCA deduction could instead apply only to debt and the current value of equity, plus the value of any new equity issued.[115] This is equivalent to a tax on retained earnings but eliminates the necessity of determining how much capital is required for each corporation.[116]

Modifying the proposed COCA system by imposing a tax on retained earnings will still eliminate the tax distinction between debt and equity. But this modification reduces the tax incentive to retain earnings because, in effect, retained earnings will not receive a COCA allowance.[117] Eliminating the COCA deduction for retained earnings is consistent, however, with the proposed American Law Institute's (ALI) position that no deduction should be allowed for retained earnings. In its supplemental study on Subchapter C, the ALI reporter states:

> The distinction that needs to be made for corporate income taxes is not between debt and equity, as such, but rather between internal and external financing; there are strong reasons to allow a deduction for the latter but not the former.[118]

But the cost of capital is the cost of acquiring assets to use in business operations. This includes the cost of retained earnings used to acquire business assets as well as the cost of debt and newly-issued stock. For smaller corporations retained earnings typically are the primary source of capital.[119] Moreover, one who contributes capital to a corporation expects a return whether the contributor is a shareholder or a lender. Thus, the funds which are retained by a corporation has a cost, just as interest which is not paid has a cost. The contributor of each expects to be compensated for the retention of each.

Other factors dictate that the COCA deduction should not be eliminated for retained earnings. If funds are needed for investment, a firm should be indifferent, from a tax standpoint, whether it

---

sion is required of all shareholders, undoubtedly some shareholders will be without the wherewithal to pay the tax which is due.

[115] Earnings retained subsequent to the institution of the COCA system would not be considered in determining the amount of the COCA deduction.

[116] Under Section 531 of the Code a penalty is imposed on a corporation for accumulating earnings and profits only if they are accumulated beyond the reasonable needs of the business. I.R.C. §§ 531, 535 (West Supp. 1991).

[117] Without COCA's incentive to retain earnings, there will be an amelioration of the incentive to distribute earnings that arises because of the inversion of corporate and shareholder level tax rates.

[118] Reporter's Study Draft, *Federal Income Tax Project*, at 11 (A.L.I. 1989). The views expressed in the draft have not been approved by the ALI, and therefore, do not represent the views of the Institute.

[119] ALAN L. FELD, TAX POLICY AND CORPORATE CONCENTRATION 59 (1982).

issues stock or debt or uses retained earnings. Elimination of a COCA deduction for retained earnings, however, would promote the issuance of debt and the distribution of earnings. Firms would increase their debt-to-equity ratios and become financially more at risk. Further, long-term projects and research and development are more easily financed with retained earnings. Elimination of a COCA deduction for retained earnings would deter this long-term financing. In addition, earnings retained by corporations cannot be consumed by the shareholders, as would clearly occur if the earnings were instead distributed to the shareholders. Thus, encouraging the retention of earnings is a method of increasing the low personal savings rate of Americans.[120] For these additional reasons, the retention of earnings should not be discouraged.

Finally, the principle argument for disallowing a COCA deduction for retained earnings is to offset any revenue which might be lost as a result of the implementation of the COCA system. But disallowing a COCA deduction for retained earnings will not fully offset the taxes collected on distributions to the corporations, shareholders and creditors. Thus, this modification to COCA — which has as its premise that not all capital is entitled to a tax allowance for its cost and which diverges from the underlying premise of COCA — should be rejected.

As an alternative to disallowing a COCA deduction for retained earnings to offset the loss of revenue resulting from the COCA system's implementation, the corporate tax rate could be raised.[121] An increase in the corporate tax rate, coupled with an allowance for all capital, would benefit capital-intensive firms and firms with the least amount of debt. Highly-leveraged firms would be induced to issue new equity and retire debt. To compensate for the adverse tax consequences that highly leveraged firms would suffer initially, the COCA system should be phased in so that only a portion of a firm's equity capital is initially eligible for an allowance. A revenue neutral tax increase would be implemented to correspond with this initial allowance.

Instead of increasing the corporate tax rate, directly taxing retained earnings or indirectly taxing retained earnings by excluding them from the COCA computation, the COCA deduction could be made revenue neutral in another fashion. First, the special capital

[120] Hatsopoulos, *supra* note 28, at 5, 14-15.

[121] There is a substantial question of who bears the brunt of the corporate tax. *See, e.g.*, CHARLES E. MCCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? (1979). Because the proposed COCA system would reduce corporate tax liability, COCA would benefit those who bear the burden.

gains rate would have to be repealed. Second, shareholders would be charged a tax equal to the interest on a shareholder's pro rata share of the corporation's annual earnings and profits. The interest charged would be at the applicable federal rate and would accrue annually. When the shareholder received a distribution or sold the stock at a gain, the tax would be collected. If the taxpayer sold stock at a loss, the loss would be reduced by the accrued interest.[122]

This method of offsetting the revenue lost as a result of the institution of the COCA system would not be without administrative headache, however. Although an individual shareholder would be advised each year of the corporation's earnings and profits per share, the taxpayer would have to retain this information for as long as the shareholder owned the stock. When a dividend was received or the stock was sold, the taxpayer would have to calculate the tax (interest) due the government. This would not be a simple process for the average taxpayer.[123]

IV. Effect on Cost of Capital

Currently, the cost of equity capital, i.e., the rate of return which the corporation's shareholders demand, depends upon the firm's debt-to-equity ratio, the cost of its debt and the firm's expenses and taxes. If a COCA firm has the identical expenses and an identical capital structure as a pre-COCA firm and the COCA deduction is equal to the interest deduction available to the pre-COCA firm, the COCA system will not alter the cost of capital. If the capital structure is different, however, the firm's cost of capital will be different. Unlike a pre-COCA firm, a COCA firm's cost of capital will not decrease as it adds debt to its capital structure, nor will its cost of capital increase if it reduces the amount of debt which it carries.[124]

Whether the COCA system will result in an increase or decrease in the cost of capital will depend upon the firm's capital structure. Table One provides a comparison of three firms with

122 A taxpayer could have a loss but still owe interest if earnings and profits had been earned in prior years but not distributed.

123 A calculation will be required for each year that the taxpayer held the stock. The taxpayer will have to multiply the applicable federal rate times the pro rata share of earnings and profits. This amount will be added to the shareholder's pro rata share of earnings and profits for the following year and will earn interest in the following year at the applicable federal rate for that year. So long as the taxpayer holds the stock, the tax will compound in this manner.

124 Currently, a firm which adds debt to its capital structure will reduce its cost of capital if the cost of the additional debt is less than its cost of capital at the time the debt is added.

different structures and the cost of capital for each under the current tax system and under the COCA system.

Some firms will benefit under the COCA system while others will not. Debt-laden firms will not receive as large a COCA deduction as the interest deduction they would otherwise receive. If equity is substituted for debt, the firms can avoid a reduction in after-tax earnings, but the earnings per share will decrease.

Nonetheless, if the COCA rate is decreased so that the COCA deduction is revenue neutral, the result is the same as if a portion of the firm's interest deduction is disallowed under current law. There will be an increase in the firm's cost of capital.[125] Consequently, one of the COCA systems primary purposes — to reduce the leveraging of corporations without increasing the cost of capital — will be undermined.

---

125 If the COCA rate decreases because of a decline in the federal rate and the firm is able to take advantage of the lower market rate of interest, its cost of capital may in fact decline.

TABLE ONE

CAPITAL STRUCTURE		COST OF CAPITAL PRE-COCA	COST OF CAPITAL COCA
FIRM 1			
Equity	$360,000[126]	15.1515%[127]	12.8619%[128]
Debt	$ -0-		
Interest	$ -0-		
COCA Rate	4.444%[129]		
FIRM 2			
Equity	$200,000[130]	12.8619%[131]	12.8619%[132]
Debt	$160,000		
Interest	$ 16,000		
COCA Rate	4.444%[133]		
FIRM 3			
Equity	$100,000[134]	11.4308%[135]	12.8619%[136]
Debt	$260,000		
Interest	$ 26,000		
COCA Rate	4.444%[137]		

126 It is assumed that bondholders and shareholders receive a ten percent return.

127 For shareholders to earn ten percent, the corporation must earn $54,545.40. After taxes the corporation will have $36,000 to pay its shareholders. To earn $54,545.40 the corporation must have an internal rate of return of 15.1515%.

128 For shareholders to earn ten percent, the corporation must earn $46,303.03. After the COCA allowance and taxes the corporation will have $36,000 to pay its shareholders. To earn $46,303.03, the corporation must have an internal rate of return of 12.8619%.

129 The actual rate is 4.444444%, but it is expressed as 4.444%.

130 *See supra* note 125.

131 For shareholders to earn ten percent, the corporation must earn $46,303.03. After the interest deduction, taxes, and the payment of interest to bondholders, the corporation will have $20,000 to pay its shareholders. To earn $46,303.03 the corporation must have an internal rate of return of 12.8619%.

132 For shareholders to earn ten percent, the corporation must earn $46,303.03. After the COCA allowance, taxes and the payment of interest to bondholders, the corporation will have $20,000 to pay its shareholders. To earn $46,303.03, the corporation must have an internal rate of return of 12.8619%.

133 *See supra* note 128.

134 *See supra* note 125.

135 For shareholders to earn ten percent, the corporation must earn $41,150.88. After the interest deduction, taxes, and the payment of interest to bondholders, the corporation will have $10,000 to pay its shareholders. To earn $41,150.88 the corporation must have an internal rate of return of 11.4308%.

136 For shareholders to earn ten percent, the corporation must earn $46,303.03. After the COCA allowance, taxes and the payment of interest to bondholders, te corporation will have $10,000 to pay its shareholders. To earn $46,303.03, the corporation must have an internal rate of return of 12.8619%.

137 *See supra* note 128.

VII. Phased Implementation of the COCA System

A firm may be adversely affected when the COCA system is implemented because its competitors' cost of capital is reduced while its cost of capital increases. To lessen the impact of the COCA deduction on the economy, the COCA system should be gradually instituted. One possibility is to permit firms to fully deduct the interest on debt held when the COCA system is implemented. The debt would not be counted as part of the firm's capital in calculating its COCA deduction. As the debt matures or is retired, a greater percentage of the firm's capital would be subject to the COCA calculation. An advantage of phasing in the COCA system in this manner is that firms would not be required to recapitalize. The phasing process will not result in corporate structural upheaval. Many firms, however, engage in active liability management. A more rapid implementation of the COCA system will not adversely affect these firms.

A disadvantage to implementing the COCA system only as debt matures or is retired is that it will take many years before the system is fully in place. Further, firms which would be adversely affected under the system will not hasten its arrival by retiring their debt. Moreover, the taxes collected under COCA will be less than they would be if all the capital of all firms is subject to the COCA regime. To offset this revenue loss, the COCA rate will have to be artificially low. Consequently, some firms will not receive the full capital allowance which they should while others will receive a greater allowance. To minimize the effects of this incongruity, it is desirable to implement the system more rapidly.

When the deduction for personal interest was disallowed upon the enactment of the Tax Reform Act of 1986, the disallowance was implemented by reducing, over a four-year period, the percentage of interest which could be deducted.[138] Corporations should be given a longer period of time to adjust to the COCA implementation, i.e., ten years.[139] The rate of disallowance should be uniform for all corporations.

A benefit of implementing COCA over a period of years is

[138] The disallowance occurred over a four year period. I.R.C. § 163(h)(5) (West Supp. 1991). An individual is still permitted to deduct interest connected with investment activities or a trade or business, as well as any qualified residence interest. I.R.C. § 163 (West Supp. 1991).

[139] Unlike individuals who borrow to purchase personal items, a corporation borrows and issues equity in order to produce income. This distinction warrants phasing COCA in over a longer period of time in order to avoid disrupting a corporation's business.

that the COCA rate can be closely related to debt-to-equity ratios and interest rates. Because changes in the capital structures of corporations will occur over a period of years, the impact of those changes will be less pronounced. Consequently, the periodic adjustment to the COCA rate, which must occur for it to be revenue neutral, will be smaller. When the COCA system is fully implemented, firms will have chosen the capital structures which are the most beneficial for them. Consequently, future adjustments to the COCA rate to keep it revenue neutral will be minor.

VIII. SHIFTING TAX BURDENS

All corporations which have the same amount of capital will receive the same COCA deduction regardless of their debt-to-equity ratios. Because some corporations will not be able to deduct as much capital costs as they currently do, while other corporations will be able to deduct more, there will be a shifting of the tax burden from less-leveraged corporations to more-leveraged corporations.[140] This shift will be diminished by the repeal of the dividends-received deduction, however, if the debt-laden corporation and the corporation which carries less debt each distribute the same percentage of equity.[141] Because the corporation with a lower debt-to-equity ratio will distribute more equity, a greater amount of tax will be collected from its shareholders. Nevertheless, the impact of the COCA deduction on the debt-laden corporation and its shareholders will be greater than the impact on the corporation with less debt and its shareholders.

Although the implementation of the COCA scheme will cause a shift in the tax burden, firms with the same types of assets generally can support the same debt-to-equity ratios.[142] Consequently, the COCA system's implementation will not provide a competitive edge to a firm. Moreover, any competitive edge which would be created will be minimized if the COCA system is phased in over time. It is the rare piece of legislation, however, especially tax legislation, which does not provide a benefit to one taxpayer at the expense of another.

---

140 There will also be a shifting of the tax burden from a corporation that pays a dividend to a non-affiliated corporation to the corporation that receives the dividend. *See supra* note 81 and accompanying text.

141 Firms try to minimize all taxes paid on corporate income, including personal income taxes. BREALEY AND MYERS, *supra* note 18, at 413.

142 *Id.* at 432.

IX. Taxation of Investors

The COCA system will increase the amount of tax levied on corporate shareholders because of the repeal of the dividends-received deduction. Nevertheless, some shareholders will have more income after the imposition of corporate and shareholder level taxes because the COCA deduction to their corporations will substantially exceed the interest expense of the corporations.

Unfortunately, the COCA system will not have a greater impact on the taxation of investors. The reduced tax preference of debt over equity to corporate issuers which will occur as a result of the implementation of the COCA scheme will not exist at the investor level. Consequently, for tax purposes it will still be necessary to determine whether a hybrid financial instrument is debt or equity. Although this distinction will still be required, issuers of financial instruments will no longer be compelled by tax considerations to structure the instruments exotically.[143] Consequently, there will be fewer issuances of hybrid financial instruments.

Because the COCA regime will provide a corporation with a deduction based on the amount of its capital, without regard to whether the corporation pays interest or dividends, the COCA deduction typically will not equal the amount its investors must include in income. This disparity is not a fatal flaw, however, because the COCA system can be revenue neutral. It may be viewed as a flaw because the corporation, whether an accrual-basis or a cash-basis taxpayer, is allowed a deduction for an expense which was neither paid nor accrued. If the COCA system is compared to a system of depreciation, however, there is no flaw. Rather, as with a statutory system of depreciation, the corporation annually accounts for the cost of its capital by deducting a statutorily determined amount. Neither actual payment nor accrual is required.

X. Investment Opportunities

If a corporation borrows to invest, it will borrow only if it expects the net present value of the investment to exceed the

143 Whether corporations are affiliated, I.R.C. § 1504 (West 1991), or whether a corporation is a personal holding company, I.R.C.§ 542(a), (c) (West 1991), a foreign personal holding company, I.R.C. § 552(a), (b)(West 1991), or a controlled foreign corporation, I.R.C. § 957(a)(West 1991), will depend in part upon stock ownership tests. Issuers who are concerned about being classified as one of these corporations will still be concerned about whether the instruments they issue are characterized as debt or equity for tax purposes.

amount borrowed. Because interest is deductible under current law, a firm will not lose money on a debt-financed investment if the yield of the investment equals or exceeds the cost of the debt. Thus, a firm may use the cost of debt as a benchmark for deciding whether an investment is profitable.

Under the COCA system, however, investors will not be able to readily determine the required yield from an investment. With the system in place, an investor will not know what percentage of the invested funds will be deductible. A correlation between the rate of interest the investor must pay and the return the investor must receive will not exist. The COCA rate will fluctuate periodically, which will prevent reliable calculations from being made.

Unfortunately, this is a necessary drawback of the system that will inevitably deter some corporations from making investments which would have been made under current law. Its impact should not be substantial, however, because even under the current system the calculation of actual yield is not precise. Although a corporation may know the precise yield it must receive, the determination of whether a project or investment will produce that yield is imprecise.

XI. Corporate Tax Base Erosion and COCA

If the COCA rate is too low, it will not be advantageous to some firms. Some firms will benefit from the COCA system because their cost of capital will be less than the COCA deduction, but other firms will be at a disadvantage because they could liquidate, form a partnership and receive a higher interest deduction than the COCA deduction to which they would ordinarily be entitled. If firms liquidate, the corporate tax base will be reduced, and the COCA rate will have to be reduced even more for the government to collect the same revenue from the remaining corporations. This will cause even more firms to be at a disadvantage under the COCA system and, therefore, stimulate corporate dissolutions. As more and more firms liquidate, only those firms which have more equity capital than debt will continue to operate as corporations.[144]

---

144 Even these corporations may prefer to liquidate because they could receive a higher interest deduction than the COCA deduction to which they are entitled. But operation as a sole proprietorship or as a partnership, however, may not be feasible. Publicly-traded partnerships, other than those which have mostly passive-type income, will be treated as corporations for federal income tax purposes. I.R.C. § 7704 (West 1991).

Removal of funds from the corporate solution results in less income tax because of the lesser taxable income produced.

> For debt-financed acquisitions and distributions, the reduction in taxable income will be achieved through increased interest deductions. For internally financed acquisitions and distributions, it will generally take the immediate form of a reduction in investment income.[145]

The American Law Institute (ALI) proposes to prevent the removal of corporate funds from corporate solution by imposing a new minimum tax on distributions (MTD), which would be imposed on the distributing corporations in most nondividend distributions.[146] In the view of the ALI:

> The main thing wrong with the corporate income tax system is that it creates an artificial, unintended subsidy for corporations engaging in cash mergers, leveraged buyouts, leveraged recapitalizations, or distribution of surplus earnings by share repurchase, as compared with corporations seeking to conduct their financing in the normal, old-fashioned manner: accumulating earnings as needed for long term growth and distributing the rest as dividends.[147]

The ALI proposal correctly recognizes that funds removed from corporate solution reduce the corporate income tax base and, therefore, future corporate income taxes. Moreover, it is logical to conclude that all transactions that result in the removal of corporate funds from corporate solution should bear the same cost.[148] But the COCA system will not achieve this end.

If a corporation borrows to purchase stock, it will gain no benefit under the proposed system, and the corporate income tax base will not be depleted. Substitution of debt for equity under the COCA system will not produce a greater deduction for cost of capital. Consequently, a corporation's taxable income will not be reduced. Nevertheless, if a corporation uses internal funds to purchase its own stock or the stock of another corporation, the purchase will reduce the amount of corporate income taxes to be collected.

If a corporation uses internal funds to purchase its own stock, the corporation's capital decreases. Although the COCA deduction

---

145 Reporter's Study Draft, *supra* note 118, at 17.

146 The MTD would be accompanied by a nonrefundable, shareholder-level credit to offset the shareholder's tax.

147 Reporter's Study Draft, *supra* note 118, at 39.

148 Shareholders whose shares are redeemed may not consider it very logical if the cost is imposed by exacting a tax on the distribution without regard to basis.

to which the corporation would be entitled in the future would be decreased, the decrease would not offset the loss of future corporate income taxes on the removed funds.[149]

Similarly, if a corporation uses internal funds to purchase the stock of another corporation, the purchase will reduce the corporate tax base by the amount of the purchase. Consequently, the corporation's tax liability will be less.

To remove the bias for corporations engaging in cash mergers and distribution of surplus earnings by share repurchase, the proposed system can be modified so that a firm's capital, for COCA purposes, will not include the value of stock purchased. This modification will increase the firm's cost of capital. But the modification should not be implemented if the COCA system's sole objective is to eliminate the preference for debt over equity without raising the cost of capital. If the objective is broader, however, and is to correct the fundamental problems with the corporate income tax system, the COCA proposal should be modified so that a firm's capital, for COCA purposes, will not include the value of stock purchased.

XII. CONCLUSION

The shape of the COCA system, as molded by its proponents, does not conform to the shape required by federal tax policy. If the capital of a corporation, for COCA purposes, includes an amount allocated for federal income taxes or an amount allocated for non-deductible interest or expenses, then partial deductions will be allowed in the form of a COCA deduction. In addition, if the COCA rate is based only on debt-to-equity ratios and interest rates, implementation of the COCA system could result in a loss of federal revenue. Finally, the implementation of the COCA regime will not prevent the erosion of the corporate tax base.

If the COCA system is modified as suggested herein, COCA can be the vehicle for correcting some of the fundamental flaws in the corporate income tax system. Moreover, the changes suggested will not undermine the COCA system's objective of eliminating the tax distinction between debt and equity. In addition, the modifications will not increase the proposed system's complexity.

149 Absent hyperinflation, the COCA rate will be less than the corporate income tax rate, and, thus, the removal of funds from corporate solution will result in a decrease of future corporate income tax revenue.