
Distinguishing Debt from Equity in the Junk Bond Era

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BECAUSE American tax law permits corporations to deduct interest payments from profits, it creates a bias in favor of debt finance. As long as their bondholders are not heavily taxed, firms have a strong incentive to compensate the suppliers of capital with payments that are labeled as interest rather than dividends. Traditionally, distinguishing debt from equity has arisen as a problem primarily in small, closely held companies, which receive loans from their owners. Until recently the dividing line between debt and equity has seemed relatively clear in the case of large, publicly traded entities.

Recent financial innovation has raised new problems as high-yield securities, which appear to many observers to be "equity in drag," have come into vogue. As an example, consider the \$8 billion pay-in-kind (PIK) securities issued in connection with the 1989 RJR Nabisco buyout, to date the largest corporate takeover transaction. These securities require no payment for a number of years, carry yields of as much as 800 basis points above Treasury bill yields, and are senior to only \$2 billion of RJR's more than \$25 billion capital structure. It is expected that they will wipe out RJR's taxable income for some years to come.

In this paper we consider the implications of recent financial innovations for the taxation of corporate source income. Most discussions of this issue focus on the possible costs of tax-encouraged debt finance. Such discussions presume that there are important differences between debt and equity securities. We argue that, in fact, financial innovation has reduced the difference between the investment characteristics of debt and equity. Firms are now able to issue securities that function very much like equity but are treated as debt for tax purposes. Current law and judicial precedents appear inadequate to counter this trend.

We begin by highlighting the fact that most of the recent increase in corporate indebtedness has been a consequence of restructurings that have made use of high-yield debt. We then argue that much of this debt