"Pearl Harbor" Proposal Targets Debt Securities

by Robert W. Wood • San Francisco

As this issue goes to press, the Treasury Department had just announced a rather frightening plan designed to raise approximately $28 billion from corporations over 7 years. It was announced on December 7, 1995 (appropriately, since that was Pearl Harbor Day), with a proposed December 7, 1995 effective date. The package of proposed changes came as a big surprise to most observers.

It was designed to cut back—if not eliminate—the use of long-term bonds and other debt securities that the Treasury Department apparently considers equity instruments masquerading as debt. See "Tax Provisions Would Hurt Wall Street," *Wall Street Journal*, Dec. 8, 1995, p. A3. Although there are a

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variety of provisions included in the proposals, the most significant would deny corporations an interest deduction on debt instruments that are issued with a term longer than 40 years. In effect, these interest payments would be treated as dividends and hence would be nondeductible.

Debt vs. Equity

At the heart of the proposal is the notion that long-term debt instruments are really treated by financial markets as equity. Because a corporation has the ability to deduct interest payments on debt, Treasury now suggests that at least on long-term debt instruments, these companies are in effect paying dividends.

Plus, Dividends Received

Unfortunately, this set of fundamental proposals would do more than affect interest deductions. Among other things, these proposed changes would materially reduce the dividends received deduction. Rather than a 70% dividends received deduction for dividends received from a company in which the dividend receiver holds less than 20% of the stock, the proposal would cut the dividends received deduction down to only 50%. This change, by itself, is projected to raise approximately $3 billion over 7 years.

Another prohibition would prevent companies from deducting interest payments on debt instruments for which there is a substantial certainty that the holder will receive stock rather than cash upon the maturity of the instrument. The proposal would also prohibit companies from issuing "monthly income preferred stock," which are securities regarded as debt for tax purposes but treated as equity on the corporation's balance sheet.

Negative Reaction

Predictably, the Treasury Department has come under attack for these ill-considered proposals. One particular outcry was from companies with long-term bond deals pending. Because the Treasury proposals would bar companies from deducting the interest they pay on bonds with a maturity of more than 40 years, the Treasury Department was urged to clarify that securities issued under a commitment that was binding before December 7, 1995 would not be subject to the proposals. For this purpose, a binding commitment includes an underwriting, purchase, distribution, overallotment option or merger agreement. See "Treasury Guidelines on Tax Plan Spare Several Bond Deals," *Wall Street Journal*, Dec. 12, 1995, p. C25.

Companies having pending bond deals that appear to be saved by this proposed effective date reportedly include BellSouth Corp., Johnson Controls, Inc., and Wisconsin Electric Power Co. However, some companies apparently missed the boat. Pacific Telesis Group, Inc., for example, was reportedly marketing a $500 million issue of trust-originated preferred securities when the fateful proposals were announced on Pearl Harbor Day.

Pacific Telesis reports that there was no deal yet, which would appear to mean that the effective date grace is not available. Companies in this boat will have to make a fish-or-cut-bait decision which could be difficult. See "Treasury Guidelines on Tax Plan Spare Several Bond Deals," *Wall Street Journal*, Dec. 12, 1995, p. C25.

We will have more details about this significant proposed change to the corporate tax regime in a forthcoming issue. ■