

then transferred it to the assignee, which is being compensated for the off-market pricing of the contract. So money passed through the non-assigning party, which was not supposed to be affected. Nijenhuis worried that the movement of the money might cause the non-assigning party to be deemed to have received a loan.

Long-standing commercial practice has been to ignore the effects on the non-assigning party for tax purposes. (For discussion, see *Doc 92-345* or *92 TNT 10-36*.) The proposed regulations generally ignore the non-assigning party, in response to complaints from the private side that these parties could be thrust into character mismatches or the straddle rules if they were required to recognize gain or loss on assignments. Prop. reg. section 1.1001-4(c) states:

Any consideration for the transfer or assignment that passes between the party transferring or assigning its rights and obligations under the contract and the party to which the rights and obligations are transferred or assigned will not affect the treatment of the nonassigning counterparty for purposes of this section.

“For purposes of this section” covers section 1001, but the deemed loan rules were issued pursuant to section 446. Walli responded that the drafters did not want to give taxpayers an incentive to prefer termination over assignment. He promised to work out an explanation for the three-party situation. ■

## ECONOMIC ANALYSIS

### Romney’s Other Tax Break

*By Martin A. Sullivan — martysullivan@comcast.net*

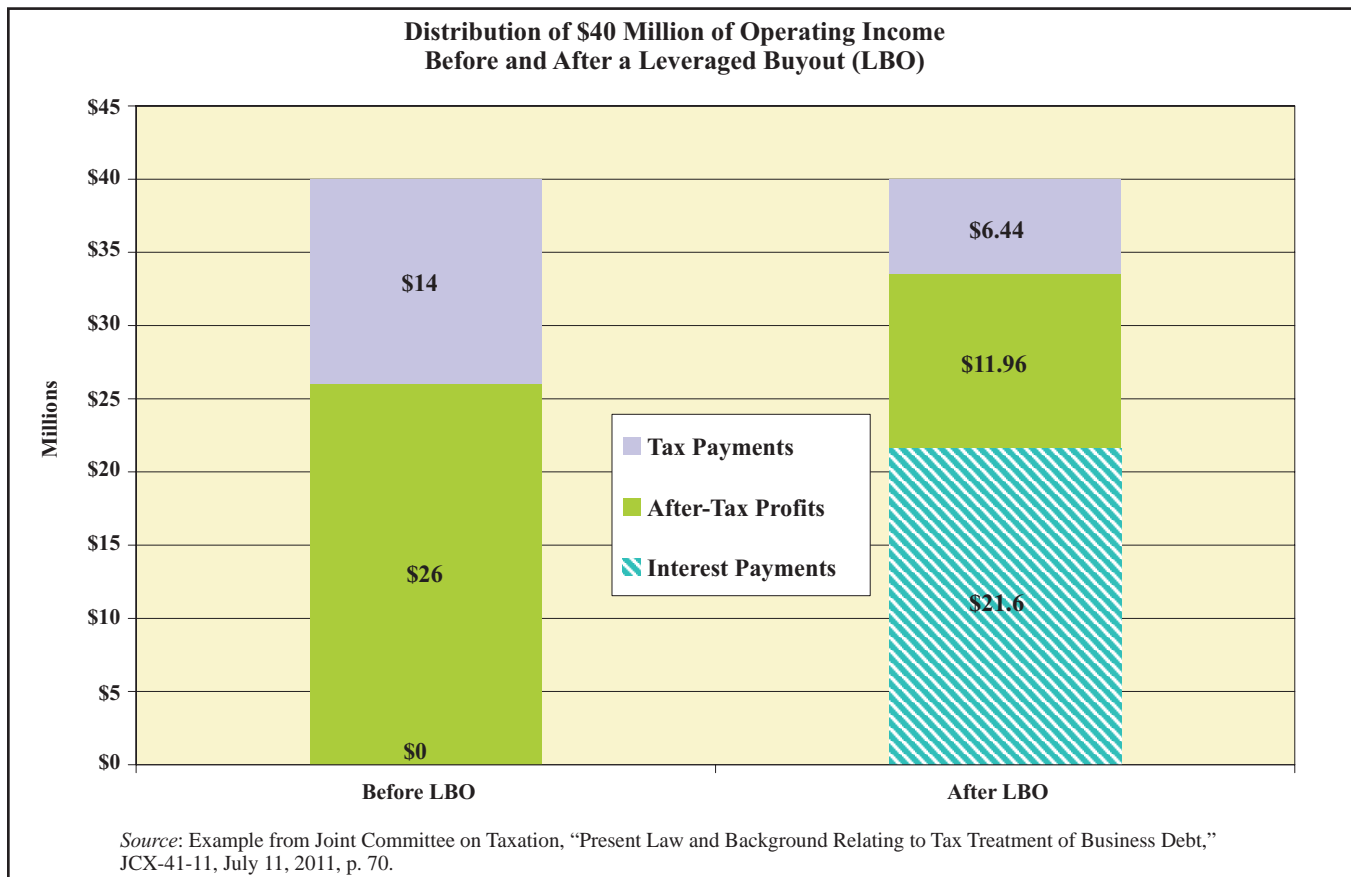
Was it creative destruction or vulture capitalism? Whatever you call what Mitt Romney did at Bain Capital, it is now a multi-pronged challenge to his presidential aspirations. Just the mention of investment shops like Bain can stir up resentment with the voters still looking for jobs and seething over the collapse of 2008.

Then there is the tax angle. When he left Bain in 1999, Romney negotiated a retirement package that gave him a share of the company’s skyrocketing profits for at least a decade after his departure (“Buyout Profits Keep Flowing to Romney,” *The New York Times*, Dec. 18, 2011). The bulk of those profits were carried interest — consulting fees paid to managing partners conditioned on upside gain for investors. The payouts were likely taxed at 15 percent. For a man with an estimated net worth of a quarter-billion dollars, a tax rate lower than middle-income families’ does not sit well with voters who are daily reminded of increasing inequality, especially when Romney is proposing a plan that cuts taxes on the rich and raises taxes on the poor (Tax Policy Center, “The Romney Tax Plan,” Jan. 5, 2012, *Doc 2012-249*, *2012 TNT 4-28*).

***Bain profited from a dangerous flaw in our corporate tax that subsidizes destabilizing financial structures.***

Just as many Wall Streeters feared, Romney’s rising presidential fortunes are threatening their monetary fortunes. The long-simmering debate about the tax treatment of carried interest is being reignited. On January 18 House Ways and Means Committee ranking minority member Sander M. Levin, D-Mich., announced his plans to reintroduce legislation to treat carried interest as ordinary income rather than capital gains. (For related coverage, see p. 405.) This is just the opening salvo. If Romney wins the Republican nomination, the president’s populist reelection campaign will ensure that the carried interest controversy goes prime time.

Despite the media coverage of everything Romney and Bain, there is another significant tax policy issue concerning the business that has been left unmentioned. Like all investment houses that do leveraged buyouts, Bain created value for its investors by increasing debt levels and reducing taxes of



its target companies. Bain profited from a dangerous flaw in our corporate tax that subsidizes destabilizing financial structures.

### Debt Is the Key

Specialized investment partnerships that do leveraged buyouts like to be called private equity firms. But their deals have more to do with debt than equity. The bulk of funds for their acquisitions comes from debt issued by the target company to outside investors. The smaller portion of funding is equity from partnership investors. Leveraged buyouts that use mostly debt to acquire established firms are very different from transactions entered into by venture capital companies that use mostly equity.

Private equity firms emphasize that they create value by applying their management skills and operating knowledge of an industry. Whether or not these contributions exist in any particular deal, there is always a significant tax component. The injection of debt into leveraged buyout transactions reduces tax payments on income from the underlying business. This occurs for the simple reason that interest payments on debt are tax deductible, while

dividend payments on equity are not. A tax system should be neutral. But our tax system favors debt over equity.

We aren't talking small potatoes. A hypothetical example used by the Joint Committee on Taxation illustrates this point ("Present Law and Background Relating to Tax Treatment of Business Debt," JCX-41-11, July 11, 2011, *Doc 2011-15103*, 2011 *TNT* 134-14). In the example, a target firm with no debt generates \$40 million of before-tax profit annually and pays \$14 million of corporate tax (at a 35 percent rate).

The rearrangement of cash flows from a leveraged buyout of this firm is shown in the figure above. Most of the funds for purchasing shares from pre-deal owners come from new debt issued by the target firm. As a result, the target has interest payments of \$21.6 million. That reduces before-tax profits from \$40 million to \$18.4 million. Of the \$18.4 million, Uncle Sam gets \$6.44 million and the private equity investors keep \$11.96 million. Without any change in the operating income of the business, there is an annual reduction in taxes of \$7.56 million. Under the assumptions in the example, the private equity firm has increased the market value of the target by over \$60 million.

This is all perfectly legal. But it is not good economics. In contrast to the carried interest loophole, which simply allows very rich partners to be even richer, the tax incentive for leverage goes to the heart of the deal and can cause serious economic damage. If we have learned one lesson from the Great Recession, it is that too much debt can be devastating to a business. Higher debt increases the possibility of financial distress for the firm, and that distress imposes real costs, including reduced availability of funds needed during business downturns. It also increases the likelihood of bankruptcy and all the costs associated with it.

And higher levels of debt threaten macroeconomic stability by leaving the economy more vulnerable to small contractions in business activity. Because insolvency and illiquidity can spark a chain reaction, one major bankruptcy can threaten the whole economy. That increases pressure for the federal government to bail out bankrupt firms. And there can also be increased pressure on the Federal Reserve to relax monetary policy, increasing the risks of inflation. After this near-death experience for the economy, you might have expected Congress to give priority to creating a tax system that discourages debt. Unfortunately, it has left in place a tax system that does exactly the opposite.

As Congress desperately searches for revenue to pay for a reduced corporate tax rate, it should consider limitations of interest deductions when there is excessive debt. Even if the Romney campaign convinces you that leveraged buyouts are totally benign, there is still no reason for the United States to maintain a tax system that favors them over venture capital. ■

## NEWS ANALYSIS

## Breaking Up Is Hard: Euro Divergence Tax Consequences

By Jeremiah Coder — [jcoder@tax.org](mailto:jcoder@tax.org)

The financial and political instability in Europe over the past year raises the possibility that if the economic crisis continues to worsen, European Union members may decide to leave the eurozone and strike out on their own. Apart from the political ramifications, a country leaving the eurozone could create unpleasant tax consequences for multinational corporations through the return to one or more national currencies.

It might be tempting to think that breaking free of the euro would lead to treatment that mirrors the regulatory decisions the IRS made after the euro was adopted and phased in more than a decade ago. But practitioners warn that dumping the currency might be much trickier for companies to navigate around this time, with unforeseen practical and timing obstacles.

### History

After the initial group of European countries signed on to the idea of a single cross-border currency, the IRS in 1998 requested public comment on what the U.S. tax consequences should be for conversion to the euro. Questions included whether conversion constitutes a change in functional currency that triggers recognition of gain or loss and whether the conversion would lead to a significant modification of a contract under section 1001 that would also produce recognition of gain or loss. The IRS initially indicated that it would take a tax-neutral approach. (For Announcement 98-18, 1998-1 C.B. 676, see *Doc 98-6980* or *98 TNT 35-12*. For prior coverage, see *Tax Notes*, May 4, 1998, p. 542, *Doc 98-13921*, or *98 TNT 84-3*.)

**A country leaving the eurozone could create unpleasant tax consequences for multinational corporations through the return to one or more national currencies in place of the euro.**

Business groups and large multinational taxpayers pressed the IRS to create a conversion framework that avoided both double taxation of income and acceleration of income or loss recognition. The introduction of the euro was a significant development because the EU was the United States' second largest trading partner at the time, after Canada.