Cut Off the Equity Funds

To the Editor:

Leveraged buyouts (LBOs) are tax deals that harm both Treasury and the general welfare. They increase debt too much and turn resilient businesses as fragile as a crystal dandelion. They give incentives to management to bet the company on bad bets. They reduce the national pool of productive capital because they give nothing to the target business, but they do flood the selling shareholders of their target with cash that is diverted too much into luxury consumption. Treasury provides all the economic juice for an LBO with an interest deduction — involuntarily — and it would not and should not consent if asked. It would be easy to shut down the harms by disallowing interest on debt used to acquire the issuer's own stock, a modest extension of current law.

The equity funds that do the LBOs dodged a bullet in the current Inflation Reduction Act (P.L. 117-169). The fund managers report their multi-million-dollar compensation for services as if the compensation were a share of their funds' capital gain. On this round, Congress at the last moment chose not to restrict the scheme, called carried interest, nor treat the compensation as high-tax-bracket ordinary income, as it should be treated. Still, the profit from LBOs comes from another source: the interest deduction.

In the LBO, a private equity fund buys out all the stock of the historical shareholders of some target corporation. The equity fund replaces 90 percent of the stock of the target with debt — bootstrap debt assumed by the target corporation to buy its own stock. The interest deduction on the new debt wipes out 90 percent of the target's taxable income. The equity fund keeps a residual 10 percent of the target stock.

The value of wiping out 90 percent of the target corporation's tax is captured by the last 10 percent of the target stock held by the equity fund. With corporate rates at 21 percent, wiping out such corporate tax can roughly triple the value of the equity fund's residual target stock within the 30 minutes that it takes to close the transaction. Back when corporate tax rates were at 35 percent, the residual stock could quadruple in the 30 minutes. The pension funds and other creditors that supply the debt for the buyout are tax exempt or low-tax entities so that the tax saved by the interest deduction is more valuable than the tax on the interest income. Treasury loses revenue overall and provides the economic value of the LBO.

The equity funds claim they are the masters of the universe, too big to be stopped. In his new book, *Two and Twenty: How the Masters of Private Equity Always Win* (2022), Sachin Khajuria praises the equity funds as if they were gods on earth. However, he fails to explain or understand that the source of their profit comes from Treasury and that they hurt the country. Because LBOs harm the general welfare and decrease revenue, Congress should cut off the tax incentives for them by disallowing the interest deduction.

When a target corporation had an all-equity capital structure before the LBO, it was resilient. A downturn in the business cycle or competitor gains would not please the shareholders, but the complicated network of employees, suppliers and customers and the customized physical plant would survive a fluctuation. When high debt replaces stock of the target corporation, the first downturn sends the target into bankruptcy and rips out its network. LBOs increase bankruptcies.

Corporation with high debt also give an incentive to the equity fund managers who own all the stock to bet the company on bad bets. Shareholders don't pay for creditors' losses, which turns a high-risk investment with a negative expected value, given the probability of success and failure, into a positive position investment for the shareholders viewed in isolation. An LBO makes bad economic investments rational for the private equity fund shareholder.

Assume for example a target company after an LBO with assets of $100 and debt of $90. The company then has access to an investment of the $100 that will double in 10 percent of the cases and be worthless in 90 percent. That is a terrible investment: A 10 percent chance of doubling has only an expected value of 10 percent of $200 or $20, for a cost of $100 of company assets. But the equity fund owners don't have to pay the debt on the down-leg and get $200 equity, less the $90 debt on the up-leg. The up-leg is worth 10 percent * $110 or $11. The equity holders put $10 of their money at risk for an $11 expected return. The LBO has turned a terrible investment into a bet that the equity fund management would like to take.

LBOs also reduce the nation's productive capital. Target businesses get nothing from the borrowed funds: no dollars to improve operations, achieve innovations, or increase productivity. The target shareholders get a flood of cash for giving up their stock. Some of that cash eventually gets back into another business, but too much is diverted into luxury consumption, which is plausibly the nation's bottom priority.

The equity funds also strip cash from the target. They pull out "consulting fees" after the takeover, claimed to be tax deductible, that can and do exceed the value of their suggestions, because they are the 100 percent shareholders and can do it.

The people running LBOs think of themselves as financial wizards — although the interest deduction is not a very high level of wizardry. They are not people who operate companies. Improving real productivity is hard to do. For example, the glass factories the equity funds took over had been processing two tons of glass per day and making the best decisions regarding how to get the optimal yield from their product in a variety of competitive markets. The equity funds were above all that. They also deferred maintenance so when there was fire in the factory, the spigots were too corroded to open up the sprinklers.[1] The biggest equity funds hold a diverse portfolio of businesses in different fields, acquired from prior buyouts, seeking to make money under the old conglomerates' principle of jack of all trades and master of no operations.

Our government should cut off the tax incentives for such harms. Section 279, from another era, disallows the deduction of interest on "acquisition indebtedness." Before enactment of section 279, the interest deduction gave an incentive for a corporation to acquire another forming an amalgamation inconsistent with best antitrust policy. Section 279 ended the interest deduction incentive. It would be a minor extension of the principle to apply the interest-disallowing remedy when it is the target's own stock that is acquired and not the stock of some other company. Consulting in which the suggestions were worth the fees would continue. Acquiring targets with stock would continue. But taking away the interest deductions would end those harmful buyouts justified only by tax incentives.

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[1] Brian Alexander, *Glass House: The 1% Economy and the Shattering of the All-American Town* (2017).