Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form

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We examine the effects of the Tax Reform Act of 1986 on the financial decisions made by firms. We review the theory and empirical predictions of prior literature for corporate debt policy, for dividend and equity repurchase payouts to shareholders, and for the choice of organizational form. We then compare the predictions to post-1986 experience. The change in debt/value ratios has been substantially smaller than expected. Dividend payouts increased as predicted, but stock repurchases increased even more rapidly which was unexpected and is difficult to understand. Based on very scant data, it appears that some activities have shuffled among organizational forms; in particular, loss activities may have been moved into corporate form where they are deducted at a higher tax rate, while gain activities may have shifted towards noncorporate form, to be taxed at the lower personal rates. In addition, several interesting new issues are raised. One concerns previously neglected implications for the effective tax on retained earnings that follow from optimal trading strategies when long- and short-term capital gains are taxed at different rates. Also, new interest allocation rules for multinational corporations provide a substantial incentive for many firms to shift their borrowing abroad.

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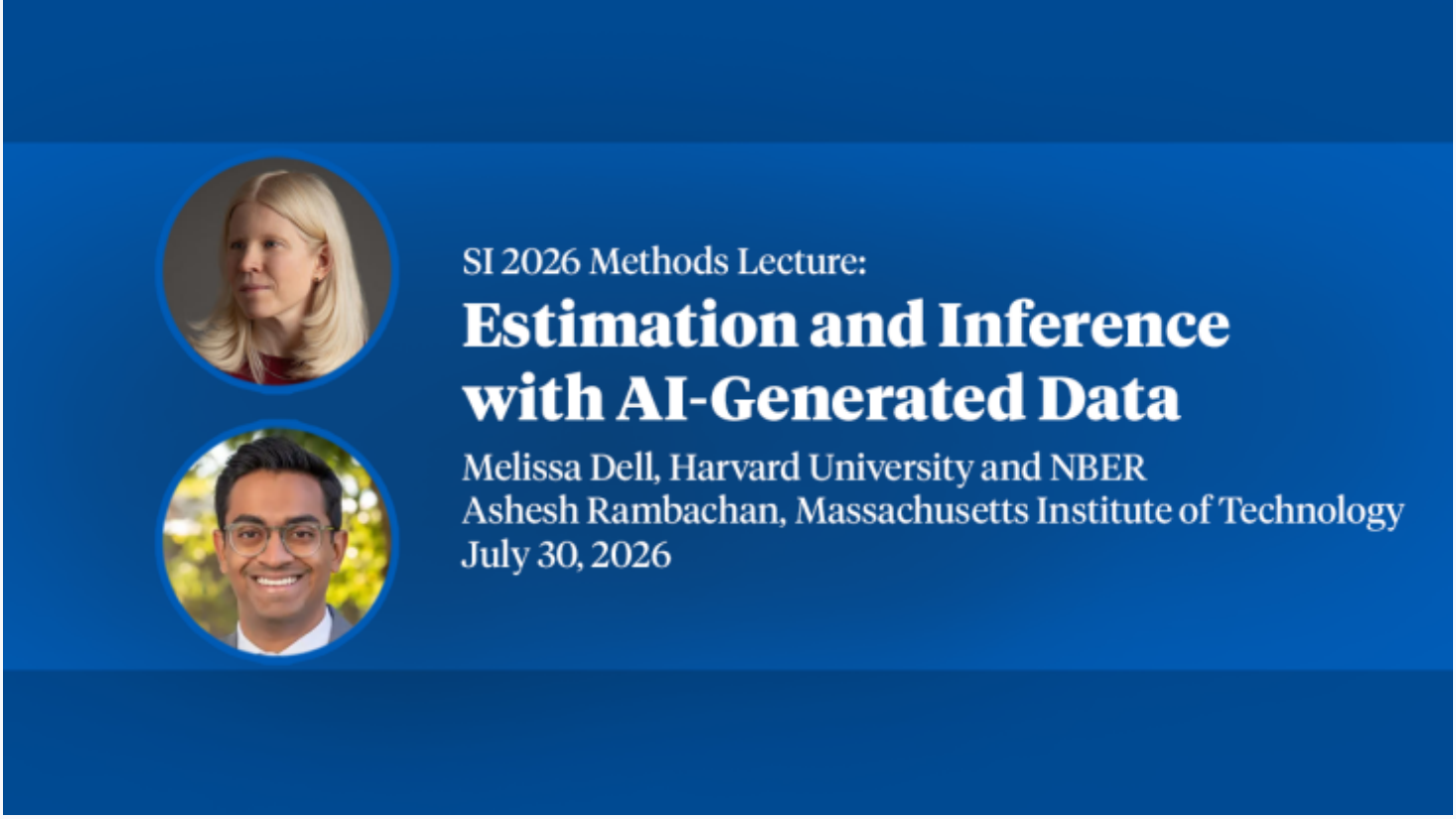


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