The Law and Economics of U.S. Corporate Taxation

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What is the U.S. Corporate Tax?

Not just the tax collected from corporations, but the entire system for taxing corporate income & transactions.

Entity level: notable features include (a) interest vs. dividends, (b) various non-recognition transactions, (c) a few special rules for executive compensation, (d) tax shelter issues.

Owner level: potential double tax for equity-financed income that is distributed to shareholders.

Note also shareholder-level capital gains (but without it, could any capital gains be taxed?).

Basics of U.S. international taxation

We tax income on both a residence basis and a source basis (WW for U.S. residents, source for foreign residents).

U.S. residents get foreign tax credits (FTCs) with respect to their foreign source income, so the U.S. gets only the excess (if any) of the U.S. rate over the foreign rate.

E.g., say $1M of foreign income, U.S. rate is 40%, U.S. rate is 30%. U.S. collects $400K - $300K = <u>$100K</u>.

U.S. firms also get deferral for income of foreign subsidiaries …

… but with current tax on Subpart F income (mainly passive or that deemed to reflect foreign tax planning).

The 4 big domestic distortions

1) Corporate versus non-corporate entity – potential double tax, use of losses, rate differences.

2) Debt versus equity – interest but not dividends are (a) deductible by the corporation, (b) imputed even if not paid, (c) taxable at the holder's regular marginal rate (vs. 15%?).

3) Distribute versus retain earnings – distributions to SHs are taxable, & therefore discouraged (?).

4) Form of distribution – dividends vs. share repurchases; the role of earnings & profits, disproportionality.

International distortions

1) Incorporate in the U.S. vs. incorporate abroad.

2) Invest in the U.S. vs. invest abroad.

3) Accounting manipulations to report income as U.S. source or foreign source (e.g., transfer pricing, passive investment, details of borrowing & cash flow).

4) For U.S. firms, repatriate earnings vs. keep them abroad.

The dirty secret about corporate taxation

Economists don’t understand it because it is an “ill-posed problem.”

E.g., what are corporate versus non-corporate entities?

What are debt and equity?

How avoidable is dividend taxation?

In international, how manipulable are the concepts of (a) residence, (b) source, (c) repatriation of foreign income?

2-way character of domestic tax distortions

1) Corporate versus non-corporate entity – the former may be taxed better if rates are lower, don't expect distributions. (Note Rangel bill, corporate tax rate-cutting in Europe.)

2) Debt versus equity – debt held by tax-exempts, equity by taxables.

3) Distribute versus retain earnings – note strong incentive to distribute in 2010 if the 15% rate actually expires.

4) Form of distribution – corporate SHs prefer dividends.

Foreign tax distortions usually have clear anti-U.S. direction, though note as well "arbitrage" (both countries lose).

Economic theory meets the corporate tax

1) What is the incidence of the corporate tax?

We presumably mean by this the extra burden of the tax vs. other business taxation. (Or could be incidence of the benefit,)

Distinguish (a) long-run incidence from (b) transition incidence (surprise, overnight change in the laws).

Corporate SHs would presumably bear (b) when the law suddenly changes – but unlikely uniquely to bear (a) given competing investments. Cf. tax-exempt municipal bonds.

Long-term incidence of the corporate tax

Harberger 1962: the candidates are (a) holders of capital, (b) consumers, (c) workers.

Key assumptions: (a) special tax purely on corporations, (b) separate corporate and non-corporate sectors (agriculture & real estate in the latter), (c) closed economy (no significant international capital mobility, (d) taxes don't affect saving.

Finding: burden of the corporate tax falls on capital, but this is fortuitous (based on how real estate & agriculture, vs. other industries, happen to use labor).

Problems with Harberger 1962

a) Separate corporate & non-corporate sectors not explained, are arguably counter-factual.

b) No effect on saving? (If people save less because capital is taxed more, burden would tend to shift to workers.)

c) Suppose we assume “small open economy” rather than closed economy. Then investment can respond to the corporate tax by exiting the U.S.

Due to (c), Harberger no longer believes in the Harberger model – says the tax is mainly borne by labor.

Many economists agree – although note again the difference between transitional & permanent incidence effects.

Economic theory, part 2: debt vs. equity

Why do corporations use equity financing, when interest is non-deductible & equity is double-taxed?

Modigliani-Miller 1958: showed capital structure is irrelevant to firm value absent agency costs, tax considerations, etc.

Use of equity therefore was often explained as a tradeoff between debt's benefit of creating a "tax shield" & its detriment of raising bankruptcy risk.

Plus, debt-equity choice may address agency costs. Use debt so managers won't exploit SHs; use equity so SHs won't exploit debt-holders.

Miller equilibrium

Miller 1977: bankruptcy costs too low for trade-off theory to be true. But what if equity isn't tax-penalized after all?

Suppose (a) instrument label (debt or equity) is purely elective, (b) double tax can be avoided, (c) corporate rate is below the top individual rate.

Say corporations pay tax at 30%, high-income investors at 40%, tax-exempts at 0%.

High-income TPs hold equity, tax-exempts hold debt. The corporate tax is a device for (a) lowering the business tax rate for high-income, (b) stripping out corporate earnings.

Relevance of the Miller equilibrium

It is contradicted by actual portfolio ownership patterns (e.g., diversification, lack of tax benefit to equity under current law).

But note (a) financial innovation, (b) discussion of corporate rate cuts.

In Wall Street these days, if marketed to tax-exempts it must be “debt.” Note tax-accounting “hybrids.”

If the Miller view is becoming truer, then conforming the tax treatment of debt & equity may be more important than corporate integration.

Some corporate integration models (CBIT & BEIT) do this, although we won’t review them today.

Economic theory, part 3: Is there lock-in of corporate earnings?

Old view: the tax on dividends discourages distributing corp. earnings.

Managers love this, but it's bad for SHs & economic efficiency.

New view: A uniform distributions tax DOESN'T discourage dividends – although it does discourage use of corporate entities and equity financing.

Best shown through a hypothetical based on the following: (a) all tax rates are 50%, (b) all rates of return are 10%, (c) \$100 of corporate earnings must be distributed to shareholders either now or in a year.

Dividend now vs. in a year with uniform distributions tax

Dividend now: $100 distribution, $50 left after-tax, invest it for a year & have $55 before-tax, $52.50 after-tax.

Dividend in a year: corporation invests $100, after a year has $100 before & $105 after-tax, dividend yields $52.50 after-tax.

Why didn't deferring the dividend tax reduce its present value? (Rule One of tax planning.)

Because the earnings remained in corporate solution, and subject to the double tax, for longer. Deferring $X of tax benefits the TP at the after-tax interest rate, but here the amount to be taxed also GREW at this interest rate.

Why the new view matters

Lock-in isn't automatic – it depends on DIFFERENCES between present & expected future distribution tax rates.

Thus, note the importance here of share repurchases & the step-up in basis at death.

Plus, expected dividend tax rate instability is very important.

Note the 2010 sunset for the 15% dividend tax rate, partisan divide & lack of stability on this issue, long-term U.S. fiscal gap.

We can make the new view truer & the corporate tax less distortive – but this requires tax law stability.

Pillars of sand in U.S. int'l taxation

Residence – is meaningful for individuals, but not entities.

How strong is the need to incorporate here?

Note recent issue of "inversions" – but no problem for companies with the foresight to incorporate initially abroad

Unfortunately, source is as weakly grounded a concept as corporate residence.

E.g., say U.S.-Co. & France-Co. merge, boosting profits due to synergies – where is the synergy income located??

Transfer pricing is a huge mess – manipulable, no good answer in theory, huge administrative costs in practice.

Legislative and regulatory issues in taxing U.S. multinationals

Policy disputes often concern whether the U.S. can/should allow favorable treatment of outbound investment.

E.g., should we disallow FTCs or apply subpart F (instead of allowing deferral) with respect to aggressive tax planning abroad?

On the one hand, why should we mind if U.S. companies avoid foreign taxes?

On the other hand, what if overseas tax avoidance opportunities reduce domestic economic activity & revenues?

This is often posed theoretically as a dispute between “capital export neutrality” (CEN) and “competitiveness.”

Capital export neutrality

CEN holds that WW welfare is maximized if firms invest based on pre-tax profitability, rather than making worse investments for tax reasons.

By imposing current U.S. tax on low-tax outbound investment, can we “do well by doing good”?

Yes, if U.S. firms respond by curtailing costly tax planning or increasing overall domestic U.S. investment.

No, if all that happens is that U.S. firms’ outbound investment declines without any effect on investment in the U.S.

Conventional tax policy wisdom has supported “yes” – but some recent empirical work (not yet conclusive) – supports “no.”

Competitiveness

Counter-intuitively, a firm taxed at a low rate CAN compete with one taxed at a high rate.

Suppose both Firm A and Firm B are taxed on their economic income – but A @ 40%, B @ 20%. Can A compete?

Yes – both will seek to maximize pre-tax profit, and both will have a positive return that keeps them in business.

We'd all rather be taxed like B than like A – but its only competitive advantages relate, e.g., to using internal funds to finance new projects.

On the other hand – suppose A and B are competing for 3rd party investment dollars based on their ability to offer a high return. B will win this competition.

U.S. welfare & U.S. multinationals

U.S. firms claim that competitive disadvantages in bidding or seeking financing are to our national disadvantage.

Not as obviously true as it may seem (since we care about U.S. individuals, not legal entities as such) – but there are two arguments potentially in support.

(a) Home country bias in who owns companies' stock.

(b) Complementarity with profitable domestic investment.

Again, however, there are open empirical issues here – plus obvious political pressures.

Are U.S. corporate rates headed down?

I would predict they are – discussed on both sides of the aisle; European experience; competitive pressures & lower rates elsewhere.

One good thing about this from a U.S. standpoint – companies will do transfer pricing more in our favor.

But if we want progressive rates for individuals, how this interacts with the corporate tax may be tricky (especially if we don't want a high tax rate on distributions).

We've been there before (for decades pre-1986, corp rates were much lower than top individual rates) – but the tools in the Tax Code for dealing with it may need a fresh look.