Comments[1] on

Professor Reuven S. Avi-Yonah and Amir C. Chenchinski:
"Corporate Tax Integration and the Debt/Equity Distinction:
The Case for Dividend Deduction" (draft dated 9/20/11)

By Deborah L. Paul[2]

Introduction

Professor Avi-Yonah and Mr. Chenchinski (the "authors") advocate a tax system under which corporations would be entitled to a deduction for dividends paid to shareholders. As discussed below, the authors identify three biases in the current double taxation system for corporations and shareholders and two purposes for taxing corporations in the first place. They argue that a dividend deduction system would avoid those three biases while still advancing the two purposes of corporate taxation.

I will question whether the three biases identified by the authors are troubling. Second, I will identify an apparent inconsistency between the two reasons the authors identify for taxing corporations. Third, I will comment on the design of a dividend deduction system. And, finally, I will comment on the authors' critiques of certain other systems for taxing corporations and shareholders.

The Three Biases

As to the three biases, it is an article of faith in some corners that taxes should not distort behavior, that inefficiencies result when tax law causes people to do things (or refrain from doing things) they otherwise would have done (or refrained from doing). However, that notion stems from the economic concept of deadweight loss, the idea that overall social utility is reduced if the supply and demand curves for a good or service are out of equilibrium, i.e., if the supply and demand curves do not cross where they would cross in a perfect market. The concept of deadweight loss seems inapposite in the case of the three biases identified by the authors, however, because none of those biases involves a good or service. Thus, even if the biases do distort behavior, it is debatable whether such distortions are problematic.

The first bias is a bias against using C corporations. However, C corporations are creatures of the Internal Revenue Code. There is no such thing as a C corporation outside of the

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tax law. State law corporations exist that are not C corporations (i.e., S corporations), and entities that are not State law corporations can be C corporations (e.g., an LLC that has been checked closed under the check-the-box regulations). Thus, the bias at issue is not really a bias against doing business as a C corporation but rather a bias against something else, perhaps going public or a bias against using State law corporations (since many domestic State law corporations are not eligible to be S corporations). As to going public, many non-tax considerations are at play when a company decides whether to go public. Typically, if the owners believe the business has developed the heft necessary to be a public company, they often will float the business in order to cash out. Alternatively, they might decide against going public in order to avoid the scrutiny applied by the public markets. I do not expect that C corporation taxation plays a major role. As to a potential bias against State law corporations, I do not see this either. There does not seem to be any social policy to protect State law corporations. Nothing much seems to be lost by businesses being conducted in LLC or partnership form.

The second bias is said to be a bias against distributions. However, upon a closer read, the paper says that the bias is a bias against dividend distributions and in favor of either retaining earnings or paying them out in a manner that qualifies for capital gain treatment (i.e., stock buybacks). Thus, since there is a way to get money out of corporate solution at capital gains rates—through buybacks—it is not clear what the problem is. Further, even if there is a bias in favor of retaining earnings, that may not be so bad. It may be a way of encouraging savings. It bears examination whether it is or is not desirable for corporations to retain earnings.

The third bias identified by the authors is a bias against equity and in favor of debt. This bias seems more compelling to me than the other two, especially in light of the recent financial crisis where many companies were overleveraged.

<u>The reasons for taxing corporations</u>

Despite the three biases identified by the authors in the current double tax system, the authors identify two reasons in favor of taxing corporations. The two reasons they adduce seem inconsistent to me.

First, the authors observe that failing to tax corporations would create opportunities for deferral of income. That anti-deferral reason presupposes that the goal of the tax system is to tax Haig-Simons income of shareholders. When we say that, absent a corporate tax, people would be able to "defer" income by letting earnings build up untaxed in a corporation, we presuppose a baseline that should ideally be taxed, namely, Haig-Simons income of shareholders.

The second reason for taxing corporations identified by the authors is that taxing corporations is a means of regulating corporations. The "regulatory" reason seems inconsistent with the anti-deferral reason, as the regulatory reason takes as its starting point that we do not want to tax a pure notion of economic income, but rather we want to use the tax system to encourage certain types of behavior.

The dividend deduction system

Now, on to the design of a dividend deduction system. First, the paper suggests, on the one hand, that only publicly traded corporations should be taxed, but in other places suggests that the corporate tax system envisaged by the authors would apply more broadly.[3] Insofar as the authors intend that only publicly traded corporations should be taxed, it is unclear why this should be so. US subsidiaries of foreign parent companies and US portfolio companies owned by private equity funds are typically C corporations. They can be very large. The regulatory purpose would apply equally to them as to publicly traded corporations.

Second, the dividend deduction system does not in fact achieve corporation-shareholder integration because it does not envisage an asset basis step up for the corporation when a shareholder sells appreciated shares. Thus, such sales would in effect be subject to double taxation. The system achieves a single layer of tax on corporate income only if the company realizes its income or gain and distributes it, thereby taking advantage of the dividend deduction.

Third, it is not clear whether the dividend deduction system as proposed by the authors envisages a carry forward or carry back of the dividend deduction. To achieve greater integration, the system would, presumably, allow for unlimited carryforwards and carrybacks. However, carryforwards and carrybacks undercut the regulatory purpose of taxing corporations as a corporation may be able to generate a deduction in one year that is used at a very different time.

Furthermore, what is a dividend for the purposes of the dividend deduction system? Under current law, a dividend must be paid out of earnings and profits. Earnings and profits are a concept much closer to cash than taxable income is. It is not clear whether the current law concept of earnings and profits is appropriate for a dividend deduction system. For example, earnings and profits are reduced for depreciation, but not as quickly as taxable income which reflects the Modified Accelerated Cost Recovery System. This divergence may, for example, lead to double dipping where a company can benefit from the accelerated depreciation deductions in computing its taxable income as well as a dividend deduction generated by a dividend paid out of earnings and profits (which are not affected by the accelerated depreciation deductions). Additionally, it bears consideration whether dividends paid out of accumulated earnings and profits, as distinguished from current earnings and profits, could be deducted under the dividend deduction system.

Fifth, the dividend deduction system softens the impact of other regulatory measures implemented through the tax law, as it provides an alternative means of reducing a corporation's tax bill. MACRS is once again a good example. If a corporation is considering whether to invest in certain equipment, the tax saving associated with MACRS may be less of an incentive than it would be absent the dividend deduction system because the corporation has an alternative means of reducing its taxes, namely, paying a dividend. Thus, the dividend deduction may reduce the ability of the tax system to regulate companies because it offers such a

[3] The paper suggests in a few places that the authors would tax US subsidiaries of foreign parent corporations. The authors mention applying a Section 163(j) principle to dividend deductions.

straightforward way to reduce the tax burden on a company, thereby making it less likely that companies will adjust their behavior in response to other "regulatory" tax deductions and credits.

Sixth, as the authors recognize, tax exempt and foreign shareholders pose a challenge for a dividend deduction system. In order to extract any tax from these classes of shareholders, the system would have to include either an entity level tax or a withholding tax. The authors posit that it may be acceptable from a policy perspective to impose no tax on the earnings of tax exempt entities. But, Congress has a clear policy of taxing certain income of a tax exempt entity, either indirectly through the current system of corporate tax on corporate earnings or directly through the unrelated business income tax. Thus, the change that the authors suggest would be a huge departure and would require much justification.

In relation to foreign shareholders the authors' proposed withholding tax would be problematic for two reasons. First, it could be avoided by foreign shareholders selling their shares before the dividend is paid. The converse of this is that a foreign person who buys shares the day before a dividend payment would be overtaxed. Second, foreign countries would insist on treaty reductions in withholding tax. Indeed, many of our existing treaty obligations to reduce withholding taxes are inconsistent with levying a substantial new tax.

Last but not least, the authors' support in footnote 18 of their paper for a shareholder to recover basis in the event of a dividend or redemption creates a gigantic opportunity for deferral that is at odds with the Haig-Simons anti-deferral purpose in taxing corporations in the first place. Indeed, I believe that such an approach would put us right back where we were before the enactment of the passive foreign investment company regime, only now it would be easier for a taxpayer to defer tax because a taxpayer could use a domestic corporation rather than a tax haven corporation. The premise of the dividend deduction system is that the corporate level income is being taxed once on a roughly current basis – either in the hands of the corporation or, if the corporation pays a dividend, in the hands of the shareholder. If the shareholder is entitled to recover basis before paying tax on any dividend, then that premise is not true.

The authors' critique of a Comprehensive Business Income Tax ("CBIT")

Before concluding, I want to comment on the authors' critique of CBIT. The authors criticize the "radical expansion" of tax on businesses (of the unincorporated kind) that would follow the introduction of a CBIT. In this respect, the CBIT does not seem to me to be such a radical expansion. Today, partners are taxed, and partnerships are not. The CBIT reverses that approach, taxing partnerships and not partners. Either way, partnership income is taxed. Furthermore, the authors comment that CBIT would place "unfair" limits on interest deductions. Interest is, after all, a legitimate cost of business. However, under CBIT, interest income in the hands of the recipient would be exempt from tax. Thus, it is not obvious that the limitation on deductibility of interest is inappropriate.

Conclusion

To conclude, the paper raises interesting issues and it is refreshing to see a different perspective on the corporate tax reform debate. However, I believe there are fundamental problems with a dividend deduction system and it is perhaps because of these problems that it has not featured heavily in the literature and academic debate. The paper leaves open a great number of questions and I am not sure whether an answer can be found to all of them.