The 2008-09 Financial Crisis: Implications for Tax Reform

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Income tax rules & the financial crisis

Gore Vidal: The 4 sweetest words in the English language are "I told you so."

Can tax experts say this about the financial crisis?

In numerous ways, tax rules often pushed in the wrong direction: excess leverage, housing bubbles, corporate governance problems, non-transparent financial instruments

Though these "fingerprints" are suggestive, tax's actual causal contribution is unclear, & generally not considered large.

Plus, countries w/ different rules ended up w/ similar problems.

E.g., housing bubbles not limited to countries with large tax preferences for home ownership.

“I told you so”??

One tax distortion actually lay in the right direction: loss nonrefundability discourages risk-taking (which nonetheless was excessive).

But I’ll suggest this countervailing distortion was ill-directed, rather than merely insufficient.

Plan: I’ll review main areas, then draw brief conclusions.

Corporate leverage

Classical corporate tax systems encourage excess leverage unless (a) SH marginal rate exceeds entity's & (b) SH-level tax on equity holdings can generally be avoided (Miller 1977).

While excess leverage in the financial crisis arguably was more a product of risky strategies to maximize earnings per share, surely the case for addressing debt bias is strengthened.

Financial innovation makes the debt classification for tax purposes increasingly elective …

… potentially transmuting the problem from bankruptcy risk to tax rate electivity?

Either way, debt-equity bias is worth addressing.

Corporate integration

Dividend exemption systems (like that proposed in the U.S. in 2003) address debt bias but not electivity.

Dividend imputation / tax credit systems do more to address electivity (SH rate ultimately applies) but may not be the wave of the future (reflecting cross-border/EC Treaty problems).

Two further corporate integration approaches to consider: CBIT (treat debt more like equity) and ACE/BEIT (treat equity more like debt).

Plus approaches outside corporate integration (lower corporate rates, thin capitalization, WW interest allocation).

CBIT

Proposed by the U.S. Treasury in 1992, CBIT would deny corporate interest deductions, & make corporate interest & dividends tax-free to investors.

Problems included transition (e.g., existing debt), failure to address capital gain on selling corporate shares.

Hard to exempt such CG, lest TPs avoid CG more generally by incorporating assets & selling the shares.

Also, trading gains that reflect labor effort (e.g., in assimilating information before the market) conceptually should be taxed.

CBIT also is flawed by its relying on corporate rates, which may face greater downward pressure from tax competition than individual rates.

ACE/BEIT

An interest deduction-like Allowance for Corporate Equity (ACE) has been proposed & implemented (& repealed) various times around the world & has several attractive features.

E.g., at the corporate level it creates more neutral cost recovery in addition to addressing debt-equity bias.

Can be accompanied (as in Kleinbard 2005 BEIT) by requiring SHs to include the notional return to equity.

Current adoption (in a period with widespread NOLs) might also address political concerns about direct revenue cost.

I'd argue that such proposals merit serious consideration – but not currently getting it in the U.S. (?).

Other approaches to debt bias

WW movement towards lower corporate rates, though reflecting global competitive pressures rather than leverage issues, make equity more attractive & augment its high-rate tax clientele.

Thin capitalization rules, though primarily motivated by defense of source-based taxation, also can discourage high leverage.

U.S. has WW allocation rules for interest of consolid. multinational groups that it has diluted but not abandoned - & that the Obama Admin might extend (to deductibility, not just FTC limits).

These rules are much criticized for (a) asymmetry between exporting & importing int deds; (b) divergence from common WW practice

But, if symmetric & used by more countries, WW allocation might reduce the usefulness of debt in source-of-income tax planning.

Cancellation of indebtedness income

Big 2009 U.S. tax issue: avoiding gain recognition when solvent companies (or their private-equity LBO owners) buy back their debt at steep discount.

Standard income tax problem of gain realization deterring desired transactions.

It's unclear why these transactions were so popular. (Taking a view? Nothing better to do with the money?)

Tax relief (dubiously?) rationalized as stimulus, revenue cost under-estimated due to lack of PV budgeting, TP self-help available for some using complex treaty-shopping structures.

All else equal, more favorable treatment increases tax law's debt bias.

Risk-Taking and the Financial Crisis

One key cause of the financial crisis was excessive risk-taking (e.g., the “pick up nickels in front of a steamroller” strategy).

U.S. firms like AIG made wildly risky, heavily leveraged bets, initially yielding high reported profits but with huge, unprotected downsides.

This reflected incentives: limited liability & “too big to fail” at entity level, business judgment rule & personal bankruptcy at agent level.

It also reflected bubble psychology, peer pressure, & the income effect of setting executive comp so high that a couple of good years was enough – no need for career-long success.

Taxation and Risk-Taking

The tax system generally discourages risk-taking via graduated rates & (more importantly for firms) loss non-refundability.

While we normally favor neutral taxation, is credit due here for thus leaning against the biases that produced excessive risk-taking?

Altshuler, Auerbach et al 2008: more frequent U.S. corporate tax losses (adjusted for business cycle) make this ever more important.

But not so fast. Non-refundability (& NOL limits) may discourage start-ups & “good” risk-taking (e.g., swiftly-resolved bet with nature) much more than the “nickels in front of a steamroller” strategy.

“Nickel-grabbers” may have good current-year odds & short time horizons, be dead anyway if things go wrong.

Net operating loss rules

If we want to increase risk neutrality, can lengthen NOL carryovers or increase transferability (limited, e.g., by takeover & leasing rules in U.S. law).

Provides a windfall if allowed for existing losses; "stimulus for losers"?

Note also the tradeoff with favoring tax shelter losses & leverage. But if true losses are now more frequent, has the optimal tradeoff changed?

Lengthening carryforwards while limiting transferability can create a "zombie firms" problem.

More favorable treatment could be targeted, e.g., for losses reflecting bonus depreciation.

Taxation of derivatives

Huge markets in complex derivatives helped trigger the financial collapse – but to what extent encouraged by tax rules?

3 big tax problems: (a) asymmetry (in treatment of counter-parties); (b) inconsistency (form creates tax electivity); (c) imbalance (TP can treat gains & losses differently).

These problems can't be solved without major reform – e.g., general mark-to-market ("MTM") or uniform cost-of-capital approach (which may still leave strategic trading for gain-loss realization).

Exploitation via tax arbitrages that are not perfect economic arbitrages (or create counter-party risk) increase riskiness.

Further problem: tax or regulatory planning, exploiting any of the above, offers managers a rationale for reduced transparency.

Domestic vs. cross-border derivatives transactions

U.S.: domestic transactions between dealers were on MTM anyway, & to that extent no problems of asymmetry, inconsistency, or imbalance.

But cross-border uses of derivatives for tax planning (e.g., dividend swaps) may result in undesirable risk-bearing & reduced transparency.

Marginal effect of tax system on such behavior is unclear given similar incentives for cross-border regulatory planning (e.g., AIG's credit default swaps).

Plus, managers may not need much of a tax or regulatory rationale to reduce transparency if they're poorly monitored & that's their aim.

E.g., they can claim to have a sophisticated trading strategy that exploits market imperfections.

Corporate governance

One thing we've learned: corporate governance problems are MUCH worse than we thought in the 1990s / Chicago-school era.

Especially big problem for financial firms, since underlying fundamentals are harder to observe (e.g., compare AIG to GM).

Tax planning offered excuses for reduced transparency, excessive compensation w/ bogus or ill-designed "incentive" rationales.

Executive compensation: standard tax policy view would be that here, as elsewhere, tax rules should be neutral.

But if markets systematically get it wrong, should tax rules aimed at steering behavior be part of the regulatory response?

Tax rules & governance issues

U.S.: $1 million cap on deductions for non-incentive comp to high executives may have encouraged ill-designed “incentive” packages as a looting strategy with collateral efficiency costs.

Allowing deferral of option compensation, though accompanied by deferring the deduction, helped make executive comp *look* lower.

Consider treating well-designed incentive comp (e.g., relative to stock market or industry sector) more favorably than the poorly designed??

Another possible tool: relationship between tax & financial accounting income.

Big problem with linkage is that the legislature gets its hands on both. Might EU countries restore linkage if international accounting standards were newly accompanied by a depoliticized CCCTB?

Taxation of housing

Many countries (e.g., U.S.) encourage (a) over-investment in housing, (b) excessive home ownership (leading to severe under-diversification), and (c) excessive leverage by home-owners.

Here the tax system’s fingerprints are truly all over the crime scene – but relationships unclear to the bubble & broader financial collapse.

Tax experts have known for a long time that the tax preferences here are bad policy.

But politics impedes responding either indirectly (e.g., by significantly limiting mortgage deductions) or directly (by taxing imputed rent).

Unclear that this will change, especially given the delicacy of exerting downward pressure on home prices before the crisis eases.

Conclusions

Tax inducements to the overuse of debt, complex financial transactions, & housing over-investment may have contributed to the financial crisis, though not a primary cause.

In general, greater tax neutrality is desirable, e.g., in debt vs. equity or housing vs. alternative investments. (But we already knew this.)

Excessive risk-taking by managers of publicly traded companies, & governance problems (enhanced by lack of transparency) arguably call for regulatory responses, potentially including through non-neutral tax rules.

Political choice problems may impede responding properly, apart from pressures for lower corporate rates, reflecting tax competition but also fortuitously addressing debt-equity.