Should corporate tax reform efforts emphasize an “allowance for corporate equity” (ACE)?

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What should be the leading corporate tax reform model?

In the U.S., the leading corporate tax reform model used to be dividend exemption, but now is lowering the corporate rate.

Not just from dividend exemption's almost (& partly) happening in 2003.

Also from view that entity, not owner, level, is currently the right place to focus – e.g., since mobile capital is largely taxed at the entity level, & residence electivity a bigger issue in the corp tax than the ind'l tax.

This shifts potential U.S. corporate tax reform interest from CBIT towards ACE.

But high U.S. corporate rate has also sparked renewed visions of 1986-style reform (lower rate, broader base) - widely accepted despite slim prospects of its happening any time soon.

Focusing on ACE instead of that would be a significant change in perspective.

ACE vs. lower corporate rate

Intuitive argument for ACE: the case for low rates presumes applying them to correct base; e.g., don't fund them by denying ordinary business deductions.

While no good theory for a particular entity-level tax (rather than flow-through to owners), if we dislike the debt-equity distinction & chose ACE over CBIT for other reasons, the above argument seems to apply.

But we should look at particular margins rather than purporting to resolve this in the abstract.

Some key issues: debt bias, depreciation, income vs. consumption tax, owner level, non-corporate business sector, transition.

Plus, the financial sector raises some distinctive issues.

Debt bias

ACE (or better still ACC*) is an obvious response - but note that lowering the corporate rate does so (to a degree) as well.

If corporate rate is below individual rate & can avoid second level of tax, get 2-way clientele effects instead of general debt bias.

Now high-rate TPs would prefer equity, though low-rate TPs still would prefer debt.

Though there'd no longer be *general* debt bias, companies would still have tax incentives to use the wrong instrument (e.g., given agency costs) with particular clienteles.

Overall debt ratio would reflect the Miller equilibrium at the expense of the socially optimal debt-equity mix.

ACE isn't perfect either, but plausible that it's less bad overall.

*ACC not only is more neutral than ACE regarding "true" debt vs. equity, but would be administratively simpler. E.g., no need to determine whether contingent debt subject to OID rules is "really" equity.

Corporate capital & accelerated depreciation

With interest deductibility plus accelerated depreciation, can have incentive to make investments that are unprofitable pre-tax.

The problem: internally inconsistent accounting. Cf. consumption tax with expensing plus either (a) interest on original cost basis or (b) income tax treatment of interest (deducted w/o principal being included/deducted).

Lower corporate rates would fail to address this problem, but ACE does.

Lower book value of assets from faster depreciation reduces future years' ACE deductions (an equal tradeoff, assuming constant tax rates).

Once again, ACE appears preferable to simply lowering the corporate rate.

Income tax vs. consumption tax

With ACE but not corporate rate reduction, effectively have a consumption tax at the corporate level.

These days, most in the “biz” would agree that consumption taxes have important efficiency advantages over income taxes (even assuming correctly measured economic depreciation in the latter).

But one can still argue for income taxation if one believes that, in practice, it will be more progressive.

E.g., suppose saving is fairly inelastic and that, under individual-level progressive consumption tax, rates wouldn’t be sufficiently adjusted.

Application to ACE vs. lowering the corporate rate isn’t immediately clear if benefits of *both* would accrue primarily to employees.

But perhaps advantage ACE if we expect greater efficiency without any obvious distributional disadvantage.

Owner level; non-business sector

One problem raised both by lowering the corporate rate & by ACE is interaction with the owner level.

In general (not just for debt bias), one must look at both.

E.g., do we want a consumption tax for some TPs but not others? Do we actually have one if SHs are under income tax? (Kleinbard's BEIT)

Note the difficulty of discerning how equity-holders are actually currently taxed – e.g., what's the actual burden from a realization-based second level of tax that potentially disappears.

This difficulty also impedes understanding how taxation of the corporate sector would relate to that of the non-corporate business sector under ACE or with a lower corporate rate.

Obviously, that sector's not facing the second level of tax doesn't guarantee overall neutrality under either proposal.

Transition

Either proposal could yield surprise SH gains as applied to old capital.

But the ACE "windfall" has desirable anticipation effects (less expected debt bias; don't wait to contribute new equity).

If we nonetheless limit ACE to new equity, note the issue of churning or freshening up old equity – administratively simpler to impose a one-time tax on old equity & then allow ACE deductions.

Lowering the corporate rate has bad as well as good anticipation effects (e.g., merely deferring taxable income, such as through pre-enactment purchases of assets with accelerated depreciation).

Note how little support Treasury II in 1985 won for its "depreciation recapture" proposal.

Under either proposal, increasing post-enactment investment levels would tend to reduce the value of old capital (Auerbach-Kotlikoff 1983).

ACE and the financial sector

Difficulty of identifying financial firms (including those embedded in other firms) may add to ACE's advantages over lowering the corporate rate.

Suppose the overall "response level" to debt at identified financial firms will be the same either way – e.g., with slightly more rigorous capital adequacy regulation if ACE isn't adopted.

ACE would still have the advantage of reducing debt bias in financial firms that we fail to identify as such.

But if the tax law retains debt bias (including from having ACE rather than ACC), can this be deployed to strengthen capital adequacy regulation of the financial firms that we do recognize?

E.g., could adopt tax rules addressing tax-regulatory hybrids (such as denying interest deductions for tax debt that is regulatory capital).

Unilateral vs. multilateral perspectives

Multilateral proposals naturally focus on what might be good rules if adopted by many or all countries.

But a given country may take interest in the possibility that others' strategic responses will be limited &/or delayed, making its policy shifts to a degree unilateral.

Cutting the corporate rate has more appeal unilaterally than multilaterally, as a key domestic payoff comes from improving one's relative position in global tax competition for investment & revenues.

Unilaterally adopting ACE, however, may comparably improve one's relative position without being as overtly tax-competitive.

If viewed by others as structural reform, might it fly more under the radar from a strategic standpoint?

Summing up

On balance, I'm persuaded that U.S. corporate tax reform should treat adopting ACE (or better yet ACC) as prior to considering rate cuts.

But our dire fiscal situation suggests financing any such changes – at present, a politically insurmountable problem.

Due to the opacity of how the realization-based shareholder-level tax actually operates, no easy answers re. how to address neutrality between the corporate and non-corporate sectors.

Adopting ACE or ACC also invites revisiting shareholder-level taxation (as does lowering the corporate rate, but perhaps less overtly).

Changing the dominant corporate tax reform model to reflect the case for ACE or ACC might help down the road, even if nothing is imminent.