Comments on Avi-Yonah & Chenchinski, *The Case for Dividend Deduction*

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Almost everyone agrees that, if we were starting U.S. income taxation all over again, including that of corporate entities, there's no way we would adopt the current system. In particular, classical corporate income taxation's bias in favor of debt over equity makes no sense. And in 2008 we learned that debt bias's effects are even worse than we had realized. The tax code didn't cause the 2008 financial crisis, but its incentive for extra leverage may, in effect, have caused there to be more loose gasoline sloshing around in the vicinity when the explosion hit.

Unfortunately, there is much less consensus about whether or not, given where we now stand, corporate tax reform should be a high-priority item. Suppose we have limited political agenda space for tax reform, or that we're concerned about long-term fiscal sustainability and fear that rational responses, such as raising individual rates or adding new instruments such as a VAT, carbon tax, or financial activities tax, are politically unavailable. Then a corporate tax reform that loses revenue and gives tax benefits to old investments, not just new ones that can respond prospectively to rule changes, may seem a low priority at best.

There is even less consensus regarding what corporate tax reform should look like if we do it. But in that regard, one thing I welcome about Reuven's paper is its focus on debt bias rather than on lowering the corporate rate, which appears to be the first-choice move in Washington these days. I myself would prefer an allowance for corporate equity or ACE, which allows an entity-level deduction without regard to dividends paid, or better still an allowance for corporate capital or ACC, which mandates the same deduction for both debt and equity without regard to dividends or interest actually paid. And any of these reforms would require thinking about the investor side, such as via Ed Kleinbard's business enterprise income tax or BEIT, which would impute income to the holders of corporate financial instruments without regard to the instrument's character.

Reuven's proposal, dividend deduction, is not entirely dissimilar. But it relies on actual dividends paid and thus retains the debt-equity distinction. This is more important than he acknowledges. In particular, dividend deductibility creates a year-by-year election regarding whether to locate taxable income at the entity or investor level. For debt, by contrast, the OID rules can make annual corporate deductions and investor inclusions mandatory, whether or not current cash is paid out.

Dividend deductibility also could confer windfall transition gains on existing corporate equity. Basically, old capital gets handed a tax benefit that no one expected when the underlying investments were made. This could in principle be addressed, but at the cost of some complexity if an immediate compensating "transition tax" was politically unfeasible.

Although I'm nonetheless generally sympathetic to Reuven's policy aims, I have some issues with the paper's analysis. The first concerns the comprehensive business income tax or CBIT. In recent years, this proposal has suffered plunging support due to concerns about focusing business taxation at the entity rather than the owner level in an era of global capital mobility and rising corporate residence electivity. Michael Graetz, for example, who played a big role in developing CBIT, no longer supports it for this reason, and I think he's right. But I question Reuven's criticisms of CBIT.

Reuven notes two reasons for entity-level taxation. First, given the income tax on individuals and the difficulty of applying partnership-style flow-through rules to corporations, we shouldn't let corporations function as tax shelters. This is certainly correct. But it doesn't establish that there would be anything wrong, as he suggests, with applying an entity-level tax even when flow-through is feasible. Thus, suppose a U.S. law firm has exclusively U.S. partners, all of whom pay tax at the same rate as corporations. Then it may not matter whether we tax them – just once under CBIT – at the individual level or the entity level. The paper doesn't explain why, in practice, over-extending the entity-level tax would have bad consequences.

This presumably would have to do with tax rate differences at the two levels. But even without CBIT, lowering the corporate rate below the individual rate would raise important problems concerning the use of corporations as a tax shelter for owner-employees' labor income.

Second, Reuven notes that the managers of publicly traded companies have a lot of discretion and economic power, so their incentives matter. He thus favors an entity-level tax so we can address their incentives. But the problem is, he doesn't address why an entity-level tax would be effective in this regard. After all, the managers of a publicly traded company do not themselves pay the company's tax out of their own pockets. Indeed, they are typically more focused on maximizing financial accounting income, an aim that often diverges from minimizing the company's tax liability.

Reuven argues that dividend deductibility would create strong managerial incentives to distribute corporate earnings, on the ground that they will want to reduce the entity-level tax while being unconcerned about the shareholder-level tax. But he doesn't say anything about how the financial accounting rules would treat deductible dividend distributions. This is an issue that accountants would have to wrestle with if dividend deductibility were enacted. For example, by analogy to the current accounting treatment of foreign subsidiaries' earnings, one could argue that full dividend distribution should be assumed for accounting purposes – unless the company declares that particular earnings will permanently remain undistributed – and that it makes no accounting difference whether dividends are declared today or one hundred years in the future. The accounting outcome to this issue, whatever it was, might end up having stronger behavioral effects than what the tax system does.

Turning to another issue, I think the paper overstates the differences between dividend deduction and imputation. These are potentially identical systems. And even where implementation details may make them different in practice, there's often a tradeoff presented that the paper insufficiently acknoweldges.

OK – how are dividend deduction and imputation in principal the same? My handout illustrates that they are identical under simple facts. The reason they're the same, despite the optical differences, is that, under each, when earnings are distributed to shareholders, application of the shareholder tax rate entirely replaces that of the entity-level tax rate.

In practice, two main things can make them different. First, if the shareholder rate is lower than the corporate rate, withholding tax **non**-refundability can cause imputation to deny the full benefit of lower shareholder tax rates. The example in the handout simply has a lower shareholder-level rate, 20 percent instead of 35%. A more important real-world example might involve non-taxpaying shareholders, such as tax-exempts or foreigners.

This is potentially a very big issue in practice. The paper is surprisingly casual about effectively expanding greatly the subsidy to tax-exempt entities by permitting them, through dividend deduction, newly to earn wholly tax-free income through corporate investment. Harvard University would no doubt love this, as it would greatly boost the value of their already $32 billion endowment.

Reuven also may be over-optimistic about the capacity of withholding taxes on dividends paid to foreign shareholders to offset entity-level deductibility as to them. In any event, however, if we *like* the result of dividend deductibility as to those groups, imputation with full withholding tax refundability, even for tax-exempts and foreigners, is just as good, and considerably more transparent.

Second, corporate-level tax preferences may work differently in imputation as compared to dividend deductibility systems if there are tax preferences. Under deductibility, if preferences reduce taxable income below true earnings, then paying dividends may create NOLs in lieu of current-year tax savings. Imputation, by contrast, avoids interacting corporate integration with entity-level NOL nonrefundability.

Reuven thinks this is a good feature of deductibility, on the ground that tax preferences shouldn't be passed through to shareholders and that limiting them is more complicated under imputation. But I have several concerns with his analysis.

First, do we really want to deny the pass-through of tax preferences to shareholders? I believe there is no good argument for this unless we don't like the tax preferences to begin with, and can't scale them back more rationally and directly. That may ultimately be a plausible position, but it involves using a seventieth-best response to tax preferences, at best.

Second, using loss nonrefundability to limit the combined net benefit from corporate integration plus using tax preferences inevitably devalues both, not just the preferences. We can't be glad that deductibility makes corporate tax preferences less economically valuable than otherwise, without also noting and regretting that it may discourage using the corporate form and paying out dividends to shareholders. So at best denying preference pass-through is a tradeoff.

Third, whether you do or don't want to pass through tax preferences to shareholders, you can combine your preferred policy either with deductibility or with imputation. For example, corporate dividend deductions could be made refundable without regard to overall taxable income, and could be excluded from the NOL computation. In effect, one could offer companies a refundable percentage credit for dividends paid, in lieu of a deduction, with a percentage reimbursement rate that equaled the marginal tax rate.

Likewise, under imputation, while Reuven criticizes the complexity of existing rules that seek to limit the benefit pass-through, there might be simpler methods if one isn't too anal about precision. An example might be adjusting the corporate tax payment that is deemed to be associated with a given dividend distribution to reflect the ratio between corporate taxable income and a broader measure, such as earnings and profits or even book income, rather than grossing it up based on the full marginal tax rate at the corporate level.

In sum, I have no objection to including dividend deductibility on the list of potential corporate integration methods. I think the main reason it's generally been so little discussed is that imputation offers so close a substitute, with better optics if you want to retain the indirect reach of the corporate tax on shareholders who are tax-exempts or foreigners. I question trying to limit the pass-through of corporate tax preferences even if you dislike the preferences, which I generally do. I'm worried about the revenue cost and windfall transition gain to existing shareholders, although a more rational and well-functioning political process than ours could handle these problems. And under the right circumstances I'd like to go further than either imputation or dividend deductibility towards fully eliminating the debt-equity divide.