

## The Reinvestment Deduction: A Modest Proposal to Reform the Taxation of Business Income

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### INTRODUCTION

Thoughts of fundamental tax reform are rarely far from the minds of policy makers and tax specialists, but problems of political choice appear to have dimmed its prospects for the foreseeable future.<sup>1</sup> As evidence, consider that agreement across a wide segment of the political spectrum on reform principles has prevailed for a number of years, but Congress lately has been unable to advance a major reform proposal, despite efforts from members of both major parties to do so.<sup>2</sup> In the meantime, narrow tax breaks of various sorts continue to proliferate in response to lobbying efforts by organized groups, despite the consensus among analysts that most such provisions are ill-advised.<sup>3</sup>

It would seem, therefore, that proposals for reform in the near term need to be relatively modest in ambition if they are to receive consideration from policy makers. The challenge is to advance ideas that represent policy improvements on their own but that also tend in the direction of desirable broader-scale

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<sup>1</sup> See Jonathan Weisman, *The Tax Wilderness, Untamed*, N.Y. TIMES, Feb. 9, 2014, at BU7 (describing the "consensus" in Washington: "There will be no comprehensive tax code overhaul this year . . .").

<sup>2</sup> For the political fate of House Ways and Means Chair Rep. Dave Camp's (R-MI) proposal, see Brian Faler et al., *How the GOP Lost Its Nerve on Tax Reform*, POLITICO (Dec. 5, 2013, 5:03 AM), <http://www.politico.com/story/2013/12/tax-code-gop-leaders-100693.html>. For the political fate of Senate Finance Committee Chair Max Baucus's (D-MT) proposal, see Kelsey Snell, *Max Baucus Tax Reform Proposal at Risk*, POLITICO (July 30, 2013, 9:18 PM), <http://www.politico.com/story/2013/07/max-baucus-tax-reform-94894.html>.

<sup>3</sup> As examples, since 2000, bonus depreciation, § 179, and the bonus depreciation allowance, § 168(k), have repeatedly been enacted with sunset provisions and renewed. See GARY GUENTHER, CONG. RESEARCH SERV., RL31852, SECTION 179 AND BONUS DEPRECIATION EXPENSING ALLOWANCES: CURRENT LAW, LEGISLATIVE PROPOSALS IN THE 112TH CONGRESS, AND ECONOMIC EFFECTS 4–10, (2012), available at <https://www.fas.org/sgp/crs/misc/RL31852.pdf> (detailing legislative histories).

reform. In addition, and as contrasted with global reform proposals, more-modest proposals need to be especially sensitive to “second-best” problems because of their incremental nature. A second-best problem arises when adoption of a reform that is favorable when viewed in isolation makes things worse overall because of its interaction with other features of the system that the reform does not address.<sup>4</sup> Because modest proposals by definition seek to advance policy goals on a piecemeal basis, they inevitably interact with other features of the law not subject to change under the proposal; where these features are themselves problematic from a policy perspective, adopting the modest change may lead to an undesirable shift towards behavior that the undesirable feature encourages.

This Essay is offered in the spirit of incremental reform. It recommends enactment of a deduction to individuals for promptly reinvested distributions received on corporate equity and gains derived from the sale or exchange of corporate equity. The reform is largely efficiency-oriented. For reasons explained below, under current law, the tax on dividends and on gains recognized from the sale or exchange of corporate equity that would be reinvested in the absence of tax considerations is often easily—and often likely—avoided, with the results that economically efficient transactions do not occur and tax is not collected. Consequently, if enacted, the proposal would remove a highly distortionary rule that produces little tax revenue. Moreover, though direct revenue gains would not arise, modest increases in tax revenue may result simply from the efficiency gains.

The proposal also moves in the direction of more-comprehensive reform for which I have argued elsewhere. In a recent essay, I advocated the adoption of a uniform tax on all business income along the lines of the comprehensive business income tax, or CBIT, that the Treasury Department proposed in 1992.<sup>5</sup> The CBIT as originally formulated would have taxed all business income once at the entity level, at a flat rate equal to the top marginal rate on individuals, which then was 31%. Taxes on distributions and on gains from the sale or exchange of CBIT-covered entities would have been eliminated. Interest on borrowings by CBIT-covered entities would have been

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<sup>4</sup> For a discussion of second-best problems, see generally David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 (1999).

<sup>5</sup> U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992) [hereinafter TREASURY REPORT], available at <http://www.treasury.gov/resource-center/tax-policy/Pages/integration-paper.aspx#summary>.

non-deductible to payors and non-includible by payees. The promised benefits of the original CBIT were considerable. In addition to simplification from the repeal of subchapters S, K, and much of C, it would have reduced or eliminated three significant tax biases: against the corporate form; against equity versus debt financing; and against tax-motivated earnings distributions or retentions.<sup>6</sup>

My earlier essay advocated retention of most features of the Treasury's CBIT but also argued for coupling the CBIT with an excise-tax and deduction regime on distributions and gains realized on the disposition of CBIT interests similar to that proposed here for corporate equity.<sup>7</sup> The motivation for the additional tax-and-deduction regime was to make the CBIT workable in light of constraints absent in 1992. These include principally the requirements that revenues increase, but that rates on business income fall in response to concerns about competitiveness.<sup>8</sup> My proposal also suggested other, less substantial, modifications to the original CBIT.<sup>9</sup>

Taking that larger reform package, or something similar to it, as a target, the question is whether the more-modest proposal discussed here would represent an improvement. That is, is it an improvement taken on its own, does it move in the direction of favorable large-scale reform, and is its implementation as a standalone reform workable? Because I have addressed the second question in the CBIT proposal, the discussion below focuses on the first and third questions. Part I outlines the basics of the proposal, Part II discusses its efficiency properties with respect to the bias against investment in the corporate sector,

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<sup>6</sup> See *id.* at ch. 4. At the time, the top corporate rate exceeded the top individual rate by 3%. *Id.* at 39. This disparity created a tax incentive to distribute earnings. Much more commonly in the history of the income tax, the disparity has run in the other direction. For all years since passage of the 16th Amendment in 1913, other than 1988 to 1993, the top individual bracket has equaled or exceeded the top corporate bracket; for all years other than 1988 to 1993 and 2003 to 2013, the top individual bracket has exceeded the top corporate bracket. See *SOI Tax Stats - Historical Table 23*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/uac/SOI-Tax-Stats-Historical-Table-23> (last updated May 1, 2013) (individual rates); TAX POLICY CTR., URBAN INST. & BROOKINGS INST., HISTORICAL TOP CORPORATE TAX RATE AND BRACKET: 1909-2013, available at [http://www.taxpolicycenter.org/taxfacts/content/pdf/corporate\\_historical\\_bracket.pdf](http://www.taxpolicycenter.org/taxfacts/content/pdf/corporate_historical_bracket.pdf) (corporate rates). When top individual rates exceed top corporate rates, the tax incentive runs in the other direction, toward tax-motivated earnings retention.

<sup>7</sup> David Hasen, *CBIT 2.0: A Proposal to Address U.S. Business Taxation*, 140 TAX NOTES 909 (2013).

<sup>8</sup> All recent legislative and executive branch proposals for business tax reform have included a substantial reduction in corporate tax rates. See *infra* note 34.

<sup>9</sup> These included modifications to the treatment of outbound investment income and a lower CBIT rate. Hasen, *supra* note 7, at 920–23.

and Part III considers additional behavioral effects that may arise at the corporate level.

### I. PROPOSAL

Under current law, income of regular, or “C,” corporations is taxed at graduated rates that rise to 34% for taxable income from \$75,000 to \$10 million and to 35% for income above that, with recapture provisions to ensure that average rates and marginal rates converge above certain thresholds.<sup>10</sup> In addition, distributions in respect of corporate equity made to individuals generally are taxable at the shareholder level as net capital gains at 15%, or at 20% for individuals having taxable income greater than \$400,000 per year (\$450,000 for married filing jointly).<sup>11</sup> The same 15 and 20% rates apply to long-term gains recognized by individuals from the sale or exchange of stock (and other property) that is held as a capital asset.<sup>12</sup> By contrast, income earned by sole proprietors, through the partnership form or by an S corporation, generally is taxed just once, at the owner level, at graduated rates ranging from 10% to 39.6% for individuals in the same brackets as those subject to the 20% rate on dividends and long-term capital gains.<sup>13</sup> In addition, as of 2013, a 3.8% tax applies to an individual’s “net investment income” (“NII”) to the extent that the individual’s adjusted gross income (subject to some modifications) exceeds \$200,000 (\$250,000 for married filing jointly).<sup>14</sup> For most taxpayers, NII includes dividend income and income from the sale or exchange of corporate stock.<sup>15</sup> The tax on NII applies in addition to the regular income tax.<sup>16</sup>

The proposal would permit individual shareholders to deduct distributions on stock held in C corporations in the year of distribution to the extent the distributions were reinvested prior to the due date for the return for the taxable year. The deduction would apply for both regular income tax and NII tax purposes. Reinvestment would not need to be in corporate equity to qualify. The proposal would extend the same treatment to timely reinvested long-term gains recognized on the sale or exchange of

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<sup>10</sup> § 11. In the discussion below, references to corporations and corporate equity generally are to taxable C corporations unless stated otherwise.

<sup>11</sup> § 1(h)(11).

<sup>12</sup> § 1(h)(1).

<sup>13</sup> § 1(c)–(d).

<sup>14</sup> § 1411. Section 1411 was added by section 1402(a)(1) of Pub. L. No. 111-152. It is effective for taxable years beginning after 2012. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1402(a)(4), 124 Stat. 1029, 1060.

<sup>15</sup> § 1411(c)(1)(A)(i) (dividends); § 1411(c)(1)(A)(iii) (gains from the sale or exchange of stock).

<sup>16</sup> § 1411(a)(1).

stock in C corporations. In either case, no basis credit for reinvested proceeds would be available. Instead, in the case of reinvestment in any business entity, outside basis would not be increased to reflect the investment of deducted amounts, and in the case of investment in the taxpayer's sole proprietorship, basis in the assets of the proprietorship would be reduced. Because the avoided income tax is charged at long-term capital rates,<sup>17</sup> basis reduction generally would apply to capital assets or to property that would generate a "section 1231 gain" or "section 1231 loss" on disposition.<sup>18</sup> To the extent basis in those assets is insufficient, the deduction on the original distribution or sale would be denied.

The overall effect of the proposal is to defer both income tax and the tax on NII on distributions and on gains from the sale or exchange of C corporation stock until the shareholder spends the income on consumption.<sup>19</sup>

The following examples illustrate the operation of current law and how the proposal would alter current law.

**Example 1:** Individuals  $O_1$  and  $O_2$  (together,  $O_s$ ), married calendar-year taxpayers filing jointly, own 100 shares of common stock in the XYZ corporation. Their ordinary income is taxed in the 35% marginal tax bracket. Their modified AGI for purposes of the tax on NII exceeds the applicable threshold. On January 1 of Year 1, XYZ distributes a dividend of \$10 per share on its common stock, or \$1,000, to  $O_s$ . One month after the distribution,  $O_s$  contribute \$1,000 to the ABC corporation in exchange for 100 shares of ABC common stock.

Under current law,  $O_s$  include the \$1,000 in gross income as net capital gain (assuming they do not elect to treat the income as net investment income for purposes of section 163)<sup>20</sup> and are taxed at a 15% rate, or \$150,<sup>21</sup> assuming they do not have

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<sup>17</sup> § 1(h)(11).

<sup>18</sup> § 1231(a)(3).

<sup>19</sup> Generally, consumption taxation differs from income taxation in that it does not reach the return to waiting. See, e.g., Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1417 (2006). If amounts are reinvested in a pass-through entity, subsequent earnings are taxed as earned, but the expensing of the cost of the investment (to  $O$ ) is equivalent to exemption of taxation on the time-value return of the investment if the tax rate is the same for the deduction and the inclusion. See Daniel I. Halperin & Alvin C. Warren, Jr., *Understanding Income Tax Deferral*, TAX L. REV. (forthcoming 2014) (manuscript at 1–2) (on file with author).

<sup>20</sup> See § 163(d)(4)(B). "Net investment income" for purposes of this provision is not the same as it is for section 1411.

<sup>21</sup> § 1(h)(1)(C).

offsetting capital losses.<sup>22</sup> *Os* also owe \$38 of tax on the dividend under section 1411. *Os* are left with \$812 after taxes, for an overall rate on the distribution of 18.8%. Therefore, the \$1,000 investment in *ABC* requires the investment of an additional \$188 of *Os*' after-tax income, which is equivalent to \$231.53 of pre-tax income, assuming that income is taxed at 18.8%. *Os* take a \$1,000 adjusted basis in the *ABC* stock.

Under the proposal, *Os* would deduct the \$1,000 investment in *ABC* for purposes of both the income tax and the tax on NII. (That is, they would take a \$1,000 above-the-line deduction for income tax purposes, and they would reduce total NII by \$1,000 for NII tax purposes.) They would not receive basis credit for the amount reinvested, regardless of whether *ABC* was a C corporation or an S corporation. Similarly, if they instead invested the \$1,000 in a partnership, they would receive no basis credit in the partnership interest thereby purchased.

The effect of the denial of outside but not inside basis is to cause the deduction to operate as a deferral mechanism. Specifically, the availability of basis credit at the entity level ensures that the deduction is not offset by excess inclusions, while the denial of basis credit at the owner level ensures the deduction is recaptured when the taxpayer receives distributions that are not again reinvested. Suppose, for example, that *ABC* is a C corporation, and that *ABC* uses the \$1,000 that *Os* contribute to purchase tangible depreciable property having a useful life of 20 years and 0 salvage value.<sup>23</sup> Assume *ABC* earns a pre-tax return of 8% on the property, or \$80 per year. In the standard case in which full basis is available in the purchased asset, *ABC* would depreciate the property by \$50 per year for \$30 of net annual income. If the property were worthless after 20 years, *ABC* would have no further income or loss. If basis credit were given at the owner but not the entity level, *ABC* would have \$80 per year of taxable income, thereby prematurely recapturing the deduction enjoyed by *Os* and burdening other *ABC* shareholders as well with tax on non-economic income, since the \$1,000 investment is a cost of producing the income.

Instead, providing depreciable basis in *ABC*'s hands ensures no excess tax at the entity level, thereby preventing other shareholders from being over-taxed and preventing *Os*' deduction from being canceled in whole or part prior to consumption. The

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<sup>22</sup> § 1222(11).

<sup>23</sup> Simplifying assumptions for the computation of depreciation are used for purposes of illustration. In practice, a mid-period convention and a declining balance method of depreciation would apply to the property. See § 168.

deduction is recouped only when *Os*' investment is withdrawn, either through distributions (or redemptions so treated)<sup>24</sup> that exceed both *ABC*'s earnings and profits and *Os*' basis in the stock,<sup>25</sup> or when *Os* sell the *ABC* stock (or it is redeemed in a transaction qualifying for sale-or-exchange treatment).<sup>26</sup> In either case, the gain would be capital.<sup>27</sup>

If *ABC* is an S corporation, the denial of outside basis again preserves the deduction unless and until distributions exceed that basis. Although distributions from *ABC* would not be eligible for the deduction if reinvested, amounts earned through the corporation before deducted amounts were distributed would be taxed in the same manner as earnings on after-tax equity contributed to the corporation. Analogous results would obtain in the case of investment in a partnership. The reduced basis in the *ABC* partnership interest (as compared to the basis funded with after-tax dollars) would cause distributions to be treated as gains from the sale or exchange of property sooner than if basis credit had been provided.<sup>28</sup>

Because there is no "outside basis" in a sole proprietorship, ensuring that the deduction operates as a deferral and not as an exemption provision requires a different approach.

**Example 2:** The facts are the same as Example 1 under the proposal, except that *Os* contribute \$1,000 to *O<sub>i</sub>*'s sole proprietorship.

In order to preserve the benefit of the deduction in this setting, it is necessary to reduce basis in the assets of the enterprise itself. The reduction ought properly be applied to assets the gain on disposition of which is capital, since the avoided tax is at capital gain rates, and a workable rule would be to apply the deduction in proportion to the relative adjusted bases of those assets. (A virtue of using adjusted bases rather than fair market values is that the taxpayer should have easy access to information about the former.) To the extent basis is insufficient, the deduction would be denied. The effect of reducing basis in the properties of the proprietorship is similar to that of reducing the outside basis in the entity. Earnings continue to be taxed as before, but depreciation deductions will

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<sup>24</sup> § 302(d).

<sup>25</sup> § 301(c)(3).

<sup>26</sup> § 302(a) (sale-or-exchange treatment on certain redemptions).

<sup>27</sup> §§ 1001(a), 1222(3). If the gain were not capital (because, for example, *Os* are dealers in stock), the investment in *ABC* would not have been deductible in the first place.

<sup>28</sup> § 731(a) (non-taxation of money distributions not in excess of partner's basis); § 1368(b) (non-taxation of distributions not in excess of shareholder's basis in S corporation).

be less, and gains on the sale or exchange of business property will be subject to greater tax than if no deduction had been taken on the initial distribution from XYZ.

Equivalently, the proposal converts the nominal income tax on earnings distributions to a consumption tax under certain restrictive assumptions. For reasons stated in the earlier proposal for a modified CBIT, there are ample grounds to support the introduction of explicit consumption taxation of distributions into what is nominally an income tax regime, chief among them that consumption tax treatment already applies to many such gains in practice for the very reasons that motivate the proposal.<sup>29</sup> For the reasons developed in that discussion and alluded to above, C corporation earnings often are not cashed out by tax-sensitive investors until the investor is ready to spend them on consumption. To that extent, the question is how removal of the tax on what is in substance investment reallocations (i.e., reinvestment of dividend distributions) affects reallocations rather than how it affects revenues or fairness. The effect of removing the tax on reallocations is the subject of the next section.

## II. EFFICIENCY IMPLICATIONS

Intuitively, it is not hard to see why a dividend tax reduction ought to lead to an efficiency gain. The general view is that current law skews investment away from the C corporation form because of the “double tax” on corporate equity.<sup>30</sup> Specifically, because earnings of C corporations are taxed to the corporation as earned and again on distribution as dividends, they may be subject to an overall effective income tax rate of approximately 45% for most investors, and 48% for high-bracket investors.<sup>31</sup> These rates apply whether distributed earnings are drawn down for consumption or reinvested. Earnings of other business forms are taxed to owners once at a maximum rate of 35% for most taxpayers and 39.6% for high-bracket individuals.<sup>32</sup> The corporate-level behavioral effects of the high rate on dividends are not entirely clear (they are discussed in the next section), but the efficiency costs at the shareholder level are more readily identifiable. To the extent shareholders are unable to avoid the

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<sup>29</sup> Hasen, *supra* note 7, at 914–16.

<sup>30</sup> See, e.g., George R. Zodrow, *On the “Traditional” and “New” Views of Dividend Taxation*, 44 NAT’L TAX J. 497, 497 (1991).

<sup>31</sup> § 11 (tax on corporations); § 1(h)(11) (treating qualified dividends as net capital gain); § 1(h)(1) (imposing a maximum tax on net capital gain of 15% for taxpayers in the 35% bracket or below on their ordinary income and 20% for taxpayers in the 39.6% ordinary income bracket).

<sup>32</sup> § 1(a)–(d).

tax on corporate earnings, the after-tax price of equity increases relative to that of alternatives, inducing an exodus of investment from the corporate equity sector to other sectors, including debt and pass-through enterprises. The drop in corporate sector equity investment raises the return to capital that remains there, but the overall effect is a macro-level misallocation of equity capital between the corporate and non-corporate sectors.<sup>33</sup>

If the law otherwise remains unchanged, the proposal would ameliorate the bias against the corporate form by reducing the *ex ante* tax cost of investing in the corporate sector. The result would be an unambiguous reduction in the tax disincentive to invest in corporations, since the consumption tax benefit with respect to the distribution tax that is already available (at the efficiency cost of retaining earnings that otherwise would be distributed or holding stock that would otherwise be sold) would simply be extended to allow earnings reallocations that, on a pre-tax basis, are more desirable than leaving earnings in the corporation where they arise or than leaving the stock in the hands of the shareholder who owned the stock during the period that the corporation derived the earnings. Further, because the benefit is only a timing one, the proposal runs the risk of inefficiently biasing investment *in favor* of corporate equity (again assuming no other change in the law) only if three unlikely conditions all hold: interest rates become very high; investors perceive a very substantial pre-tax advantage in being able to reallocate earnings to other vehicles over leaving earnings in the corporation where they arise or continuing to hold stock; and the marginal investor is in a bracket above the maximum 35% bracket for corporations. (For purposes of the last requirement, the tax on NII should be added to the shareholder's income tax bracket.) Under these circumstances, the slightly lower rate on corporate equity as compared to other forms of investment for high-tax investors, together with the extension of that tax rate to reallocated profits, might create a tax bias in favor of investment in the corporate form. Note, however, that in particular the second condition is unlikely to hold. It is the fact that keeping profits in the corporation where they arise is a close substitute for reallocating them to other investments that creates the deadweight loss that the proposal seeks to reduce in the first place.

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<sup>33</sup> For a general discussion of this phenomenon, see R. Glenn Hubbard, *Corporate Tax Integration: A View from the Treasury Department*, 7 J. ECON. PERSP. 115, 118–19 (1993). See also TREASURY REPORT, *supra* note 5, ch. 13.

Wholly apart from the consequences of adopting the proposal, the magnitude of the tax bias against the corporate form would change, and its sign possibly even reverse, if Congress succeeds in materially reducing the top corporate rate, especially in light of the tax on NII.<sup>34</sup> By lowering the rate on corporate investment and leaving the rates on pass-through entities and sole proprietorships unchanged, an advantage to investment in corporations would arise to the extent the ultimate tax on corporate distributions (or gains on the sale of corporate stock) does not outweigh the benefits of a lower rate on corporate income compared to the income of more highly-taxed investors in pass-through entities and sole proprietorships. The proposal here would increase that advantage to some extent, because it lowers the effective rate on returns from corporate equity. In general, the trade-off becomes taxation at a lower entity rate for corporate equity in exchange for an ultimate excise tax on distribution for consumption rather than on distribution simply. The longer the time between the investment and consumption and the greater the discount rate, the lower the real effective tax on corporate equity that would otherwise be distributed and reallocated.

Again, however, in light of the availability of self-help in the form of earnings retention (especially where distributions are sensitive to expected shareholder uses of the distributions), it does not seem that any additional incentive to invest in the corporate form or revenue loss from adoption of the proposal will be substantial, while any efficiency benefits with respect to already-invested amounts would persist. In short, if Congress lowers the maximum corporate rate, the tax bias in favor of corporate equity will result from that rate reduction, not from the proposal. Even if corporate investment becomes tax-favored, it would still be welfare-improving to provide the deduction if distribution behavior is sensitive to the tax on distributions, a topic briefly discussed in the next section.

### III. ADDITIONAL BEHAVIORAL EFFECTS

The preceding section described the most easily predicted effect of adoption of the proposal, but other adjustments are

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<sup>34</sup> Proposals to reduce corporate rates enjoy theoretical support across a wide segment of the political spectrum. *See, e.g.*, MAX BAUCUS, U.S. SENATE COMM. ON FIN., SUMMARY OF STAFF DISCUSSION DRAFT: INTERNATIONAL BUSINESS TAX REFORM 2 (2013), available at <http://www.finance.senate.gov/imo/media/doc/Chairman's%20Staff%20International%20Discussion%20Draft%20Summary.pdf> (advocating “significantly lower corporate tax rates”); HOUSE COMM. ON WAYS & MEANS, 113TH CONG., DISCUSSION DRAFT ON TAX REFORM ACT OF 2014 (2014), available at [http://waysandmeans.house.gov/uploadedfiles/statutory\\_text\\_tax\\_reform\\_act\\_of\\_2014\\_discussion\\_draft\\_022614.pdf](http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft_022614.pdf) (reducing the corporate tax rate to 25% under proposed section 3001 of the 2014 Act).

likely to occur as well. In general, the proposal potentially will have an impact across two additional behavioral margins: the corporation's decision to distribute earnings or not, and the corporation's decision to finance marginal investment with equity or not. Even if the overall efficiency consequences of adopting the proposal would be positive for the reasons discussed above, the question remains what the new steady state will be along all margins once all adjustments occur. For example, if the dividend tax rate does not markedly affect dividend policy, it is not clear that the proposal will reduce inefficient earnings retention (if corporations in fact retain earnings that should be distributed). Similarly, if managers finance marginal projects with retained earnings, the proposal may have little effect on levels of equity finance. More generally, the answer to whether adoption of the proposal would result in an increase in equity finance, in distributions, or in both, depends not only on the benefits from a reduction in the tax burden of owning corporate equity, but also on managerial incentives. Depending upon the role that dividends and equity issuances play in corporate finance and the alignment of managers' and shareholders' interests, the corporate-level behavioral effects of a dividend tax reduction can differ.

#### A. Theories of Managerial Behavior

Currently, four main views vie for explanatory power over managerial behavior;<sup>35</sup> the consequences of adoption of the proposal depend in some measure on the extent to which each theory accounts for managerial behavior. This subsection briefly outlines these views and the consequences of adoption of the proposal under each of them. Subsection B then reviews some recent empirical findings.

Until the 1980s, economists generally held what has since been termed the "old" or "traditional" view of managerial behavior. The old view assumes that managers seek to maximize shareholder value and that corporations finance new projects with either debt or equity.<sup>36</sup> Because dividend taxes have the effect of "double-taxing" corporate earnings, managers incline toward debt finance, which permits a deduction to the firm for

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<sup>35</sup> Alan Auerbach & Kevin Hassett, *Dividend Taxes and Firm Valuation: New Evidence* 1–2 (Nat'l Bureau of Econ. Research, Working Paper No. 11959, 2006). Another theory, the "tax irrelevance" view, posits that the marginal investor is tax-indifferent and therefore that dividend taxes are entirely irrelevant to managerial finance decisions; the evidence does not appear to support this view. *Id.*

<sup>36</sup> Zodrow, *supra* note 30, at 497.

interest payments,<sup>37</sup> and away from equity finance, which provides no deductions for dividends paid. To the extent the old view holds, a dividend reinvestment deduction enhances the attractiveness of equity finance to managers because the greater after-tax value to shareholders of dividend payments reduces the cost of equity to the corporation.<sup>38</sup> Similarly, the overall increase in corporate equity implies greater total dividend payouts.<sup>39</sup> Further, where managers know that shareholders expect to reallocate distributions rather than to spend them on consumption, one would expect an increase in distributions.

A second view, and the primary competitor to the old view, is the “new” view. In its basic formulation, it likewise posits that managers seek to maximize shareholder value, but it assumes that corporations finance marginal investments with retained earnings rather than with new equity or debt issues.<sup>40</sup> In this setting, dividend taxes are thought to have no effect on the marginal finance decision or the size of dividend distributions, though they do affect the price of corporate equity.<sup>41</sup> When retained earnings are available to finance new projects, a firm will use those earnings for the project, and the dividend tax operates similarly to an excise tax.<sup>42</sup> Because the present value of such a tax is constant, changes in the dividend tax rate have no differential impact on the timing of the dividend payment—it has the same present value no matter when paid.<sup>43</sup> Yet even if the new view better explains manager behavior than does the old view, the proposal should result in an increase in distributions, because the excise tax effect, which is to say deferral, continues even on distributed earnings that are reinvested, assuming managers seek to maximize shareholder value.<sup>44</sup> To some extent,

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<sup>37</sup> Hans-Werner Sinn, *Taxation and the Cost of Capital: The “Old” View, the “New” View, and Another View*, in 5 *TAX POLICY AND THE ECONOMY* 25, 27–29 (David Bradford ed., 1991).

<sup>38</sup> Roger Gordon & Martin Dietz, *Dividends and Taxes* 3–4, (Nat’l Bureau of Econ. Research, Working Paper No. 12292, 2006).

<sup>39</sup> Raj Chetty & Emmanuel Saez, *An Agency Theory of Dividend Taxation* 1 (Nat’l Bureau of Econ. Research, Working Paper No. 13538, 2007).

<sup>40</sup> Zodrow, *supra* note 30, at 497.

<sup>41</sup> Auerbach & Hassett, *supra* note 35, at 1; Zodrow, *supra* note 30, at 497–500.

<sup>42</sup> Zodrow, *supra* note 30, at 500. See also Seppo Kari et al., *The Impact of Dividend Taxation on Dividends and Investment: New Evidence Based on a Natural Experiment* 7 (CESifo, Working Paper No. 2756, 2009), available at [http://ideas.repec.org/p/ces/ceswps/\\_2756.html](http://ideas.repec.org/p/ces/ceswps/_2756.html).

<sup>43</sup> Raj Chetty & Emmanuel Saez, *Dividend and Corporate Taxation in an Agency Model of the Firm*, 2 *AM. ECON. J.: ECON. POLY* 1, 4–5 (2010).

<sup>44</sup> The cost to the firm of the dividend tax is constant. *Id.* But the cost to shareholders is not under current law, because the after-tax proceeds available for investment are reduced by the dividend tax. Because the proposal extends consumption tax treatment to reinvested distributions, shareholders continue to derive a benefit from deferring consumption of the distribution.

however, this analysis assumes that distribution policy is informed by managers' knowledge that distributions are likely to be reinvested rather than spent on consumption. Equivalently (under the assumption of alignment of shareholder and management incentives), it assumes that shareholders dictate the timing of distributions.

A third view posits that dividend payouts serve a signaling function in the public corporation setting.<sup>45</sup> They enable managers to demonstrate that the firm is "healthy."<sup>46</sup> Under the signaling view, a cut in the dividend price generally reduces the cost of the (costly) signal and so should result in an increase in the size, if not the number, of dividend payouts. However, under at least one formulation of the signaling model, the dividend tax actually increases efficiency, at least for dividend-paying firms not engaged in share repurchase programs.<sup>47</sup> For these firms, the increase in dividends could actually result in an efficiency cost.

Finally, a more recent theory posits that principal-agent problems afflict managerial decision making where ownership and control of the corporation are separate. Because owners cannot effectively monitor managers, managers pursue policies inconsistent with those that maximize shareholder value.<sup>48</sup> Under this view, managers use retained earnings to fund "perks and pet projects" even though shareholders would prefer that the earnings be distributed or spent on a better investment.<sup>49</sup> The effect of the reinvestment deduction on managers' behavior in this setting depends on the amount of earnings on hand, though in the model developed by economists Raj Chetty and Emmanuel Saez, a reduction in dividend taxation would be associated with an unambiguous welfare improvement whether or not earnings are available. Under their model, if dividend taxes are lowered, cash-rich firms that otherwise would use retained earnings to pursue unproductive pet projects face pressure to distribute the earnings, and cash-poor firms that otherwise would not finance a marginal meritorious project do so with additional equity issues.<sup>50</sup> The first of these effects relates to the question of whether to retain or distribute earnings, while the second relates to the question of whether to finance with equity or not. Hence the productivity effect of a reduction in the dividend tax on the marginal finance decision appears to be modest but

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<sup>45</sup> *Id.* at 2.

<sup>46</sup> Gordon & Dietz, *supra* note 38, at 2.

<sup>47</sup> *Id.* at 27.

<sup>48</sup> *Id.* at 28–29.

<sup>49</sup> Chetty & Saez, *supra* note 43, at 2.

<sup>50</sup> *Id.* at 15.

unambiguously positive under the agency view: A dividend tax reduction increases the incentive of cash-rich firms to distribute earnings that should be distributed and reduces the disincentive of cash-poor firms to finance with equity because of the tax disadvantage as compared with debt.

#### B. Empirical Findings

Evidence regarding the explanatory power of the theories is somewhat mixed, but it appears that the most robust theory is the agency model, followed by the traditional model. François Gourio and Jianjun Miao, summarizing literature on the 2003 dividend tax cut, report substantial increases in dividend payouts following that cut, which lowered top dividend rates from 35 to 15%.<sup>51</sup> Chetty and Saez report similar findings regarding the 2003 dividend tax cut, noting in addition that the response was rapid and larger where executives were substantial shareholders or where substantial shareholders served on the board of directors.<sup>52</sup> These phenomena are mostly consistent with the predictions of the traditional model and more consistent with their agency model, but less so with the other models.<sup>53</sup> Gourio and Miao's model also predicts substantial efficiency gains from reduction of the barrier to efficient allocation of investment that result from the rate cut.<sup>54</sup> Roger Gordon and Martin Dietz, reviewing findings dating back to 1980, similarly conclude that the agency model best fits the evidence.<sup>55</sup> Further, under any of these theories except the signaling model, a reduction in dividend taxes has no efficiency losses at the managerial level; under the traditional and agency views, it results in unambiguous efficiency gains at the managerial level.

These studies focused on the 2003 dividend tax reduction (as well as, in some cases, on other tax law changes), a less targeted but larger tax benefit than that proposed here. It was less targeted in that it applied without regard to the purpose for which dividends were spent; it was larger in that it represented a dramatic rate reduction, at least in nominal terms, when measured against prior law. (The extent to which it represented a real rate reduction depends on the availability under prior law

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<sup>51</sup> See generally François Gourio & Jianjun Miao, *Firm Heterogeneity and the Long-Run Effect of Dividend Tax Reform*, 2 AM. ECON. J.: MACROECONOMICS 131 (2010) (summarizing recent studies).

<sup>52</sup> Chetty & Saez, *supra* note 43, at 2.

<sup>53</sup> See James Poterba, *Taxation and Corporate Payout Policy*, 94 AM. ECON. REV. 171, 174–75 (2004) (predicting a high response to the 2003 reduction in taxes on dividends).

<sup>54</sup> Gourio & Miao, *supra* note 51, at 133.

<sup>55</sup> Gordon & Dietz, *supra* note 38, at 28–29.

of better-taxed substitutes for distributions, of which two are of significance: share repurchases qualifying for sale-or-exchange treatment,<sup>56</sup> and simple sales of stock to third parties.) These two features of the comparison between the 2003 change and the reinvestment deduction proposal cut in opposite directions. Other things equal, a larger tax reduction should result in a larger behavioral response, because of the larger avoided tax cost associated with the more favored activity when measured against prior law. On the other hand, the deduction reinvestment proposal targets more elastic behavior than did the 2003 Act. Distributions earmarked for consumption (to the extent shareholders control or effectively inform distribution policy) are inherently less elastic to dividend tax rates than are distributions that are expected to be reinvested, because consumption is not a close substitute for continued investment. By contrast, the effect of reinvesting distributed earnings is simply a reallocation of the shareholder's capital; leaving the earnings in the corporation where they arise is a relatively close substitute for that activity, which means that in many cases taxing earnings on distribution that otherwise would be reinvested will result in non-distribution of the earnings (again, assuming distribution policy is affected by the shareholders' expected use of the distribution proceeds). In short, whatever the pre-tax difference between distribution of earnings for the purpose of reallocation on one hand, and non-distribution of earnings on the other, it is almost certainly too small to warrant the payment of a 15 or 20% tax for the privilege. The dividend reinvestment proposal, because it provides a benefit only for deferred consumption, targets tax-motivated earnings retention when the alternative would be reinvestment.

The implication is that the deduction proposal is likely to result in a more modest behavioral change than that of the 2003 Act at both the shareholder and the corporate levels, but in a more dramatic welfare improvement when measured in terms of the ratio of avoided deadweight loss to reductions in tax revenues. In short, the proposal appears to offer a fairly unambiguous policy improvement.

#### CONCLUSION

The object of the proposal discussed here is twofold. First, it is to identify a low-cost reform measure that is relatively modest in ambition, clearly favorable in efficiency terms, and therefore more likely than a comprehensive reform proposal to meet with

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<sup>56</sup> § 302(a)–(b).

serious consideration from policy makers in the present environment. Second, it is to point in the direction of larger-scale reform that would bring with it much more substantial benefits, including dramatic simplification and enhanced efficiency, if and when global reform becomes a viable policy option. Enactment of the reinvestment deduction would accomplish these goals by eliminating substantial efficiency losses at little revenue cost in static terms (and possibly by generating tax revenue increases in dynamic terms) and establishing a precedent for a simplified, mixed income-consumption tax regime applicable to all business income.