AEI STUDIES ON TAX REFORM

Fundamental Tax Reform and Corporate Finance

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W.M.G. and R.G. H.

A slightly different version of this text will appear in the NBER's Tax Policy and the Economy series, to be published by the MIT Press.

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Foreword

Economists, policy makers, and business executives are keenly interested in fundamental tax reform. High marginal tax rates, complex tax provisions, disincentives for saving and investment, and solvency problems in the social security program provide reasons to contemplate how reforms of the tax code and other public policies toward saving and investment might increase economic efficiency, simplify the tax code, and enhance fairness. Many economists believe that gains to the economy from an overhaul of the income tax or from a move to a broad-based consumption tax can be measured in the trillions of dollars. Most conventional economic models indicate a potential for large gains from tax reform.

While many economists agree broadly on the simple analytics of tax reform, they are in much less agreement on such key empirical questions as how much saving or investment would rise in response to a switch to a consumption tax, how much capital accumulation would increase under a partial privatization of social security, how reform would affect the distribution of taxes, and how international capital markets influence the effects of tax reforms in the United States. This lack of professional consensus has made the policy debate fuzzy and confusing.

With these concerns in mind, Diana Furchtgott-Roth and I organized a tax reform seminar series at the American Enterprise Institute beginning in January 1996. At each seminar, an economist presented new empirical research on topics relating to fundamental tax reform. These topics include transition problems in moving to a consumption tax, the effect of taxation on household saving, distributional effects of consumption taxes in the long and short run, issues in the taxation of financial services, privatizing social security as a fundamental tax reform, international issues in consumption taxation, distributional consequences of reductions in the capital gains tax, effects of tax reform on pension saving and nonpension saving, effects of tax reform on labor supply, consequences of tax reform on business investment, and likely prototypes for fundamental tax reform.

The goal of the pamphlet series in fundamental tax reform is to distribute research on economic issues in tax reform to a broad audience. Each study in the series reflects many insightful comments by seminar participants—economists, attorneys, accountants, and journalists in the tax policy community. Diana and I are especially grateful to the two discussants of each paper, who offered the perspectives of an economist and an attorney.

I would like to thank the American Enterprise Institute for providing financial support for the seminar series and pamphlet series.

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Introduction

One of the most complex areas of the U. S. tax system is the treatment of business financing and investment decisions. Much of the complexity arises because managers try to minimize their firms' tax liability through tax planning. These tax-planning strategies could differ substantially if the United States undertakes a fundamental tax reform. In this volume, we describe the major effects of fundamental tax reform on corporate financial policy and summarize economists' knowledge of the magnitude of these different effects. We concentrate on financial policy issues rather than on the effects of fundamental tax reform on aggregate saving and investment, which are often cited as an impetus for reform (see, for example, the analysis in Auerbach 1996).

We identify four major areas of policy concern. First, in the short run, tax reform could cause changes in asset values by changing the relative tax treatment of existing and new investment. Such changes could create substantial windfall gains and losses to owners of specific assets. Second, tax reform could affect decisions on business organization and reorganization. Third, fundamental tax reform could influence firms' decisions on capital structure—the choices between debt and equity financing and between dividends and retained earnings. Fourth, fundamental tax reform could greatly alter the tax-planning landscape, which would affect the complex financial transactions (derivatives and swap contracts, for example) that firms use to lower their tax payments under current tax rules.

Fundamental tax reform is a broad term that encompasses a wide range of policies, including income tax reforms and replacing the current tax system with a broad-based consumption tax. Despite this range of policies, possible reforms have several common features. First, a common goal of tax reforms is to reduce the disparity in tax rates across different types of real assets and across different financial contracts. Second, fundamental tax reforms of both the income and the consumption variety typically call for a broad tax base with lower marginal tax rates. For income tax reform, our definition of fundamental tax reform includes proposals to integrate the personal and corporate tax systems and move toward a more consistent definition of income across types of assets. Moving to a consumption tax can be thought of as taking such an income tax reform one step further—the consumption tax would replace the system of depreciation allowances under the integrated income tax with immediate deductions for capital outlays of businesses. Because the two reforms share this first step, many of their effects on corporate finance are similar.[1] For the issues we consider, however, the administrative feasibility of the consumption tax may have advantages over income tax reform.

This volume proceeds as follows. Chapter 2 briefly outlines prototypes for tax reform and their treatment of the business sector and financial assets. Chapter 3 discusses how the transition to a new tax system could affect the relative valuation of assets. Depending on the transition rules included in tax reform, these asset valuation effects could be larger for moving to a consumption tax rather than income tax reform. The key issue for the valuation effects is whether the rules governing the transition to a consumption tax would disallow depreciation allowances expected on current assets. In chapter 4, we discuss the potential effects of tax reform on the organizational form of businesses, the source of finance, and payout policy. Chapter 5 discusses how fundamental tax reform would affect tax planning by businesses, especially with respect to their use of complex financial transactions. Chapter 6 summarizes our findings.

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Prototypes for Fundamental Tax Reform

The current U.S. tax system is a hybrid of income and consumption tax rules (see, for example, the review in Engen and Gale 1996). The reasons behind the hybrid tax system include both administrative issues (for example, difficulties in measuring income accruing as unrealized capital gains or as consumption flows from consumer-owned durables) and policy choices (for example, special tax provisions for retirement saving). Proposals for fundamental tax reform typically suggest moving to either a purer income tax or a purer consumption tax. Although these two "goals" appear to be on opposite ends of a spectrum, the purer income tax and the purer consumption tax may affect corporate financing decisions in similar ways. Moving to a purer tax system of either type would reduce tax-planning opportunities because tax-minimizing strategies often involve combining transactions with different tax treatments (for instance, part of the transaction receives pure income tax treatment, but another part receives consumption tax treatment) or taking advantage of disparities in tax rates across investors.

In the next section, we describe a prototype of income tax reform. We proceed to show how this income tax could be converted into a consumption tax and argue that this conversion would not have major implications for corporate finance issues. We conclude the chapter with a brief discussion of how some of the policy choices in the prototype reforms affect the possibilities for tax planning.

Broad-based Income Tax Reform

For corporate finance, the critical element of fundamental reform of the income tax is the integration of the corporate and the personal income tax systems. In theory, integrating the systems would eliminate two distortions from the current tax system. First, integrating them would erase the distinction between corporate and noncorporate businesses by abolishing the double taxation of equity-financed corporate taxation. Second, this reform would remove the differential taxation of debt and equity finance. Whether the actual tax reform process would deliver these benefits depends on the details of the new system.

The U.S. Treasury Department's recent study of corporate tax integration (see U.S. Department of the Treasury 1992) presents several alternative approaches to integrating the individual and corporate tax systems. Rather than repeat this discussion of the many different proposals, we outline a stylized version of one proposal, the comprehensive business income tax (CBIT). The goal of CBIT is to tax business income once. CBIT is a business-level tax on the return to capital of businesses. Broadly speaking, the business-level tax base under CBIT is revenue from the sale of goods or real assets less wages, material costs, and depreciation allowances for capital investments. To conform to standard income accounting, the CBIT tax base uses depreciation allowances that follow as closely as possible economic depreciation. Because CBIT is a tax on capital income, it runs afoul of the standard income tax accounting problem of adjusting for inflation. If the government wants to tax real, rather than nominal, capital income, the cost recovery system (depreciation allowances) must be indexed for inflation. CBIT does not distinguish whether capital is financed by borrowing or by issuing equity. That is, relative to the current tax system, CBIT would not allow businesses to deduct interest payments from their tax base.[2] Because CBIT taxes business income at the entity level, there is no need for investor-level taxes on capital gains, interest, or dividends received.[3]

CBIT can be thought of as the capital income tax component of a broad-based income tax that collects taxes from labor income through a tax on household wages. We assume, for simplicity, that the marginal tax rate in CBIT is the same as the marginal rate for wage taxes. With this assumption, capital and labor income face the same tax rate. If the wage tax rate differs from the CBIT rate, then labor and capital income face different tax rates; however, capital income from different types of assets faces a common tax rate regardless of whether it is financed by debt or by equity.[4]

Converting the Income Tax into a Consumption Tax

Converting CBIT into a consumption tax turns out to be quite straightforward. Instead of measuring business income through depreciation allowances, a consumption tax version of CBIT would allow businesses a deduction for capital investments when assets are purchased. This adjustment converts the combination of CBIT and a wage tax into the flat tax proposed by Hall and Rabushka (1983, 1995). We use the flat tax as the model of the consumption tax for the purposes of this book.[5] Our focus on expensing as the central difference between CBIT and the flat tax reflects our emphasis on the effects of tax reform on business finance. The flat tax has an added advantage of mitigating the distortions of capital allocation between the business and the housing sectors. In the aggregate, the tax base is a measure of consumption because sales between businesses induce offsetting inclusions and deductions for the seller and buyer: the seller's tax base increases by the purchase price, but the buyer's tax base decreases by the purchase price. If the buyer and seller face the same tax rate, then the transaction creates no revenue for the government. When a business sells goods to households, the aggregate tax base increases by the value of the purchase.

Having described CBIT and the flat tax in this way, we can see that the flat tax does not exempt all of what is commonly called "capital income" from taxation (see also Gentry and Hubbard 1997). Under the business cash-flow tax component of the flat tax, the present value of depreciation allowances for one dollar of current investment is one dollar, while the present value is less than one dollar under the income tax. For a risk-free investment project, the tax savings from depreciation allowances represent risk-free flows,[6] which the firm would discount at the risk-free rate of interest. For a marginal investment (in which the expected rate of return just equals the discount rate), the upfront subsidy to investment provided by expensing equals the expected future tax payments. It is in this sense that the "return to capital" is not taxed under a cash-flow tax or a consumption tax.[7]

What about inframarginal investments? That is, in addition to risk-free projects, suppose that certain entrepreneurs have access to investments with inframarginal returns (associated with rents to ideas, managerial skill, or market power). In this case, what is taxed are rates of cash flow in excess of the firm's discount rate for depreciation allowances. Cash flows representing inframarginal returns are taxed equivalently under the broad-based income tax and the cash-flow tax (or consumption tax). As long as the scale of inframarginal projects is limited (and entrepreneurs' project selection is optimal), the tax saving from expensing should be invested in another risk-free asset. Hence, for inframarginal projects only the return representing the risk-free rate is untaxed under the cash-flow tax or consumption tax.

What about risky investments? First, risky investments generate *ex post* high or low returns. The component of capital income that represents luck after a risky investment has been made can be treated like the inframarginal return in the foregoing example of the income tax and the cash-flow tax. Second, risky investments have a higher *ex ante* required rate of return than risk-free investments, reflecting a risk premium to compensate savers for bearing risk. Whether either tax system levies a tax on the risk premium depends on how one defines a *tax*. If a tax is defined as an increase in expected government revenue, then both the income tax and the cash-flow tax include the risk premium. If, in contrast, a tax is an increase in the discounted present value of government revenue, then neither tax system includes the risk premium. In either case, the central point is that the stylized income tax and consumption tax treat the return to risk taking similarly.

To summarize, what is often called the return to capital can be thought of as the sum of the risk-free return (opportunity cost), inframarginal returns (economic profits), and returns to risk taking (payment for bearing risk and luck). In contrast to the base of the consumption tax, the income tax includes the opportunity cost of capital, which equals the rate of return on a marginal riskless project.

Critical Issues for Tax Planning under the Prototype Reforms

The returns to tax planning depend on the level of tax rates and the dispersion of tax rates across investors. Higher tax rates increase the returns to arranging financial contracts to minimize taxable income. In the simple specification described above, we assumed a single tax rate for wage income and the business-level tax. The magnitude of this single tax rate depends on policy choices about revenue needs and the desired progressivity of the tax system. Either type of tax reform can be made more progressive by increasing a household-level exemption for the wage tax component of the tax system. For a given level of revenue, increasing the household exemption typically requires a higher marginal tax rate. Most proposed versions of these tax reforms include household exemptions, which would result in a lower marginal tax rate for businesses and high-income households. Because the benefits of lowering a firm's tax base are inversely related to the tax rate, these lower marginal tax rates reduce the returns to tax planning.

The variation in tax rates across entities is an important part of tax planning because differences in tax rates across investors lead to investor "clienteles" for particular financial assets. Under current tax rules, for example, interest payments are deductible for borrowers and taxable to investors. If a high-tax-rate borrower (for example, a corporation) pays interest to a low-tax-rate lender (for example, a pension fund), then aggregate tax collections fall; in contrast, if the lender has a higher tax rate than the borrower, then the interest payment increases aggregate tax revenue. Under the tax reform proposals we examine, because there are no investor-level taxes, this form of tax planning is eliminated. Foreign investors may provide an exception to this rule. If foreign governments levy residence-based taxes, then foreign investors may face taxes on income received from U.S. businesses. Tax-exempt investors (for example, nonprofit organizations and pension funds) also deserve mention. As the largest group of zero-rate investors under current tax rules, these tax-exempt investors may lose relative to other investors as the tax rate on all domestic investors falls to zero.

Even with a single marginal tax rate for businesses, effective tax rates can still vary across firms depending on the tax rules for loss-offset provisions. Under current tax rules, firms can carry current tax losses back to offset taxes in the previous three years or carry losses forward to offset taxable income for fifteen years; however, these rules do not adjust for the time value of money. Hence, such rules motivate several tax planning strategies, including leasing and some forms of corporate reorganization. Fundamental tax reforms that retain such loss-offset rules will continue to create incentives for this form of tax planning.

Working Definition of Tax Reform

For the remainder of this volume, we use the term *fundamental tax reform* to represent tax proposals with the following characteristics:

- We assume a combination of a business-level tax (with either cash flow or business income as the base) and a household wage tax.
- For an income tax version of reform, we assume that depreciation allowances are as close to economic depreciation as possible; for the consumption tax version of reform, businesses will deduct capital expenditures.
- The business-level tax does not distinguish between debt and equity financing.
- To minimize the differences in marginal tax rates across business entities and investments, firms will be allowed to carry net operating losses forward with interest.
- We assume lower marginal tax rates with a single marginal tax rate across business entities and households; the household tax can have a personal or family exemption.

Because fundamental tax reform implies either income tax reform or moving to a consumption tax, we will distinguish between effects on corporate finance issues that do not depend on the choice of tax reforms and those that differ.