tax break

by William G. Gale and Peter R. Orszag

The Administration's Proposal to Cut Dividend and Capital Gains Taxes

William G. Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy at the Brookings Institution. Peter R. Orszag is the Joseph A. Pechman Senior Fellow at Brookings. They thank David Gunter for excellent research assistance, and Henry Aaron, Alan Auerbach, Reuven Avi-Yonah, Robert Cumby, Mihir Desai, Peter Diamond, and Jim Poterba for valuable comments and discussions. The views expressed are their own and should not be attributed to the trustees, officers, or staff of the Brookings Institution.

Overview

In the United States, some corporate income is never taxed, some is taxed once (either at the individual or the corporate level), and some is taxed twice. Many economists — ourselves included — would prefer a system that taxed all corporate income, but taxed it once and only once, at nonpreferential tax rates. Such a system would modify the tax incentives for various types of corporate behavior in important ways. In this article, we focus on two crucial dimensions of corporate incentives affected by the tax system: The incentive to shelter corporate income from taxation and the incentive to retain corporate earnings rather than pay dividends.[1]

> ***The administration's recent proposal may not even reduce to a significant degree the incentives that exist under the current system to shelter corporate income from taxation and then to retain the earnings.***

We show that the administration's recent tax proposal does not eliminate, and may not even reduce to a significant degree, the incentives that exist under the current tax system to shelter corporate income from taxation and then to retain the earnings. Thus, in our judgment, despite the administration's rhetoric to the contrary, its proposal does not represent tax reform. The administration's proposal does the "easy" part of tax reform: It cuts taxes. It fails, however, to do the difficult part of any serious tax reform effort: Broadening the tax base and eliminating the share of corporate income that is never taxed (or taxed at preferential rates). That difference is what distinguishes "tax reform" from "tax cuts."

I. Introduction

The most prominent component of the administration's new tax plan is something described as a dividend tax cut. In reality, the provision would represent a significant tax cut for both dividends and capital gains on corporate stocks. In simplest terms, under the administration's proposal, dividends paid out of corporate earnings that were already taxed at the corporate level would not be subject to the individual income tax. In addition, earnings that were already taxed at the corporate level and that were retained by the corporation would generate a basis adjustment for shareholders. Such a basis adjustment means that, when the stock is ultimately sold, the increase in stock price due to retained earnings taxed at the corporate level would not generate a capital gains tax liability at the individual level.

Vice President Cheney has claimed that the administration's proposal would "transform corporate behavior in America and encourage responsible practices."[2] Likewise, the Treasury Department claims that "Corporations will have good reason to pay taxes and not to engage in aggressive tax sheltering. A dollar in taxes saved by a corporation no longer translates into more cash for their shareholders." Also, the proposal ". . . will reduce huge distortions and ineffeciences, allowing corporations to make decisions based on what makes good business sense instead of what makes good tax sense."[3] Other officials and analysts have similarly claimed the plan represents an important tax reform that will substantially reduce or eliminate the incentives for corporate tax sheltering and for retaining earnings. In this article, we develop a simple model that implies that such claims are unlikely to be correct. Our analysis reaches several conclusions. First, a substantial share of corporate equity

[1]Other important dimensions of the incentives created by the tax system involve the effect on organizational form and corporate financing, but we focus here on the incentives to shelter funds and to retain earnings.

[2]"Remarks by the Vice President on the Economy," U.S. Chamber of Commerce, January 10, 2003.

[3]"Fact Sheet: The President's Proposal to the End of the Double Tax on Corporate Earnings," Office of Public Affairs, Department of Treasury, Jan. 14, 2003, KD-3762.

is held by investors that are not subject to individual dividend and capital gains taxes. To the extent that firms are owned by these shareholders, the administration's proposal provides literally no incentive to reduce sheltering or pay out earnings. Second, to the extent that firms are owned by taxable shareholders, firms would maximize shareholders' after-tax return by sheltering corporate income from taxation and then retaining the earnings — the same strategy that maximizes shareholders' after-tax returns under current law. Third, the administration's proposal would create at least one massive new loophole that we describe below, and possibly many more.

As a result, the administration's proposal would not eliminate the incentives for corporate tax shelters. This crucial aspect of its proposal betrays the administration's tax reform rhetoric.

We also show that if the administration truly wanted to tax all corporate income once and to eliminate any tax-related incentives to shelter and retain earnings, it would have to modify its proposal to tax all of the following at the same statutory tax rate:

- Earnings that the corporation chose not to shelter;
- Dividends paid out of nontaxable corporate earnings (more technically, dividends that are not paid out of the Excludable Distribution Accounts that the administration's plan would create); and
- The change in market value of the company less retained earnings that come from the Excludable Distribution Account (more technically, the change in the market value less the part of the EDA that is not paid out in dividends).

If the administration modified its proposal to meet this condition, dividends paid out of EDAs and capital gains due to the retention of funds in EDAs would not be taxed at the individual level, just as under the administration's current proposal. The crucial difference, however, is that this modification (which would require taxing dividends and accruing capital gains at the full corporate tax rate to the extent such capital gains or dividends reflected income not already taxed at the corporate level) would ensure that all corporate income was taxed once at a nonpreferential rate. The administration's proposal does not produce such a result.

We emphasize that the goal of this article is not to advocate that the administration adopt this particular change to its proposal; there are many ways to tax all corporate income once and only once. Modifying the administration's proposal in this manner may not be the best way. Rather, the goal of the paper is to demonstrate what would be required to tax all corporate income once, only once, and at a nonpreferential rate within the administration's framework, and to show that the administration's proposal does not achieve this objective.

Moreover, because the administration appears to be opposed to tax increases (including base broadening) of almost any kind, it is important to realize that any reasonable prospect for bona fide corporate reform will be lost if the dividend and capital gains tax cut is enacted without simultaneous base-broadening measures.

II. Background

The United States is often said to tax corporate earnings twice, once at the corporate level when the earnings are obtained, and again at the individual level when the earnings are paid out as dividends (and taxed at the individual level) or kept as retained earnings that generate capital gains (which are eventually taxed, albeit at preferred rates, at the individual level if the shareholder sells the stock before death). In fact, however, most corporate income is not taxed twice:

- A substantial share of corporate income is not taxed at the corporate level, due to shelters, corporate tax subsidies, and other factors.[4] Recent evidence suggests growing use of corporate tax shelters.[5]
- Half or more of dividends are effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and nonprofits.[6]
- A substantial share of capital gains on corporate stocks is never taxed because of the basis step-up at death. The share of capital gains that is subject to taxation, furthermore, is taxed at preferred rates relative to ordinary income and taxed only on a deferred basis; both factors reduce the effective tax rate on these gains.[7]

As a result of these features of the tax code, some corporate income is not taxed at either the corporate or individual level, some is taxed once (at either the firm or individual level), and some is taxed twice. Although data limitations make definitive judgments difficult, the component of corporate income that is not taxed (or is preferentially taxed) appears to be at least as large as the component that is subject to double taxation. That is, the nontaxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

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[4]Robert McIntyre, "Calculations of the Share of Corporate Profits Subject to Tax in 2002," January 2003.

[5]Mihir Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," NBER Working Paper 8866, April 2002.

[6]William G. Gale, "About Half of Dividend Payments Do Not Face Double Taxation," *Tax Notes,* Nov. 11, 2002, p. 839. Although taxes are due on pensions and 401(k) plans when the funds are paid out or withdrawn, the effective tax rate on the return to saving in such accounts is typically zero or negative because the present value of the tax saving due to the deduction that accompanies the original contribution is typically at least as large as the present value of the tax liability that accompanies the withdrawal.

[7]The taxation of nominal (as opposed to real) capital gains exerts an upward bias in the effective tax rate on capital gains. Given recent trends in inflation and real returns, however, this effect is relatively minor in the current environment.

Table 1: After-Tax Returns From $100 in Pre-Tax Corporate Income for a Taxable Investor

	Shelter $100 in corporate earnings/ do not pay corporate tax		Do not shelter $100 in corporate earnings/ pay corporate tax	
	After corporate tax	After individual tax	After corporate tax	After individual tax
Current law				
Pay dividend	$100	$74	$65	$48
Retain earnings	$100	$90	$65	$59
Administration's proposal				
Pay dividend	$100	$74	$65	$65
Retain earnings	$100	$90	$65	$65
Administration's proposal modified to tax at 35 percent dividends and accruing capital gains based on income not taxed at corporate level				
Pay dividend	$100	$65	$65	$65
Retain earnings	$100	$65	$65	$65

Given the differential tax treatment of dividends, capital gains, and corporate earnings, and other related features of the tax code, the effective rate of taxation on corporate income varies. This system generates several well-known problems. We focus on the following two issues:

- Corporations have economic incentives and legal opportunities to shelter income from the corporate tax; and
- Corporations have incentives to retain earnings rather than pay dividends.

These problems have led to proposals for integration of the corporate and personal taxes. Under a well-designed integration scheme, all corporate income would be taxed; all corporate income would be taxed once; and all corporate income would be taxed at the same nonpreferential rate.

The nontaxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

As noted above, under the administration's proposal, dividends paid out of corporate earnings that were already taxed at the corporate level would not be subject to taxation under the individual income tax. In addition, corporate retained earnings that were taxed at the corporate level would generate a basis adjustment for shareholders so that — when the stock was eventually sold — capital gains taxes would not have to be paid on the increase in stock price that was due to already-taxed retained earnings.

To implement this plan, firms would have to create excludable distribution accounts based on their taxable earnings. The creation of these accounts is likely to involve a variety of complicated issues. From the shareholder perspective, however, the system could be relatively simple. For example, the 1099 that shareholders receive could list (a) total dividends paid to the shareholder (as it currently does); (b) the taxable share of these dividends; and (c) the appropriate adjustment in basis for the stock price.

III. Incentives in a Simple Model

A. Taxable Investors

To analyze the effects of the administration's proposal for firms owned by taxable investors, we consider a simple example. We assume that the marginal statutory corporate tax rate is 35 percent, the marginal individual tax rate on taxable dividends is 26 percent,[8] and the effective marginal individual tax rate on capital gains (on an accrual rather than realization basis) is 10 percent. These rates are assumed for simplicity; the qualitative findings do not differ under other similar rates. Furthermore, we assume that $1 in retained earnings results in $1 in capital gains for shareholders. We also assume the firm's motivation is to maximize after-tax income for its shareholders.[9]

Under these assumptions, consider a firm that has $100 in pre-tax earnings. We focus on two of its choices: Should it shelter the funds? Should it pay dividends or retain earnings on any after-tax profits? Table 1 works through this example under current law and the administration's proposal for a firm owned by taxable investors.

Under current law, if the corporation pays taxes on the $100 and then pays the rest out in dividends, the shareholder ends up with after-tax income of about $48 (=100*(1-0.35)*(1-0.26)). If the firm pays taxes and retains the earnings, the shareholder has a capital gain of $65, and thus keeps about $59 on an accrual-equivalent basis (=100*(1-0.35)*(1-0.10)).

[8]This rate is based on Treasury data reported in Kiefer, *et al.*, "The Economic Growth and Tax Relief Reconciliation Act of 2001: Overview and Assessment of Effects on Taxpayers," *National Tax Journal,* March 2002.

[9]If managers were more interested in maximizing the firm's after-tax income (rather than shareholders' after-tax income), the incentives to shelter corporate income under the administration's proposal would be even stronger than depicted below.

Table 2: After-Tax Returns From $100 in Pre-Tax Corporate Income for a Nontaxable Investor				
	Shelter $100 in corporate earnings/ do not pay corporate tax		Do not shelter $100 in corporate earnings/ pay corporate tax	
	After corporate tax	After individual tax	After corporate tax	After individual tax
Current law				
Pay dividend	$100	$100	$65	$65
Retain earnings	$100	$100	$65	$65
Administration's proposal				
Pay dividend	$100	$100	$65	$65
Retain earnings	$100	$100	$65	$65
Administration's proposal modified to tax at 35 percent dividends and accruing capital gains based on income not taxed at corporate level				
Pay dividend	$100	$65	$65	$65
Retain earnings	$100	$65	$65	$65

Under the administration's proposal, the shareholder receives $65 after tax (=100*(1-0.35)), regardless of pay-out policy. If the firm pays a dividend, the dividend is not taxable at the individual level. If the firm retains the earnings, the retained earnings raise the basis of the stock value for the shareholder and therefore wipe out any capital gains taxes that would have been owed at the personal level. Therefore, as long as the corporation pays taxes on the $100, the shareholder gains $65 after tax, regardless of whether the firm pays out or retains the after-tax earnings.

Now consider the incentives for sheltering the $100 from corporate taxation.[10] Under both current law and the administration's proposal, if the firm shelters the funds (and thus pays no corporate tax), the only tax paid is at the individual level (since taxable shareholders continue to be liable for taxes on dividends and capital gains resulting from nontaxed corporate earnings). Under both current law and the administration's proposal, shareholders end up with $74 (=100*(1-0.26)) if sheltered funds are paid out as dividends and $90 (=100*(1-0.10)) if sheltered funds are retained.

These calculations lead to several conclusions:

- Under current law, some corporate income is taxed at more than the full corporate rate (35 percent) and some corporate income is taxed at less than the full corporate rate. (After-tax returns to the shareholder that are above $65 reflect taxation at less than the full corporate rate; after-tax returns to the shareholder that are below $65 reflect taxation at more than the full corporate rate.) Funds that are sheltered pay less tax than those that are not. Earnings that are retained face less tax than earnings paid out as dividends. The implication is that taxing all corporate income once and only once at the full corporate rate requires reducing the tax burden on some forms of corporate income and raising it on others.
- Under current law, the most profitable after-tax strategy is to shelter income and retain the earnings. The same strategy is also the most profitable under the administration's proposal. Under both regimes, firms have incentives to shelter income, regardless of payout policy. These incentives are smaller in the administration's plan, but they are present in both systems.
- Under current law, tax incentives induce firms to retain earnings if they pay taxes on their earnings. Under the administration's proposal, tax incentives would not bias firms to retain earnings or to pay dividends if they pay taxes on their earnings. That is, the administration's proposal does eliminate the tax bias toward retaining earnings if and only if the corporation has paid tax on the earnings.
- In short, the administration's proposal eliminates the double taxation of corporate earnings: In all the scenarios where shareholders end up with less than $65 under the current system, they end up with $65 under the administration's proposal. But it does not eliminate incentives for corporate tax sheltering: In all the scenarios where shareholders end up with more than $65 under the current system, shareholders also end up with more than $65 under the administration's proposal. And, given sheltering, the administration's proposal does not eliminate the incentive to retain earnings.

B. Nontaxable Investors

All of the calculations and conclusions above refer to firms owned by taxable investors. The problems with the administration's proposals are even more significant to the extent that firms are owned by nontaxable investors. We define "nontaxable investors" as

[10]For simplicity, we assume that sheltering eliminates the corporate tax. In reality, sheltering may reduce rather than eliminate the tax. In addition, sheltering typically involves administrative expenses. Incorporating partial rather than full tax savings as well as administrative expenses would attenuate the incentives for tax sheltering under both current law and the administration's proposal, but would not eliminate them. The basic point remains.

shorthand for investors whose individual income tax liabilities would be unaffected by reductions in income taxes on dividends and capital gains. As noted above, half of all dividends accrue to entities that do not pay dividend taxes — including pension funds and nonprofit institutions. These entities own a substantial share of all outstanding equities (though not necessarily exactly half, since dividend payout ratios vary) and thus also receive a substantial share of all capital gains.

> ***To the extent that firms are owned by nontaxable shareholders, the administration's proposal provides no new incentives for corporations to pay taxes or dividends.***

To the extent that firms are owned by nontaxable shareholders, the administration's proposal provides no new incentives for corporations to pay taxes or dividends. Because they do not pay dividend or capital gains taxes anyway, those shareholders would prefer that corporations shelter their earnings, under current law and under the administration's plan. Table 2 shows these effects.

IV. Taxing All Corporate Income

The final two rows of Tables 1 and 2 show the incentives that would arise if the administration's proposal were modified to tax at the same rate:

- Earnings that the corporation chose not to shelter;
- Dividends paid out of nontaxable corporate earnings; and
- The change in market value of the company less retained earnings that come from the Excludable Distribution Account (more technically, the change in the market value less the part of the EDA that is not paid out in dividends).

Under this change, as under the administration's existing proposal, dividends paid out of EDAs and capital gains due to the retention of funds in EDAs would not be taxed.

These changes would tax income sheltered at the corporate level at the same rate as nonsheltered income. Under these changes, as under the administration's proposal, nonsheltered corporate earnings would be taxed at the corporate rate. Unlike the administration's proposals, however, these changes would also tax sheltered earnings — which have to be either paid out as dividends or retained — at the same rate as nonsheltered earnings. Any dividends paid out of sheltered earnings would be taxed at the full corporate rate (albeit at the individual level). Any retained earnings out of sheltered earnings would raise the firm's market value and thus would be taxed under this plan. To see this, note that the change in the firm's value is the sum of retained earnings out of EDAs and retained earnings out of sheltered income. Thus, the difference between the total change in market value and the amount of retained earnings from EDAs is the value of retained earnings out of sheltered earnings. That difference would be taxed under this change.

In Tables 1 and 2, we assume that the tax rate for all three items is 35 percent. The key result, shown in the final two rows of the table, is that taxing the three items above at the same rate eliminates incentives to shelter income at the corporate level and eliminates any tax-induced incentive to retain earnings. Modifying the administration's proposal in this manner — which would require taxing dividends and accruing capital gains for individuals at the 35 percent corporate tax rate if such capital gains or dividends did not reflect earnings already taxed at the corporate level — would be necessary to achieve the goals that the administration has apparently set, and claims, for its proposal.

It is worth emphasizing that the requisite modification to the administration's proposal would not eliminate the legal opportunity for corporations to shelter income. It would just take away the economic incentive to do so. To see this, note the following examples for taxable shareholders (similar conclusions apply to nontaxable shareholders):

- If the corporation paid tax on its $100 of earnings, the outcome is the same as under the administration's existing proposal: the shareholder would end up with $65 in dividends or $65 in capital gains and does not have to pay individual-level taxes on either. The shareholder thus receives $65 after tax.
- If the corporation sheltered its earnings and then paid $100 in dividends, the dividends would be taxable at the individual level (just as under the administration's existing proposal). The individual income tax rate on the dividends, however, would be set at the corporate tax rate, 35 percent, rather than the existing 26 percent rate (the average rate that would also prevail under the administration's proposal). As a result, the shareholder would receive $65 after tax.
- If the corporation sheltered its earnings and retained the $100 in earnings, the market value of the firm would increase by $100 — but the firm would have no increase in its EDA. As a result, taxing (at the full corporate rate) the increase in market value less the retained earnings paid from the EDA (in this case, none) would leave the shareholder with $65 in capital gains that would not be taxed again. Again, the shareholder would receive $65 after tax.[11]

[11]A hybrid example may also be insightful. Suppose the firm sheltered $50 and paid taxes on $50. It would pay $17.50 in taxes on the $50 of declared earnings, so that its EDA would be $32.50 (=50-17.50). Suppose it paid out $10 in dividends and kept $22.50 of the EDA as retained earnings. With the other (sheltered) $50, it paid $20 in dividends and retained $30. How would the modified version of the administration's proposal work in this case? The shareholder would have $10 in dividends paid from the EDA, and would keep

(Footnote 11 continued on next page.)

V. New Sheltering Opportunities

In addition to failing to eliminate the incentive for corporations to shelter income and retain it, the administration's proposal is likely to result in a variety of new tax shelters. As just one example, the Treasury Department has indicated that the EDA will be calculated as U.S. taxes (plus foreign tax credits used to offset U.S. tax liability), divided by 0.35 minus U.S. taxes plus foreign tax credits used to offset U.S. tax liability, plus excludable dividend income.[12]

This approach to computing the EDA opens a potentially large loophole involving corporate tax rates below 35 percent. In particular, corporate income is currently taxed at a 15 percent rate on income up to $50,000, and 25 percent on income between $50,000 and $75,000. Now consider a consultant earning $500,000 a year, who is currently in the 38.6 percent individual marginal tax bracket. Assume the consultant opens a new corporation to handle some of her specialized cases. She could channel up to $50,000 in income through such a corporation, pay $7,500 in corporate tax (= 0.15*$50,000), and pay herself a tax-free dividend of $42,500. The result is that the consultant will have succeeded in reducing the effective marginal tax rate on the $50,000 in income to 15 percent and saved almost $12,000 in taxes. Given the proposed EDA formula, this loophole is likely to be extremely difficult to monitor or offset.

VI. Conclusion

The administration's proposal to exclude dividends from individual taxation (and allow a basis adjustment for retained earnings) if the income has been taxed at the corporate level is a significant tax cut on dividends and capital gains. Although it is being marketed as an effort to reform the corporate tax, it would not eliminate the incentives for corporate tax shelters, nor would it eliminate the incentives to retain earnings based on shelters. These findings hold especially strongly to the extent that firms are owned by shareholders whose tax liability is not affected by individual income taxes on dividends and capital gains. Indeed, under the administration's proposal, as under current law, the strategy that generates the highest after-tax returns for the firm's shareholders involves sheltering the income from corporate taxation and retaining the earnings.

Modifying the administration's proposal to achieve true tax reform — which would tax corporate income once and only once at a nonpreferential rate, and eliminate the incentives for corporate tax sheltering as well as double taxation — would require taxing dividends and accruing capital gains at the full corporate tax rate to the extent such capital gains or dividends reflected income not already taxed at the corporate level. The implication is that for the administration's proposal to achieve its ostensible goals, it would have to be modified to include an increase in the effective marginal tax rate on dividends and an increase in the effective tax rate on accruing capital gains.

[Last week's column, "The President's Tax Proposal: First Impressions," (Jan. 13, 2003, p. 265) included the statement that "Davis (2002) reports that the administration believes that a $200 billion reduction in the surplus raises interest rates by 3-5 basis points. By that measure, a $900 billion package would reduce rates by between 13 and 22 basis points." The word "reduce" should have been "raise." Thanks to Bruce Bartlett for pointing out this mistake.]

that with no individual level taxes owed. The shareholder would have $20 in dividends from outside the EDA and have to pay $7 in taxes on that, keeping $13 after tax. The firm would have an increase in market value of $22.50 + $30 = $52.50. But the shareholder would owe tax on the $30 of that increase that is due to retained earnings from outside the EDA. So the shareholder pays $10.50 in taxes (=0.35*$30). The bottom line is that the shareholder gets $10 + $13 + $52.50 - $10.50 = $65 after tax.

[12]"Fact Sheet: The President's Proposal to the End of the Double Tax on Corporate Earnings," Office of Public Affairs, Department of Treasury, Jan. 14, 2003, KD-3761.

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