
BOOK REVIEW

DECODING THE U.S. CORPORATE TAX Daniel Shaviro

BOOK REVIEW BY ANDY HAILE*

Is it possible to make a book about reforming the U.S. corporate tax accessible and interesting? Daniel Shaviro does a credible job of both in “Decoding the U.S. Corporate Tax.” While tax policymakers and professors constitute the most likely audience to read and appreciate the book, Professor Shaviro’s entertaining writing style makes the book a useful primer for anyone interested in understanding the theoretical foundations (or lack thereof) of the existing corporate tax as well as possible future directions for the tax. Here is an example of how Professor Shaviro’s humor and style make what could be a dry subject more engaging:

Sometimes we hear of a solution in search of a problem, which someone offers to a baffled world despite the lack of any discernible need for it. Examples include the George W. Bush administration’s endless advocacy of tax cuts, interminable concert tours by the Rolling Stones when they are past age 60, and the live-action theatrical movie version of *Scooby-Doo*.¹

While the book does not maintain this level of catchy prose throughout, it sprinkles in enough entertaining examples and explanations to keep the reader engaged even when the material turns to some of the more arcane aspects of the corporate tax.

As for substance, the book notes that some commentators contend that “corporate integration” (i.e., eliminating the existing double

* Assistant Professor, Elon University School of Law. © 2010 Andy Haile.

¹ DANIEL N. SHAVIRO, *DECODING THE U.S. CORPORATE TAX* 151 (The Urban Institute Press 2009).

taxation of corporate income at both the entity and shareholder levels) is the analytical opposite of the live-action *Scooby-Doo* movie: a cure-all solution to real problems with the existing corporate tax system. While Professor Shaviro recognizes the benefits of corporate integration, he also suggests that implementing corporate integration presents its own challenges and that it would not solve all of the inefficiencies and distortions characteristic of the existing corporate tax. Given the administrative and political barriers to corporate integration, Professor Shaviro offers several more modest, and perhaps more realistic, proposals to improve the corporate tax system. These include:

- reducing the U.S. corporate tax rate to improve U.S. competitiveness, while at the same time undertaking additional reforms to ensure that our tax system remains progressive and that reduced revenues from a lower corporate rate do not deepen the projected U.S. long-term fiscal gap;²
- simplifying the taxation of income generated abroad by taxing the income in the year it is earned (rather than in the year the income is “repatriated” by foreign subsidiaries to their U.S. parent corporations, as under the current law), while maintaining revenue-neutrality by lowering the tax rate on foreign-source income;³ and
- addressing corporate governance problems by tying corporate income for financial reporting purposes to corporate income for tax reporting purposes. At present, corporate managers may overstate income for financial reporting purposes while understating it for tax purposes. By tying tax reporting and financial reporting together, investors would get a more realistic picture of corporate performance and managers would pay a price (in the form of higher taxes) for overstating their corporation’s income.⁴

All told, Professor Shaviro does an excellent job in “Decoding the U.S. Corporate Tax” of first explaining the problems with the current corporate tax system and then advocating realistic reforms that address these problems. He strikes a somewhat pessimistic tone, however, when assessing the likelihood of enactment for even those more modest reforms.

² See *id.* at 167-71.

³ See *id.* at 172-74.

⁴ See *id.* at 174-78.

PROBLEMS WITH THE U.S. CORPORATE TAX

Professor Shaviro spends the first part of the book explaining the basics of the existing corporate tax system and the inefficiencies caused by the system. The book explains that under the present corporate tax there are certain binary choices, each of which has potential tax consequences:⁵

- an entity is either a corporate entity or a non-corporate entity;
- financing is either in the form of debt or equity;
- earnings are either distributed or retained; and
- if earnings are distributed to shareholders, they are distributed either as dividends or through share repurchases.

The disparate tax consequences associated with these choices may result in inefficient decisions. For example, if corporate tax rates are lower than individual tax rates, shareholders may prefer that a corporation retain earnings rather than distribute them, thereby avoiding the incurrence of higher shareholder-level taxes. If the shareholders would make more effective use of the earnings than the corporation, however, the tax bias in favor of corporate retention prevents optimal decision-making.

The disparate treatment of dividends and share repurchases illustrates another potential distortion in corporate decision-making. Because a shareholder selling shares back to the corporation gets to offset the income received from the sale by his or her basis in the shares, most taxpayers should prefer, for tax purposes, a share repurchase to a dividend distribution (which is taxed in its entirety, without any offset for basis).⁶ To be treated as a share repurchase, however, the selling shareholder must sell a substantial percentage of his stock,⁷ thereby possibly “disrupting the desired internal balance of power” between shareholders.⁸ The effort to obtain favorable tax results may therefore cause undesirable non-tax consequences.

Shaviro further contends that the classification of financial instruments as either debt or equity has become an artificial distinction in light of financial innovations that have blurred the lines between the

⁵ See *id.* at 27-28.

⁶ The exception to this general rule is if the shareholder itself is a corporation, in which case it may be eligible for a dividend-received deduction under I.R.C. § 243 (2006).

⁷ See I.R.C. § 302(b) (2006).

⁸ SHAVIRO, *supra* note 1, at 40.

two. Debt traditionally offered: (1) a fixed return; (2) a fixed maturity date; (3) creditors' rights, including bankruptcy enforcement; (4) payment priority over equity owners; and (5) no voting rights.⁹ Equity offered the opposite characteristics. How, Shaviro asks, should one characterize a traditional debt instrument that includes an equity-conversion option? Such an option may provide the holder with unlimited upside, comparable to classic equity. Likewise, what about equity that is subject to a "collar" (a put option that limits the holder's downside risk and a call option that restricts upside potential)?¹⁰ The limit on upside potential and downside risk looks conspicuously like debt.

Despite the "hybrid" characteristics of many modern financial instruments, the IRS continues to treat these instruments as either pure debt or pure equity. As explained by Professor Shaviro, the ability of sophisticated taxpayers to play around the margins of key concepts in the corporate tax system (like what constitutes debt or equity) will almost certainly result in "continued trench warfare [between corporate taxpayers and the IRS] over the key operative definitions, which is good news for corporate tax practitioners, albeit not necessarily for anyone else."¹¹

THE INTERSECTION OF ECONOMIC THEORY AND THE CORPORATE TAX

After identifying the binary choices that exist in the current corporate tax system and the possible tax biases resulting from those choices, Professor Shaviro turns the discussion to an economic analysis of the corporate tax. This section of the book may be the most rough-going for those not accustomed to the vocabulary of professional economists. The complexity of the analysis is compounded by the arguable incoherence of the corporate tax itself. As explained by Shaviro:

[E]conomists have failed the lawyers who want their help in understanding the corporate tax because the lawyers first failed the economists by handing them an ill-posed problem. Fail to specify adequately what you are doing, and you are bound to be dissatisfied with substantive analyses of your handiwork.¹²

Thus, Professor Shaviro lays the foundation for his discussion of the economic analysis of the corporate tax by contending that any economic analysis is necessarily ambiguous due to the ambiguity of the

⁹ See *id.* at 49.

¹⁰ See *id.* at 51.

¹¹ *Id.* at 54.

¹² *Id.* at 56.

corporate tax itself. Unlike the income tax, which has relatively clear-cut tax biases (it “discourages work and saving by taxing their fruits, and reduces the taxpayer’s risk level . . . by taxing gains and partly refunding losses”),¹³ the corporate tax proves more difficult to model economically. This is because with the corporate tax “[n]ot only are the directions of particular biases . . . variable and ambiguous, but it is not always clear what a given bias actually is about.”¹⁴

Despite these shortcomings, Professor Shaviro contends that economic analysis of the corporate tax still deserves our attention because it may shed some (albeit limited) light on the corporate tax’s efficiency and progressivity, as well as the direction that possible reforms should take. Consequently, Professor Shaviro considers economic analyses of the following three questions:

1. Who bears the burden of the corporate tax?¹⁵
2. Does the double tax on equity investments deter dividend distributions?¹⁶ and
3. Is there an ideal combination of debt and equity investment for corporations?¹⁷

Shaviro does an admirable job of reducing supremely complex economic analysis into a relatively understandable narrative to explain the contradictory conclusions that respected economists have reached on each of these questions. He does this primarily by using simplified examples. For example, the book explains the economic incidence of a tax (i.e., who bears its economic burden) by discussing various scenarios addressing who ultimately pays the sales tax (the consumer or the manufacturer) with respect to the purchase of an everyday item like a pack of gum.¹⁸ The book explains relative tax elasticity (i.e., changes in supply or demand in response to tax burden) by examining whether a tax on Las Vegas hotel rooms would be passed through to consumers, borne by hotel owners, or reduce the salaries of hotel employees.¹⁹ In each case, Professor Shaviro distills complicated concepts down to concrete and understandable terms.

¹³ *Id.* at 55.

¹⁴ *Id.* at 56.

¹⁵ *See id.* at 57-72.

¹⁶ *See id.* at 73-88.

¹⁷ *See id.* at 89-99.

¹⁸ *See id.* at 58.

¹⁹ *See id.* at 60.

The discussion of these questions also makes clear that even sound economic analysis can lead to entirely irreconcilable conclusions. For example, classical economic analysis has determined that the owners of capital, rather than labor, bear the burden of the corporate tax. Based on the ever-increasing mobility of capital, however, more recent economic analysis indicates that labor now shoulders more of the economic impact of the corporate tax (in the form of lower wages and/or reduced benefits).²⁰ On the issue of dividend distributions, the traditional view holds that taxing corporate earnings twice—at the corporate level and upon distribution to the shareholders—discourages dividends. After explaining this traditional analysis, the book presents an alternative view developed by more recent scholarship showing that under certain conditions the corporate tax has no effect on the timing of dividend distributions. Finally, the book compares theories of how corporations establish their ratio of debt to equity. Some economists contend that corporations seek an ideal equilibrium point between the benefits (interest deductibility) and risks (bankruptcy) of debt. Others contend that “no individual firm[s] . . . have an optimum debt ratio,” but that “[l]ow-leverage firms . . . target investors in high tax brackets, while high-leverage firms . . . target tax-exempts[.]”²¹ Thus, on each of these questions the book shows that economists have reached conflicting conclusions depending on their starting assumptions.

Professor Shaviro intersperses helpful and sometimes highly entertaining explanations into his discussion of complicated economic issues. An example is the discussion of why, despite the taxes they trigger, corporations pay dividends. To explain this phenomenon, Shaviro analogizes to the animal kingdom and compares dividends with “the evolutionary puzzle of the male peacock’s tail[.]”²² A male peacock’s tail reduces the bird’s mobility and increases visibility to predators. So why would peacocks evolve such tails? The prevailing theory is that the ostentatious tail signals to females that, despite handicapping themselves, the males are strong enough to survive and therefore would make desirable mates. Professor Shaviro connects this evolutionary theory with a theory of why corporations issue dividends known as the “money-burning” theory. According to the “money burning” theory, companies pay dividends to signal to the marketplace that

²⁰ See *id.* at 67-70.

²¹ *Id.* at 97.

²² *Id.* at 86.

they are healthy enough to “offer investors sufficient financial returns over time despite wasting so much money by triggering extensive double taxation.”²³ In effect, dividends are a form of conspicuous consumption meant to demonstrate economic health to prospective investors, just as a peacock’s tail is intended to signal to peahens that the male bird has the physical strength to make a good mate.

While the discussion of these issues is interesting in its own right, the book does an excellent job of connecting the ambiguities of economic analysis with possible directions for reform of the corporate tax. After addressing each of the three questions set out above, the author suggests how the various answers might lead to different approaches for tax reform. For example, if capital mobility has in fact shifted the incidence of the corporate tax from capital to labor, the book suggests that one might consider policy changes that would re-establish a more progressive tax system.²⁴ Thus, Professor Shaviro attempts to construct his policy proposals around sound economic analysis, while at the same time recognizing that competing views exist with respect to the conclusions reached by that economic analysis.

THE INTERNATIONAL DIMENSION

The book also addresses the ongoing debate over international taxation. The existing corporate tax regime for U.S. multinational corporations taxes corporations on their worldwide income, but provides substantial opportunities to defer those taxes if the income is earned by a foreign subsidiary. Until income earned by a foreign subsidiary is “repatriated” to the U.S. parent corporation, the tax on that income is deferred. In addition, the U.S. allows for a limited credit against taxes paid to foreign governments on income generated abroad.

After cogently explaining the current taxation of U.S. companies that derive income from abroad, Professor Shaviro considers possible changes to the existing system. He identifies two options at opposite ends of the spectrum: (1) tax worldwide income and eliminate deferral of tax on income earned by foreign subsidiaries, or (2) tax U.S.-source income, but exempt foreign-source income from U.S. tax.²⁵ Shaviro contends that either alternative may be preferable to the current sys-

²³ *Id.*

²⁴ See SHAVIRO, *supra* note 1, at 68-71.

²⁵ See *id.* at 114. Under this second alternative, the U.S. would still tax foreign-source, passive income such as interest and dividends paid by foreign corporations.

tem. He suggests, however, that neither option may be politically feasible because of entrenched political interests. On the one hand, multinational corporations argue against worldwide taxation and the elimination of deferral based on their contention that it would place U.S. corporations at a competitive disadvantage compared to foreign companies whose home jurisdictions do not tax worldwide income.²⁶ On the other hand, labor supporters argue against exempting foreign-source income from taxation because this could result in corporations relocating their investments and jobs abroad.²⁷

Perhaps this pessimism was prescient. In May 2009, the Obama Administration proposed significant changes to the taxation of U.S. corporations operating abroad that would have amounted to a partial repeal of the tax deferral on foreign source income. But based on arguments by lobbying groups representing the interests of multinational corporations—that effectively increasing taxes during an economic recession would serve no one's interests—the Administration shelved the proposed changes in October 2009.²⁸

FUTURE OF THE CORPORATE TAX

The book concludes with an analysis of where the corporate tax may be heading. Professor Shaviro identifies three trends that he believes will cause changes to the existing corporate tax system: ongoing financial innovation, rising worldwide capital mobility, and changing U.S. political dynamics.²⁹ With respect to financial innovation, the book argues that the discrete binary choices inherent to the existing corporate tax system no longer apply. Financial derivatives make it possible to create equity with debt-like characteristics and vice-versa. Through the use of complex financial instruments, Professor Shaviro contends that investors will effectively be able to choose whether to be taxed at their own individual tax rate or at the corporate rate, whichever is lower. Moreover, the combination of limited liability and flow-through tax treatment available with limited liability companies has

²⁶ See *id.* at 137. Shaviro contends that this competitiveness argument requires additional research to resolve. See *id.* at 135-36.

²⁷ See *id.* at 137.

²⁸ See Neil King Jr. & Elizabeth Williamson, *Business Fends Off Tax Hit—Obama Administration Shelves Plan to Change How U.S. Treats Overseas Profits*, WALL ST. J., Oct. 13, 2009, at A14.

²⁹ See Shaviro, *supra* note 1, at 141.

eliminated much of the motivation that previously prompted investors to elect the corporate form.

As to increased capital mobility, this is a recognized trend.³⁰ Perhaps more interesting is the discussion of the changing political landscape. Professor Shaviro argues that the Republican political strategy to appeal to ever-more conservative voters, known as “energizing the base,” has caused both political parties to move away from the political center.³¹ He suggests that the abandonment of political moderation makes back-and-forth swings in future tax policy more likely, as legislative control shifts between the Democrats and Republicans. This tax policy instability, along with a projected long-term U.S. fiscal gap, will create uncertainty for businesses in their tax planning.

In light of this changing financial and political backdrop, the book discusses possible reforms to the corporate tax. One potential reform that has been espoused by numerous policymakers and academics is corporate integration.³² Under a system of corporate integration, all corporate income would be taxed once, and only once, at either the entity or shareholder level. But according to Professor Shaviro, despite the theoretical appeal of corporate integration substantial practical challenges stand in the way of its implementation. Foremost, perhaps, are administrative problems. As the book explains, “[s]everal leading studies have concluded . . . that applying [flow-through taxation] to publicly traded companies would involve undue complexity given both the frequency with which capital interests may change hands and the myriad forms that these interests may take[.]”³³ In other words, the ownership of modern publicly-traded companies may just be too widespread and complex to accommodate corporate integration.

After setting forth the many practical problems with implementing corporate integration, the book describes the leading methods that have been proposed to accomplish elimination of the double tax. The most-often proposed method would exempt shareholders from taxa-

³⁰ See SASKIA SASSEN, *THE MOBILITY OF LABOR AND CAPITAL: A STUDY IN INTERNATIONAL INVESTMENT AND LABOR FLOW 1* (Cambridge University Press 1988).

³¹ SHAVIRO, *supra* note 1, at 147.

³² See generally MICHAEL J. GRAETZ & ALVIN C. WARREN, *INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS* (Tax Analysts 1998) (discussing integration of corporate and individual income taxes).

³³ SHAVIRO, *supra* note 1, at 154.

tion on dividends. While this would eliminate the double tax now applicable to corporate investments, Professor Shaviro argues that it would do nothing to eliminate several existing potential distortions that hamper the present corporate tax system, such as whether to use a corporate entity if the corporate tax rate differs from the individual tax rate or whether to use debt or equity financing.³⁴

Professor Shaviro offers more support for two alternative integration methods, one known as the comprehensive business income tax (CBIT) and the other as the business enterprise income tax (BEIT).³⁵ The CBIT would apply to all businesses, regardless of whether they were incorporated. It would eliminate the disparity between equity and debt by making both dividends and interest payments non-deductible to the payer and excludable from the recipient's income. In contrast, the BEIT would eliminate the debt-equity distinction by making both dividend and interest payments deductible at the entity-level and includable in the income of the recipient, even if no distributions were actually made from the business to its investors. Shaviro states that either the CBIT or the BEIT would constitute a "broader structural" reform than dividend exclusion.³⁶ Moreover, the fact that both alternatives conform to the tax treatment of debt and equity would allow their supporters to "reframe advocacy of corporate integration" as a way to "rationalize the taxation of financial instruments" rather than as a way to eliminate the double tax to which corporate shareholders are now subject.³⁷

While supportive of the CBIT or the BEIT as methods for achieving corporate integration, Professor Shaviro recognizes the unlikelihood that either of these reforms will be enacted in the near future. Consequently, he also examines several "less-fundamental changes to the structure of U.S. corporate taxation" that "might be either desirable or likely (or better still, both)."³⁸ Chief among these changes is a reduction of the corporate tax rate. Shaviro endorses lowering the rate from its current 35% to 25%, if the reduction were also accompanied by "progressivity-maintaining elements of the individual income

³⁴ See *id.* at 159.

³⁵ Shaviro discusses other possible integration methods in addition to dividend exemption, but gives the most attention to the CBIT and the BEIT. See *id.* at 161-64.

³⁶ *Id.* at 165.

³⁷ *Id.*

³⁸ *Id.*

tax” and financed so as “not [to] increase the long-term U.S. fiscal gap.”³⁹

The second reform proposed in the book is to simplify the taxation of U.S. companies that generate income from abroad. The book suggests that this could be accomplished in a revenue-neutral manner by lowering the tax rate on foreign-source income, eliminating the deferral now available for foreign-source income, and converting foreign tax credits into deductions.⁴⁰ In making this proposal, Professor Shaviro seeks to maintain the same tax revenues on foreign-source income while reducing high tax-planning and compliance costs prevalent with the current system.

Finally, the book proposes using tax policy to improve corporate governance and to provide investors with more information about company performance. Professor Shaviro suggests that companies should “be required more specifically to disclose their annually reported taxable income and tax liability” and to provide investors with an explanation of any differences between a company’s taxable income and its financial accounting income.⁴¹ He stops short of endorsing a “one-book” system, in which companies would be required to use financial accounting income as their taxable income. This could inject a political component into the determination of generally accepted accounting principles (GAAP), which is currently absent. Instead, Professor Shaviro argues that taxable income should be adjusted by a fixed percentage (he proposes fifty percent) toward financial accounting income.⁴² This would reduce tax sheltering and earnings manipulation.

As to the likelihood that even these more modest proposals will be enacted, Professor Shaviro appears pessimistic. This is because of the short-term thinking that has infected our political system. Fareed Zakaria’s assessment of the current political landscape resonates with Shaviro, and he quotes it at length:

[The United States] has developed a highly dysfunctional politics. What was an antiquated and overly rigid political system to begin with (now about 225 years old) has been captured by money, special interests, a sensationalist media, and ideological attack groups. The result is ceaseless, virulent debate about trivia—politics as theater—and very little substance, compromise, or action. A can-do country is now saddled with a

³⁹ *Id.* at 167-68.

⁴⁰ *See id.* at 172-74.

⁴¹ *Id.* at 176.

⁴² *See id.* at 177.

do-nothing political process, designed for partisan battle rather than problem solving.⁴³

We can only hope that substantial reforms to the corporate tax system are more likely than Zakaria and Shaviro suggest. Perhaps the depth of the existing economic turmoil will force changes to the distortive, inefficient, and costly corporate tax system currently in place. But given politicians' reluctance to be viewed as doing anything to increase taxes at a time of economic recession, substantial corporate tax reform may, at least in the short term, be unlikely. Regardless of whether Professor Shaviro's proposed reforms are in fact pursued, he has done a service by succinctly identifying and explaining some of the major problems with the existing corporate tax regime. That may be the enduring value of "Decoding the U.S. Corporate Tax."

⁴³ Fareed Zakaria, *The Future of American Power: How America Can Survive the Rise of the Rest*, FOREIGN AFFAIRS, May/June 2008, at 18, 41.