Trojan Horse, or Merely a Mask for the Costume Ball?

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Edward Kleinbard, *The Trojan Horse of Corporate Integration*, 152 **Tax Notes** 957 (Aug. 15, 2016), available at SSRN.

Edward Kleinbard's *The Trojan Horse of Corporate Integration* critiques the U.S. Senate Finance Committee's current proposal for corporate integration. This is an important read for those who have not yet come to grips with the forces at play in contemporary tax policy. Kleinbard refers to these forces as the "political economy agenda" behind the proposal. That agenda has as much to do with appearances relating to tax liabilities as it does with any cash actually being paid.

Most tax policy analysis has historically assumed that it is the amount of tax that is actually paid that matters most. Taxes paid are resources that are no longer available to the private sector; taxes not paid are not available to the public sector. At bottom, the tax policy challenge has usually been seen as balancing the deadweight losses that are inevitable with resources taken away from the private sector with the market failures associated with leaving deployment of all resources in private hands. This view of the impact of taxes is all well and good for economists to theorize about, but does not capture very much of the political decisions taking place in the real world about the type of taxation that should be adopted.

As Kleinbard points out, a significant portion of the "political economy agenda" behind the Senate Finance Committee proposal is simply to allow corporations to report paying lower taxes for financial accounting purposes, without lowering the overall taxes paid on corporate investment. The Senate Finance Committee proposal would do this by allowing a corporation to deduct from its tax base dividends paid from corporate income. But even as it allows the corporation this "dividends paid deduction" (DPD), the proposal would require the corporation to withhold tax from the dividends actually distributed to the shareholder. This withholding tax would not be treated as a liability of the corporation, and therefore would not be included in the corporation's financial accounting reports reflecting the taxes it pays. Thus, the taxes imposed at the corporate level would be reduced, even though the total taxes on corporate earnings (taking into account both the tax on corporate income and the withholding tax) may not be.

The equivalence between the collection of taxes paid by a corporation on its own behalf and the taxes paid by the corporation as unrefunded withholding taxes remains uncertain. It will depend on many features relating to the design of the tax (including the preservation of tax exemption for certain domestic taxpayers and any mechanism available for credits for foreign taxpayers).

As Kleinbard also points out, the DPD often produces a similar result as the imputation credit approach to corporate integration, since in both approaches a payment made by the corporation is credited against the shareholder's tax liability. In fact, the DPD approach may often produce greater tax liabilities if the withholding scheme does a poorer job than the credit imputation scheme of taking into account the particular characteristics of shareholders, including tax exempt or foreign status. (Incidentally, Kleinbard's piece is a good place for those having lost track of the complexities of integration design to get back up to speed.)

But the DPD, unlike the imputation credit approach, would also have the salutary effect, from a political economy point of view, of making the burden of taxes on investments in US corporations *appear* to be less because the withholding tax would not be treated as a corporate tax for financial accounting purposes. Kleinbard intimates that no one should consider this as an actually accomplishing anything different. After all, he asks, “how stupid are we?”

The relevant research is still in progress, but at least some of it suggests that many groups of suppliers of capital may actually be that stupid, at least in the sense that the way that taxes are reported for financial purposes is important independently of the amounts ultimately paid. This may be true if the focus is on management incentives and perhaps even if the focus is on investor behavior. Kleinbard’s explication of this phenomenon is a good first step in helping the rest of us see the implications.

Kleinbard is especially dismayed at the possibility that the DPD would allow, more cleanly than other forms of integration, repatriation and distribution of the foreign income of US multinationals that has only been lightly taxed, if taxed at all, in any foreign jurisdiction without any additional corporate tax. This possibility is the not-so-very-well-hidden secret in the DPD approach to integration. Kleinbard does seem to acknowledge that this change could break the log jam that has previously blocked progress in corporation tax reform. But he decries the breaking of the log jam as wasting a chance to do something more significant.

We probably are not so stupid as to not see the political economy behind the DPD. But the best part of the Kleinbard contribution is its capacity for pointing out that we could really be that stupid when it comes to more generally neglecting the importance of the appearance of tax burdens rather than the burdens themselves. There is a real possibility that analysts and the investors they serve may respond favorably to the reporting of lower corporate taxes, even though investors’ overall burdens will not be reduced. Although Kleinbard takes no view on whether and when such responses dominate over actual tax payments, he reminds us well that we cannot ignore such possibilities when implementing corporate tax reform.

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