

TAXATION OF CORPORATIONS AND SHAREHOLDERS: A  
DISCUSSION OF DEAN SCHIZER'S RECENT PROPOSAL

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## INTRODUCTION

In his recent essay *Between Scylla and Charybdis: Taxing Corporations or Shareholders (or Both)*,<sup>1</sup> Dean David Schizer elucidates the complexities involved in choosing how to divide the tax burden on corporate profits between a tax paid by the corporation itself and one paid by its shareholders. He emphasizes the important point that strategic behavioral responses must be considered when choosing the rules and that different avoidance concerns are at play at the corporate and shareholder levels.<sup>2</sup> His main recommendation for a path forward is to retain two levels of tax<sup>3</sup> with the goal of reaping advantages from built-in redundancy. In addition, in suggesting how the tax burden should be divided between these two taxes, he recommends reducing the corporate-level tax significantly to decrease tax-avoidance incentives for corporations.<sup>4</sup> This decrease would be coupled with an offsetting increase of the shareholder-level tax so that the aggregate rate of tax achieves a target level to be determined by the government.<sup>5</sup>

This Piece assesses Dean Schizer's proposal for the relative allocation of the corporate tax burden between the corporate and shareholder levels in order to see what obstacles may lie in the way of achieving the

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1. David M. Schizer, *Between Scylla and Charybdis: Taxing Corporations or Shareholders (or Both)*, 116 *Colum. L. Rev.* 1849 (2016) [hereinafter Schizer, *Scylla and Charybdis*].

2. See, e.g., *id.* at 1853 (“[T]his Essay emphasizes . . . [c]orporate and shareholder taxes prompt different tax planning.”); see also *id.* at 1864–82 (discussing planning strategies and challenges around the high corporate tax and the high shareholder tax).

3. See *id.* at 1883 (forwarding the “central recommendation” to use both taxes); see also *id.* at 1882–86 (discussing the value and challenges of using both the corporate and shareholder taxes).

4. See *id.* at 1855 (“The corporate tax is probably more distortive, so it should be cut significantly.”). Note that this recommendation is based on the assumption that the corporate tax causes more of a distortion than the shareholder tax, and the validity of this assumption is not determined in *Scylla and Charybdis*. See *id.* at 1889 (“[I]f one [tax] is significantly more distortive, it should have a much lower rate. If the corporate tax induces more planning—as seems likely, although this empirical question cannot be resolved here—its rate should be lower.”).

5. See *id.* at 1854 (“The two rates should be coordinated so that they aggregate to the combined rate Congress wants . . .”).

desired results. Many of the relevant challenges are already discussed in *Scylla and Charybdis*.<sup>6</sup> The contribution here is the introduction of a few further considerations and the provision of additional perspective on the points already raised by Dean Schizer. The goal is to help readers come to a fuller understanding of the pressure points of the proposal and what exactly would be necessary to make it work.

The topics discussed are grouped into several sections. Part I uses a simple stylized model of the cost of tax avoidance to help understand how large a tax rate cut must be to make avoidance unprofitable. A key point is that avoidance can remain profitable even after a rate cut, particularly if the costs of avoidance are fixed and do not scale with the size of income. Whether a tax cut will actually reduce avoidance depends upon the specific factual situation in question, but it is important to note that a rate cut of the sort proposed in *Scylla and Charybdis* may not reduce tax-avoidance incentives for all firms, particularly large firms with relatively low fixed costs of avoidance.

Part II examines the question of what exactly constitutes tax avoidance. An example shows some of the subtleties involved in answering this question and highlights the inherently fact-dependent nature of the analysis. An important point is that preferential treatment for certain activities by the tax law may have an ambiguous status, sometimes giving rise to a permissible grant of preferential treatment for taxpayers and other times amounting to a loophole that provides an incentive for tax avoidance. To accomplish the goal of avoidance reduction as part of the reform proposed by *Scylla and Charybdis*, it is important to tease out precisely which behaviors constitute avoidance.

Part III considers whether a reduction in the applicable statutory rate is sufficient to eliminate tax avoidance. An example continued from Part II makes the central point that the benefits of structural features of the tax code, such as deferral, cannot necessarily be undone by simple rate reductions. If such features are thought to provide incentives for tax avoidance, then structural changes may be necessary in order to reduce or eliminate the avoidance. When implementing tax reform along the lines contemplated in *Scylla and Charybdis*, it is, however, important to consider all effects of such structural changes and to be sure that desirable features of the original structure are retained while undesirable incentives are being eliminated.

Part IV considers three additional issues. The first is the question of parity with pass-through entities, addressed in section IV.A. Such parity is not the main goal of the reform proposal in *Scylla and Charybdis*, but it is a desirable additional one. The main contribution of the discussion is to

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6. Challenges to the plan to use both rates are discussed in section II.B of *Scylla and Charybdis*. Id. at 1885–86. In addition, incremental reforms that can help ease distortions from the plan for a high shareholder rate and low corporate rate are discussed in section III.C of *Scylla and Charybdis*. Id. at 1891–97.

emphasize Professor Daniel Halperin's finding that parity can be achieved by imposing a tax on income stemming from retained corporate earnings but that the rate of such a retained earnings tax would have to be as high as the personal tax rate.<sup>7</sup> Such a high tax may run counter to the goal of the *Scylla and Charybdis* proposal of cutting tax rates at the corporate level.

The second issue, considered in section IV.B, is the possibility of future changes in the tax code. The main point here is if deferral of shareholder-level taxation is permitted, then dividends may be withheld in the hope that a future change in law will reduce the shareholder-level tax rate. There has been considerable variation in tax rates historically, and it is not implausible that there may be future changes to any reform undertaken now. The reform proposal in *Scylla and Charybdis* may create a situation in which this sort of long game is possible. There are ways to address this issue, although they generally involve more substantial tax reforms. One possibility would be to levy a tax at the shareholder level on unrealized share appreciation.

The third issue, considered in section IV.C, is the likelihood of coordination between corporate managers and shareholders. The proposal of *Scylla and Charybdis* exploits the fact that shareholders and managers have misaligned interests in order to treat the corporate and shareholder levels of tax as independent of each other. A key point of the discussion is that in some cases, such as closely held firms, interests are more likely to be aligned, and tax avoidance may continue to be problematic for such firms even if it is curbed for firms with misaligned shareholder and manager interests.

#### I. THE COST AND BENEFIT OF TAX AVOIDANCE

An important component of the analysis in *Scylla and Charybdis* is the idea that a lower applicable tax rate will tend to result in less tax avoidance. As Dean Schizer observes, the costs of tax planning "are justified only when they are less than the tax savings," and so a particular tax planning strategy may be "cost effective for avoiding a high tax, but not a low tax."<sup>8</sup>

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7. See Daniel Halperin, Corporate Tax Reform—The Issues and the Choices, 154 Tax Notes 705, 708 & n.10, 709 & n.23 (2017). Note that Professor Halperin's findings pertain to achieving parity between the choice of retaining corporate earnings and distributing such earnings for passive investment by individual shareholders. However, the same analysis can be applied to achieving parity between corporate and pass-through investment choices. For simplicity here the tax rate on pass-through entities is taken to be the same as the personal tax rate.

8. Schizer, *Scylla and Charybdis*, supra note 1, at 1863; see also *id.* at 1854 (stating that "when the tax rate is low enough, paying a tax is cheaper than avoiding it" and that a lower tax rate "induces less planning").

This proposition must certainly be correct in a general sense. However, it is not clear just how much lower the tax rate needs to be in order to produce a meaningful decrease in tax avoidance. The exact relationship between the level of the tax rate and resultant tax-avoidance behavior is an empirical one in any given case, but it is conceivable that a tax rate may need to be very low indeed before avoidance is unprofitable.

Consider a stylized situation in which the cost of tax avoidance associated with an amount of pretax profits  $P$  is described by a function  $C(P) = F + \gamma P$ , where  $F$  is a positive fixed cost, and  $\gamma$  is a positive scale factor. The fixed cost may be thought of as legal and other planning fees that must be incurred regardless of the size of the associated profits. The scale factor may be thought of as a cost that is proportional to the size of associated profits, perhaps reflecting a lower return on investment as a result of the choices that must be made in order to adopt a particular tax-avoidance strategy.

As concrete examples of the fixed and scaled costs, consider two U.S.-based multinationals that believe they can avoid taxes by moving a portion of their business to an overseas subsidiary. The first firm derives substantial profit from intellectual property and would be able to cause the move to happen by incurring legal and advisory fees that are fixed and relatively modest compared to the size of the profits at stake. The second firm is a manufacturer that would need to move operations overseas, building new plants and hiring new workers there. The costs in this case may be more appropriately expressed as a proportion of the relevant profits.<sup>9</sup>

Suppose that tax is levied at a flat rate  $t$  so that  $tP$  is the tax that is due without any avoidance strategy. Suppose also that avoidance leads to a lower flat rate  $t_a$ , which results in a tax due of  $t_a P$ . The benefit of tax avoidance is thus given by the reduction in tax due,  $B(P) = (t - t_a)P$ .

In the simple model of costs and benefits just described, a tax-avoidance strategy will be carried out whenever  $B(P) > C(P)$ , and this happens exactly when:

(1)

$$t - t_a - \gamma > \frac{F}{P}$$

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9. These two cases are idealized, and in a real-world situation there would likely be a mix of fixed and proportionate costs. In addition, real-world cases would likely present ambiguities in determining what exactly the cost is. In any given case, one might observe a net benefit to the firm from tax avoidance, and it might not be clear how to separate out how much is "pure" tax avoidance and how much is the offsetting, associated cost. For purposes of the stylized model in this section, however, we abstract away from these issues and simply assume a reduced form for the cost function, as described in the text.

In the special case in which  $F = 0$ , tax avoidance will not happen as long as the rate reduction achieved by avoidance (i.e.,  $t - t_a$ ) is less than the scale factor,  $\gamma$ , in the cost function.

In a different special case in which  $\gamma = 0$ , avoidance will always happen as long as  $P$  is large enough relative to the fixed cost  $F$ . This is the case because the fraction  $F/P$  decreases toward a limit of zero as  $P$  grows without bound, and so as long as  $t - t_a > 0$ , so that there is some possibility of benefit to tax avoidance, then tax avoidance will happen when  $P$  is sufficiently large.

The true costs and benefits of tax avoidance are undoubtedly more complex than either of these special cases and indeed more complex than the simple model described here can adequately capture. Nonetheless, the model serves to illustrate two important points. First, it is plausible that a decrease in the tax rate,  $t$ , can have the result of eliminating tax avoidance. Second, it is also plausible that in some cases a decrease in  $t$  will not serve to curb avoidance very much, if at all.

The precise relationship of the costs and benefits of tax avoidance will depend upon the specific firm involved and the nature of the tax-avoidance strategy being used. The key point demonstrated here is simply that tax reductions may need to be very substantial in order to make tax avoidance unprofitable. This is particularly the case when the cost of an avoidance strategy is largely fixed and does not scale with the size of profits.

## II. WHAT CONSTITUTES TAX AVOIDANCE?

An important goal of tax reform discussed in *Scylla and Charybdis* is to reduce tax-avoidance behavior by taxpayers.<sup>10</sup> In order to understand how well a reform proposal accomplishes this, it is necessary to define what exactly constitutes avoidance. This may seem straightforward, but there can be significant subtleties involved.

An example can help explain the difficulties that arise in defining tax avoidance. Consider the following hypothetical that has been laid out by Professor Alvin Warren.<sup>11</sup> A U.S. parent corporation has a foreign subsidiary and is deciding when to cause the subsidiary to pay a dividend.

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10. *Scylla and Charybdis* explains how its proposal can reduce tax avoidance and tax planning by lowering rates. See Schizer, *Scylla and Charybdis*, supra note 1, at 1854 (“When the rate is low enough, paying a tax is cheaper than avoiding it . . . [as a lower rate] induces less planning.”). It specifies in particular that the corporate-level tax rate should likely be lower to reduce distortions from tax planning. See *id.* at 1855 (“Since lower rates discourage planning, the more distortive tax should be lower. The corporate tax is probably more distortive, so it should be cut significantly.”). The concepts of tax avoidance and tax planning are used somewhat interchangeably in *Scylla and Charybdis*. For purposes of this Piece, the term “avoidance” will be used to capture both concepts.

11. This example is based on cases (A) and (B) in Alvin C. Warren, Jr., *Income of Foreign Subsidiaries: A Review of the Basic Analytics*, 145 *Tax Notes* 321, 325–26 (2014).

Choice “A” is to pay a dividend now, in which case the United States will levy tax at a rate  $t_r$ , and the after-tax proceeds will be invested in an active business in the United States where they will grow at an annual after-tax rate of  $(1 - t_{US})r_{US}$  for the next  $n$  years.<sup>12</sup> Choice “B” is to forgo a current dividend, in which case the amount that would have been paid as a dividend will instead be invested by the subsidiary in an active business overseas where it will grow at an annual after-tax rate of  $(1 - t_F)r_F$  for the next  $n$  years. At that point, a dividend of the original amount plus all after-tax earnings will be made to the parent, and the United States will tax the dividend at the rate  $t_r$ .<sup>13</sup> At the end of  $n$  years, the two after-tax outcomes for the parent are:<sup>14</sup>

(2)

$$\text{A: } (1 - t_r)(1 - (1 - t_{US})r_{US})^n$$

$$\text{B: } (1 - (1 - t_F)r_F)^n(1 - t_r)$$

As Professor Warren explains, the difference between these two outcomes is driven entirely by the difference between the after-tax returns available in the United States and the foreign country. The corporation can achieve the higher return by locating its  $n$ -year investment in the jurisdiction providing a higher annual after-tax return, and the dividend tax collected by the United States does not affect the decision, provided that the tax rate  $t_r$  remains constant over time.

Is choice B a case of tax avoidance? The answer may perhaps depend on the particular rates of return and rates of tax, and this section will consider two specific cases. First, suppose that  $t_{US} = t_F$ ,  $r_{US} = r_F$ , and  $t_r = 0$ , and that these parameters remain constant over time.<sup>15</sup> The company will obtain the same after-tax return in each case, but suppose that it happens to make choice B. Is this tax avoidance? It is certainly true that the U.S. government collects less revenue than in choice A, but this is immaterial to the firm because the overall tax burden is the same, even if the taxes are levied by different governments. If we think of the foreign tax imposed as a substitute for the U.S. tax, and we do not think of tax substitution as tax avoidance, then there is no tax avoidance in this case.

12. The pretax rate of return available in the United States is denoted by  $r_{US}$ , and the applicable tax rate in the United States is denoted by  $t_{US}$ .

13. If  $t_{US} > t_F$ , and if the foreign tax rate and U.S. tax rate are both flat and have remained constant over time, then we generally have  $t_r = \frac{t_{US} - t_F}{1 - t_F}$ , a formula that reflects the foreign tax credit allowed under U.S. law.

14. Note that the factor  $(1 - t_r)$  is written on the left in formula A and on the right in formula B. This is to emphasize the fact that the repatriation tax would be paid at different times, namely at the outset in A and at the end in B. Because multiplication is commutative, however, it would be algebraically equivalent if  $(1 - t_r)$  were written on the same side of both formulas, and keeping this in mind may make it easier to compare the two formulas.

15. If  $t_{US} = t_F$  and  $t_r = \frac{t_{US} - t_F}{1 - t_F}$ , then  $t_r = 0$ .

If instead we think that a choice reducing revenue to the U.S. Treasury is avoidance, then there is in fact avoidance in this case.

In the second case, suppose that  $t_F = 0$ ,  $r_{US} = r_F$ , and  $t_r = t_{US}$ , again holding everything constant over time.<sup>16</sup> The company now makes choice B because it results in a lower tax burden. Is this a case of tax avoidance? Perhaps, but note that this treatment of case B is completely permissible under current U.S. law, and so Congress has specifically allowed this sort of deferral of U.S. tax and favorable treatment for corporate foreign investments.<sup>17</sup> In light of this, it may not be so clear that we should label choice B as tax avoidance, although reasonable people may disagree.

Consider again the second case, and add the additional fact that the foreign investment to be made involves the placement of intellectual property overseas in a jurisdiction generally considered to be a “tax haven.” Suppose that the only reason to hold the intellectual property outside the United States is to lower the overall tax burden faced by the corporation on revenues generated by the property. Suppose further that the placement of this property overseas involves relatively little effort, such as the creation of an offshore affiliate to hold the property, the structuring of relevant contracts, the adjustment of corporate books, and other paperwork. Finally, suppose evidence shows that Congress did not intend favorable deferral treatment for this sort of activity. With all this new information, many would agree that choice B should be categorized as tax avoidance.

The point of the variations on this example is to highlight the difficulty in determining exactly what constitutes tax avoidance. The answer to the question can be significantly fact dependent, and it requires making judgments about whether particular aspects of the tax code give rise to a permissible grant of preferential treatment for taxpayers or instead amount to a loophole that provides an incentive for undesirable avoidance behavior. What may seem like a “bug” from a certain perspective may actually be a useful “feature,”<sup>18</sup> and the answer as to which it is may depend sensitively on the particular facts involved.

There are many provisions of the tax code that may be ambiguous in terms of their status as features or bugs. These certainly include the deferral benefit for overseas corporate investment<sup>19</sup> but also such familiar rules as the deferral of capital gains until realization,<sup>20</sup> the step-up in ba-

16. If  $t_F = 0$  and  $t_r = \frac{t_{US} - t_F}{1 - t_F}$ , then  $t_r = t_{US}$ .

17. In general, earnings of a foreign subsidiary are subject to U.S. taxation only when a dividend of the earnings is made to the U.S. parent. See I.R.C. § 301 (2012) (providing for the taxation of the dividend); id. § 11(d) (providing for the general nontaxation of earnings at the subsidiary level).

18. The “bug” and “feature” terminology comes from a common phrase related to computer programming: “It’s not a bug, it’s a feature!”

19. See *supra* notes 11–17 and accompanying text.

20. Gain is generally taxed at the time of disposition of property. See I.R.C. § 1001.

sis at death for appreciated property,<sup>21</sup> or the special treatment of charitable organizations.<sup>22</sup> In pursuing the goal of minimizing corporate tax avoidance, as articulated in *Scylla and Charybdis*, it seems important to decide the circumstances under which each of these gives rise to tax avoidance and how best to correct such bugs while still preserving desirable features.

### III. IS A REDUCTION IN THE STATUTORY RATE SUFFICIENT TO REDUCE TAX AVOIDANCE?

In some situations, a reduction in the statutory tax rate cannot, by itself, eliminate, or even reduce, tax avoidance. This is because the avoidance technique depends not only on a stated rate but also on a structural benefit conferred by the tax code, such as deferral. In such cases, if the goal is to reduce tax avoidance, a reform must include more than just rate reductions,<sup>23</sup> as Dean Schizer also indicates.<sup>24</sup>

To make the discussion concrete, let us return to the second case in the example from Part II. This is the situation in which  $t_F = 0$ ,  $r_{US} = r_F$ , and  $t_r = t_{US}$  and in which the taxpayer makes choice B. Suppose that we think of choice B as tax avoidance, and we want a reform that will reduce or eliminate it. Consider the effect of lowering the applicable U.S. tax rate, say from its current maximum level of 35% to a new maximum of 20%. Will this cause a firm in the second case to choose A over B?<sup>25</sup> The answer is no, because the foreign annual after-tax growth rate is still larger than the U.S. annual after-tax growth rate.<sup>26</sup> Multiplication by the factor  $(1 - t_r)$  is the same for both choices A and B, and so it is only the

21. *Id.* § 1014.

22. The entire value of a charitable contribution of long-term capital gain property is generally deductible, even though the appreciation in value of the property has never been subject to income taxation. *Id.* § 170. In addition, dividends received by charitable shareholders are generally exempt from shareholder-level taxation. *Id.* § 501.

23. It is important to note that, in a very general sense, a rate adjustment can in fact achieve any desired structural reform. The adjustment just needs to be dynamically tailored to particular situations so that the applicable rate is raised or lowered to precisely the right level so that imposition of a tax at that rate achieves the same outcome as a structural reform would at a different prevailing rate. For purposes of this Piece, it is assumed that the rate change under discussion would simply be a change to a static prevailing rate and not one that would adjust and tailor itself dynamically so as to mimic the effect of what this Piece terms structural reform.

24. See Schizer, *Scylla and Charybdis*, *supra* note 1, at 1891–1902 (discussing a variety of incremental reforms to strengthen corporate and shareholder taxes).

25. Recall that Choice A is to pay a dividend now, in which case the United States will levy tax at a rate  $t_r$  on the dividend. Choice B is to forgo a current dividend, in which case the subsidiary will instead invest the amount in an active business overseas, and the United States will collect no current tax. See *supra* Part II.

26. Note that for simplicity we are assuming here that there are no other costs associated with tax avoidance, such as legal fees or planning costs. If there were large enough costs, then a sufficiently large rate reduction could make tax planning unprofitable. See *supra* Part I (discussing the costs and benefits of tax avoidance).

comparison of after-tax growth rates that matters. This reasoning shows that in fact the U.S. tax rate would need to be lowered all the way to 0% in order to eliminate the incentive for the firm to make choice B.<sup>27</sup>

Is there anything that the United States can do to make choice B less desirable? One possibility would be to impose a heavier tax on the foreign earnings. In fact, if the United States imposed an annual tax of its own on the overseas profits, designed to raise the effective annual tax rate to the U.S. level, then the result for a corporation reinvesting overseas would be:

$$(3) \quad B': (1 - (1 - t_{US})r_F)^n (1 - t_r)$$

This produces exactly the same result as A, and so the firm no longer has an incentive to choose B. With this change, the United States does not lose any tax revenue if the corporation makes choice B instead of choice A.

Imposing an additional tax to transform the B result into the B' result is certainly possible. Doing so, however, would represent a complete reform of the U.S. mechanism for taxing foreign income, as opposed to the simpler approach of lowering the statutory rate applicable to the income of U.S. corporations.<sup>28</sup>

Provisions like deferral reflect structural design choices in the tax code. If such a provision is thought to allow for tax avoidance at either the corporate or shareholder level, then, in general, more than just a decrease in the applicable statutory rate would be necessary to eliminate the avoidance incentive. In such cases, a more fundamental and less incremental reform would be necessary.

The decision of whether to reform the tax code fundamentally involves many more considerations than just making incremental rate adjustments. It is necessary to focus not only on distortions in corporate and shareholder behavior but also on the overall effect of all taxes involved on the economy. It is also necessary to define the goal of the fundamental reform, which may be something like maximization of a suitable aggregate social welfare function. The reform should then be made in the service of the overall goal and may or may not wind up removing incentives for corporations or shareholders to engage in activity that is deemed to be tax avoidant or distortionary when viewed in isolation. Analysis of this sort of reform is beyond the scope of this Piece, just as it is also beyond the scope of the rate adjustments and other

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27. Note that even if the U.S. tax rate is set at 0% (so that  $t_{US} = 0\%$ ), this results in simple parity between choices A and B. In such a case, the firm should be indifferent as to which it chooses.

28. But see *supra* note 23 (explaining that it would generally be possible to achieve a structural reform by changing the applicable tax rate if the rate were specified in such a way that it varied depending upon circumstances, with the variation designed exactly to mimic the effects of a structural tax reform).

incremental reforms considered in *Scylla and Charybdis*.<sup>29</sup> It is important to keep in mind, however, that tax rate adjustments alone may not always be sufficient to remove incentives for a particular behavior.<sup>30</sup> When this is the case, fundamental reform needs to be considered, and deep questions involving the goals of the overall tax system need to be addressed in connection with any such sweeping reform.

#### IV. FURTHER CONSIDERATIONS

##### A. Parity with Pass-Through Entities

One of the goals described in *Scylla and Charybdis* is avoiding a distortion of the choice between investing through a corporate or a pass-through entity.<sup>31</sup> In the very simple world of a single period and flat tax rates, this is relatively straightforward to accomplish. We would simply require the various tax rates to be coordinate relative to each other so that:

$$(4) \quad (1 - t_p) = (1 - t_d)(1 - t_c)$$

Here,  $t_p$  is the personal rate of tax, which is also presumed to be the tax rate applicable to the earnings of a pass-through entity;  $t_d$  is the tax rate applicable to dividends; and  $t_c$  is the tax rate at the corporate level.

When multiple periods and other complexities are taken into account, parity with pass-through entities becomes significantly harder to accomplish. In general, we would want taxes not to encourage corporations to retain earnings, but if the corporate tax rate is lower than the personal tax rate, then compounding over a period of several years can create an enhanced after-tax return for retained corporate earnings and provide just such encouragement. To see why this is so, suppose the annual pretax rate of return available to both corporations and pass-through entities is the same, and denote it by  $r$ . The desirable equivalence is:

$$(5) \quad (1 + (1 - t_p)r)^n(1 - t_p) = (1 - t_d)(1 + (1 - t_c)r)^n(1 - t_c)$$

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29. Fundamental reform proposals are discussed in *Scylla and Charybdis*, but they are not part of the incremental reform proposal that is the focus of this analysis. See Schizer, *Scylla and Charybdis*, supra note 1, at 1902–12 (analyzing fundamental tax-reform proposals).

30. But see supra note 23 (explaining a change to a complex tax rate that varies with circumstances would generally be able to accomplish a structural change). The point is that a simple change to a single new tax rate that is not tailored to particular circumstances would generally not effect a structural change.

31. See Schizer, *Scylla and Charybdis*, supra note 1, at 1854 (“The two rates should be coordinated so that they aggregate to the combined rate Congress wants, which ideally would be the same as the rate on pass-through businesses (or, at least, close to it).”).

This will be true for all  $n$  only if the corporate rate is set at the personal rate and if dividends are simply not taxed (i.e.,  $t_p = t_c$  and  $t_d = 0$ ). This would be a very different reform than that proposed in *Scylla and Charybdis*, because it would increase taxes at the corporate level rather than decrease them and eliminate the shareholder-level tax.<sup>32</sup>

Professor Halperin has shown that it is possible to achieve the desired parity if income generated by retained corporate earnings is taxed at the personal tax rate.<sup>33</sup> Let  $t_{re}$  be the tax rate applicable to reinvested earnings. The equation we want to have satisfied is:

$$(6) \quad (1 + (1 - t_p)r)^n (1 - t_p) = (1 - t_d)(1 + (1 - t_{re})r)^n (1 - t_c)$$

Following Professor Halperin, we can see that if  $t_{re} = t_p$  and equation (4) holds, then we have the parity we desire.

Dean Schizer discusses the possibility of a retained earnings tax as a way to achieve the goal of parity with pass-through entities and prevent tax avoidance by accumulating earnings inside a corporation.<sup>34</sup> Professor Halperin's analysis shows that such a tax on retained earnings would have to be as high as the personal tax rate,<sup>35</sup> which is well above the corporate-level rate that *Scylla and Charybdis* proposes.<sup>36</sup> This high level of tax on a portion of corporate earnings might be compatible with the proposal in *Scylla and Charybdis*, and it is a possibility *Scylla and Charybdis* briefly mentions, but it would be an important additional aspect of the proposal to consider further.<sup>37</sup> In addition, even if this is part of the proposal, it is important to note that enacting such a high tax on such a broad category of retained earnings would likely be politically challenging.<sup>38</sup>

32. See *id.* at 1854 (defending the use of both the corporate tax and the shareholder tax); *id.* at 1855 (explaining that corporate taxes, which are more distortive, should be cut).

33. See Halperin, *supra* note 7, at 709 n.23 (providing further discussion and an algebraic derivation equivalent to the one presented here).

34. See Schizer, *Scylla and Charybdis*, *supra* note 1, at 1894. (“[A] ‘split rate’ system[] taxes retained earnings at a higher rate than distributed earnings.”).

35. See Halperin, *supra* note 7, at 709 & n.23 (describing the relevant algebraic derivations).

36. *Scylla and Charybdis* proposes that the corporate rate be relatively low and the shareholder rate be relatively high, with the two rates combining to impose a burden equal to the personal tax. See Schizer, *Scylla and Charybdis*, *supra* note 1, at 1891, 1913. From Schizer's analysis, it follows that the proposed corporate rate would be substantially below the applicable personal rate.

37. See Schizer, *Scylla and Charybdis*, *supra* note 1, at 1894 n.187 (describing a hypothetical example of a split-rate system with an effective corporate tax rate on earnings paid out as dividends of 15% and a tax rate on retained earnings of 30%).

38. Even President Franklin D. Roosevelt was not able to get a robust undistributed-profits tax implemented. See Joseph J. Thorndike, News Analysis: When Corporations Demanded Double Taxation, *Tax Analysts* (Dec. 1, 2011), <http://www.taxhistory.org/thp/readings.nsf/ArtWeb/3CE9AC56254F41C6852579C200746114> [<http://perma.cc/3QV5-6C4P>].

B. *Future Changes in Law and Playing the Long Game with Deferral*

Suppose that corporate rates are set relatively low and shareholder rates are set relatively high, just as *Scylla and Charybdis* proposes. If a corporation anticipates that there will be a future change in the law that reduces shareholder rates (i.e., a change that deviates from the *Scylla and Charybdis* proposal), then it can be advantageous to wait for such a change before paying a dividend.<sup>39</sup> The high shareholder rate is effective only if dividends are paid while the law maintaining the relatively high rate is in effect.

It is important to qualify this point by noting that corporate dividend policy will not necessarily be driven entirely, or even predominantly, by tax considerations. Corporate managers can have substantial nontax reasons for retaining earnings for future use inside the corporation or for paying dividends at particular times. Still, to the extent one is interested in achieving a particular combined tax rate on corporate earnings through two levels of tax, the point remains that it is necessary that one has control over both tax rates over the entirety of the time horizon in question.

Of course future changes in law are always possible, but the ability of a corporation to defer until the law becomes more favorable is a powerful tool to extract value from any future favorable change. A way to combat this would be to collect the full amount of tax due under current law now, with the corporation acting as a type of withholding agent for the shareholders. This would ensure that payment of the shareholder tax, by the corporation as withholding agent, would be at the rate prevailing when corporate profits were earned, rather than some time later. This technique is known as an imputation system.<sup>40</sup> Having a high effective rate of tax collected by the corporation would seem, however, to run contrary to the proposal in *Scylla and Charybdis* to keep the tax rate paid by corporations low in order to minimize corporate tax-avoidance incentives, and so perhaps it would not be compatible with the proposal.<sup>41</sup>

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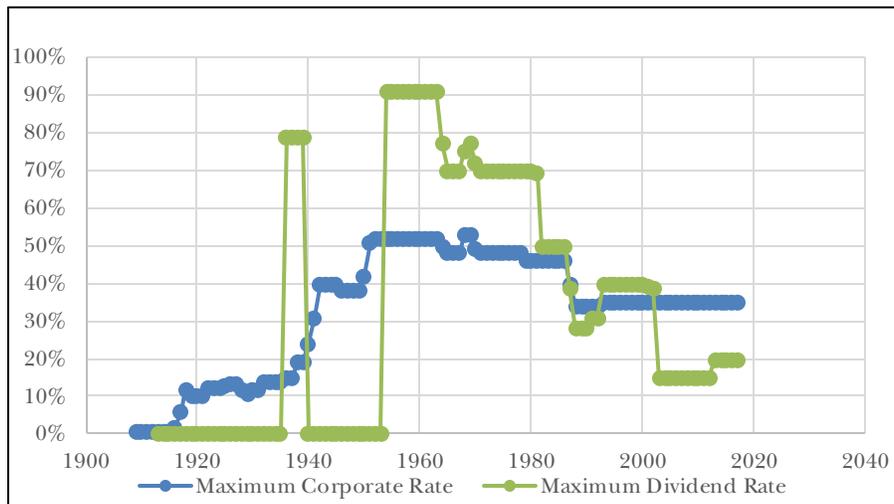
39. See Schizer, *Scylla and Charybdis*, supra note 1, at 1876–77 (“[The] tax advantage of corporations was widely used when corporate rates were significantly lower than personal rates. Although this planning receded when this gap narrowed in 1981, it would revive if the gap were to widen.” (footnote omitted)); see also Daniel I. Halperin, *Mitigating the Potential Inequity of Reducing Corporate Tax Rates*, 126 *Tax Notes* 641, 642 (2010); Schizer, *Scylla and Charybdis*, supra note 1, at 1877 nn.113–114 (referencing Professor Halperin’s argument). Note, however, that corporate managers might not plan in a way designed to minimize combined taxes paid at the corporate and shareholder levels. See *infra* section IV.C.

40. For discussion of an imputation system, see Schizer, *Scylla and Charybdis*, supra note 1, at 1885–86; see also Michael J. Graetz & Alvin C. Warren, *Unlocking Business Tax Reform*, 145 *Tax Notes* 707, 708–09 (2014); Schizer, *Scylla and Charybdis*, supra note 1, at 1885 n.144 (referencing the arguments by Professors Graetz and Warren).

41. *Scylla and Charybdis* does not address the issue of whether corporate tax avoidance could be reduced to desired levels if the corporation paid a high tax rate but such rate was composed of a low corporate tax and an additional withholding tax paid in anticipation of

If the corporate-level rate is indeed low, and there is no advance withholding of shareholder-level taxes, one might wonder what the chance of a future change in law might be. It is impossible to say with certainty, but it may be informative to consider the historical data available about corporate tax rates and dividend tax rates. Figure 1 illustrates the highest marginal rate in each of these two categories from 1909 to the present.<sup>42</sup>

FIGURE 1: HISTORICAL CORPORATE AND DIVIDEND TAX RATES



As is evident from the figure, dividend tax rates have changed considerably in the past, and it is entirely possible that they will change again in the years after a current reform.<sup>43</sup> If shareholders and a corporation

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future shareholder taxes. See *supra* note 4 (discussing the goal of lowering the corporate-level tax rate in the *Scylla and Charybdis* proposal). It is beyond the scope of this Piece to analyze how a corporation might react to a tax levied for different purposes in this way, but this question is something that would need to be considered carefully to determine whether an imputation system and withholding regime would be compatible with the proposal in *Scylla and Charybdis*.

42. The corporate tax was introduced in 1909. Jack Taylor, IRS, Corporation Income Tax Brackets and Rates, 1909–2002, IRS Stat. Income Bull., Fall 2003, at 284, 284. The personal tax was introduced in 1913. Robert A. Wilson, IRS, Personal Exemptions and Individual Income Tax Rates, 1913–2002, IRS Stat. Income Bull., Spring 2002, at 216, 216. Dividends were generally not taxed until 1954, except for the period from 1936 to 1939. When dividends were taxed, they were taxed at the ordinary rates applicable to individuals, except for the period from 2003 to the present, during which qualifying dividends have been taxed at capital gains rates. See Michael Flannelly, A Brief History of Dividend Tax Rates, Dividend.com: Tax Ctr. (Sept. 9, 2014), <http://www.dividend.com/taxes/a-brief-history-of-dividend-tax-rates/> [<http://perma.cc/95K7-YZY3>].

43. See Schizer, *Scylla and Charybdis*, *supra* note 1, at 1885 (“Congress constantly tinkers with tax rates.”).

have a sufficiently lengthy time horizon, they can engage in a long game and simply wait to see if shareholder rates fall in the future. If they do come down to a low level, even for a short time, the corporation can pay dividends then and get the benefit of the low rate.<sup>44</sup>

Another addition to the proposal in *Scylla and Charybdis* that could combat this type of strategic behavior by taxpayers would be to tax shareholders even if no dividend is paid. The tax could be levied on unrealized appreciation in shares, for example, so that shareholders would be taxed on a “mark-to-market” basis. This would lock in the tax rate shareholders have to pay now, rather than giving shareholders the beneficial tool of deferral.<sup>45</sup> This would be a substantial change to current tax law, however, and a detailed discussion of such a reform is beyond this scope of this Piece.

### C. *Coordination Between Shareholders and Corporate Managers*

The proposal in *Scylla and Charybdis* makes a clever use of the managerial agency problem. The idea is to harness the fact that managers and shareholders do not have aligned interests so that the two levels of tax can be treated independently. In this way, shareholder taxes can be raised without concern that managers will coordinate with shareholders to reduce the effective joint tax burden.<sup>46</sup>

The idea of exploiting the manager–shareholder misalignment is a very nice one. The only comment here is that it would be useful to understand how far this approach can be taken and what its limits are. Presumably, if the tax burden becomes high enough, or if shareholders are sufficiently closely controlling of corporate managers, the two levels of tax might be more appropriately be viewed as a single level. In such a

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44. See supra note 39 and accompanying text for a discussion regarding historical experience with this sort of strategic behavior by corporations and shareholders. However, note also that shareholders and managers may not actually coordinate. See infra section IV.C.

45. See Schizer, *Scylla and Charybdis*, supra note 1, at 1904–07, for a discussion of recent proposals for mark-to-market taxation of shareholders as part of fundamental tax reform.

46. This is a point that is made more implicitly than explicitly in *Scylla and Charybdis* but is nonetheless critical to its proposal. If there is coordination of planning between shareholders and corporations so that the plans respond to the aggregate combined tax rate rather than each component-rate tax in isolation, then the proposal in *Scylla and Charybdis* does not work. See id. at 1854 (“[A]lthough the [two] taxes are supposed to back-stop each other, they cannot do so when a planning strategy avoids both.”); id. at 1885 (“[A]lthough using two taxes can ease distortions from component-rate planning . . . it cannot do so for combined-rate planning.”). Dean Schizer also explains that managers have motivations to engage in tax planning at the corporate level without regard to shareholder tax consequences. See id. at 1873 (“When managers are motivated to engage in tax planning, they focus on corporate taxes instead of shareholder taxes.”); id. at 1909 (“[E]ven when shareholders do not benefit from corporate tax planning, managers still have agency-cost reasons to invest in it . . .”).

case, the shareholders and managers will work together to reduce the overall tax burden on corporate profits.

Distributional consequences may also be worth consideration. Small, closely held firms may be more likely to act in a coordinated way to minimize the overall tax burden. Larger firms may not be so coordinated, except in cases in which there are one or more particularly powerful shareholders. These shareholders, and their firms, might be more favorably treated than others under the proposal in *Scylla and Charybdis*.

It is beyond the scope of this Piece to determine how robust the assumption of *Scylla and Charybdis* is that shareholders and managers will not coordinate. It is also beyond the scope of *Scylla and Charybdis*, which expressly limits its analysis to publicly traded firms and limits its proposal to firms in which corporate managers and shareholders do not coordinate to minimize aggregate taxes.<sup>47</sup> Before adoption of the proposal in *Scylla and Charybdis*, however, it seems that it will be important to understand more fully what sorts of firms may exhibit shareholder-managerial tax coordination and how large of an effect this will have on overall policy goals.

#### CONCLUSION

In *Scylla and Charybdis*, Dean Schizer has given us a detailed and thoughtful work that illuminates the many considerations and challenges presented when considering how to structure taxes at the corporate and shareholder levels.

The main conclusion in *Scylla and Charybdis* is that public companies should be taxed at both the corporate and shareholder level, and in making this argument, Dean Schizer also proposes a reform that lowers tax rates at the corporate level but increases them at the shareholder level, with a goal of keeping the joint burden the same as it would be for an individual. The idea is to achieve less tax avoidance at the corporate level because of the lower tax rate, with the thought being that avoidance at the corporate level is more common and concerning than avoidance at the shareholder level.

The proposal to structure the tax burden on corporate income in this way is intriguing, and it bears further study. This Piece has provided some directions in which further analysis of the proposal may progress. First, as discussed in Part I, it is important to understand the cost of tax avoidance and whether that cost is large enough that a rate cut could render avoidance unprofitable. Second, as discussed in Part II, it is necessary to be clear about what exactly constitutes avoidance. This is a

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47. See *id.* at 1855 (clarifying that the essay focuses on “publicly traded businesses”); see also *id.* at 1856 n.19 (discussing further how controlling shareholders of a corporation may engage in tax planning coordinated to minimize overall taxes); *supra* note 2 and accompanying text (explaining how the proposal in *Scylla and Charybdis* relies on independent planning by shareholders and corporate managers).

subtler and more difficult question than it may appear to be at first, but it is important to determine precisely what avoidance is in order to target it with reform proposals. Third, as discussed in Part III, it is necessary to bear in mind that rate cuts may not always be a sufficient tool to achieve a desired result. In particular, if avoidance is driven by structural features of the tax code, then structural changes may be necessary to end the avoidance, although care should be taken to retain useful aspects of the structural features, if possible.

Part IV discussed further issues. First, keeping parity between investments in corporate and pass-through entities is challenging and likely requires a high-rate tax on retained corporate earnings. This is in a bit of tension with the goal of the proposal in *Scylla and Charybdis* of keeping corporate tax rates low. Second, the possibility of using deferral of shareholder taxation to wait for a future favorable change in the law that lowers tax rates for shareholders is a concern. It might be possible to address this with taxation of shareholders on unrealized appreciation, but this would be a more substantial reform than the incremental proposal of *Scylla and Charybdis*. Third, there may be cases in which there is not much misalignment between managers and shareholders, and in these cases, the two levels of tax cannot be treated as imposed independently of each other, as is generally assumed in *Scylla and Charybdis*.

The goal of highlighting these various challenges and questions is to help readers come to a fuller understanding of the pressure points of the reallocation of the corporate tax burden between corporations and shareholders proposed by *Scylla and Charybdis*. It is hoped this contribution helps to understand what exactly would be necessary to make the proposal work and what modifications to the proposal or other alternatives might also be worth considering.