

Cash is not everything

By Alice G. Abreu

In the opening paragraph of his essay on the Bush dividend exclusion proposal, Professor Booth acknowledges that the proposal is not fair and will probably not do much to spur the economy. What, then, commends it? Professor Booth's answer is simple: cash.

Professor Booth maintains that the Bush proposal will cause corporations to pay increased dividends. He believes that will restore investor confidence in the capital markets because the payment of cash dividends will serve as proof positive of corporate well being. Those are all good things.

The certain unfairness of the proposal, which benefits those able to own corporate stock directly but disadvantages those who only own stock through tax preferred retirement vehicles and provides no tax relief whatsoever for those at the bottom of the income distribution, does not trouble Professor Booth. He notes that the fairness objection can be levied against any proposal for corporate tax reform and on that ground, he dismisses it.

Yet, the fairness objection should not be dismissed. Even if corporate tax reform as proposed were unquestionably desirable, it doesn't follow that it should be undertaken now, when the country is facing record unemploy-

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ment and an ever-burgeoning deficit, not to mention the possibility of war, as part of a package that provides little tax relief for those at the bottom of the income distribution (many of whose children will form the bulk of the front line in any war). Timing matters.

Furthermore, Professor Booth's enthusiasm for this proposal appears to reflect some confusion on how the proposal will operate. Although the administration has publicly touted the plan as encouraging the payment of corporate earnings in the form of dividends, the actual proposal issued by the Treasury Department does no such thing. The proposal will not encourage corporations to give shareholders their money. On the contrary, it will actually reduce the cost of retaining corporate earnings, giving corporate managers even more incentive to retain them.

To understand why this is so it is necessary to understand the proposal. First, the proposal does not make all dividends tax exempt when received by shareholders. That might be simple, it might be appealing and it might be what people think when they hear nontechnical descriptions of the proposal — but it is simply not what the proposal does. Second, the proposal does not encourage the payment of cash dividends. On the contrary, the proposal takes pains "[t]o ensure that distributions and retentions of previously taxed earnings are treated similarly." *Eliminate the Double Taxation of Corporate Earnings*, Treasury Department Explanation, <http://www.treasury.gov/press/releases/docs/bluebook.pdf>. Treating distributions and retentions similarly can hardly be said to encourage distributions. I will address

each of these points in turn.

First, the proposal does not make all dividends tax exempt. Under the proposal, dividends will be tax exempt only if they are paid out of corporate earnings *that have been subject to tax*. Although it may not be obvious to nontax lawyers, that is a crucial limitation because much corporate income is not subject to tax. The reasons are numerous but a simple example should suffice to illustrate the point.

Assume that a corporation has purchased equipment on which it is allowed to take accelerated depreciation deductions. The corporation will have greater book income than taxable income because accelerated depreciation reduces taxable income but not book income. Although all of its book income would usually be available for distribution to shareholders, any dividends paid would be exempt under the proposal *only* to the extent that they are paid out of taxable income. If a corporation has book income of \$100 but has purchased equipment that would entitle it to accelerated depreciation of \$30 more than what GAAP allows for book purposes, its taxable income would only be \$70. Only a portion of the \$70 would be subject to exclusion under the Bush proposal. No portion of the \$30 would be excludable.

Thus, even if the proposal could be said to encourage the payment of dividends, it could not be said to encourage the distribution of all earnings as dividends. Indeed, corporations whose tax managers have done a good job of minimizing their tax exposure

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for concocting elaborate corporate tax shelters that themselves divert resources?

Contrary to popular belief, repeal of the dividend tax does not constitute repeal of double taxation. The capital gains tax remains in place. And, for the most part, capital gains on stock come from a corporation's withholding available cash and reinvesting it in the business. Reinvestment means higher returns in the future, and higher returns in the future mean a higher stock price now (assuming the market agrees in the wisdom of growth for the business). In other words, capital gains are the discounted present value of future dividends.

The current proposal would reduce the capital gains tax a bit by allowing stockholders to add their share of undistributed income to the cost basis of shares. But to the extent that a capital gain is attributable to a company's future prospects or a general increase in market prices, it remains taxable as under current law. Then again, only those stockholders who choose to sell their expectancy (so to speak) would ever pay capital gains. I'm no fan of the capital gains tax, but if it becomes a more or less voluntary penalty for early withdrawal — one that discourages investors from short term in and out trading — I think I could learn to like it.

Moreover, dividends that go into most retirement plans will still be taxed twice as they are under current law — once as income to the corporation and once when the retiree receives a distribution. Given that about half of all stock is held in some such account, the half of dividends

currently paid into such accounts will eventually be taxed anyway (except to the extent that folks convert to Roth IRAs as presumably many will do). As it is, the dividend tax is in the process of withering away on its own. As of 1998, only 33.7 percent of dividends

**Repeal won't
cost much
in the end.**

paid to all recipients were currently taxable (compared to 48.5 percent in 1990). So it is not clear that repeal of the dividend tax is really going to cost much in the end.

Eliminating the tax on dividends also removes the perverse incentive for corporations to retain cash even in the absence of a business use for it. Under current law, a stockholder would prefer to have a corporation invest excess cash even in stodgy government securities so that the returns could be taken out at will in the form of capital gains. With tax-free dividends, investors can decide where to reinvest.

But wait. There's more. Current tax law also makes compensatory stock options more attractive than they should be. Don't get me wrong, I am a big fan of stock options. They are the best way we have to align the interests of managers and stockholders. The traditional bonus based on earnings is an invitation to cook the books. But to the extent that the increase in a company's stock price is the result of retaining cash simply because investors dislike dividends, stock options are nothing more than a wind-fall transfer of wealth from stockholders to managers — compensation for the passage of time as Warren Buffett so aptly put it. A tax system that encourages managers to keep cash even when they have no particular use for it — and that leaves stockholders liking it — is hardly consistent with the notion that the stockholders own the company.

Finally, repeal of the dividend tax may help stem the exodus of corporations to Bermuda. Under the current proposal, tax-free dividends may only be paid to the extent of a corporation's U.S. taxed income. And that may even induce some companies to move jobs back home.

The Bush tax plan is a marvel of financial engineering. In one fell swoop — and very much on the cheap — it addresses many of the ills currently afflicting business, and it achieves most of the sensible reforms to the corporate tax that folks have been talking about for the last 40 years — all without touching the third rail of capital gains (much). Ironically, it may only be possible because no one has been talking about it for 40 years. **BT**

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might see little change in the incentive to distribute earnings. The better the corporate tax planning, the smaller the effect of this proposal.

The reason for the foregoing effect is found in the objective of the proposal, which is the elimination of the double taxation of corporate earnings. To eliminate the double tax on corporate earnings one needs only to ensure that amounts that have been taxed once are not taxed again. Amounts representing corporate earnings that have not been taxed do not need to be excluded from income when distributed as dividends because the imposition of a shareholder-level tax would still result in the payment of only one tax.

Treasury has pointed out that removing one level of tax should reduce the attractiveness of corporate tax planning, presumably because paying taxes at the corporate level eliminates the tax at the shareholder level. The problem is that this reasoning assumes that corporate managers want to pay dividends, but both the current literature on agency costs and the very history of the double taxation of corporate earnings shows that precisely the opposite is true. See, for example, Steven A. Bank, "Corporate Managers, Agency Costs, and the Rise of Double Taxation," 44 *Wm and Mary L. Rev.* 167 (2002); Jennifer Arlen and Deborah Weiss, "A Political Theory of Corporate Taxation," 105 *Yale L.J.* 325 (1995).

Second, to the extent that a corporation has income that has been subject to tax and which could therefore serve as the basis of an excludable dividend under the proposal, the corpo-

ration will have the choice of either paying the dividend or retaining the funds and passing the benefits of its tax payment to the shareholders in the form of a basis increase. As described above, this choice was provided explicitly "[t]o ensure that distribu-

**Don't increase
the deficit
at this time.**

tions and retentions of previously taxed earnings are treated similarly." Treasury Department Explanation, *supra*.

While the basis increase could be as attractive as the dividend exclusion for shareholders who engage in frequent trading and thus hold the stock for less than a year (their capital gains are short-term and are thus taxed at the same rate as ordinary income) it will not be as attractive as the dividend exclusion for taxpayers whose capital gains are taxed at a rate lower than ordinary income or not at all, (if they die holding the stock).

Nevertheless, the ability to have shareholders receive all or most of the

benefit of the corporate level tax without the need to part with any of the actual cash significantly detracts from the incentive to distribute it. Add the proposed repeal of both the accumulated earnings tax and the personal holding company tax, (penalty taxes designed to curb the incentive to retain earnings), and what emerges is a system that not only fails to provide an affirmative incentive for distributing earnings but may make it even more attractive to retain earnings than current law. Score one for the managers.

Finally, Professor Booth asserts that "[u]nder the current proposal, tax-free dividends may only be paid to the extent of a corporation's U.S. taxed income. And that may even induce some companies to move jobs back home." This conclusion does not necessarily follow. As long as the rate of tax overseas is less than the U.S. rate, shifting income (and jobs) overseas will remain attractive because in many cases no U.S. income tax will be due until the profits are repatriated. Granted, a dividend exclusion will make repatriation more attractive if the profits are to be distributed, but it is unlikely to eliminate the incentive to manufacture offshore.

In sum, the effects that Professor Booth predicts are hardly certain. The only thing the proposal will clearly do is reduce the rate at which corporate income is taxed. That may help to restore investor confidence and give Wall Street a boost, but it will do so at the cost of increasing a burgeoning deficit during a time of unemployment and possible war. It is the wrong tax policy at the wrong time. **DTI**

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Banking Law Basics:
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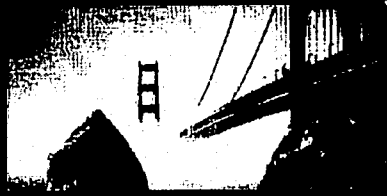
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AUGUST

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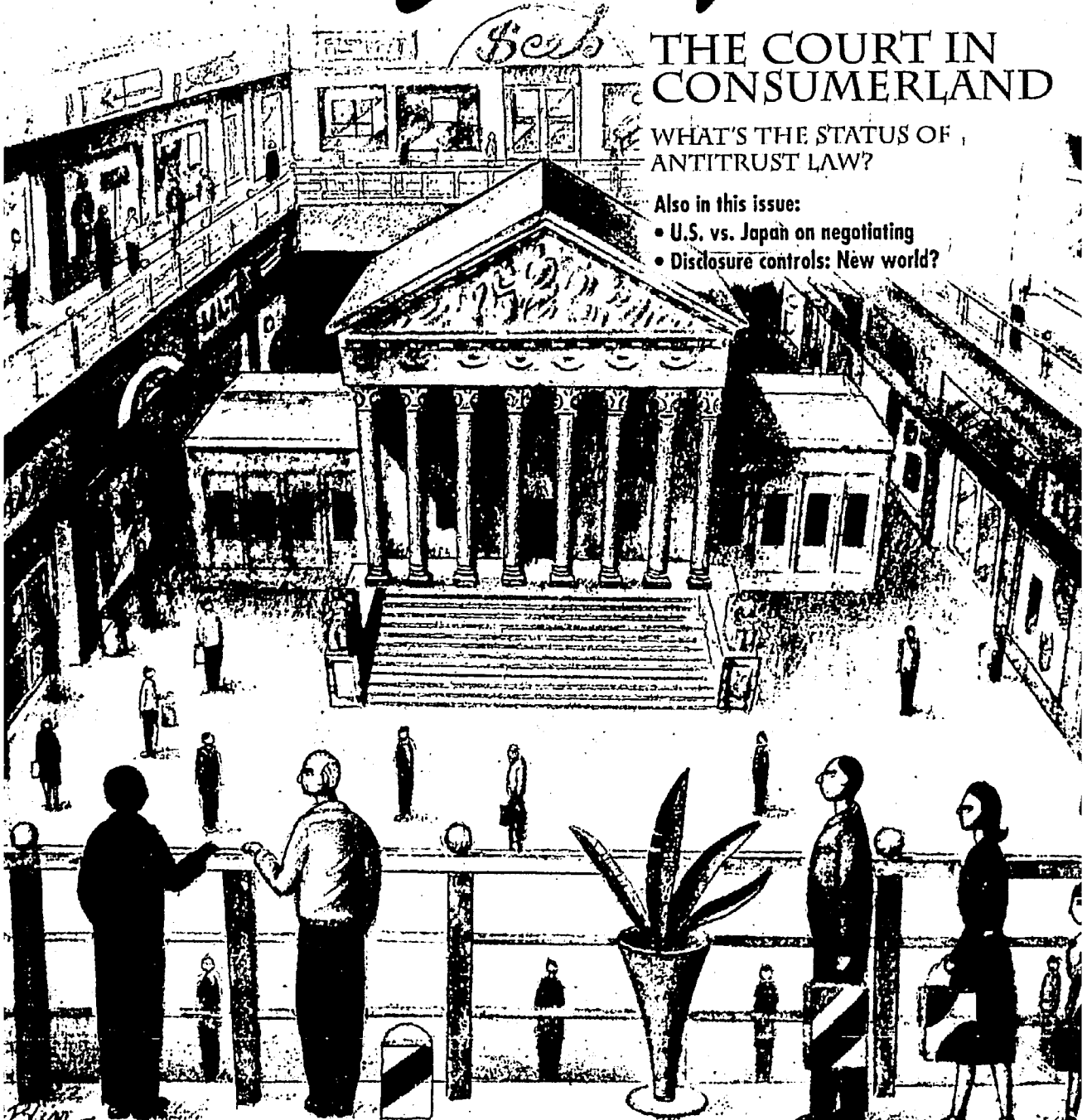
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Ask the ADR Professionals

News You Can Use from The National Arbitration Forum

Is it true that arbitrators will frequently "split the baby" in rendering awards?

The short answer to this persistent myth is "no." There is no evidence that arbitrators split awards down the middle in order to make parties happy — or at least to make them equally dissatisfied. This misperception probably derived years ago from labor-management arbitrations, where one arbitrator heard disputes from two parties over and over again.

However, the empirical evidence we have today suggests that "splitting" awards is simply a myth. In one study of international business arbitrations, the majority of awards resulted in outright "wins" or "losses" 66% of the time. The results of the remaining 34% were widely distributed, with awards from 10% to 90% of the amount claimed. This would imply that arbitrators, as a rule, make decisive awards and do not "split the baby."

University of Kansas law professor, Christopher Drahozal, makes a compelling point that arbitration administrators such as the American Arbitration Association, JAMS, National Arbitration Forum, and CPR Institute for Dispute Resolution have a strong interest in making sure arbitration awards are fair, and in ensuring that "repeat players" do not get preferential treatment. According to Prof. Drahozal, since arbitration administrators generate fees by providing administrative services for arbitration, they want to ensure that courts continue enforcing their arbitrators' awards. So, not only do the major arbitration administrators

shave a reputational interest in having their arbitrators produce fair awards, they also have a strong incentive to make sure that awards get enforced.

Drahozal's advice? "One thing you might keep an eye on, if you are ever asked to look at arbitration clauses, is whether it is administered by an institution or not. If it's administered by an institution, there are good incentives to keep the process fair." ("Privatizing Civil Justice: Commercial Arbitration and the Civil Justice System", The Kansas Journal of Law & Public Policy, Vol. 9, No. 3 (2000)).

Courts have been very favorable to arbitration. Are there any studies about the public perception of arbitration?

There actually have been quite a few studies of this kind over the years and the results are that the American public favors arbitration. In one recent study, 90% of participants in arbitration believed their cases were handled fairly. A Roper survey showed that 59% of Americans would automatically choose arbitration over litigation. That number jumped to 83% in favor of arbitration when survey participants were informed that arbitration could be significantly less expensive than litigation.

In their Worker Representation and Participation Survey, Princeton Survey Research Associates found that 83% of employees thought arbitration was "good" or "very good." The majority of employees (62%) thought arbitrators would resolve disputes more fairly than courts. Seventy-one percent of these employees thought it would be easier for an employee to get a fair hearing; and 73% thought employees would be better off.

Even in long-ago 1985, a survey by "Dispute Resolution Times" found that 83% of those surveyed favored using arbitration instead of the courts, while only 8% said it was a bad idea.

In a 2002 edition of the Pepperdine Dispute Resolution Law Journal, one legal commentator succinctly summed up the public's perception of arbitration's fairness to individuals with this statement, "There is also a general feeling of goodwill the public has about arbitration; people like it and believe it is fair."

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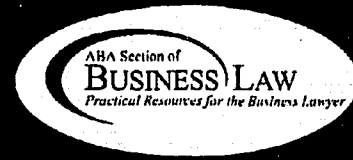
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