CORPORATE INCOME TAX CONFERENCE


The conference featured nine original research papers from leading scholars in economics and accounting on the effects of corporation taxation on economic activity and tax avoidance. The proceedings of the conference will be published in 2006 by Cambridge University Press. Short summaries of the papers follow. Final versions of the papers can be found as Working Papers on the OTPR and Burch Center web sites.

The Effects of Taxes on Market Responses to Dividend Announcements and Payments: What Can We Learn from the 2003 Dividend Tax Cut?

Raj Chetty, University of California, Berkeley and NBER
Joseph Rosenberg, University of California, Berkeley
Emmanuel Saez, University of California, Berkeley and NBER

This paper investigates the effects of capital gains and dividend tax rates on excess returns around announcements of dividend increases and ex-dividend days for U.S. corporations. Consistent with standard no-arbitrage conditions, we find that the ex-dividend day premium increased from 2002 to 2004 when the dividend tax rate was cut. Consistent with the signaling theory of dividends, we also find that the excess return for dividend increase announcements went down from 2002 to 2004. However, these findings are very sensitive to the years chosen for the pre-reform control period. Semi-parametric graphical analysis using data since 1962 shows that the relationship between tax rates and ex-day and announcement day premia is very fragile and sensitive to sample period choices. Strong year-to-year fluctuations in the ex-day and announcement day premia greatly reduce statistical power, making it impossible to credibly detect responses even around large tax reforms.

Dissecting Dividend Decisions: Some Clues about the Effects of Dividend Taxation from Recent UK Reforms

Stephen R. Bond
Institute for Fiscal Studies and Nuffield College, Oxford
Michael P. Devereux
University of Warwick and Institute for Fiscal Studies
Alexander Klemm
Institute for Fiscal Studies and University College, London

We present empirical evidence which suggests that a big increase in dividend taxation for UK pension funds in July 1997 affected the form in which some UK companies chose to make dividend payments, but otherwise had limited effects on both the level of dividend payments and the level of investment. These findings are consistent with a version of the ‘new view’ of dividend taxation. We also identify a group of firms whose dividend choices are difficult to reconcile with (stock market) value maximization.
The political debate over the dividend tax reductions of 2003 took a number of surprising twists and turns. Accordingly, it is likely that the views of market participants concerning the probability of significant dividend tax reduction fluctuated significantly during 2003. In this paper, we use this fact to estimate the effects of dividend tax policy on firm value. We find that firms with higher dividend yields benefited more than other dividend paying firms, a result that, in itself, is consistent with both new and traditional views of dividend taxation. But further evidence points toward the new view and away from the traditional view. We also find that non-dividend-paying firms experienced larger abnormal returns than other firms as the result of the dividend tax cut, and that a similar bonus accrued to firms likely to issue new shares, two results that may appear surprising at first but are consistent with the theory developed in the paper.

How Elastic Is the Corporate Income Tax Base?
Jonathan Gruber, MIT and NBER
Joshua Rauh, University of Chicago and NBER

We estimate the impact of the corporate tax rate on the level of corporate taxable income for publicly traded firms from 1960–2003. We overcome the endogeneity of corporate tax rates to taxable income by modeling the effective tax rates faced by firms in one period, and the effective tax rate that would be faced by firms with the same characteristics in the next period. Using industry level aggregates, we find strong evidence that the corporate tax base is elastic with respect to the marginal effective tax rate, though the magnitude is smaller than typical estimates of household taxable income elasticities.

An Empirical Examination of Corporate Tax Noncompliance
Michelle Hanlon, University of Michigan
Lillian Mills, University of Arizona
Joel Slemrod, University of Michigan

Using data on audit and appeals records, matched with tax information and financial statements of several thousand corporations, we find that corporate tax noncompliance, at least as measured by deficiencies proposed upon examination, amounts to approximately 13 percent of “true” tax liability, and is “regressive” in the sense that noncompliance as a fraction of a scale measure increases with the size of the company. We find some evidence that incentivized executive compensation schemes are associated with more tax noncompliance, but only with respect to bonuses and not for stock options and other equity-related incentive pay. We uncover no relation between the quality of corporate governance and the extent of proposed (scaled) tax deficiency, nor is there consistent simple or partial negative association between our measure of tax noncompliance and the effective tax rate calculated from financial statements.

On the Extent, Growth, and Efficiency Consequences of State Business Tax Planning
Donald Bruce, University of Tennessee
John Deskins, University of Tennessee
William F. Fox, University of Tennessee

Our focus in this essay is on the extent to which tax planning in response to variations in state tax policy has affected state corporate income tax bases and revenues. Tax planning is defined as a broad set of actions undertaken by firms to reduce their tax liability. Financial or accounting tax planning is contrasted with what we refer to as locational distortions, in which firms move physical operations to avoid higher tax liabilities. Results from a fixed effects instrumental variables regression model using a 1985–2001 panel of state-level data suggests that tax planning activity significantly diminishes taxable corporate profits in high tax states. Specifically, we find that state corporate income tax bases decline by nearly 7 percent following a one-percentage-point increase in the top marginal corporate income tax rate, controlling for locational distortions. We also find that throwback rules are usually ineffective in restoring corporate income tax bases while combined reporting requirements are often effective.

Corporate Taxation and International Competition
James R. Hines Jr., University of Michigan and NBER

Countries around the world continue to tax corporate income at significant rates despite downward pressures from international competition. Average statutory corporate income tax rates fell from 46 percent in 1982 to 33 percent in 1999, though tax bases simultaneously broadened, as a result of which average corporate tax collections actually rose from 2.1 percent of GDP in 1982 to 2.4 percent of GDP in 1999. Two pieces of evidence point to the possibility that mobile capital has received favorable tax treatment in recent years as a result of tax competition. The first is the experience of American multinational firms, whose average foreign tax rates fell from 43 percent in 1982 to 26 percent in 1999. The second is the
cross-sectional pattern of tax rate-setting: small countries, facing elastic supplies of world capital, taxed corporate income at significantly lower rates than did larger countries in 1982. Corporate tax rates in 1999 did not substantially differ between small and large countries, implying that large countries set their tax rates in response to the same competitive pressures that small countries have always faced.

The Changing Role of Auditors in Corporate Tax Planning

Edward L. Maydew, University of North Carolina
Douglas A. Shackelford, University of North Carolina and NBER

This paper examines changes in the role that auditors play in corporate tax planning following recent events, including the well-known accounting scandals, passage of the Sarbanes-Oxley Act, and regulatory actions by the SEC and PCAOB. On the whole, these events have increased the scrutiny of auditor independence. We examine the effects of these events on the market for tax planning, in particular the longstanding link between audit and tax services. There has already been a dramatic shift in the market for tax planning away from obtaining tax planning services from the same firm that does one’s audit. We estimate that the average ratio of tax fees to audit fees paid by firms in the S&P 500 to the firms doing their audits declined from approximately one in 2001 to one-fourth in 2004. At the same time, we find no evidence of a general decline in spending for tax services. In sum, the evidence indicates a decoupling of the longstanding link between audit and tax services, such that firms are shifting their purchase of tax services away from their auditor and towards other providers.

Taxation and the Evolution of Aggregate Corporate Ownership Concentration

Mihir A. Desai, Harvard University and NBER
Dhammika Dharmapala, University of Connecticut
Winnie Fung, Harvard University

The concentration of corporate ownership is a critical element of a corporate governance environment and reflects the degree to which different income groups participate in the stock market. An extension of standard clientele arguments demonstrates that changes in the progressivity of taxes can significantly influence corporate ownership concentration. A novel index of the concentration of corporate ownership over the twentieth century in the United States provides the opportunity to quantitatively test for the role of taxes in shaping ownership concentration. Analysis of this index indicates that the progressivity of taxation significantly influences corporate ownership concentration and equity market participation as predicted by the model. This evidence supports the intuition of the classic work of Berle and Means that taxation can significantly influence patterns of equity ownership.

President’s Advisory Panel on Federal Tax Reform

Both of OTPR’s directors testified before the President’s Advisory Panel on Federal Tax Reform in Washington, D.C. On March 3, 2005 OTPR Director Joel Slemrod presented testimony entitled “The Costs of Tax Complexity.” Slemrod described the magnitude of causes and consequences of tax complexity. He emphasized that the keys to simplifying the tax system include resisting fine-tuning both the tax liability of individuals and the economy by subsidizing and rewarding activities deemed to be especially valuable, and making it easier to take advantage of large-scale withholding by business, either radically with a VAT or through a return-free income tax system.

On May 12, 2005 OTPR Research Director James R. Hines Jr. presented testimony entitled “Exempting Foreign-
Source Dividends from U.S. Taxation.” Hines spoke about the current U.S. tax regime, why foreign income is taxed the way it is, capital export neutrality, and the downsides of worldwide taxation.

As of the publication of this newsletter, the release date of the report has been temporarily postponed. Watch our web site (www.otpr.org) for analysis of the panel’s report.

**Tax Art**

To our knowledge, OTPR has the fourth largest collection of “tax art” in the world. The collection includes an original copy of the very first (1913) U.S. income tax form, an original copy of the tax form for the 1801 British income tax, wartime posters exhorting taxpayers to do their duty, and a map from 1780 showing salt tax smuggling routes from Sichuan to Yunnan in China. Pictured below is an original WWII poster.

**Former OTPR Ph.D. Student Receives Award**

OTPR is proud to announce that Professor Shih-Ying Wu, assistant professor of economics at the National Tsing Hua University in Taiwan, is the winner of the first annual “Outstanding Paper Award” selected from the articles published in Public Finance Review in the year 2004. His paper is titled “Tax Effects on Charitable Giving in the Presence of Uncertainty.” OTPR’s director Joel Slemrod chaired Professor Wu’s dissertation committee.