

THE ETHICS OF CORPORATE INCOME TAXATION AND CORPORATE INCOME TAX SHELTERING

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Abstract

What follows is a defense of corporate tax shelters. The first section shows that there is no ethical case in favor of the corporate income tax by examining traditional, as well as original arguments. The second section studies the effects of the corporate income tax on the economy and its various actors. On that basis, the last section argues that corporate tax shelters are not only respectful of natural rights, but also socially useful, and thus compatible with both deontic and utilitarian ethics.

THE ETHICS OF THE CORPORATE INCOME TAX

The corporate income tax (CIT) is a tax on income earned through investment in incorporated businesses. The return on such investments equals the value added by the business' activity less taxes on production and the costs of labor, borrowing, and capital replacement. Of this post-tax return, a part is distributed to shareholders through dividends, while the rest is retained for reinvestment. Shareholders pay taxes on both distributed and undistributed profits; but while they are taxed immediately on the dividends they receive, they are taxed later on on undistributed income—when they sell their shares and realize capital gains. This results in a double taxation of income earned through investment in

incorporated businesses as profits are taxed both at the corporate and at the shareholder level.

The CIT as a withholding tax

The most common argument in defense of the CIT is that “all the world should be taxed”¹. According to the Congressional Budget Office, “only profits that are distributed as interest to lenders or dividends to shareholders are considered cash flows, which are subject immediately to taxation under the individual income tax. Thus, in part to fully tax all profits, the United States’ tax system subjects a corporation’s profits to their own income tax”².

The argument, explains Avi-Yonah, goes as follows: “If there were no corporate tax imposed, given that corporations are treated as separate legal entities from shareholders, individuals could shelter their income from tax by earning it through corporations;” which would “result in total income tax exemption if the shareholder holds the shares until her death and a step up in basis is available”³. Indeed, a step up in basis means that future capital gains on inherited financial assets will only be calculated based on their value at the time of inheritance.

However, this argument for the taxation of undistributed incomes is also an argument against the taxation of distributed incomes. Thus, Avi-Yonah—who defends the CIT, but for other reasons—argues that, if the CIT is a withholding tax imposed on shareholders at the corporate source of their income, then “It naturally follows that shareholders should not be taxed again when dividends are distributed to them”⁴.

Unincorporated businesses organized as sole proprietorships or partnerships are not subject to the CIT: their owners simply include their share of the business’ revenues in their taxable individual income. Could the same ‘fiscally transparent’ status be extended to incorporated businesses? Of course, since such is the case for some of them (organized under subchapter S of the Internal Revenue

Code.) Indeed, many advocate such an ‘integration’ of taxes on distributed and undistributed profits.

The distinctive trait of the CIT is that it is, as Harberger explained in the most influential paper on the subject, “a tax on capital income originating in the corporate sector, layered on top of the individual income tax collected on capital income”⁵. Any successful defense of the CIT should therefore justify the taxation of corporate earnings both at the corporate and individual levels. For instance, some argue that it is more efficient to collect taxes at the corporate level, especially for corporations with a (very) large number of shareholders⁶. But this does not justify the double taxation of corporate income: if it has to be taxed at the corporate level for greater fiscal efficiency, then shareholders should pay no tax on either dividends or capital gains.

The CIT as a benefit tax

Another view of the corporate tax interprets it as a benefit tax linked to advantages provided by the government to corporations. The argument implied, here, is an ethical interpretation of the principle of accountability, according to which it is those who receive a benefit who should pay for it.

More precisely, one may distinguish between two views. According to the first, the corporate tax is a payment in return for the benefits of incorporation, such as limited liability. The strength of this argument is that, were it correct, it would justify a tax specifically imposed on those businesses that are actually subject to the CIT. Its weakness, however, is that, in fact, “the government does not grant corporations a privilege of limited liability.” Indeed, creditors know beforehand about the limited liability status of the organization with which they are dealing, and “anything announced and freely contracted for in advance is a right of a free individual, not a special privilege”⁷.

A second view is that a tax on corporate income is justified by the fact that corporations benefit from positive externalities stemming from government services. Thus, corporations are said to

benefit from (i) the protection of their property, the enforcement of their contracts, etc.; but also from (ii) such public services as education.

(i) The first argument is unconvincing, because it fails where the previous seemed to succeed: were it correct, it would not justify a tax specifically imposed on those businesses that are actually subject to the CIT. One could say that, since it is only thanks to such public services as the police, the armed forces, and the courts of law that contracts can be enforced and private property defended, everyone in society should contribute a share of his income to their financing. As a matter of fact, it is precisely the reason why some libertarian authors consider the financing of such “proper services of a government” as the only justification for taxation in general⁸. However, it is an obvious sophism to use the same argument in order to justify a particular tax imposed on a particular group—such as corporate shareholders. It would be just as ridiculous to argue that corner stores benefit from the rule of law, which protects them against robberies, so that a grocery-income tax should be imposed on grocers. Corner stores, corporations, and medical practices do not earn any income: only grocers, shareholders and doctors do. And if part of that income should be taxed in order to finance governmental protection, then the individual income tax will do just that.

(ii) the argument according to which corporations benefit from such public services as education is just as sophistic as the previous. First, such a positive externality, if it exists, exists for all businesses in society, not just corporations, and thus cannot be used to justify a specific tax on corporations. Second, if anyone does benefit from public education, it is the corporations’ employees, not its shareholders, since the corporation pays in full for the higher productivity⁹ of their services in the form of higher wages.

The CIT as a regulatory tax

Any successful defense of the CIT will have to justify the double taxation that it implies, i.e., to justify a specific tax of corporate income at the corporate level, which is a specific tax on incorporated businesses. For that reason, the only way to justify the CIT would be to prove that incorporated businesses exist apart from their shareholders, and that the CIT falls, for good reasons, upon the corporation ‘itself.’

According to Avi-Yonah, a case can be made for this “real-entity” view of the corporation: “there is one way in which the corporation clearly exists as a separate entity from the shareholders and the state, and that is as an organization under the control of corporate management. It is management who make the decisions on deploying the corporation’s economic resources, and in that sense they can be regarded as the “real” corporation. This is particularly true for the publicly traded corporation in which ownership is (to use Berle and Means’ famous phrase) separated from control”¹⁰. Furthermore, “by virtue of their position at the top of the corporate hierarchy and the financial resources they therefore control,” managers have a tremendous “power” that need be regulated in ways that only a CIT can achieve¹¹.

In order to understand why corporate managers have power, according to this author, one must start by distinguishing between two spheres: the economic, or private, and the political, or public. The first consists of free exchanges between equals by the use of money, ‘equality’ meaning that no party to an exchange can legitimately exercise power on the other. Indeed, the exercise of power should be limited to the second political sphere, where it should also, according to the principle of democracy, be ultimately exercised by the majority.

However, Avi-Yonah contends, passed a certain point, the control of economic resources such as corporate capital is indiscernible from the exercise of political power. Quoting philosopher Michael Walzer, he thus argues that corporate managers “make all sorts of decisions that severely constrain and

shape the lives of their employees (and their fellow citizens, too)”; which amounts to a private power that is illegitimate and needs be regulated, since “In a democracy, all power should ultimately be accountable to the people”^{12,13}.

Finally, Avi Yonah concludes, this can only be done through a CIT, because corporate power is consubstantial to corporate activity, so that the only other way to control it would be “to tell corporate management directly how to run their business,” an idea that “was tried and failed in the socialist economies”¹⁴.

A CIT is therefore the only solution, since “the corporate tax is imposed on corporate income, which adds to the economic resources of the corporation. These resources are managed by individual corporate managers, and their control over such resources gives them significant economic, social and political power. In that sense, imposing a corporate tax reduces the economic resources and therefore also the power of corporate management”¹⁵.

Such a view of the corporation and a rationale for the taxation of its income, Avi-Yonah points out, were present in the 1909 Act, which is the origin of the current CIT, and are now truer than ever with the appearance and development of very large and ‘powerful’ publicly traded multinationals whose shareholders are “widespread over the globe and clearly separate from the corporate entity”¹⁶.

There are so many confusions in this line of reasoning that all cannot be mentioned here. It is sufficient to our purpose, however, to address the vagueness of its concept of ‘power.’

Avi-Yonah defines power as “the ability to influence the behavior of others”¹⁷. This is in line with famous political scientist Robert Dahl’s “intuitive idea of power”: “A has power over B to the extent that he can get B to do something that B would not otherwise do”¹⁸. But this overlooks the real question: *by what means?* By way of logical argumentation or through coercion? Clearly, if one does not specify the type of means the use of which characterizes power, then all interactions will be relations of

power. For instance, if Robinson specializes in berry-picking and offers to trade his surplus against Friday's fishes, then he can be said to have power over his only friend, since the latter would have pursued his autistic course of action—and autarkic way of life—, had not Robinson had a comparative advantage in berry-picking. More formally, the mere fact that A is A implies that B interacts with A differently from the way he would have, had A not been A ; thus, A is A implies that A has power over B as soon and long as they interact with each other.

The consequence, however, is that there is no more distinction between exchange and power, and thus between the economic and political spheres. But then, if “all power should ultimately be accountable to the people,” the majority should regulate all interactions in society.

Another consequence is that such an extensive definition of power fails to distinguish between peaceful and violent interactions. Thus, a victim and its aggressor can only be said to exert power over each other. Ridiculously, the fact that B attacks A proves that A has power over B, for instance because B would not have attacked A, had A not worn such a glittering golden watch.

There is, however, a sound definition of power: A exerts power over B to the extent that he gets B to do something that B would not otherwise do—by the use or threat of physical force. Not “threat” in general, such as the threat to fire somebody, or even to close a whole facility, but the threat of physical force. Power is the ability to influence the behavior of others —through coercion.

On that basis, there is a clear distinction between exchange and power, and the economic and political spheres, as well as between peaceful and violent interactions. But corporate managers can no longer be said to have any kind of power, since corporate capital cannot be used in order to coerce, i.e., physically constrain, other people.

Avi Yonah completely overlooks this fact when, arguing in favor of the “real-view” of the corporation, he writes that “An interesting analogy is to compare corporations and the state... This

point was made by Machen, who noted in 1911 that ‘Uncle Sam is a fictitious person; but the government of the United States is a reality’¹⁹. The difference between politicians and managers is not that, while they both hold power, the former are the people’s representatives, while the latter are not selected through a democratic process and pursue mere private interests. It has long been explained that officials exchange privileges against votes, and that consumers constantly ‘vote with their dollars,’ channeling productive resources towards those businesses that most satisfy the general demand²⁰. The real difference is that officials control the use of other people’s goods and services, which they acquire through coercion, while managers are agents hired by shareholders to make profitable use of their capital.

There is, thus, another possible definition of power—or rather another formulation of its only meaningful definition: A exerts power over B when A employs B’s property without B’s consent. This matters, because all of Avi-Yonah’s argument may be subsumed under the traditional ‘negative externality’ argument. According to this author, corporate managers have power in the sense that they may choose between alternative uses of their corporations’ resources without taking under consideration their consequences on other people, because those costs or benefits do not affect their relative profitability. However, this argument is flawed in that the concept of ‘negative externality’ is only meaningful when A’s actions are detrimental to B’s *property*. If A decides to hire a bodyguard, for instance, this is detrimental to his virtual aggressor, B—a cost that A does not take into consideration. But this is not a negative externality, because B is not entitled to A’s money. Likewise, when its managers decide to close a corporation’s facility, the jobs lost by its former employees do not constitute a negative externality, because the latter are not entitled to the corresponding wages (which are shareholders’ money). On top of that, it is obviously a biased perspective to highlight only the managers’ so-called ‘power’ to close a facility without mention of their corresponding ‘power’ to reopen it

elsewhere, or to make any other use of this capital in order to create wealth by satisfying their fellow citizens. Indeed, all 'economic power' is, ultimately, held by consumers, who are sovereign over corporations.

There are two very different kinds of power. One is positive and peaceful: it is the power to create. The other is negative and violent: it is the power to destroy. Naively, Avi-Yonah rejoices that a CIT has the power to destroy the corporations' pseudo-power to create wealth:

"...the corporate tax does significantly slow down the accumulation of corporate resources, which are the foundation of managerial power. For example, imposing a tax at 35% on corporate assets invested at a 10% yield (compounded annually) over ten years results in approximately 27% less assets being available to management at the end of the period than would be available in the absence of the tax.²¹"

THE ECONOMICS OF THE CORPORATE INCOME TAX

The previous section has shown that there is no ethical justification for the corporate income tax, either as a withholding tax under the principle of equality before the tax law, as a benefit tax under the principle of accountability, or as a regulatory tax under the principle that all power should be accountable to the people. The following section will show that, to the contrary, there is an ethical justification for the sheltering against the CIT. In order to do so, it will be necessary, first, to assess the economic consequences of the CIT, as well as their detrimental effects on social utility. This being done, it will be possible to argue that corporate tax shelters are ethically sound from a utilitarian, as well as from a deontic, point of view.

The tax itself, and its effects

Like all taxes, the corporate income tax distorts economic decisions, and thus reduces well-being. As the Congressional Budget Office explains, “Taxes—including corporate income taxes—distort incentives, primarily by taxing endeavors unevenly. When two kinds of economic activity are taxed at different rates, the more highly taxed activity tends to diminish and the less heavily taxed activity expands. Once economic activity takes on a pattern that is based on tax rates, resources in the economy are misallocated and inefficiency results, as economic activity shifts away from its most valuable opportunities”²².

In order to analyze the incidence of the CIT, one has to determine who it affects first, and then how this impact initiates a chain of reactions that extend to the rest of the economy. The question “Who bears the CIT?” is far from settled²³. It may be clarified, however, by a simple distinction between the tax itself and its effects. As a profit-seeking organization, a corporation can be expected to have, at any time, the lowest labor costs and the highest selling prices it can obtain. As a consequence, a tax on corporate income cannot be shifted backwards to employees, or forward to consumers: it is entirely borne by corporate shareholders. Yet, this does not mean, that other agents are not adversely affected by its effects.

The CIT against saving

Because it lowers the revenues of corporate shareholders, a CIT causes capital to flow from the “corporate” towards the “non-corporate” sector, as well as from property towards credit titles; which results in a decrease in the supply of saving.

As Harberger explained in the most famous paper on the subject, a lower (after-tax) return in the corporate sector modifies the incentives facing investors, and must drive capital into the non-corporate sector until equilibrium is restored at a lower level. Thus, a CIT affects all capital owners: “if corporate capital accounts for 25 percent of the economy’s capital, its individual owners will bear

25 percent of corporate taxes; the other 75 percent will be shifted to owners of non-corporate capital”²⁴. Nevertheless, the equilibrium being restored at a lower level of return, this must lead to a decrease in the supply of saving. This effect on capital accumulation is one of Harberger’s “important omissions”²⁵.

The incentive to invest in stock is the opportunity to earn a profit over the interest rate on credit instruments. However, while one’s interest income is taxed at one’s marginal income tax rate, one’s income from investment in equity is taxed, first, at the corporate level, and then at the individual level also; which results in a higher taxation of returns from investment in equity. Therefore, a CIT must have the effect to divert capital from property towards credit titles, and thus do decrease returns received, not only by shareholders, but all capital owners. And as it passes on to all suppliers of capital, depressing the price of their services, a CIT must reduce the incentive to save, and thus lower the supply of capital.

Does a CIT really decrease the supply of capital?

Auerbach argues that such a consequence only holds for the long-run. In the short run, capital cannot move freely from the corporate to the non-corporate sector. Thus, a CIT may affect asset values rather than rates of return, but “tax-induced reductions in rates of return distort saving and investment decisions, while unexpected drops in asset values do not”²⁶.

However, the consequence holds, even in the short run, for new savings. On top of that—and it will prove to be an all-important point—resources diverted from shareholders to government officials will presumably earn a very lower, if any, return, and thus decrease the building-up of capital. In the case of profits that would not be distributed, it is obvious that they would be reinvested. But such is also the case at least for a part of a corporations’ profits that would be paid to shareholders as dividends. To the contrary, the revenues of the tax are usually, either immediately spent on consumption, or invested less

efficiently than they would be if they were allocated by market forces.

The CIT against investment

A lower quantity of capital supplied—economy-wide, and through credit as well as property titles—implies, in its turn, a lower level of investment, since it raises businesses' cost of capital, i.e., the marginal return they must yield in their competition for a scarcer stock of capital. From the point of view of the suppliers of capital, a CIT, since it lowers their price (return), has the same consequence as a lower demand for their services would have. But, from the businesses' point of view, a CIT has the same consequence as a lower supply of capital would have. Thus, the CIT can be said to “driv[e] a wedge between the after-tax return that investors demand and the pretax return that a business's investment must earn to pay both taxes and investors”²⁷.

Such a decrease in investment cannot be neutral, however. For one thing, a CIT must also distort the way investments are financed. We have already seen that it entices capital suppliers to favor debt over equity; but this is no less true for corporations, since the interests they pay to creditors are deductible from their taxable income, while dividends are not. Overall, this must result in more leveraged positions, and thus higher bankruptcy risks, than would otherwise be the case

The CIT against productivity

A CIT does not only hamper the formation of capital, but also its efficient use. Thus, on top of the amount of the tax, the CIT imposes compliance costs on corporations, in the sense that the latter must allocate to the observation of the fiscal law resources that could otherwise be used in productive ways. “Significant costs may arise simply from the task of properly applying detailed corporate tax rules to often highly complex business activities, organizational structures, and transactions”²⁸. Indeed, a 1992 survey found that “the cost to big business of complying with the

income tax system is, in an absolute sense, large—over \$1 billion for the Fortune 500 companies,” when total revenues from the tax were \$124 billion²⁹.

The CIT against organizational efficiency

So called “S corporations” are exempted from the CIT. As a consequence, “The importance of S-corporation status has grown steadily over the years”³⁰. However, there are reasons why corporations would not choose the S-form, would it not be for fiscal considerations. Indeed, such a status is available only for corporations with a single class, and a limited number of, shares. Inversely, there are economies of scale in compliance costs that may favor mergers and acquisitions that would not be profitable otherwise : “As companies get larger, their total cost of tax compliance increases, but it increases at a rate less than proportional to the increase in company size”³¹. In either case, “Tax planning leads to efficiency costs when businesses structure their organizations and activities in less-than-optimal ways to take advantage of the opportunities that tax planning offers”³².

The CIT against incorporation-prone activities

Because the CIT must divert capital towards unincorporated businesses, it creates a bias in investment against activities particularly prone to incorporation—typically, ones that are highly capitalistic and / or allow for important economies of scale.

Another reason why it must distort capital allocation is that the corporate income tax is levied on the basis of schedules for depreciation that are determined by the fiscal authority and do not correspond to the actual capital replacement costs of corporations. As a consequence, “it taxes different kinds of assets and industries at different effective rates, creating a bias in investment and production toward the more lightly taxed assets and sectors”³³.

The CIT against accurate information

There are several reasons why the CIT acts against the payment of dividends. First, shareholders pay taxes immediately on distributed profits, while taxes on retained profits are deferred (at the individual level) until capital gains are realized. Thus, the payment of dividends constrains the shareholders' fiscal timing, while the retention of profits in the corporation allows them to schedule the payment of associated taxes. Second, dividends are more heavily taxed than capital gains. Third, because of the time value of money, the simple deferral in taxation they imply favors capital gains. But the distribution of profits through dividends is also a signal sent to financial markets. Thus, its distortion may lead to ill-informed investment decisions and capital allocation.

Likewise, being a tax on corporate profits, the CIT only falls on profitable corporations. As a consequence, it must reduce the profitability-gap between the former and the latter, thus causing less capital to be channeled by market forces from wasteful towards useful enterprises.

The CIT against entrepreneurial activity

From an entrepreneurial view of the firm, "markets adjust continuously to modifications in preferences, technologies, and resource availabilities" because "this process of constant change creates new profit opportunities: only alert entrepreneurs who succeed in anticipating the new patterns of consumption gain a positive profit; those who fail suffer from loss"³⁴. In this context, a CIT "does decrease incentives for talented entrepreneurs to engage in satisfying consumers' wants." This is because it reduces profits by the full amount of its marginal rate, which must act as a break on risk-taking on the part of entrepreneurs³⁵. "Individuals find convenient to engage more in routine tasks and less in innovation, speculation, forecasting."

This, in turn, must have various consequences. First, "prices adjust to equilibrium values more slowly, the economy becoming less flexible" and efficient. Second, this is all the more

true as profits create new information, so that the outcome of taxing profits is “a society in which people are less informed and less responsive to consumer’s preferences.” Third, what precedes is another reason why the economy’s rate of growth and capital formation must be lower in a CIT-situation than they need be.

The CIT against the efficient worldwide allocation of capital

Whenever corporate income taxes differ from country to country, they must distort the incentives for international investment and cause, not only domestic, but also worldwide inefficiencies. Other things being equal, it is clear that capital must flow from countries that tax corporate profits heavily towards lower-tax countries, since a less productive investment before-tax in a low-corporate-tax country may become more profitable after-tax than a more productive one in a high-corporate-tax country. From the point of view of a country with a relatively high effective CIT, such a fiscal policy must not only push domestic investment abroad, but also fail to attract foreign investment.

How counter-productive is the CIT?

Because it hampers capital formation and efficient production, the CIT must slow down economic growth. Indeed, causes for economic inefficiencies in the structure of production are numerous in the CIT. But are they important? Numerous researches have clearly shown that the CIT has an exceedingly high rate of inefficiency, i.e., rate of revenues destroyed over revenues collected. Indeed, a survey of corporate tax studies by Jane Gravelle concluded that the efficiency cost of the CIT “could exceed the total amount of corporate tax revenues collected”³⁶. And such an estimate does not take into account the compliance costs imposed on incorporated businesses. Neither does it consider the international distortions that result from the CIT, nor the fact that revenues destroyed would compound, while revenues collected do not.

Who does the CIT harm?

The CIT entails numerous and large costs. But on whom do they fall? The corporation being the sum of capital pooled by its shareholders, they are the ones upon whom the taxation of its revenues falls. In 2008, over 45% of US households owned equities, and were thus directly affected by the CIT³⁷. Obviously, those millions of Americans are not a small minority of privileged profiteers. One of the explanations, for instance, of the growth in equity ownership throughout the 90's has been the expansion of so-called "Defined-Contribution" retirement plans, the number of participants to which has risen from 36 to 65 million between 1989 and 2004. In fact, the typical shareholder is the average American.

Ultimately, the costs of the CIT are also borne by employees and consumers in the form of lower wages and higher prices. However, this does not happen because shareholders pass on corporate taxes to other stakeholders: as a profit-seeking organization, a corporation already has the lowest costs and the highest revenues it can obtain. It happens because, as we said, the CIT hampers (i) the formation, as well as (ii) the efficient allocation and (iii) the compounding-effect of capital. Working with less capital, employees are less productive, and thus receive lower wages. Lower production, in its turn, means higher prices for consumers.

According to a 2006 study by the Congressional Budget Office, "domestic labor bears slightly more than 70 percent of the burden [of the CIT]." A more recent European study examining data on thousands of companies concludes that "in the long run, a \$1 increase in the tax bill tends to reduce real wages at the median by 92 cents;" a decrease that must be relatively harder on the lowest incomes³⁸.

More generally, if the corporate tax itself falls on a great part of working and saving Americans, the costs of its effects fall on everyone in society. A lower building-up and efficient use of capital imply a lower rate of growth, and lower living standards.

THE ETHICS OF CORPORATE TAX SHELTERS

What is ethics?

What follows construct an ethical case for corporate tax shelters (CTS.) In order to do so, CTS are first defined, and then shown, in detail and on the basis of the previous section, to be socially useful, i.e., consistent with the utilitarian principle of the greatest prosperity for the greatest number of people.

A deontic approach, according to which ethics is the defense of natural rights—understood as property rights, and based on the principle of self-ownership—may be preferable, in itself, to an utilitarian approach. However, as David Friedman wrote, “Although I reject utilitarianism as the ultimate standard for what should or should not happen, I believe that utilitarian arguments are usually the best way to defend libertarian views... To the extent that I can show that a particular libertarian proposal... produces attractive results, I have an argument which will have some weight in convincing almost anyone to support it”³⁹.

Most of those who support the CIT actually do so because they assume that it falls only on ‘the rich,’ while its receipts benefit everyone (else) in society, and especially ‘the poor.’ Thus, if one can explain that the CIT falls, in fact, on the majority and is detrimental to everyone in society, and especially to its poorest members, then one will have a convincing argument against it—and in defense of corporate tax shelters.

What are corporate tax shelters?

There is a very good reason why corporate tax shelters are nearly impossible to subsume under a single encompassing categorization: they are precisely intended not to be so easily recognized. However, one may resort to Professor Graetz’ tongue-in-cheek description: “a deal done by very smart people that, absent tax considerations, would be very stupid”⁴⁰. Although half serious, this definition highlights several characteristics of corporate tax shelters, among which their high transaction costs,

and so called “lack of economic substance”⁴¹. Just like any wit, it is exceedingly simplifying. Thus, certain tax sheltering strategies are all but “stupid,” enabling to invest profitably while avoiding corporate taxes. It has the merit, nevertheless, to focus on the kind of CTS that must be defended—precisely because they seem the least defensible: those transactions that have no purpose whatsoever but to decrease a corporation’s tax liabilities, i.e., those transactions for which, “absent tax considerations,” it would be certain that they would lead to economic losses.

If corporate tax shelters are a problem, then it is large and growing. “Since the mid-1990s, the corporate tax in the U.S. has been under significant practical attack by the growing corporate tax shelter movement”⁴². This translates in the fact that corporate tax revenues represent, since then, an ever lower share of corporate income (25% in average, compared to nearly 40% in the 1960s), of the economy (2% of GDP, about half their share in the 1960s), and of total federal tax revenues (less than 10%, compared to more than 20% in the 1960s.) Ralph Nader’s Citizenworks organization estimates that tax sheltering activities represented a loss of \$18 billion in tax revenues in 2003—around 13.5% of the total collected by the CIT. More prudent, and maybe trustworthy, Joel Friedman recognized that there were no reliable measure of corporate tax shelter activity, but referred to a statement from the Joint Committee on Taxation, which concluded in 2000 that “there is a corporate tax shelter problem” and that “the problem is becoming widespread and significant.” Internal IRS studies on tax sheltering indicated in 2003 that “tens of billions of dollars of taxes are being improperly avoided”⁴³.

Corporate tax shelters are certainly a problem for the fiscal authority. But are they an ethical problem? From a legal point of view, one may distinguish between two types of corporate tax shelters: those that cheat with the tax law, and those that play with it, profiting from discontinuities in the tax code⁴⁴. In a sense, such a distinction may be of importance. That is because corporations are free to reduce their taxes as the law allows, since “The legal

right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted,” and, more generally, “Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes”⁴⁵. The frontier between those two strategies is made fuzzy, however, by the so called “business purpose,” or “economic substance” doctrine, which the IRS uses in its war on corporate tax shelters. According to this doctrine, tax benefits should be granted only if they are consistent, not only with the letter, but also the spirit of the law. (Which implies that it is unlawful not to follow the letter of the tax code—or to follow it too literally.) Another reason why this distinction will not be retained, here, is that all of the following arguments pro- and contra-CTS apply to both types of strategies.

CTS are productive

In its November 2005 study on the CIT, the Congressional Budget Office counted corporate tax sheltering activities as part of the waste of resources implied by the CIT. Six years before, the Department of the Treasury also argued that the “current trend among public companies to treat corporate in-house tax departments as profit centers that strive to keep the corporation’s effective tax rate low and in line with that of competitors” diverts resources from productive activities. For instance, according to Peter Cobb, former Deputy Chief of Staff of the Joint Committee on Taxation, one “can’t underestimate how many of America’s greatest minds are being devoted to what economists would all say is totally useless economic activity”⁴⁶.

Indeed, “Companies are likely to engage in tax planning up to the point at which additional gains in their after-tax profits are equal to the added costs and risks of greater planning”⁴⁷. It is certainly not true, however, that all economists would characterize tax sheltering as a “totally useless activity.” It is true that, compared to a situation in which there would be no CIT, the

allocation of resources by corporations to the minimization of their tax liabilities is wasteful and unproductive. In that very situation in which the CIT exists, however, tax shelters are socially useful. Indeed, if the CIT hampers, because of its great economic costs, the maximization of social utility, then its reduction through tax shelters must be socially useful.

CTS favor saving and investment

Because they increase corporate income, tax shelters enable and give incentives to save and thus increase the quantity of capital supplied, not only in corporation and through property titles, but economy wide, and through credit titles also. Which implies a lower cost of capital for all businesses in general, and thus a higher level of investment and a higher rate of growth.

CTS favor efficient business organization and structure of production

For the same reason, tax shelters must help restore a more efficient organization of production, since, thanks to them, some capital that has been diverted towards S-corporations, partnerships and sole proprietorships may be invested in corporations and activities particularly prone to incorporation.

Tax shelters also help restore the equilibrium between the payment of dividends and the retention of profits; and since the former function as signals sent to financial markets *à propos* a corporation's health and prospects, CTS must allow for better investment decisions and capital allocation.

Tax shelters are only useful to profitable corporations. Thus, they must help restore the profitability gap with unprofitable ones and cause capital to be channeled by market forces from wasteful towards useful businesses.

CTS favor an efficient worldwide allocation of capital

Some CTS strategies consist in taking advantage of international tax competition. Compared to a no-CIT situation, this

constitutes an inefficiency (of the CIT, then.) But, given the existence of the CIT, and more precisely of discrepancies between national CIT rates, such CTS strategies allow for an efficient worldwide allocation of capital—one in which it earns as high a return as it can.

CTS favor CTS

According to the Department of the Treasury, there are reasons why CTS are a problem that are “far more important than the short-term revenue loss.” Among them is their “corrosive effect,” i.e., the fact that CTS favor CTS, since they «bree[d] significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions”⁴⁸.

Far from being a problem, however, one could argue that this is an instance of what Carl Menger called “organic phenomena”⁴⁹: the profits accruing to corporations that resort to CTS lead their competitors to follow the same path, which, in turn, entices the first to resort to ever more CTS; and so on. Obviously, this is also a “discovery procedure”⁵⁰ in which new CTS strategies have to be constantly devised.

It is worth noting that the very existence of such an effective-tax-rate competition between corporations sufficiently proves that shareholders are CIT-sensitive, so that a CIT must impact the level of saving and investment.

Who do CTS benefit?

Everything that precedes shows that CTS help get closer to the level of accumulation, as well as efficient use of capital that would be the case in a no-CIT situation. Just as the CIT entails numerous and large costs, CTS, which reduce the CIT, entail numerous and large benefits. But for whom?

Once more, one has to distinguish, here, between CTS themselves and their effects. The CIT falling on shareholders, it is

clear that CTS benefit them—i.e., a vast number of average Americans. But, because they favor saving and investment, and because workers are more productive when they work with more capital, CTS have the effect to increase real wages—and even more so since a higher production translates into lower consumer prices. If the benefits of CTS themselves fall on a great part of working and saving Americans, the benefits of their effects fall on everyone in society, and more heavily so on its less productive members.

At that point, it may be concluded that CTS are ethically sound, since they maximize social utility without infringing on anyone's natural rights. Joel Friedman argues that "Corporate tax shelters reduce the corporate tax base, raising the tax burden on other taxpayers"⁵¹. However, CTS are not the cause of this passing of the burden tax: the fiscal authority is—while it could very well adapt government spending to a lower level of total tax receipts. Actually, because of the Laffer curve, one cannot even assume without proper empirical analysis that lower tax rates (through CTS) lead to lower tax receipts. In any case, CTS do not enable corporations to receive additional incomes paid for by other taxpayers: they simply manage to shelter what they have earned from confiscation.

CONCLUSION

As we have shown, it is certainly not true that "the resources that the corporation expends on tax planning, though producing a private benefit for the shareholders," are, from the point of view of society, "essentially wasted"⁵². To the contrary, tax shelters are socially useful in that they help restore the steady formation and efficient allocation of capital that would be the case if no CIT was layered up, at the corporate level, on the income tax shareholders already pay, at the individual level, on income earned through investment in corporations.

Furthermore, such strategies benefit not only shareholders—i.e., a great number, and in fact vast majority of

Americans—but all members of society, since it increases real incomes and living standards through higher labor productivity and lower consumer prices.

For that reason, whether one conceives of ethics as the respect of natural rights or the promotion of social utility, corporate tax shelters cannot be said to be unethical.

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