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Taxation and Incentives in the Business Enterprise

By David Gamage[1] & Shruti Rana[2]

I. Introduction

Tax law is intimately connected to enterprise law.[3] In many legal practices, lawyers who serve enterprise clients regularly turn to tax lawyers for advice on structuring transactions. Often, the enterprise lawyers first devise a transaction in order to further some business-law related end, and then turn to tax lawyers to insure that the transaction is structured in a tax-favorable manner. In other instances, tax lawyers devise transactions in order to minimize an enterprise client's tax liabilities, and then turn to the enterprise lawyers to structure the transaction in accordance with the client's non-tax goals. Enterprise lawyers and tax lawyers thus need a mutual understanding so that they can work together to meet their clients' tax and non-tax goals. At a minimum, enterprise and tax lawyers need to know when to ask each other for advice and when to defer to each other's expertise.

Similarly, anyone interested in the design of enterprise law must engage with taxation. Tax laws significantly impact all of the major incentive bargains analyzed in this volume. The agreements managers reach with employees, shareholders, and creditors are all regularly structured with an eye to tax considerations.[4]

Tax law potentially offers policymakers a powerful tool for influencing the incentive bargains that comprise the business enterprise.[5] Even if policymakers do not

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[3] *See* DWIGHT DRAKE, BUSINESS PLANNING: CLOSELY HELD ENTERPRISES, at v (3d ed. 2011); John Flood & Fabian Sosa, *Lawyers, Law Firms and the Stabilization of Transnational Business*, 28 NW. J. INT'L L. & BUS. 489 (2008); Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984).

[4] *See, e.g.*, Prakash Deo, *Cross-Border Lease Financing with Japanese Leveraged Leases*, J. STRUCTURED FINANCE, Winter 2008, at 36; Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2003); Koji Toshima & Rintaro Shinohara, *Magic Triangles*, 27 INT'L FINANCIAL L. REV. GUIDE TO JAPAN 71 (2008)

[5] *See, e.g.*, Zenichi Shishido, *Reform in Japanese Corporate Law and Corporate Governance: Current Changes in Historical Perspective*, 49 AM. J. COMP. L. 653 (2001); James R. Hines, Jr., *Lessons from Behavioral Responses to International Taxation*, 52 NAT'L TAX J. 305, 308-19 (1999) (empirical observations of corporate behavior in response to tax policy).

wish to use tax law as a tool for regulating the business enterprise, tax laws will nevertheless remain an important background force that policymakers must take into account. It is impossible to design a completely neutral tax system with respect to enterprise law's incentive bargains; taxation will inevitably impact these bargains, whether policymakers wish it to or not. Consequently, a thorough examination of enterprise law requires engaging with tax law and policy.

II. The Tax Policy Perspective

To understand why it is impossible to design a tax system that is neutral with respect to the incentive bargains that comprise the business enterprise, it is useful to begin by evaluating the goals of taxation. Anyone interested in the design of enterprise law must engage with the tax system and hence must understand the tax policy perspective on the interactions between taxation and enterprise law.

Nevertheless, before proceeding to evaluate the goals of taxation, we should first briefly discuss possible underlying models of government behavior. Much of tax policy scholarship adopts what might be called the beneficial dictator model.[6] This scholarship asks how a government concerned only with public welfare *should* design tax policy. This scholarship thus takes little account of the possibility that government actors may be influenced by goals other than promoting the general welfare.

In contrast, tax scholarship operating within the public choice tradition frequently adopts what might be called the leviathan model of government behavior.[7] Under this model, governments are assumed to act so as to maximize the government's power, thus usually raising as much tax revenue as the government can get away with. Scholars who analyze tax policy based on leviathan models often focus on prescribing mechanisms for constraining the power of government actors. Questions related to determining what is the ideal tax system are viewed as less important, because a leviathan government would never enact an ideal tax system.

Between the extremes of the beneficial dictator and leviathan models, what might be called the interest group bargaining model assumes that governments sometimes pursue the general welfare and other times attempt to reward narrow interest groups

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[6] *See* James M. Poterba, *Public Finance and Public Choice*, *in* TAX POLICY IN THE REAL WORLD 429- (Joel Slemrod ed., 1999) (discussing critiques of the public finance tradition of tax policy scholarship).

[7] *See* Michael A. Livingston, *Reinventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy*, 83 CORNELL L. REV. 365, 382 (1998) (discussing the public choice tradition of tax policy scholarship).

that can help politicians win reelection.[8] As a general rule of thumb, scholars often assume that governments are more concerned with broad public opinion and the general welfare when issues are highly salient, and that governments are more concerned with rewarding narrow interest groups when issues are less salient.[9]

Because our goal is to explain why it is not possible to design a tax system that is completely neutral with respect to the incentive bargains that comprise the business enterprise, we mostly adopt the beneficial dictator model in this chapter. Yet we do not mean to suggest that real-world governments operate following the beneficial dictator model. In our view, interest group bargaining models offer better predictions of real-world government behavior than do either the beneficial dictator or leviathan models. The beneficial dictator model does not sufficiently take account of the fact that politicians in democracies rely on the support of narrow interest groups whose goals do not always involve promoting the general welfare. And the leviathan model ignores that democratic governments are composed of many individual politicians facing collective action problems, such that even politicians unconcerned with the general welfare often have little incentive to prioritize expanding the government's powers. For enterprise law scholars then, it is important to keep in mind that taxation will often affect enterprise law due to rules that governments design for the benefit of particular narrow interest groups rather than for the goal of advancing the general welfare through sound tax policy.

A. The Goal of Minimizing Excess Burden

The most important reason why governments enact tax laws is to raise revenues for funding government spending. Yet a central dilemma of tax policy is that taxing any activity typically leads taxpayers to engage in less of that activity.[10] Hence, for example, taxing the income from work incentivizes taxpayers to shift from work to leisure; taxing purchased goods incentivizes taxpayers to buy less of the taxed goods; and taxing investment returns incentivizes taxpayers to make fewer taxable investments.

When taxation induces taxpayers to engage in less of a taxed activity, both the individual taxpayers and the government are made worse off. The taxpayers are made worse off because the taxpayers have shifted from a more desired activity – the activity the taxpayers would have preferred to engage in were it not for the tax – to a less

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[8] For an early example of this form of scholarship, see, e.g., Stanley S. Surrey, *The Congress and the Tax Lobbyist – How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957).

[9] This idea is often called the Mancur Olson hypothesis, and is attributed to: MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965).

[10] David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19, 61-63 (2011).

desired activity. The government is made worse off because the government receives no revenue to the extent that taxpayers shift to untaxed activities. When taxation causes taxpayers to shift to untaxed alternative activities then, society as a whole is made worse off. This harm to society that results from tax-induced changes to taxpayer behavior is often called "excess burden" or "deadweight loss."[11]

Consequently, a simple maxim for designing optimal tax policy is that governments should focus on taxing "inelastic" activities – activities for which taxpayers do not shift their behavior much in response to taxation. Another simple maxim is that it is usually best to make the tax base as comprehensive as possible; the more activities that are taxed at the same rate, the fewer options taxpayers have for shifting to untaxed or lower taxed alternative activities.

Unfortunately, governments find it very difficult to tax capital income – the income that taxpayers earn from investments. Governments that rely significantly on income taxes, such as the U.S. and Japan, thus face enormous problems in enacting a comprehensive tax base with respect to capital income.[12] Exacerbating this problem, wealthy taxpayers have developed a number of techniques for transforming the monetary compensation they receive from working into a form that is taxed as capital income under an income tax rather than as labor income.[13] Hence, the difficulties governments face in taxing capital income threaten governments' ability to collect taxes from wealthy taxpayers even on their labor income. And the techniques that taxpayers use to minimize their tax liabilities, both with respect to capital income and labor income, create significant excess burden beyond the revenue loss to the government.

The transactions that wealthy taxpayers use to reduce their capital income tax liabilities, and the anti-abuse rules that governments develop in order to combat these transactions, have significant impacts on enterprise law. For instance, the income tax laws of both the U.S. and Japan create a significant bias for debt-financing as opposed to equity financing.[14] Sophisticated taxpayers respond to this bias both by shifting from equity financing to debt financing and by creating new hybrid financial instruments that maintain some of the economic characteristics of equity while being taxed as debt.

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[11] For a more complete discussion, see *id*.

[12] *See generally* Alan J. Auerbach, *The Future of Captial Income Taxation*, INSTITUTE FOR FISCAL STUDIES ANNUAL LECTURE (2006), http://escholarship.org/uc/item/90v90406 accessed 10/1/2012.

[13] *E.g.*, Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008) (analyzing one such technique).

[14] *E.g.*, Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF STAFF DISCUSSSION NOTE, May 3, 2011.

These tax-motivated transactions then significantly impact corporate governance, as equity holder and debt holders have different control rights and as enterprise law must cope with the control rights granted to the holders of hybrid instruments.

B. The Goal of Promoting Distribution Policy

If policymakers cared only about the goal of minimizing excess burden, then there would be a simple solution for designing the optimal tax system. Under a "head tax", each citizen is taxed the exact same fixed amount – an amount that remains constant regardless of any activities or behaviors the taxpayers engages in. Hence, a head tax assesses tax liabilities based on an activity that is highly inelastic – being a citizen. The only option taxpayers have for escaping a head tax is to leave the country and renounce their citizenship.

The reason that governments do not exclusively rely on head taxes for raising revenues is distribution.[15] Even the most conservative of commentators generally agree that poorer citizens should not be assessed the same tax liabilities as richer citizens. Note in this regard that even a pure "flat tax" is in no way a head tax. Under a pure flat tax, all citizens are assessed tax liabilities based on the same percentage of their income or consumption. Because richer individuals have higher income and consumption than poorer individuals, a pure flat tax thus results in richer citizens paying far higher tax liabilities than poorer citizens. And conservative advocates of a flat tax rarely call for a pure flat tax. Instead, most proposals for a flat tax include an exemption amount, wherein income or consumption under a specified threshold is exempt from tax, thus making flat tax proposals even more progressive by reducing the effective tax rates on poorer taxpayers as compared to richer taxpayers.

A major reason why many support imposing taxes on corporations and large business enterprises is based on distribution. Liberals often argue that the incidence of taxes imposed on large business enterprises falls primarily on monetary capital providers, who tend to be far wealthier than workers or consumers.[16] However, it is not at all clear the extent to which the incidence of taxes on large business enterprises actually falls on capital; much recent scholarship suggests that workers and consumers may bear the majority of the burden of these taxes.[17]

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[15] We avoid the term "redistribution", instead using the phrase "distribution policy", because the term redistribution misleadingly implies a state-of-nature baseline prior to government in which taxpayers would control the entirety of their pre-tax incomes. For further discussion on this point, see Gamage & Shanske, *supra* note 10, at 79-98.

[16] For a discussion of the debate over corporate tax incidence, *see* Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, 20 TAX POLICY AND THE ECONOMY 1-40 (NBER, 2006).

[17] *Id.*

A simple maxim for evaluating tax incidence – who bears the economic burden of a tax – evaluates the relative elasticity of the parties that might potentially be subject to the tax.[18] With respect to corporate taxes and other taxes on large business enterprises, the question then becomes the extent to which workers are more able to switch jobs if their salaries are lowered, as compared to the extent to which consumers are more able to switch to buying alternative products if prices are raised, and as compared to the extent to which monetary capital providers are comparatively more able to switch their investment choices if the expected returns are lowered. Taxing large business enterprises reduces their profitability, which means that less money will be available to pay workers, keep prices low for consumers, and reward monetary capital providers. For distributional considerations, the question is which of these groups comparatively bears the greatest burdens from the tax.

Looking beyond taxes directly imposed on large business enterprises, distributional considerations also motivate other tax instruments that significantly affect enterprise law's incentive bargains. Both the U.S. and Japan have a progressive structure to their income taxes, wherein higher-income taxpayers face higher tax rates than do lower-income taxpayers.[19] The higher marginal income tax rates that high-income taxpayers face under a progressive income tax impact the compensation packages paid to mangers and to other high-income workers, as higher marginal tax rates increase the incentives to structure compensation packages in a tax-advantaged fashion. For example, under the income tax laws of both Japan and the U.S., fringe benefits and performance-based compensation can often be made tax favorable as compared to wage salaries, thus impacting the form of compensation paid to managers and workers, and thereby altering the incentive bargains reached between managers, employees, and monetary capital providers.

C. The Goal of Promoting Desirable Behavior

Beyond the goals of raising revenues while minimizing excess burden and promoting socially desirable redistribution, taxes are also used to influence taxpayer behavior. By taxing activities that generate "negative externalities" (harms that affect parties external to the taxpayer), or by granting tax credits or deductions for activities that generate positive externalities (benefits that accrue to parties external to the taxpayer), governments can induce taxpayers to internalize the externalities so that the

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[18] *Id.*

[19] Hiroshi Kaneko, *The Japanese Income Tax System and the Disparity of Income and Wealth Among People in Japan,* in *Proceedings from the 2009 Sho Sato Conference*, 3-4 (2009), *available at* http://www.law.berkeley.edu/files/sho_sato_tax_conf_web_paper--kaneko.pdf, accessed 10/1/2012 (noting that the Japanese income tax has used progressive rates since its inception in the 19th Century).

taxpayer's decisions maximize social welfare rather than just the taxpayer's own welfare. Taxes designed to control externalities are sometimes called "Pigouvian taxes." A classic example are taxes imposed on pollution, which if set correctly can cause the taxpayers to pollute only to the extent that the social benefit of the activity causing the pollution exceeds the harm caused by the pollution.[20]

Pigouvian taxes are less important with respect to enterprise law than are taxes designed to raise revenues and promote distribution policy. Yet both corporate and individual income taxes are filled with tax incentives designed to promote behavior that governments deem socially beneficial. These Pigouvian tax provisions can and do affect the incentive bargains of the business enterprise.

D. The Goal of Enacting Fiscal Stimulus

The final tax policy goal that we will discuss is probably the least important for enterprise law. Tax laws can play an important role in macroeconomic stabilization policy. Ideally, tax systems should be structured so as to provide fiscal stimulus during temporary economic downturns and to take away that stimulus during upturns. When government budgets do not need to be balanced in the short run, income taxes and especially corporate income taxes can provide stimulus, because these forms of taxation take far less revenue from the economy during economic downturns than during periods of strong economic growth.[21] The manner in which tax laws are designed to promote fiscal stimulus can affect enterprise law by impacting the timing of investment decisions and the attractiveness of debt as opposed to equity financing, which can affect the incentive bargains between managers and monetary capital providers. As both Japan and the U.S. have been facing sustained periods of stagnant economic growth, the fiscal stimulus policies these governments adopt may carry significant stakes for the incentive bargains negotiated between managers and monetary capital providers.

III. Taxation and Enterprise Law's Incentive Bargains

Other chapters in this volume will analyze some of the specific ways in which taxation and other government activities affect enterprise law's incentive bargains. We aim in this chapter only to provide a brief overview of the goals of tax policy and how

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[20] For further discussion in another context, see David Gamage, *Taxing Political Donations: The Case for Corrective Taxes in Campaign Finance*, 113 YALE L.J. 1283 (2004).

[21] *See, e.g.*, David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 787-88 (2010).

these goals inevitably lead to taxation impacting enterprise law. Our purpose is to assist readers interested in the design of enterprise law to understand the tax policy perspective so as to facilitate understanding between those interested in enterprise policy and those interested in tax policy. Having outlined the goals of tax policy, we can now analyze how managers, employees, and monetary capital providers respond to taxation.

However, as a preface, it is worth noting that while the laws governing enterprises and taxation are often similar in the U.S. and Japan,[22] the goals of policymakers and other stakeholders often differ. For instance, many Japanese companies still place relatively greater emphasis on promoting the long-term welfare of their employees.[23] It is important to recognize and account for differences in legal cultures and context in considering the varied ways in which managers, employees, and monetary capital providers might respond to taxation.

A. How Managers Respond to Taxation

Individuals seek at least three rewards from their participation in the workplace: (a) monetary compensation, (b) non-monetary compensation such as fringe benefits, and (c) work-related power and prestige. Managers seek these rewards just as much as do non-managerial workers.

Within most income tax systems, monetary compensation is the mostly highly taxed, non-monetary fringe benefits often go only partially taxed or are not taxed at all, and work-related power and status are rarely taxed.[24] The reason for this disparity is valuation problems and concerns related to administrability. Tax agencies have no ready means for assessing the value of work-related power and status, and it is also prohibitively difficult to assess the value of many forms of fringe benefits.

Predictably then, taxation biases managers toward seeking more untaxed fringe benefits and work-related power and prestige than they would in the absence of taxation. The higher the tax rates, the larger the bias against monetary compensation and toward these alternative workplace rewards.

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[22] *See* Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L.J. 3, 14-15 (1996) (explaining that U.S. corporate and securities law were imported into Japan during the postwar period, and that "following the war, with one major exception, the constituent organs of the Japanese corporation and the basic rules for its organization and governance took on a highly American cast").

[23] *Id*. at 26 ("Concern for the long-term welfare of employees serves as a major constraint on the Japanese firm").

[24] *See* Calvin H. Johnson, *An Employer-Level Proxy Tax On Fringe Benefits*, 123 TAX NOTES 483, 483-486 (2009) (explaining some of the ways that fringe benefits are tax favored).

Perhaps this bias plays out most powerfully in incentivizing managers to build empires through mergers and acquisitions and through investing earnings in questionable expansion projects rather than returning earnings to shareholders. Managers seek to build workplace empires partially for the rewards these empires offer in terms of work-related power and status. Were the managers to forgo these power and status related rewards in order to focus exclusively on maximizing profits, at best the mangers would receive higher monetary compensation (which is subject to taxation) in place of the foregone power and status (which is not subject to taxation).

This empire-building bias is only one of the ways in which taxation affects managers' incentives. As we noted earlier, taxation affects the forms of monetary compensation offered to managers and other employees, and this in itself can affect mangers incentives, particularly to the extent taxation biases compensation packages toward stock options and other incentive-based forms of compensation as opposed to guaranteed salaries. Managers typically have significant power to negotiate compensation packages that are designed in a tax-favorable fashion.

B. How Employees Respond to Taxation

Employees have similar incentives to managers, although many (especially lower-income) employees may be relatively more motivated by the pursuit of monetary compensation and less by work-related power and prestige. Yet employees often have far less ability to negotiate custom compensation packages than do mangers.

It is far more difficult to design tax-favored compensation packages for employees who are not able to negotiate for custom-tailored forms of compensation. These employees will typically prefer to be compensated in the form of cash wages because receiving cash wages grants the employees flexibility in how to spend the wages. Cash wages are almost always fully taxable; providing compensation in a tax-favored form typically requires limiting employee's flexibility in how to use the compensation. Employees who are not in a position to custom negotiate a compensation package to design limitations that are not overly restrictive with respect to the employees' goals will thus often prefer to have their compensation fully taxed in order to maintain the flexibility of cash wages.

The incentive bargains managers reach with employees are also influenced by tax provisions that are regulatory in nature – tax provisions designed to encourage or discourage certain behaviors, in a Pigouvian fashion. In the U.S., for instance, beginning in 2014, employers may be subject to tax penalties for not providing their

employees with affordable employer-sponsored health insurance.[25] U.S. tax law also includes a number of tax provisions that may penalize employers who offer fringe benefits if the employer offers the fringe benefits in a proscribed fashion.

C. How Monetary Capital Providers Respond to Taxation

Monetary capital providers are generally motivated by the desire to secure the highest possible returns to their investments. To this end, monetary capital providers sometimes also desire control rights over the business enterprises they invest in. The major influence of tax laws is to make certain forms of investments more tax-favorable than others, thus encouraging monetary capital providers to structure their investments in a tax-favorable fashion.

We have already noted that most developed country tax systems treat debt investments more tax-favorably than equity investments.[26] This bias for debt financing both leads monetary capital providers to invest through debt instruments rather than equity investments and encourages monetary capital providers to develop hybrid financial instruments with the tax characteristics of debt but some of the economic characteristics of equity.

Beyond the bias for debt financing, international tax rules also have a strong influence on investor behavior. It is often possible to make investments more tax favorable by structuring the investments as cross-border transactions. The flaws in the international tax rules of the U.S. and other nations are legendary.[27] The desire to minimize tax liabilities by exploiting gaps in the relevant international tax rules strongly influences the bargains reaches between managers and monetary capital providers.

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[25] David Gamage, *Perverse Incentives Arising from the Tax Provisions of Healthcare Reform: Why Further Reforms are Needed to Prevent Avoidable Costs for Low and Moderate Income Workers*, TAX L. REV. (forthcoming), at 20-25, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2067138 (June 4, 2012).

[26] *See* de Mooij, *supra* note 14 and accompanying text. *See also* Ilma Ghouse & Humera Sultana, *Entrepreneur Activity and Statutory Tax Requirement: An Empirical Analysis for Pakistan*, ECON. REV., Feb. 1, 2012, at 13.

[27] *E.g.*, Robert J. Dilworth *Tax Reform: International Tax Issues and Some Proposals,* INT'L TAX J. 5 (2009) *available at* http://www.mwe.com/info/pubs/taxreform.pdf; Michael J. Graetz, *Taxing International Income – Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy*, 54 TAX L. REV. 261 (2001); Hugh J. Ault, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, *in* TAXATION IN THE GLOBAL ECONOMY 28 (Assaf Razin & Joel Slemrod eds., 1990), *available at* http://www.nber.org/chapters/c7203.pdf ("As the discussion of the legal rules…makes clear, implementing these general principles is far from straightforward. The present system is the result of a long process of successive "loophole closing" efforts, as the tax policy makers have discovered one way after another in which taxpayers (or foreign governments) can organize their affairs to take advantage of the U.S. rules.")

IV. Conclusion

Although the goal of minimizing excess burden supports designing a comprehensive tax system that is neutral with respect the economic decisions affecting the business enterprise, it is impossible to achieve a completely neutral tax system in practice. This is especially true in countries like the U.S. and Japan that rely on income taxes, as income is an inherently nebulous concept. Taxpayers find it all too easy to play tax minimization games by restructuring transactions so as to alter the character, timing, or jurisdiction of the transaction with respect to tax laws.

To the extent the goal of promoting distribution policy leads governments to enact progressive income tax schedules, such as in the U.S. and Japan as well as in most other nations, the distortions created by non-comprehensive tax bases are multiplied. And, even recognizing that it is not possible to design a fully comprehensive tax base, governments fall far short of what might theoretically be possible. The goals of promoting desirable behavior and enacting fiscal stimulus often lead policymakers to enact tax preferences or penalties in order to achieve non-tax-policy-related ends. Furthermore, politicians frequently prioritize rewarding narrow interest groups over providing for the general welfare; real-world tax laws are thus rife with special provisions intended to reward narrow interest groups.

Tax laws thus create many biases that affect the behavior of managers, employees, and monetary capital providers. Many volumes have been written analyzing subsets of these biases, and there is still considerably more to be said. In this chapter, our goal has been only to provide a high-level overview of the tax policy perspective on the interactions between tax law and enterprise law, and to sketch a few examples of how the nature of tax law influences the incentive bargains reached between managers, employees, and monetary capital providers. It is important for those interested in tax policy and those interested in enterprise policy to understand one another’s perspectives. Only through communication and collaboration can we combat the ways in which tax laws create problems for enterprise law or use tax law as a tool for correcting biases in enterprise law.