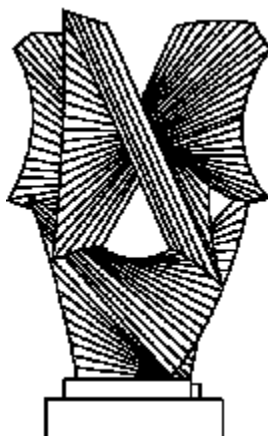


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## CORPORATE TAX AVOIDANCE

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# Corporate Tax Avoidance

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December 11, 2003

## Abstract

This essay analyzes the problem of corporate tax avoidance. It shows how the marginal efficiency cost of funds and optimal elasticity of taxable income measures can be used to analyze the problem and determine the proper scope of allowable tax planning. It then analyzes the optimal form of tax laws addressing shelters, such as whether the law should use more detailed rules or broad standards.

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## Corporate Tax Avoidance

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December 11, 2003

This paper considers two aspects of corporate tax avoidance or tax shelters. First, it considers measures of the welfare loss from corporate tax avoidance or tax shelters. Second, it considers how the tax rules themselves, as opposed to the audit and penalty structures, can be used to limit shelters. The claim underlying both discussions is that the primary problem facing policy makers is not the standard evasion problem of determining optimal audit and penalty rates. Instead, the problem is determining which activities should be treated as allowable and which should not. The goal of this paper is to evaluate this problem using economic tools. Section I sets forth the problem as one of defining shelters, avoidance, and evasion rather than the typical economic problem of setting optimal audit and penalty rates given a definition. Section II considers the marginal efficiency cost of funds and optimal elasticity measures as tools for defining avoidance and evasion. Section III considers how the tax rules themselves can be optimally drafted to limit shelters. In particular, it considers whether the law should use detailed rules or broad standards.

### I. The Problem of Defining Avoidance

Most studies of tax avoidance and evasion are written as if we knew what these terms meant, and the problem is analyzing the various incentives to engage in these activities. Take for example, a typical statement from a public finance text (a book that I otherwise very much admire), Tresch (2002 p. 512).

*Tax avoidance* refers to taxpayers taking advantage of the provisions of the tax laws to reduce their tax liability, such as arranging to take income in the form of lightly taxed capital gains or untaxed fringe benefits rather than as fully taxed wages and salaries. Avoidance taxes is legal and its consequences certain. *Tax evasion* refers to hiding sources of taxable income from the tax authorities to reduce one's tax liability, such as not reporting gambling winnings or failing to file a tax return when required to do so. Evading taxes is illegal and its consequences are uncertain; they depend on the probability of the taxpayer being caught.

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Given this definition, numerous authors, following Allingham and Sandmo (1972), have analyzed the incentives to evade taxes. The case these authors seem to have in mind is an individual simply not paying taxes. It is clear in this case that the relevant activity is evasion.

The typical corporate tax shelter case is more difficult. It will almost always be ambiguous whether the transaction should be treated as permissible tax reduction or not. The transaction will involve numerous complicated steps, and each step individually will comply with the law even though the overall result might be egregious. The problem facing the policymaker, whether it is a court, Congress, or the Treasury, is whether the transaction should work as claimed. Assuming that there are set categories of evasion and avoidance, as is done in most of the literature, assumes the central problem.

To put the problem in a welfarist framework, we cannot assume pre-existing definitions of tax avoidance and evasion. Instead, we must determine which responses to taxation will be treated in various fashions based directly on the welfare consequences of such treatment. For example, working less, elaborate financial structuring, and plain old cheating are all merely responses to taxation. Absent some reason directly linked to social welfare, we should treat them the same. These activities will not be the same because the welfare consequences of allowing or disallowing them will be different. The class of activities that turn out to be socially optimal to punish with criminal sanctions is what we should call evasion. The remainder of responses to taxation, which it is socially optimal to accept, are perfectly legal avoidance. There is also nothing sacred about a division of the world between evasion and avoidance. We could alternatively divide the world in to three, four, or any number of categories with scaled penalties for the various categories (as we

actually do). The task is to determine how to classify and treat the various responses to taxation based directly on the welfare consequences.<sup>1</sup>

## II. Tools for evaluating the social costs of shelters

Determining the optimal definition of avoidance and evasion is similar to the problem considered in the economics literature of how to optimally set a tax instrument other than the tax rate. For example, determining which shelters work to reduce tax is the same as determining the scope of the tax base. Deciding that a transaction reduces tax is akin to deciding that it is not part of the tax base. Slemrod and Yitzhaki's (1996) MECF and Slemrod and Kopczuk's (2002) optimal elasticity are designed for precisely this task. The MECF, in particular, is an attempt to create a simple method of determining the consequences of tax law changes through readily available data, which makes it particularly promising. Consider each in turn.

Slemrod and Yitzhaki's MECF is equal to  $X/MR$ , where  $X$  is the static revenue estimate from a small increase in the tax rate (i.e., the estimate assuming no behavioral response) and  $MR$  is the actual estimate. It is worth reviewing the derivation here because it is important in interpreting its application to tax shelters. Consider a representative taxpayer with a well-behaved utility function and allocation of his budget that satisfies  $y = \sum_i q_i X_i$  where  $q_i$  is the after-tax price of the  $i$ th commodity and  $X_i$  is the quantity consumed. Using Roy's Identity, we can state the marginal burden of a marginal change in tax rates as  $MB = \sum_i X_i dq_i$ . That is, the marginal burden is a function of the quantities consumed and the change in prices due to a small change in the tax rate.

The change in tax revenues from a small change in the  $i$ th tax instrument is  $MR_i = \partial R / \partial t_i$  where  $R$  is total tax revenues. If we let  $dt_i = dq_i$  and substitute, we get  $MB = \sum_i (X_i / MR_i) \partial R$ . The

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<sup>1</sup> An example of this type of analysis is Stern (1982). He concludes may be optimal to accept the labor/leisure distortion of an income tax to avoid the benefits of errors in administering a lump sum tax. This argument has basically the same structure as the argument in the text. Others have made similar points about analyzing all possible tax instruments with a unified framework. See, for example, Feldstein (1999), Slemrod (1990), Slemrod and Kopczuk (2002).

term in the parenthetical is the MECF. For a given small change in revenue,  $\partial R$ , the marginal burden depends on the MECF.

We can extend this to include compliance costs incurred by the taxpayer and administrative costs incurred by the government because of the change in a tax instrument. If the  $i$ th tax instrument is changed, the marginal burden is a function not only of the quantities consumed and the change in tax but also of changes in compliance costs. Therefore, we can write  $MB = \sum_i X_i dq_i + C_i'$  where  $C_i'$  is the marginal change in compliance costs from a change in the  $i$ th tax instrument. Similarly, the marginal revenue from a change in tax rates is reduced by any increase in administrative costs. Subtracting this from marginal revenue, we get  $MR_i = \partial R / \partial t_i - A_i'$  where  $A_i'$  is the marginal change in administrative costs. Substituting, we get

$$MECF = (X_i + C_i') / (MR_i - A_i')$$

Slemrod and Yitzhaki also extend the formula to allow corner solutions, an extension I will ignore here.

Slemrod and Yitzhaki (1996, p 184) and (2001, p. 195), claim that the MECF should apply to any tax instrument. The concept was derived in the context of a tax on a commodity, but they argue that the cost of a “leaked” dollar of tax revenue due to behavior changes,  $X - MR$ , is the same regardless of its source. Therefore, dollars lost to evasion and avoidance have the same impact as dollars lost to other responses to taxation. The efficiency of a change in any parameter of the tax system, therefore, can theoretically be measured by the MECF.

The goal of the MECF measure is to provide a simple way of evaluating the efficiency effects of the change in any tax instrument. The key to the simplicity comes from the application of Roy’s identity to convert utility changes to changes in consumption. This allows us to use the static revenue estimate, which is information necessary for generating the revenue estimates used in

evaluating tax law changes. The marginal revenue number in the denominator is also generated as part of the tax lawmaking process.<sup>2</sup> Therefore, estimates of the MECF should be readily available.

Turning back to shelters, suppose there is a proposal to change the tax rules so that some particular shelter no longer generates tax benefits, and we want to measure the MECF of the proposal. Using the interpretation of  $X$  as the static revenue estimate, we might see a very large number if the shelter is popular. If there are slightly less attractive alternative shelters, however, the actual revenue estimate, the marginal revenue, may be very small. Once the shelter is shut down, some individuals will give up sheltering and pay tax, but if substitute shelters are available, most individuals will simply switch to another shelter. This suggests that it is highly inefficient to attack most shelters, at least on a piecemeal basis.

This is not, however, a correct interpretation of the MECF. The idea of using the static revenue estimate for the numerator does not work in this context. The MECF is derived by assuming that the individual has consumption of  $X$  and, therefore, the burden of a small change in the tax on  $X$  is simply  $\$X$ . Slemrod and Yitzhaki argue that we can interpret  $X$  as any response to the tax system because taxpayers will equalize all responses at the margin. The additional cost of avoiding another dollar of tax through shelters will be the same as the cost of avoiding another dollar of tax by changing the consumption bundle. But a small increase in the tax on sheltering does not result in an additional burden on individuals equal to the amount sheltered. Instead, it results in an additional burden equal to the increase in costs to enter into the next best shelter. That is, we should interpret  $X$  not as the static revenue estimate but the fees or other costs incurred to purchase

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<sup>2</sup> Both numbers must be estimated with care. Tax revenue estimates are yearly numbers while the MECF refers to the total (present value) change.

the shelter. The fees and other costs are the cost of the “consumption” of the shelter, and a small increase in the strength of anti-shelter rules results in a marginal burden of this amount.<sup>3</sup>

The MECF, applied to tax avoidance or sheltering in this way makes more sense. A small increase in anti-shelter rules results in a small increase in the cost of sheltering. The measure of this, applying an envelop theorem like Roy’s identity, is the cost of sheltering. The problem with this reading of the MECF is that it is no longer based on observable data. In particular, the costs of sheltering include the costs of distorted financial structures and risk aversion, neither of which is readily observable. Thus, the MECF, when applied to shelters, loses one of its most attractive features. Moreover, it indicates that studies of tax dollars lost to sheltering are incomplete, and to perform a welfare analysis (at least using the MECF measure), we need know the fees and other costs of shelters.

The elasticity of taxable income approach is essentially the same as the MECF except that it breaks up the marginal revenue term into two distinct terms. The intuition, due to Feldstein (1999), is that all tax-induced behavior entails costs that will be incurred until at the margin, the private cost equals the tax savings. All tax reduction behavior, therefore, has the same effect on the margin, and we can measure overall efficiency by simply measuring the compensated elasticity of taxable income. For example, suppose that individuals have the option of structuring their compensation as non-taxable fringe benefits or working less. Both reduce taxable income. Traditional analysis would focus on labor elasticity to determine the efficiency effects of a labor income tax. We should,

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<sup>3</sup> The fees for sheltering and the amount sheltered will be equal at the margin. But if we are measuring marginal burden by the amount consumed, we need to look at the absolute amount of fees, not the absolute amount sheltered.

Another way to see this point is to analogize shutting down a shelter to adding a commodity to the tax base of a commodity tax. Yitzhaki (1979), Wilson (1989). The additional burden on an individual when the commodity is added to the base is not the amount of tax avoided by individuals who chose that commodity because it was previously excluded from the base (analogous to the amount of income sheltered by a tax shelter). Instead, it is the tax on the commodity. In the case of shelters, the commodity is the amount spent purchasing the shelter that is being eliminated.

however, look at the taxable income elasticity on the assumption that at the margin, the private cost of switching cash wages into fringe benefits is equal to the costs of working less. The change in taxable income when the tax rate is increased measures the cost of both substitutions. Focusing only on labor supply would make the tax system seem too efficient because labor supply changes less than taxable income when individuals can receive tax-free fringe benefits.

Slemrod and Kopczuk (2002) observed that the elasticity of taxable income can be manipulated by changing tax instruments. For example, increasing the tax base reduces the elasticity. Given administrative costs of using various tax instruments, we can then calculate the optimal elasticity. This approach would seem to lend itself naturally to tax shelters because one of the main goals of proposals to limit shelters is to reduce the elasticity of taxable income – they reduce avoidance opportunities by expanding the base.

Slemrod and Kopczuk (2002, equation 10) give the first order condition for setting the strength of an arbitrary tax instrument given a linear income tax and a uniform lump sum tax. They break down the change in social welfare due to a change in a tax instrument into three parts. First, there is the change in (indirect) utility, distributionally weighted, from the change in the instrument. Second, there is the change in tax revenues holding elasticity fixed. Finally, there is the change in tax revenues due to the change in elasticity of taxable income. Combining these, their equation 10, loosely translated, is that at the optimum:

$$MV + MR(\epsilon \text{ fixed}) - MR(\text{due to change in } \epsilon) = A'$$

where MV is the distributionally weighted marginal indirect utility, MR is marginal revenue,  $\epsilon$  is the elasticity of taxable income, and  $A'$  is marginal administrative costs.

If we combine the two marginal revenue terms and rearrange, we get:

$$\text{Marginal utility}/(MR - A') = -1$$

This is, essentially, the MECF formula with minor changes. For example, the MECF formula uses marginal burdens instead of marginal utility, which accounts for the change in sign. In addition, the MECF formula is not set at the optimum, so the MECF does not always equal 1. The optimal elasticity is a statement about the optimal tax structure, so it equals 1. The MECF formula includes compliance costs but the elasticity formula as expressed so far does not. These differences as well as others, are insignificant.<sup>4</sup> The two measures are effectively the same (as they should be).

Given that the two measures are the same, the problem with measuring marginal burden will apply. That is, the elasticity of taxable income concept will not reduce the measurement problems because we once again cannot rely on Roy's identity to transform a change in utility into a simple measure of consumption.

The nice thing about the elasticity measure, however, is that it focuses attention on the right variable in thinking about shelters – the effect of changing shelter rules on the elasticity of taxable income. When the government issues a rule that a particular transaction no longer shelters income, it does not expect to raise revenue from taxpayers who continue to engage in that shelter. The revenue effects from shutting down a tax shelter, holding elasticity constant, are likely to be zero or close to zero. Absent tax benefits, nobody does these transactions. All of the revenue comes from changing the elasticity of taxable income.

We can see, then, that the efficiency effects of attacking shelters depend on three variables. First, we need to know the increased fees and other costs that will be incurred by those taxpayers

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<sup>4</sup> There are several other differences. For example, the MECF formula as given here does not include distributional weights, although these are easily added. See Slemrod and Yitzhaki (2001). Similarly, the elasticity measure breaks up the revenue change into two pieces while the MECF measure simply considers the entire change in revenue. These differences are essentially minor elements of their derivations, and it is easy to see how the two formulas are essentially the same.

who continue to shelter.<sup>5</sup> Second, we need to know the effects of changing the elasticity of taxable income. Third, we need to understand the compliance and administrative costs of various approaches to reducing shelters. Studies that focus on the volume of sheltering, while interesting, do not directly determine any of the relevant variables. Instead, they should be thought of as suggestive of the potential revenue that attacks on shelters might yield. We need to know more about the fees and other costs of shelters, the elasticity effects, which relate primarily to the availability of substitute shelters, and the compliance and administrative costs of reducing shelters.

It is easy to imagine how the avoidance/evasion type regime we have arises from this analysis. Begin with the simple case where there are only two classes of activities, allowable avoidance and disallowed evasion. Disallowed evasion is simply the class of responses to taxation that it is efficient to prevent. Tax rules preventing these activities have a low MECF. Allowable avoidance activity is the class of responses to taxation that are efficient to allow. Tax rules that would disallow these activities would have a high MECF. The dividing line is where the MECF of preventing more avoidance equal the MECF of raising money in other ways. Disallowed evasion is likely to include those activities that are relatively cheap to prevent or that would lose a lot of revenue if allowed. For example, failing to file a return or filing false returns, if allowed, would lose substantial revenue and, therefore, must be treated as disallowed evasion. Working less, while potentially creating a large revenue loss, would be difficult or impossible to prevent, and, therefore, falls into the class of allowed avoidance.

Current law uses a finer grained analysis, imposing criminal penalties for some activities and a scaled set of non-criminal penalties for others. There are two primary considerations in thinking about how to scale penalties. First, Becker (1968) suggests that we use very high criminal sanctions.

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<sup>5</sup> I have previously called this the distortionary effect. The idea is that when we increase the strength of anti-shelter rules, we make those shelters that remain worse. See Weisbach (2002).

But considerations of risk aversion and corruption modify this to argue for lower penalties. See, for example, Polinsky and Shavell (1979). This is particularly true where it is uncertain whether a particular activity will be treated as disallowed evasion. Second, we need to consider substitution effects among responses to taxation. If very high sanctions were imposed on all disallowed evasion, a taxpayer who engages in a minor type of evasion might have no incentive to avoid more egregious evasions. Scaled punishments limit this effect. Thus, we should expect a range of punishments for responses to taxation based on the cost of preventing an activity, the revenue raised from preventing the activity, and factors such as how well the activity can be defined.

Note also that the scope of disallowed evasion depends on the MECF of other tax instruments. If tax rates are high, MECF's are likely to be higher and we should expect more sheltering activity to be disallowed. If there are other low MECF instruments, we might not want to address sheltering. We cannot say anything about shelters in the abstract without considering alternative tax instruments.

### **III. Using the Structure of the Tax Law to Reduce Sheltering**

The problem is translating these measures into actual policy proposals. The measures are helpful because they tell us what sort of data we need and perhaps provide intuitions about why the law takes the general form that it does. But they are a long way from, say, telling congressional staffers whether to increase disclosure and penalties, to codify an economic substance doctrine, to provide more resources to IRS litigation teams, or to not do anything. The economics literature has studied the optimal use of audits and sanctions. It has not, however, studied how the actual drafting of the tax law itself can reduce sheltering. In particular, the tax law can be made more or less complex or it can use broad anti-sheltering standards such as the economic substance doctrine.

These issues, like the use of audits, can and must be analyzed by examining the welfare created by each approach.<sup>6</sup> This task is taken up below.

Attacks on shelters often rely on vague standards, such as the business purpose, sham transaction, or economic substance doctrines. Under these standards, transactions that otherwise meet the literal requirements of the law are treated as not working. For example, under the business purpose doctrine, transactions must have a non-tax business purpose to be respected for tax purposes, even if the transaction otherwise meets the requirements of the tax law. Under the economic substance doctrine, transactions must change the economics of the taxpayer in a meaningful way. The exact content of these standards is uncertain, and attempts to clarify the content often conclude that the doctrines are incoherent.<sup>7</sup> Moreover, they seem to contradict the literal language of the law. The question is why these doctrines persist.

Begin by considering why we might want the tax law to use rules in most circumstances. Following Kaplow (1992) we can define a rule as a law which is given content before individuals act. Think of a speed limit that requires individuals to drive less than 55 MPH. The 55 MPH limit is a rule because the detailed content of the law is given prior to individuals acting. A standard is given content *ex post*, after individuals act. Suppose the law required drivers to drive reasonably instead of 55 MPH. The “drive reasonably” limit is a standard because what it means to drive reasonably will only be determined after an individual has driven and been charged with driving unreasonably.

Kaplow (1992) argues that we should choose between rules and standards to minimize the cost of determining the content of the law. If the law uses rules, so that its content is determined *ex ante*, the government incurs the one-time cost of determining the content but it is cheap for

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<sup>6</sup> This section is based on Weisbach (1999). Surrey (1969) makes a similar argument.

<sup>7</sup> See, for example, Bankman (2001).

individuals to look up the rule and cheap for courts or law enforcement officials to apply the law. For example, it is costly to determine the correct speed limit, but once it is determined it is simple to determine whether a driver is speeding.

If, alternatively, the law uses standards so that its content is determined ex post, the government need not incur the up front cost but it will be more expensive for individuals to determine the content of the law and more expensive for courts or law enforcement officials to apply the law. For example, the government would incur a low up front cost to require drivers to drive reasonably but it will be expensive for drivers to determine the appropriate speed and for a court to determine whether a driver was in fact driving reasonably. The tort system largely relies on standards, namely that individuals must take due care. Presumably it does this because it is cheaper to determine due care ex post than to try to specify all the details of care ex ante.

It is cheaper to use rules than standards for the vast majority of the tax law. Because most tax rules apply millions or hundreds of millions of times, it is likely that it is cheaper for the government to incur the one-time cost of promulgating rules than for individuals to have to guess at the content of the law. More generally, if the law applies with great frequency, ex ante promulgation of rules takes advantage of economies of scale incurred by the government, and, therefore, rules are likely to be desirable.

A key assumption in this argument is that the content of the law is the same for both rules and standards, and the only issue is how to promulgate that content at the least cost. That is, for minimization of promulgation costs to be the appropriate social goal, we have to believe that the content of the law is the same, so that the benefits of some particular law are the same regardless of whether it is promulgated as a rule or a standard. This may often be a good first approximation. Standards have the advantage of more information because they occur later in time. But rules have

the advantage of economies of scale in determining the right content. While the likely content might be different in most cases, there may be no systematic pattern to the differences. Neither rules nor standards can be expected to be systematically more accurate or biased in one direction or another. Equal content might be as good or better an assumption as any other and, therefore minimizing the cost of promulgation is a reasonable goal.

There is at least one place, however, where the differences in content between rules and standards are likely to be systematic and to favor standards – tax shelters. The argument is that rules would have to be systematically more complex than standards, making the total costs of applying the law higher with a pure rules-based approach.

To see this, suppose that the tax law only used rules. One would expect that in specifying the content of most laws, it would be sufficient to provide content for common transactions. If uncommon ones are improperly regulated, the social losses are likely to be small because they are, by assumption, uncommon. This strategy does not work, however, for the tax law. The reason is that if a rare transaction is taxed incorrectly, there will be an opportunity to shelter income. Once the opportunity is discovered, the transaction will become common as taxpayers take advantage of it. Thus, if the tax law relied exclusively on rules, it would have to correctly specify the treatment of rare transactions, indeed of transactions that have never yet occurred or even been considered. Otherwise, a purely rules-based approach will be subject to easy manipulation.

An approach that mixes rules and standards, such as current law, does not have this flaw. Rules can be used to cover common transactions. If an uncommon transaction is mis-taxed and occurs, standards can trump the rules to provide an appropriate result. If individuals know that standards will trump rules to provide an appropriate result, there will be no incentive to discover the odd mis-taxed transaction. Therefore, it is unlikely that these rare transactions will ever occur and,

the content of the law in these odd cases need never be given. The standards-based approach thus avoids the complexity of a purely rules-based approach. A mix of rules and over-riding standards minimizes the overall cost of promulgating the tax law. We should expect the law to take this approach, as it does, mixing a set of detailed rules with over-riding standards.

The hard part, of course, is determining the optimal mix of rules and standards, and specifying when exactly standards will trump rules. I believe that failure to appreciate the simplifying aspect of standards has led to a approach that is too rules-oriented. In addition, the tax bar, which has a significant impact on the drafting of the tax law, opposes the uncertainty of standards because it impedes their ability to give tax advice. The tax bar, in this regard, however, poorly represents the interests of its clients. There is no reason to believe that business taxpayers would be significantly averse to uncertainty and good reasons to believe that increasing reliance on standards would reduce compliance and administrative costs.

The question of when standards should trump the usual rules is also not difficult. One merely needs to apply the logic of having standards. Standards are needed when the tax rules mis-tax a rare transaction. Standards, therefore, should apply when the rules (or the drafters) fail to anticipate a rare transaction and when mis-taxation of the transaction would lead to the problem of a proliferation of the mis-taxed transaction. Otherwise, the usual rules should govern. The application of this principle in any given case will be difficult, but the concept is straightforward.

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