

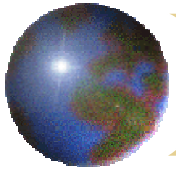
Taxing Corporate Capital Gains

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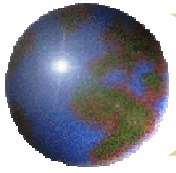
Harvard & NBER



Motivation

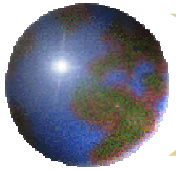
Many studies of capital gains realized by individuals but little work on corporate capital gains – particularly puzzling given:

- 1) Corporate capital gains are substantial relative to individual capital gains and relative to corporate income
- 2) Efficiency issues differ between individuals & corporations
- 3) Missing link in assessment of capital income taxation generally – particularly given Dividend Received Deduction



Outline

- I. An Overview of the Tax Treatment of Corporate K Gains
- II. Characterize Nature and Scope of Corporate K Gains
- III. Regression Analysis for Elasticity Estimates
- IV. International Evidence
- V. Reform Alternatives



The Tax Treatment of Corporate Capital Gains

What is a corporate capital gain? Sale of investment assets (stocks and non-operating assets) and "1231" (operating) assets above depreciable amount – eg.

- Divesting a successful subsidiary

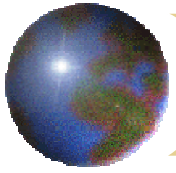
- Appreciated intercorporate equity investments

- Corporate venture capital successes

What rates are employed? Since 1986, ordinary rates

How do losses and gains interact with each other and with ordinary income? Netting rules at various stages – capital gains can be used to offset capital losses and can be offset by ordinary losses but capital losses do not net against ordinary income

What are incentive effects? (1) Lock-in effects (deferral); (2) Timing issues (selective realization); and (3) Tax planning issues



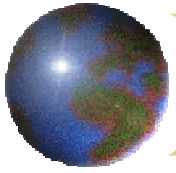
Efficiency Considerations of Capital Gains Taxation

Relative to individuals, no concerns from risk aversion or life-cycle issues

BUT, owner identities matter for productivity and asset returns

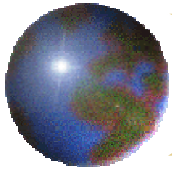
AND capital gains taxes could influence the level of cross-holdings and corporate venture capital

AND capital gains taxes could interact with capital market imperfections given reliance on internal cash flows

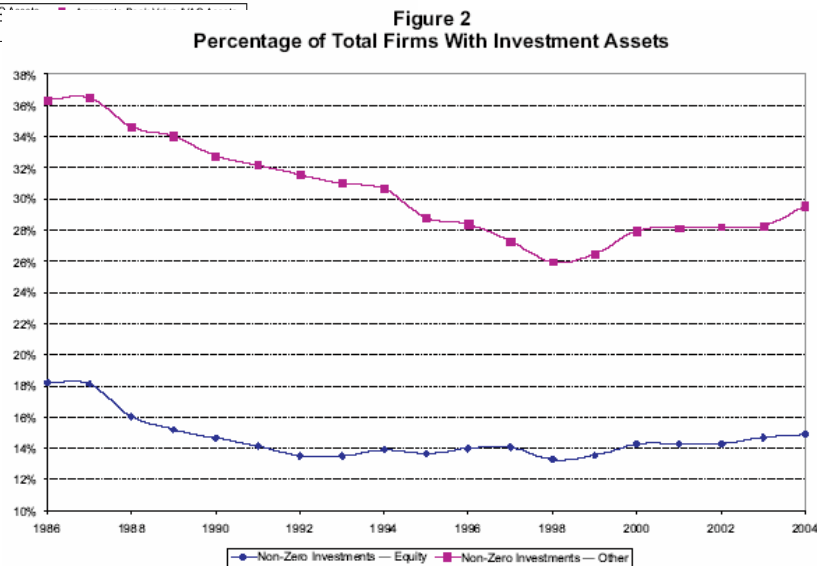
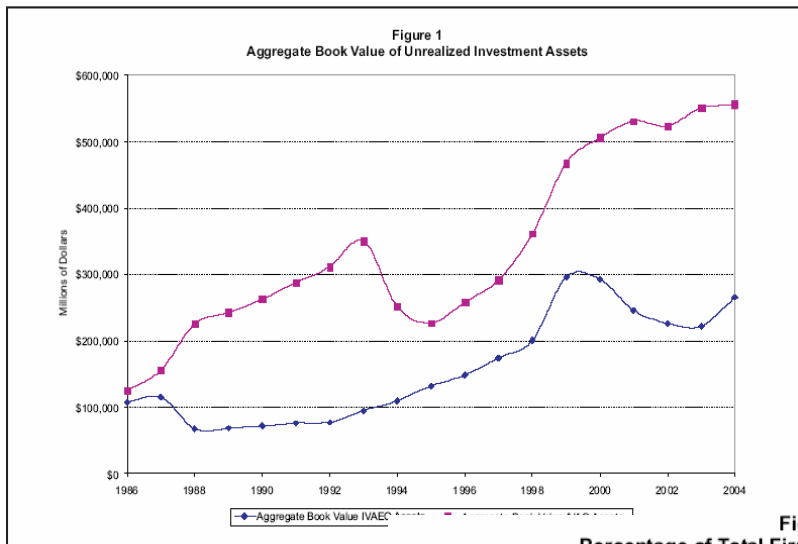


Capital Gains Taxes and Tax Planning

- Realization-based taxation affects the form of M&A activity (in addition to the level) – Stocks vs. cash, Cash-rich Split-Offs, Reverse Morris Trusts...
- Incentives to hedge rather than sell (e.g., issue exchangeable securities)
- Dividend clienteles and dividend capture strategies (interplay between dividend and capital gains taxation)
 - Restrictions in the tax code play an important role

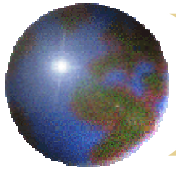


The Nature & Scope of Corporate Capital Gains



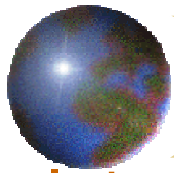
What is the scope of CCG?

- 30% of individual capital gains and increasing in importance
- 19% of income subject to tax
- Lower bound of \$821 billion of unrealized gains
- Greater in FIRE but widespread



Regression Analysis

- Framework is similar to time series regressions for individuals (Auerbach; Eichner & Sinai)
- Standard control variables: GDP, GDP deflator, S&P 500 Index - We add measures of market sentiment, M&A activity & IPO activity
- Estimated elasticity is at the high end of measured elasticities for individual capital gains
- Results are consistent with a lock-in effect for corporate holdings
- Panel analysis using public financial records provides related evidence

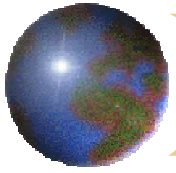


International evidence – The German Reform (1)

- Backdrop of considerable cross-holdings - See figure for 1996 cross-holdings

- Relief for corporate capital gains in 2001-2002





Reform Alternatives

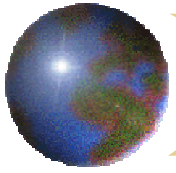
1. Repeal
2. Reduction to 15%
3. One-year holiday

Consequences

Increased realizations

Efficiency gains

Tax revenue consequences – lost and gained revenues



Conclusion

Corporate realizations of capital gains are large relative to individual capital gains and corporate income – and increasingly so

Efficiency consequences are potentially larger given the importance of ownership to the productivity of assets and capital market imperfections

International efforts suggest considerable consequences to cross-ownership

Reform alternatives provide opportunity for considerable efficiency benefits