Taxes and Corporate Finance

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Differential Taxation of Debt & Equity

- Debt
  - Interest expense is deductible by firm
  - Interest taxable to investor
- Equity
  - Return taxed at corporate level
  - Preferential treatment for investors
    - Rates & Deferral

Possible Corporate Tax Reforms

- Integration of entity & investor taxes
- Lower rates, (possibly) broader base
- Either reform can narrow the tax differential between debt & equity

Distortions from Differential Taxation of D & E

- Incentive to borrow: increased corporate debt
  - Increased costs of financial distress
  - Less robust in financial crises
- Tax preference for debt favors firms with higher debt capacity
  - Tangible vs. intangible assets
  - Older vs. newer firms

Tax Arbitrage: Transactions at the Margin

- Borrow: Tax deductible
- Invest: Fully taxable? No big deal
  Partially taxable? Negative ETR?
- "Partially taxable":
  - Tax-exempt bonds
  - Foreign subsidiaries (in some cases)
  - Accelerated depreciation
  - Pension funding (for those few DB plans left)

Tax Reform & Tax Arbitrage

- Lower tax rate: fewer arbitrages will be profitable
- Revenue consequences of tax reform are challenging to estimate

Narrowing Tax Rate Differentials Across Firms

- Lower tax rates could lead to less dispersion in tax rates across firms
  - Dispersion can come from loss positions
- Interfirm tax arbitrage
  - Leasing
  - M & A activity