

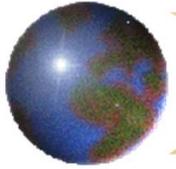
The Tax Elasticity of Financial Statement Income: Implications for Current Reform Proposals

National Tax Association Spring Symposium

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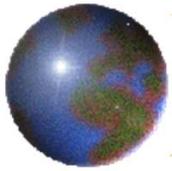
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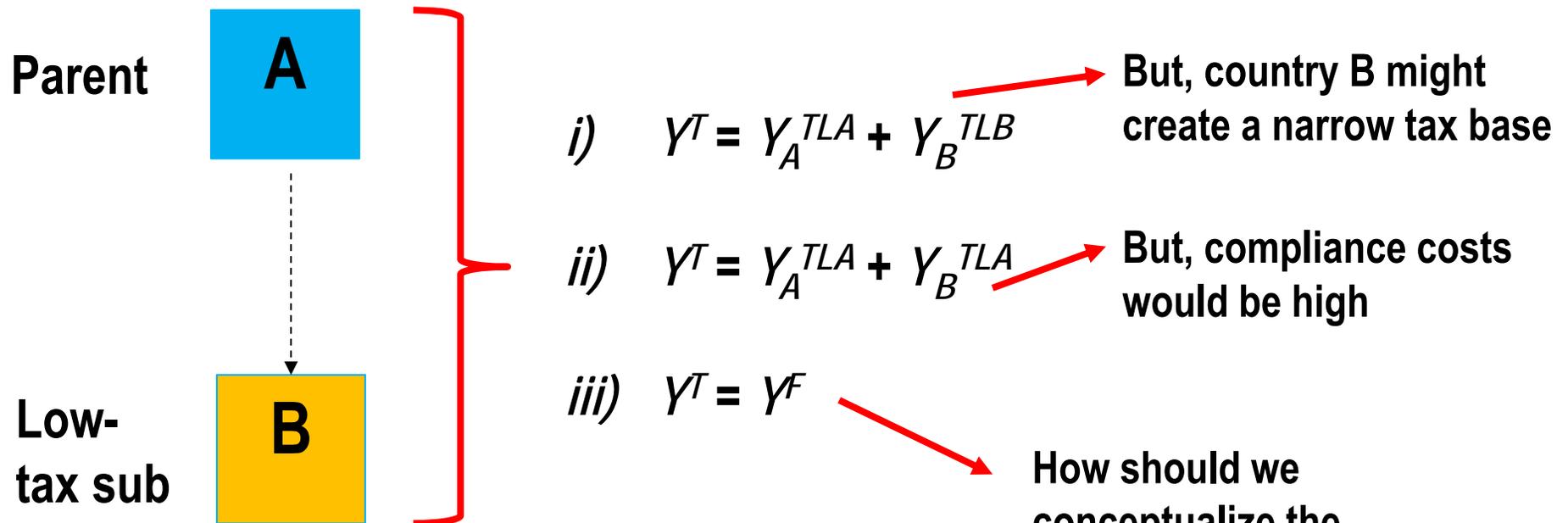
Introduction

- Early-to-mid 2000's: concern about book-tax divergence, tax avoidance and earnings management
 - Desai (2005); Desai and Dharmapala (2009)
 - Hanlon and Shevlin (2005)
- Recent proposals for reforming MNC taxation
 - OECD/G-20 GloBE (Pillar Two) proposal (OECD, 2019)
 - “Real Corporate Profits” Tax (Saez and Zucman, 2019)
- Aim: to bridge accounting and economics/policy perspectives by interpreting the evidence in terms of potential efficiency costs



GloBE Proposal: Global Minimum Tax

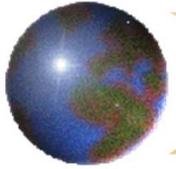
But on what tax base should the minimum tax be imposed?



Y^T : tax base

Y^{TL} : taxable income defined by tax law

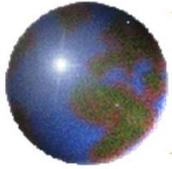
Y^F : consolidated financial statement income



Elasticity of Taxable Income (ETI)

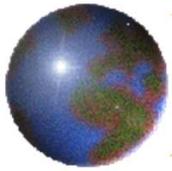
Approximately:
$$\frac{\% \Delta \text{ in } Y^T}{\% \Delta \text{ in } (1-t)}$$

- Feldstein (1999): ETI is a sufficient statistic for the deadweight loss under fairly general conditions
 - Regardless of whether Δ in Y^T is due to real responses or tax avoidance, as taxpayers equate the marginal costs
 - Exceptions – e.g. when costs of tax avoidance are not social costs (e.g. Chetty, 2009)
 - But, if ETI is a sufficient statistic for the deadweight loss from profit shifting, we would also expect this to be true for tax-motivated earnings management

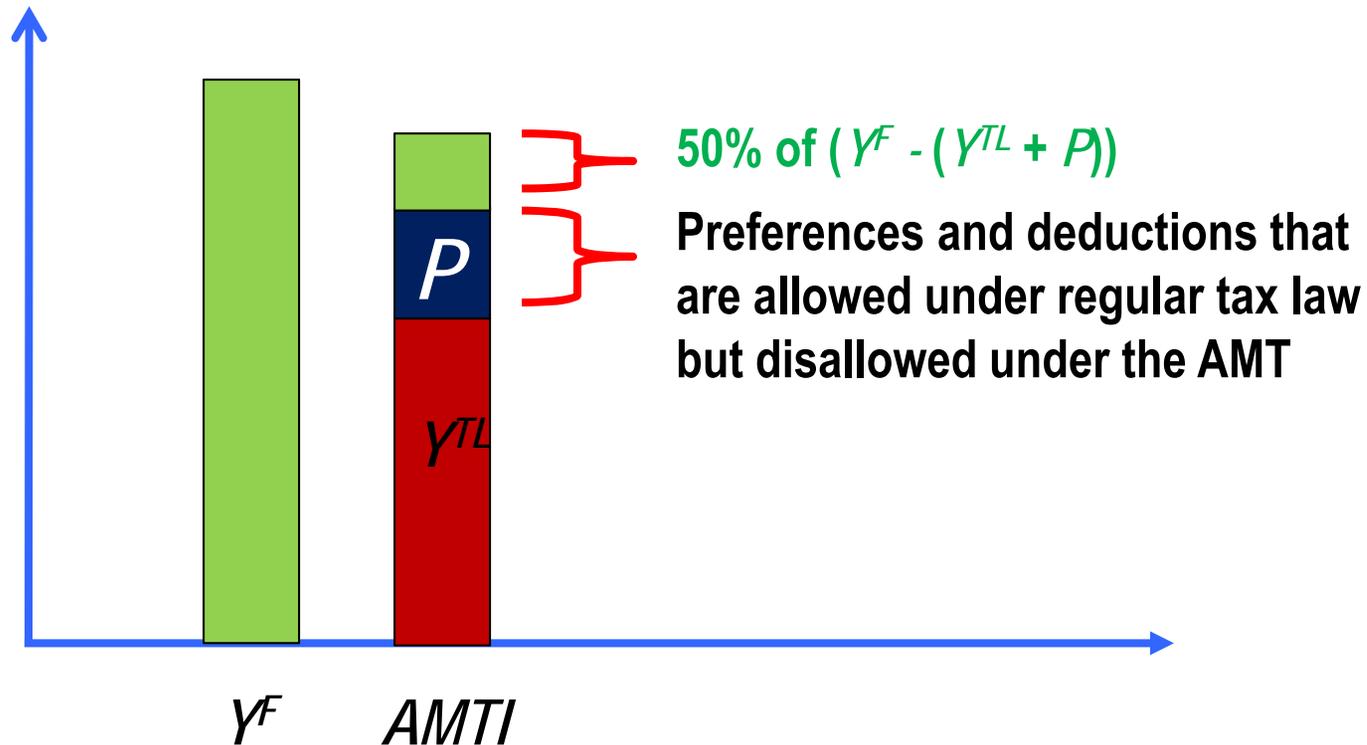


ETI for Corporate Income

Tax Base	Study	Sample	Reported ETI
<i>Tax Law Income</i> ($Y^T = Y^{TL}$)	Gruber and Rauh (2007)	US firms (Compustat)	0.2
	Devereux, Liu and Loretz (2014)	UK firms around £300,000 "kink" (tax return data)	0.13 to 0.17



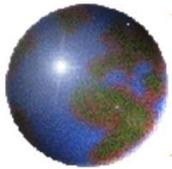
TRA86: Book Income Adjustment to AMT



BIA or “Business Untaxed Reported Profit” (BURP) adjustment:

$$AMT = 20\% \text{ of } (Y^{TL} + P + 0.5(Y^F - (Y^{TL} + P)))$$

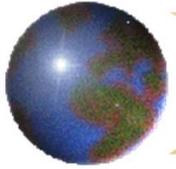
→ 10% tax rate on Y^F for firms subject to the AMT in 1987-1989



ETI for Financial Statement Income

Tax Base	Study	Sample	Reported ETI	Implied ETI
<i>Tax Law Income</i> ($Y^T = Y^{TL}$)	Gruber and Rauh (2007)	US firms (Compustat)	0.2	
	Devereux, Liu and Loretz (2014)	UK firms around £300,000 "kink" (tax return data)	0.13 to 0.17	
<i>Financial Statement Income</i> ($Y^T = Y^F$)	Dhaliwal and Wang (1992)	US firms (Compustat)		1.7
	Manzon (1992)	US firms subject to the AMT (hand-collected)		1.4 to 1.9

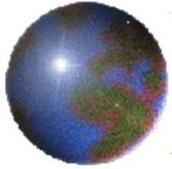
Studies of US firms' responses to the BIA/BURP adjustment – do not discuss magnitudes (but these can be inferred using some assumptions)



Caveats

Consistent with downward earnings management of Y^F (v. that of Y^{TL}) being relatively unconstrained; but:

- Various potential problems with these studies?
 - Choi, Gramlich and Thomas (2001); Shackelford and Shevlin (2001)
- Short-run v. long-run responses?
- However, a number of biases → underestimation of effect
 - TRA86: ↓ in corporate tax rate
 - AMT credits
- No “precise zero” estimates in the literature



Conclusion

- The available evidence on the ETI of Y^F is limited, but suggests quite large deadweight losses from taxing Y^F
 - Potentially mitigated by adjusting $Y^F \rightarrow Y^{TL}$, but this seems to undermine the rationale for taxing Y^F
- OECD (2019): why pursue GloBE proposal?
 - Profit shifting
 - Tax competition
 - Putative danger of countries unilaterally imposing digital services taxes (DSTs)
- But, should also bear in mind the potential costs of GloBE and similar proposals