

## DECODING THE U.S. CORPORATE TAX\*

WRITTEN BY DANIEL N. SHAVIRO

REVIEWED BY WESLEY BAILEY

In *Decoding the U.S. Corporate Tax*, author Daniel Shaviro discusses a topic which has been at the center of countless conversations taking place from boardrooms to dining rooms. Shaviro begins by pointing out that, despite the open dialogue and consensus as to the necessity of corporate tax reform, nothing has been done in the last several decades to significantly change the corporate tax system. There may be several causes of the prior inaction, but Shaviro believes that the current trends “do not merely invite, but may end up necessitating, a major rethinking of how (and if) the U.S. corporate tax operates.”

Shaviro, the Wayne Perry Professor of Taxation at New York University School of Law, is one of the nation’s leading legal scholars on tax policy and his “rethinking” in the corporate tax area, as discussed in this book, might be a reality in the near future. Shaviro testified before the Senate Finance Committee last year about his reform proposals.

The organization of the book into four distinct parts, each with several chapters, serves as a roadmap that leads the reader on a natural progression to understanding the intricacies of the corporate tax. Part One attempts to explain the tax concepts that are at the center of the corporate tax. This is not such an easy task because, as Shaviro explains, the corporate tax does not have a coherent core; instead, “it resembles a ramshackle mansion erected by multiple builders whose work was crudely joined together once the pieces were almost complete.” Chapter One starts by thoroughly examining the components which presently make up the U.S. corporate tax while sparing the reader the overly technical details. Shaviro then focuses on the interactions between and the rationales behind three key components of the corporate tax: (1) the tax on the corporate entity itself, (2) the shareholder-level tax which may be either a dividend tax or a capital gains tax, and (3) the

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disparate treatment of debt and equity. Together, the three components currently operate to effectively impose a double tax on equity-financed corporate income. Several rationales exist for retaining the existing corporate tax structure, such as its ability to achieve progressivity which otherwise would be politically unfeasible and the fact that its repeal would result in substantial revenue loss to the government and a windfall gain to current shareholders. However, most scholars agree with Shaviro that the current system “would be extremely hard to defend if one were starting from a blank slate.”

In Chapters 2 and 3, Shaviro discusses the efficiency problems with the corporate tax, how the various components of the corporate tax cause additional distortions which increase inefficiency, and how the lack of clear meaning of the underlying corporate tax components serves as an obstacle in reducing the inefficiency. All income tax systems necessarily cause inefficiencies by burdening individuals' decisions to work and their decisions to save, thus discouraging productive economic activity. Yet, we tolerate these inefficiencies due to the unappealing distributional consequences of the alternative. In creating a corporate income tax system, Shaviro points out that we should be careful not to add more distortions on top of the two inherent in the basic income tax. Shaviro identifies four major distortions present in our current corporate tax system: (1) the choice between using a corporate or a noncorporate entity, (2) the choice between debt or equity financing of a corporate investment, (3) the choice between distributing corporate earnings to shareholders or retaining them in corporate solution, and (4) the choice between distributing earnings in a form that is taxed as dividends or a form that is taxed as capital gains. For each of these distortions, Shaviro examines how the current tax rules create a bias toward one of the choices and how the tax-favored choice often leads to needless inefficiency. For example, the current corporate tax rules create a bias toward the use of debt by individual investors due to the immediate corporate deduction of interest payments but not dividend payments. Thus, an investor may accept a risk profile, considering the tax-favored status of debt, that would otherwise be inferior. This efficiency problem is only intensified by what Shaviro calls the “Pillars of Sand” on which the corporate tax is built. In other words, he describes the corporate tax as built on concepts that have no

core. Take for example debt vs. equity: many of the innovative financial instruments used today combine features that were historically associated with either classic debt or classic equity. However, the disparate tax treatment of debt and equity for tax purposes necessitates the classification of these hybrid instruments as one or the other. Taxpayers can effectively elect the desired classification because the tax code provides no clear guidance for the classification of these instruments, even though in 1969 Congress instructed the Treasury to comprehensively define debt and equity for tax purposes. This leads to inefficiency because corporations and investors expend resources by hiring attorneys to create financial instruments that will obtain the classification that provides optimal tax treatment but possess whichever combination of debt and equity attributes that they desire economically. The end result is that the government loses out on tax revenue. The game playing caused by the debt-equity distinction is well-known and Shaviro references this by telling a Wall Street joke “that the best way to tell whether a complicated financial instrument that offers no current cash flow to investors is debt or equity is simply to ask what sort of investors it is being marketed to.”

Part Two explores the leading economic theories of the corporate tax and is separated into three sections. The first section starts by examining the incidence of the corporate tax and shows the importance of determining who exactly bears the incidence of the tax. Next, Shaviro provides a thorough, and at times amusing, discussion of the theories regarding the economic effect of a tax on dividends. Part Two concludes with a concise discussion of capital finance theory. Although Shaviro finds the economic theories of the corporate tax an important part of the analysis which must be considered, he does not appear to believe that much insight will be gained by examining these theories. The corporate tax has an intricate web of diverse and complex features, any of which have the ability to affect the operation of the tax. Thus, economists must produce greatly simplified models when trying to gain insight about the tax system. Simplifying models are used often and prove to be very effective tools in many areas of study as long as the appropriate simplifying assumptions are chosen. However, since the corporate tax is built on “Pillars of Sand,” there are no discernable core concepts on which to form an effective economic model. Nonetheless, Shaviro takes

pointy-headed economic theories of the corporate tax and explains them in a manner that even laypeople could understand.

How the corporate tax is applied in an international context is considered in Part Three. An understanding of how the corporate tax is applied to both outbound investment by U.S. residents and inbound investment by residents of other countries is essential when considering the problems resulting from our current corporate tax system. In Chapter Seven, Shaviro takes on the staggering task of outlining the basic U.S. international tax rules, as well as the effects and rationales behind such rules. Shaviro uses many hypothetical examples in order to help the reader comprehend these complicated issues. Chapter Eight then attempts to shed some light on the corporate tax policy dilemmas associated with the international tax. Shaviro starts by comparing one's journey through international tax policy to being lost without a compass or a map. After reading Chapter Eight, I believe this portrayal is fairly accurate.

Shaviro concludes the Book, in Part Four, with a discussion of where the corporate tax is headed. Despite the lack of significant changes to the corporate tax in the last several decades, Shaviro identifies three emerging trends which he believes will lead to substantial corporate tax reform in the near future: (1) ongoing financial innovation, (2) rising worldwide capital mobility, and (3) changing U.S. political dynamics which can cause legal instability in the year-to-year content of the corporate tax. Shaviro also explores the most widely-discussed solution to the current corporate tax problem, Corporate Integration. Given the political and administrative constraints that he believes that the adoption of Corporate Integration would bear, Shaviro concludes with a discussion of other possible new directions for the U.S. corporate tax.

Throughout this book, Shaviro relies not only on his extensive knowledge of the corporate tax, but also on his ability to explain complex issues in a down-to-earth way. Shaviro succeeds in keeping the reader interested by continually discussing the history and political environment in which our present corporate tax was shaped. I highly recommend this book to anyone who cares about the real-world implications of the current corporate tax and the steps that should be taken to adopt an efficient corporate tax structure.

## JEFFERSON VS. THE PATENT TROLLS: A POPULIST VISION OF INTELLECTUAL PROPERTY RIGHTS\*

WRITTEN BY JEFFREY H. MATSUURA  
REVIEWED BY W. MICHAEL SCHUSTER

As Jeffrey H. Matsuura sets forth early in his book *Jefferson vs. the Patent Trolls: A Populist Vision of Intellectual Property Rights*, “[t]here is a tension regarding rights of ownership of, access to, and use of intellectual property.” The United States’ intellectual property system seeks to incentivize innovation through, among other things, grants of limited monopolies, such as patent or copyrights. However, a primary policy question is at what point the grant of limited monopolies begins to constrict the free flow of information, as opposed to providing incentives to those who share their inventions with the public.

In *Jefferson vs. the Patent Trolls*, Matsuura addresses this question through the eyes of Thomas Jefferson. The work can be broken down into three primary sections: (1) Jefferson’s underlying philosophical ideals and the development of his theories on intellectual property; (2) the application of these theories in the late eighteenth century and early nineteenth century; and (3) a short discussion on the potential application of such theories in modern times.

Matsuura devoted Chapters Two and Three of the work to describing Jefferson’s views on intellectual property and the importance of the dissemination of knowledge. Jefferson believed that information was a resource that could elevate human society and therefore advocated wide-spread dissemination of such. Accordingly, Jefferson was a strong advocate of robust educational systems, which he saw as a means to “introduce[e] young people into the key knowledge networks of the nation and the world.” Such conveyance of knowledge was believed to serve three distinct purposes: (1) enabling individuals to contribute work to the present state of knowledge while remaining current on recent breakthroughs; (2) providing for the possibility of constant testing and refining of knowledge; and (3) ensuring that information was not lost in the future.

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\* Charlottesville, Virginia: University of Virginia Press, 2008. Pp. 154. \$27.95 (hardcover).

To these ends, Jefferson viewed ideas and knowledge as an asset that should be generally available for the public benefit. As Matsuura describes: “[For Jefferson, i]deas and knowledge were public assets that had value that extended beyond the basic economic perspective. They were forms of intellectual property, but they were not proprietary to any one person, organization, or nation.”

In further elaborating on the Jeffersonian theory of knowledge and intellectual property, Matsuura described Jefferson the scientist. In this role, Jefferson was not a standout in any single area of study, but rather worked in a range of fields. Further, consistent with his strong belief that knowledge could serve to better society, Jefferson commonly discussed his scientific observations with a focus on their practical applications. It was through such pursuits that Jefferson was able to engrain science into his daily life and work as an advocate for science and technology in public affairs. However, as Jefferson would find out, this advocacy would serve to undercut his primary goal of wide dissemination of information. Specifically, the environment that Jefferson helped to create would eventually lead to a situation where the public saw “science as a means to improve their economic, political, and social conditions.” Such views led to “the development of commercial, industrialized science [that] encouraged a less collaborative, more proprietary approach to scientific inquiry” in which financial gain was a primary motivation. Despite his influence on this movement, Jefferson never came to appreciate the fact that commercial science would become a significant agent of technological progress.

In addition to his endeavors in the sciences, Jefferson was an inventor. Jefferson’s views on the role of an inventor can be derived from his actions as the originator of an improved plow. In accordance with his belief that knowledge serves to better society, Jefferson sought no proprietary protection for his invention and freely disclosed the improvement to the public. Actions such as this commonly placed Jefferson at odds with commercial research and development (and any attempts to recoup the costs associated therewith).

In Chapters Four and Five, Matsuura further develops the themes set forth earlier in the work by describing Jefferson’s application of his ideas on intellectual property. The section begins in 1790, when Jefferson went from being a user and

creator of intellectual property to a member of the Board of Arts for the United States. In this position, Jefferson was responsible, along with two other members of the Board, for creating and managing the first United States patent system. However, neither the constitution nor the statute that created the Board expressly stated the manner in which the patent system should be run. Accordingly, members of the Board had significant impact on the workings of the new regime. As an experienced scientist and inventor, Jefferson was able to exert significant influence and, not surprisingly, Jefferson's personal beliefs on intellectual property shone through in the Board's actions.

Jefferson entered into this new post with the belief that the grant of a patent was a tool to encourage innovation, but not necessarily the sole tool available. This was consistent with the Founding Fathers' recognition that, while the potential grant of a patent could encourage invention, the United States should not limit its "interest in promoting science and development of the useful arts to the grant of rights to inventors and authors." Following this line of thought, the Board sought to create a limited patent system by instituting two significant restrictions on patentability: (1) the invention must have utility, meaning that it was able to fulfill some useful task; and (2) the invention must be novel, meaning that the invention had not been disclosed previously. These requirements were consistent with Jefferson's desire to "limit the scope of patenting to those instances when the invention offered clear value to the public." Both restrictions continue to exist.

In further displaying the application of Jeffersonian ideas on intellectual property, Matsuura addresses Jefferson's interaction with "patent trolls." Patent trolls are patent owners whose business model does not include gainful production of the claimed invention, but rather seeking profit through licensing the right to produce the invention. Specifically, trolls seek to force licenses upon parties who unknowingly began to utilize a patented invention and must choose between licensing or ceasing production. While such a business model was not prevalent during Jefferson's time, patentees were beginning to seek to license their patented inventions. For example, Jefferson was accused of patent infringement by the holder of a patent on an automated milling process. This assertion of patent rights stood in stark contrast to the most important as-

pect of invention that Jefferson recognized—the public’s benefit. In Jefferson’s eyes, the patentee was seeking to *harm the public* by requiring parties to either pay royalties or cease utilization of the invention. Jefferson’s outrage at the lawsuit was consistent with his theory of intellectual property, but showed his near obliviousness to the wishes of some inventors—economic remuneration for their toils in inventing.

In Chapter Six of *Jefferson vs. the Patent Trolls*, Matsuura begins a third section of the work by providing a brief discussion on the potential application of Jefferson’s theories in modern times. The author states that one may view “Jefferson’s experiences and actions as a useful model for the opportunities and challenges available to political leaders to influence in constructive ways efforts to facilitate creativity, invention, and innovation.” Accordingly, the text briefly describes how Jefferson’s intellectual property theories might apply to modern topics, such as restrictions on the movement of scientists imposed by immigration laws, limitations on the dissemination of information by noncompetition and nondisclosure agreements, and the open-source software movement. Each example clearly exemplifies a policy that Jefferson likely would have identified as an obvious success or failure in modern intellectual property policy. However, it is in this discussion that the reader may find a drawback in Matsuura’s work.

Upon a quick reflection on the work as a whole, *Jefferson vs. the Patent Trolls* is immediately viewed in one of two lights. The book is either a complete historical story of the development and application of Jefferson’s theories on intellectual property or it is an incomplete discussion of the evolution and application of such theories and their applicability to modern society. Viewed as a historical work, the book fully establishes the evolution and historical application of Jefferson’s theories on knowledge and how knowledge could be used to better society. However, in viewing the work as setting forth a theory of intellectual property jurisprudence to be applied in modern times, *Jefferson vs. the Patent Trolls* fails to address a multitude of interesting points. For example, while Jefferson clearly favored easy dissemination of information, how might he have reconciled this view with the fact that such information is, in modern society, commonly created only as an investment from which returns are hoped to be reaped? How might Jefferson have viewed arguments for compulsory licensing in the United

States and the Supreme Court's decision in *eBay Inc v. MercExchange, L.L.C.*, 547 U.S. 388 (2006)?

It is only after asking such questions that the real value of Matsuura's *Jefferson vs. the Patent Trolls* becomes clear. The work's value lies not in any attempt to apply Jefferson's theories to modern intellectual property dilemmas, nor does it lie in the work's historical underpinnings. Rather, the real benefit of the book is found in its clear and insightful manner of setting forth Jefferson's ideas on intellectual property and its inherent ability to raise questions in the reader's own mind about their present application. It is only when viewed in such a light that Matsuura's success becomes clear.

