

# The right tax at the right time

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## THE RIGHT TAX AT THE RIGHT TIME

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The companion paper to this (*Capital Taxation in an Age of Inequality*) argues that a moderate flat-rate (proportional) income tax on capital imposed and collected annually has attractive theoretical and political economy properties that can be harnessed in actual tax instrument design. This paper continues the analysis by specifying in detail how such a tax might be designed.

The idea of the Dual Business Enterprise Income Tax, or Dual BEIT, is to offer business enterprises a neutral profits tax environment in which to operate, in which normal returns to capital are exempt from tax by means of an annual capital allowance termed the Cost of Capital Allowance (COCA). In turn, investors in firms include in income each year the same COCA rate, applied to their tax basis in their investments. The result is a single tax on capital income (rents plus normal returns), where the tax on normal returns is imposed directly on the least mobile class of taxpayers. Labor income continues to be taxed at progressive tax rates.

The paper considers in detail three particular design issues. First, because labor is taxed at progressive rates whose top rate exceeds the capital income rate, the Dual BEIT must specify a labor-capital income tax centrifuge, to tease apart labor from capital income when the two are intertwined in the case of the owner-entrepreneur of a closely-held firm. Second, the paper considers the theory and practice behind the choice of the COCA rate. Third, the paper specifies an international tax regime that should be attractive to firm managers yet robust to stateless income gaming.

Throughout, the emphasis is on developing pragmatic technical solutions that are implementable without profound transition issues, that are administrable, and that fairly balance theoretical desiderata against political economy realities.

## I. INTRODUCTION.

### A. From Theory to Practice.

A companion paper (*Capital Taxation in an Age of Inequality*) argues that a relatively low flat rate tax on business capital income, measured and collected annually, is a desirable instrument for U.S. federal fiscal policy, and in practical application dominates progressive consumption tax proposals. Economic theory does not proscribe taxing capital income, once real world considerations like the importance of gratuitous transfers of capital are considered. Further, political economy considerations strongly support using a capital income tax, measured and collected annually, as an important constituent fiscal policy instrument, both to raise substantial revenues and as a targeted inequality remediation device.

As a proportional tax, a flat-rate capital income tax applies at the same marginal and effective rates to both income and losses, thereby preserving the symmetry on which rests the theoretical analysis of returns to risk. And as a political economy matter, a flat-rate capital income tax measured and collected annually operates as a progressive tax in application: because only high-ability taxpayers or those who are the beneficiaries of gratuitous transfers can afford indefinite deferral of consumption, the increasing “tax wedge” on savings over time introduces a measure of top-bracket progressivity along the margin of time. In other words, what many economists view as the fatal flaw of capital income taxation (the increasing tax wedge over time) in fact is a feature, not a bug. A low flat capital income rate actually imposed annually may thus offer some efficiency gains when compared with an “ideal” progressive consumption tax straw man, while still being progressive in fact.

An annual capital income tax fits with American constitutional constraints that would bedevil an annual wealth tax. Further, it is more robust to legislative panic (or pandering) in the face of recessions or other developments than is any system (including the estate tax) that relies on collecting tax decades in arrears. The 2004 tax holiday for “repatriating” offshore low-taxed earnings held by foreign subsidiaries of U.S. multinational firms demonstrates the fragility of any taxing scheme that allows inchoate tax liabilities to accrue over long time periods;<sup>1</sup> like a reservoir behind a dam, all those contingent tax revenues can be flooded away in a single breach of the system.

*Capital Taxation in an Age of Inequality* explains the desirability of imposing a flat rate tax on all instances of business capital income, measured and collected annually, notwithstanding

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<sup>1</sup> Section 965 (2004).

the obvious point that economic rents in theory can bear much higher tax rates without inducing deadweight loss.

A flat rate structure has the great advantage of symmetry in the rate imposed on losses and gains of differing magnitudes, measured ex post: this is an essential feature if the resulting tax is not to distort ex ante investment decisions. As described in Part IV and in the companion article, the entire theory of why a cash flow tax operates to exempt normal returns from tax is that the expensing of investment makes the government an undivided proportional co-investor in that investment: a progressive tax structure destroys that neutral co-investment ex post, and therefore burdens investment decisions, ex ante.

And while the case for a higher tax rate on rents is easy to make in theory, it is difficult to implement in practice, particularly when one remembers that firms and investors in those firms make investment decisions at different points in time. A firm might capture economic rents through the extension of its market-dominant core intangibles, but to a late-arriving investor in the firm's stock, those firm-level rents would be priced as normal returns.<sup>2</sup>

A flat rate tax on business capital income is an incremental extension of current tax policies, and thus minimizes transition issues and dislocations to asset prices. By taxing all business capital income in whatever form derived (that is, regardless of entity type, form of financing or nature of industry) in a consistent manner, such a tax also minimizes allocative distortions resulting from current law's uneven application of capital taxation.

Finally, there is no reason, beyond pure coincidence, why an ideal income tax should burden labor income and capital income under the identical rate schedule. The elasticities of labor and capital taxable income, and the elasticities of real labor and capital supply in the face of taxation, are not identical to one other, and the role played by each in the economy and in social structures also differ. As suggested above, a flat (proportional) tax on capital income will operate as progressive along the relevant margin of time, but that reasoning does not extend to labor income. From the other direction, and particularly in light of the relatively inelastic real labor responses to tax rates in the range with which we have recent experience, an explicit progressive tax rate structure on labor income both raises substantial revenues and can do so in a way that satisfies political economy redistribution concerns.

This Article takes both the reasoning and the conclusions of *Capital Taxation in an Age of Inequality* as prologue, and extends that paper by specifying in reasonable detail the design of the flat rate, uniformly-applied capital income tax that I have in mind. The proposed tax – called the Dual Business Enterprise Income Tax, or Dual BEIT (where “BEIT” is pronounced “bite,” as in a tax bite) – builds on earlier work of mine, but is substantially amended and restated from its earliest iterations.

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<sup>2</sup> Capital Taxation in an Age of Uncertainty, Section \_\_\_\_.

The BEIT half of the Dual BEIT is a robust technology for measuring explicit returns to capital, but is agnostic about tax rates, and does not by itself address the issue of labor income masquerading as capital income. Dual income tax learning adds a conscious commitment to different tax rates on capital and labor income – for example, 25 percent on the former and 40 percent on the latter (ignoring lower tax rate brackets on lower incomes) Marrying the two themes yields the Dual BEIT.

U.S. academic and policy circles are awash in proposals that generally might fall under the rubric of business tax reform. The Dual BEIT differs from some competing ideas in its breadth, as it covers all forms of business organization and all forms of financing a business, in its depth, in that it encompasses and coordinates firm and investor taxation, and in its practicality, as it requires very little by way of new information exchange or collection.

More generally, it is incumbent on proponents of new tax structures intended for actual implementation to specify their proposals in sufficient detail that their operation and administrability can be assessed. This is surprisingly difficult work, and while that work might be described by some as tax engineering rather than physics (or mere lawyers’ work, to put things more directly), it is what separates tax policy chatter from feasible legislation. Some proposals currently in the marketplace of tax policy ideas do not satisfy this standard, and remain largely abstractions.

This Article therefore describes the Dual BEIT sufficiently that its operation and practical implications are laid bare; I think of the Article as a preliminary term sheet from which a first draft of legislation could be produced. In doing so, there is a risk that readers will confuse some of the inevitable design details with conceptual complexity, or a detail as to which they might come to a different conclusion as evidence that the entire structure is faulty. I ask such readers for forbearance, and urge that this effort to think through important design details not be held against the Dual BEIT when compared to other ideas whose detailed implementations remain unexplored.

## B. Capital Income is the Issue.

1. *Capital Income Taxation Today.* In policy circles today, “corporate” or alternatively “business” income tax reform is a hot topic. But “business income” is an underspecified tax concept, and reform proposals often are framed so narrowly as to vitiate their own objectives. The challenge in designing a “business income” tax is to measure comprehensively and tax consistently taxpayers’ returns on the capital they invest in businesses of all shapes and sizes, regardless of legal labels or traditional accounting norms.

When policymakers speak of business income, therefore, what they should mean is *capital income* from business investment. Only a holistic focus on capital income can lead to consistent tax burdens on that income, regardless of the formal labels attached to its different practical iterations (the entity vs. its stakeholders, debt vs. equity, and so on).

As in *Capital Taxation in an Age of Inequality*, I use the term “capital income” here to comprise all returns to capital, in the narrow, traditional sense of that term.<sup>3</sup> Capital income includes, by way of example, interest and dividend income, property rental income, royalties, capital gains and the imputed rental income of owner-occupied housing. Capital income also includes most net business income. Firms bring both labor and capital to bear in generating net income; at least in the case of publicly held corporations, however, the labor component is fully compensated and deducted from the business tax base. As a result, the remaining business tax base contains only capital income. (The problem of the closely held business, whose owner-entrepreneur puts both her own capital and her labor to work, and where the net income of the firm cannot through simple inspection be divided into labor and capital income components, is addressed through the new “labor-capital income centrifuge” discussed later in this Article.)

The standard presentation in the legal tax literature basically divides the returns to capital into three categories.<sup>4</sup> First are “normal” returns, usually (incompletely) explained as the pure return to waiting, or time-value-of-money returns. These are usually presented as the core risk-free return from postponing consumption of one’s wealth. that one might expect to earn, for example, by investing in a Treasury bond. As discussed in Part IV, however, this is an incomplete formulation: normal returns also include ex-ante returns to risk, where those risk opportunities are replicable – that is, where an investment can be described as a marginal investment. To an economist, all business capital earns at least a normal return.

The standard presentation next describes risky returns, the higher returns that one expects to obtain as compensation for accepting the risk of uncertain rewards. From an ex ante perspective, risky returns are measured by the risk premium associated with an investment, as reflected in its expected return less the risk-free normal return. Actual ex post risky returns, of course, will vary considerably from this expected return, and often will be negative. Part IV argues that ex ante returns to risk – that is, a firm’s set of marginal investment opportunities – in fact constitute (risk adjusted) normal returns. The concept of “risky” returns might better be limited either to returns to true uncertainty,<sup>5</sup> or to ex post returns to risk, because tax systems generally operate ex post. One of the great difficulties in designing an income tax on capital is

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<sup>3</sup> Thus, as used in both Articles the term “capital” does not include human capital.

<sup>4</sup> John R. Brooks II, *Taxation, Risk and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax*, 66 TAX L. REV. 255, 261 n. 25 (2013); David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1 (2004); Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91 (2004); Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); Lawrence Zelenak, *The Sometimes-Taxation of the Returns to Risk-Bearing Under Progressive Income Tax*, 59 SMU L. REV. 879 (2006); Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX. L. REV. 17 (1996); Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993); Edward D. Kleinbard, *Designing an Income Tax on Capital*, in TAXING CAPITAL INCOME (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle eds., 2007).

<sup>5</sup> See *Capital Taxation in an Age of Uncertainty*, Section \_\_\_\_.

ensuring that the taxation of ex post returns to risk does not distort ex ante marginal investment decisions.

Finally, taxpayers also can earn “economic rents” or “inframarginal returns” – the supersized returns that come from a unique and exclusive market position or asset, such as a valuable patent or trade name.<sup>6</sup> Rental income from renting an undeveloped lot for use as a parking lot typically would represent a normal return on one’s capital; economic rents, by contrast, are jumbo returns that are not attributable simply to taking on large quanta of risk.

As in the companion Article, the phrase “capital income” here includes all returns to capital. Net business income after accounting for labor inputs is simply one important instance of capital income, not a separate type, and typically would comprise all of normal returns, ex-post returns to risk, and rents. I follow economists in using the word “profits” to mean returns over and above risk-adjusted ex ante normal returns.<sup>7</sup> This means that in ideal implementations the term encompasses only economic rents (again, when measured from an ex ante perspective).

Economists often equate capital (and therefore the measurement of returns to capital) with “real” assets employed in a business, by which they mean investments in tangible, greasy machinery, or buildings, or land, or even intangible assets like patents, trademarks, or goodwill, but *not* financial assets such as stocks and bonds. But at a more practical level, any income tax must address the fact that capital income is earned in respect of investments in both real assets and financial assets that, in the broadest sense, are indirect claims on those real assets.

Coordinating the taxation of returns to real and financial assets is one of the great challenges in designing an income tax on capital. For example, a corporate income tax reform proposal that does not consider the impact of the taxation of dividends and interest paid by the corporation to ultimate individual stakeholders, or the impact of capital gains realized on a sale or other disposition of an interest in a firm, fails ab initio in constructing a coherent business capital income tax. Therefore, throughout this paper, “capital” comprises both real and financial assets.

As briefly summarized in Part IV, and as is well known, the standard presentation in the literature is that the difference between a capital income tax and a profits tax (including a cash flow tax or a consumption tax) is that only the former burdens normal returns. The standard presentation concludes that both burden economic rents, and that neither burdens pure returns to risk. Because the Dual BEIT is intended to operate as a capital income tax, its success will be measured as a function of its ability to measure and tax normal returns accurately. As the next subsection suggests, in practice this is a low bar to clear.

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<sup>6</sup> Robert H. Wessel, *A Note on Economic Rent*, 57 *American Economic Review* 1221, 1223 (1967) (“The traditional rent concept also allows to divide, conceptually at least, factor compensation into two parts, payments which induce factors to work and surplus which only confers a greater reward for work which would have been done anyway.”).

<sup>7</sup> *E.g.*, Jennifer Gravelle, *Corporate Tax Incidence with Excess Profits* (unpublished manuscript).



2. *Capital and Labor Income Taxation in Practice*. There are only two important kinds of income: returns from labor and returns from capital. When tax law professors in the United States teach Tax 1, we like to discuss cases involving cash stuffed into a piano bought at a second-hand shop, or treasure trove, but these are not important contributors to economic output.

I submit that we know a good deal about how to tax labor income, and in general do a pretty good job of it. If we fail, we do so largely by choice. (The mischaracterization under U.S. law of “carried interest” as capital income is an obvious example.) But when it comes to taxing capital income, we perform very poorly. We are inconsistent in how we measure capital income, depending on the formal labels that different investments take, and we likewise are inconsistent in the tax rates we apply to that capital income that does come to our attention.

In brief, capital income taxation in the United States today is incoherent in both theory and application.<sup>8</sup> The United States taxes returns to capital at wildly varying rates, depending on such factors as accidents of history (the form in which a business might originally have been organized or capitalized), purely formal distinctions (the labeling of an investment as debt or equity), divergences between tax and economic depreciation, accidents in the timing of sales of financial or real assets, and the efficiency of the capital markets in matching tax-sensitive issuers with tax-indifferent investors, or vice versa. The U.S. system for taxing capital income is thus fundamentally rotten at its core: it can neither measure nor tax consistently the most straightforward returns to real or financial capital.<sup>9</sup>

Both the Congressional Budget Office<sup>10</sup> (CBO) and the U.S. Treasury Department<sup>11</sup> have closely studied how the United States taxes capital income in practice. For example, CBO (2005) found that the effective marginal *total* tax rate on corporate income — that is, the “all in” tax rate on a prospective marginal investment, *including* the aggregate tax burdens imposed on the interest, dividend income and capital gains of investors, taking into account their tax posture and

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<sup>8</sup> Kleinbard, *Rehabilitating the Business Income Tax*, (The Hamilton Project at the Brookings Institution, 2007); Kleinbard, “Designing an Income Tax on Capital,” chap. 4 in *Taxing Capital Income* (Washington, D.C.: Urban Institute Press, 2007).

<sup>9</sup> Interest income earned by a taxpaying investor is the great exception; those rules are largely rational in their measurement of this form of capital income – if inflation is set to one side.

<sup>10</sup> Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform* (October 2005); Congressional Budget Office, *Computing Effective Tax Rates on Capital Income* (Dec. 2006); CBO, *Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options* (Dec. 2014).

<sup>11</sup> U.S. Treasury, *Treasury Conference On Business Taxation and Global Competitiveness: Background Paper* (Jul. 2007), reprinted as “Business Taxation and Competitiveness,” 116 Tax Notes 399 (Jul. 30, 2007). The Treasury Department has repeated its analysis with more recent data, in *The President’s Framework for Business Tax Reform: An Update*, Joint Report by the White House and the Department of the Treasury (Apr. 2016), updating *The President’s Framework for Business Tax Reform*, Joint Report by the White House and the Department of the Treasury (Feb. 2012).

relative size — was around 26.3 percent, compared with a statutory marginal rate on corporate income alone of 35 percent. The effective marginal total tax rate on capital invested in *noncorporate* businesses was much lower — 20.6 percent. That difference alone points to a fundamental weakness of the current system, which is the differing tax burden the Code imposes on capital invested in different legal forms of business.<sup>12</sup> In 2014, another study by CBO came to broadly similar results, except that 2014 tax rates were somewhat higher across the board, so that the all-in corporate effective marginal tax rate for a firm with a typical capital structure was 31 percent, and that for unincorporated businesses 27 percent.<sup>13</sup>

Second, the CBO and Treasury analyses demonstrates that our current business tax system imposes wildly divergent burden on marginal investments depending on funding source (debt vs. equity) and asset class. Using just CBO (2005)'s figures, equity-funded corporate capital investments were taxed at a marginal effective total tax rate of 36.1 percent (higher than the statutory rate of 35 percent because of investor-level taxes), while debt financed investments faced a *negative* 6.4 percent rate — a 42.5 percentage point swing. (A negative marginal tax rate implies that the tax system actually subsidizes the cost of the investment.<sup>14</sup>) And there was a 12.3 percentage point difference between the effective total tax rate imposed on a marginal investment in the 25th percentile of asset classes (ranked in order of tax burden) and that imposed on the 75th percentile—that is, between the top and the bottom of the middle half of all assets. Again, CBO (2014)'s conclusions are broadly similar, as are those of the U.S. Treasury.

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<sup>12</sup> One can argue that many small businesses are unincorporated and that the rate difference noted in the text in turn reflects a congressional decision to tax small businesses more lightly. If that is the justification, it is a poorly directed incentive, as the tax benefits from adopting a noncorporate business structure are freely available to very large enterprises as well as small ones.

<sup>13</sup> Congressional Budget Office, *Taxing Capital Income: Effective Marginal Tax Rates Under 2014 and Selected Policy Options* (Dec. 2014).

<sup>14</sup> The 26.3 percent effective marginal total tax rate on corporate investments is the weighted average of those two rates, weighted by the CBO to reflect the relative amount of debt financing by American corporations (roughly 41.3 percent of the total capital invested in corporations). (CBO 2006 at 47.)

*The President's 2016 Framework Update* concluded that debt financed investment in equipment faced an effective marginal tax rate in 2011 of -60 percent. Presumably this extraordinary figure reflects the availability of 100 percent expensing (“bonus depreciation”) in that year. For comparison, the *The President's 2016 Framework Update* found that the effective marginal corporate tax rate on such an investment was -38.9 percent in 2015.

A negative effective marginal tax rate means that the after-tax rate of return exceeds the pretax rate. The driver of this outcome is that the marginal investment in question (typically, debt-financed property eligible for accelerated depreciation) generates a loss for tax purposes, which loss is presumed to be used to offset tax on a different equity-funded marginal investment by the taxpayer. Although the Treasury does not literally write out a check to a taxpayer in respect of an isolated marginal investment with a negative effective marginal tax rate, the result is the same, once a taxpayer is presumed to act rationally and to pair such an investment with an equity-funded one. CBO (2014), n. 30, p. 18.

And both studies concluded that returns to owner-occupied housing (the largest physical asset class) enjoy a negative tax rate environment.

The usual response is to suggest that the U.S. tax system today is a combination of comprehensive income and consumption tax themes, but this simply reduces to an observation that sometimes the United States taxes capital income (or some components thereof), and sometimes it does not. Moreover, the observation fails to capture the extraordinary variations in the burdens that the U.S. tax system imposes today on capital income, depending either on the nature of the real asset deployed in a business, or the other, more formal, characteristics mentioned above. Most fundamentally, the formulation says nothing useful about when capital income taxation should be turned off, and when turned on—and if turned on, at what effective marginal tax rate.

### C. Practical Obstacles to a Functioning Capital Income Tax.

Simply measuring capital income is famously difficult in theory, and nearly impossible in contemporary practice. To do so requires uprooting at least six deeply engrained practical hurdles in our tax system.

First, we must confront the realization doctrine. The realization doctrine in practice means that the taxation of capital gain is essentially optional on the part of the taxpayer. More generally, “deferral” (the consequence of reliance on the realization doctrine) directly undercuts the entire objective of capital income taxation: it effectively exempts from tax the compounding of simple interest returns on an investment held for a period of time.<sup>15</sup>

Second, we must deal with the debt-equity distinction, under which completely different income measurement tools apply to financial instruments that might be economically similar, but that give rise to different formal legal rights and obligations. The tax model treats stockholders as the indirect owners of all of a business enterprise, and creditors as simply temporary lessors of money. This simplistic model collapses under the weight of overwhelming contrary factors in the modern world. Today, it often is not possible to label one financial capital instrument as evidencing ownership of the underlying real assets of a business enterprise, and all other instruments as evidencing the temporary rental of money.

The International Monetary Fund, among others, has done important recent work demonstrating the systematic “debt bias” introduced by income tax systems that allow deductions for interest on debt obligations.<sup>16</sup> In light of the large amount of tax-exempt

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<sup>15</sup> Edward D. Kleinbard, “Capital and Labor Stuffing in the New Tax Rate Environment,” <http://ssrn.com/abstract=2239360>.

<sup>16</sup> IMF Fiscal Affairs Department, *Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy*, June 12, 2009; IMF Fiscal Affairs Department (Ruud A. de Mooij, author), *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, May 3, 2011.

institutional investment, and the ease with which financial engineers can package equity-type returns within an instrument treated as indebtedness for tax purposes, tax revenue collections suffer, normal returns escape taxation, and firms' capital structures become more fragile, as a result of their appetite for increased leverage.

Third, we must address the (non)coordination of firm and investor-level measures of the same real incomes. One very difficult challenge in designing an income tax system that properly measures capital income is to coordinate and allocate tax liabilities at these two different levels – the financial investor holding financial capital instruments, and the business enterprise investing in real assets and earning net business income – to advance the fundamental objective of imposing a single comprehensive and constant tax burden on returns to capital generally, and normal returns in particular. The current tax system fails utterly in this critical exercise.

Fourth, we must address our arbitrary tax depreciation and expense capitalization rules. This sounds excessively tedious, but depreciation and capitalization go to the heart of whether capital income, in the form of net business profits on firm income tax returns, is accurately measured. Systematically measuring and taxing these time-value returns is much more difficult than it appears. Much of the complexity of any business income tax stems from this fact; proposals that essentially assume away the issue (e.g. the U.S. Treasury's 1992 CBIT proposal<sup>17</sup>) thus evade the heart of the problem.

An income tax will properly measure and tax time-value-of-money (normal) returns on real assets only if two conditions are satisfied. First, the tax system must develop comprehensive rules to capitalize, rather than deduct, expenditures that create or enhance the value of a real asset (for example, expenditures to build a factory or to establish a brand name). This problem is pervasive in the current tax system, where, for example, all advertising expenses are currently deductible, even if they are incurred to develop a valuable brand name.

Fifth, accepting the conclusions of the companion article that capital and labor incomes should be taxed under the Dual BEIT at different rates, we face a new and important question: how do we distinguish the two? For example, an entrepreneurial chef decides to open a new restaurant. She invests her life's savings of \$500,000, and works there 16 hours a day, six days a week, taking out no salary. Five years later, the restaurant is a great success, due in part to her culinary skill. What fraction of the current annual profits is attributable to her labor contributions, and what to the capital she has invested? When a few years later she sells the restaurant, including its name and associated goodwill, how much of the gain attributable to those intangible assets is a return to capital, and how much to labor? The latter question is particularly fraught, because we know the answer under current law: the entirety of the chef's

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<sup>17</sup> *Report of The Department of the Treasury on Integration of The Individual and Corporate Tax Systems: Taxing Business Income Once* (Jan. 1992), Ch. 4. CBIT is discussed in Section II.D.

gain attributable to those self-created intangible assets constitutes long-term capital gain.<sup>18</sup> In this way, labor income of an owner-entrepreneur is systematically converted to capital income.

These points were particularly underappreciated, until the controversy surrounding the taxation of “carried interest” received by investment fund managers focused policy makers on the issue.<sup>19</sup> If capital and labor incomes are taxed on different schedules (which in fact we do today, sometimes), we need an administratively reliable means to distinguish labor from capital income in cases where the two are hopelessly intermingled.

The problem is pervasive in small businesses, where an owner-manager earns net business income attributable to the combination of her personal effort and the capital she puts at risk. So long as different tax rules are applied to labor income and capital income, this indissolubly intermingled income is likely to be characterized by taxpayers in whichever way minimizes their tax liabilities (currently, as capital income).

Finally, reimagining capital income taxation requires rejecting many deeply engrained modes of thought relating to the institutional foundations of our income tax. Even without regard to the five sets of problems already described, the tax burden imposed on different legal forms of conducting a business (for example, corporation versus partnership) is not constant, and there is no satisfactory economic explanation for the difference. This failing—the differing tax burdens imposed on different legal forms of doing business— is a paradigmatic example of a crucial bad habit of thought that is the source of much of what ails the U.S. business tax system.

Fundamentally, the tax code has always attempted to categorize all business activity into a few discrete cubbyholes, each with its own operative rules. These cubbyholes in turn are defined by recourse to intuitive understandings of the ideal types of each form of organization or each method of raising capital, based largely on nineteenth-century legal, accounting and social norms, not economic considerations. For example, the tax code observes that Entrepreneur A has organized her business as a partnership, whereas Entrepreneur B has formed a corporation. The tax code responds, “The tax model must respect each choice. Rules must be developed for taxing partnerships that reflect the nature of partnerships, and different rules must be developed for taxing corporations that reflect the different nature of corporations—after all, there must be a reason why each entrepreneur chose the form he or she did.” The end result is separate tax cubbyholes for “partnership” and “corporation.”

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<sup>18</sup> The former collapsible corporation rules (former section 341, repealed by the Jobs and Growth Tax Relief Reconciliation Act of 2003, repeal made permanent in 2013) stand as a lone counterexample, but probably would not apply to the mature business described in the text, and in any event the statute was repealed. It had a loose analogy in the partnership tax arena, in section 751’s rules relating to unrealized receivables, but again those rules would not reach the intangible assets described in the text.

<sup>19</sup> Victor Fleischer, “Two and Twenty: Taxing Partnership Profits in Private Equity Funds,” 83 NYU L. Rev. 1 (2008). The term “carried interest” refers to the shares of an investment partnership’s capital gains that are awarded to fund managers in return for their agreement to run the investment partnership; that is, carried interest represents a profits interest in the partnership disproportionate to capital interests.

The tax code then relies on outmoded norms, not economic insight, to develop the substantive tax rules applicable to each conceptual cubbyhole. The resulting rules reflect these antique viewpoints by assuming, for example, that partners are closely tied to one another through personal bonds, while their arrangements with each other lack institutional continuity. As a result, a partnership is not itself subject to tax, but instead is viewed as a simple pass-through vehicle.

Over the decades the tax code has extended this mode of thought without any reexamination of its premises. As a consequence, today the pass-through model applies even to well-capitalized limited liability companies, which, in their protection of investors from entity-level liabilities and in their governance structures, are indistinguishable from corporations. The net result is that a limited liability company with dozens or even hundreds of members (or for that matter a handful of corporate owners only) and a billion dollars of annual revenue is taxed under the same rules as are two partners operating the local dry cleaning establishment—and the local dry cleaning establishment, if it happened to organize itself as a corporation, is taxed as if it were Apple Inc.

The differing taxation of different forms of business enterprises is just one example. The same point can be made about most financial instruments, or the poor targeting of preferential capital gains tax rates, which turn out to have nothing to do with “double taxation” or the like. As one simple example of the latter, when interest rates decrease, the value of an outstanding bond increases, because the present value of the future interest receipts now exceeds the rate that borrowers need to pay. But when a taxpayer sells a U.S. Treasury bond held for more than one year at a profit attributable to just such a decline in rates, the gain is treated as long-term capital gain, notwithstanding that the gain reflects payments received today in lieu of future interest income.

This bad intellectual habit of building the tax system on the shoulders of outdated social and legal norms explains why the tax code is riddled with so many seemingly inconsistent rules for economically similar investments or transactions, and why Congress and tax administrators continue to compound these inconsistencies. This mode of thought alternatively bewilders and infuriates economists, because it has almost nothing to do with economic logic. Notwithstanding this frustration, the phenomenon is real and pervasive.

#### D. Criteria for Measuring the Success of a Capital Income Tax.

1. *An Annual Flat-Rate Tax.* *Capital Taxation in an Age of Inequality* recommends a capital income tax imposed at a flat rate disconnected from the rate structure for labor income, measured and collected annually. Section I.A. has quickly summarized some of the reasoning behind this recommendation, and as noted there, this Article begins by embracing this goal.

It is worthwhile to emphasize why political economy considerations counsel in favor of the annual taxation of capital income, rather than retrospective tax structures that can be designed to have the same present value, through the imposition of deemed interest charges in the calculation of tax due.<sup>20</sup> There are two reasons: one relates to the trustworthiness of individual taxpayers to recollect correctly how long they have owned securities (which in the case of public companies, but arguably not private ones, is susceptible to third party reporting), the other, which to me is the more fundamental, is simply that Congress has shown itself to be an untrustworthy guardian of deferred tax revenues. The 2004 repatriation tax holiday is the most obvious and egregious example; through that holiday, U.S. multinational firms had the opportunity to repatriate to the United States offshore low-taxed earnings at a nominal rate of 5.25 percent, and an effective rate near 3.5 percent – precisely one-tenth the tax rate that was the condition imposed for the deferral of tax in the first place.<sup>21</sup> The 2001-3 tax cuts on accrued but unrealized capital gains can be adduced as another, as can the one-year repeal of the estate tax, or the [one-year] suspension of any limitations on rolling tax-deferred retirement accounts into tax-paid Roth IRAs.

A retrospective tax whose measure includes an embedded interest charge compounds not only the putative tax bill, but also the likelihood of an escape hatch suddenly opening. Many members of Congress are unlikely to understand why a nominal tax rate of, say, 60 or 70 percent (or higher) is appropriate for gain derived from an asset held for many decades; indeed, many will argue for the opposite result, that the social payoffs to patient investing are sufficiently large as to justify lower rates than those imposed on assets held for just a year or two. In turn, the risk of a holiday from retrospective tax rates becomes even more acute when one imagines the question arising in a year like 2010, when the economy was in the depths of the Great Recession, and a one-time tax holiday could be spun as just the sort of economic stimulus that the country required.

2. *Applied Consistently and Comprehensively.* A business capital income tax should look past formalisms and apply consistent tax rates to all capital income, however earned. Normal returns, for example, should be taxed as such, regardless of whether labeled marginal returns to investment in a business asset, or interest income; capital income of unincorporated and corporate firms should bear the same tax burdens, and so on. This ambitious goal means that a successful business capital income tax system should make no distinctions based on the legal type of entity engaged in business, or in the different legal modes of expressing the rights and obligations of stakeholders and firms – that is, since debt and equity can often substitute for one

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<sup>20</sup> Alan J. Auerbach, “Retrospective Capital Gains Taxation,” 81 *American Economic Review* 167 (1991). Cf. James Kwack, “Reducing Inequality With a Retrospective Tax on Capital,” 25 *Cornell J. of Law and Policy* 191 (2015).

<sup>21</sup> Edward D. Kleinbard and Patrick Driessen, “A Revenue Estimate Case Study: The Repatriation Holiday Revisited,” 120 *Tax Notes* 1191 (Sep. 22, 1998).

another in a firm's capital structure, the tax system should not yield different burdens depending on which is chosen, and instead capital structures should reflect non-tax market considerations.

Because firms and investors are separate juridical persons, all this requires some sort of effective business-investor tax integration strategy, so that normal returns, returns to risk and rents are each taxed consistently when looking holistically at aggregate outcomes, regardless again of the legal form of the relationships or the juridical person (firm or investor) recognizing the income. This does not, however, require a formal corporate dividend imputation or similar scheme; indeed, many such structures either are insufficiently ambitious, and leave in situ a debt bias, or distinctions between corporate and noncorporate forms of business organization, or reach too far, and claw back business tax incentives in one context that might be available in the other.<sup>22</sup>

3. *A Feasible Labor-Capital Income Centrifuge.* Like any dual income tax,<sup>23</sup> in which capital income is taxed under a different schedule from labor income, the Dual BEIT depends entirely on what I term a labor-capital income tax centrifuge – a mechanism to tease apart net business income, particularly in the context of an owner-manager of a closely-held business, into its constituent labor and capital income components. Part III of this Article proposes such a mechanism. To the extent it is adjudged a hopeless failure, so too does the Dual BEIT as currently conceived fail.

A dual income tax accentuates the difficulties in distinguishing capital from labor income in appropriate cases, but the issue of course is present in current law, chiefly by virtue of the preferential tax rates afforded capital gains. The issue has largely been ignored, as the earlier example of the chef who sells her restaurant for a price that reflects self-developed goodwill and tradename value was intended to illustrate. The Dual BEIT at least attempts to address the issue head-on.

4. *A Featureless Tax Topography.*<sup>24</sup> Every peak or canyon in the topography of tax institution design is problematic: it either invites gaming up to the border between one set of rules and another, or it leads to substantially different results for economically similar situations. Congress often seeks to grasp perfection, by refining rules for smaller and smaller subsets of affected taxpayers, and in doing so is the enemy of the good, because the end result is excessive complexity, unintended consequences from the intersection of those complex rules, and

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<sup>22</sup> Edward D. Kleinbard, "The Trojan Horse of Corporate Integration," 152 Tax Notes 957 (Aug. 15, 2016).

<sup>23</sup> Edward D. Kleinbard, "An American Dual Income Tax: Nordic Precedents," 5 Nw. J.L. & Soc. Pol'y 41 (2010).

<sup>24</sup> I proposed this terminology in Kleinbard, "Designing an Income Tax on Capital," chap. 4 in TAXING CAPITAL INCOME (Washington, D.C.: Urban Institute Press, 2007).



excessively enthusiastic tax gaming. The issue is not simply one of tax preferences: fundamental conceptual cubbyholes of current law, like the distinction between debt and equity, are the source of endless gaming, revenue loss, and economic distortions.

The proposals made here, by contrast, draw sharp distinctions in outcomes as sparingly as possible. The author is confident that Congress can and will respond to the resulting rough justice with ever more reified rules, but there is no tax system that is immune to this institutional instinct. The best that can be done is to start with a tax design that relies on as few major distinctions as possible, to deny the legislature footholds from which to erect ever more complex superstructures.

Examples of the sort of sharp dividing lines that would prove troublesome in practice include proposals that apply different tax systems to public and private firms.<sup>25</sup> Section I.E., below, considers briefly reform proposals to tax investors in public firms on a mark-to-market basis. These proposals of necessity adopt a completely different scheme for non-public firms, and in doing so create the potential for distortions at least as great as those attributable today to the debt-equity distinction. The growth in private equity firms and similar alternative funding sources means that it is not inevitable that a private firm become publicly-listed as the business grows; rounds of private investor funding can replace the public capital markets, thereby offering successful new firms low cost options to choose whichever tax regime is to their advantage.

5. *Resistant to Base Meddling.* A capital income tax system should be as resistant as possible to Congressional interventions and accretions. No tax legislation can be wholly immune to Congressional enthusiasms for tweaks, refinements and exceptions, but experience argues for a simple system, even at the expense of perfection. It further argues in particular for a system that obviates the importance of depreciation and capitalization, either through expensing or (as in the Dual BEIT) an expensing-equivalent deduction. Proposals like the Comprehensive Business Income Tax (CBIT), as suggested by the U.S. Treasury many years ago,<sup>26</sup> discussed in Section I.E., below, rely entirely on a firm's business income tax base being correctly specified to accomplish their economic objectives of imposing a uniform tax on capital income. But this requires not only the adoption of economic depreciation models, but also comprehensive expense

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<sup>25</sup> See, e.g., Mark P. Gergen, "How to Tax Capital," (Feb. 2016) (unpublished manuscript, forthcoming, Tax L. Rev.); Eric Toder and Alan D. Viard, "Replacing Corporate Tax Revenues With A Mark To Market Tax On Shareholder Income," 69 Nat'l Tax J. 701 (2016). Gergen's thoughtful article reviews much of the recent tax law and policy literature. Gergen recommends a periodic wealth tax on ownership interests in public firms; Toder and Viard are closer to the many proposals that have been made over the years for mark-to-market income taxation on the values of interests in public firms. Each in turn of necessity proposes a complementary tax regime for privately-held firms. In Gergen's case, for example, that complementary scheme is expressly modeled on the BEIT.

<sup>26</sup> *Report of The Department of the Treasury on Integration of The Individual and Corporate Tax Systems: Taxing Business Income Once* (Jan. 1992), Ch. 4.

capitalization rules. Even the best intentioned of Congresses over the years has found it impossible to resist the call of accelerated depreciation, and no Congress has been fully committed to comprehensive expense capitalization, as the kerfluffle surrounding Chairman Dave Camp's proposal to capitalize some advertising expenses demonstrates.

6. Extensible to All Financial Instruments. A successful capital income tax regime must incorporate rules that achieve the regime's overall objectives, taking into account the great variety of instruments representing claims against firms that are available in the capital markets, the ingenuity of those markets in tailoring new instruments to arbitrage tax rules, and the presence of exchange traded and private financial derivative contracts that can replicate virtually any conceivable capital markets instrument cash flow.

7. Minimal Recordkeeping and Coordination Requirements. A practical capital income tax system must be administrable when deployed to millions of taxpayers. This argues that the system should keep to a minimum investor-level recordkeeping requirements – particularly requirements that might stretch over many years. Current law suffers from this in respect of tax basis in an investment, which is essentially irrelevant to most investors unless and until the time comes to sell that investment. Relatively recent basis reporting requirements for some publicly-traded securities – fiercely resisted by the securities industries, and implemented only over a painfully slow transition period – point to how information technology can help here, but the smaller the requirements to retain information of no immediate application, the better. Further, a tax regime should require minimal direct coordination between firms and investors: readers are familiar with the nuisance and the anxiety that comes from trying to retain all the IRS Form 1099s that arrive in one's mailbox at different times. Again technology could help – that is the intuition behind the Ready Return initiative, which would send taxpayers prepopulated draft tax returns containing information currently provided to the Internal Revenue Service by third parties – but third party information, however communicated, sometimes is wrong or must be amended, to the great confusion and consternation of investors.

For example, pass-through models of business capital income taxation suffer acutely from information coordination problems, because it is impossible to allocate the income of firms to their investors in real time, yet stocks can be bought and resold in milliseconds. Similarly, dividend imputation corporate integration schemes must have in place rules to address subsequent adjustments in corporate tax liability after imputation credits have been awarded, to handle investors who receive dividends and sell their stock before year end, and so on. And retrospective taxation puts a premium on the verification of the term of an investor's ownership, not just her gross sales proceeds.

To be clear, none of these issues is insurmountable, particularly in light of the power of information technology. But proponents of arrangements that pose these sorts of issues must

specify their resolution at a level of detail that permits the evaluation of what these information collection or coordination requirements actually would entail in practice, and what tax avoidance or arbitrage opportunities they might present.

8. *Clear Constitutional and Treaty Compliance.* Fundamental capital income tax reform is a heavy lift, to borrow an inside the Beltway phrase. Despite bipartisan interest in corporate tax reform in particular, neither house of Congress has passed legislation that might fit this description in recent memory. Given the political reality that capital income tax reform is likely to remain a once a generation effort, it is important that any proposal rest on firm Constitutional footings. This calls into question in particular annual wealth taxes and the like, because they probably run afoul of Constitutional characterization as “direct” taxes that require apportionment among the states, thereby rendering them impossible to implement.<sup>27</sup> At a minimum, it is incumbent on proponents of plans that raise a Constitutional issue to offer a cogent defense, so that policymakers can judge whether the political costs of voting for major legislation with losers as well as winners is worthwhile.

Further, although more controversially, it is highly desirable that any major capital income tax reform effort be compliant with the many multilateral trade treaties to which the United States is a party, under the auspices of the World Trade Organization. Bilateral tax treaties are amended all the time, but the WTO’s networks of trade treaties are revised at a pace that makes the Congress of the United States look nimble by comparison. The WTO treaties are the foundation of the global economy’s open markets, from which the United States has gained much, and contain enforcement mechanisms that have been applied in the past. The United States found to its chagrin in the Domestic International Sales Corporation and Foreign Sales Corporation cases that the WTO can interpret its treaties in ways that directly reject U.S. domestic tax legislation, and in doing so impose fines on the United States, in the form of authorizing the imposition of compensatory tariffs by other countries – in the FSC case, \$4 billion of such penalties.<sup>28</sup> Again, proponents willing to run this risk have an obligation to lay out a legal defense of their proposals, and a workable scenario for what should happen should the United States lose the case.

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<sup>27</sup> See Capital Taxation in an Age of Inequality, Section \_\_\_.

<sup>28</sup> The history is briefly summarized in David L. Brumbaugh, “Export Tax Benefits and the WTO: Foreign Sales Corporations and the Extraterritorial Replacement Provisions,” Cong. Res. Serv. Report RS20746 (Apr. 2007).

## II. DUAL BEIT MECHANICS – KEY FEATURES.

### A. High Level Overview.

*Capital Taxation in an Age of Inequality* develops the case for why a flat-rate tax on capital income is an attractive policy instrument. The Dual BEIT is the proposed mechanism for implementing such a tax.<sup>29</sup> The analysis begins with the fundamental observation that the difference between a capital income tax and a profits-only tax is that the former burdens normal returns, while the latter by design exempts them. How can we systematically tax ex ante risk-adjusted normal returns, while preserving neutrality in the taxation of profits, in a world of small firms and big ones, private and public, partnerships and corporations, debt financing and equity funding?

The Dual BEIT answers this challenge by imposing a profits-only tax on firms, and a corresponding tax on the normal returns of investors. The two together sum up to a single tax on capital income, because from an ex ante perspective, capital income comprises only risk-adjusted normal returns and rents.

As explained below, the Dual BEIT employs a capital account allowance to create a profits tax base for a firm's business income.<sup>30</sup> I use the term "Cost of Capital Allowance" (COCA) to describe the Dual BEIT's firm-level capital account allowance.<sup>31</sup>

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<sup>29</sup> I first presented the "Business Enterprise Income Tax" and "Cost of Capital Allowance" ideas in 2007; their embryonic form dates back to 1989. Edward D. Kleinbard, *Rehabilitating The Business Income Tax* (The Hamilton Project, The Brookings Institution, Discussion Paper 2007-09, 2007); Edward D. Kleinbard, "Designing an Income Tax on Capital," in *TAXING CAPITAL INCOME* 165, 179 (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle eds., 2007); Edward Kleinbard, *Beyond Good and Evil Debt (And Debt Hedges): A Cost of Capital Allowance System*, 67 *TAXES* 943 (1989). The details of the Dual BEIT as summarized in this paper supersede those presented in these earlier contributions.

For readers familiar with the earlier papers, the major developments include:

- The adoption of the dual income tax structure, in which capital income and labor income are taxed under two different rate schedules. As suggested above, this has important theoretical and practical implications.
- To implement the dual income tax structure, the development of a novel "labor-capital income centrifuge" to tease apart the two kinds of income when they are intermingled, as in the case of the owner-entrepreneur of a closely held firm.
- The explicit adoption of a consistent flat rate capital income tax rate on all forms of business capital income. This is consistent in practice with distributional concerns and preserve neutrality in the taxation of risky investments.
- A more complete articulation of a theory for taxing the international income of multinational enterprises, and its instantiation in the Dual BEIT.
- The abandonment of a second-level tax on extraordinary capital gains (itself the product of a misguided intuition as to the political climate at the time it was suggested).

<sup>30</sup> "Capital Account Allowance" is the terminology used, for example, in ROBIN BOADWAY & JEAN-FRANCOIS TREMBLAY, *CORPORATE TAX REFORM: ISSUES AND PROSPECTS FOR CANADA* (Mowat Centre for Policy Innovation,

Unlike a standalone profits tax, however, the Dual BEIT is designed as a true income tax. The missing piece that must be added to economic profits (rents) to turn a profits-only tax into an income tax – basically, normal returns – is accomplished by requiring *investors* in business enterprises to include the same COCA rate, applied this time to their unrecovered investments in business firms, in income every year. This is the unique feature of the Dual BEIT: a profits-only tax at the firm level combined with a correlative tax only on normal returns at the investor level equals an income tax on capital income.

The “dual” part of the Dual BEIT name reflects the proposal’s debt to Nordic dual income taxes.<sup>32</sup> Their fundamental insight was that there is no economic or policy reason to assume that an ideal income tax would burden labor income and capital income under the identical rate schedule; in turn the Nordics developed administratively plausible mechanisms for separating capital from labor income in difficult cases. The “Business Enterprise Income Tax,” or BEIT part, is the mechanism I developed to introduce a feasible system for taxing capital income in a comprehensive and consistent manner. The “dual” component relates to rates, and to identifying capital income when it is intermingled with labor income; the “BEIT” component is the mechanism for defining and measuring the annual capital income base.

Dual income tax systems are income taxes that explicitly reject the ideal of a single rate of tax on all income from whatever source derived, and instead adopt a two-pronged schedular design that imposes different rates on capital income, on the one hand, and all other income (principally, labor income), on the other.<sup>33</sup> In its simplest form, a dual income tax adopts a relatively low flat rate of tax on capital income, and progressive rates on labor income, where the highest labor income rate is materially greater than the flat capital income rate, but other rate structures are possible.

Norway has been the leader in designing dual income taxes; over the years, it has implemented different systems that alternatively have taxed all capital income at one flat rate, or

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School of Public Policy and Governance, University of Toronto, Mowat Research No. 88, 2012). Other authors use synonymous terms, like “allowance for corporate capital.” For reasons of consistency with my prior work, I use “Cost of Capital Allowance” (COCA).

<sup>31</sup> Edward D. Kleinbard, *Beyond Good and Evil Debt (And Debt Hedges): A Cost of Capital Allowance System*, 67 TAXES 943 (1989). As summarized in note 31 and more generally in the text of this Article, the actual proposal made there has been superseded by subsequent work.

<sup>32</sup> For the different iterations of Nordic dual income taxes, see Edward D. Kleinbard, “An American Dual Income Tax: Nordic Precedents,” 5 *Northwestern J. of Law and Social Policy* 41 (2010). Part III briefly summarizes some of that paper’s findings.

<sup>33</sup> Wolfgang Eggert and Bernd Genser, *Dual Income Taxation in EU Member Countries* (CESifo DICE, January 2005), 43 (“The [dual income tax] is a schedular tax regime which divides total income into capital and labour income and regards them as different tax bases.”). In practice, a dual income tax can be implemented in such a manner that there is no risk of some unspecified type of income failing to be taxed under either schedule.

that more recently have taxed normal returns at a low rate while endeavoring to tax economic rents at basically the top rate on labor income.<sup>34</sup>

A dual income tax, in which capital income is taxed on a different and lower rate schedule from the top rate on labor income, brings squarely to the front the necessity of developing a new tax tool, a “labor-capital income centrifuge,” to tease apart labor and capital income when they are commingled in the hands of the small business owner-entrepreneur (or other cases). The Nordic countries experimented with different designs to accomplish this. Part III explores this important issue in more detail.

Dual income tax systems by themselves do not assure that capital income is measured accurately. That is, other than in the one area of segregating capital from labor income, dual income tax systems by themselves do not define the capital income base. That is the purpose of the BEIT part of things.

The BEIT mechanism is designed to tax at the firm level the economic profits (rents) and net ex-post returns to pure risk taking earned by business enterprises, and normal returns to capital at the investor level.<sup>35</sup> This means that all the components of capital income are taxed once, and only once. It is this allocation of returns (normal returns only to investors; profits to firms) and the consistent use of the same capital account allowance type mechanism to accomplish both these results that are the novel contributions of the BEIT mechanism.

The BEIT part of the Dual BEIT has only a handful of new components, built on top of existing income tax concepts. This should mitigate transition issues, reduce price dislocations for existing real and financial capital assets, and make the proposal tractable for policymakers.

The BEIT mechanism has two irreducible parts. First, it adopts a firm-level profits-only tax through a capital account allowance mechanism, and applies that mechanism to all business enterprises (other than micro-firms).

A “cash-flow tax” is one instance of a profits tax, because a well-designed one does not burden normal returns. An ideal firm-level cash-flow tax looks very much like an income tax, except that firms are permitted an immediate deduction for any business investments that they make, and must include in income all returns in respect of that investment, including the return of the original amount invested.<sup>36</sup>

A cash-flow tax is, however, only one available mechanism to implement a profits tax while still preserving income tax-like optics (in particular, annual tax returns that look to receipts and expenses to determine a tax base). Another approach to designing a profits tax base for firms

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<sup>34</sup> Edward D. Kleinbard, “An American Dual Income Tax: Nordic Precedents,” 5 *Northwestern J. of Law and Social Policy* 41 (2010).

<sup>35</sup> This can also be phrased as taxing ex ante risk-adjusted normal returns to investors, and profits to firms.

<sup>36</sup> See Part IV.

is to introduce a new tax deduction that is designed explicitly to exempt a normal return from tax.<sup>37</sup> Under the standard interpretation of the components of capital income, a deduction that offsets a firm's normal returns from invested capital leaves only profits (rents) in the tax base, because under the standard interpretation, pure returns to risk, in the form of capital-free bets, are taxed neither by an income nor a profits tax.

These cash-flow equivalent forms of profits taxes rely on a "capital account allowance," "allowance for corporate equity" ("ACE"), or the like, to exempt a firm's ex ante risk adjusted normal returns from tax.<sup>38</sup> An allowance for corporate equity, for example, does so by combining a firm's deduction of its actual interest expense, plus a notional deduction for a deemed normal return on the firm's equity capital.

The ACE in particular is not simply an academic daydream. Several countries have adopted ACE regimes as their corporate tax regimes.<sup>39</sup> And in October 2016, the European

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<sup>37</sup> David F. Bradford, *THE X TAX IN THE WORLD ECONOMY: GOING GLOBAL WITH A SIMPLE, PROGRESSIVE TAX* (2004), 26-30

<sup>38</sup> The term "Allowance for Corporate Equity" (ACE) was proposed by the Institute for Fiscal Studies in 1991, and Michael Devereux and Harold Freeman. Institute for Fiscal Studies, *Equity for Companies: A Corporation Tax for the 1990s* (1991); Michael P. Devereux and Harold Freeman, "A General Neutral Profits Tax," *Fiscal Studies* 12, no. 3 (1991): 1-15.

For more recent general overviews of ACE regimes, see Geerten M.M. Michielse, Ruud de Mooij & Charlotte Van Peteghem, "Allowances for Corporate Equity," *TAX DESIGN ISSUES WORLDWIDE* (2015) ch. 4; Alexander Klemm, *Allowances for Corporate Equity in Practice* (Int'l Monetary Fund, Working Paper No. WP/06/259, November 2006);

The BEIT and ACE (or comparable) systems have different agendas. ACE was conceived as an alternative mechanism for implementing a *profits-only* tax: corporations would receive a tax deduction equal to a notional cost of equity, calculated in a manner similar to the COCA deduction (applied, however, to "shareholders' funds," not all assets), and continue to deduct actual interest expense. Distributions to shareholders would in some fashion be exempt from tax; like the Treasury Department's CBIT proposal (discussed in Section II.D.) the proponents of ACE became a bit vague when discussing how preference items would be handled, and capital gains taxed. ACE proposals were not intended to advance the taxation of financial derivatives at all. Like COCA, however, ACE deductions for notional capital charges corrected for errors in company-level depreciation practices. Devereux and Freeman, "A General Neutral Profits Tax," 5.

Unlike both CBIT and COCA, ACE applied only to corporations and retained a distinction between debt and equity: actual interest expense on the former would be deductible, while notional capital charges could be deducted in respect of the latter. The limitation of ACE to one class of business entities and the preservation of the debt-equity distinction seem to be fundamental weaknesses of the proposal.

<sup>39</sup> Croatia was the first to implement a full ACE regime from 1994 to 2000 with a notional deduction for a deemed normal return on the firm's equity capital. Austria had a partial ACE regime from 2000 to 2004, taxing at a reduced rate notional return on new equity capital. Italy also implemented a regime similar to Austria's, in which notional return on new equity capital was taxed at a lower rate whereas profits were taxed at a higher rate. Since 2006, Belgium has used a full ACE regime with a deductible notional rate of return applied to a firm's equity, where the notional return is set at a 10-year government bond rate, measured as of two years previous to the year in question. The history and impact of the Belgian ACE system is reviewed in Jozef Konings, Cathy Lecocq, Bruno Merlevede, and Robrecht Vandendriessche, *The Role of an Allowance for Corporate Equity for the Capital Structure and Employment in Multinational Enterprises: An evaluation of the Notional Interest Deduction in Belgium*, KU Leuven

Commission announced that it would re-launch its “Common Consolidated Corporate Tax Base” (CCTB) initiative, this time incorporating an ACE.<sup>40</sup> The CCTB initiative is designed to create a uniform tax *base* for all large European companies: each Member State will then set its own tax *rates* to be applied to corporate income attributable to such country under the principles of the CCTB. The draft CCTB statute introduces a new “Allowance for Growth and Investment,” which appears to operate as an ACE applicable to net new equity (that is, increases in a firm’s equity after the effective date of the CCTB regime). The ACE rate will be the European Central Bank’s benchmark 10-year bond, plus 2 percent (or 2 percent, if the benchmark bond’s yield is negative).<sup>41</sup>

The capital account allowance implemented in the Dual BEIT dispenses with a deduction for interest, rent or royalty expenses, and instead provides a single tax deduction for all of a firm’s invested capital, whether financed through debt or equity. I use the term “Cost of Capital Allowance” (COCA) to describe the Dual BEIT’s firm-level capital account allowance. The Cost of Capital Allowance is a deduction equal to a statutorily-set rate (as an arbitrary example, 1-year Treasury Bills plus 300 basis points<sup>42</sup>) applied to all of a firm’s business capital, whether actually financed by debt or equity.<sup>43</sup>

Allowance for corporate equity (ACE) regimes afford a firm a notional deduction in respect of their equity financing, while continuing to permit a deduction for actual interest expense. Unlike ACE systems, the BEIT offers the same deduction (the COCA) regardless of whether real assets are financed with debt or equity, or for that matter whether assets are leased, licensed or owned.<sup>44</sup> The BEIT thus removes the temptation to issue equity-flavored debt

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VIVES Center (Jul. 2016). Since 1996, Brazil has used a partial ACE regime where notional interest is deductible when paid out to shareholders.

<sup>40</sup> The press release and associated texts may be accessed at: [https://ec.europa.eu/taxation\\_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en).

<sup>41</sup> European Commission, *Proposal for a Council Directive on a Common Corporate Tax Base*, COM(2016) 685, (Oct. 25, 2016), Article 11, available at [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/com\\_2016\\_685\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_685_en.pdf).

<sup>42</sup> The reasons why the COCA rate should be a risk-adjusted normal return, rather than a risk-free normal return, are discussed in Part IV. It is worth noting here, however, that this is consistent with the European Commission’s proposal just described in the text.

<sup>43</sup> EDWARD D. KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX 11-14 (The Hamilton Project, The Brookings Institution, Discussion Paper 2007-09, 2007); Edward D. Kleinbard, *Designing an Income Tax on Capital*, in TAXING CAPITAL INCOME 165, 180-89 (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle eds., 2007). See n. 34, *supra*, as to the continuing relevance of these.

<sup>44</sup> Michael P. Devereux, “Issues in the Design of Taxes on Corporate Profit,”<sup>65</sup> *National Tax J.* 709 (2012, and Edward D. Kleinbard, *Rehabilitating The Business Income Tax* (The Hamilton Project, The Brookings Institution, Discussion Paper 2007-09, 2007) specify some of the difficulties inherent in constructing an ACE to replicate the economics of a cash flow tax.



instruments, which still remains in ACE systems where the “interest” rate on the hybrid instrument exceeds the ACE allowance. It also prevents domestic base erosion through intercompany royalty streams within a foreign-domiciled multinational group.

A capital account allowance implementation of a profits tax further has the advantage over cash flow taxes of easier transitions from current law (because existing investment in assets – i.e., tax basis – at the time of transition does not become useless in the new regime), and because they are less susceptible to windfall gains and losses through the timing of investments as tax rates change.<sup>45</sup>

At the firm level, then, the Dual BEIT looks superficially much like the current income tax. The Dual BEIT taxes all business operations identically, by taxing all enterprises, regardless of legal form, as taxpaying entities, and subject to the same rules. The COCA deduction replaces a deduction for interest, rent or royalty expenses, and, because it applies to the entirety of a firm’s business capital, renders moot for tax purposes the firm’s capital structure or mode of obtaining control over real assets.<sup>46</sup> A business enterprise continues to claim depreciation deductions, but because those deductions reduce the firm’s capital, the Dual BEIT also renders moot the depreciation schedule chosen: at any moment in time, the present value of future depreciation deductions in respect of an asset and future COCA deductions in respect of that asset sum to the same figure.

*Capital Taxation in an Age of Inequality* and this paper assume that current law will continue to measure the amount of an investor’s non-business interest income, which in turn will be taxed at the same flat capital income tax rate as is applied to investor-level business capital income. Thus, interest income from Treasury securities would be measured under current law. The Internal Revenue Code in fact does a very credible job of applying original issue discount principles consistently to such securities. All other instances of capital income (rents or royalties, for example) would be deemed to arise in the conduct of a business.

The Dual BEIT would apply to all business enterprises, without regard to their legal form. In the United States in particular, with its profusion of unincorporated businesses, taxing all firms as entities is necessary to define the tax base consistently across different forms of business organization that compete directly with one another.<sup>47</sup> As described in Section II.C.,

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<sup>45</sup> David Bradford, Christian Keuschnigg & Martin D. Dietz, *A Growth Oriented Dual Income Tax*, 14 Int’l Tax & Pub. Fin. 191, 197 (2007); David F. Bradford, THE X TAX IN THE WORLD ECONOMY: GOING GLOBAL WITH A SIMPLE, PROGRESSIVE TAX, American Enterprise Inst. (2004) at 28-30; David Bradford, *Transition to and Tax-Rate Flexibility in a Cash-Flow-Type Tax*, in Tax Policy and the Economy (1998); David F. Bradford, FUNDAMENTAL ISSUES IN CONSUMPTION TAXATION, American Enterprise Inst. (1996) at 36.

<sup>46</sup> EDWARD D. KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX 17 (The Hamilton Project, The Brookings Institution, Discussion Paper 2007-09, 2007); Edward D. Kleinbard, *Designing an Income Tax on Capital*, in TAXING CAPITAL INCOME 165, 180 (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle eds., 2007). See n. 34, *supra*, as to the continuing relevance of these.

<sup>47</sup> The importance of this foundation is described in Edward D. Kleinbard, *Rehabilitating The Business Income Tax* (The Hamilton Project, The Brookings Institution, Discussion Paper 2007-09, 2007); Edward D. Kleinbard,

below, it also is extremely attractive as a matter of political economy, because firm managers will operate under a profits-only (i.e., consumption) tax regime, thereby responding to their perennial pleas for a more “competitive” business tax system. Moreover, a profits tax environment permits radical simplification of otherwise esoteric corners of the law, like tax-free business combinations.

The second irreducible feature of the Dual BEIT is its taxation of the normal returns to business capital investment at the investor level. Unlike a pure profits tax whose base carries through to investors (so that their normal returns also are exempt from tax), the BEIT imposes at an investor level a tax on normal returns (and no other returns), measured only by the investor’s tax basis (cost) in her financial assets multiplied by the same COCA rate used by firms to exclude normal returns from tax at their level. The investor tax on normal returns restores the combination of the two levels of income tax (firm and investor) to a single income tax on capital (which by definition burdens normal returns as well as profits). The investor side of the BEIT accomplishes de facto integration and a single level of tax on normal returns, imposed on the least mobile class of capital owners.

More specifically, investors include in income annually an amount equal to the same COCA rate multiplied by *their* adjusted tax basis in their investments (the “Includible Amount”). (The recent Dutch “box tax” on financial assets is comparable.) Includible Amounts function much like original issue discount under current U.S. tax law: the investor’s tax basis goes up by the amount of her Includible Amount, and down in respect of cash received on her investment (e.g., dividends or interest). Cash returns thus are relevant only insofar as they affect an investor’s remaining tax basis in her investment. Sales or any other disposition of investments (including by gift or bequest) have no immediate tax consequence, but the new owner of the investment (whether by purchase, gift or bequest) would take a purchase price/fair market value basis in the investment, from which the new owner’s Includible Amounts would be calculated in future periods.

Ideally, tax-exempt institutions would fall under the Includible Amounts investor tax regime just described. I recognize, however, that this is not a probable practical outcome. To the extent such institutions remain tax exempt, one can nonetheless take comfort in the fact that the effective tax rate on firms’ leveraged investments in equipment, where the leverage is provided by tax exempts, will have been brought up from negative tax rates (i.e., circumstances where after tax returns exceed pretax returns) to zero, and debt-financed assets yielding economic rents will face a positive tax liability, rather than zero.

Under the BEIT, an investor’s deemed normal return is includible in taxable income regardless of whether it is received in cash; more generally, the BEIT *ignores* actual cash flows on financial investments, except to use them as adjustments to basis (cost). Obviously an income

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“Designing an Income Tax on Capital,” in TAXING CAPITAL INCOME 165, 179 (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle eds., 2007). Exceptions would be made for genuinely micro-scale businesses.

inclusion equal to a specified interest rate applied to a financial asset, which in turn is taxed at a specified tax rate, could be reduced to a simple annual wealth tax on that asset, but to deal with U.S. constitutional constraints on direct wealth taxation, the BEIT rejects that framing and further permits a loss deduction on sale equal to any prior income inclusions not ultimately received in cash. This last feature is required to address U.S. constitutional concerns, as explained in the companion article. Beyond that, however, the concept of capital gains or losses disappears.

The firm-level profits tax rate and the investor tax rate on deemed normal returns in general would be the same annual flat rate (e.g., 25 percent). Labor income would be taxed on a progressive schedule whose top rate was substantially higher (e.g. 40 or 45 percent). This decision introduces the need for the labor-capital income centrifuge described in Part III.

Allowances would be made for small businesses (through graduated tax rates and higher capital account allowances), and investor retirement plans (subject to a lifetime cap of, for example, \$1 million). If desired, genuinely micro-scaled businesses with a handful of investors could be taxed in the same manner as S corporations are today.

The BEIT mechanism measures returns to capital consistently, no matter the form of the business organization through which they are earned, or the label of the financial instrument through which an investor holds her claim. It also automatically coordinates investor and firm income, in a manner that is parsimonious with regard to the information that the two must share. And the BEIT does not rely on administratively unreasonable mechanisms, like aligning tax depreciation with economic depreciation, taxing investors in some firms but not others on a “pass-through” basis, or relying on mark-to-market taxation of investors in public but not privately-held firms. The BEIT thus contemplates a relatively featureless tax topography, rather than one pockmarked by distinctive peaks and rifts, in the form of bright line distinctions between different modes of calculating the tax base (e.g., public vs. privately-held firms).

At the same time, the BEIT mechanism by itself is largely agnostic about tax rates. The concept originally was conceived primarily as a vehicle for the accurate measurement of capital income, and it can be adjusted to tax normal returns, on the one hand, and rents and risky returns, on the other, at the same or different rates, which rates in turn can be the same as or different from those applied to labor income. Dual income tax principles and the BEIT thus are complementary. The Dual income tax offers a device for accurately teasing apart labor and capital income in those cases where they otherwise form an indissoluble matrix, and a theoretical hook from which to hang a reasoned view of the appropriate tax burden on all capital income. The BEIT picks up from there, and ensures that all capital income is taxed once, and only once, through its consistent and comprehensive design of the tax base.

As just outlined, the Dual BEIT’s basic operation is quite straightforward, although its implementation in specific settings (such as cross-border investment) necessarily requires additional explication. To make the presentation tractable, Sections II.B. and C. assume away some of these incremental issues, in order to present in a bit more detail the application of the

Dual BEIT to a publicly-held industrial firm with entirely domestic operations and investors. By ignoring the problem of the mixed income of an owner-entrepreneur in a privately-held firm, I can defer until Part III a discussion of the Dual BEIT's mechanism for teasing apart labor and capital income in such circumstances. Part IV then considers in detail the specification of the Dual BEIT's Cost of Capital Allowance. Getting the COCA rate a bit wrong is not fatal to the tax system as a whole, in the sense that it would still function to a first approximation as a capital income tax, but the efficiency of the system does require that the Cost of Capital Allowance be reasonably accurate. Parts V and VI extend the analysis to cross-border income and to special industries and circumstances.

## B. Firm-Level Computations.

1. *In General.* Under the Dual BEIT, a "business enterprise" (which term encompasses both corporations and unincorporated businesses) deducts each year its Cost of Capital Allowance – an annual allowance for the financial capital invested in it, measured at a specified rate multiplied by the issuer's total capital. The COCA allowance replaces current law's deductions for interest, rent and royalty expenses, and is available regardless of whether any amount is distributed to investors. No further deductions are available to the issuer even if payments to investors exceed the annual COCA rate. As a result, any extraordinary returns (returns above the COCA rate) are taxed at the business enterprise level.

Because the COCA deduction is not tied to actual payments to investors, or to any particular mode of financing a business, issuers no longer will face a tax imperative to employ as much debt financing as possible or to issue complex financial instruments designed to give issuers tax-deductible interest expense in respect of contingent returns. Instead, issuers will minimize the *economic* cost of their financial capital, secure in the knowledge that there is no tax component to that calculation.

The annual COCA rate is set by statute at a formula rate that varies with 1-year government debt rates, plus a spread, designed to approximate a typical firm's overall cost of capital.<sup>48</sup> For the reasons developed in Part IV of this Article, the COCA rate should not be a riskless rate of return, but rather one that reflects an average risk-adjusted return. Special concessionary rates would apply to the smallest firms, which accords with the fact that their cost of capital is higher than that of more established ones.

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<sup>48</sup> Part IV explains why I believe that a risk-free government bond rate without a spread is not the right rate to use. For the moment, however, consider that the ACE, a widely studied form of profits-only tax, and one that actually has been implemented by several countries, essentially reaches the same result I do, as an ACE provides an allowance for capital comprising the sum of a firm's actual interest expense plus an additional allowance in respect of equity capital.

Since balance sheets in fact balance, the total tax-cognizable investment in a business enterprise (the right-hand side of a tax balance sheet) must equal the total tax basis of the issuer's assets (the left-hand side). As a result, the annual COCA deduction is calculated in practice as the statutory COCA rate multiplied by the issuer's total adjusted tax basis in its assets.

Real assets that today are depreciable (or amortizable) would remain so under the COCA system. Since the effect of depreciation is to reduce asset basis, a business enterprise's COCA deductions would decrease as it depreciates its nonfinancial assets. Thus, the COCA deduction is in addition to, not in place of, asset depreciation.<sup>49</sup>

2. Coordination between COCA and Asset Depreciation Rules. The COCA system operates alongside, not in place of, standard asset depreciation rules. An issuer's COCA deductions interact in interesting ways with the issuer's deductions for asset depreciation.

Because a business enterprise's aggregate asset basis is used to calculate the COCA deduction, the COCA system effectively mitigates distortions attributable to too fast or too slow depreciation, to yield a neutral tax base. This is a well-known result in public finance literature,<sup>50</sup> but worth explaining in a little more detail for a wider audience.

Consider two extremes. In the first, an issuer that deducts rather than capitalizes an expenditure forfeits any COCA deduction with respect to the capital invested. In the second, an issuer that treats that same cost as a nondepreciable capital expenditure receives a COCA deduction in perpetuity. The net result of this self-correcting mechanism is that the present value of the sum of a business enterprise's COCA and depreciation deductions will remain a constant percentage of the enterprise's capital (measured as historic cost), *regardless* of the depreciation and capitalization rules the business employs.<sup>51</sup> This is precisely the result desired: exemption of a normal rate of return from tax at the business enterprise level, and inclusion of a normal return on investment at the investor level.

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<sup>49</sup> A holder of a financial capital instrument that itself is a business enterprise (other than financial institutions, which are subject to special rules summarized below) would be treated like any other investor in respect of that asset, and therefore would be required to follow the income inclusion rules described below, including recognizing in income each year the Includible Amount on that financial capital instrument (that is, the business enterprise's tax basis in that instrument multiplied by the COCA rate). At the same time, financial capital instruments owned by a business enterprise constitute part of that enterprise's asset base and therefore would also enter into a business enterprise's COCA expense calculations. A business enterprise would obtain a COCA *deduction* for its tax basis in a portfolio investment and would include in income from that investment its Includible Amount equal to the same amount. The net result is that there would be no tax at the business enterprise level on interfirm investments.

<sup>50</sup> David F. Bradford, *THE X TAX IN THE WORLD ECONOMY: GOING GLOBAL WITH A SIMPLE, PROGRESSIVE TAX*, American Enterprise Inst. (2004), at 28-30; Robin Boadway and Neil Bruce, "A General Proposition on the Design of a Neutral Business Tax," 24 *J. of Pub. Econ.* 231 (1984).

<sup>51</sup> Bradford, *supra* n. 50, argues that economic theory requires that basis for this purpose be measured by the current market value of an asset; that might be right, but is more than can be expected from a practical tax system, particularly one so deeply imbued with century-old accounting norms as its perspective on income definition and measurement.

This observation in turn leads to a question: why not retain the COCA concept to measure normal returns to investors but dispense with it at the business enterprise level? If the result is equivalent, why not disallow all deductions on financial capital instruments and permit issuers to expense all investments as they are made?

There are several good reasons not to do so. First, as the late David Bradford pointed out, a COCA/depreciation system has the advantage over a simple asset expensing rule of mitigating the effects of changes in tax rates, because unlike expensing, the value to an issuer of the “tax receivable” it holds (the stream of future COCA deductions) depends on future tax rates.

Second, the Dual BEIT’s combination of deductions for depreciation and financial capital can roughly be analogized to the current law’s deductions for depreciation and interest expense. I believe that presenting the BEIT as building on well understood tax concepts is helpful as a political economy matter.<sup>52</sup> Finally, if the COCA rate diverges from the normal rate of return, the COCA/depreciation system resembles more closely the status quo of relative tax burdens across different industries than does an expensing solution.

3. *The Dual BEIT’s Asset Sales Rules; Superconsolidation; Business Losses.* Because the COCA system operates to make the business enterprise tax base a neutral profits tax, sales of assets by one firm to another have the same consequences on a present value basis as if every sale were a tax-free carryover basis event. This means that the tax system no longer operates as an impediment to efficient firm dispositions of assets.

For this reason, the BEIT mechanism repeals all “tax-free reorganization” (merger) rules and the like. As a result, corporate mergers, as well as acquisitions of control of the stock of one firm by another, are treated as a sale of all of the target firm’s assets, and a realization event to investors. Because the deemed asset sales have no present value tax cost to firms, and because investors have no tax liability beyond their Includible Amounts, the only net economic effect of these rules is to “reset the clock” on investors’ tax bases in their financial interests.<sup>53</sup>

For example, imagine a business enterprise that holds a depreciable asset with a tax basis of zero and a value of \$100, which firm sells that asset to Buyer for \$100, incurring \$25 of tax on the sale. Seller’s \$25 tax liability represents the present value of Buyer’s future tax savings from depreciating its \$100 tax basis for the asset. As a result, Seller and Buyer will be in the same aggregate after-tax position as if the asset were transferred tax-free (in this case with a zero basis) to Buyer. Unlike tax-free incorporations and reorganizations under current law, however, the BEIT system does not duplicate gain (or loss). Buyer has invested \$100 for an asset with a

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<sup>52</sup> Conversely, there might be merit in exploring a simple expensing rule within BEIT/COCA for small businesses because administrative and systems considerations are more important for small companies than for large firms.

<sup>53</sup> See in Edward D. Kleinbard, *Rehabilitating The Business Income Tax*, The Hamilton Project, The Brookings Institution, Discussion Paper 2007-09 (2007).

tax basis of \$100 (as would be true of any other investment), and Seller does not take a carryover basis in any asset or security Buyer issues.

After its \$25 tax charge, Seller now holds \$75 in cash, where before it held an asset with a value of \$100 and a tax basis of zero. If one imagines Seller now borrowing \$25 and buying a new \$100 asset, the present value of its future COCA deductions will equal \$25, effectively reimbursing Seller for the cash tax it laid out at the time of sale. As this example implies, however, the COCA rate must be commensurate with firms' borrowing rates rather than risk free rates for the system to be neutral in application.

Because the Dual BEIT is a neutral profits tax at the enterprise level, the Dual BEIT not only can dispense with tax-free reorganization rules, but also with consolidated tax return intercompany transaction and similar rules, because there no longer is any meaning to the concept of tracking different tax attributes of different corporations within the umbrella of a common parent. Instead, every group of enterprises with a common parent can be viewed as a single agglomeration of assets, just as is done in financial accounting today. I refer to this as “superconsolidation,” to contrast it to the impenetrable hodgepodge of rules governing consolidated tax returns today. Nonpractitioners will find it difficult to grasp just how much complexity is swept away in the immediately preceding sentences.

The Dual BEIT also contemplates that a business enterprise's net operating losses would compound each year at the COCA rate. This rule preserves economic neutrality in the timing of income and loss recognition where a loss produces only a nonrefundable net operating loss carryover. If a firm were to liquidate (for example, through bankruptcy) with an unused balance of net operating losses, theory would dictate that those losses be refunded, but practical experience suggests that this is a highly improbable outcome for a legislature to endorse. It appears to subsidize foolish investments as opposed to sensible risky ones, and it would incentivize firms at the cusp of bankruptcy to throw in the towel to claim their refund. These are the sorts of imperfections that one must accept as the price of descending from the Olympian heights of academia to actual policy recommendations.

### C. Investor Taxation of Normal Returns.

1. *Income Inclusions.* The Dual BEIT requires all investors in business enterprises – including (in an ideal world, at least) tax-exempt institutions – to include each year in ordinary income an “Includible Amount,” which equals each investor's tax basis in its investments in business enterprises multiplied by the COCA rate for that year. This is designed of course to represent a deemed normal return on investments in business enterprises.

Under the Dual BEIT, Includible Amounts generally are taxed currently at flat capital income rates (in the running example in this paper, 25 percent), regardless of the amount

received in cash. If those Includible Amounts are not received, the accrued but unpaid amount is added to a taxpayer's basis in its investment and compounded at the COCA/Includible Amount rate each year. This is essentially identical to how original issue discount operates today.

An investor's starting tax basis in an investment is her purchase price, or, in the case of a transfer by gift or bequest, the instrument's fair market value. Cash distributions are treated simply as reductions in an investor's tax basis in her investments. Cash distributions in excess of basis are not themselves taxed, but if those cash distributions are invested in new investments, the new investments will attract Includible Amounts. The result is similar to existing U.S. tax rules for original issue discount debt instruments: the investor includes in income  $\text{Yield} \times \text{Investment}$  (where yield here is the COCA rate), and treats cash flows as returns of previously taxed yield or principal.

The concept of capital gains no longer would be relevant, as the capital income tax rate applied to the Investor's Includible Amount constitutes the full extent of the investor's tax liability. The Dual BEIT of course can accommodate exceptions for retirement savings (up to a lifetime cap of, say, \$1 million), and graduated tax rates for those taxpayers whose labor income is taxed below the capital income flat rate.

The Dual BEIT places the taxation of normal returns on investors for three reasons. First, an important intuition undergirding the proposal is that financial capital instruments turn over more rapidly than do noninventory real assets. As a result, investors' tax bases in their financial capital instruments should reflect more closely economic measures of income than do business enterprises' bases in their real assets. Second, investors do not have tax preferences, like accelerated depreciation, that are reflected in investors' bases in their investment assets. Third, as discussed in Part V, moving the taxation of normal returns to the investor level has helpful political economy knock-on effects in an international context.

Holders of financial capital instruments calculate their Includible Amounts by reference to the tax basis in the instruments they own. As a result, the aggregate of investors' Includible Amounts will *not* equal the sum of issuers' COCA deductions, and generally will exceed those deductions, for two reasons. First, the intuition here is that market trading in securities is likely to lead to more realization events at the investor level than will corresponding sales by business enterprises of noninventory real assets. (Remember here as well that under the Dual BEIT all realization events are recognition events, so that an investor's basis is reset to market value, while firms have zero present value tax consequences.) Second, current law effectively permits business enterprises to deduct the cost of developing many intangibles; these immediate deductions reduce an enterprise's aggregate tax basis in its assets but not the actual economic capital invested in the enterprise (which presumptively would be reflected in market prices for the enterprise's securities).

The COCA system applicable to holders requires no special recordkeeping by the issuer or information from prior holders. In particular, calculations are personal to each investor; Includible Amount accounts do not carry over from a prior third-party investor from which the



current investor purchased that security, or alternatively received the security as a gift or bequest. In the first case, the new owner begins with her purchase price as her basis for measuring her Includible Amounts; in the second, the donee or recipient of a bequest takes a fair market value starting basis. In practice there should be little difference, particularly in the case of public companies.

The COCA system applicable to holders admittedly requires some modest recordkeeping by each holder, but that recordkeeping would be mathematically straightforward and, because it would be reflected on each year's tax return, can be kept up to date by an individual investor simply referring to her prior year's return. Modern tax preparation software will make this even easier, again because all the requisite information is personal to the taxpayer. As a result, investors would not find themselves in the common predicament today of trying to reconstruct the basis of stock received as a Christmas present forty years earlier.

A simple example is desirable here. Imagine that Investor pays \$1,000 on January 1 to acquire an Issuer security (which might be denominated as debt, or stock, or an exotic hybrid – it does not matter which). Assume for simplicity that the COCA rate is six percent in every year. Issuer immediately purchases an asset that is depreciated on a five-year straight-line basis. Issuer's COCA deductions each year will equal the sum of the tax bases of all its assets. Assuming for this example a simple rule that looks only to asset basis at the start of the year, Issuer's COCA deduction for this asset will equal \$60 in year one, \$48 in year two,<sup>54</sup> and so on. (Issuer also will obtain a COCA deduction for any asset basis attributable to any net cash the asset generates and Issuer retains.) At the end of five years, Issuer's tax basis in the asset will be zero, and Issuer will no longer obtain any COCA deductions.

Investor, meanwhile, continues to own his Issuer security. Each year, Investor takes into ordinary income a six percent yield on his tax basis in his financial capital instrument. If Issuer happens to distribute exactly \$60 a year to Investor in respect of that security, Investor will include that \$60 a year in income – not because \$60 represents the cash received, but because Investor's tax basis in the asset remains constant (it goes up by \$60 in Includible Amounts, and down by \$60 in respect of cash distributions). If Issuer distributes nothing, Investor will include \$60 in year 1, \$64 in year two (six percent of \$1,060 tax basis), and so on. If Issuer makes no current cash distribution and Investor sells the security at the end of year one for \$1,200, Investor pockets the cash without further tax. New Investor will now recognize \$72 of minimum inclusion income in her first year of ownership ( $\$1,200 \times 6\%$ ). Issuer's COCA deductions continue unaffected.

One important source of inefficiency in current capital income tax design is the “lock-in” problem experienced by investors, in which an investor with substantial unrealized appreciation in respect of an investment continues to hold that investment to avoid triggering capital gains tax liability, when she would prefer to sell it. (The problem of course is compounded in the United

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<sup>54</sup> Six percent multiplied by the asset's opening of the year tax basis of \$800. In practice, the Dual BEIT would employ conventions to average tax basis over the course of a year.

States by the fact that capital gains tax is forgiven in respect of the unrealized appreciation on assets held at death.)

In one sense, the Dual BEIT eliminates the lock-in phenomenon, because the Dual BEIT simply does not impose any investor tax beyond that on Includible Amounts. As a result, the decision whether to hold an investment or to sell it and finance consumption with the proceeds is unaffected by tax considerations. In another sense, however, the Dual BEIT retains an unwanted lock-in incentive problem. Here, it is not the capital gains as such, but rather the fact that if one investment is sold at a gain to purchase another investment, the new investment will have a higher tax basis than will the old one, and therefore will attract greater Includible Amounts.

The Dual BEIT thus does not wholly eliminate the lock-in problem, but it does ameliorate it in several respects. First, the fact that Includible Amounts are added to basis and compound means that the gap between the market value and tax basis of an investment security will tend to converge over time (albeit very slowly in some cases). Second, the Dual BEIT is designed to trigger investor-level realization events as often as possible (as when one business enterprise merges with another). The hope is that in this way the incentive problem will not be hugely problematic.

The Dual BEIT serves as a comprehensive income tax on capital invested in business enterprises, whether domestic or foreign. As such, its intended scope does not reach interest income earned from non-business borrowers – in particular, the U.S. Treasury. Part VI returns to this, but the expectation is that current law would continue to apply to such debt instruments, but income therefrom would be taxed at the same flat capital income rate applicable to the BEIT (in the running example in this Article, 25 percent).

2. *The Special Problem of Investor Losses.* As developed in *Capital Taxation in an Age of Inequality*, the U.S. Constitution presents a special issue for investor-level taxation. It is likely that even today an annual wealth tax, even if limited to a taxpayer's business investments, would be viewed as a "direct" tax (in the constitutional sense) requiring apportionment among the states, which is impossible (because it would impose different tax rates on residents of different states, depending on their relative wealth). And in turn, an annual "income" tax that takes the form of a simple deemed return on investment is at risk of being characterized as an impermissible stealth form of direct tax on property.<sup>55</sup>

The only response is to permit an investor who sells an investment at a loss, relative to the investor's adjusted tax basis, to claim a loss deduction (at the capital income tax rate), up to the amount of prior Includible Amounts. Losses beyond this amount (losses of principal) would

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<sup>55</sup> *Pollock v. Farmers Loan & Trust Co.*, 158 U.S. 601 (1895), *vacating* 157 U.S. 429 (1895). For all the criticism leveled at the case, it has never been overruled, and the facts here, where the income in question is completely notional in its measurement, surely would be at risk.

be ignored, just as capital gains are ignored. Current law's wash sale rules would be retained, but beyond this restraint, the loss deduction (adjusted to reflect the allowable tax rate) effectively could offset current year labor income. Administratively, the loss allowance could be implemented as a 25 percent tax credit, and made refundable or eligible for carryback/carryover.

This loss allowance rule should be sufficient to distinguish the Dual BEIT from a wealth tax, where diminutions in value never trigger rebates of prior taxes on the property's former higher value. It also can be justified as a normative matter, because the imputed return mechanism of Includible Amounts is meant to serve as an administrable approximation of the normal returns that an investor expects to earn; where the expectation is definitively unmet, then reversing the prior inclusions can be argued to be appropriate.<sup>56</sup>

The extent of any economic distortions attendant on this rule would depend to a significant extent on the tax treatment of a firm's bankruptcy. If for example on the bankruptcy of a firm its net operating loss carryovers were to disappear, then the investor loss allowance rule would be easier to justify.

#### D. Competing Solutions.

Because capital income taxation long ago fell out of academic favor, at least in U.S. law schools, relatively little work was done for several decades in rethinking how we might better define the capital income tax base.<sup>57</sup> In recent years, however, several broad capital income tax reform proposals have been offered, and corporate income tax reform ideas (particularly in respect of the taxation of the returns to U.S. corporations' foreign direct investment) are a hardy perennial. Those ideas that are focused on flows rather than stocks (that is, income rather than wealth taxes) typically run into one of three impediments: they rely on measuring accurately normal returns to real capital, they rely on devices (such as "mark-to-market" taxation of publicly-traded financial assets) where information is imperfect, and where the resulting system introduces sharp divisions between different modes of taxation applicable to different taxpayers that compete directly in the marketplace, or they are so incompletely specified that their administrability is untestable. This section I.E. briefly signals why I believe the Dual BEIT to be a more attractive policy instrument; the companion article also touches on these issues.

1. Wealth and Bequest Taxes. An ideal capital income tax can be viewed as approximating an indirect form of annual wealth tax. The intuition is simply that wealth when

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<sup>56</sup> If the reason for the investor-level loss is that the business enterprise has incurred losses, then it is true that the firm will have a net operating loss at the same time that the investor has a loss on sale of her interest in the firm, but that is not a doubling of the loss: the latter reduces the sum of firm and investor income back to zero, and the former records losses from the starting point of original capital invested in the enterprise.

<sup>57</sup> Daniel N. Shaviro, *Decoding the Corporate Income Tax*, is a principal exception.

invested ordinarily should yield normal returns (again, which means risk-adjusted normal returns), and a tax on normal returns therefore can, through appropriate rate-setting, approximate a tax on the wealth itself.

There does not appear to be any practical advantage, however, to implementing a wealth tax over an income tax on normal returns, given government's great difficulty in directly observing or valuing wealth (stock) rather than income (flows) in the hands of savers. As a political economy matter, taxing flows always has the advantage of resolving taxpayers' cash flow difficulties (although admittedly the Dual BEIT runs afoul of this observation). And in the United States, a national direct wealth tax probably would violate the U.S. Constitution: indeed, the Supreme Court case that struck down the late 19<sup>th</sup> Century federal income tax did so precisely on the basis that a capital income tax was an indirect means of taxing capital, which Congress could not do directly.<sup>58</sup> (The companion paper discusses this in more detail.) For all these reasons, there appears to be little reason to pursue annual taxes framed as wealth taxes in preference to annual capital income taxes.<sup>59</sup>

In theory, one fairly could compare potential economic efficiency gains from taxing bequests rather than lifetime capital income, but in practice, in the United States at least, "death taxes" are even more politically fraught than are lifetime capital income taxes. What is more, bequest taxation is susceptible both to outright evasion (the Van Gogh that mysteriously disappears while the owner is on his deathbed) and to complex avoidance strategies that are at least as difficult to address as is capital income taxation. Moreover, in the United States broad-based bequest taxation essentially would function as a brand new tax, in that only about 5,000 federal estate tax returns are filed annually.<sup>60</sup> This raises difficult economic efficiency transition issues (because long-term assets held at the time of introduction ultimately will be subject to both income and broad-based bequest taxation), beyond the politically charged question of broad-based "death taxes."

Finally, an estate tax operates as an ex post excise tax, and therefore the tax rate that must be imposed will always be substantially higher than that necessary to raise equivalent revenues through a periodic income tax. And as with any tax that allows the deferral of an individual's

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<sup>58</sup> *Pollock v. Farmers Loan & Trust Co.*, 158 U.S. 601 (1895), *vacating* 157 U.S. 429 (1895). The decision has been vigorously criticized from the day it was handed down; the best response to the Supreme Court would have been that framing matters, particularly when dealing with terms that have no real substantive meaning in economics. The particular issue was resolved through a constitutional amendment authorizing a federal income tax.

<sup>59</sup> Mark P. Gergen, "How to Tax Capital," (Feb. 2016) (unpublished manuscript, forthcoming, *Tax L. Rev.*) argues for a periodic wealth tax measured as a fraction of the mark-to-market value of investments in publicly traded firms. Gergen, however, does not expressly engage with the constitutional issue. Gergen also must then propose a complementary tax for privately held firms. He does so by adopting the BEIT for these cases, a move with which this author surely cannot disagree, given the circumstances Gergen has placed himself in by accepting a radical difference in tax regimes between public and private firms.

<sup>60</sup> I acknowledge of course that this number is kept artificially low by aggressive tax planning, which in turn incurs real deadweight loss.

contingent tax liability for many decades, a bequest tax is susceptible to swings in political perspectives, putting at risk accruals of wealth under prior law. As more fully developed in *Capital Taxation in an Age of Inequality*, bequest taxation thus serves as a useful adjunct to annual income taxation, but the income tax is better equipped to handle the bulk of the load.

2. *Pass-Through Models*. One cluster of capital income tax proposals argues that directly taxing financial capital instruments is a waste of time: why not instead simply apportion business income in some fashion to all stakeholders, in accordance with their relative claims? This is a “pass-through” approach to taxing business capital income.

A pass-through model of taxing business income retains all the problems of current law’s income mismeasurement attributable to the realization principle at the entity level. The pass-through model simply distributes that mismeasured income to investors. In this model, enterprise-level real asset depreciation reasserts itself as the means by which time-value returns are taxed, because it determines in part the aggregate taxable income to be divided. As a result, the pass-through model will tax normal returns accurately only if that model adopts economically perfect capitalization and depreciation rules for purchased and self-created tangible and intangible assets. Decades of experience with the political and administrative process have demonstrated the fragility of that assumption, as well as the administrative difficulties in distinguishing annual expenses from capitalizable costs of self-developed intangibles.

Further, in the United States the taxation of publicly-traded partnerships provides administrative experience with this approach. That experience teaches us that full pass-through models are extraordinarily complex to implement, largely because of the difficulties of relating income realization at the entity level (where income from the business first is determined) to realization events at the investor level, through secondary market trading in those partnership interests. When ownership interests are traded in time spans of a few seconds, or less, the pass-through model breaks down completely. Many firms do not have systems to generate income figures on a daily basis, if that were the relevant time period to be allocated. “Hot potato” rules that allocate the income of a firm to the investor owning its stock at an appointed day or hour invite tax arbitrage. These are very difficult problems to resolve, as can be seen in the taxation of publicly-traded master limited partnerships today, but would of course be greatly exacerbated if extended to all publicly-traded securities.

3. *Entity-Driven Tax Models*. Some of the leading capital income tax reform ideas that have been proposed, such as the “Comprehensive Business Income Tax” (CBIT), proposed by the U.S. Treasury Department in 1992, assume away the actual problem, by postulating that the tax base (e.g., business net income) is accurately measured, and presenting the issue as one simply of coordination between firms and investors. CBIT, for example, was a proposal to tax all the components of capital income, including normal returns, at the business enterprise level, and

(implicitly, because this side was never fully specified) to exempt normal returns at the investor level.<sup>61</sup> To accomplish this, CBIT would disallow all interest expense deductions, and would offer no allowance for corporate capital beyond (ideally, economic) depreciation.

In a helpful comparison of CBIT to ACE systems (and by implication, profits taxes more generally), Ruud de Mooij and Michael Devereux summarized the consensus public finance view of the relative merits of the two as follows:

Among the two, economists typically favour ACE. This system grants equity holders a certain allowance equal to a notional risk-free return. This is attractive as it reduces the effective marginal tax rate to zero, implying that ACE is a tax on economic rent. As such, it does not distort decisions about the scale of investment, though even a tax on economic rent can affect discrete investment choices that depend on an effective average tax rate. A potential disadvantage of ACE is that its narrower tax base reduces corporate tax revenue, and thus requires higher tax rates to yield the same revenue.

By contrast, CBIT disallows the exemption of interest. It turns the corporate income tax into a broad-based tax on capital at the level of the firm. This raises the overall cost of capital so that investment declines. The broadening of the base under CBIT will raise corporate tax revenue and, if revenue is to be maintained, allows for a lower corporate tax rate. A lower rate will typically not be sufficient to prevent a rise in the effective marginal tax rate, which is why CBIT has not gained the same popularity as ACE.<sup>62</sup>

Nonetheless, de Mooij and Devereux went on to argue that profit shifting by multinational firms in particular muddies the analysis, because it is highly responsive to statutory rates. The two therefore conclude that “it is attractive for individual countries to broaden their tax base and cut the rate, as under CBIT, as opposed to narrowing the tax base and raising the rate, as under ACE.”<sup>63</sup>

I submit that the Dual BEIT allows Messrs. de Mooij and Devereux, and all the rest of us, to eat their cake and have it too. The Dual BEIT can generally narrow the enterprise-level base without raising the rate – indeed, the current U.S. corporate system is so porous that the proposal here is to narrow the base and reduce the rate – because the imposition of a worldwide superconsolidation base responds to the system’s most egregious source of hemorrhaging, and because the imposition of a consistent tax on normal returns that actually is collected annually makes up any enterprise-level shortfall.

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<sup>61</sup> *Report of The Department of The Treasury on Integration of The Individual and Corporate Tax Systems: Taxing Business Income Once* (Jan. 1992), Ch. 4.

<sup>62</sup> Ruud A. de Mooij and Michael P. Devereux, “An Applied Analysis of ACE and CBIT Reforms in the EU,” 18 *Int’l. Tax Pub. Fin.* 93, 94 (2011).

<sup>63</sup> *Id.*

CBIT would have achieved its objectives only by getting what today is the corporate income tax exactly "right" – that is, to allow businesses a deduction only for economic depreciation, which is notoriously difficult to measure, and impossible to maintain as a political matter. It would also require much subtler approaches to the capitalization of expenditures than has ever been the case in U.S. business taxation.<sup>64</sup> Recognizing CBIT's limitations, its proponents argued for a magical "compensatory tax" scheme that would undo the imperfections in whatever business enterprise tax system Congress adopted, so as to produce, in the end, the same result as would be obtained under an ideal enterprise tax system in the first place.<sup>65</sup> But such a magical compensatory tax would not eliminate the time value benefit of compounding within a firm, and more directly begs the question, if the magical compensatory tax were so easy to design and adopt, why would the firm level tax be defective in the first place?

What is more, by taxing normal returns at the firm level, CBIT makes its extension to international investment more fraught, by virtue of the mobility of capital within a multinational firm. Modern thinking points in the opposite direction, to tax normal returns at the investor level, both because those returns are easier to measure there and because individual investors are less mobile than is the capital of firms.<sup>66</sup> The Dual BEIT reflects this modern thinking.

In a related vein, CBIT is a very unfavorable tax environment from a corporate manager's perspective, because it pushes the combined taxation of investors and firms down to the firm level. The political economy claims of an "uncompetitive" corporate tax system would be redoubled when compared with a firm profits tax. This point in turn is exacerbated still further when one looks at a firm through the lens of U.S. Generally Accepted Accounting Principles, because the firm's tax expense line would now include tax that today is imposed at the individual level. While this would be true of U.S. competitors as well, it would not necessarily be true for firms keeping their financial records under International Financial Reporting Standards.

Recently, the majority staff of the Senate Finance Committee has worked on a "corporate integration" tax proposal based on a dividends-paid deduction. I have written extensively

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<sup>64</sup> If tax depreciation perfectly tracked economic depreciation, and tax law could perfectly distinguish expenses that relate to the current period from expenses that should be capitalized, a business enterprise could simply use that depreciation to measure normal returns at the entity level. CBIT would then be an attractive avenue to explore for administrability reasons; under that alternative, the issuer would obtain *only* a depreciation deduction in respect of the capital deployed in its business, and investors would receive returns out of tax-paid earnings free of additional tax.

<sup>65</sup> The CBIT's compensatory tax was completely unspecified, in keeping with its *deus ex machina* character -- leaving unanswered the question of how such a system could be fairly and practically applied across the broad spectrum of business enterprises. (There was also the not insignificant problem that the CBIT never addressed of how capital gains fit into the picture.) One might just as well have begun the CBIT presentation by writing, "Assume an ideal enterprise-level income tax. . . ."

<sup>66</sup> Harry Grubert and Rosanne Altshuler, "Shifting the Burden of Taxation from the Corporate to the Personal Level and Getting the Corporate Rate Down to 15 Percent," 69 Nat'l Tax J. 643 (2016).

elsewhere about this proposal, and need not repeat that analysis here.<sup>67</sup> Briefly, however, I summarized my understanding of the project as follows:

In reality, a dividends paid form of corporate integration would create more problems than it solves. It would not necessarily create parity between corporations and passthrough forms of business organizations regarding business tax preferences and incentives. It also by its terms would not create parity between distributed and retained earnings or between debt and equity. By the time optional bolt-on modules were added to deal with those important issues, the dividends paid proposal would increasingly resemble a Rube Goldberg construction, dominated both in theory and in elegance of implementation by any of several clean-sheet comprehensive capital income tax reform ideas. The withholding tax that is central to the plan might violate U.S. tax treaties regarding dividends paid to foreign investors, and would certainly violate tax treaties if it is extended to interest payments (as some proponents wish).<sup>68</sup>

In the present context, it is important to recognize that corporate integration proposals, whether implemented through a dividends-paid deduction or a shareholder imputation credit, suffer from the same problem as does CBIT of starting from a real tax base that is likely to be highly imperfect, when viewed through normative capital income tax metrics. Integration models, like pass-through or entity-driven tax models, cannot measure capital income accurately without imagining a legislature with an uncanny ability and willingness to enact depreciation and capitalization rules that perfectly mirror economic reality. Compensatory taxes are exercises in magical thinking, or cumbersome ways of doing what could be done more directly through fundamentally different approaches.

4. *Mark-to-Market Models*. Another approach to a comprehensive solution is to tax returns to capital solely at the investor level, by requiring investors to value all their financial assets at the end of the year and tax those gains not already realized.<sup>69</sup> Under this “mark-to-market” approach, business enterprises would not be taxed, because their economic income would be incorporated into prices, and thereby recognized currently by investors. Nearly every such proposal limits its reach to publicly traded instruments, which creates sharp dichotomies with private enterprises (and does not answer how capital income should be taxed in the second case). This sharp division into two separate regimes would introduce new instabilities into the tax code – new mountains and valleys in the tax topography – at least as troublesome as current

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<sup>67</sup> Edward D. Kleinbard, “The Trojan Horse of Corporate Integration,” 152 Tax Notes 957 (Aug. 15, 2016). Michael J. Graetz and Alvin C. Warren Jr. took a more positive view in “Integration of Corporate and Shareholder Taxes,” \_\_\_ Nat’l Tax. J. \_\_\_ (2016). The Trojan Horse of Corporate Integration considers the Graetz and Warren analysis.

<sup>68</sup> Id. at 958-59.

<sup>69</sup> Capital Taxation in an Age of Inequality at \_\_\_ briefly summarizes the recent proposals of Mark Gergen (a mark-to-market wealth tax) and Eric Toder and Alan Viard (a mark-to-market income tax)



law's debt-equity distinction, as the next few paragraphs illustrate. Administrative solutions should point in the opposite direction – to have as flat a tax topography as possible, to minimize taxpayer gaming opportunities to shoehorn themselves into whichever result minimizes their tax liabilities.

The intuition driving mark-to-market proposals is plain enough: the public trading of a firm's securities provides new information not available when examining a privately-held firm. This information in turn can be put to work to measure annual income more precisely, typically through a mark-to-market ("accruals," in the language of economists) regime, and it seems a pity to throw this information away by ignoring it. But practical realities are far more complex.

A firm might be public in a technical sense, but the market for its securities might be so thinly traded, or the proportion of the firm's stock that is in the public float so small, as to call into question the accuracy of the prices of trades in those securities as a proxy for the value the firm as a whole. For that matter, it must be remembered that there is a fundamental tension between mark-to-market valuations, on the one hand, and the annual tax accounting period, on the other. A mark-to-market valuation looks not only to changes in future projected cash flows or income, but also to the discount rate to apply to those projections. The resulting valuation is real enough, of course, and does represent an accession to or diminution of wealth from one period to another (if the markets in question are a close enough proxy for the valuation of the firm as a whole), but almost by definition the magnitude of year to year fluctuations in mark-to-market valuations will be far greater than changes in annual cash flows from the prior period to the current one.<sup>70</sup> This in turn puts tremendous stress on how to handle tax losses to produce economically consistent outcomes (e.g. through immediate refunds), particularly in a period when government revenues might be far lower, and "automatic stabilizer" spending like unemployment insurance far higher, than in normal circumstances – just as happened in the Great Recession.

If the public firm regime is more attractive than a private one, firms will accelerate plans to go public with a small floatation, and capital markets will be overrun by the tax-induced corporate living dead – firms that are public in only the most nominal of senses. If, as is more likely, the private firm environment is more congenial, then one must appreciate how radically the corporate finance environment has changed in recent years, through the proliferation of endless "rounds" of equity financing from private equity funds and other institutional investors. If the tax stakes are sufficiently high, the reasons that firms like Facebook go public – which are not to secure necessary equity financing, but rather to have a more attractive currency to offer employees through equity compensation plans, and to use in acquisitions – could be overcome.

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<sup>70</sup> Eric Toder and Alan D. Viard, "Replacing Corporate Tax Revenues With A Mark To Market Tax On Shareholder Income," 69 Nat'l Tax J. 701 (2016), at 714-21.

Readers whose investments survived the Great Recession will no doubt recall how much more volatile were their assets' mark-to-market valuations than were fluctuations in period-to-period cash returns on those investments.

Phrased differently, how much tax would Mark Zuckerberg choose to absorb for the privilege of being a public firm, when no financial imperative required that outcome?

To their great credit, Toder and Viard, in their recent proposal for mark to market income taxation, not only recognize both the volatility issue and the substantial differences in outcomes between their regimes for public and private firms, but suggest specific ameliorative policies. Nonetheless, the complexity of their “geometric smoothing” of mark-to-market volatility is a perfect example of how important it is, when moving from pure theory to actual policy advice, to work through how precisely that advice would be implemented in an administrable fashion, so that competing ideas can be compared fairly. To the same effect, their proposal to tax founders on the shares they retain when a firm goes public leaves unanswered the specific rate to apply (although they do suggest some metrics here) and begs the question, why would a founder ever do this? Rounds of private equity financing deal with the firm’s financing needs, and borrowing against one’s appreciated stock position puts cash into the pockets of the founders. By introducing an enormous gulf in the tax topography, mark-to-market taxation distorts taxpayer behavior in first-order ways.

As an accounting system, mark-to-market accounting itself raises interesting (and largely unexamined) conceptual issues. Even the mark-to-market accounting that should be easiest to implement – the application of that accounting method to the country’s largest securities dealers – has proven difficult in practice. (For example, should mark-to-market taxation of over-the-counter derivatives dealers include fluctuations in value attributable to changes in the dealer’s own credit rating?) The alternative idea of mark-to-market accounting at the *entity* level, and not separately taxing financial capital instrument holders, is even more problematic in that it would require annual valuations of real assets.

### III. THE LABOR-CAPITAL INCOME CENTRIFUGE.

The BEIT mechanism summarized in Part II is designed to impose an annual tax on capital income tax is reasonably comprehensive and consistent, while preserving existing income tax norms as much as possible, and adopting as featureless a tax topography as the complexities of our modern economy permit. The dual income tax part of the Dual BEIT signals this project’s commitment to a different tax schedule for capital and labor income – in particular, for the reasons developed in the companion paper, a moderate flat rate on capital income (for example, 25 percent), and higher graduated rates on labor income.<sup>71</sup> But this in turn requires an explicit

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<sup>71</sup> It is perfectly feasible to implement the Dual BEIT with a lower tax rate on low-income taxpayers, so that 25 percent (to continue with that example) is a ceiling rate. This paper largely abstracts from this issue for the simple reason that capital income is a perquisite of owning capital, which by definition the poor do not possess in great quantity.

tool for segregating labor from capital income – what this Article calls a labor-capital income centrifuge.

A labor-capital income centrifuge is necessary because without one, an owner-entrepreneur of a closely held firm will face strong incentives to pay herself as small a salary as possible, in order to treat the bulk of her total income as capital income taxed within the firm at a 25 percent rate (to continue that example). The U.S. Treasury is exposed to this issue today, in the form of the Edwards – Gingrich Medicare tax avoidance stratagem that has attracted considerable attention, and which has proved resistant to attack using the conventional means available to the Internal Revenue Service.<sup>72</sup> A more sophisticated mechanism is required. From the other direction, a labor-capital income centrifuge is unnecessary if the business enterprise tax rate is set at the top labor income marginal rate, but for the reasons developed in the companion paper, the Dual BEIT proceeds with a more moderate rate on firm income.<sup>73</sup>

Norway has been the leader in designing dual income taxes; over the years it has implemented different systems that alternatively have taxed all capital income at one flat rate, or that more recently have taxed normal returns at a low rate while endeavoring to tax economic rents at basically the top rate on labor income.<sup>74</sup> In doing so, Norway was forced to develop labor-capital income centrifuges of varying design and institutional success.<sup>75</sup>

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<sup>72</sup> Edward D. Kleinbard, “Capital and Labor Stuffing in the New Tax Rate Environment,” <http://ssrn.com/abstract=2239360>.

<sup>73</sup> Capital Income in an Age of Inequality, Section I.E.

<sup>74</sup> Edward D. Kleinbard, “An American Dual Income Tax: Nordic Precedents,” 5 *Northwestern J. of Law and Social Policy* 41 (2010).

There is a large public finance literature (predominantly authored by European economists) on the theory and practice of dual income taxes, much of which is summarized in the article just cited. Three helpful brief papers are Robin Boadway, “The Dual Income Tax System – An Overview,” CESifo DICE Report at 3 (Mar. 2004); Wolfgang Eggert and Bernd Genser, “Dual Income Taxation in EU Member Countries,” CESifo DICE Report at 41 (Jan. 2005); Peter Birch Sorensen, “Dual Income Taxation: Why and How?,” 61 *FinanzArchiv* 559 (2005).

<sup>75</sup> Edward D. Kleinbard, “An American Dual Income Tax: Nordic Precedents,” 5 *Northwestern J. of Law and Social Policy* 41, 67-79 (2010); OECD, *OECD Economic Surveys: Norway 2012* (Feb. 2012) (hereinafter, *OECD 2012 Norway Survey*). That monograph summarizes succinctly the economic case for dual income taxation at 70-74.

Putting to one side the technical issues in Norway’s original labor-capital income centrifuge, the first generation of the Norwegian dual income tax attempted to reach a uniform flat tax on capital income by relying on an accurate specification of a firm’s income tax base (as did the U.S. Treasury’s Comprehensive Business Income Tax), and marrying that to a dividend imputation system (so that dividends ideally would not be double taxed), and providing that other capital income of an investor (such as interest income) would be eligible for the same flat rate as that imposed on firms. It also employed a complex basis adjustment mechanism (the “RISK” mechanism, which had nothing to do with the English word “risk”) effectively to give investors a ratcheting stock basis (up or down) reflecting corporate retained profits or losses, to avoid a double tax when stock was sold at a gain. Mechanically, the original dual income tax operated principally by taxing all income from whatever source derived at a flat rate (28 percent), and then imposing a surtax on labor incomes above a certain level.

The United States also has made desultory efforts to disentangle labor from capital income. Our rules disallowing deductions for excessive compensation paid to owner-entrepreneurs are one example, but are highly subjective in application and point in one direction: that is, the opposite condition, which I call “labor stuffing,” is not addressed.<sup>76</sup> The more one looks, in fact, the more acute (and understudied) the problem is under current law. “Carried interest” is one particular instantiation of the phenomenon, but probably not the most important in aggregate size. The example given earlier of the hard-working chef who turns her labor into her restaurant’s goodwill, on which she can realize a direct return when she sells her restaurant, is a much more typical fact pattern that raises the same basic question.

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The current Norwegian implementation of its dual income tax introduces a novel variant, the “rate of return allowance” (RRA). The RRA system turns the proposal in this article upside down, by taxing normal returns to the firm, taxing inframarginal returns to the firm at the same rate as normal returns, and then in effect imposing a surtax on economic profits when realized at the investor level.

More specifically, the RRA dual income tax system taxes all capital income, including corporate net income, at one flat rate (28 percent), but deliberately imposes a double tax on corporate dividends and capital gains, *after* taking into account an investor-level deduction for a normal rate of return (the RRA). The net result is that interest and other forms of capital income generally are taxed at 28 percent, corporate net income is taxed at 28 percent at the corporate level, dividends and capital gains from the sale of stock are tax exempt in the hands of investors to the extent of a normal return on their investments, and those dividends or capital gains are fully subject to another 28 percent tax to the extent they exceed that normal return. This brings the tax on such income to a level similar to the highest tax rate on labor income.

The idea is twofold. First, it solves what I call the “labor stuffing” problem that bedeviled the first iteration of the Norwegian dual income tax, by taxing any extractions from corporate solution at rates closely comparable to labor tax rates. (“Labor stuffing” is the problem that, whenever firm income is taxed at lower effective tax rates than individual labor income, owner-entrepreneurs of closely held firms will have an incentive to recast their labor inputs as returns on their capital in the firm.) Edward Kleinbard, “Capital and Labor Stuffing in the New Tax Rate Environment,” <http://ssrn.com/abstract=2239360>. The labor stuffing problem under the first Norwegian dual income tax system was not technical, but rather political – the labor-capital income centrifuge rules by design were easily evaded. Under the new system, an owner-entrepreneur’s returns to labor will be taxed twice, once at the firm level, and once at the individual level (assuming the returns exceed the normal return to the individual’s capital investment).

Second, the new system taxes economic rents at close to labor rates. This is its chief policy virtue, as the labor stuffing problems under the original system could easily have been solved by more adroit legislative drafting. It does so by virtue of the fact that dividends and capital gains attributable to inframarginal returns are unshielded from the second-level investor tax.

Kleinbard and OECD, *supra*, both raise objections to the new system, including the introduction of asymmetrical payoffs, and the fact that, if inflation is taken into account, normal returns may be taxed at rates comparable to those imposed on economic rents. The firm-level tax system is as vulnerable as any other to getting asset capitalization and depreciation wrong, and further is susceptible to overleveraging (subject only to a limited antiabuse rule). Finally, the OECD review pointed out that a system like the BEIT has very important advantages over the RRA approach, in that it moves the tax exemption for normal returns to the firm level. In the case of open economies this makes the system’s exemption of normal returns available to all investors, including foreign investors, which is not true of the exemption for normal returns offered to Norwegian domestic investors.

<sup>76</sup> Edward D. Kleinbard, “Capital and Labor Stuffing in the New Tax Rate Environment,” <http://ssrn.com/abstract=2239360>.

It is possible to do better than any of the existing precedents. The starting point – a labor-capital income centrifuge, version 1.0 – might resemble the mechanism adopted (at least for a period of time) by Norway, in which a reasonable return to capital is imputed, and the remaining income treated as labor income. The idea of this form of labor-capital income centrifuge is that, in those cases where markets cannot be expected reliably to separate labor from capital income – that is, in the case of closely held companies – an owner-manager of a firm determines the portion of her total returns that are attributable to her capital invested in the firm by multiplying that capital by a fraction (which typically could be determined by a formula tied to one-year government securities); the result would be the deemed return to capital, and the remainder a deemed return to her labor. Actual Nordic implementations rapidly grew more complex, for example to deal with whether the asset base should be a net or gross asset concept, and how to determine when a company was sufficiently closely held as to invoke the labor-capital income centrifuge, but as these questions have been considered in great detail elsewhere, they will not be repeated here.<sup>77</sup>

Widely held firms would be presumed to compensate employees fully; as a result, no further emendation to the BEIT principles outlined earlier would be needed. In particular, the labor-capital income centrifuge would not apply.<sup>78</sup> As a result, all of a widely held firm’s post-compensation income would be treated as capital income. The COCA allowance, in conjunction with depreciation, would be employed simply to separate out the normal return component and tax that component at the firm level at an effective rate of zero.

Closely held firms would be subject to a different regime, but one with the same ultimate objective. The COCA mechanism would be applied to a closely held firm in the same general manner as under the standard BEIT: the firm would multiply its tax basis in its assets by the COCA rate. The resulting figure, however, would now be used for a slightly different purpose: not simply to provide (in conjunction with depreciation) an effective firm-level deduction for normal returns to capital, but rather to separate the closely held firm’s income into capital and labor components.

A labor-capital income centrifuge along the lines summarized above follows early Nordic precedents, but has several major drawbacks. First, it violates the strong preference for a featureless tax topography, by distinguishing sharply between private and public firms. A public firm like Facebook Inc., with a founder who actively manages the business and still owns a large percentage of its stock, might be mischaracterized under this division. It certainly would

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<sup>77</sup> Edward D. Kleinbard, “An American Dual Income Tax: Nordic Precedents,” *Northwestern Journal of Law and Social Policy* 5, no. 1 (2010): 41–86 (2010).

<sup>78</sup> This distinction is consistent with Nordic models. The late Steve Jobs might be offered as an exception that proves the rule, in light of his nominal cash compensation. In fact, he received substantial deferred compensation in the form of stock options. To the extent that he in fact was undercompensated for his services, and thereby enriched other shareholders, that income in fact became their capital income, and would be reflected in their Includible Amounts as those shares turned over.

incentivize startups to become public as soon as possible, to turn off the special income recharacterization rule. Further, the Nordic-style rule summarized above is an all-or-nothing rule: that is, it recharacterizes all of an affected private firm's income beyond normal returns (as determined through the COCA style mechanism) as labor income. This will be wrong in fact in many cases, and will be unfair in every case to investors in such firms who are not owner-managers.

A superior labor-capital income centrifuge can be developed along the following lines. First, business enterprises would all be taxed identically – that is, income at the firm level would not be recharacterized as labor income, and all firms would face the same profits-only tax (in the running example, at a 25 percent tax rate). Public and private firms would face the same tax system and the same tax rates.

The statute would define a new class of individual: A Participating Controlling Owner. Again resorting to U.S. tax shorthand, a “Participating Controlling Owner” would be defined as a material participant in the management of a business enterprise who owns at least five percent of the enterprise (by vote or value), and where 50 percent or more of the ownership of such enterprise (by vote or value) is owned by five or fewer such material participants. The definition would not turn on whether a firm were privately-held or a public company.

Both parts of this compound definition are drawn from existing U.S. tax rules; redeploying existing standards gives comfort that the detailed rules in fact can be drafted and administered. “Material participation” is a concept embodied in Internal Revenue Code section 469, setting out rules limiting the deductibility of losses incurred in the “passive” participation in a trade or business. The concentrated ownership standard is drawn from the personal holding company rules of section 542. The five percent ownership threshold is intended to simplify compliance by weeding out from the class of employees who might be subject to the operative rules described below those with relatively small ownership interests.

One aspect of tax system design that the United States does very well (and that the Nordics, for example, handled quite poorly) is to incorporate broad “attribution” rules in ownership standards. The purpose of these attribution rules (phrased for convenience with respect to corporate stock) is to treat a party as owning shares actually owned by another, where by virtue of a personal relationship (parents and children) or impersonal ownership (individual and corporation owned by that individual) doing so accords with commercial reality. What is more, in their most fulsome form these rules treat stock constructively owned by one party as actually owned by that party, for purposes of reattributing the stock yet again. The Internal Revenue Code is festooned with these sorts of attribution rules;<sup>79</sup> the point here is not to engage

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<sup>79</sup> E.g., section 544; section 318.

in statutory drafting, but rather to signal that incorporating these principles is central to the proposal.<sup>80</sup>

If an individual is a Participating Controlling Owner, then she is subject to a special annual “basis bump,” under which she adds to her basis in her ownership interest (1) a specified fraction of (2) her share of the firm’s income after its profits-only tax, retroactive to the start of the year. The new higher basis would attract larger Includible Amounts.

The individual’s share of post-profits tax firm profits would be determined simply by reference to her ownership interest in the firm (actually and constructively owned). The specified fraction would be  $(LT - CT) \div [CT \times (1 - CT)]$ , where LT and CT are the maximum labor tax and capital tax rates, respectively. Where the labor tax rate is 40 percent and the capital tax rate is 25 percent, the individual would be subject to a basis bump of 80 percent of her share of firm post-profits tax income.

For example, imagine that Participating Controlling Owner puts \$1 into a wholly-owned firm. The firm develops a new app, attributable in fact to the work of the PCO. The firm earns \$100,000 after all business deductions but before the COCA. Here, the COCA would be zero, because the firm has no basis in assets, and the firm would be left with \$75,000 after profits-only tax. The PCO would receive a basis bump retroactive to January 1<sup>st</sup> of 80 percent x 100 percent x \$75,000, or \$60,000. The PCO would pay tax at the 25 percent capital income rate x her basis of \$60,000 in perpetuity (all other things being equal). That is the same as taxing her \$60,000 at 25 percent today, or \$15,000. As a result, the total tax paid is \$25,000 (firm profits-only tax), plus \$15,000 (in present value terms) investor-level tax, for a total of \$40,000 – the same as the labor tax rate.

The Participating Controlling Owner mechanism sounds complex, but it is not really difficult in practice, given that the specified percentage will be an invariant fraction, in the absence of tax rate changes. It has the great advantage of not drawing any distinctions between private and public firms (that is, the mechanism can continue indefinitely, provided that the material participation and ownership concentration standards are satisfied, regardless of whether the company is publicly held). It focuses on material participation as a requirement, and does not apply to rents or other profits earned by a firm with concentrated ownership and great business acumen. And most important, it does not subject passive investors to any incremental tax burden. I therefore believe it is the key to implementing a practical labor-capital income centrifuge.

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<sup>80</sup> When applied in their usual settings, these attribution rules can cause multiple parties to be treated as owners of the same shares. For example, mother, father and adult daughter all participate materially in the management of Firm X; daughter owns 30 percent of the firm, and mother and father own none. The usual attribution rules would treat mother, father and daughter as *each* owning 30 percent of Firm X, thereby subjecting it to the special Participating Controlling Owner rules. This obviously is not intended, and so one would adopt a rule under which stock actually or constructively owned by one material participant will not be treated as constructively owned by another material participant. The rule would have a failsafe that when all the attributing was finished, no more than 100 percent of the firm’s ownership interests could be accounted for. This sort of thing actually borders on commonplace in U.S. tax law practice.

It might be objected that this mechanism does not address the modern world of enterprises like “unicorn” start-ups – private firms without any net income that nonetheless are valued in excess of \$1 billion. This is true, in the sense that in the absence of firm income there is no basis bump to a Participating Controlling Owner. But a labor-capital income centrifuge of the first sort also would not operate to divide income between its labor and capital components when again there was no net income to divide.

A mark-to-market basis bump for Participating Controlling Owners when such a firm goes public would be responsive at one level, but would then lead to strong incentives not to go public, and to ersatz financing arrangements designed to arbitrage the distinction. Readers familiar with the multiple “rounds” of financing now considered standard practice in Silicon Valley, as venture capital investors are replaced over time by private equity firms, will appreciate the byzantine (and deep pocketed) forms of private market equity financing already deployed in practice.

One small useful rule that could be adopted would be to treat any “monetization” of stock by a Participating Controlling Owner, through borrowings secured directly or indirectly by the owner’s stock, would be treated as a mark-to-market event in respect of all of the Participating Controlling Owner’s investment, thereby creating the basis to which the COCA/Includible Amounts regime could apply. Such a mark to market event would not raise difficult valuation issues, given that the lending institution must express an opinion on value in conjunction with its extension of credit.

#### IV. WHAT IS A NORMAL RETURN, ANYWAY?

##### A. Different Implementations of Profits Taxes.

The COCA rate is the mechanism that makes the Dual BEIT a neutral profits tax at the firm level, and that measures normal (taxable) returns to investors. As described in Part II, the COCA mechanism does this by affording a firm an annual deduction equal to the aggregate capital invested in the firm multiplied by the COCA rate, and from the other direction requires investors to include in income each year the amount of their unrecovered investments in firms multiplied by the same COCA rate. It obviously follows from this that specifying the COCA rate properly is essential to the intended operation of the Dual BEIT.

A business cash flow tax is the best-known and most closely studied example of a practical profits tax. In thinking about the COCA rate, it therefore is helpful to consider why a cash flow tax operates as a profits tax, in order to illumine what COCA rate is required to produce economic equivalence.

There is a vast literature exploring the taxation of capital income under idealized tax systems, both from a tax law and a public finance economics perspective, that relies on this



decomposition.<sup>81</sup> Painting with a broad brush, much of the literature begins with the decomposition of capital income described in Part I (normal returns, returns to risk, and rents), and then proceeds to consider how each of these types of returns is taxed under an ideal income tax, or, alternatively an ideal profits tax implemented as a cash-flow tax.

A cash-flow tax looks very much like a Haig-Simons income tax, except that taxpayers are permitted an immediate deduction for any investments that they make, and include in income all returns in respect of that investment, including the return of the original amount invested.<sup>82</sup> By contrast, in an ideal income tax all investments are capitalized, and those capitalized amounts are recovered only through depreciation (which is meant to accord with the economic loss incurred in respect of wear and tear on a real asset) or on sale of the asset. For this purpose, an ideal income tax comprises a comprehensive Haig-Simons type income tax, with one rate schedule for both labor and capital income. Both an ideal income and an ideal cash-flow tax allow for an immediate cash refund of the tax benefit of any losses.<sup>83</sup>

Under the “Cary Brown Theorem,” the step of permitting the full expensing of a firm’s capital investments is understood to exempt from tax the firm’s normal returns on its investments.<sup>84</sup> The tax benefit afforded by the immediate write-off of investments that yield a normal return under a cash flow tax means that the government theoretically funds the scaling up

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<sup>81</sup> See for example David Hasen, “Income Taxation and Risk-Taking,” unpublished manuscript, at fn 1; Theodore Sims, “Capital Income, Risky Investments, and Income and Cash Flow Taxation,” 67 *Tax L. Rev.* 3 fns. 2 – 5 (2014), and John R. Brooks II, “Taxation, Risk and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax,” 66 *Tax L. Rev.* 255, fns 2 -6 (2013) for references to much of the tax law and public finance literature.

<sup>82</sup> The cash-flow tax just described is described as an “R” based cash-flow tax if it ignores financial flows entirely (such as borrowing money, paying interest thereon and ultimately repaying the loan), and an “R+F” base if financial flows are included in income when received (e.g., when borrowing money) and deducted when repaid.

<sup>83</sup> John Brooks specifies in more detail the key terms of the idealized income tax that most authors appear to assume. Brooks at 263.

<sup>84</sup> Cary Brown demonstrated that, under certain plausible assumptions, expensing an investment that yielded normal returns was the same as exempting the investment’s yield. E. Cary Brown, “Business-Income Taxation and Investment Incentives,” in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen* 300, 309-10 (1948). What is today called the Cary Brown Theorem was introduced to tax law specialists by William D. Andrews, “A Consumption-Type or Cash Flow Personal Income Tax,” 87 *Harv. L. Rev.* 1113 (1974). This of course exactly describes how a cash-flow tax operates. By expensing all investments, therefore, it is said that a cash-flow tax exempts from tax the normal return on those investments.

Cary Brown’s insight was sufficiently straightforward that it is taught in most introductory income tax courses. An investor permitted to expense an investment – that is, an investor operating in a cash flow tax environment – receives an immediate cash refund of the tax benefit of that deduction, which can be used to buy more of the same investment (the simplest assumption being that, since the investment yields only normal returns, there should be infinitely elastic supply<sup>84</sup>), which in turn generates a second deduction, and so on, until the investor has a total investment, not of her original pretax investment of  $I$ , but rather of  $I/(1 - T)$ , where  $T$  is the tax rate. The cash flow tax applied to this scaled-up investment yields a return  $r$  equal to the investor’s pretax rate of return: that is,  $r(1 - T) \times I/(1 - T) = rI$ .

(or alternatively “grossing up”) of a firm’s marginal investments without cost to the firm, to the point where the firm’s after-tax and pre-tax yields on its marginal investments are equivalent. Another formulation of the same point is that the government has acquired a partial interest in the investment, so that the investor’s after-tax investment (immediately following her original investment) is simply smaller than her pretax investment, and she therefore can acquire more of the asset than she could in a tax-free environment. Finally, the government can be described as making an interest-free loan to the firm, repayable when the investment is sold, which loan the firm uses to buy more of its marginal investment opportunity. All are simply different phrasings of the same phenomenon, which is that a cash flow tax (or other profits tax) exempts the firm’s normal yield on investment.

In contrast, an ideal income tax does not permit an investor to deduct the amount of an investment when made, but instead requires that the investment be capitalized; as a result, the tax system does not provide any mechanism by which the taxpayer can costlessly scale up her investment yielding normal returns in the face of the imposition of an income tax. It follows that the income tax burdens normal returns, while a cash flow (or other profits tax) does not.<sup>85</sup>

In fact, the consensus view is that this is the only important difference between a well-designed income tax and a cash-flow or other profits-only tax: by design, the former taxes time-value-of-money returns, whereas the latter exempts them from the tax base. The measure of success of a capital income tax under this view is its ability to measure and tax normal returns consistently.

Authors describing this standard analysis usually set up their analyses in terms of the construction of a portfolio, comprising a risk-free asset and a risky asset, where the agent’s strategy in response to different idealized taxes is to readjust her portfolio from her pre-tax optimum to accomplish this scaling up, and thereby return as nearly as possible to her status quo ante.<sup>86</sup> The risky asset has known alternative payouts, and therefore has no element of uncertainty associated with its returns. Many of the apparent differences in results hinge on the fact that authors make different assumptions as to whether the risk-free asset earns any positive return at all; in some cases, authors seem to shift their assumptions on this key point as they work from example to example.

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<sup>85</sup> Joseph Bankman & David A. Weisbach, “The Superiority of an Ideal Consumption Tax over an Ideal Income Tax,” 58 *Stan. L. Rev.* 1413 (2006); Daniel N. Shaviro, “Replacing the Income Tax with a Progressive Consumption Tax,” *Tax Notes* 103, no. 1 (2004): 91–113; Joseph Bankman & David A. Weisbach, “Consumption Taxation is Still Superior to Income Taxation,” 60 *Stan. L. Rev.* 789 (2007-2008); Joseph Bankman & Thomas Griffith, “Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?,” 47 *Tax L. Rev.* 377 (1991-1992).

<sup>86</sup> David A. Weisbach, *The (Non)Taxation of Risk*, 58 *Tax L. Rev.* 1 (2004); Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 *Tax. L. Rev.* 17 (1996); Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?*, 52 *Tax L. Rev.* 1 (1996).

A corollary to this standard analysis is that rents are taxed under both a cash flow tax (or other profits tax) and an income tax. In the income tax case rents are taxed as income, and in a profits-only tax, whether implemented as a cash flow tax or otherwise, those returns either are taxed directly or fund consumption (which is all that money is supposed to be good for), which in turn is taxed. The critical assumption here is that an investor has already exploited all the rents available to him, and that under a cash flow tax the investor therefore can expect to earn only normal returns on his government-funded additional investment. Because rents cannot be scaled up (there being no additional rent-bearing investments to make), rents are taxed under both the ideal income tax and the ideal cash flow tax. Taxing rents is viewed as unproblematic, because, even after a substantial tax burden, rents are more desirable than the next best alternative (investing in generally-available normal returns).<sup>87</sup>

The analysis to this point is well-settled. The bulk of the tax law literature in this area therefore has focused primarily on the taxation of risky returns. (As previously noted, these returns are presented as known alternative payoffs from the investment, so that the analyses abstract from authentic uncertainty.) Again the scale-up strategy takes central stage, but the analysis becomes more complex than in the case of a simple investment in an asset bearing normal returns, because the investor in the models considered in the literature invariably holds two assets – a risk-free asset (which may or may not have positive returns ascribed to it in the model), and a risky one, where the scaling up of the risky asset in response to the introduction of taxation is funded by the sale of the risk-free investment.

This stream of analysis can be traced to a 1944 paper by Domar and Musgrave,<sup>88</sup> and entered the tax law literature through an early paper by Alvin Warren.<sup>89</sup> The analysis was extended by Bankman and Griffith, Cunningham, and many others, and reached its apogee in David Weisbach's influential paper, *The (Non)Taxation of Risk*<sup>90</sup> The idea in every case was that when moving from a nontax environment to one that purported to tax risk, an investor could rearrange her investments by scaling up her risky investment, typically by selling some of her risk-free investment, and thereby avoid the tax burden on returns to risk.<sup>91</sup>

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<sup>87</sup> Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax Really a Debate About Risk? Does It Matter*, 47 TAX L. REV. 377, 406 (1992) (arguing that "taxation of [economic rents] is much less troublesome than taxation of" normal returns).

<sup>88</sup> Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. Econ. 388 (1944).

<sup>89</sup> Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 Yale L.J. 1081 (1980).

<sup>90</sup> Joseph Bankman & Thomas Griffith, "Is the Debate Between an Income Tax and a Consumption Tax Really a Debate About Risk? Does It Matter?," 47 Tax L. Rev. 377 (1992); Noel B. Cunningham, "The Taxation of Capital Income and the Choice of Tax Base," 52 Tax L. Rev. 17, 29 n.51 (1995); David A. Weisbach, "The (Non)Taxation of Risk," 58 Tax L. Rev. 1 (2004).

<sup>91</sup> The "scaling up" strategy is thus deployed in two different contexts: in profits-only taxes, to avoid tax on normal returns, and in both ideal income and profits-only taxes, to avoid tax on ex-post returns to risk. Alvin C. Warren, Jr.,

Louis Kaplow extended the analysis by considering the question, where will all these new risky investments come from? That is, the scaling up strategy requires that the investor be able to buy more of the same risky investment at the same price as the original investment, but in the absence of some new seller entering the market, the additional demand for such assets would push up price. Kaplow showed that, at least in an idealized model, the government itself could be that new seller. That is, the imposition of a tax on risky returns (in the presence of full loss offsets) can be analyzed as the government buying a slice of every risky investment; if one hypothesizes that the government has no interest in holding all those assets, it could in turn sell them short into the marketplace, thereby ensuring a general equilibrium result in which scaling up had no effect on prices.<sup>92</sup>

Once the general equilibrium problem was solved, at least in theory, it followed that a cash flow tax would not burden risky returns any more than it did riskless (normal) returns, because the Cary Brown Theorem could operate to scale up both normal and risky returns – assuming again, for emphasis, that the risky investment could, conceptually at least, be scaled up without affecting the price of the investment, and the tax system treated losses symmetrically with gains, which requires both a refund mechanism and a proportional tax.<sup>93</sup>

What is more, if the risky investments in question are pure bets (for example, derivatives in which no variation margin is required), then (under the assumption made in the models that investors have unlimited borrowing capacity, and therefore constant creditworthiness) the income tax analysis is the same as in the cash flow tax case. Because there is no cost to scaling up, an investor can do so costlessly under an income tax as well as a cash flow tax, and thereby neutralize the effect of the imposition of the tax on returns to risk.

When the risky assets have capital invested in them, however, then the income tax scale-up story becomes more complex, because the investor incurs a cost to scaling up – the government does not provide a hypothetical interest-free loan, as in the cash flow tax case. As noted earlier, the setup in the models invariably assumes that the investor starts by holding two assets, a risk-free asset yielding normal returns and a risky one. The investor funds the additional scale-up of the risky asset required to restore her pretax risk profile by selling the risk-free one.

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*How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1 (1996), explores these two different applications of the scaling up principle.

<sup>92</sup> Louis Kaplow, “Taxation and Risk: A General Equilibrium Perspective,” 47 Nat’l. Tax J. 789 (1994).

<sup>93</sup> David A. Weisbach, “The (Non)Taxation of Risk,” 58 Tax L. Rev. 1 (2004). Neutrality is achieved only if firms have an absolute certainty of recovering from the government the tax benefit of losses, which requires either immediate refundability (a nonstarter everywhere as a practical matter) or an interest charge and ultimate refundability on windup of the business. Bond, S. R., and Devereux, M. P. (1995), On the Design of a Neutral Business Tax Under Uncertainty, *Journal of Public Economics* 58, 57–71; Peter Birch Sorensen, *Dual Income Taxation: Why and How?*, *FinanzArchiv* 61 (2005), 559–586, at 574; Peter Birch Sorensen, *Neutral Taxation of Shareholder Income*, *International Tax and Public Finance*, 12, 777–801, 2005, at 784–86; S.R. Bond and M.P. Devereux, “Generalized R-Based and S-Based Taxes Under Uncertainty,” 87 *J. of Public Economics* 1291, 1296 (2001).

Further, the models usually assume that the investor can borrow at the risk-free normal rate of return.

From these assumptions, the conclusion usually is phrased that the investor under an income tax bears tax on the normal return on the entirety of her invested capital, whether held in riskless or risky assets.<sup>94</sup> This conclusion can be explained in a variety of ways, but the simplest is that a risky asset must have an expected return greater than the normal return, so that all risky assets can be decomposed into a pure capital investment, bearing a *riskless* normal return, stapled to a bet.<sup>95</sup> The former component is taxed, just as a straightforward investment in riskless assets is taxed, and the latter component is not, by virtue of scaling up the size of the risky bet. The investor who sells the riskless asset to increase her investment in the risky one cannot escape tax on the normal return to capital implicit in all the capital she has invested.<sup>96</sup>

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<sup>94</sup> Sims describes this as the “conventional wisdom.” Sims, *supra*, at n. 7. See also Daniel N. Shaviro “Replacing the Income Tax with a Progressive Consumption Tax,” 103 Tax Notes 91 (April 5, 2004) (summarizing consensus).

<sup>95</sup> This decomposition has echoes in the Black-Scholes option pricing model.

<sup>96</sup> A recent wave of academic papers in this area takes issue with the scaling up story as a matter of economic logic. Theodore Sims and John Brooks both emphasize that the wealth effect of the income tax means that the investor cannot simply replicate the same risk profile after tax as she could in a world without tax, even though the variance of her returns on her risky investment (after scale-up and after tax) would be constant, because in all states of the world she will be poorer – the same investment has become less attractive, and she therefore would decline to scale up, at least to the full extent necessary to hold her after-tax amount at risk constant.

Brooks goes on to consider the implications of modern portfolio theory, which incorporates the fact that most people are more loss averse than they are risk averse, and therefore weight the risk of loss more heavily than the prospect for gain. Again, the consequence is that rational investors would not fully scale up (because doing so exposes them to the possibility of a greater absolute after-tax loss), and to the extent they do not fully scale up in the presence of an income tax, the pure risk component of their investment does bear a tax burden.

David Hasen, among other points, adds to Sims and Brooks by making the sensible observation that it is unrealistic to imagine that the government imposes a tax on risky returns only to undo the consequences of that tax by selling the risky assets short. He further relates the government’s risk profile to its budget constraints; once one allows revenues to fluctuate with returns to risk (financed when necessary by riskless government borrowing), there is no logical reason for the government to sell risk short, and the general equilibrium conditions specified by Kaplow may not hold. Indeed, Hasen concludes, extensive real world government borrowing can be construed as the government selling the *riskless* asset short, and retaining an interest through the tax system in risky ones.

What follows from these recent papers is that the conventional wisdom – that an income tax, like a profits tax, does not burden the pure return to risk, but rather only the normal return – may be an incomplete picture, although more work (including empirical research) would be desirable here. Rational investors have good reason not to scale up completely, and government behaves precisely the opposite of what general equilibrium theory requires, by selling fixed returns short (borrowing more money) and retaining volatile tax returns. Even under the conventional view, normal returns may be higher than is generally supposed, because the relevant metric should be the yield on medium-term rather than short-term government obligations.

## B. Normal Returns Are Not Necessarily Riskless Returns.

The formulation described at the end of the last Section conflates normal returns with riskless ones. Often, this conflation follows from the models themselves, which for simplicity assume that an investor can borrow at the risk-free rate (or funds new risky investments by selling risk-free assets). The narrowest instance of the time value of money is a government bond risk-free return, but the normal return to business capital is a more elusive concept than this one case, because it also encompasses the ex ante expected return on a marginal investment by a firm. Thus, a recent working paper published by the Organization for Economic Cooperation and Development noted that:

“While there is no universally accepted meaning of the expressions normal and excess returns, a common thread in these references is the implicit agreement that a normal return should include a risk element. In the absence of a specific definition, the normal rate of return on equity is often linked to a risk-free rate of return or the interest an investor would receive from holding a long-term government bond. Investors are unlikely to consider this a fair measure for the opportunity cost of the next best alternative investment. Equally, a firm is not likely to consider this a fair return when returns are generated by active management and services provided.”<sup>97</sup>

Firms exist to take risk, and their cost of capital reflects this fact. From a firm’s perspective, when looking at a new marginal investment, the normal return can be understood as the *risky* return whose expected returns will just cover its own existing cost of capital (which in turn reflects the composition of its assets, until equilibrium is reached); anything less means that it is engaged in systematic negative arbitrage (when viewed from the perspective of the asset), since its own capital will be priced by investors at some spread to riskless government bonds, as is any other risky asset.

A more useful formulation is that an income tax burdens a firm’s *risk-adjusted normal returns* – that is to say, its marginal returns – whatever they might be, in light of the firm’s overall exposure to risk. As Ethan Yale has observed, in efficient markets ex-ante expected returns to risk and normal riskless returns are fair trades for one another: from the perspective of ex ante opportunities, expected *returns* increase with risk, but the market *value* of that expected return is the same as that of the riskless government investment.<sup>98</sup> An investor with \$1000 to invest might choose to buy a government bond yielding two percent, or 20 shares of common stock of a corporation with an attractive but untested business plan that the market values at \$50/share. The latter might have an *expected* return of 7 percent, but its value remains \$1,000. In this second use, the normal return is a risk-adjusted normal return.

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<sup>97</sup> Hayley Reynolds and Thomas Neubig, *Distinguishing Between “Normal” And “Excess” Returns for Tax Policy*, OECD Taxation Working Papers, No. 28 (2016), at 6.

<sup>98</sup> Ethan Yale, “Investment Risk and Deferred Compensation,” 62 Tax L. Rev. 362, 390-91 (2009).

The two assets have different ex ante expected payouts (to compensate for the assumption of risk), and different ex post actual returns, but equivalent values. For example, if the government were to auction off a perpetual “outperformance” contract on risky investments, in which a perfectly creditworthy buyer would receive all tax revenues above the riskless threshold, but would pay to the government all shortfalls below that rate (including immediate refunds in respect of losses), the winning bid should be approximately zero. But equivalence in value is not the metric by which to establish the COCA rate, for the reasons described below.

All tax systems of course tax ex-post results, not ex ante expectations. Given that a firm’s investment outcomes will diverge from ex ante expectations in all cases involving the assumption of risk, how can we relate a tax on ex post outcomes to pretax ex ante expected returns from that same investment? The answer is that we would ideally choose an ex post business firm-level tax that leads to the same ex ante investments as would be true in a world without that firm level tax. A proportional (flat rate) tax system, full credit for losses (or as close to that as possible), and an exemption from tax for ex ante marginal returns does the trick. Only in such a system does a firm hold the same portfolio of investments in a world with the tax as in a world without it. That is exactly the outcome envisioned by a cash flow business tax, or alternatively the firm-level operation of the Dual BEIT (or other capital account allowance profits tax). (The fact that investors (savers) are taxed on their returns may affect the supply of investment capital (subject to the usual observation that investment abhors a vacuum, and capital from outside the United States would flow into the country until global after-tax returns were equalized), but does not change the portfolio of what a firm would invest in, up to the limit of the cost of its capital.<sup>99</sup>) But to accomplish this, the Dual BEIT, or any capital account allowance, must offer an allowance sufficient to exempt from tax the entirety of a firm’s ex ante marginal expected returns. These in turn will always exceed risk free returns, because that is what it means to be in business.

In other words, the standard analysis of why a cash flow tax is a profits tax relies on the scaling up metaphor presented earlier, but does not by itself describe what it is that the firm is scaling up. The answer cannot be that the hypothetical firm is loading up on government bonds. It is clear that the scaling-up analysis cannot apply to rents, because any rational firm would already have exhausted its opportunities to capture them, but that observation does not mean that a firm’s only available marginal investment is a riskless one. To the contrary, firms have a great many risk-adjusted marginal investments available to them, and the choice of which to make reflects the firm’s appetite for risk, as mediated through investors’ tolerance for accepting that risk (in turn reflected in the firm’s cost of capital).

To summarize, a firm does not invest in risk-free assets, just as its own cost of capital will never equal the government’s risk-free rate. For a firm to do so would be to engage in

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<sup>99</sup> Mihir A. Desai and James R. Hines, Jr., “Evaluating International Tax Reform,” 56 Nat’l. Tax J. 487 (2003).

negative arbitrage.<sup>100</sup> And from the firm's perspective, its cost of capital (which is to say, the minimum return demanded by investors in the firm) is an existential priority to the firm. From inside the perspective of the firm, its own cost of capital is riskless, in the sense that the firm itself cannot survive without covering that cost. The investor's risky investment thus is the firm's existential imperative.

Noel Cunningham pointed in this direction in an early article in this field, in which he demonstrated that under an ideal income tax and the scaling-up strategy described earlier, a firm that financed the scaling up of its risky investment at market rates of interest (that is, at rates above the riskless rate), incurred a tax cost (and revenue to the government) equal to the after-tax cost of that borrowing.<sup>101</sup> (A more complete description of the income tax burden on risky returns within the confines of the models in this strand of the literature is that the burden equals the after-tax cost of scaling up plus any tax on the returns to the scaled-down investment.<sup>102</sup>)

### C. Application to the COCA Rate.

The distinction between riskless returns and risk-adjusted normal returns – that is to say, a firm's marginal returns – becomes important when implementing a profits tax through any capital account allowance framework (including the Cost of Capital Allowance Mechanism employed by the Dual BEIT), or for that matter, an Allowance for Corporate Equity, which provides a firm with full interest deductions plus an additional allowance in respect of its equity capital. A cash flow tax affords taxpayers costless scaling up through expensing, in which government can be viewed as purchasing a share of each asset outright. Allowances for corporate capital instead offer taxpayers a direct government subsidy for the marginal cost of capital expended to acquire the asset. For the two systems to be economic equivalents, the subsidy rate must be specified by reference to some assumed return on marginal investments or cost of finance such that taxpayers could obtain the same costless scaling up available through expensing in a cash flow tax.

A cash flow tax has the great virtue of completely sidestepping the issue of what constitutes a normal return. The scaling up principle simply permits a firm to scale up its

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<sup>100</sup> An exotic exception would be a securities dealer borrowing on a short-term basis to hold government bonds, and using secured "repo" financing, which has a special creditor-friendly status under bankruptcy law, to do so.

<sup>101</sup> Noel B. Cunningham, "The Taxation of Capital Income and the Choice of Tax Base," 52 Tax L. Rev. 17 (1996).

<sup>102</sup> Brooks, at 265, points in this direction as well. When dealing with a firm that scales up a risky investment by issuing equity rather than debt, the preferred description explains the apparent anomaly that a cash flow tax and an income tax appear to produce the same after-tax result. The difference is that in the cash flow tax the scaling up is authentically costless, while in the income tax case the burden to the firm is the cost of that equity. In turn the returns to that equity will appear as revenue to the government at the investor level.



marginal investment, whatever that investment may be. In practice the marginal investment will bear a risk adjusted ex ante expected return greater than the riskless return.

Because a capital account allowance like the COCA deduction is designed to have the same value to a firm as expensing, which is to say, the ability costlessly to scale up its marginal investment, so as to have an effective marginal tax rate on that investment of zero, the allowance must be specified at a rate commensurate with a firm's marginal cost of finance (which in equilibrium also should be the return on a marginal investment). This would suggest that the COCA rate (or any competing cost of capital allowance proposal) should approximate a typical firm's cost of funds – by way of arbitrary example, 1-year Treasuries + 300 basis points

Much of the relevant literature in this field comes to a different conclusion, and instead recommends that a cost of capital allowance should reflect a riskless rate of return.<sup>103</sup> In some cases this assertion reflects the misapprehension that a normal return necessarily is a riskless one, thereby assuming the conclusion.<sup>104</sup> (As noted, this misapprehension often follows from the

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<sup>103</sup> In particular, it frequently is assumed that the relevant measure, as applied to the United States, is the (inflation adjusted) return on short-term Treasury bills – from which follows the observation that the income tax burden on normal returns is basically inconsequential. Bankman and Griffith; Cunningham; Zelenak (observing that inflation-adjusted average return on Treasury Bills from 1926 – 2004 was 0.7%). A separate question in the literature begins by assuming that a normal return is a government bond return (on the theory that this is as close to a riskless investment as can be obtained), but then questions whether the relevant comparison is to a short-term or long-term government instrument. The Mirrlees Review, for example, concluded that the relevant comparison is to a medium-term (7-year?) government bond rate. James Mirrlees et al., *TAX BY DESIGN: THE MIRRLEES REVIEW*, at 298, 302. (The Mirrlees Review was a comprehensive rethink by some of the world's leading public finance economists, and chaired by Sir James Mirrlees, of the lessons for actual tax policies to be drawn from the current state of the art in public finance economic analyses.) In this regard, Lawrence Zelenak has observed that the historic return on inflation-protected Treasury bonds is in the neighborhood of 1.5 – 2.0 percent.

<sup>104</sup> At the same time, the term “normal return” is sometimes used (more appropriately, in this context) as synonymous with a firm's marginal cost of capital, or alternatively (and equivalently) the minimum expected return required for an investment to break even. Thus the Mirrlees Review refers to “the normal or required rate of return on investments financed by equity” [by which it presumably means a risk-adjusted return], Mirrlees Review p. 436-7. and observes that exempting the “normal return on corporate investments” from tax means that “[corporate] [m]arginal investments, which just earn the minimum required rate of return in the absence of tax, remain marginal investments in the presence of the tax.” Id. p. 419. Again, this latter usage implicitly looks to a firm's cost of capital, not the government's.

To similar effect, Peter Birch Sorenson writes:

By definition, rents are “pure profits” in excess of the going market rate of return on capital. For debt capital, the normal return is the market rate of interest on debt in the relevant risk class, and for equity it is the required market rate of return on stocks with the relevant risk characteristics. If markets for risk pooling are underdeveloped, the required risk premia will tend to be higher, and so will the normal return.

Peter Birch Sorenson, *Can Capital Income Taxes Survive? And Should They?*, CESifo Economic Studies, Vol. 53, 2/2007, 172–228, at 176.

This again is a risk-adjusted concept of a normal return, viewed from the perspective of a firm's cost of capital. As one final example, Alvin Warren offers two competing definitions of “normal returns,” as either “riskless returns,” or alternatively as “what the investor could earn on [a] marginal investment,” which in the latter case could equal the

extension to policy of assumptions in models that for simplicity assume that a firm borrows at the risk free rate, or sells risk-free assets to fund the scaling up feature.) In other cases, however, the reasoning relies on a different point of confusion, by misapprehending the value to a firm of its “tax receivable” – the present value to the firm of its future capital account allowances.

Boadway and Tremblay, for example, in an excellent review of business tax reform in the Canadian context, argue that a Capital Account Allowance mechanism like the COCA should employ the government risk-free rate.<sup>105</sup> Their reasoning relies on the belief that the government’s promise of future capital account allowances – the tax receivable – is the same as any other government IOU (abstracting from political risk as to future tax law), and therefore should yield the same rate as a government bond.<sup>106</sup>

The intuition is attractive, but in the end is simply an imperfect metaphor. A firm’s tax receivable – the promise of future tax deductions through the COCA system – is a claim against the government, and thus in a creditworthiness sense can be analogized to holding a notional government bond (abstracting from political risk as to future tax law, as Boadway and Tremblay note). The difficulty with this metaphor, however, is that firms have no choice but to hold this risk-free receivable. That is, unlike an actual Treasury security, the notional stream of government subsidy *cannot* be monetized through sale or rehypothecation, any more than can future depreciation deductions under an income tax.<sup>107</sup>

If firms could somehow monetize their claims to future capital account allowances, then in fact they could reduce those claims to cash equal in value to the cost of the marginal investment they actually wish to make. By doing so, they would put themselves in the same position as they would have been enjoyed in a cash flow tax. But firms cannot do so; there is no market in tax receivables, because a tax receivable cannot be stripped from the property to which it relates in order to be sold or collateralized. This in turn means that a firm’s marginal investment must be financed at the firm’s marginal cost of finance – and firms do not finance their operations at the risk-free rate.

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investor’s own cost of borrowing (through an investment taking the form of a reduction thereof). Alvin C. Warren, “How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?,” 52 Tax L. Rev. 1 (1996).

<sup>105</sup> Robin Boadway and Jean-Francois Tremblay, *Corporate Tax Reform*, Mowat Centre for Policy Innovation, School of Public Policy and Governance, University of Toronto, (2012) at 45.

<sup>106</sup> Stephen R. Bond and Michael P. Devereux, “On the Design of a Neutral Business Tax Under Uncertainty,” 58 J. of Pub. Economics 57 (1995).

<sup>107</sup> One can view “safe harbor leasing,” an experiment tried in the United States in 1981 and repealed two years later, as a mechanism that by statute permitted firms to sell future depreciation deductions as if they were pure claims against the government. In the absence of some such creature of statute, however, firms cannot monetize their future cost of capital allowances by selling them, because those allowances are attributes of owning the underlying capital assets. Firms further cannot borrow at risk free rates against those tax receivables, because in practice the tax receivable cannot be segregated from the assets to which the receivable appertains.

In this connection, it should be noted that an Allowance for Corporate Equity, which is viewed as a form of profits-only taxation, yields a government subsidy far greater than a risk-free rate, because under an ACE a firm deducts its actual cost of debt capital plus a statutory allowance in respect of equity capital. The ACE mechanism cannot be correct as a matter of theory and at the same time a neutral capital account allowance be conceptualized as a risk-free rate.

Admittedly, a trading market in tax receivables *could* be created by statute, although I am not aware of any capital account allowance proposal that has thought through how such a market would be designed and function. In light, however, of the enormous political pushback to safe harbor leasing, which was a brief and inglorious experiment along similar lines in the United States, it does not seem profitable to tie the fate of the Dual BEIT or any other capital account allowance system to the parallel creation of a free trading market in tax receivables, especially when an alternative mechanism is at hand.

In short, the risk-free notional government bond embodied as a tax receivable might have a theoretical value equal to the risk-adjusted normal return on the assets in which a firm invests, but a firm's actual cost of capital will follow from its risk profile, and that always will be higher than a risk-free investment. A firm therefore will go broke quickly investing in notional risk-free assets with liabilities (its capital structure) priced as risky investments to the holders of those investments. Perhaps for this reason David Bradford contemplated a capital account allowance set at rates close to an issuer's cost of funds, to reflect some of these pragmatic issues: "Conceptually, the interest rate called for is the one that would make the taxpayer indifferent between expensing and capitalization with interest allowance (in a constant tax rate environment)." <sup>108</sup>

The neutral COCA rate therefore must be one that just covers the cost of investing in assets with similar risk characteristics, which is to say a representative weighted average cost of capital for domestic firms. That formulation admittedly is imperfect, because a particular firm's cost of capital will depend on the riskiness of the particular portfolio of investments that it makes, but it seems to be as close as can be expected of an administrable tax. As a result, the COCA, and other allowances for corporate capital, will always suffer from the problem that a statutory allowance of this nature will never be perfectly attuned to each firm's circumstances.

To some extent, the Dual BEIT mitigates this concern by using the same COCA rate for firms and investors; if the COCA rate is too low from a firm's perspective, because its investments are quite risky, then by the same token investors will enjoy a somewhat lower annual income inclusion than would be the case if their expected returns were measured more

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<sup>108</sup> David Bradford, *A Tax System for the Twenty-First Century*, in *Toward Fundamental Tax Reform* (Alan J. Auerbach and Kevin A. Hassett, eds) (AEI Press 2005), 11- 33, at 23; see also Bradford, *Transition To and Tax-Rate Flexibility In a Cash-Flow-Type Tax*, in *Taxation, Wealth, and Saving* (Collected Essays), 311 – 331, at 321 (MIT Press 2000).

granularly. At an economy-wide level, these distinctions should more or less cancel out, and provided that the tax rate is not particularly high, any attendant distortions within a firm's decision calculus should not be all that large.

Further, the higher cost of capital to small firms can be recognized through special concessionary higher Cost of Capital Allowance rates. Thus the first \$X million of firm capital might enjoy a high COCA rate, and the remainder a lower rate – with or without phaseouts. This idea does fairly reflect the much higher costs of financing to which small firms are subject. More generally, the system is adaptable to a range of policy and political economy concerns. In this regard, a system whose design cannot easily accommodate special concessionary rates for small business is not a system likely to be enacted into actual law.

As suggested above, the COCA rate used to calculate investors' Includible Amounts should be the same as the base COCA rate used by business enterprises. This has three great advantages. First, the rate should be to a first degree of approximation a good estimate of real-world normal returns. Second, using the same COCA rate, along with one base tax rate on both business income and Includible Amounts, minimizes the economic distortions and risk to the fisc of getting that rate wrong. Third, legislatures should find it relatively easy to approximate an appropriate COCA formula simply by weighing the whines of investors against the opportuning of firms, until their volumes are in balance.<sup>109</sup>

## V. THE DUAL BEIT IN INTERNATIONAL APPLICATION.

### A. A Residence Based Tax.

Most tax administrations and academics agree that corporate income tax systems today are largely dysfunctional in measuring and taxing appropriately the income of multinational enterprises. The problems are income shifting from business operations in the jurisdiction in which the multinational enterprise is domiciled to low-tax foreign countries, and stateless income: income derived by a multinational enterprise from business activities in a country other

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<sup>109</sup> In the absence of an anti-abuse mechanism, one might speculate that firms would be established to invest only in Treasury securities. Following the recommendations in Part II, such a firm would obtain a COCA deduction greater than Treasury rates, but have income inclusions only at the Treasury rate. Not all investors would find this structure attractive relative to owning the Treasuries outright, because were an investor simply to purchase a Treasury obligation herself, her annual income inclusion would be limited to the Treasury's actual interest, rather than the higher COCA rate. Nonetheless, such a firm might be expected to trade like a closed-end government bond mutual fund, and therefore have a low cost of capital; this would suggest that it might generate annual losses available for other activities. If this is thought to be problematic, the most straightforward solution is to limit a firm's COCA deduction in respect of non-business financial assets (e.g. Treasury securities) to the yield actually earned on those securities (the obverse of today's arbitrage regulations for state and local governments that seek to borrow at tax-exempt bond rates and invest in Treasury securities).

than its ultimate domicile, but which is subject to tax only in a jurisdiction that is neither that domicile nor the location of the customers or the factors of production through which the income was derived.<sup>110</sup>

The pervasiveness of stateless income tax planning upends standard characterizations of how U.S. tax law operates, as well as the case for the United States to move to a territorial tax system, unless accompanied by strong antiabuse rules. U.S. tax rules do not operate as a worldwide system, but rather as an ersatz variant on territorial systems, with hidden benefits and costs when compared with standard territorial regimes. That claim holds whether one analyzes the rules as a cash tax matter, or through the lens of financial accounting standards. Under current law, effective foreign tax rates do not disadvantage U.S. multinational companies when compared with their territorial-based competitors.

Stateless income prefers U.S.-based multinational companies over domestic ones by allowing the former to capture tax rents, or low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. Other important features of stateless income include the dissolution of any coherence to the concept of geographic source (in turn the exclusive basis for the allocation of taxing authority in territorial tax systems); the systematic bias toward offshore rather than domestic investment; the bias in favor of investment in high-tax foreign countries to provide the raw feedstock for the generation of low-tax foreign income in other countries; the erosion of the U.S. domestic tax base through debt-financed tax arbitrage; many instances of deadweight loss; and, unique to the United States, the exacerbation of the lockout phenomenon, under which the price that U.S. companies pay to enjoy the benefits of dramatically low foreign tax rates is the accumulation of extraordinary amounts of earnings (about \$2.6 trillion) and cash outside the United States.<sup>111</sup>

U.S. policymakers and observers sometimes think the United States should not object if U.S.-based multinational companies successfully game the tax laws of foreign jurisdictions in which they do business, but the preceding paragraph demonstrates why the United States would lose if it were to follow that strategy. By generating tax rents by moving income from high-tax foreign countries in which they actually do business to low-tax jurisdictions, U.S. multinational companies have an incentive to locate investment in high-tax foreign countries. And by leaving their global interest expenses in particular in the United States without significant tax constraints, U.S.-based multinationals in turn can erode the U.S. tax payable on their domestic operations.

At the request of the G-20 countries, the OECD embarked on an urgent project to develop comprehensive recommendations to address “Base Erosion and Profit Shifting,” and the United

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<sup>110</sup> See Edward Kleinbard, “Stateless Income,” 11 *Florida Tax Review* 699 (2011); see also Edward Kleinbard, “The Lessons of Stateless Income,” 65 *Tax Law Review* 99 (2011).

<sup>111</sup> Jeff Sommer, “A Stranded \$2 Trillion Overseas Stash Gets Closer to Coming Home,” *New York Times*, Nov. 4, 2016.

States in May 2015 announced major proposed revisions to its model income tax treaty to address stateless income. A 2015 study by the Congressional Research Service found that in 2012, about one-half of all international earnings of U.S. firms (\$600 billion out of \$1.2 trillion) was attributable to seven countries ordinarily considered tax havens.<sup>112</sup> That same report found that base erosion and profit shifting was a global sport, not confined to U.S.-domiciled firms. To the same effect, recent work by Kimberly Clausing has estimated the U.S. tax revenue loss to profit shifting exceeds \$100 billion per year.<sup>113</sup>

More recently, the Competition Commission of the European Union in 2016 concluded that Apple Inc. had been the recipient of illegal state aid from Ireland, in the form of a tax transfer pricing agreement that permitted an Apple's Irish subsidiary that functioned as Apple's principal sales subsidiary in Europe to enjoy extremely low Irish effective tax rates – in fact, below 1 percent.<sup>114</sup> The controversy surrounding whether EU competition law was an appropriate policy instrument in this case overshadowed the Competition Commission's substantive tax findings, which were that the Irish subsidiary in question derived most of Apple's income from the entirety of its European operations, and paid very little tax anywhere; by one estimate, Apple paid tax to all foreign jurisdictions combined on \$200 billion of profits at an effective rate of about 4 percent per year over a 10-year period.<sup>115</sup>

As these examples suggest, there is a widespread consensus that existing “arm's-length pricing” tools are insufficient to the task confronting tax administrations, and that new tax instruments are required. In the United States, the tax-writing committees of the Congress have over the last several years released discussion drafts of comprehensive revisions to the U.S. corporate tax system that would lower corporate statutory rates and make other major changes, and more relevantly here would rewrite the tax rules applicable to the international income of

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<sup>112</sup> Mark P. Keightley and Jeffrey M. Stupak, Congressional Research Service, *Corporate Tax Base Erosion and Profit Shifting (BEPS): An Examination of the Data*, CRS Rel. No. R44013 (April 30, 2015).

<sup>113</sup> Clausing 2016 NTJ article (forthcoming); Kimberly A. Clausing, Profit Shifting and U.S. Corporate Tax Policy Reform, Washington Center for Equitable Growth (May 2016).

<sup>114</sup> European Commission Press Release, “State aid: Ireland gave illegal tax benefits to Apple worth up to €13 billion” Aug. 29, 2016 ([http://europa.eu/rapid/press-release\\_IP-16-2923\\_en.htm](http://europa.eu/rapid/press-release_IP-16-2923_en.htm)) (negative decision, with recovery); Edward Kleinbard, “Apple's Ireland tax avoidance should spur major reforms,” *The Hill*, Sept. 6, 2016 (<http://thehill.com/blogs/pundits-blog/finance/294453-apples-ireland-tax-avoidance-should-spur-major-reforms>); Edward Kleinbard, “The myths behind Apple's manufactured tax crisis,” *Financial Times*, Sept. 5, 2016. The Competition Commission's 2014 preliminary analysis is State aid SA.38373 (2014/C) (ex 2014/NN), available at <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=OJ:C:2014:369:TOC>.

<sup>115</sup> Id; Vanessa Houlder, “Apple's €13bn bill swamps its EU tax filings: FT calculations highlight how tech group concentrated profits in ultra-low tax Irish subsidiaries,” *Financial Times*, Aug. 31, 2016; Vanessa Houlder et al., “Apple's EU tax dispute explained: The consequences of the commission's complaint and the wider implications of its ruling,” *Financial Times*, Aug. 29, 2016 (calculating 4 percent effective total foreign tax rate over 10 year period).

U.S.-based multinationals.<sup>116</sup> Similarly, the President’s 2016 Fiscal Year Budget proposed to rewrite these same rules, in ways that were not that far apart from the most comprehensive proposal made by the Republican party (the discussion draft released by former House Ways and Means Committee chairman Dave Camp).<sup>117</sup>

Very generally, the thrust of these legislative proposals is for the United States to adopt a “territorial” tax system for outbound foreign direct investment, but to couple that approach with stringent anti-avoidance provisions.<sup>118</sup> In particular, the President’s 2016 Fiscal Year Budget proposed that the United States impose a country-by-country 19 percent profits tax as a minimum tax on the income of U.S. controlled foreign corporations.<sup>119</sup> (The 2014 Camp proposal recommended a minimum tax as one possible anti-abuse rule as well.) The minimum tax would operate as a soak-up tax, bringing the effective tax rate on the foreign operations of a U.S. multinational up to the level of the 19 percent profits tax in each country in which it did business. In practice, this floor would operate as a ceiling: tax directors at U.S. multinationals would not long hold their jobs if they consistently missed that target. Of course, a minimum tax like this in fact is a worldwide residence-based tax system, and so one has the ironic result of an ostensible territorial tax system, protected from the easy gaming that follows from simplistic territorial designs by a worldwide residence based country by country minimum tax that in practice will be the binding policy.

While these proposals were framed as income taxes, similar transfer pricing problems can arise in value added taxes or profits taxes. David Bradford struggled to develop a workable origin based framework for the international aspects of his X Tax, but the results were complex and uncertain of success.<sup>120</sup> Destination-based value added taxes or the destination based cash flow tax described in Section V.B. largely avoid exposure to transfer pricing problems, but arguably surrender too much taxing jurisdiction when applied to the United States, whose technology, pharmaceutical and other firms have led the world in the development of highly valuable intangibles in recent decades.<sup>121</sup>

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<sup>116</sup> Edward D. Kleinbard, “Why Corporate Tax Reform Can Happen,” 146 Tax Notes 91 (Apr. 6, 2015).

<sup>117</sup> Id.

<sup>118</sup> Id.

<sup>119</sup> Id.

<sup>120</sup> Compare David F. Bradford, *THE X TAX IN THE WORLD ECONOMY: GOING GLOBAL WITH A SIMPLE, PROGRESSIVE TAX* (2004) with David Weisbach, *Does the X Tax Mark the Spot?*, 56 SMU L. Rev. 2001 (2003) (criticizing the X Tax’s international operation). Robert Carroll and Alan D. Viard, *PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED* (2012), at 111-14, describes the transfer pricing abuses to which the origin-based X Tax could be subject, but concludes that the solutions proposed by Bradford are feasible.

<sup>121</sup> It can be argued that the apparent gratuitous surrender of taxing jurisdiction over exports of high-value intangibles in a destination based VAT or cash flow tax is not in fact a loss to the U.S. fisc, because the returns from those intangibles ultimately will fund consumption by the firm’s owners, and to the extent they are U.S. persons the

For these reasons I believe it useful to explore another fundamental direction in international tax design that is stable, that does not involve perpetuating the lock-out effect of current law, and that constrains stateless income planning – a worldwide residence-based profits tax.

At the outset, it must be acknowledged that such a tax falls into neither the pure destination nor pure origin cubbyholes through which most profits taxes (including value added taxes) are analyzed.<sup>122</sup> Nonetheless, if one accepts that corporate residence is stickier than is sometimes supposed, it is not clear why this novelty is fatal. It is driven from one direction by the limits of destination based profits taxes (as discussed here and in Section V.B.), and from the other direction by the political economy necessity that standard “territorial” tax proposals are easily gamed, and that the result of such gaming is the capture of tax rents – that is, the capture in a low tax country of returns priced under the expectation that they would be taxed in a high-tax

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United States will capture that revenue through increased consumption in the United States. This has merit, but overlooks the significant minority interests held by foreign investors. As applied to a company like Microsoft or Facebook, the question here ultimately is whether a rigorous consumption base is appropriate, or whether instead we can fairly treat those companies as entirely U.S. juridical persons, notwithstanding their global stock ownership, in order to assert at least residual taxing jurisdiction over the entirety of their value added. Tax law academics have been quick to deride the concept of a firm having a nationality, but outside of tax law there is much less confusion.

Another way to pose the question is to begin with the iron law of trade economics that the present value of a country’s exports must equal the present value of its imports. (Phrased alternatively, exports have value because they pay for imports; any other theory is an expression of long-discredited mercantilism by another name. Robert Carroll and Alan D. Viard, *PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED* (2012) at 106-07.) Then the question is, how should one apply this principle to a U.S. firm that generates economic rents on exports, but where the firm itself is (for example) 20 percent owned by foreign investors? Are 100 percent of the firm’s sales outside the United States properly viewed as exports, or only 80 percent? The firm itself is an actor, with its own imports. Moreover, the firm employs the U.S. dollar as its functional currency, and in this respect the firm is in the same position as a U.S. individual: purchases of imports require foreign currency, and sales of U.S. exports require the foreign purchaser to obtain U.S. dollars. At the same time, however, its owners ultimately reap the benefits of the economic rents it captures. The Dual BEIT effectively treats this firm as entirely U.S. resident.

Destination based frameworks are one logical approach when applied to value added or cash flow taxes. Harry Grubert has convincingly argued, however, that they are internally inconsistent in important respects when married to income taxes. Harry Grubert, *Destination-Based Income Taxes: A Mismatch Made in Heaven?*, 69 *Tax L. Rev.* 43 (2015). One way to see the problem is to ask why normal returns to capital (the unique identifier of an income tax) should belong to the jurisdiction of consumption, rather than the jurisdiction of production or ownership of the capital asset in question.

<sup>122</sup> As between the two, worldwide profits tax consolidation can best be seen as an extension of origin-based profits tax frameworks, in which an irrebuttable presumption is employed that rent-bearing intangible assets of a firm ultimately have their origin in the home country jurisdiction, and therefore can appropriately be reached by a residual residence-based tax. This, for example, is entirely consistent with Apple Inc.’s claims in connection with its EU State Aid case as to where that firm’s core intangible assets are developed, even today.



country.<sup>123</sup> This in turn paradoxically creates an incentive to situate activities in high-tax foreign countries, as the raw feedstock for the tax rents capture machinery.<sup>124</sup>

Put another way, a worldwide residence-based profits tax can be rephrased as a territorial tax with a per-country minimum tax as an anti-abuse rule, where the minimum tax happens to be imposed at the same rate and on the same base as the domestic tax (net of foreign taxes). This statement is less facetious than it may at first appear, because the purpose of the minimum tax is not to collect revenues so much as it is to vitiate the returns to planning strategies designed to capture tax rents. The foreign tax credit preserves the primacy of source country taxation, which is a concept firmly embedded in existing international tax norms.

Unlike destination-based profits taxes, worldwide residence-based profits tax retains residual taxing jurisdiction over the export of high-value intangible assets, which after all are the drivers of most real economic rents in the modern economy. Unlike origin-based profits taxes along the lines of Bradford's X Tax, worldwide tax consolidation exposes the fisc to very little in the way of tax gaming. And finally, because the tax is a profits tax, and one imposed at middling tax rates, the worldwide consolidation approach recommended for the Dual BEIT should introduce very little in the way of deadweight loss: by virtue of the foreign tax credit, foreign direct investment is not discouraged, and by virtue of the worldwide design foreign direct investment is not encouraged vis a vis domestic investment. It is true that the system might impose a higher tax burden on genuine investment in low-tax Freedonia than would be the case in a destination based or pure territorial tax system, but this complaint should be tempered by inspection as to how much real investment (in the form of property, plant and equipment, or employees) actually takes place in the tax havens currently favored by U.S. multinational firms.

Under the proposed international tax module of the Dual BEIT, a U.S.-resident multinational business enterprise would be taxed on the profits arising from its consolidated worldwide income, including all of its subsidiaries wherever located.<sup>125</sup> This rule mirrors how a multinational firm today presents its activities to investors, through the lens of financial accounting. By virtue of true worldwide consolidation, all group income and assets would be treated as owned by the U.S. parent for purposes of its U.S. tax bill, and intercompany interest, rents, royalties or dividends would be ignored. Foreign losses would be immediately deductible in the United States, which leads to more neutral after-tax outcomes from returns to risk.

It is true that a comprehensive worldwide superconsolidation regime puts pressure on what it means to be a "U.S." as opposed to a foreign firm, which pressure does not exist in the

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<sup>123</sup> Edward D. Kleinbard, "Stateless Income," 11 Florida Tax Rev. 1 (2011).

<sup>124</sup> Id.

<sup>125</sup> See Edward D. Kleinbard, "Rehabilitating the Business Income Tax," *The Hamilton Project at the Brookings Institution*, (2007) (laying out in more detail the standards of consolidation, the definition of a "U.S." firm, and other technical issues).

Destination-Based Cash Flow Tax, discussed in the next section. It has been suggested that the identity of a firm's residence as the United States is as artificial as is the construct of "source" under current international tax norms. This is an overstatement today, and one that in any event is made less fraught by the Dual BEIT, because the firm level tax will become an attraction, rather than a source of frustration, for U.S. enterprises.<sup>126</sup> Most of us are not confused that General Electric is "American," and Philips Electronics "Dutch." Similarly, no person or institution except the tax law is confused that Mylan, headquartered in Minneapolis, and with a predominantly U.S. shareholder base, is not an Irish corporation in substance. At the same time, there is little evidence that new U.S. business enterprises are organized in foreign jurisdictions.<sup>127</sup>

It is true that the U.S. definition of residence is outmoded in not embracing a "mind and management" alternative leg to the analysis, but that is easily remedied.<sup>128</sup> To this can be added a rebuttable presumption that firms that employ the U.S. dollar as their functional currency and that have some managerial presence in the United States are U.S.-resident for tax purposes. Too many critics are too quick to overlook the practical power of presumptions such as this.

Once normal returns are "kicked upstairs" to investors, the entire question becomes less urgent, because the remaining tax base is neutral in the technical sense, and moderate (if this Article's recommendations are heeded) as applied to profits. When combined with robust anti-inversion rules, the result is an environment in which there would remain little incentive for a foreign firm to acquire a U.S. one simply to create value by liberating the U.S. firm from the reach of the Dual BEIT.

At one blow, and without further international coordination, the returns to stateless income planning across foreign jurisdictions would be vitiated, because low-taxed foreign income would be taxed on a current basis in the United States. Moreover, because the Dual BEIT contemplates that all business enterprises, however organized, would be subject to the same tax regime, there is no risk of tax arbitrage across different forms of business organization within the United States. Finally, the residence basis for the firm-level tax in the Dual BEIT does not require any coordination across countries, or international clearing houses to transfer tax

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<sup>126</sup> For a summary of the issue under current law, and straightforward suggestions for clarifying corporate residence, see Edward Kleinbard, "The Lessons of Stateless Income," 65 *Tax Law Review* 99 (2011); Edward Kleinbard, "Competitiveness Has Nothing to Do With It," 144 *Tax Notes* 1055 (Sep. 1, 2014). For a contrasting point of view, compare Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 *Tax L. Rev.* 155, 178 (2007).

<sup>127</sup> Susan C. Morse, "Startup Ltd.: Tax Planning and Initial Incorporation Location," 14 *Florida Tax Rev.* 319 (2013).

<sup>128</sup> Cf., International Tax Competitiveness Act of 2010, H.R. 5328, 111th Cong. § 2 (2010).

payments collected by one country to another.<sup>129</sup> These are all sound practical reasons to prefer a true worldwide tax system relying on full global tax consolidation.

The Dual BEIT is a profits-only tax, and that principle would apply from a U.S. perspective to the entirety of the group's operations, so that normal returns wherever earned would be exempt from U.S. tax. In turn, the Dual BEIT contemplates that U.S. investors would include in income their Includible Amounts in respect of all financial investments, whether in a U.S. or a foreign firm. This moves the core of capital income taxation to the least mobile taxpayers (resident individuals), and presents a uniform tax environment for domestic investors, so that portfolio investment decisions are not systematically distorted.<sup>130</sup>

Foreign investors in U.S. firms will obtain the full benefit of U.S. profits-only business taxation, because that is the base of the business enterprise tax, and those foreign investors will not be subject to U.S. Includible Amount taxation or compensatory withholding taxes. This makes investment in U.S. domestic business operations attractive to foreign investors and U.S. investors alike – particularly if the U.S. profits-only tax rate is in the range suggested by this paper (around 25 percent). Thus, unlike CBIT, shifting the taxation of normal returns to investors leads to neutrality in cross-border portfolio investment decisions, in both directions.

The Dual BEIT contemplates that U.S. enterprises would obtain a foreign tax credit against foreign income or profits taxes, subject to the same ceiling that applies today, under which a foreign tax credit can only be used up to the tentative U.S. tax on that foreign income. This is the “foreign tax credit limitation” of section 904(d).

As applied to the Dual BEIT, the foreign tax credit limitation would be measured by a fraction, the numerator of which is the firm's foreign profits tax base, and the denominator of which is the firm's worldwide profits tax base, determined under the same principles. In order to address vestigial stateless income planning opportunities, this foreign tax credit would be applied on a country-by-country basis.<sup>131</sup>

A U.S. firm's foreign profits tax base employed to measure the availability of foreign tax credits would be determined using U.S. tax principles in general, including the disallowance of all local interest expense, and would apply the COCA deduction to the firm's basis in foreign

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<sup>129</sup> Compare Michael Devereux & Rita de la Feria, “Designing and Implementing a Destination-Based Corporate Tax,” *Oxford University Centre for Business Taxation*, working paper 14/07, May, 2014.

<sup>130</sup> Obviously different jurisdictions will impose different business entity level effective tax rates, but that is both true today and unavoidable. The point in the text is that U.S. investors' decisions to buy one or another post-business tax income streams will not be distorted by the Dual BEIT.

<sup>131</sup> This actually parallels recent U.S. proposals to “backstop” a territorial tax system with a country-by-country minimum tax. In practice the combination of foreign taxes and this minimum tax would produce an effective tax rate on all current non-U.S. income of a U.S. group no lower than the minimum tax rate, combined with country-by-country foreign tax credits.

business assets as so determined.<sup>132</sup> The result is that a U.S. multinational enterprise would apportion its COCA expense for foreign tax credit limitation purposes to its worldwide assets based on its real investments in each country.

The ultimate idea is that foreign income taxes on normal returns technically could be credited against U.S. taxes on foreign profits, but foreign taxes on normal returns would not offset U.S. taxes on U.S. profits. In practice, however, foreign taxes paid on foreign normal returns would be utilizable to reduce a tentative U.S. tax bill only where the foreign operations generated profits as well as normal returns, and where the blended foreign tax rate were sufficiently low that the total foreign tax burden on the sum of normal returns and profits were lower than the U.S. tentative tax on those foreign profits alone.

It is true that multinational firms might find themselves with excess foreign tax credits, particularly if foreign countries retain firm-level taxes on normal returns, but I have reluctantly concluded that this is largely unavoidable. No unilateral tax system can create international harmony out of disharmonious competing tax regimes.<sup>133</sup>

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<sup>132</sup> The international application of the COCA deduction should not be problematic as an administrative matter. The COCA deduction is calculated in respect of investment (basis) in business assets, and those assets generally have a known location. Moreover, the firm itself has detailed records of its costs. It would, however, be desirable to explore in more detail the viability of following local tax law depreciation rules in calculating the COCA deduction attributable to a jurisdiction. The reason for this hybrid approach would be that to use U.S. tax depreciation accounting rules here might create unnecessary volatility in foreign effective tax rates.

<sup>133</sup> One of my original concerns in an early version of the BEIT had been to minimize the risk that an enterprise would face tax on its normal returns anywhere in the world, in particular by systematically incurring excess foreign tax credits attributable to taxation of foreign normal returns. I therefore conceived an overgenerous foreign tax credit system, under which foreign taxes on foreign normal returns could in some cases offset tax otherwise due the United States in respect of U.S.-source profits. The particular mechanism to accomplish this was to treat a U.S. firm's worldwide COCA deduction as allocable entirely against U.S. domestic source income for purposes of determining the effective tax rate imposed by the United States on foreign income.

I have come to the view that this was a mistake, and instead here propose that foreign taxes on foreign normal returns can be used as tax credits only against foreign profits. In particular, I have focused more closely on the implications flowing from the idea that in a small open economy, a tax on normal returns should lead to a reduction of investment and an increase in pretax yield, to preserve a constant global post-tax normal return. (Some of these implications are developed in "The Lessons of Stateless Income," 65 *Tax Law Review* 99 (2011).) As a result, the incidence of such a tax would not come to rest on the multinational enterprise doing business in that small open economy, but rather on labor in that country. If this is correct, then there is no reason to feel sympathy for firms that find themselves unable to claim a foreign tax credit in respect of taxes whose incidence did not fall on them in the first place.

The discussion in the text also has benefitted from rereading an exchange of letters with Alvin Warren of Harvard Law School. See Edward D. Kleinbard, letter to the editor, *Tax Notes*, Mar. 3, 2008, p. 1043, Doc 2008-4155, 2008 TNT 43-48; Daniel Shaviro, letter to the editor, *Tax Notes*, Mar. 3, 2008, p. 1048, Doc 2008-4031, 2008 TNT 43-47; Alvin C. Warren, "The Business Enterprise Income Tax: A First Appraisal," *Tax Notes*, Feb. 25, 2008, p. 921; Alvin C. Warren, "How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?" 52 *Tax L. Rev.* 2 (1996-1997). I have taken both my own work on the pervasiveness of stateless income today and Prof. Warren's concerns to heart in revising my earlier suggestions here.

The prospect that a U.S. firm operating in the new profits-only tax environment could in some cases obtain a tax credit for income taxes paid to a foreign jurisdiction in respect of foreign normal returns requires elaboration. The basic rationale is that normal returns attributable to foreign operations are not tax exempt at all, at least in the hands of U.S. investors. A U.S. investor will include in income as Includible Amounts a normal return on the entirety of her investment in a multinational firm, which investment has gone to fund the enterprise's foreign as well as domestic assets. The U.S. investor's Includible Amounts are not sheltered by any foreign tax credits at the investor level.<sup>134</sup> As a result, normal returns on financial investment indirectly representing the entirety of a multinational enterprise's asset base are fully subject to U.S. taxation when owned by U.S. investors.

In turn, the foreign tax credit limitation operates to ensure that foreign income taxes on foreign normal returns do not reduce a U.S. firm's tax liabilities in respect of economic rents. To the contrary, it means that in practice U.S. firms often will face excess tax credits, in the absence of self-help.

For example, imagine that a U.S. firm all of whose owners are U.S. individuals earns \$100 in the United States and \$100 in Freedonia, before COCA. It has \$1,000 of assets in each country, and a total COCA deduction (at 4 percent) of \$80. (The firm thus has earned significant profits.) The firm's U.S. tax base on its global operations is \$120; assuming a 25 percent tax rate, its pre-foreign tax credit tax bill will be \$30. Meanwhile, if the U.S. owners happen also to have \$2000 invested in the firm, their Includible Amounts will be \$80, and their tax bill \$20, for a total integrated tax charge of \$50.

Imagine that Freedonia taxes the firm \$25 (i.e. 25 percent of \$100), because Freedonia employs a corporate income tax, and the firm is equity funded (and holds perpetual assets – the most extreme case). If that amount were fully creditable, the total integrated tax bill would remain \$50, but Freedonia would capture \$25, and the United States only \$5, of firm-level tax.<sup>135</sup> Here is where the foreign tax credit limitation comes into play. The Freedonian tax bill would be creditable only to the extent of  $\$60 / \$120 \times \$30$ , or \$15. Total firm taxes would rise to \$40, and the total integrated tax bill to \$60.

The U.S. firm would be required to employ self-help to reduce its tax bill back to \$30 – for example, by capitalizing its investment in Freedonia in part with intercompany debt, the interest on which is deductible in Freedonia. (Since the United States would employ worldwide tax superconsolidation, under which intercompany interest payments would be ignored, this would have no U.S. tax meaning.) The practical risk is double taxation, even with the foreign tax credit. This is particularly the case with a country-by-country foreign tax credit, but that

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<sup>134</sup> An exception might be made for withholding taxes on dividends from foreign corporations, to preserve neutrality in post-enterprise tax investment environments.

<sup>135</sup> This essentially tracks an example suggested by Professor Warren, *supra* n. 120.

restriction is needed to remove any incentive to produce large streams of low-taxed foreign-source rents to absorb excess foreign tax credits from operations elsewhere.

Now imagine the same facts, except that Freedomian operations earn only a normal return of \$40, on which tax is due of \$10. The U.S. profits-only tax on this would be zero, after the COCA deduction. What should the foreign tax credit be? If the \$10 were allowable as a credit, it would offset \$10 of the tentative \$15 U.S. tax on U.S. profits, leaving a U.S. tax bill of \$5 and a Freedomian tax bill of \$10. If the foreign tax credit is zero, then total taxes rise to \$60, as in the first part of the example. (That is, the normal return from Freedomian operations in either case is subject to firm-level tax.)

On the one hand, allowing the credit in full would preserve a system under which the total integrated tax burden would remain \$50 – or, phrased alternatively, under which normal returns are taxed once, and once only, to investors. On the other hand, if U.S. investors made portfolio investments in a standalone Freedomian firm with exactly the same income and assets as the Freedomian operations of the U.S. multinational in this example, those U.S. investors would face a firm that incurred the same \$10 enterprise level tax, and would pay \$10 of tax in respect of Includible Amounts to boot.

In the end, the second argument is more convincing: it is not sustainable to use the foreign tax credit system to hold U.S. portfolio investors harmless from a tax charge that their firm would suffer if it were a standalone foreign operation, because then the United States effectively would subsidize foreign countries for not reforming their tax systems to profits-only taxes.<sup>136</sup> The good news is that, at least today, a U.S.-based multinational enterprise could use intercompany debt and similar techniques to strip the Freedomian tax base to a Dual BEIT-level equivalent. (Stripping further than that would serve no purpose, since the Dual BEIT would apply to any Freedomian income unsheltered by Freedomian tax.)

The international tax regime contemplated above can be implemented unilaterally. It creates a neutral profits-only U.S. domestic business tax environment that is available to both U.S. and international portfolio investors. It does not incrementally burden foreign normal returns of a U.S. multinational group, and thereby again is a neutral investment platform for U.S. and foreign portfolio investors (when “neutral” here is understood to mean comparable in result to a portfolio investment in a standalone firm domiciled in the foreign jurisdiction in question). And it substantially vitiates any opportunities for stateless income tax planning. Provided that the U.S. profits-only tax rate is not greatly disproportionate to world norms, investment in U.S. business operations and in U.S. multinational business enterprises should face more neutral and more attractive tax environments than currently is the case.

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<sup>136</sup> This is a different way of phrasing the conclusion urged by Prof. Warren in the exchange of letters in 2008. It remains the case, however, that tax-exempt investors are a red herring here.

## B. A Novel Alternative: The Destination-Based Cash Flow Tax.

1. *In General.* Recognizing the scope of the stateless income problem, Alan Auerbach and Michael Devereux have proposed in a series of papers a “destination-based cash-flow tax” (DBCFT), one of whose chief aims is to deflate the returns to profit shifting.<sup>137</sup> The DBCFT idea has attracted tremendous attention, and its principles are reflected in the 2016 House Republican “Better Way” package of fiscal proposals, usually referred to as the “House Blueprint.”<sup>138</sup> For that reason, it is useful to consider briefly the DBCFT, and how it might relate to the Dual BEIT.

The DBCFT would replace the corporate income tax. Thus, while in some respects it can be analogized to a value added tax (as discussed below), it is not intended as an additional tax on domestic consumption sitting on top of traditional business income taxes.

As its name implies, the DBCFT is a cash-flow tax, and therefore operates as a firm-level profits tax, just as does the Dual BEIT. As such, the wholly-domestic application of the DBCFT is unexceptional. Current expenses (including in respect of labor inputs) and capital costs alike would be deductible, so that in ex ante terms the tax would fall on profits. Because they both are profits taxes, neither structure burdens normal returns earned by a business enterprise. And because the cash-flow design of the DBCFT reduces the effective marginal tax rate on investment to zero, the DBCFT (like any other well-designed profits tax) disallows any deduction for net interest expense (interest expense net of interest income).

The interesting aspects of the DBCFT relate to its international application. The Dual BEIT could adopt the Auerbach-Devereux DBCFT as its bolt-on international tax module, but there are good reasons, I believe, not to do so. This Section V.B. explains my reasoning.

While both are profits taxes, the DBCFT differs from the Dual BEIT in a number of respects, of which three are of paramount importance. First, the DBCFT is silent as to the coordination of its proposed business entity tax with investor-level taxation. *Capital Taxation in an Age of Inequality* argues that this coordination exercise is important, difficult and, if handled poorly, the source of its own potential efficiency losses. More generally, that paper argues that capital income taxation is desirable, once properly situated against the political economy background of substantial income and wealth inequality.

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<sup>137</sup> Alan J. Auerbach, “A Modern Corporate Tax,” *The Hamilton Project*, (Dec. 2010); Michael Devereux & Rita de la Feria, “Designing and Implementing a Destination-Based Corporate Tax,” *Oxford University Centre for Business Taxation*, working paper 14/07, May, 2014.

<sup>138</sup> “A Better Way: Our Vision for a Confident America – Tax,” Jun. 24, 2016, available at <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>. Analyses include Martin Sullivan, “A U.S. VAT May Be Closer Than You Think,” 152 Tax Notes 1608 (Sep. 18, 2016); Sullivan, “GOP Plan Not So Easily Gamed,” 152 Tax Notes 1060 (Aug. 22, 2016), *restating conclusions in* Sullivan, “Difficulties With the House GOP’s Business Cash Flow Tax,” 152 Tax Notes 771 (Aug. 8, 2016); Wei Cui, “Destination-Based Taxation in the House Republican Blueprint,” 152 Tax Notes 1419 (Sep. 5, 2016); Kyle Pomerleau and Stephen J. Entin, “The House GOP’s Destination-Based Cash Flow Tax, Explained,” Tax Foundation Blog, Jun. 30, 2016, available at <http://taxfoundation.org/blog/house-gop-s-destination-based-cash-flow-tax-explained>.

Second, the DBCFT's international tax rules allocate taxing jurisdiction strictly on the basis of the ultimate destination of goods. In this, the DBCFT can be analogized to a value added tax with border adjustments (the standard implementation around the world). Third, while the DBCFT has no explicit coordination or integration with investor level taxation, it is integrated in a way with domestic labor taxation, as explained below, by permitting a deduction for domestic (but not foreign) labor inputs. This arguably is its most unusual feature, and one that raises significant issues under global trade agreements.

More specifically, unlike a conventional value added tax, to which the DBCFT has many economic similarities, the DBCFT permits firms to deduct the cost of domestic labor inputs. (Another way of saying this is that a conventional value added tax burdens labor income at the flat VAT rate, collected from the employer; an income tax or the DBCFT burdens labor income at progressive tax rates, collected from the employee.) At the same time, the DBCFT follows value added tax border adjustment precedent, by disallowing any deduction for the cost of imported goods, the value of which of course reflect foreign labor inputs, and by excluding (zero rating, if that is a helpful value added tax reference) from income the value of any export.<sup>139</sup> The result is that a U.S. firm whose production activities are in the United States, but all of whose output is exported, would run at a perpetual tax loss, because labor and capital inputs would all be deductible, and export sales would be excludable. Making a credible commitment to such a firm that it will obtain the use of these losses, while reassuring legislators that this is the intended result, and not a tax shelter, remains one of the practical challenges for the managers of the House Blueprint.

By virtue of its destination-based design and the deductibility of wages, the DBCFT's tax base becomes economic rents generated anywhere in the world that are attributable to domestic consumption.<sup>140</sup> The location of production or asset ownership becomes irrelevant: rents generated in the United States but embodied in goods sold for export are not directly taxed by the United States, and rents from foreign ownership or production embodied in goods consumed in the United States are fully taxable in the United States.

The DBCFT thus is a novel hybrid. It is not an income tax, and it is not an origin-based cash flow like the X Tax. It bears many similarities to a subtraction-method VAT (a form of VAT not often seen outside the laboratory), but like the X Tax differs in one fundamental respect, which is that in a conventional subtraction-method VAT, labor inputs (domestic or foreign) are nondeductible.

Auerbach and Devereux have designed their DBCFT proposals to vitiate the returns to base erosion and profit shifting through its destination-based cross-border design. For simplicity,

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<sup>139</sup> In the same fashion, royalties paid to a foreign affiliate to use foreign-owned intangibles in the United States would be disallowed as imports of services, and royalties received from foreign affiliates for the use of intangibles outside the United States would be excluded from the tax base.

<sup>140</sup> The treatment of foreign labor inputs is discussed in the next subsection.



this design element can be analogized to how value added taxes are designed: exports are not taxed in the country of export, and intermediate goods imported into a country are not deductible by the business using them.<sup>141</sup> (Alternatively, the non-deductibility of imports under the income tax optics of the DBCFT – that is, its subtraction method of calculating its tax base – can be rephrased as a tax on imports, as in a credit-invoice value added tax.)

The theory at work in the DBCFT is that a cash-flow tax creates a zero-rate business tax environment for normal returns from domestic operations (i.e., returns on marginal investments), and the destination-based extension eliminates any advantage to sourcing the location of production or the ownership of high-value intangible assets in low-tax jurisdictions. As Auerbach has written:

One might view this treatment of international transactions as a super territorial system—one that ignores not only activities that occur abroad, but also those going and coming. While a simple territorial system would worsen the transfer-pricing problem because it would encourage companies to shift the reported location of activity from the United States to low-tax countries, the two stages together would actually alleviate the problem, because such shifting would no longer be possible.<sup>142</sup>

The destination-based cash flow tax can further be understood as a rejection of standard instruments designed to isolate the geographic source of income:

Briefly, though, the determination of worldwide profit occurs in many locations and is dependent on many types of activities. For example, many aspects of firm activity including headquarters, R&D, production, marketing, and finance could be located in different places or more than one place. In addition, consumers and shareholders could be located throughout the world. There is simply no answer to the question: in which country is profit generated? All of these elements of the company's activities play a part in generating worldwide profit. The combination of them almost certainly plays an additional part. The idea on which the international tax system appears to be based — that the “source” of profit is where the various “productive” activities take place — is actually a historical burden that creates substantial institutional barriers to reform.<sup>143</sup>

The proposals substitute “destination” for “source” as the basis of allocating the right to tax, on the theory that destination jurisdictions have authority to do so, in the institutional sense, and that doing so is neutral in respect of the place of production, which has important efficiency gains. Alternatively, the destination-based cash flow tax can be seen as a territorial profits tax

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<sup>141</sup> Auerbach p. 10 (“The destination principle is already familiar in the context of taxation, because it is the approach used around the world in the implementation of value-added taxes (VATs).”)

<sup>142</sup> Auerbach p. 10.

<sup>143</sup> Devereux, Issues in the Design of Taxes on Corporate Profit, 65 Nat'l Tax J. 709, 725 (2012).

that relies on an apportionment formula to allocate profits across jurisdictions, which formula employs a single factor (place of consumption of a good) that does not create incentives for a firm to modify its business operations to reduce its tax liabilities.<sup>144</sup>

Because the location of production or the ownership of assets is irrelevant to its consumption tax base, the DBCFT generally obviates the relevance of a corporation's residence. While Section V.A. argued that concerns in respect of this issue are overblown, it unquestionably is true that eliminating any relevance to this determination would be desirable, if otherwise costless.

The Auerbach and Devereux proposals accomplish their intended objectives of neutralizing the production location decision within the four corners of their systems, but the DBCFT appears vulnerable to gaming if it is not adopted comprehensively. For example, if the United States were to adopt the new regime only for corporations, then unincorporated firms will become the importers of choice, because they will remain able to deduct the cost of their imports, thereby reducing the U.S. tax burden on U.S. ultimate consumption. The House Blueprint in fact extends its DBCFT to unincorporated businesses, including both the disallowance of net interest expense and the destination-based design; as of this writing, it is not clear whether the "small business" community has fully absorbed this.

As another example, if the United States alone adopts a destination-based cash flow tax, that tax system would apply neutrally to a firm's location decisions as between the United States and a foreign jurisdiction, but the new tax would not seem to address existing law's incentives to generate stateless income, and thereby tax rents, by shifting income from high-tax to low-tax foreign jurisdictions that have themselves not migrated to destination-based systems.

As pointed out in section V.A., a destination-based tax system is not the only stable international tax regime that obviates the relevance of stateless income gaming. As suggested in *The Lessons of Stateless Income*, there are in fact two approaches to the design of business taxes that are robust to international base erosion and profit shifting. One is a territorial system whose source rules or apportionment formula cannot be gamed (comprehensive destination-based profits-only taxes being one example, at least from the perspective of the residence country). The other stable solution stakes out the opposite corner: a residence-based worldwide "superconsolidation" tax system. This is the approach just presented in respect of the Dual BEIT, although in fairness to the overall reform program, the Dual BEIT can accommodate either solution.

2. *Border Adjustments*. At least as of the date of this writing, the border adjustment feature of the DBCFT has engendered tremendous confusion on the part of proponents and opponents alike. Proponents, for example, promise exporters that the DBCFT will subsidize their

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<sup>144</sup> Id.

U.S. production destined for foreign consumption, while simultaneously arguing to importers that currency rate adjustments will protect them from any adverse consequences. It is worth teasing this issue apart.

Economists are clear that a border-adjustable VAT does not in fact operate as an export subsidy or import penalty. The basic argument is simply that if trade is in equilibrium today, the imposition of a uniform tax on all domestic consumption will affect an individual's budget constraint (just as a wage tax would), but not the relative prices of goods.<sup>145</sup> As a result, real prices should be unaffected by the introduction of a border-adjusted VAT: goods wherever produced will be taxed by the United States when consumed in the United States, and goods produced in the United States for export will be taxed only under the consumption tax of the country in which the goods are consumed.

The principal mechanisms by which real prices – the equilibrium in trade – are maintained after the introduction of a value added tax are currency exchange rate adjustments. Thus, if foreign currency markets are open and liquid, economists would expect to see a prompt movement in currency exchange rates that preserves real relative prices of goods. If the United States, for example, imposes a 20 percent DBCFT, economists would expect to see the U.S. dollar appreciate 25 percent against foreign currencies.

In other words, if one were to imagine the first country to introduce a VAT, and compared trade between it and other countries before and after the introduction of the VAT, one might be surprised to observe that external trade flows were unaffected by the introduction of the VAT. Currency exchange rates would adjust, so that, while trade would be unaffected, the currency of the first country to introduce the VAT would rise relative to the currencies of its trading partners.<sup>146</sup> (As an aside, this conundrum should be employed as a litmus test by every

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<sup>145</sup> David F. Bradford, *THE X TAX IN THE WORLD ECONOMY: GOING GLOBAL WITH A SIMPLE, PROGRESSIVE TAX*, American Enterprise Inst. (2004), at 6 – 9; Alan D. Viard, "Border Tax Adjustments Won't Stimulate Exports," 122 Tax Notes 1139 (Mar. 2, 2009).

<sup>146</sup> David F. Bradford, *THE X TAX IN THE WORLD ECONOMY: GOING GLOBAL WITH A SIMPLE, PROGRESSIVE TAX*, American Enterprise Inst. (2004), at 6 – 9; Alan D. Viard, "Border Tax Adjustments Won't Stimulate Exports," 122 Tax Notes 1139 (Mar. 2, 2009).

Robert Carroll and Alan D. Viard, *PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED* (2012), ch. 7, explains in similar terms the "illusion" of any alleged competitiveness effects from the introduction of a destination based tax with border adjustments, and further shows the equivalence of origin and destination based consumption taxes in this regard. In the context of a simple one-period model, for example, they conclude that "As measured in foreign currency, destination-based taxes raise [nominal] consumer prices, while origin-based taxes lower disposable income, but both taxes cause the same reduction in real disposable income." *Id.* at 106.

The authors go on, however, to consider a number of cases where the simple exchange rate adjustment story can run into difficulty. One is the introduction of different tax rates on different industries. Another, relevant to a VAT but *not* the DBCFT or the Dual BEIT, is the stickiness of wage rates (in nominal terms). The Federal Reserve could be compelled on the introduction of a VAT to accept a one-time increase in nominal prices (inflation) as a mechanism to reduce wages, to reflect the fact that in a VAT the firm rather than workers is paying the tax on labor inputs. *Id.* at 166-70.

university career services office. Economists see intuitively why this must be so; tax lawyers remembering reading that it is true, but cannot explain why; and policymakers neither remember nor believe that it could possibly be true.)

From this, the argument continues, the concerns expressed above that the DBCFT might burden imports and subsidize exports must be mistaken: exchange rate adjustments will restore equilibrium.<sup>147</sup> If this is true in practice, trade will be unaffected. If it is untrue in practice, then exports will be subsidized and imports penalized. Boeing will be advantaged, and Walmart disadvantaged. Economists point to Brexit's effect on sterling, and the presidential election's effect on the Mexican peso, as instances where currency rates did in fact promptly respond to events – in both those cases, however, to threats to the prior trade equilibrium.

What follows from this argument as well is that the reason why foreign firms might rush to relocate production to the United States following the adoption of the House Blueprint is *not* that the DBCFT penalizes imports as such, but rather that such a move eliminates *foreign income* tax to which the exporter might otherwise be subject. That is, a Freedomian exporter of widgets to the United States for consumption therein generally faces the same U.S. tax regime as does a U.S. producer (subject to the observations below about labor tax rates), and in addition presumably faces Freedomian corporate income tax on the income generated by its Freedomian production. It is the foreign tax that the relocation eliminates, not an incremental U.S. one.

It also follows from this that the transition to a destination based profits tax, and with it the appreciation in the U.S. dollar, will work a one-time very large wealth transfer from U.S. investors to foreign investors. Foreign investments held by U.S. investors overnight will be worth less in dollar terms, and U.S. investments held by Freedomian investors overnight will be worth more in Freedomian pfennig terms.<sup>148</sup> Carroll and Viard have estimated that at the end of 2010 the wealth transfer attributable to the introduction of border adjustments without any transition relief would have amounted to a \$7.88 trillion loss to American investors and an \$8.85 trillion pickup in wealth for foreign investors.<sup>149</sup> As of the time of this writing, I am reasonably confident that policymakers have not weighed the implications of this.<sup>150</sup>

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<sup>147</sup> See in addition to the sources in the preceding footnote, Alan J. Auerbach and Douglas Holtz-Eakin, *The Role of Border Adjustments in International Taxation*, American Action Forum (Nov. 28, 2016), available at <https://www.americanactionforum.org/print/?url=https://www.americanactionforum.org/research/14344/>.

<sup>148</sup> Robert Carroll and Alan D. Viard, PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED (2012), at 109-11 (observing that the issue has received “surprisingly little attention”); Alan D. Viard, “Border Tax Adjustments Won’t Stimulate Exports,” 122 Tax Notes 1139 (Mar. 2, 2009).

<sup>149</sup> Robert Carroll and Alan D. Viard, PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED (2012), at 110-11.

<sup>150</sup> As previously noted, Robert Carroll and Alan D. Viard, PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED (2012), at 111-14, describes the transfer pricing abuses to which the origin-based X Tax could be subject, but concludes that the solutions proposed by Bradford are feasible. Those authors then conclude that an origin-based consumption tax system like the X Tax is to be preferred over a border-adjustable destination based system, because the former does not introduce the one-time wealth transfer described in the text.

3. *World Trade Organization Rules*. One important objection to the DBCFT is that it would operate as an illegal tariff – either an import tax or an export subsidy – under the World Trade Organization’s (WTO) General Agreement on Tariffs and Trade (GATT) and its Agreement on Subsidies and Countervailing Measures (ASCM).<sup>151</sup> Experts in WTO law have expressed opinions on this issue, some of which at least raise significant concerns.<sup>152</sup> Counterarguments no doubt can be mustered (some of which are mentioned below). As a political economy matter, however, it seems odd to base once in a generation U.S. business tax reform on a central pillar whose ultimate survival is not free from doubt. The Domestic International Sales Corporation/Foreign Sales Corporation debacle referenced in Part I at least had a relatively narrow impact, and thus was salvageable without tearing out the entire business tax system lock, stock and barrel. Here, the WTO challenge would be to a much more fundamental design element.

At one level, the issue is simple. WTO rules unquestionably permit border adjustments for destination based credit and invoice VATs, and just as clearly prohibit such adjustments for business income taxes. Art. III, Par. 2 of GATT, for example, provides a general rule that:

The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products.

And Art. XVI, Par.1 of GATT generally prohibits export subsidies, including subsidies delivered through a tax system. GATT does, however, contemplate border adjustments for VATs, if (in the case of imports) the VAT applies to domestic production as well as imports.<sup>153</sup>

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The Dual BEIT’s recommended solution also avoids the one-time wealth transfer, and its worldwide superconsolidation regime is simple to implement and plainly robust to transfer pricing gaming.

<sup>151</sup> As a result of the Uruguay Round of negotiations, the WTO replaced GATT as an international organization, but GATT (technically now called GATT (1994)) still exists as the WTO’s umbrella treaty for trade in goods. World Trade Organization, “Understanding The WTO: Basics – The Uruguay Round,” available at [https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact5\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact5_e.htm).

<sup>152</sup> Recent summaries of the application of the agreements mentioned in the text (as well as the complementary agreement for trade in services) include Michael Daly, “Is the WTO a World Tax Organization?: A Primer on WTO Rules for Tax Policymakers,” International Monetary Fund, Fiscal Affairs Department (Mar. 2016); Wolfgang Schoen, “Destination-Based Income Taxation and WTO Law: A Note,” Max Planck Institute for Tax Law and Public Finance (Jan. 2016). Both express skepticism that the border adjustments contemplated by the DBCFT would pass muster under GATT, ASCM and other relevant agreements. See also Wei Cui, “Destination-Based Taxation in the House Republican Blueprint,” 152 Tax Notes 1419 (Sep. 5, 2016); David Weisbach, *Does the X Tax Mark the Spot?*, 56 SMU L. Rev. 2001 (2003). These also express doubts as to the DBCFT’s WTO compliance.

<sup>153</sup> Wolfgang Schoen, “Destination-Based Income Taxation and WTO Law: A Note,” Max Planck Institute for Tax Law and Public Finance (Jan. 2016), summarizes the rules.

The usual shorthand consensus summary of the opaque language of the various WTO agreements and official explanatory texts is that the WTO rules, taken as a whole, prohibit border adjustments as export subsidies and tariffs, unless those adjustments fall within the exception for “indirect” value added taxes. This leads to extensive dialogues concerning the essential difference between direct and indirect taxes, which exchanges are no more satisfying than those surrounding the use of the same terms (albeit in a different context) in the U.S. Constitution.

Economists in particular find it frustrating that taxes with similar economic effects could fall into different legal cubbyholes, but of course that is exactly the world that lawyers inhabit. The DBCFT employs a subtraction method (revenues minus costs), and further (and more substantively) includes a deduction for labor inputs. As a result, it could be argued to more closely resemble an income tax than a value added tax, as the latter term ordinarily is understood, which would mean that border adjustments to the DBCFT are not permissible. In the end, experts in WTO law (who do not include this author) will have to conclude whether this simplistic legal argument will prevail, but the point worth emphasizing here is that this issue is one that should be resolved as convincingly as possible before the DBCFT is enacted into law, in the form of the House Blueprint, not after the fact. It would be a great pity if a once in a generation business tax reform effort later were ruled to be WTO non-compliant, as happened to the U.S. Foreign Sales Corporation tax regime some years ago.

The economists’ case is clear: in economic theory, origin-based and destination-based VATs are economic equivalents, as are credit-invoice VATs and subtraction method VATs. The only differences relate to questions of administration or accommodation of special circumstances (such as different VAT rates or an entity’s taxable status within an economy). Moreover, border adjustments should have no effect on trade, once foreign currency (or other nominal price) movements are considered. Proponents of the DBCFT in particular argue that the DBCFT can be analogized to a combination of two new tax moves: a conventional VAT (albeit implemented as a subtraction method rather than a credit-invoice method VAT) and the application of the revenues from the VAT to reduce payroll taxes (but presumably not Social Security benefits). Each of these moves does not raise any obvious WTO issue, and therefore, it is argued, it cannot be the case that doing them together can be problematic either.

The argument is ingenious, but arguably proves too much. Any tax can be rephrased as a combination of other taxes and rebates – indeed, as one of many possible combinations of different real or imagined taxes and rebates. It asks too much of any institution, whether the WTO or a court, to take what is done and recast it as one of many possible alternative sets of policy instruments that were not pursued.<sup>154</sup> If, for example, the United States were to introduce

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<sup>154</sup> Recourse to substance over form or economic substance doctrines would not avail proponents of the DBCFT here. Those doctrines take a taxpayer’s formal steps and compress them into a tax-cognizable transaction that reflects observable impacts of the taxpayer’s actions on others. Those doctrines cannot be invoked to rearrange what actually was done into something else that, in retrospect, might have laid on a more tax-savvy path.

an iVAT – the “imported value added tax” – we would agree that this was a tariff by another name, not a VAT as that term is ordinarily employed. The iVAT would affect trade, for that reason. To turn the proponents’ argument on its head, if we were to couple that troublesome iVAT with a separate cash flow tax on domestic production sold for domestic consumption (in which labor is deductible), would not the result look much like that reached by the DBCFT?

Nonetheless, in an effort to hold out an olive branch to the economics profession, I have endeavored to think through why the DBCFT strikes legal scholars as troublesome from the perspective of the overall objectives of the WTO, beyond the formalistic arguments just presented. Given the theoretical equivalences just noted, it is unlikely that there is an answer that economists will find very satisfying, but it is nonetheless worth considering some of the pits of economic confusion into which lawyers fall.

One such argument would be that the DBCFT penalizes foreign labor inputs relative to domestic labor inputs. This concern is made a bit less fatuous by virtue of the fact that many policymakers’ enthusiasm for the DBCFT is motivated in large part by its apparently asymmetrical preference for domestic labor over foreign labor, and by the misperception that the DBCFT will be a boon to exports.<sup>155</sup>

The best place to start is with a simple value added credit-invoice tax with border adjustments, because GATT specifically allows this arrangement, and then to compare that to the results obtained under the DBCFT. In a VAT, there is no concept of business profits or losses, just consumption. Total VAT collected by Freedonia is based on the value of domestic consumption in Freedonia, regardless of the place of production of the goods consumed therein. The VAT is not imposed on production or income arising in Freedonia. The place of production of a good (that is, where the value is added, as opposed to where it is consumed) is simply irrelevant: consumers in Freedonia pay the same VAT in the end regardless of where the production takes place. Similarly, consumers in other countries do not bear any Freedonian VAT costs in respect of goods produced in Freedonia.

When Freedonia employs border adjustments (i.e. taxes imports and rebates VAT collected along the supply chain on exports), Freedonia is just ensuring that all consumption in Freedonia (and only Freedonian consumption) will be subject to Freedonian VAT. The same result could be reached through a simple retail sales tax, for example, where sales for export were excluded as not constituting taxable retail sales. Mechanically, an exporter of goods produced in Freedonia gets a VAT refund on inputs that were subject to VAT when purchased, and a Freedonian importer pays VAT on imported goods.

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<sup>155</sup> David Morgan, *Republicans Aim to Coax Trump Toward House Trade Tax Plan*, Reuters News, Nov. 30, 2016, available at <http://www.reuters.com/article/us-usa-trump-tax-idUSKBN13P2H8>. Cf. Kyle Pomerleau and Stephen J. Entin, *The House GOP’s Destination-Based Cash Flow Tax, Explained*, Tax Foundation Blog, Jun. 30, 2016, available at <http://taxfoundation.org/blog/house-gop-s-destination-based-cash-flow-tax-explained>.

By paying VAT on import, the Freedonian importer can be viewed as making a down payment on the total VAT ultimately due in respect of Freedonian consumption, in an amount equal to the value added outside Freedonia. From the other direction, a Freedonian exporter obtains a VAT refund, but only of VAT previously collected along the chain of production. The result is that exported goods – including goods that incorporate components imported into Freedonia – in the end are not subject to Freedonian VAT, because consumption did not take place in Freedonia. There is no VAT refund for direct domestic labor costs paid by the exporter in respect of exported goods, but neither is there a VAT cost. Alternatively, this can be phrased as domestic labor inputs are nondeductible, but income attributable to domestic labor is not taxable.

In short, the border-adjustable features of a conventional credit-invoice VAT assure a level playing field in a way that even lawyers can understand, in that Freedonia is not imposing a differential tax on domestic consumption derived from foreign production (including labor inputs) compared with domestic production. It is possible that intuitions along these lines explain the impetus behind the GATT rule permitting border-adjusted conventional VATs, but not other taxes.<sup>156</sup>

By contrast, it might be argued, under the DBCFT domestic labor inputs (but not foreign labor inputs) are excused from the tax base. As in a VAT, if the United States were to adopt the DBCFT, a U.S. importer of goods ultimately sold for domestic consumption effectively would pay U.S. VAT on the value of its imported goods, including foreign labor inputs, although the mechanism to do so would be the nondeductibility of imported goods. When domestic consumption occurs, U.S. firm-level tax effectively ends up being collected on the full value added, including foreign labor inputs, but excluding the value of any domestic labor inputs, because those are deductible. This applies not only to simple imports and resale, but also to imports of intermediate goods included in finished goods sold for U.S. consumption.

From this a lawyer might then argue that there is a differential tax rate imposed on domestic consumption derived from domestically produced goods and domestic consumption attributable to foreign production. The latter is subject to full VAT, and the former is subject only to VAT on a smaller tax base that excludes the value added by domestic labor. On its face, this seems to be a thumb on the scale disfavoring imported goods, which if true would be problematic.

The economists' answer is that the conclusion is simply wrong. The relevant question is not which party nominally is the taxpayer, but rather which party bears the economic incidence of the tax. Currency or other price movements will ensure that the real balance of trade is unaffected by the DBCFT; an array of imports that today all cost \$100 and that have differing foreign labor inputs will, after the enactment of the DBCFT, continue to cost \$100 in real terms –

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<sup>156</sup> Michael Daly, "Is the WTO a World Tax Organization?: A Primer on WTO Rules for Tax Policymakers," International Monetary Fund, Fiscal Affairs Department (Mar. 2016).



which is to say, the incidence of the tax will not fall on exporters to the United States. As a result, neither absolute levels of imports nor relative prices across imports with different labor inputs will be affected.

Nonetheless there is something to be said for the proposition that this result is easier for nonspecialists to see in the conventional VAT, where global labor and capital inputs are treated identically, based on the location of consumption, when compared to the DBCFT, with its apparent two-tier tax on foreign versus domestic labor. Again, focusing on incidence explains away the optical illusion, but that does not mean that the argument has no power, just as intelligent proponents in policy circles cannot help but argue that the DBCFT will “incentivize” exports. More generally, it may be the case that arguments resting on the incidence of a tax are simply orthogonal to the tools used by lawyers to distinguish one conceptual cubbyhole from another.

As another possible example of the optical illusions that make it difficult for nonspecialists to fit the DBCFT into WTO learning, consider the export case. Continuing with the VAT analogy, if the United States were to adopt a DBCFT, the United States would not impose VAT on exported goods, just as in the ordinary VAT case, but because the DBCFT also permits the deduction for all labor inputs from domestic production, whether aimed at domestic or foreign consumption, the DBCFT would lead to exporters operating at a perpetual tax loss, which is not a relevant concept within a conventional credit-invoice VAT.<sup>157</sup> The DBCFT contemplates that exporters will get tax refunds for these structural losses created by the definition of the tax base (that is, by deducting wages as an expense, and valuing exports at zero).<sup>158</sup> So again there is an apparent distortion relative to VATs: in a VAT, the country of export does not impose VAT or offer VAT refunds on exported goods, while in the DBCFT, exported goods are entitled to government refunds, which is to say, subsidies.

If labor tax rates under the DBCFT are the same as the business enterprise cash flow tax rate, then this apparent subsidy is entirely an optical illusion. The “missing” tax revenues are safe and sound, collected from workers in the form of the wage tax to which they are subject under the DBCFT, but not a conventional VAT. Interestingly, however, if the weighted average tax rate imposed on workers is lower than the DBCFT, then the tax system does seem to have embedded in it a structural arbitrage favoring exports: wages would be deducted at the higher firm cash flow tax rate, and included in income at the lower aggregate rate imposed on workers. This is not problematic in an origin based tax – it is rather simply a matter of domestic tax policy to subsidize wages in this manner – but it does seem on its face to have some substantive merit as

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<sup>157</sup> Again, under a standard VAT with border adjustments, exporters get VAT refunds, but only of VAT paid along the chain of production; as a result, an exporter is left with a net VAT liability/asset of zero.

<sup>158</sup> The House Blueprint cannot bring itself to offer immediate cash refunds, and therefore increases the value of unused net operating loss carryovers by an interest factor. As a practical matter, I would anticipate the adoption of the DBCFT to induce exporters to buy importers, so as to use the export-related losses on a current basis.

an argument when applied in the border adjustment context, because the net effect does appear to give an authentic subsidy to exports.

## VI. SPECIAL INDUSTRIES AND CIRCUMSTANCES

### A. Special Cases.

An earlier paper on a preliminary iteration of the business enterprise income tax<sup>159</sup> described in detail how the Dual BEIT would apply to financial institutions, investment companies, micro businesses, financial derivatives, and other special cases.<sup>160</sup> In retrospect, this author ruefully acknowledges that overspecifying a proposal leads to reader fatigue or nitpicking, rather than admiration and adoption. For these reasons I incorporate here by reference to that earlier paper the application of the Dual BEIT to special cases like those listed above.

Notwithstanding my own good advice to myself, it might be helpful to make a few quick observations. As applied to financial institutions, the rough justice of the Dual BEIT's COCA mechanism is too rough indeed. For financial institutions, money is their stock in trade, and for all relevant purposes (managerial, regulatory, investor relations) firms operate in an entirely or largely mark-to-market environment.

The solution is to put all financial services firms (including active securities traders) on a mandatory mark-to-market system in respect of both their financial assets and their financial liabilities, and to then provide a COCA deduction on the firm's net tax basis in nonfinancial assets, plus the net mark-to-market value of all of its financial assets.<sup>161</sup> The idea here is, first, to capture all of the financial institution's income (through comprehensive mark-to-market accounting) and then to provide a deduction of an amount that reflects a normal return on the institution's net capital, so as not to overtax financial institutions relative to other businesses. (Standard implementations of mark-to-market systems effectively give a deduction for interest payments, but not an allowance for equity.)

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<sup>159</sup> Edward D. Kleinbard, "Rehabilitating the Business Income Tax," *The Hamilton Project at the Brookings Institution*, (2007), at 36-40.

<sup>160</sup> The earlier proposal contained tax rate suggestions, drawn arbitrarily from then-current analogies, but its focus was on working through the technical operation and implications of the BEIT mechanism.

The current Dual BEIT proposal differs from that earlier work in many important respects, including by fully specifying proposed tax rates (as to which the original proposal was largely indifferent), coming to grips with the labor-capital income dilemma, and dropping an earlier surtax on investors' extraordinary returns. That surtax was included originally for tactical political economy reasons, but this author now realizes that he misread the political climate in this respect. Nonetheless, the technical solutions proposed therein generally continue to be relevant.

<sup>161</sup> As applied to financial services firms, the BEIT thus would function much like an ACE system. Financial institutions would obtain deductions in respect of all the actual costs of their liabilities (through the mark-to-market system) as well as the more arbitrary COCA deduction in respect of their net assets (that is, their equity).

Financial institutions today have the systems in place to perform this comprehensive accounting, and banks and dealers in fact already are required to do so in respect of their “trading books” for both tax and financial accounting purposes. The proposal is economically sound; it is consistent with the institutions’ own internal risk assessment, compensation, and capital allocation practices; and it is technically feasible as applied to this specific group of taxpayers.

The BEIT component of the Dual BEIT can be extended to financial derivatives, to assure conformity in outcomes between investments in derivatives and investments in “physicals” (stocks and bonds).<sup>162</sup> Unlike the latter instruments, where one can draw neat distinctions between issuers and investors, derivatives are employed by both. Moreover, a derivative can change its character from asset to liability and back. At the same time, a derivative can move substantial cash from one party to the other. The COCA system therefore can form the basis of a consistent approach to the taxation of derivative instruments, including the returns to capital embedded in them. The detailed proposal is set out elsewhere, but basically the idea would be to continue current tax law’s hedge accounting principles, and mark-to-market for professional dealers and traders; other holders of financial derivatives would be taxed under an asset/liability model, under which outflows would be treated as investments in the contract giving rise to future Includible Amounts, and inflows as recovery of basis, and then a liability.<sup>163</sup>

The issue of tax-exempt institutions pervades current law, and every reform proposal as well. Some, like CBIT, hide the ball for a minute, but no rational person can expect the ultimate political outcome to turn on such cosmetic matters. I therefore have always accepted the likelihood that the Dual BEIT, when implemented in practice, would exempt tax-exempt investors from tax on Includible Amounts, notwithstanding that I would prefer a different outcome.

This subsidy should not influence the actual behavior of firms. The Dual BEIT has no incentive for tax-exempts to hold one type of security over another, or to invest in firms with one mix of income as opposed to another, because the tax consequences for holders on one hand and issuers on the other do not turn on the label of the financial instrument. In turn, the taxation of issuers does not depend in any way on the composition of the firm’s investors. The result is that, even if the subsidy of tax-exempt institutions is maintained in the Dual BEIT, the subsidy should not affect a firm’s financing or investment decisions, whether in respect of the capitalization of the firm or in the firm’s decisions as to where to invest. Similarly, the Dual BEIT thus does not encourage firms to make foreign direct investments at the expense of U.S. ones to generate tax-favored income streams for U.S. tax-exempt investors.

Finally, the overall tax burden on debt provided by tax-exempts to finance equipment purchases by business enterprises will rise from the negative effective marginal tax rates enjoyed

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<sup>162</sup> See Edward Kleinbard, “Rehabilitating the Business Income Tax,” *The Hamilton Project at the Brookings Institution*, pp. 51-53 (2007).

<sup>163</sup> *Id.*

by users of that financing today, to zero. And debt financed rent-bearing assets will pay tax at the business enterprise rate, rather than zero, as can be true today.

To the same general effect, this paper does not address how adjustments for inflation could be incorporated into the Dual BEIT proposal, although I believe that the Dual BEIT is sufficiently flexible in its design to include a solution. In part, this decision reflects the luxury of current times, in which inflation is not (and has not been for several years) of any immediate concern. And in part it reflects both the length of this paper and the sad lesson learned by the author from past iterations of this general theme, which is that overly fulsome explanations of all possible issues convince readers that the idea is simply too complex, rather than fill them with admiration for the care that the author has expended.

In practice, most tax systems today are vulnerable to base measurement problems attributable to inflation, including the income tax regimes in force in major economies, as well as alternative capital income tax proposals. Nor are profits taxes necessarily exempt: even a simple Value Added Tax can expose a firm to tax on phantom inflation income if there is any appreciable lag between the time inputs are purchased and outputs are sold. I therefore think it appropriate for a prospectus of this sort to defer the topic of inflation adjustments until a point further along the implementation path for the Dual BEIT.

#### B. Non-Business Capital Income.

The Dual BEIT is a comprehensive income tax on capital invested in the business sector. This means that it does not reach two hugely important forms of capital investment: investments in government securities (or bank deposits) and investments in owner-occupied housing.

The proposal is to continue existing law addressing the taxation of bank deposits, U.S. government securities and other securities not issued by business enterprises (e.g., foreign governments, or state and local governments). Current law does a good job of measuring capital income on debt instruments in general, at least where those instruments do not have embedded equity features. Current law's exclusion from income of municipal bond interest is mistargeted, but that mistargeting can be addressed separately from the issues considered in this paper.

My proposal for the taxation of owner-occupied housing is brutally simple, yet a step forward in the efficient allocation of capital investment. I propose, as I have developed elsewhere, that the personal itemized deductions, including those relating to owner-occupied housing, be scaled back, at first to a 15 percent effective tax rate deduction (that is, to a 15 percent credit), and then over the course of years to zero.<sup>164</sup> I further propose retaining current law's inclusion in the tax base of capital gain on the sale of an owner occupied home, subject to the \$500,000 exclusion provided by current law (purely as a political accommodation, in the latter case).

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<sup>164</sup> Edward Kleinbard and Joseph Rosenberg, "The Better Base Case," 135 Tax Notes 1237 (2012).

The Dual BEIT's mechanism *could* be extended to the imputed rental value of owner-occupied housing – indeed, Norway did just that under its dual income tax for a few years – but the political economy hurdles to simply explaining the concept of imputed rental income, much less legislating it, are so self-evidently daunting as to make that enterprise an impediment to enacting any change at all.

The idea then is to move towards a world where imputed rents on owner-occupied housing are taxed approximately at a zero rate. This sounds defeatist, but in fact would be a significant efficiency enhancement over current law, where such investments enjoy a negative tax rate.

## VII. IMPLEMENTING AND EVALUATING THE DUAL BEIT

### A. Implementation: Tax Rate and Transition.

1. *Tax Rates.* In practical political economy terms, the designer of a capital income tax does not have a free hand at choosing capital income rates, for the simple reason that corporate income tax rates are subject to worldwide competition across jurisdictions. The trend has been to lower corporate rates, so that in most major OECD economies other than the United States the headline rate is now below 30 percent. The corporate income tax in turn is probably the largest single capital income tax; it thus probably serves to anchor capital income tax rates.

For simplicity, the proposal developed in this paper has adopted a flat corporate (technically, business enterprise) profits-only tax rate of 25 percent. (I ignore here any micro-business lower rates.) *Capital Taxation in an Age of Inequality* discussed some of the tradeoffs underlying this thinking, but basically the worldwide tax consolidation that I recommend counsels strongly in favor of a moderate headline rate.<sup>165</sup> I recognize the case for taxing rents at higher rates than this, but I also recognize the political economy resonance of not burdening entrepreneurship, the political economy demands of worldwide competition in headline business tax rates, the inability actually to identify rents in practice, and the importance in tax design of symmetry in the treatment of gains and losses across the blurred lines of returns to risk, returns to uncertainty and rents.

The taxation of normal returns is a similarly fraught exercise in balancing competing objectives. Because the Dual BEIT uses the same mechanism to separate out normal returns from the business enterprise tax base and to include in income normal returns to investors, the tax rate on normal returns as a practical matter should follow from the business enterprise tax rate – that is, by way of example, a flat rate of 25 percent. This is a substantial reduction in the capital

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<sup>165</sup> *Capital Taxation in an Age of Inequality*, Section I.E.

income tax rate on individuals who earn interest income outside tax-deferred accounts, but on the other hand the tax will be measured and collected annually, which raises the rate relative to the long-term deferral (and even exemption on death) available today.

If the COCA formula (for example, 1-Year Treasuries plus 300bp) overstates normal returns at the firm level (where they are excluded from income), the same mechanism will include a comparable amount at the investor level. Some harm is done, but that harm is minimized when the rates are identical.

2. Transition Issues. Transition issues are extremely important in any fundamental tax reform proposal. A new tax system will not only create future winners and losers but will also affect current stores of wealth. Nonetheless, a transition from a badly-implemented capital income tax system to a better one should minimize those issues. The relative prices of some real and financial capital assets may change, as effective tax rates are made more neutral, but this is no different than a change in cost recovery methods, or any of the other tweaks to the income tax that markets have absorbed. And whatever the magnitude of those changes, they will be less than would be true in a switch to a consumption tax. In particular, existing basis in real and financial assets will remain relevant under the BEIT, which is not the case in consumption tax proposals.

Income tax reform obviously poses fewer transition issues than a switch to a consumption tax, but that does not mean the issues are trivial. An overnight switch to COCA, for example, could literally bankrupt highly leveraged companies. The Dual BEIT proposal therefore contemplates different transition rules for its non-COCA components (uniform entity-level profits tax, true consolidation principles, and a revised business asset and acquisition regime), on the one hand, and COCA, on the other.

The Dual BEIT'S non-COCA rules just do not seem to work under a phase-in model and therefore must apply *in toto* as of a specified date. Since, in many respects, the rules are simplifications of current law, applying them immediately to operations should not cause irreparable harm to taxpayers. At the firm level, the COCA concept, in contrast, can be phased in by specifying a multiyear period over which the interest expense deduction scales down and the COCA deduction ramps up. The investor side is more debatable, but probably should simply be adopted *in toto* as of a specified date near the end of the business enterprise phase-in period.

Admittedly, these suggestions would require more work, but the key thought is that, because the Dual BEIT remains an income tax, its transition issues should be more tractable than those implicit in a move to a consumption tax as the principal instrument in U.S. tax policy.

## B. Evaluating the Dual BEIT.

1. *In General*. Parents make bad evaluators of their offspring, but I nonetheless submit that the Dual BEIT, as just summarized, would be a very substantial improvement over current

law capital income taxation, and is superior to other capital income tax proposals once those are sufficiently fleshed out to make a fair comparison possible. Of course, one must first accept the desirability of an annually-measured and collected flat tax on capital income, but that is the job of the companion article to this one.

First, the Dual BEIT is comprehensive, in that it reaches all forms of business organizations and all forms of investments therein.

Second, it yields consistent measures of normal returns. Unlike other comprehensive capital income tax proposals, the BEIT mechanism splits the taxation of returns to capital by taxing time value of money (normal) returns only at the investor level, while taxing profits (in the broadest sense – that is, including returns to risk, returns to uncertainty and rents) at the business enterprise level. By doing so, the BEIT mechanism sidesteps the problems that plague CBIT and similar comprehensive entity-only income tax proposals, all of which accurately tax normal returns only if they get capitalization and depreciation precisely right.

To emphasize, the depreciation allowance in respect of real assets is fundamental to the measurement of net income, and getting that allowance right is not simply a question of determining the economic life of various real assets. More fundamentally, any income tax that measures net income at the enterprise level must also solve the riddle of distinguishing current expenses from capitalizable ones – for example, in respect of advertising expenses. An enterprise-level net income tax (other than an unrealistic *deus ex machina* solution like the universal mark to market of all real assets) will always be error-prone in this regard.

Second, the BEIT mechanism seeks to reduce the realization principle to its smallest possible component. By taxing normal returns to investors rather than business enterprises, and by imputing those returns, the BEIT takes advantage of the intuition that investment assets turn over more rapidly than do noninventory real assets, so that the *base* for determining normal returns is closer to the economic ideal. For the same reasons, the BEIT repeals numerous exceptions to the recognition of income. The result is a system where reported taxable income tracks economic income more closely than under current law.

Specifically, the Dual BEIT makes every gratuitous transfer, business merger or the like an occasion to revalue investors' basis in the financial assets they hold, and measures Includible Amounts under quasi-original issue discount principles. Borrowing against appreciated securities also would be treated as a revaluation opportunity. As a result, the Scylla and Charybdis of capital income taxation (the debt-equity distinction and our fulsome reliance on the realization doctrine) are largely disarmed.

Third, the Dual BEIT achieves investor-firm integration, without any of the baggage associated with imputation credit schemes or the like.<sup>166</sup> The COCA mechanism accomplishes this without requiring that investor income turn on any aspect of firm-level tax liability. To the extent that investor Includible Amounts exceed firms' aggregate COCA deductions, that is a

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<sup>166</sup> Edward Kleinbard, *The Trojan Horse of Corporate Integration*, \_\_ Tax Notes \_\_ (2016).

feature, not a bug: it would reflect the greater velocity of investors' trading in securities than firms' trading in their income-producing real assets (to that extent mitigating the relevance of the realization doctrine in the measurement of normal returns), and the fact that firms will have traded off COCA deductions for immediate expensing of self-developed intangibles.

Fourth, the Dual BEIT offers a surprisingly featureless a tax topography, which minimizes both tax gaming and occasions of comparative unfairness. Importantly, it does not rely on different tax regimes for private and public firms, or for debt and equity.

Fifth, the Dual BEIT is very parsimonious in the information it requires of investors in particular, and imposes no investor – firm coordination requirements at all.

Sixth, by moving the taxation of normal returns to the investor level, the Dual BEIT fixes that burden on the least capital mobile taxpayers – individual investors rather than multinational firms. At the same time, the individual investor level is a cleaner canvas on which to calculate taxable normal returns, because neither depreciation nor other business tax incentives are relevant.

Finally, the Dual BEIT embodies several very attractive political economy characteristics. Most important in this regard, the Dual BEIT will be compelling to firm managers: firms (and thus the managers of firms) will face a comprehensive profits tax system, in which normal returns to capital are exempt from tax. As a result, firms' capital structures will no longer be distorted by tax considerations, mergers and acquisitions – including all-cash deals – will be tax-free in present value terms at the firm level, and marginal investments will bear zero firm-level tax. Managers thus will enter a tax land of milk and honey, in which their perennial pleas for a more “competitive” business tax system will have been answered. And while it is true that investors will in some cases face a tax liability without the receipt of cash, most firms can be expected to adjust their cash payout policies to address this; in return, investors will face capital gains tax rates of zero.

2. *Efficiency Considerations*. Like any profits-only tax, the firm-level component of the Dual BEIT affords business enterprises a neutral environment along the margins of how tax might affect the scale of investment (its effective marginal tax rate is zero), and the capital structure of the firm.<sup>167</sup> In the latter respect, the Dual BEIT, like an actual cash flow tax or other capital account allowance mechanisms, is superior to an ACE, because it is not at risk of financial legerdemain employing equity-flavored debt instruments or the like to enhance the total deductions available in respect of a firm's capital. The firm-level component of the Dual BEIT also is efficient along the margin of the choice of form of business organization, because all firms are subject to the same regime.

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<sup>167</sup> Michael P. Devereux, “Issues in the Design of Taxes on Corporate Profit,” *National Tax J.* 65, no. 3 (2012): 709-730.



When applied to multinational activities, tax systems generally face a Hobson's choice between the unattainable (accurate geographic sourcing of income) and the arbitrary (for example, worldwide tax consolidation).<sup>168</sup> Worldwide tax consolidation, as envisioned for the Dual BEIT, shares with destination based cash flow taxes the great merit of being relatively robust to "stateless income" planning by multinational firms.<sup>169</sup> In both cases, the idea is that there are no payoffs to doing so, in the former case because the income is taxed in the residence country regardless, and in the latter case because only the destinations of sales drive the allocation of taxing responsibilities.

Worldwide tax consolidation, where the tax rate itself is quite moderate by world norms, operates more as a "territorial" tax system with a very robust floor on stateless income gaming than it does the assertion of taxing jurisdiction over profits arising in important market economies with markedly lower tax rates. Admittedly there are some exceptions to this observation. In particular, in the case of worldwide tax consolidation employing country-by-country foreign tax credits, a U.S. multinational doing business in a country (Freedonia) with systematically higher tax rates than the U.S. rate would face incentives to use stateless income planning to bring its foreign tax rate in Freedonia down to the U.S. effective rate. If such strategies retain vitality, the worldwide system puts a hard floor on their use, because there is no utility in driving rates below the U.S. rate.

Viewed from a worldwide efficiency perspective, and ruling stateless income out of the picture, there might appear to be a distortion along the margins of real investment (U.S. firms would locate investment in the lower-taxed United States rather than Freedonia). In many cases this fact pattern will boil down to the case that Freedonian normal returns will be taxed by Freedonia, whereas the ideal in the Dual BEIT is that normal returns are not burdened at the firm level. The short answers are, first, that no unilateral tax system can achieve worldwide harmony, and, second, because Freedonian normal returns tax will be paid by all firms conducting business in Freedonia, that the rate logically should be reflected in (higher) Freedonian pretax returns. If that in fact is the case, then a U.S. firm is fully compensated by the market for the Freedonian tax.<sup>170</sup>

Conversely, if Freedonia enjoys systematically lower effective tax rates on firm income than does the United States, then a worldwide tax consolidation system would seem to distort investment decisions by imposing a higher global tax rate on that income than that enjoyed by Freedonian competitors. This concern is misplaced, however, where, as here, the Dual BEIT is a profits-only tax. If there are rents to be captured in Freedonia, they will remain attractive even after a U.S. profits-only tax.

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<sup>168</sup> Edward D. Kleinbard, "The Lessons of Stateless Income," 65 Tax L. Rev. 99 (2011).

<sup>169</sup> Id.; Edward D. Kleinbard, "Stateless Income," 11 Florida Tax Rev. 1 (2011).

<sup>170</sup> Edward D. Kleinbard, "The Lessons of Stateless Income," 65 Tax L. Rev. 99 (2011, develops this in detail.

Worldwide tax consolidation admittedly places great stress on the fiction of corporate residence. I discuss this issue at length elsewhere in this paper and elsewhere.<sup>171</sup> Very briefly, however, at least as applied to the United States today, corporate residence is rarely difficult to discern. The case of corporate inversions does not disprove this assertion, but rather reminds us of the many failings of the U.S. tax legislative process. A more appropriate definition of corporate residence is straightforward as a drafting matter.<sup>172</sup> Moreover, it remains the case that U.S.-domiciled firms ultimately are overwhelmingly owned by U.S. persons.<sup>173</sup> This means that a profits-only worldwide tax will fall predominantly on profits accruing to U.S. persons. And unlike a destination based cash flow tax a worldwide consolidated profits-only tax can obtain reasonable allocations of tax revenue collection without imagining any form of international cooperation.

At the investor level, the Dual BEIT contemplates that U.S. resident investors will bear the full burden of the capital income tax on the normal returns to all their portfolio investments, wherever located. As a result, there will be no significant incremental distortion along the margins of their portfolio investment decisions. Since the capital of multinational firms is generally held to be much more mobile than the residence of individual citizens of the United States, the result will be a more attractive environment for investment in the United States, and a reduction in the impetus to move capital out of the United States.<sup>174</sup>

Moreover, because foreign portfolio investors in U.S. corporations will face a domestic profits-only tax, and no U.S. investor-level tax, those investors will enjoy the benefits of investing in U.S. domestic operations without facing any direct or indirect burden on normal returns. Other capital income tax solutions, like CBIT, that attempt to measure and impose tax on normal returns at the firm level, burden foreign portfolio investors.

3. *Incidence*. There is a rich literature on the incidence of the corporate income tax.<sup>175</sup> This literature generally agrees that there are three possible groups of individuals on whom the

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<sup>171</sup> Id.

<sup>172</sup>Edward Kleinbard, “Competitiveness Has Nothing To Do With It,” 144 Tax Notes 1055 (Sept. 1, 2014). As noted earlier, to this should be added a presumption that firms employing the U.S. dollar as their functional currency, and with some managerial contacts in the United States, should be treated as U.S. residents.

<sup>173</sup> Edward D. Kleinbard, “The Lessons of Stateless Income,” 65 Tax L. Rev. 99 (2011).

<sup>174</sup> Organization of Economic Co-ordination and Development, *Economic Survey of Norway 2012* (2012), 87; Rosanne Altshuler, Benjamin H. Harris, and Eric Toder, *Capital Income Taxation and Progressivity in a Global Economy* (Tax Policy Center, April 26, 2011), expand on this important point.

For the sake of brevity this paper does not discuss the BEIT’s international dimensions, beyond this one observation as to its effects on inbound investment and capital mobility.

<sup>175</sup> See, e.g., Arnold C. Harberger, “Corporation Tax Incidence: Reflections on What Is Known, Unknown, and Unknowable,” In John W. Diamond, and George R. Zodrow (eds.), *Fundamental Tax Reform: Issues, Choices and*

burden of a corporate income tax conceivably could come to rest: capital owners generally, labor, and consumers. Most of the literature concludes that the corporate income tax is not shifted to consumers, because of competition from noncorporate and foreign providers. Further, the literature generally agrees that, in the case of a small open economy, the burden of a corporate income tax imposed on a marginal investment yielding normal returns is shifted entirely to labor, because the effect of the tax is simply to reduce the available pool of investment capital until pretax yields rise sufficiently high to offer investors the required after tax rate of return on capital. Beyond that, consensus is more difficult to find.

A good deal of the literature assumes away the issue when it models the corporate income tax as a tax on normal returns; as applied to U.S. multinational enterprises, it might be more accurate to think of the corporate income tax today as closer to a tax on rents (including “tax rents” of the sort I describe elsewhere<sup>176</sup>). In turn, there is no reason to think that a tax on rents is shifted to labor, because the mechanism described above, of money finding its own global level in after-tax normal returns through changes in country-level investment pools across fungible marginal business investments, by definition does not apply to profits, which are not fungible. Profits, and the incidence of taxes imposed on profits, are properties of capital owners.

If in fact the incidence of the firm-level component of the Dual BEIT fell on labor, then the whole thrust of the project would be misplaced, because it would simply do indirectly what could be accomplished directly through fine-tuning a labor income tax. But because the firm-level Dual BEIT is a tax on profits, not normal returns, its incidence should fall on the owners of capital, and in particular on the historic owners of the firms generating such rents.<sup>177</sup> Moreover, as applied to the United States, there are persuasive arguments that the U.S. economy does not behave like a small open economy. Economists generally agree that in a simple model of a small open economy, looking at a firm earning marginal returns, the incidence of a corporate income tax would fall on labor rather than capital, but empirical evidence, particularly relating to the operation of the U.S. economy within the larger global economy, point to the conclusion that capital owners in fact bear the great preponderance of the burden of the U.S. corporate income tax. This conclusion is made more forceful in the case of any profits tax, including the Dual BEIT, because by definition rents are a property of capital ownership that capital owners do not share with labor.<sup>178</sup>

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*Implications*, 283–307 (2008). One helpful recent analysis that is sensitive to the issues posed by our global economy for an analysis of corporate tax incidence is Kimberly A. Clausing, “Who Pays the Corporate Tax in a Global Economy?,” 66 Nat’l Tax J. 151 (2013).

<sup>176</sup> Edward D. Kleinbard, “The Lessons of Stateless Income,” 65 Tax L. Rev. 99 (2011).

<sup>177</sup> The Harberger closed economy model in which all capital bears the corporate income tax is relevant to normal returns, but not rents. The latter are unique to specific firms.

<sup>178</sup> Jennifer C. Gravelle “Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis,” 66 National Tax Journal 185 (2013); Kimberly A. Clausing, “Who Pays the Corporate Tax in a Global Economy?,” 66 Nat’l Tax J. 151 (2013). In preparing distributional analyses of the burden of the corporate tax under current law, as

As a result, the incidence of the Dual BEIT should fall predominantly on owners of domestic capital (the investors in financial claims against firms), because firms themselves face a zero effective marginal tax rate on new investments yielding normal returns. In turn, the investor-level tax on Includible Amounts is in economic substance close to (but a constitutional whisker away from) a periodic tax on domestic owners of capital, and as such the incidence should fall on those domestic capital owners (the investors in financial claims against firms). Like any tax on savings, the Dual BEIT conceivably may affect the quantum total savings by domestic owners of capital, depending on competing income and substitution effects, but an individual level tax of this sort does not necessarily create a capital vacuum for investments in attractive U.S. business opportunities, because foreign investors (to whom the income inclusion rules would not apply) will make up any shortfall in domestic savings.<sup>179</sup>

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well as the distributional consequences of proposed changes to current tax law, the Congressional Budget Office and the Staff of the Joint Committee on Taxation both attribute 75 percent of the burden of the corporate income tax to owners of capital. The Treasury Department attributes 82 percent of the burden of the corporate income tax to capital owners. See Staff of the Joint Committee on Taxation, *Modeling The Distribution of Taxes on Business Income*, JCX-14-13 (Oct. 16, 2013) (summarizing the work of all three agencies). The nonpartisan Tax Policy Center treats 20 percent of the corporate income tax burden as falling on labor, 20 percent on the normal return to all capital, and 60 percent on the supernormal returns to corporate equity (shareholders). Jim Nunns, *How TPC Distributes the Corporate Income Tax*, Tax Policy Center (Sep. 12, 2012)

<sup>179</sup> Mihir Desai and James Hines, *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487, 496 (2003).

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