Reimagining capital income taxation

November 2015

WP15/24

Edward D Kleinbard
University of Southern California

SAID
BUSINESS SCHOOL

UNIVERSITY OF
OXFORD

REIMAGINING CAPITAL INCOME TAXATION

Edward D. Kleinbard
University of Southern California Gould School of Law
ekleinbard@law.usc.edu

I. <u>INTRODUCTION</u>.

This paper is an exercise in the design of tax institutions — in particular, a comprehensive regime for the taxation of capital income, in all its many guises. The paper is mindful of the recommendations of public finance theory, but its contributions lie in the domain of tax engineering, not physics. The paper serves as a comprehensive reformulation and reimplementation of the "Business Enterprise Income Tax" and "Cost of Capital Allowance" ideas first presented in Kleinbard (2007a, 2007b and 2010), and whose embryonic form dates back to Kleinbard (1989), in light of experience gained since those earlier efforts.

Throughout this paper, I use the term "capital income" to comprise all returns to capital, in the narrow, traditional sense of that term.[1] The term of course is not synonymous with "capital gain;" the latter is just one instance of capital income. Capital income includes, by way of example, interest and dividend income, property rental income, and royalties, as well as capital gains. Capital income also includes most net business income. Firms of course 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, where an owner-entrepreneur puts both her own capital and her labor to work, and where

---

[1] Thus, as used in this paper the term "capital" does not include human capital.

the net income of the firm cannot through simple inspection be divided into labor and capital income components, is addressed through the new mechanism described later in this paper.)

Economists traditionally 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. In a more quotidian sense, 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. Therefore, throughout this paper, "capital" comprises both real and financial assets.

Economists and tax law academics often confuse one another by applying different meanings to the same word; the problem is compounded when moving between American and British usages. In general, I follow the U.S. tax law practice of using the phrase "capital income" to include all returns on capital, including normal returns. I follow economists in using the word "profits" to mean returns over and above risk-adjusted normal returns. This means that the term encompasses extraordinary returns to risk (or, as discussed later, uncertainty) from an individual project, as well as rents.

In the U.S. tax law academy, at least, any tax that by design does not burden normal returns is swept up in the term "consumption tax." This would include a value added tax, a wage tax, or a cash flow tax. In an effort at cross-Atlantic comity, this paper uses the term "profits-only" tax to refer to all such taxes, "cash-flow equivalent tax" to encompass profits-only taxes that rely on a Capital Account Allowance, Allowance for Corporate Equity, or the like to obtain results intended as comparable in effect to a cash flow tax, and "consumption tax" to refer only to taxes whose

nominal incidence falls on consumption itself (retail sales tax, value added tax).[2] Finally, the paper uses the term "mark-to-market" rather than "accruals" accounting, to avoid confusion with cash vs. accrual methods of financial accounting.

Part II briefly summarizes the key features of the Dual Business Enterprise Income Tax (Dual BEIT). Part III of this paper offers a brief review of why taxing capital income is not simply an exercise in nostalgia for economically inefficient ideas. Part IV then lays out the classic problems inherent in designing a tax instrument that can accurately measure and tax capital income in a complex economy; Part IV further suggests a bundle of capital and labor tax rates that have some plausibility as a matter both of theory and political economy. Part V considers the Dual BEIT in detail, including the implementation of a "labor-capital income centrifuge," to break apart labor from capital income when the two are intermingled in the operations of a private firm dominated by one or more owner-entrepreneurs. Finally, Part VI considers the special problems of international business tax design (for which application the Dual BEIT turns out to be highly suitable).

The paper's focus is on the United States, which means that on occasion I can take refuge in the fact that the United States is not a small open economy. (This is relevant, for example, when considering the incidence of the U.S. corporate income tax, as I do in Part III.) The paper also occasionally discuss anomalies of U.S. law or custom. Nonetheless I believe that the paper's basic proposal has general applicability. In fact, variations the firm-level tax component of the paper's proposals have been tried in other jurisdictions, and the dual income tax structure of course has been widely explored by the Nordic countries in particular (Kleinbard 2010).

II. <u>OVERVIEW OF DUAL BUSINESS ENTERPRISE INCOME TAX.</u>

---

[2] "Capital Account Allowance" is the terminology used in Robin Boadway and Jean-Francois Tremblay, *Corporate Tax Reform*, Mowat Centre for Policy Innovation, School of Public Policy and Governance, University of Toronto, (2012). Other authors use synonymous terms. For reasons of personal history and idiosyncratic preference, I use "Cost of Capital Allowance" (COCA).

A. <u>Summary of Proposal</u>.

Because capital income taxation long ago fell out of academic favor, at least in U.S. law schools, very little work has been done in recent decades in rethinking how we might better define the capital income tax base. Moreover, 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 normal returns at the business enterprise level. This implicitly would require 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.[3]

---

[3] In recognition of these facts, the designers of the CBIT imagined 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.

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. . . . "

It is possible to do better. That is the purpose of the "Dual Business Enterprise Income Tax" (Dual BEIT).[4] The "dual" part of the name reflects the proposal's debt to Nordic dual income taxes.[5] 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 (pronounced "bite," like a tax bite) 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.[6] In its simplest form, a dual income tax adopts a relatively low flat

---

[4] An early conceptual presentation of the BEIT was Edward D. Kleinbard, "Designing an Income Tax on Capital," chap. 4 in *Taxing Capital Income* (Washington, D.C.: Urban Institute Press, 2007).

 A detailed implementation has been considered in Edward D. Kleinbard, "Rehabilitating the Business Income Tax," *The Hamilton Project at the Brookings Institution*, (2007). In both cases, it was included for reasons of perceived political economy imperatives a feature (an extra tax on "excess returns") that was both complicated and logically unnecessary. This presentation does not repeat that tactical error.

The firm-level "Cost of Capital Allowance" was proposed in Edward D. Kleinbard, *Beyond Good and Evil Debt (And Debt Hedges): A Cost of Capital Allowance System,* 67 Taxes 943 (1989).

[5] For different iterations of Nordic dual income taxes at length, see Edward D. Kleinbard, "An American Dual Income Tax: Nordic Precedents," *Northwestern Journal of Law and Social Policy* 5, no. 1 (2010): 41–86 (2010).

[6] 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

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; 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 (Kleinbard 2010).

A dual income tax, in which capital income is taxed on a different schedule from 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 VII 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 economic profits (whether rents or net risky returns) from business enterprises at the firm level, and normal returns to capital at the investor level. 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 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 of the information that the two must share. And the BEIT does not rely on administratively unreasonable mechanisms, like aligning tax depreciation with economic

---

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.

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 has only a handful of new components, built on top of existing income tax concepts. This should mitigate transition issues and make the proposal tractable for policymakers. The BEIT 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 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 short answer is, first, to adopt a firm-level profits-only tax through a Capital Account Allowance type mechanism (which of course has a long and distinguished intellectual pedigree), and to apply that mechanism to all business enterprises (other than micro-firms). 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.

Second, and unlike true profits tax proposals (for example, Boadway and Bruce, Boadway and Tremblay, Auerbach, and Devereux), the BEIT imposes at the 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 a specified interest rate. (The recent Dutch "box tax" on financial assets is comparable.) 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). Importantly, the investor side of the BEIT is a central design element that accomplishes de facto integration and a single level of tax on normal returns, imposed on the least mobile class of capital owners.

Under the BEIT, an investor's 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 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. Beyond that, however, the concept of capital gains or losses disappears.

Here is a high-level view of how the BEIT would work, once labor and capital income have been teased apart:

First, all business enterprises (other than the very smallest) are taxed as entities.

Second, firm-level interest deductions are disallowed, and replaced by a new "Cost of Capital Allowance" (COCA). The annual COCA rate is set by statute at a fixed or formula rate that varies with 1-year government debt rates. A firm's annual COCA deduction is simply its adjusted basis in its assets multiplied by the COCA rate. Thus, the COCA deduction is available regardless of whether a firm's real assets are financed with debt or equity.

Third, 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"). 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.

As noted, the BEIT at the firm level is a profits-only tax, because the COCA return on unrecovered basis has the same present value as a deduction for capital investment (assuming the COCA rate is set properly). (Boadway and Tremblay, Bond and Devereux, Bradford.) The COCA mechanism has a number of practical advantages over current expensing, however.

More particularly, the BEIT can be explained at the firm level as a superior implementation of an "Allowance for Corporate Equity" (ACE) system of the sort actually adopted by some European countries. ACE systems 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. [7] The BEIT thus removes the temptation to issue equity-flavored debt instruments, which still remains in ACE systems where the "interest" rate on the hybrid instrument exceeds the ACE allowance.

At the same time, the BEIT 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 former offer 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

---

[7] Michael P. Devereux, "Issues in the Design of Taxes on Corporate Profit," *National Tax J.* 65, no. 3 (2012): 709-730, and Kleinbard 2007a specifiy some of the difficulties inherent in constructing an ACE to replicate the economics of a cash flow tax.

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. 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 drafters of CBIT, however, the proponents of ACE became a bit vague when discussing how preference items would be handled, and capital gains taxed.

Like CBIT, ACE did not 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.

ensures that all capital income is taxed once, and only once, through its consistent and comprehensive design of the tax base.

In the international context, the firm-level component of the Dual BEIT could be implemented as a destination-based tax, as recommended by Devereux and de la Feria (2014), and Auerbach (2010). Part VI of this paper, however, makes the case for implementing it through full residence-based firm taxation, in the form of true worldwide consolidation, accompanied by country-by-country foreign tax credits. In the context of U.S. political economy considerations, this recommendation is made easier by the size of the U.S. economy, and more urgent in light of the adroitness of U.S. multinational firms in generating "stateless income." It has more general application, however, because it is robust to gaming, simple in implementation, consistent with financial accounting (the lens through which public firms are viewed) and reasonably neutral in actual outcomes, provided the tax rate is chosen wisely.

Meanwhile, domestic investors include in income Includible Amounts in respect of both domestic and foreign firms in which they might invest, and foreign investors receive the full benefit of the profits-only domestic tax environment. Normal returns thus are taxed to domestic investors in all cases, but as they are the least mobile capital owners, the expectation is that they the incidence of the tax will come to rest with them.

B. <u>At What Rates?</u>

The Dual BEIT contemplates three different tax rate schedules for three separate streams of income: firm profits-only income; investor normal returns; and labor income. The Dual BEIT can adapt to any combination of tax rate structures, but long rumination on the political economy aspects of the question have led me to recommend a simple answer. As explained further in Part IV, and as applied to the United States, I recommend that labor income be taxed on a progressive rate schedule similar to that employed today, with a top rate for illustrative purposes of 40 percent. I further contemplate that the firm profits-only tax and the investor normal returns tax will apply at the same flat moderate rate – for illustrative purposes, 25 percent. (In practice, both would have progressive rate structures up to that maximum rate, but those lower tax rate brackets are not

terribly important in practice, unless deployed as part of a political compromise to bring U.S. unincorporated businesses into the corporate fold.[8])

Parts III and IV explain these tax rate recommendations in more detail, but some brief explanation is desirable here. Many economists believe that the income tax itself is a flawed norm, and that economic efficiency can be enhanced (without impairing equity concerns) by adopting a progressive consumption tax.[9] These economists will applaud the idea that normal returns should be taxed at rates materially lower than labor income tax rates, but will be puzzled as to why I have suggested a number greater than zero. Part III addresses this. Part IV addresses my specific rate recommendations as applied to the different components of capital income.

C. Efficiency and Incidence Concerns.

1. *Efficiency*. 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.[10] In the latter respect, the Dual BEIT, like an actual cash flow tax or other Allowance for Corporate Capital 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.

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,

---

[8] Edward Kleinbard, "Why Corporate Tax Reform Can Happen," *Tax Notes*, Feb. 10, 2015.

[9] Joseph Bankman and David A. Weisbach, "The Superiority of an Ideal Consumption Tax over an Ideal Income Tax," *Stanford Law Review* 58, no. 5 (2006): 1413–56; Edward J. McCaffery, "A New Understanding of Tax"; Daniel N. Shaviro, "Replacing the Income Tax with a Progressive Consumption Tax," *Tax Notes* 103, no. 1 (2004): 91–113.

[10] Michael P. Devereux, "Issues in the Design of Taxes on Corporate Profit," *National Tax J.* 65, no. 3 (2012): 709-730.

worldwide tax consolidation).[11] The destination based cash flow tax advanced by Auerbach, Devereux and others falls into the latter camp, as an arbitrary allocation of taxing rights to the jurisdiction of destination. This allocation avoids distortions of investment decisions (the location of production facilities does not affect tax liability, which is driven solely by the location to which goods or services are delivered), but arguably does so at the price of getting the amount of tax liability wrong, or paid to the wrong jurisdiction. In particular, it is not clear why such a tax system would be in the interests of the United States, in light of the tremendous value created by U.S. firms' investments in intangible assets of all kinds.

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.[12] 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 actual destination drives the allocation of taxing responsibilities.

Admittedly there are some exceptions to this observation in the case of worldwide consolidation. In particular, and couched in terms of U.S. tax policy, 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,

---

[11]Edward Kleinbard, "The Lessons of Stateless Income," 65 Tax L. Rev. 99 (2011).

[12] Id.;Edward Kleinbard, "Stateless Income," 11 Florida Tax Rev. 1 (2011).

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.[13]

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.

Worldwide tax consolidation admittedly places great stress on the fiction of corporate residence. I discuss this issue at length elsewhere.[14] 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. legislative process. A more appropriate definition of residence is straightforward as a drafting matter. Moreover, it remains the case that U.S.-domiciled firms ultimately are overwhelmingly owned by U.S. persons.[15] 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 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

---

[13] Kleinbard, The Lessons of Stateless Income, develops this in detail.
[14] Id.
[15] Id.

a more attractive environment for investment in the United States, and a reduction in the impetus to move capital out of the United States.[16]

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.

2. *Incidence*. There is a rich literature on the incidence of the corporate income tax. This literature generally agrees that there are three possible groups of individuals on whom the burden of a corporate income tax conceivably could come to rest: capital owners generally,[17] 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[18]). 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

---

[16] 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.

[17] Harberger stuff.

[18] Kleinbard, The Lessons of Stateless Income.

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 not fall on labor. Moreover, as applied to the United States, there are persuasive arguments that the U.S. economy does not behave like a small open economy.[19] As a result, the firm-level component of the Dual BEIT should come to rest on capital owners.

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, it may or may not affect the quantum total savings by domestic owners of capital, depending on competing income and substitution effects, but as others have developed, 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 will make up any shortfall in domestic savings.

D. <u>Summary</u>.

For a tax system that purports to tax capital income and that could in fact be implemented in a large modern economy, the Dual BEIT does a remarkably good job. Most fundamentally, it taxes all capital income once, and only once, without cumbersome (and frequently abused) integration schemes or the like. Economic profits are taxed to the enterprise, and normal returns to investors. The sum of the two is an income tax on capital.

The Dual BEIT thus replaces the disarray of current law's taxation of capital income with a coherent regime, in which all capital income, regardless of legal label, is taxed at a consistent rate. That moderate rate mitigates the distorting effects of high marginal rates on some capital

---

[19] Gravelle; CBO allocations; JCT allocations.

income, collects significant revenues (especially when compared with the current partiality to bonus depreciation and the like).

The Dual BEIT taxes all business operations identically (by taxing enterprises, regardless of legal form, consistently). Moreover, the Dual BEIT eliminates enormous layers of firm-level tax rule complexity, such as the multiplicity of rules for different forms of business organization, the consolidated return rules, and the "tax-free reorganization" (merger) rules.

The Dual BEIT eliminates the debt-equity distinction, neutralizes the importance of different depreciation or capitalization regimes, automatically coordinates firm-level and investor level incomes, and mitigates (but does not wholly eliminate) the consequences of the realization doctrine. The tax liabilities of investors are driven by the capital they invest, not the label of the instruments they hold.What is more, the Dual BEIT moves a large fraction of capital income to the level of investors, rather than firms, a development that has important helpful ramifications in light of the relative international capital mobility of firms, compared to people.

The system employs a relatively simple mechanical rule for teasing apart labor and capital income, so that each can be taxed according to its nature; as a result, labor income cannot masquerade as capital income in the first instance. And in turn, disguised labor income retained by the firm becomes capital (in the form of retained earnings), and that capital again is taxed neutrally, whether inside or outside the firm.

Finally, the Dual BEIT, although an income tax, offers corporate managers a profits-only tax environment in which to conduct business. This should resonate with managers who today express concern about international "competitiveness," and further means that those managers will be able to pursue acquisitions and divestitures without regard to substantial tax consequences.

For all these reasons, it is the right direction in which capital income taxation should head.

III. A FOOL'S ERRAND?

Writing a long paper on the institutional engineering required to implement a successful income tax on capital presupposes a commitment either to the wisdom or the necessity of capital income taxation. This Part III attempts to make that case.

A. Decomposing Capital Income.

The standard presentation in the economic literature basically divides the returns to capital into three categories.[20] First are time-value-of-money returns ("normal" returns), which represent the core risk-free return from postponing consumption of one's wealth. These are the dull, plodding, interest-like returns that one might expect to earn, for example, by investing in a savings account or a Treasury bond. To an economist, all capital earns this normal return.

Second are risky returns, the higher returns that one expects to obtain for accepting the risk of uncertain rewards. (Actual risky returns, of course, may be negative in individual cases.) Individual returns to risk might be very large (or negative), but the idea is that a large enough portfolio of risky projects held for a long enough period of time should yield a normal return plus a risk premium – that is, the risk-adjusted normal return.

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.[21] Rental income from renting an undeveloped lot for use as a

---

[20] David A. Weisbach, "The (Non)Taxation of Risk," *Tax Law Review* 58, 64 (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); Edward D. Kleinbard, "Designing an Income Tax on Capital," chap. 4 in *Taxing Capital Income* (Washington, D.C.: Urban Institute Press, 2007).

[21] Robert H. Wessel, "A Note on Economic Rent," *American Economic Review* 57, no. 5 (1967): 1223 ("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.").

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 lots of risk.

A well-designed *income* tax systematically measures and taxes normal returns. Indeed, this is the key difference between a well-designed income tax and a profits-only tax: by design, the former taxes time-value-of-money returns, whereas the latter exempts them from the tax base.[22] The measure of success of a capital income tax is its ability to measure and tax normal returns consistently.

In theory, both income taxes and profits-only taxes burden economic rents, because in one case they are taxed as income, and in the other 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. 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 marginal returns).[23]

Economists like to confuse ordinary folk by using "inframarginal" actually to mean greater than marginal, when discussing returns to investment, and smaller than marginal, when discussing tax rates.

[22] 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 Taz and a Consumption Tax a Debate About Risk? Does it Matter?," 47 Tax L. Rev. 377 (1991-1992).

Edward McCaffery has shown that the combination of a postpaid consumption tax and progressive rates of tax on the amount consumed in a year can be viewed as taxing normal returns in a year of outsized consumption, when compared with the results reached under a "steady state" consumption model, in which savings are used to smooth lifetime consumption, rather than to finance a single year of consumption run riot. Edward J. McCaffery, "A New Understanding of Tax," *Michigan Law Review* 103 (2005): 807–938. This point is discussed later in this Part III.

[23] 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).

Finally, in theory neither an ideal income tax nor an ideal profits-only tax imposes any burden on pure risk-taking, provided that the tax system treats losses symmetrically with gains.[24] The theory is that a taxpayer can always scale up his bet to reflect the taxes imposed on returns to risk (assuming losses are fully refundable). This usually is explained by imagining the government as a silent partner in risky investments: so long as the silent partner absorbs its share of losses as well as gains, the taxpayer can restore his pretax risk-taking profile by adding more risk (whether through leverage or simply injecting more equity into risky projects. Many counterexamples might leap to mind (if I am already working full out to run one restaurant, I can't just open a second one), but these counterexamples often in fact demonstrate confusion between labor and capital income, not a bona fide example of being unable to increase an investment wager.

     B. <u>Selected Recent Literature</u>.

In the U.S. law school academy, the analysis of the wisdom of capital income taxation has been dominated for some time by the work of Joseph Bankman and David Weisbach,[25] who introduced to tax law academics the Atkinson-Stiglitz Theorem (A-S Theorem).[26] The A-S

---

[24] David A. Weisbach, "The (Non)Taxation of Risk," 58 Tax L. Rev. 1, (2004).

Neutrality technically 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).

[25] *See, e.g.*, Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 Stan. L. Rev. 1413 (2006). This paper spawned a mini-industry of point and counterpoint with Daniel Shaviro and Chris William Sanchiricco [cites]. [*Consumption Tax is Still Superior*, *A Critical View of a Critical View*, and so on.]

Other important contributions include Edward J. McCaffery, *A New Understanding of Tax*, 103 Mich. L. Rev. 807 (2005); Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 Tax Notes 91 (2004).

[26] Atkinson, A. B., and Stiglitz, J. E. (1976), *The Design of Tax Structure: Direct Versus Indirect Taxation*, Journal of Public Economics 6, 55–75. U.S. law school academics have not emphasized the

Theorem has been described as "arguably the most policy-relevant result to come out of the optimal income tax literature."[27] In a nutshell, it holds that, if an optimal progressive wage tax is an available tax instrument for government to deploy, and if certain conditions are satisfied (which conditions either do or do not approximate reality, depending on which strand of the post- A-S Theorem literature one prefers[28]), then there is no reason to employ differential commodity taxation on top of that progressive wage tax, whether for revenue or "redistributive" purposes.

The conditions underlying the A-S Theorem include the absence of inheritances (so that wage rates and hours worked alone determine income), that relative wage rates are fixed, and that individuals with the same wage incomes have the same consumption preferences, even if one (for example) must work twice as many hours as the other to earn that income, and therefore has fewer hours available for leisure.[29] (This last assumption is termed the "weak separability of leisure," even though it arguably is a pretty strong assumption.)

The extension of the A-S Theorem to the taxation of capital income works by considering future consumption goods (tomorrow's apples) as just more consumption goods arrayed on the buffet table of a consumer's life, along with present day consumption goods (today's apples).[30] To

---

alternative argument for zero taxation of capital income that follows from Christophe Chamley "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives." *Econometrica,* 54(3): 607–22 (1986) and Kenneth L. Judd, "Redistributive Taxation in a Simple Perfect Foresight Model." *Journal of Public Economics,* 28(1): 59–83 (1985), probably because the key assumption in those models of infinitely-lived agents with perfect foresight and supreme rationality does not map well onto the experience or training of lawyers. The A-S Theorem, by contrast, has the quality of a simple and elegant syllogism (which lawyers can enjoy) that does not on its face make heroic assumptions about human nature (although in fact the assumptions that are made arguably are stronger than sometimes appreciated).

[27] Boadway, R. and Pestieau, P. *Indirect Taxation and Redistribution: The Scope of the Atkinson-Stiglitz Theorem*, in Arnott. R., Greenwald, B., Kanbur, R., Nalebuff, B. (eds.), Economics For an Imperfect World: Essays in Honor of Joseph Stiglitz, MIT Press 2003.

[28] See infra note 17 and accompanying text.

[29] Joseph Stiglitz has written a plain English summary of these conditions in his textbook. Joseph E. Stiglitz and Jay K. Rosengard, Economics of the Public Sector (4th ed. 2015), p. 640. A more formal presentation is Louis Kaplow, On the Undesirability of Commodity Taxation Even When Income Taxation is Not Optimal, J. of Pub. Economics 90 (2006): 1235 – 1250, at 1239.

[30] Id.

buy tomorrow's apples, an individual with a fixed budget constraint must forgo today's apples (or tomatoes, or whatever) and invest the savings at normal rates of return. When an individual does so, her budget in the future reflects the interest on her savings as well as today's forgone consumption. An individual's "purchase" of tomorrow's apples by forgoing current consumption signals that the slightly larger quantity of apples she can buy tomorrow with the interest on her forgone consumption compensates her today for deferring the pleasure of biting into a juicy Macintosh right now.

A tax on an individual's returns on her savings serves to increase the after-tax price of tomorrow's apples relative to today's, when compared to the relative prices of the two goods in a world without taxes. This distortion in relative prices through the introduction of a tax on returns to savings therefore operates as a differential commodity tax, making tomorrow's apples relatively more expensive than today's. By contrast, a simple wage tax reduces an individual's budget constraint, but does not distort the relative prices of the consumption goods arrayed before her.[31]

These recommendations drawn from the A-S Theorem of course do not dominate tax policy as it is lived, in that capital income in general is taxed in almost all developed economies.[32] They further have surprisingly little sway over the policy recommendations of working public finance specialists, if a recent survey of members of the National Tax Association is to be believed.[33]

---

[31] Louis Kaplow, On the Undesirability of Commodity Taxation Even When Income Taxation is Not Optimal, J. of Pub. Economics 90 (2006): 1235 – 1250, at 1237.

[32] N. Gregory Mankiw, Matthew Weinzierl and Danny Yagan, *Optimal Taxation in Theory and Practice*, J. of Economic Perspectives 23, No. 4 (2009) 147-174, at 167 -169 (contrasting theory of zero tax on capital income with practice of taxation that is "far from zero.")

[33] http://ns.umich.edu/new/releases/21386-what-do-tax-policy-exp. Eight percent of those surveyed thought that capital income should not be taxed at all; 62 percent thought that realized, inflation-adjusted capital gains should be taxed as ordinary income.

Boadway and Pestieau (2003) list some of the reasons for this, and as noted earlier some analysts take strong exception to the claim that the assumptions in the A-S model map onto reality.[34]

Nonetheless, in American law schools at least, the A-S Theorem retains its position as the paramount guide for actual policy in the (non)taxation of capital income. The usual recommendation that follows is the adoption of a "progressive consumption tax," which, following the terminology employed in this paper, would be termed a progressive profits tax.

One perfectly fair reason to deprecate capital income taxation that falls squarely within the domain of legal academics is that as a matter of institutional design we have failed so miserably at the task for so many decades.[35] The Dual BEIT is responsive to these institutional failures, and I therefore ask readers inclined to be skeptical about the institutional ability of government actual to tax capital income to hold this objection in abeyance until the end of this paper.

Tax law academics sometimes make the case against capital income taxation too easy for themselves, either by comparing a pristine hypothetical progressive consumption tax to the barnacle-encrusted current income tax law, or by comparing a progressive income tax to an "ideal" income tax under which labor and capital income are taxed at the same rates. But in fact there is no reason to assume that this rate structure is ideal in any economic sense. A flat rate capital income tax (of the sort recommended in the Dual BEIT) has important efficiency gains over this "ideal" (such as symmetry in the taxation of losses and income), and importantly actually is a progressive tax when measured over the relevant margin, which is time; that is, the "tax wedge" on savings over time can be understood as a measure of progressivity along the relevant margin (because only high-ability taxpayers can afford indefinite deferral of consumption). A low flat rate actually imposed annually may thus be more efficient than the "ideal" income tax straw man, while still being progressive in fact.

---

[34] Compare Chris William Sanchirico, "A Critical Look at the Economic Argument for Taxing Only Labor Income," 63 Tax L. Rev. 867 (2010) and Joseph Bankman & David A. Weisbach, "A Critical Look at a Critical Look," 64 Tax L. Rev. 539 (2011).

[35] David Bradford in fact relied heavily on this practical point in formulating his policy recommendations.

Moreover, recent public finance literature has explored reasons why the A-S Theorem does not necessarily yield robust results to guide policy. As nicely laid out in Mankiw, Weinzierl and Yagan (2009), "the central tax problem" in optimal tax theory is that, in the face of significant income taxation, a high wage-rate individual might choose to work less (to "mimic a low wage-rate person," in the unfortunate framing of the literature), and that government is unable directly to observe ability or work effort. Government therefore cannot impose taxes on high ability individuals directly measured by those abilities rather than incomes, in order to fund "redistribution" to lower ability individuals. Instead, government, constrained by its information vacuum, must "provide sufficient incentive for high-ability taxpayers to keep producing at the high levels that correspond to their ability," which translates into lower tax rates on high-ability individuals than would be the case if their ability were fully transparent to government.

This formulation of the central problem of optimal tax theory ties into the A-S Theorem because, as Mankiw and colleagues explain, the Theorem rests on the assumption that "there is no information about unobserved ability in an individual's consumption choice that is not also revealed by the individual's income." (This is what the weak separability of leisure assumption means – low-ability/long-hour workers have the same consumption preferences as high-ability individuals who "mimic" them by working fewer hours.) *But what if the act of savings itself is a marker of a high-ability person?* Then the A-S Theorem no longer holds, and taxing those savings is a way of increasing the tax burden on high-ability taxpayers, just as optimal tax theory might suggest.

I take this to be one of several points made by Banks and Diamond (2010) in their comprehensive review of the literature for the Mirrlees Review. [36] Banks and Diamond conclude

---

[36] James Banks and Peter Diamond, *The Base for Taxation*, in *Dimensions of Tax Design: The Mirrlees Review*, ch. 6 (2010). A shorter presentation of the arguments is in James Mirrlees et al., *Tax By Design:*

that there in fact is room for capital income taxation in optimal tax theory, and summarize their findings in part as follows:

> Support by economists and tax lawyers for exempting capital income from direct taxation has been influenced by the well-known Atkinson–Stiglitz and Chamley–Judd analyses. However, we conclude that the policy relevance of the sharp finding of the optimality of no taxation of capital income is thoroughly undercut by the implications of large uncertainty about future earnings [i.e., that the A-S Theorem's assumption of fixed wages is not empirically accurate over time] and the growing disparity in earnings as a cohort ages. Adding such uncertainty and disparity to the frameworks employed by Atkinson–Stiglitz or Chamley–Judd results in the conclusion that taxation of capital income or of wealth is indeed part of optimal taxation. . . . In addition, in light of the widely varying individual saving rates in the economy, there is a natural presumption that during working years there is a positive correlation between the tendency to save and earnings potential (although the empirical underpinning is not so clear). This is another reason for taxing capital income as a means of more efficiently taxing those with higher earnings potentials. A further case comes from the difficulties in distinguishing between labour and capital incomes, which gives an advantage to reducing the difference in taxes between them. [37]

Diamond and Saez (2011) also conclude that capital income taxation is consistent with best practice policy recommendations.[38] They find that the results obtained by Atkinson-Stiglitz (and Chamley-Judd) are "not robust enough to be policy relevant."[39] Like Banks and Diamond, Diamond and Saez emphasize the difficulty of distinguishing between labor and capital income in many instances, and the heterogeneity of savings preferences, which in turn signals something useful about abilities (wage rates). They also develop the point that when individuals are borrowing-constrained in the capital markets, a tax on capital income (which falls on those individuals who are not borrowing-constrained) and a wage tax reduction on those who are so constrained leads to greater efficiency in outcomes. Finally, Diamond and Saez consider the role of savings (and taxing savings) in a world imbued with uncertain future earnings, including the

---

The Mirrlees Review, at 307 – 317 (concluding, however, that the efficiency arguments for taxing returns to household savings are not convincing).

[37] Id. at 634.

[38] Peter Diamond and Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, J of Economic Perspectives 25, No. 4: 165-190 (2011).

[39] Id. at 167.

"new dynamic public finance" literature;[40] the conclusion is that high-ability individuals might choose to over-save as insurance against future earnings drops, and in these circumstances taxing savings can encourage such individuals to keep their noses to the collective grindstones.[41]

Most recently, Piketty and Saez (2012) come to similar conclusions, albeit framed primarily in terms of the desirability of taxing bequests, or capital income as a surrogate.[42] The authors' basic point is that in a world imbued with both imperfect capital markets and bequests, made in differing amounts, an individual's stock of capital depends in part on the heterogeneous abilities of an individual's predecessors and those predecessors' heterogeneous tastes for bequests. As a result, a realistic model of lifetime income must consider two factors, not one — one's own labor productivity/effort, and one's inherited capital. But because of the heterogeneity of prior generations' abilities and tastes for bequests, the two factors are weighted differently in different people today — someone in the 95th percentile of inheritance receivers is not necessarily in the 95th percentile in labor income earnings ability: "With inheritances, labor income is no longer the unique determinant of life-time resources. [And In contrast to A+S], two-dimensional inequality [different distributions of inheritances and ability across a population] requires two-dimensional tax policy tools."

Because inherited (starting point) capital is highly concentrated relative to earnings abilities, differential taxation of capital (measured either as stock or flows) and labor income becomes useful. Piketty and Saez therefore develop a model that reflects variation in inheritances, in turn not linked to earnings ability. The model treats bequests and capital income as economic

---

[40] See Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 Stan. L. Rev. 745 (2007-2008)

[41] Because this last set of arguments is counterintuitive and seemingly inconsistent with U.S. social norms about personal liberties, I do not emphasize them.

[42] Piketty, T. and Saez, E., *A Theory of Optimal Capital Taxation*, NBER Working Paper 17989 (April 2012). A version of the working paper was published as *A theory of optimal inheritance taxation*, Econometrica, vol.81, n.5, 2013, p.1851-1886; the published paper comes to similar conclusions, albeit framed primarily in terms of the desirability of taxing bequests (except in the last paragraph, which considers the tradeoffs between bequest taxation and lifetime capital income taxation).

equivalents of each other, because in the model each generation has a specified term and does not overlap with other generations, and returns on capital are normal returns.

The model does not assume anything to the effect that the rich get a better education and therefore in fact operate at a higher functional level of ability than do those deprived of those educational opportunities ─ it instead assumes that the total lifetime returns to inherited capital are simply financial returns on that capital ─ but of course the practical connection between inherited capital and higher wage rates (through greater investment in human capital) would only increase the robustness of the conclusions reached by Piketty and Saez.

The Piketty and Saez model yields an important result, which is that across many plausible assumptions, social welfare is maximized with a significantly positive tax on bequests, or, alternatively, on annual capital income. Because the government revenue requirement is fixed, taxing bequests reduces the need for revenues from a labor income tax, and thereby improves the welfare of those receiving no or small bequests. Taxing bequests at 100 percent and redistributing the revenues is undesirable, because even those who inherit nothing can believe they will pass on substantial assets to their heirs, but overall social welfare is enhanced by a significant capita income or bequest tax, to reduce labor income tax burdens.

Piketty and Saez continue that, for a given total government tax take, the mix of the bequest tax rate and the labor income tax rate will vary, depending on three factors: the "bequest flow" (i.e., the percentage of annual national income that is inherited by the next generation), the rate of growth in national incomes (g), and the prevailing returns to capital (r). "There is no general reason why . . . inheritance would be taxed more or less than labor income. Any situation can be optimal, depending on parameters [described above]." High national income growth rates imply lower bequest flows [bequests as percentage of national income], just because the denominator is outstripping the numerator. And high r relative to g (a "rentier society") implies that bequest flow rates are increasing. In the former fact pattern, the case for taxing bequests (or annual capital

income) is weaker. In the latter, it is stronger. These last conclusions will be familiar to readers of

Thomas Piketty's book *Capital in the 21st Century*.

C. <u>Other Reasons for Capital Income Taxation</u>.

There are at least four additional reasons to improve capital income taxation, rather than to dismiss the effort as fundamentally misguided.

The first and most salient is regard for political economy constraints. Following on the reference that closed the previous section, the work of Thomas Piketty and his colleagues, many other researchers, and important nonpartisan organizations with unique access to granular-level data (particularly, the Congressional Budget Office) all point in the direction that market inequalities of incomes and wealth have increased dramatically in recent decades, particularly in the United States. (Kleinbard (2014) surveys the research on economic inequality and mobility trends.[43])

Taxing capital income is a direct response to the social and political strains that an evolving rentier society would impose on advanced-economy democracies. By definition, capital income is a property of those with capital, which in turn means the most affluent citizens. Capital income taxation therefore invariably is highly progressive in its distributional consequences. And it is worth emphasizing again that the A-S Theorem rests on a model in which there are no inheritances; the Piketty and Saez paper summarized above shows how the introduction of bequests – which

assuredly do exist in the real world – fundamentally changes the analysis. Joseph Stiglitz himself

argues for higher taxes on capital gains, a more robust corporate income tax, and a more robust estate tax in his policy work.[44]

Moreover, as noted earlier, even a flat rate capital income tax is progressive in a second sense, which is that its effective tax rate goes up along the relevant margin of time. Some of the

---

[43] Edward Kleinbard, We Are Better Than This: How Government Should Spend Our Money (Oxford U. Press 2014).

[44] Joseph E. Stiglitz, The Price of Inequality: How Today's Divided Society Endangers Our Future (W. W. Norton & Co. 2012).

literature reads as if the only relevant fact pattern were university professors saving a bit in a rainy day fund. When, by contrast, the concern shifts to enormous concentrations of wealth that are susceptible to compounding for many decades without being drawn down for current consumption, this "tax wedge" property of capital income taxation, usually described (following Chamley-Judd) as a fatal defect, turns out to be a feature rather than a bug. Because only the most affluent can afford to postpone market consumption for extremely long periods, a low flat rate capital income tax nonetheless operates as a progressive one in application, provided the tax is well designed (so that it in fact reaches annual accretions of normal returns).[45]

Like the fellow who delayed seeking medical attention for his wife who thought she was a chicken, because they needed the eggs, most developed economies need the eggs, today: deficit financing is an important political economy constraint on government policy, and the transition to a new order with equivalent present value revenues that are back-loaded as a cash flow matter would have important practical repercussions for the role of government today. There are also of course the exhaustively studied transition problems of substituting profits-only taxes and consumption taxes for capital income taxes.

Capital income now accounts for about 40 percent of gross domestic income in the United States: pragmatic political constraints on tax rates suggest that it would be extraordinarily difficult to envision tax rates sufficiently high on a narrower base to hold tax revenues constant on a present value basis.[46] (This allocation is more heavily weighted towards capital income than was true a few decades ago, when the split might better have been summarized as 65 - 35.[47]) This means that we intuitively can expect the taxation of capital income to be highly relevant as a matter of government revenues.

---

[45] A retrospective capital income tax of course has similar properties, provided that the tax bill reflects a compounding "interest" charge over time. The United States has some experience with such a tax under the Passive Foreign Investment Company (PFIC) rules. That experience suggests that as a political economy matter very high nominal tax bills relative to realized gains are nearly impossible to explain as a fair tradeoff for having deferred that bill for an extended period.

[46] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* (Jan. 2012), at Figure 2-8, p. 42 (labor income share of gross domestic income estimated to be roughly 60 percent in 2012 and 2017).

[47] Id, p. 41, n. 27. The CBO allocates 65 percent of proprietorship and partnership income to labor, and 35 percent to returns to capital, based on this older benchmark.

In 2007 (that is, the last year before the major dislocations still reverberating through the economy) the U.S. corporate income tax alone (which of course is just one component of the federal tax burden on capital income) amounted to roughly 15 percent of total federal government receipts.[48] One relatively recent European cross-national study concluded that in 2004, when corporate income taxes amounted to 8.7 of all tax revenues in the United States (federal, state and local), personal capital income taxes amounted to another 7.5 percent, for a total of 16.2 percent of all tax revenues collected in the United States.[49] And a paper by Joel Slemrod summarizing his work with several colleagues concluded that, in pure revenue terms, federal revenues collected in 2004 in respect of marginal returns to capital — which his team measured by calculating the excess of the revenues collected by the *actual* income tax then in effect (including the expiration of the 2003 bonus depreciation rules) over the revenues that would have been collected by an *ideal* profits-only tax – amounted to about $89 billion for that one year.[50] I would submit that the difference in taxes that might be collected from an actual income tax when compared to an *actual* profits-only tax (were such a comparison feasible) might be greater than that sum.

---

[48] In theory some portion of the corporate income tax could be a tax on labor income not extracted by the owners of closely held "C" corporations in the form of arm's length compensation rates (what this paper calls "labor stuffing"), but that behavior would be irrational in the current tax environment. Moreover, the great bulk of the corporate income tax is paid by large public corporations, where the occasion for labor stuffing is more attenuated.

It also is true, of course, that the corporate income tax base includes not simply returns to marginal investments, but also returns to risky ones (and hence includes the risk premium such investments demand) as well as rents, and that the latter two classes of capital income would also be taxed by a well-designed consumption tax, so this observation should not be misconstrued as suggesting that the revenues today collected through the corporate tax would entirely disappear in a consumption tax.

[49] Sorensen, "Can Capital Income Taxes Survive? And Should They?," 53 *CESifo Economic Studies* 172, 192-196 (2007).

[50] Slemrod, "Does the United States Tax Capital Income?," in Aaron, Burman and Steuerle, eds., *Taxing Capital Income* (2007), ch. 1.

The Slemrod analysis is particularly interesting in its demonstration that the U.S. tax burden on capital income has fluctuated very substantially over the last couple of decades. Id. at n. 14 (reporting a swing in incremental income tax collections over ideal consumption tax collections from negative $15.2 billion for 1983 to positive $108 billion in 1995).

In short, despite all the preferences and incentives of current law, in fact the United States today imposes significant levels of tax on capital income, whether understood in the broad sense to include returns to risk and economic rents, or in a narrower sense of including only marginal returns. To replace those revenues under a progressive consumption tax or the like would require much higher nominal top tax rates than might seem feasible in the current political environment.

To the same effect, standard alternative proposals, such as a progressive consumption tax, are extremely vulnerable to "one-time" tax holidays of the sort that the United States adopted in 2004 with respect to the repatriation of earnings held by foreign subsidiaries of U.S. firms.[51] In my view, were the United States to have adopted a progressive consumption tax in years past, such a holiday would have been irresistible in 2008 or 2009.

An ideal capital income tax can be viewed as approximating an indirect annual wealth tax. There does not appear to be any practical advantage to implementing the latter over the former, 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 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 19th 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.[52] For all these reasons, there is no advantage to pursuing annual taxes framed as wealth taxes in preference to annual capital income taxes.

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,

---

[51] See infra pp. 45-48.

[52] *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.

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.[53] 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."

The second reason to rehabilitate capital income taxation is that the standard tax instrument proposed (at least within the American legal academy) to replace capital income taxation, which is a progressive cash flow tax (usually with a R+F base), actually leads to anomalous burdens on capital income.[54] A well-designed flat rate cash flow tax does not burden normal returns, but a cash flow tax with increasing tax rates on increased consumption within a period actually either burdens or subsidizes normal returns, depending on the pattern of annual earnings and consumption.

For example, imagine a low wage earner under a R+ F cash flow tax that employs a progressive rate structure. The individual scrimps and saves for years to enjoy an orgiastic experience in Las Vegas to celebrate his 60th birthday. This individual obtains a low tax rate benefit in respect of his annual deductions for savings, but suffers a high tax rate on his big-ticket spending spree. This fact pattern violates the Cary Brown theorem (which relies on a constant tax rate to show that deducting investment is identical to exempting the normal return from tax[55]) in a direction that in retrospect imposes a significant tax burden on the now sadder but wiser individual's normal returns. From the other direction, imagine a high wage earner who saves a

---

[53] I acknowledge of course that this number is kept artificially low by aggressive tax planning, which in turn incurs real deadweight loss.

[54] Daniel N. Shaviro, "Replacing The Income Tax With a Progressive Consumption Tax," 103 *Tax Notes*, April 5, 2004, p. 91 at 92.

[55] Staff of the Joint Committee on Taxation, "Present Law And Analysis Relating To Tax Treatment Of Partnership Carried Interests And Related Issues, Part II," JCX-63-07, Sep. 4, 2007, p. 7.

little bit every year and who then constrains her consumption patterns in her dotage. She actually finds her normal returns subsidized, by virtue of a high tax benefit from her peak year savings and modest consumption in her later years.[56] That is, her first dollar of savings is a deduction against her highest dollar of income in her peak years, but her consumption in later years is taxed at lower rates, because her wage income has disappeared.

There are no easy solutions to this. A flat rate cash flow tax is neutral with respect to the taxation of normal returns, but then limits tax progressivity tools to exclusions and demogrants. A wage tax again is neutral, but does not reach rents, and is extraordinarily vulnerable to the recharacterization of labor income as capital income. The point here is simply that the practical alternatives to capital income taxation that include some measure of progressivity are not easily designed to exempt normal returns, and only normal returns, from the tax base.

The third reason not to reject capital income taxation takes the A-S Theorem at its word, but argues that there are non-market payoffs to savings. These payoffs are forms of consumption, although less easily observed than market purchases that, in the absence of capital income tax would enjoy a differential tax preference of precisely the type to which the A-S Theorem is addressed.

The best evidence here lies in the fact that bequests dominate inter-vivos gifts, for reasons difficult to explain as the accidental outcomes of lives, interrupted.[57] The most plausible inference is that savers derive independent utility from possessing savings, and that utility is a form of consumption. The point survives the usual retort that any power or prestige that come with savings

---

[56] As previously observed, Edward McCaffery acknowledges that the combination of a postpaid consumption tax and progressive rates of tax on the amount consumed in a year can be viewed as taxing normal returns in a year of outsized consumption, when compared with the results reached under a "steady state" consumption model, in which savings are used to smooth lifetime consumption, rather than to finance a single year of consumption run riot. Edward J. McCaffery, "A New Understanding of Tax," *Michigan Law Review* 103 (2005): 807–938. McCaffery however seems to see these results as a feature rather than as a bug. Doing so conflates two different issues. If one sees progressive tax structures as socially useful, the high-income taxpayer who consumes heavily today should bear more tax than one who consumes more modestly today, but that does not mean that future consumption should be tax-subsidized relative to current taxation, which is what the progressive structure does in some fact patterns.

[57] Barbara Fried, "Who Gets Utility from Bequests? The Distributive and Welfare Implications for a Consumption Tax," 51 Stanford L. Rev. 641 (1999).

rest simply on the ability to consume in the future, because however that utility is described, it exists in the present, not the future.[58]

One such example is the direct power that a saver can exert over family members angling for bequests (what Barbara Fried described as the "exchange motive"). Another is the leverage that relative wealth provides in negotiations, because (for example) the threat to litigate is more salient when backed by ample financial resources.

Less obnoxious examples emphasize the utility that captured by a saver freed from money anxieties – the liberating knowledge that one works because one chooses to, that no conceivable bill cannot be paid, and so on. From the other direction, an important recent research paper showed that poverty impedes cognitive function.[59] That is, poverty, by itself, leads to people behaving as if their IQ were 13 points lower, because of the amount of mental energy constantly channeled into coping with that poverty. In effect, the brain turns out to have limited bandwidth, and poverty permanently absorbs a substantial fraction of it, beyond measures of the consequences of stress and the like.[60] There is a reason, after all, why the one adjective invariably linked to "poverty" is "grinding." This research is consistent with the idea that the pure capacity to consume, as represented by savings, has immediate utility beyond the market consumption it allows, because

---

[58] For an example of the standard view, see e.g., David A. Weisbach, "The Case For a Consumption Tax," 110 Tax Notes 1357 (Mar. 20, 2006) "Perhaps savings bring benefits beyond consumption -- say, power and prestige. Robert Frank famously argued the opposite -- prestige and status come from too much consumption -- but maybe he had it backwards. Power and prestige from savings come from the ability to direct the money, from the possibility of future consumption. They come from the fact that bank accounts are not Monopoly money. Taxing that future consumption reduces the power and prestige from savings."

[59] Anandi Mani et al., "Poverty Impedes Cognitive Function," *Science* 341, no. 6149 (August 30, 2013): 976–980.

[60] The figure of speech comes from Emily Badger, "How Poverty Taxes the Brain," *The Atlantic Cities*, August 29, 2013, http://www.theatlanticcities.com/jobs-and-economy/2013/08/ how-poverty-taxes-brain/6716/. See also Cardiff Garcia, "Poor Choices," *Financial Times Alphaville*, November 27, 2013, http://ftalphaville.ft.com/2013/11/27/1622532/poor-choices/.

savers derive independent cognitive and emotional benefits from the knowledge that all reasonable options afforded by the marketplace are available.

This increment of utility should be viewed as an independent consumption good that, under the A-S Theorem, should be taxed uniformly with others. It can be argued, however, that this consumption good is unique, in that its future utility is not reduced by its current period consumption. (That is, the pleasure of making one's children miserable, or the cognitive benefits flowing from freedom from want, do not diminish with their enjoyment.) Moreover, unlike other consumption goods, this one increases automatically with the passage of time. If the only tax is a labor income tax (the A-S Theorem's setup), then standard market consumption goods are uniformly taxed through the reduction in funds available for consumption after taxes, but it seems that this consumption good becomes tax-preferred, not neutrally burdened, as it grows at the pretax rate of return, r.

The final objection to a broad reading of the A-S Theorem as informing current policy also relates directly to the Theorem itself. Unlike the argument just considered, this fourth point accepts the standard view that savings are just claims to future consumption with no independent utility, but sounds more in psychology and philosophy than in economics. The A-S Theorem addresses capital income taxation through its characterization of future consumption as another potential current consumption good, whose relative price is distorted when normal returns are taxed. But this ultimately is a metaphor, not a fact.

Without meaning to channel Yoda, one either consumes, or one does not. The expectation of consuming a good in the future is not the same thing as consuming a discounted fraction of that good today. The A-S Theorem, like most economics, rests on a deeper set of assumptions that preferences are stable, and that the individual personality itself also is stable. But the first almost certainly is untrue, and the second is highly debatable. Consumption preferences fluctuate unpredictably with incomes, cultural shifts, physical health and a thousand other factors. As a result, the act of saving cannot be simplified to a tradeoff between current apples and future apples, because the current self in reality has no idea what the future self actually will want in light of resources then on hand (and unknowable today), and the cost of satisfying those wants. Treating

all future consumption goods as a single good does not solve the issue, because then one is trading off known current consumption against a high level abstraction.

It is in this respect that the A-S Theorem's application to capital income rests on metaphor, not fact. People do save, and do demand compensation for the use of those savings, but the metaphor does not explain the internal psychological mechanism or the actual payoffs to savings. As a result, the pretax return to capital, r, cannot simply be asserted to be the price of deferred consumption.[61] That single number can reflect the net of many different vectors, perhaps pointing in opposite directions, of which the deferral value of consumption is only one.

The third objection focused on the current utility garnered by savings, independent of the consumption to which those savings ultimately are applied. This last objection question whether the central metaphor necessarily maps onto reality. The two objections overlap in their emphasis on the complex psychological motivations that underlie savings, and with those the dissolution of a necessary relationship between the pretax rate of return, r, and the value of future consumption.

At an even deeper level, the self is less monolithic than we sometimes assert. Future me will not be the same person I am today. When we say that the past is a different country,[62] we actually are saying, the past self was a different person. We assert that our values, if not our preferences, remain constant, but in many traditions (e.g. Buddhism) that is understood as the ego defending itself from the realization of how contingent our personalities really are. The A-S Theorem adopts the simplifying assumption of a constant self confronted by a buffet table of known consumption choices, some of which are earmarked for future delivery, but neither the contents of the table nor the self sitting down to choose from among the offerings really is a constant. The metaphor has value, as all metaphors do, but its rhetorical power can obfuscate the point that a metaphor is not a fact, and that the pretax rate of return, r, is not definitionally the price of future consumption.

---

[61] See Thomas Piketty & Emmanuel Saez, "A Theory of Optimal Capital Taxation," *National Bureau of Economic Research*, Working Paper No. 17989 at 74. (2012) (speculating that the normal pretax return, may not in fact be the fair measure of the required return to waiting, although they refrain from popular movie references).

[62] L.P. Hartley, The Go-Between (1953).

IV. <u>DESIGNING AN INCOME TAX ON CAPITAL.</u>

   A. <u>Existential Despair.</u>

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.[63]   The   United   States   taxes returns   to   capital   at   wildly   varying   and largely unpredictable 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.[64]

---

[63] 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).

[64] Interest income earned by a taxpaying investor is the great exception; those rules are rational.

Both the Congressional Budget Office[65] (CBO) and the U.S. Treasury Department[66] 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 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 *non*corporate 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.[67] CBO (2014) came to broadly similar results, except that rates had increased 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.

Second, the CBO analysis 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

---

[65] CBO (2005), CBO (2006) and CBO, "Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options" (Dec. 2014). Slemrod (2007) offers some criticisms of the CBO methodology, but in the end his ingenious approach and the CBO model produce roughly comparable numbers, as Slemrod points out. Slemrod (2007) at 16.

[66] Treasury (2007). The Treasury Department has repeated its analysis with more recent data, in connection with The President's Framework for Business Tax Reform, A Joint Report by the White House and the Department of the Treasury, Feb. 2012 at 5.

[67] 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 of adopting a noncorporate business structure are freely available to very large enterprises as well as small ones.

percent rate — a 42.5 percentage point swing.[68] (A negative marginal tax rate implies that the tax system actually subsidizes the cost of the investment). 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. And both studies concluded that returns to owner-occupied housing (the largest physical asset class) enjoy a negative tax (i.e. subsidy) rate environment.

The usual response is to observe that the U.S. tax system today is a combination of comprehensive income and consumption tax themes,[69] 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.

B. Taxing the Components of Capital Income in Practice.

As previously described, the standard presentation in the economic literature basically divides the returns to capital into three categories: normal returns, risky returns, and rents. This

---

[68] The 26.3 percent marginal effective 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 2012 Framework 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.

[69] *See, e.g.*, Stiglitz, Joseph E. The Price of Inequality: How Today's Divided Society Endangers Our Future. New York: W.W. Norton & Co, 2012. at [page number].

standard presentation would lead to three sets of design considerations for a comprehensive capital income tax.

First, normal returns must be accurately measured and taxed. That tax rate plainly should not be excessive, but if a labor-capital income centrifuge is available, the rate can be divorced from consideration of labor income rates.

Second, the most important institutional design criterion for the taxation of risky returns is symmetry: that is, the government as silent partner should absorb losses on a current basis, just as it takes its share of winnings. This would mean immediate refundability of net operating losses, which is not the norm in practice. But a second best resolution is more realistic, which is to permit net operating loss carryovers and to provide and interest charge to reflect the fact that the government effectively has borrowed from the taxpayer when the government does not absorb its share of losses on a current basis.[70]

Third, economic rents can bear substantial tax burdens, because they are neither replicable nor scalable. An owner is thrilled to receive economic rents, and so long as she is left after taxes with more than she could get by way of normal returns, the theory goes, why should she complain?

I submit that this neat division of capital income into three conceptual pots, each with a potentially different tax rate associated with it, collapses in practice. The category of returns to risk is too simplistic an explanation of business behavior, and returns to rents are too difficult to tease apart from other returns to serve as the basis for differential taxation.

To paraphrase Frank Knight, what the standard presentation labels returns to risk in many cases are returns to uncertainty.[71] Knight's prose is dense, sometimes internally inconsistent and

---

[70] It has been suggested that this second best solution requires ultimate refundability of unused losses on the winding up of a failed company, but again this is wholly implausible in practice. I further would argue that that it is not strictly necessary, at least when viewed from the firm's perspective, because from that point of view winding up is a post mortem experience. The firm's existential imperative is to remain a functioning enterprise, and it therefore makes investments on the basis that it will endure forever. When that premise fails, its past risk calculus becomes essentially irrelevant.

[71] Frank Knight, Risk, Uncertainty and Profit. CITE also Sarah Lawsky, *Unknown Probabilities and the Tax Law*, Stanford L Rev; Lawsky, *Probably?: Understanding Tax Law's Uncertainty*, 157 U. Penn. L. Rev. 1017 (2009) (examining uncertainty and risk in the context of the decision to comply with tax law).

often vague, even as he lectures the reader about the necessity for precision. The result is an entire corner of literature devoted to explaining what he really meant, at least to each writer. In my reading, however, Knight tried to establish a class of returns to capital exposed to uncertainty, labeled "profits," which he distinguished from returns to risk and economic rents. He then related profits to the role of the entrepreneur, as the party willing to bear uncertainty in return for these profits.

A more colloquial interpretation of Knight takes inspiration from Donald Rumsfeld to argue that the world is full of known knowns, known unknowns, and unknown unknowns. The first are risk-free returns, the second risk-adjusted returns, and the third are returns to uncertainty. Glimmers of this taxonomy can be gleaned from Knight; his idea again is that someone absorbs the unknown unknowns.

The mainstream economic view is that Knight's distinction of uncertainty as something different from risk is simply incorrect. In this telling, Knight had a poorly developed understanding of risk, and thought that each individual risk had to be objectively measurable (like the outcomes of a fair roulette wheel), thereby throwing most everything into the uncertainty bucket. In fact, most individual risk assessments are subjective, just like our individual appraisals of the value of any good sold in a marketplace, and what markets do is price risk, just as they price widgets, through the price mechanism.

A second interpretation, which is fairer to Knight, and in any event more useful, is that what Knight meant by "uncertainty" was "uninsurability." In this telling, there are at least three reasons why a risk might not be insurable: adverse selection, moral hazard, and uniqueness (so that the law of large numbers cannot operate). I would add to "uninsurable" the alternative thought of "unhedgeable." The two are not the same: insurance ultimately is a mutualisation of risk, in which everyone in the pool accepts a certain small loss in lieu of contingent large ones, while hedging relies on risk shifting.

In sum, the key idea, imperfectly articulated by Knight, is that business involves accepting an unavoidable residuum of risk whose magnitude (or alternatively whose returns thereon) are not susceptible of pricing through the workings of a market's price mechanism. That unavoidable residuum exists because some risks are uninsurable, or unhedgeable, or because the risk itself is unknowable, or because the dispersion of returns on that risk are so uncertain that reasonable people throw up their hands and say, ' I can't price that.'Knight usefully labels this unavoidable residuum of risk as "uncertainty." [72]

In turn, the entrepreneur is the person who is willing to absorb the unavoidable residuum — the uncertainty — in return for the possibility of profits. Why would any entrepreneur take on unavoidable and unpriceable risk for completely uncertain returns? The answer is that the entrepreneur takes on uncertainty because the entrepreneur is irrationally optimistic. That is plainly true from observation, and (together with uncertainty) offers a useful model of what makes the entrepreneur special: the entrepreneur, unlike the risk-averse general population, or the risk neutral homus economicus, accepts uncertainty because the entrepreneur alone is irrationally optimistic.

Ronald Coase in his *Theory of the Firm* takes jabs at Knight, but there is something incomplete in Coase's story. His story is largely about the managerial aspects of the firm — the idea that the firm exists because the price discovery mechanism itself has agency costs, and the firm occupies the conceptual space where management is more efficient than contracts, after the costs of contracting are considered. That insight is powerful and plainly true, but what Knight said (or should have said) is that this is incomplete. The firm also occupies another conceptual space that is orthogonal to Coase's point, which is the firm is the name we give for the entrepreneur as actualized in practice — the person or institution willing to absorb uncertainty in risk or returns, because of a fundamental bias towards irrational optimism.

---

[72] Knight does not do himself much of a favor when he describes this residual risk as what today would be called "tracking error" — positive or negative returns associated with imperfect hedges or insurance. That is a trivialization of his own insight.

One story does not crowd out the other: some firms are primarily about the managerial case for the firm, and others about the entrepreneurial case. For example, it is possible today to have a firm that is nothing but contracts — an entrepreneur can have an idea for a new gadget, hire a design firm to design it, hire Foxcomm to build it, and hire Amazon to sell it. In this firm, the entrepreneurial element dominates any modest managerial added value.

What follows from this story of irrational optimism for capital income taxation? The standard story about tax and risk, as summarized above, is that even in an income tax, risk is not taxed. The government becomes a silent partner, taking a fixed share of the profits, but also absorbing a fixed share of the losses; risk is therefore reduced by the symmetrical tax (because both upside and downside are scaled back for the same investment). To restore the original risk profile, one need only scale up one's bet.

If, however, the basic story of entrepreneurship is that of irrational optimism, then it follows that from the perspective of the entrepreneur, the interposition of a silent partner is fundamentally unfair, because the entrepreneur (irrationally) values the silent partner's absorption of a percentage of possible losses much less than the entrepreneur values the silent partner's slicing off of a share of profits. The optimism leads to an asymmetrical view of risk, and therefore of the cost to the entrepreneur of the silent partner (the tax system).

Perhaps intuitions along these lines explain the broadly shared view among policy makers that entrepreneurship is special (in a good way), and has positive externalities, so that the tax system should in some way "reward" entrepreneurial returns relative to other returns.[73] The cult of "small business" among many policymakers might in fact be a misphrasing of what the proponents really admire, which is entrepreneurship.

If one were to accept for the moment the common view of the positive externalities of entrepreneurship, one might respond by saying that the tax system should shoulder more loss than

---

[73] Giles Wilkes, "The Misplaced Hero Worship of Start-Up Founders," Financial Times, Jun. 3, 2015.

it does gain, for example by giving 150 percent as large a refund in the loss case as it takes in the gain case, but this runs directly into adverse selection and moral hazard problems. As a result, the universal instinct among policymakers is that positive entrepreneurial returns should be taxed more lightly than returns from nonentrepreneurial endeavors, to create a "neutral" investment horizon for this special class of cockeyed people.

The second conceptual problem with the standard presentation of capital income as falling neatly into three buckets is that returns to risk or uncertainty beget rents, or more accurately quasi-rents (rents that dissipate over time), in ways that occupy a continuum, and that are not susceptible of neat division. In practice, therefore, it is very difficult to tell when returns to risk or uncertainty leave off, and rents begin.

The Portugese language implementation of Microsoft Office is an example. Presumably it was a straightforward extension of an existing cluster of intangible assets whose origins could be traced back to highly risky (or uncertain) investments in a complex new suite of computer applications. The Starbucks story is another example. An individual gets an idea for a new way of serving coffee, and Starbucks is born. The expansion of "the Starbucks experience" (as the firm describes it) to the United Kingdom in turn yielded outsized profits, because the original returns to uncertainty generated a cluster of intangible assets that could be extended to new horizons far beyond what the founder would ever have confessed to having in the back of his mind when he started.[74]

If one accepts the policy bias in favor of entrepreneurship, there is a fundamental tension in practice between getting correct the taxation of rents, on the one hand, and entrepreneurial returns, on the other. One points in the direction of high tax rates, the other in the direction of concessionary low rates. But because returns to uncertainty in turn can beget rents, distinguishing between the two seems impossible, in any reasonably implementable capital income tax.

The principle of symmetry between gains and losses is important, and the difficulty in teasing apart quasi-rents from returns to risk seems unresolvable. This leads me to reduce the

---

[74] Edward D. Kleinbard, "Through a Latte, Darkly: Starbucks' Stateless Income Planning," 139 *Tax Notes* 1515 (Jun. 24, 2013).

standard view's three pots of capital income to two, even if that means some identifiable rents are systematically undertaxed.

The economic case for taxing rents at full labor-income rates is undeniable in theory. This in fact was the objective of the 2006 revision of the Norwegian dual income tax system, but its implementation shows how difficult this can be to achieve.[75] Among other problems, the 2006

[75] Ibid, 67–79; 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.

The current Norwegian implementation of its dual income tax introduces a novel variant, the "rate of return allowance" (RRA). The RRA system turns the proposals in this paper 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, [SSRN CITE]. 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.

Norwegian approach exposed risky returns to asymmetrical after-tax outcomes, as when years of small losses lead to one hugely successful investment. It also commingled returns to risk or uncertainty with rents – a problem for which there is no straightforward solution.

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, I adopt a corporate (technically, business enterprise) profits-only tax rate of 25 percent. Again, 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 income tax burden on individuals who earn interest income outside tax-deferred accounts.

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.

In this way, if the mechanism understates 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. While it is possible to use the Dual BEIT to impose a higher tax rate on firm-level profits than on normal returns to individuals (or vice versa), doing so puts substantial stress on getting the COCA rate correct, to avoid systemic under or over taxation.

A tax burden on normal returns of around 25 percent can be understood at least as moving in the direction of a pure profits-only tax, even if such a system does not fully achieve all the purported efficiency ends of taxing normal returns at zero.[76] Importantly, a low flat-rate tax on normal returns does so while largely avoiding the extraordinarily difficult transition issues that would be raised by the replacement of an existing capital income tax with a consumption tax.[77]

In sum, the Dual BEIT gives policymakers the flexibility to tax rents and normal returns on completely different schedules; nonetheless, for reasons developed above, there are good practical reasons to adopt what might be thought of as "first generation" Nordic dual income tax principles.[78] Under this approach, all returns to capital would be taxed at one low flat rate, while labor income would be taxed at increasing marginal rates to a top rate considerably higher than the capital income tax – again by way of illustration, 25 percent in one case, and 40 percent in the other.

We start from a place where capital income often is untaxed, or taxed at wildly different effective rates. To move to a world where all capital income is taxed consistently would be an

---

[76] Sijbren Cnossen, "Taxing Capital Income in the Nordic Countries: A Model for the European Union?," in *Taxing Capital Income in the European Union: Issues and Options for Reform*, ed. Sijbren Cnossen (2000), 187 (explaining that it "should be possible to tax capital income positively but that moderation is advisable").

[77] See, e.g., Daniel N. Shaviro, *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity*. Chicago: University of Chicago Press, 2000; Ronald A. Pearlman, "Transition Issues in Moving to a Consumption Tax: A Tax Lawyer's Perspective," in *Economic Effects of Fundamental Tax Reform*, 393 (describing these transition issues in detail).

[78] See Kleinbard, supra note 5, at 41–86.

enormous accomplishment; if doing so required undertaxing economic rents somewhat, I would argue that the result still would be good enough for government work.

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.[79]

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.[80] In light of the large amount of tax-exempt 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

---

[79] Kleinbard Capital and Labor Stuffing in the New Tax Rate Environment, http://ssrn.com/abstract=2239360.

[80] IMF Fiscal Affairs Department, *Debt Bias and Other Distortions: Crisis-Related Issues in Tax Poli*cy, 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.

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 normal returns. 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. CBIT) thus are avoiding 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, assuming that capital and labor incomes will 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?

This last point was particularly underappreciated, until the controversy surrounding the taxation of "carried interest" received by investment fund managers focused policy makers on the issue.[81] 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 structure of an 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 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

---

[81] This 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.

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."

The tax code then relies on outmoded social and legal 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 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 partners 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 capital gains preferential rates, which turn out to have nothing to do with "double taxation" or the like, as the earlier example of preferential tax rates on the present value of future interest receipts demonstrates.

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. Competing Solutions.

I have described elsewhere in detail why the BEIT mechanism is superior to other proposed capital income tax reforms, but it is worth summarizing briefly a few of the points.[82]

The Dual BEIT responds directly to the fundamental problem of measuring returns to real capital invested in business operations, and then coordinating the resulting measurement of real income with the measurement of returns to the financial assets that collectively represent the division of that income among the ultimate providers of capital to the firm. Some earlier capital income tax reform proposals, including the Comprehensive Business Income Tax (CBIT) and Nordic dual income tax systems, largely assumed away the first problem in particular, and in doing so delivered less than they promised.

The BEIT mechanism adopts two novel strategies. First, unlike other comprehensive 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 depreciation precisely right.

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.

---

[82] Kleinbard 2007a and 2007b.

Other approaches have regularly been mooted, but they 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, or they are so incompletely specified that their administrability is untestable.[83]

For example, one cluster of alternative approaches 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? Such 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.

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.

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

---

[83] The next few paragraphs are drawn from Kleinbard, "Designing an Income Tax on Capital," chap. 4 in *Taxing Capital Income* (Washington, D.C.: Urban Institute Press, 2007).

tax those gains not already realized. 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 law's debt-equity distinction. 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.

If mark-to-market taxation applies to publicly traded firms, then new firms would be discouraged from floating their shares on public markets, because to do so presumably would expose founders to large mark-to-market gainsThis is a substantial problem. Taxpayers would opt out of mark-to-market accounting or minimize its consequences through factual argumentation about valuation (block discounts and the like) or by holding non-traded derivatives that track the returns on publicly traded assets. The proposals also leave unanswered what tax system would apply to financial capital instruments that are *not* viewed as publicly traded; much corporate debt falls into this category.

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.

V. <u>MECHANICS OF THE DUAL BEIT</u>.

    A. <u>Enterprise Taxation</u>.

    1. *The Cost of Capital Allowance*. The Cost of Capital Allowance system replaces current tax law's different treatment of debt capital, equity capital, and various derivatives with a uniform allowance for issuers and a mandatory income inclusion to investors. Very simply, the COCA system operates at the business enterprise level as a Capital Account Allowance device of the sort proposed by several authors, dating back at least to Boadway and Bruce,[84] to create a neutral profits tax base. But then, unlike previous proposals, the same COCA rate is used to measure and tax normal returns to investors, thereby restoring the overall system to an integrated firm-investor comprehensive tax on all capital income.

    Under COCA, a "business enterprise" (which term encompasses both corporations and unincorporated businesses) deducts each year an annual allowance for the financial capital invested in it, measured at a rate (equal to a fixed percentage over one-year Treasuries) multiplied by the issuer's total capital. This deduction 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.

    Since balance sheets in fact balance, the total tax-cognizable investment in a business enterprise (the righthand side of a tax balance sheet) must equal the total tax basis of the issuer's assets (the lefthand 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.

---

[84] Robin Boadway and Neil Bruce, *A General Proposition on the Design on a Neutral Business Tax,* Journal of Public Economics, 24 North-Holland 231-39 (1984).

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. [85]

In sum, under the COCA system, 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.

2. *Coordination between COCA and Asset Depreciation Rules*. The COCA system operates alongside, not in place of, standard asset depreciation rules. [86] 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

---

[85] 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 unless the returns on those investments exceeded the COCA/ Includible Amounts rate.

[86] If tax depreciation perfectly tracked economic depreciation, a business enterprise could simply use that depreciation to measure normal returns at the entity level. CBIT would be a more logically compelling alternative for administrability reasons (given the same assumption of tax depreciation perfectly tracking economic depreciation); 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.

depreciation, to yield a neutral tax base. This is a well-known result in public finance literature,[87] 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. 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.

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. This is desirable for political economy reasons.

Third, the reason that capitalization and depreciation rules are contentious today is that the substantive *consequences* of those rules are momentous. In a world where the

---

[87] Boadway and Bruce, etc.

capitalization/depreciation decision has no present value consequences, today's tax dramatics should dissipate.

Finally, the COCA system can easily be extended to financial derivatives as well as physical securities (e.g., stocks and bonds).[88] 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 seems to be a necessary (or at least a convenient) part of taxing derivative instruments. Finally, there are important ancillary reasons for retaining COCA/depreciation for issuers rather than adopting a simpler asset expensing solution.[89]

3. *COCA and the Dual BEIT's Asset Sales Rules.* 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.

Similarly, 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

---

[88] See Edward Kleinbard, "Rehabilitating the Business Income Tax," *The Hamilton Project at the Brookings Institution*, pp. 29-30, (2007).

[89] First, 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. Second, BEIT/COCA'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 may enhance its political prospects.

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.

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.

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 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 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. Nonpractitioners will find it difficult to grasp just how much complexity is swept away in the immediately preceding sentence.

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.

B. Investor Taxation of Normal Returns.

On the other side, the COCA system requires all holders – 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.

Includible Amounts are taxed currently at 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/minimum inclusion rate.

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 yield x investment (where yield here is the COCA rate), and treats cash flows as returns of previously taxed yield or principal.

COCA 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. 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 concept of capital gains no longer would be relevant, as the capital income tax rate (25 percent, by way of example, in this paper) applied to the Investor's Includible Amount constitutes the full extent of the investor's tax liability. Nonetheless, an investor that sold an investment at a loss, relative to the investor's adjusted tax basis, would be permitted 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 be ignored, just as capital gains are ignored.

As applied to the United States, this loss allowance rule is required to ensure the constitutional characterization of the Dual BEIT as an income rather than a wealth tax. 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 is appropriate.*[90]*

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

---

[90] 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.

Amount accounts do not carry over from a prior third-party investor from which the current investor purchased that security. The COCA system applicable to holders admittedly requires some recordkeeping by each holder, but that recordkeeping would be mathematically straightforward and, if reflected on each year's tax return, can be kept up to date even by individual investors, particularly in light of modern tax preparation software.

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, 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. 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. 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

States by the fact that capital gains tax is forgiven for 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 also suffers from a 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 does not eliminate this 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.

C. COCA Rate.

The COCA rate is the mechanism that makes the Dual BEIT's business enterprise tax a neutral profits tax, and that measures normal returns to investors. Enabling legislation would specify that rate as a floating rate determined each year by reference to a benchmark government bond rate – in the United States, for example, 1-year Treasury debt. The issue is whether legislation should specify the COCA rate as simply that risk-free rate, or instead as a rate that better approximates an issuer's cost of funds – by way of arbitrary example, 1-year Treasuries, or 1-year Treasuries + 200 basis points.

Boadway and Tremblay,[91] among others, argue that a Capital Account Allowance mechanism like the COCA should employ the government risk-free rate. Intuitively, this has appeal, in that a firm's "tax receivable" – the promise of future tax deductions through the COCA

---

[91] Boadway & Tremblay, supra note 2, at 45.

system – is a claim against the government, and thus can be analogized to holding a government

bond. The practical difficulty here, however, is that firms have no choice but to hold this risk-free

receivable (that is, it cannot be sold for cash today), which in turn means that the asset must be

financed – and firms do not finance their operations at the risk-free rate. Perhaps for this reason

David Bradford contemplated a Capital Account Allowance set at rates closer 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."*92*

It obviously is not administrable to imagine setting the COCA rate individually for every

business enterprise, but for the reasons suggested above a rate higher than the risk-free rate is both

normatively appealing and much more probable of success in political economy terms. Moreover,

whatever the base COCA rate applicable to business enterprises, the design of the system can

accommodate concessionary COCA rates for small business, however designed. Thus the first $X

million of firm capital might enjoy a high COCA rate, and the remainder a lower rate – with or

without phaseouts. The point is simply that the system is adaptable to a range of policy and political

economy concerns.

This idea might be repugnant as a theoretical matter, but does fairly reflect the much higher

costs of financing to which small firms are subject. More generally, a system whose design cannot

easily accommodate special concessionary rates for small business is not a system likely to be

enacted into actual law.

To the same effect, the neutral profits-only tax rate applicable to business enterprises also

can be graduated, with lower rates on the first several million dollars of taxable profits, and a

phase-out of those graduated rate brackets beginning at some significantly higher point. In a recent

---

[92] 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).

paper, I discuss using just this mechanism to encourage unincorporated U.S. businesses to incorporate to take advantage of a hypothesized new corporate tax regime.[93]

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.

D. <u>Integration of Dual Income Tax and BEIT Principles</u>.

The Business Enterprise Income Tax by itself 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. The traditional form of dual income tax of the sort adopted by Nordic countries does adopt a view on tax rates (for example, capital income should be taxed at a single flat rate that is lower than the highest marginal labor rates), and does employ a labor-capital income centrifuge to tease apart labor and capital income. Marrying the two yields the Dual BEIT. What dual income tax learning adds to the presentation above is, first, a conscious commitment to different tax rates on capital and labor income – here, 25 percent on the former and 40 percent on the latter (ignoring lower tax rate brackets on lower incomes) – and second, the imperative need of developing an administrable and reasonably accurate labor-capital income centrifuge, so that each kind of income can be taxed appropriately when the two otherwise are hopelessly   intermingled.[94]

---

[93] Kleinbard, supra note 9, at 2.

[94] These themes are developed in Edward D. Kleinbard, "An American Dual Income Tax: Nordic Precedents," supra n. 5.

1. *A Labor-Capital Income Centrifuge, Version 1.0*. An explicit dual income tax – that is,

any regime that taxes capital income at one rate, and labor income at another – requires a labor-

capital income centrifuge, to divide business income between labor and capital components in

those cases where the suppliers of labor and capital cannot be relied on to specify those returns

accurately by themselves. Given the shoddy work the United States at least has made of the issue

in the past, some sort of novel mechanical solution is required.

The starting point might be a mechanism of the sort 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, can hardly be faulted as inexcusably imprecise. Moreover, the solution is self-

assessable and universally applicable.

The idea of this form of labor-capital income centrifuge is straightforward. 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 recently been considered in great detail elsewhere, they will not be repeated

here.[95]

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

Daniel Halperin, "Mitigating the Potential Inequity of Reducing Corporate Rates," *Tax Notes* 126, no. 5

(February 1, 2010): 641–58, also briefly raises the possibility of solutions along these lines.

[95] See generally Kleinbard, supra note 5, at 41–86.

labor-capital income centrifuge would not apply.[96] As a result, and as explained in the previous subsection, 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. For this purpose, and lapsing into the lingo of U.S. tax law, a closely held enterprise might be defined, at least as an initial matter, by reference to the ownership tests of current law's personal holding company rules.[97] Admittedly, it is inconsistent with the BEIT's aspirations to introduce a dividing line that in turn will inspire aggressive tax planning, but as developed below it is difficult to avoid drawing this distinction.

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.

---

[96] 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.

[97] It is true that such rules require a distinction between debt and equity, but only for the limited purpose of determining who is an owner of stock. A more comprehensive test might look to all financial claims holders other than those holding nonvoting interests that do not participate in earnings growth to a significant extent, or to a "vote or value" test. See also section 544(b) of the Internal Revenue Code (treating convertible debt as stock for personal holding company purposes).

As developed in Kleinbard, supra note 5, at 41–86, one of the chief failings of the original Norwegian dual income tax, whose basic design mirrored that proposed here, was that its definition of a closely held firm was easily evaded by inserting family members into the ownership structure of a firm. Norway did not adopt constructive ownership rules remotely as comprehensive as those contained in section 544.

The labor component in turn can be capped at an arbitrarily high rate of return; firm income above that level would be classified as profits. (Norway's pre-2006 dual income tax did just this.)

Because the idea here is to use a COCA type mechanism to assign a fraction of firm income as capital income, and because the special regime would apply only to privately-held firms with concentrated ownership, the right COCA rate here presumably should be much higher than the rate used in general under the Dual BEIT, to reflect the much higher cost of capital to small business. For example, in Norway's pre-2006 implementation of this sort of approach, the rate used was 5-year government bonds + 600 bp. [98]

The closely held firm's COCA-derived capital income component, as determined above, would remain taxed at capital income rates, and at one level only – that is, it would not be taxed at the firm level. The remaining income of the closely held firm, however, would be deemed to constitute labor income (subject to any ceiling, as described above). This is the critical difference in treatment between widely held and private firms under the Dual BEIT, because of course widely held firms would treat their post-COCA deduction income as capital income taxed at the flat capital income rate.

The treatment of a closely held firm's taxable income (that is, income after business expenses, including the COCA allowance, depreciation and compensation deductions) as entirely labor income will strike many as controversial. This result is normatively appealing, however, if one adopts the highly plausible theory that most profits (that is, income after a normal return is deducted) in small firms are deferred returns to labor. An example would be the restaurant that apparently earns superior returns, relative to its capital, thanks to its owner-manager, whose hard work and constant presence has built a powerful reputation for the establishment. Since small businesses largely are a reflection of their owner-managers, while widely held ones generally have greater continuity, global reach and diversity of labor inputs, the difference is not unprincipled.

---

[98] Kleinbard, supra n. 5, at 58. That paper describes some of the mechanical drafting issues associated with this sort of mechanism in more detail.

2. *A Labor-Capital Income Centrifuge, Version 2.0.* A labor-capital income centrifuge along the lines summarized above follows 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 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.

I believe that 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.

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;[99] the point here is not to engage in statutory drafting, but rather to signal that incorporating these principles is central to the proposal.

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.[100] 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.

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

---

[99] E.g., section 544; section 318.
[100] In turn consanguinity priority rules would be established. For example, shares actually owned by a material participant are not treated as constructively owned by another material participant, shares owned by one spouse are constructively owned by another spouse before being treated as constructively owned by a child, and so on. In each case the normal rules would continue unless a constructive owner were a material participant, at which point they would stop.

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 1st of 80 percent x 100 percent x $75,000, or $60,000. The PCO will 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.

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.

E. <u>Special Cases</u>.

An earlier paper on a preliminary iteration of the business enterprise income tax[101] described in detail how the BEIT would apply to financial institutions, investment companies, micro businesses, financial derivatives, and a great many other special cases. The current Dual BEIT proposal differs from that earlier work in fully specifying proposed tax rates (as to which

---

[101] Edward D. Kleinbard, "Rehabilitating the Business Income Tax," *The Hamilton Project at the Brookings Institution*, (2007)

the original proposal was largely indifferent[102]), 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. Further, 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.

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 actual subsidy at issue (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.

VI. THE DUAL BEIT IN INTERNATIONAL APPLICATION.

---

[102] 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.

A. <u>A Residence Based Tax</u>.

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 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.[103]

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

---

[103] 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).

dramatically low foreign tax rates is the accumulation of extraordinary amounts of earnings (about $2 trillion) and cash outside the United States.[104]

U.S. policymakers and observers sometimes think the United States should not object if U.S.-based multinational companies successfully game he 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 is embarked on an urgent project to develop comprehensive recommendations to address "Base Erosion and Profit Shifting," and the United States in May 2015 announced major proposed revisions to its model income tax treaty to address stateless income. A 2015 study by the nonpartisan U.S. 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.[105] That same report found that base erosion and profit shifting was a global sport, not confined to U.S.-domiciled firms.

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 U.S.-

---

[104] Gretchen Morgenson, *Piles of Overseas Profits Investors Can See but Not Touch,* New York Times, May 22, 2015, at 1.

[105] 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).

based multinationals. Similarly, the President's 2016 Fiscal Year Budget also proposes to rewrite

these same rules, in ways that are 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).[106]

Recognizing the scope of the problem, Alan Auerbach and Michael Devereux have

proposed in a series of papers a "destination-based cash-flow tax."[107] Because their parallel

proposals begin with a cash-flow tax, they are neutral business tax systems, in the same sense as

the Dual BEIT: none of these proposals burdens normal returns earned by a business enterprise.

The important point here is that both Auerbach and Devereux have designed their proposals to

vitiate the returns to base erosion and profit shifting through a destination-based cross-border

design. For simplicity, this design element can be analogized (imperfectly) 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.[108]

The theory at work is that a cash-flow tax creates a zero-rate business tax environment for

normal returns from domestic operations, and the destination-based extension would eliminate any

advantage to sourcing the location of production in low-tax jurisdictions:

> 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.[109]

---

[106] Kleinbard, supra note 86, at 11.

[107] Alan J. Auerbach, "A Modern Corporate Tax," *The Hamilton Project*, (Dec. 2010); Michael Devereux

& Rita de la Feria , "Designing and Implimenting a Destination-Based Corportate Tax," *Oxford University Centre for Business Taxation*, working paper 14/07, May, 2014.

[108] 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).)

[109] Auerbach p. 10.

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.[110]

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 taxes can be seen as territorial tax systems that rely on an apportionment formula to allocate profits across jurisdictions, which formula employs a single factor (ultimate consumption of the final good) that does not create incentives for a firm to modify its business operations to reduce its tax liabilities.[111]

The Auerbach and Devereux proposals accomplish their intended objectives of neutralizing the production location decision within the four corners of their systems, but the destination-based cash flow tax 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. 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

---

[110] Devereux, Issues in the Design of Taxes on Corporate Profit, NTJ, p. 725
[111] Id.

thereby tax rents, by shifting income from high-tax to low-tax foreign jurisdictions that have themselves not migrated to destination-based systems.

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 (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 tax system. This is the approach that I recommend for the dual BEIT, although in fairness to the overall reform program, the structure can accommodate either solution. For convenience, I present the idea from the perspective of the United States.[112]

A U.S.-based multinational would be taxed on the profits arising from its consolidated worldwide income, including all of its subsidiaries wherever located. 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.

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 payments collected by one country to another.[113] These are all sound practical reasons to prefer a true worldwide tax system relying on full global tax consolidation.

---

[112] See Kleinbard, supra note [fill in], at [fill in] (laying out in more detail the standards of consolidation, the definition of a "U.S." firm, and other technical issues).

[113] Compare Michael Devereux & Rita de la Feria , "Designing and Implementing a Destination-Based Corportate Tax," *Oxford University Centre for Business Taxation*, working paper 14/07, May, 2014.

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.[114]

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.

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." This is an overstatement today, and one that in any event is made less fraught by the Dual BEIT.[115] Most of us are not confused that General Electric is "American," and Philips Electronics "Dutch." At the same time, there is little evidence that new U.S. business enterprises are organized in foreign jurisdictions.[116] It is true that the U.S. definition of residence is outmoded in not embracing a "mind and management" alternative leg to the analysis,

---

[114] 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.

[115] 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); *but compare* Daniel Shaviro, Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?, 60 Tax L. Rev. 155, 178 (2007)

[116] [Susan Morse paper.]

but that is easily remedied.[117] Finally, 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 paper's recommendations are heeded) as applied to profits.

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.[118]

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 business assets as so determined.[119] The result is that a U.S. multinational enterprise would apportion its

---

[117] Cf., International Tax Competitiveness Act of 2010, H.R. 5328, 111th Cong. § 2 (2010).

[118] This actually parallels recent U.S. proposals to "backstop" a territorial tax system with a "minimum tax." In practice this minimum tax would operate as a worldwide tax on all current non-U.S. income of a U.S. based group (albeit at a lower rate than that employed for domestic income), combined with country-by-country foreign tax credits.

[119] 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.

COCA expense for foreign tax credit limitation purposes to its worldwide assets based on its investments in each country.

The ultimate idea is that foreign income taxes on normal returns technically could be credited against foreign 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 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.[120]

---

[120] 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 through 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

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.[121] 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 profits. 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.

---

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.

[121] An exception might be made for withholding taxes on dividends from foreign corporations, to preserve neutrality in post-enterprise tax investment environments.

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.[122] 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 x $30, or $15. Total firm taxes would rise to $40, and the total integrated tax bill to $60.

The U.S. firm would have 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 "true" consolidation, 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 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 Freedonian 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 Freedonian 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 Freedonian 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 Freedonian firm with exactly the same income and assets as the Freedonian operations of the U.S. multinational in this example, those U.S. investors would face

---

[122] This essentially tracks an example suggested by Professor Warren, supra n. 120.

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.*123* The good news is that, at least today, a U.S.-based multinational enterprise could use intercompany debt and similar techniques to strip the Freedonian tax base to a Dual BEIT-level equivalent. (Stripping further than that would serve no purpose, since the Dual BEIT would apply to any Freedonian income unsheltered by Freedonian 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.

---

[123] 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.

Oxford University Centre for Business Taxation
Working Paper series recent papers

WP 15/23 James R Hines Jr, Niklas Potrafke, Marina Riem and Christoph Schinke *Inter vivos transfers of ownership in family firms*

WP 15/22 Céline Azémar and Dhammika Dharmapala *Tax sparing agreements, territorial tax reforms, and foreign direct investment*

WP 15/21 Wei Cui *A critical review of proposals for destination-based cash-flow corporate taxation as an international tax reform option*

WP 15/20 Andrew Bird and Stephen A Karolyi *Governance and taxes: evidence from regression discontinuity*

WP 15/19 Reuven Avi-Yonah *Reinventing the wheel: what we can learn from the Tax Reform Act of 1986*

WP 15/18 Annette Alstadsæter, Salvador Barrios, Gaetan Nicodeme, Agnieszka Maria Skonieczna and Antonio Vezzani *Patent boxes design, patents,location and local R&D*

WP 15/17 Laurent Bach *Do better entrepreneurs avoid more taxes?*

WP 15/16 Nadja Dwenger, Frank M Fossen and Martin Simmler *From financial to real economic crisis: evidence from individual firm–bank relationships in Germany*

WP 15/15 Giorgia Maffini and John Vella *Evidence-based policy-making? The Commission's proposal for an FTT*

WP 15/14 Clemens Fuest and Jing Xing *How can a country 'graduate' from procyclical fiscal policy? Evidence from China?*

WP 15/13 Richard Collier and Giorgia Maffini *The UK international tax agenda for business and the impact of the OECD BEPS project*

WP 15/11 Irem Guceri *Tax incentives and R&D: an evaluation of the 2002 UK reform using micro data*

WP 15/10 Rita de la Feria and Parintira Tanawong *Surcharges and penalties in UK tax law*

WP 15/09 Ernesto Crivelli, Ruud de Mooij, Michael Keen *Base erosion, profit-shifting and developing countries*

WP 15/08 Judith Freedman *Managing tax complexity: the institutional framework for tax policy-making and oversight*

WP 15/07 Michael P Devereux, Giorgia Maffini and Jing Xing *Corporate tax incentives and capital structure: empirical evidence from UK tax returns*

WP 15/06 Li Liu and Ben Lockwood *VAT notches*

WP 15/05 Clemens Fuest and Li Liu *Does ownership affect the impact of taxes on firm behaviour? Evidence from China.*

WP 15/04 Michael P Devereux, Clemens Fuest and Ben Lockwood *The taxation of foreign profits: a unified view*

WP 15/03 Jitao Tang and Rosanne Altshuler *The spillover effects of outward foreign direct investment on home countries: evidence from the United States*

WP 15/02 Juan Carlos Suarez Serrato and Owen Zidar *Who benefits from state corporate tax cuts? A local labour markets approach with heterogeneous firms*

WP 15/01 Ronald B Davies, Julien Martin, Mathieu Parenti and Farid Toubal *Knocking on Tax Haven's Door: multinational firms and transfer pricing*

WP 14/27 Peter Birch Sørensen *Taxation and the optimal constraint on corporate debt finance*

WP 14/26 Johannes Becker, Ronald B Davies and Gitte Jakobs *The economics of advance pricing agreements*

WP 14/25 Michael P Devereux and John Vella *Are we heading towards a corporate tax system fit for the 21st century?*

WP 14/24 Martin Simmler *Do multinational firms invest more? On the impact of internal debt financing on capital accumulation*

WP 14/23 Ben Lockwood and Erez Yerushalmi *Should transactions services be taxed at the same rate as consumption?*

WP 14/22 Chris Sanchirico *As American as Apple Inc: International tax and ownership nationality*

WP 14/19 Jörg Paetzold and Hannes Winner *Taking the High Road? Compliance with commuter tax allowances and the role of evasion spillovers*

WP 14/18 David Gamage *How should governments promote distributive justice?: A framework for analyzing the optimal choice of tax instruments*

WP 14/16 Scott D Dyreng, Jeffrey L Hoopes and Jaron H Wilde *Public pressure and corporate tax behaviour*

WP 14/15 Eric Zwick and James Mahon *Do financial frictions amplify fiscal policy? Evidence from business investment stimulus*

WP 14/14 David Weisbach *The use of neutralities in international tax policy*

WP 14/13 Rita de la Feria *Blueprint for reform of VAT rates in Europe*

WP 14/12 Miguel Almunia and David Lopez Rodriguez *Heterogeneous responses to effective tax enforcement: evidence from Spanish firms*

WP 14/11 Charles E McLure, Jack Mintz and George R Zodrow *US Supreme Court unanimously chooses substance over form in foreign tax credit*

WP 14/10 David Neumark and Helen Simpson *Place-based policies*

WP 14/09 Johannes Becker and Ronald B Davies *A negotiation-based model of tax-induced transfer pricing*

WP 14/08 Marko Koethenbuerger and Michael Stimmelmayr *Taxing multinationals in the presence of internal capital markets*

WP 14/07 Michael Devereux and Rita de la Feria *Designing and implementing a destination-based corporate tax*

WP 14/05 John W Diamond and George R Zodrow *The dynamic economic effects of a US corporate income tax rate reduction*

WP 14/04 Claudia Keser, Gerrit Kimpel and Andreas Oesterricher *The CCCTB option – an experimental study*

WP 14/03 Arjan Lejour *The foreign investment effects of tax treaties*

WP 14/02 Ralph-C. Bayer Harald Oberhofer and Hannes Winner *The occurrence of tax amnesties: theory and evidence*

WP14/01 Nils Herger, Steve McCorriston and Christos Kotsogiannisz *Multiple taxes and alternative forms of FDI: evidence from cross-border acquisitions*

WP13/25 Michael Devereux, Niels Johannesen and John Vella *Can taxes tame the banks? Evidence from European bank levies*

WP13/24 Matt Krzepkowski *Debt and tax losses: the effect of tax asymmetries on the cost of capital and capital structure*

WP13/23 Jennifer Blouin, Harry Huizinga, Luc Laeven, Gaëtan Nicodème *Thin capitalization rules and multinational firm capital structure*

WP13/22 Danny Yagan *Capital tax reform and the real economy: the effects of the 2003 dividend tax cut*

WP13/21 Andreas Haufler and Christoph Lülfesmann *Reforming an asymmetric union: on the virtues of dual tier capital taxation*

WP13/20 Michael Blackwell *Do the haves come out ahead in tax litigation? An empirical study of the dynamics of tax appeals in the UK*

WP13/19 Johannes Becker and Ronald B Davies *Learning and international policy diffusion: the case of corporate tax policy*

WP13/18 Reuven S Avi-Yonah *And yet it moves: taxation and labour mobility in the 21ˢᵗ century*

WP13/17 Anne Brockmeyer *The investment effect of taxation: evidence from a corporate tax kink*

WP13/16 Dominika Langenmayr and Rebecca Lesterz *Taxation and corporate risk-taking*

WP13/15 Martin Ruf and Alfons J Weichenrieder *CFC legislation, passive assets and the impact of the ECJ's Cadbury-Schweppes decision*

WP13/14 Annette Alstadsæter and Martin Jacob *The effect of awareness and incentives on tax evasion*

WP13/13 Jarkko Harju and Tuomos Matikka *The elasticity of taxable income and income-shifting between tax bases: what is "real" and what is not?*

WP13/12 Li Liu and Andrew Harper *Temporary increase in annual investment allowance*

WP13/11 Alan J Auderbach and Michael P Devererux *Consumption and cash-flow taxes in an international setting*

WP13/10 Andreas Haufler and Mohammed Mardan *Cross-border loss offset can fuel tax competition*

WP13/09 Ben Lockwood *How should financial intermediation services be taxed?*

WP13/08 Dominika Langenmayr, Andreas Haufler and Christian J bauer *Should tax policy favour high or low productivity firms?*

WP13/07 Theresa Lohse and Nadine Riedel *Do transfer pricing laws limit international income shifting? Evidence from European multinationals*

WP13/06 Ruud de Mooij and Jost Heckemeyer *Taxation and corporate debt: are banks any different?*

WP13/05 Rita de la Feria *EU VAT rate structure: towards unilateral convergence?*

WP13/04 Johannes Becker and Melaine Steinhoff *Conservative accounting yields excessive risk-taking - a note*

WP13/03 Michael P.Devereux, Clemens Fuest, and Ben Lockwood *The Taxation of Foreign Profits: a Unified View*

WP13/02 Giorgia Maffini *Corporate tax policy under the Labour government 1997–2010*

WP13/01 Christoph Ernst, Katharina Richter and Nadine Riedel *Corporate taxation and the quality of research & development*