

DISCUSSION PAPER 2007-09

JUNE 2007

Edward D. Kleinbard

Rehabilitating the
Business Income Tax

The Hamilton Project seeks to advance America’s promise of opportunity, prosperity, and growth. The Project’s economic strategy reflects a judgment that long-term prosperity is best achieved by making economic growth broad-based, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments. Our strategy—strikingly different from the theories driving economic policy in recent years—calls for fiscal discipline and for increased public investment in key growth-enhancing areas. The Project will put forward innovative policy ideas from leading economic thinkers throughout the United States—ideas based on experience and evidence, not ideology and doctrine—to introduce new, sometimes controversial, policy options into the national debate with the goal of improving our country’s economic policy.

The Project is named after Alexander Hamilton, the nation’s first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that “prudent aids and encouragements on the part of government” are necessary to enhance and guide market forces.





Rehabilitating the Business Income Tax

Edward D. Kleinbard

Cleary Gottlieb Steen & Hamilton LLP

This discussion paper is a proposal from the author. As emphasized in The Hamilton Project's original strategy paper, the Project is designed in part to provide a forum for leading thinkers from across the nation to put forward innovative and potentially important economic policy ideas that share the Project's broad goals of promoting economic growth, broad-based participation in growth, and economic security. The authors are invited to express their own ideas in discussion papers, whether or not the Project's staff or advisory council agree with the specific proposals. This discussion paper is offered in that spirit.

THE BROOKINGS INSTITUTION

JUNE 2007

Abstract

This paper introduces the Business Enterprise Income Tax (BEIT), a comprehensive and detailed proposal for reforming business income taxation. Current law fails to tax all business income consistently and comprehensively. It distorts economic behavior and diverts managerial effort toward tax avoidance.

In contrast, the BEIT achieves comprehensive and consistent taxation of capital income and reduces tax-planning incentives. The BEIT integrates taxes at the corporate and the individual levels, ensuring that all income is taxed once and only once.

The BEIT eliminates current law distinctions between debt and equity. Instead, the BEIT uses its cost of capital allowance (COCA) system to tax investors on the normal (risk-free) return to capital and to tax businesses only on risky returns and rents. Under the COCA system, businesses obtain a uniform deduction for a normal return on their capital and pay tax on the rest of their income; investors include an assumed normal return in their taxable incomes, whether or not received by them in cash. (Investors also pay a small tax on gains beyond normal returns for practical and ability-to-pay reasons). In practice, the COCA system functions as a business-level consumption tax plus an add-on investor tax on normal returns.

The BEIT proposal also rationalizes the tax system by applying a single set of rules to all forms of business enterprises and business acquisitions. As a result, all business income is taxed identically and consistently, regardless of niceties of form.

Contents

I. Introduction	5
II. The Economic Components of Capital Income	8
III. The Business Enterprise Income Tax in a Nutshell	10
IV. Economic and Policy Implications of the Cost of Capital Allowance System	17
V. How Bad Is the Current Tax System?	20
VI. How the Cost of Capital Allowance Rehabilitates the Business Income Tax	26
VII. Application of the COCA System to Special Situations	36
VIII. International Aspects	42
IX. Transition Issues	44
References	45
Annex A: Mechanics of the Cost of Capital Allowance	46
Annex B: The Rules for Taxing Affiliated Groups, Business Acquisitions, and Business Losses	54
Annex C: Interest (COCA) Expense Allocation for Foreign Tax Credit Purposes Under the BEIT	58

I. Introduction

A New Way of Taxing Capital

This paper proposes the Business Enterprise Income Tax, or BEIT, a comprehensive and detailed recommendation for reforming the U.S. federal income tax on business income. The Business Enterprise Income Tax constitutes a systematic rehabilitation of the rules by which the federal government taxes both business enterprises and investors therein. The BEIT redresses current law's fundamental logical discontinuities and reflects current economic thinking on income tax design.

Every business makes money through the application of both labor and capital. Tax policymakers have struggled for generations with the capital part of that equation—how to measure economic “returns to capital” comprehensively and tax them consistently. The result is our current Internal Revenue Code and implementing regulations—a universe of rules developed over decades of taxpayer action and government reaction, and extending for many thousands of pages, most of which relate to the taxation of business income.

The core of the Internal Revenue Code is now roughly ninety years old. Many of its fundamental underlying assumptions about the measurement and taxation of business income—in particular, returns to capital—do not reflect modern financial theory or commercial practice, and those outmoded assumptions in turn often contradict one another. These engrained habits of thought, obsolete understandings, and internal contradictions are the root cause of the waves of tax strategies that erode the business tax base and threaten to overwhelm tax administration. They also result in misallocations of capital and business activity, because returns to capital are not burdened (taxed) consistently across different industries and legal forms of doing business.

Climatologists develop complex computer models to understand and predict global weather patterns. The Internal Revenue Code can be analogized to such a model—in this case one that accepts cash flows and business transactions as inputs and then abstracts all that data into a simple picture of a taxpayer's “income” and consequent tax liability. The difference between the tax code and other models of reality on which modern society relies is that the tax code is a patchwork that has evolved largely by historical accident.

This paper presents the BEIT as an economically up-to-date and internally consistent replacement model for the business tax components of the current Internal Revenue Code. In the course of this presentation, the paper identifies at a conceptual level the underlying logical fissures running through the current tax model, in light of four generations of distance from (and experience with) the original design. The paper also explores recent advances in the understanding of the economic criteria for designing an effective income tax. Finally, the paper specifies the BEIT in sufficient detail to demonstrate that the new tax model is comprehensive and administrable. Annexes to the paper address some of the BEIT's details that are important to specialists.

This paper focuses in particular on the policy implications of the BEIT's most important component, which is its *cost of capital allowance* (COCA) system—a new way of taxing the economic income earned on capital invested in business operations. The COCA system is the heart of the BEIT, because the proper taxation of returns to capital is the core challenge faced by any business income tax.

In one sense, the BEIT proposal is radical. It calculates taxable income earned from the investment of business capital by reference to anticipated returns, rather than current-year cash flows, and it replaces many longstanding and essentially elective

provisions of the current U.S. corporate income tax system (such as “tax-free reorganizations”) with a single mandatory set of operating rules.

In another sense, however, the BEIT is evolutionary. Its allocation of tax liabilities between investors and business firms approximates that under current law (as opposed, for example, to proposals that would shift all income tax on capital to the level of the firm). By doing so, the BEIT mitigates the transition costs of migrating to this new system. Moreover, the underlying tax technologies employed by the BEIT to measure income and collect tax can all be found in the tax code today and therefore have been vetted through real-world experience. The BEIT’s particular application of those technologies may be novel, but because it draws on existing tools, the BEIT is a technically feasible alternative to current law.

The BEIT is an economically up-to-date and internally consistent replacement model for the business tax components of the current Internal Revenue Code.

Section II briefly recounts some recent advances in the understanding of the economic components of income and how those ideas should inform the design of a business income tax. Section III then describes the principal operating rules of the Business Enterprise Income Tax, and section IV summarizes its economic and policy consequences. Next, section V considers whether the current tax system really is so badly flawed as to justify the pain of abandoning it completely in favor of the BEIT; that section concludes that radical reform in fact is required. Section VI in turn demonstrates how the BEIT satisfies the fundamental objectives of a rehabilitated business income tax developed in section V. Finally, sections VII through IX consider

some key aspects of implementing the BEIT in a little more detail.

Our Patchwork Tax Code

Both Congress and the Internal Revenue Service (IRS) regularly respond to perceived failings in the Internal Revenue Code by tweaking its rules. There has been little effort, by contrast, to consider more fundamental income tax reforms—to rebuild rather than patch the code. Even the often-lauded Tax Reform Act of 1986, the last major federal tax reform initiative, although accomplishing a great deal, left largely untouched the fundamental postulates on which the code’s business tax rules are based.

The responses of Congress and the IRS to the sophisticated leasing schemes known as “lease-in, lease-out” (LILO) and “sale-in, lease-out” (SILO) illustrate the bias in favor of patching rather than rebuilding. The leasing industry developed LILOs and SILOs to circumvent earlier congressional amendments to the tax code intended to limit the tax benefits obtained through leasing property to tax-exempt lessees, including foreigners. LILOs and SILOs employed traditional leasing structures, along with sophisticated options and “defeasance” (collateralization) technologies borrowed from the financial markets, to produce a novel (and, for their users, highly favorable) tax result, but one that, in the view of proponents, represented a linear evolution from earlier practice.

After several years of active promotion of the transactions, and after billions of dollars in closed deals, the IRS responded by declaring the arrangements to have been unlawful corporate tax shelters all along. Each side took its case to Congress, which in 2004 resolved the matter by adding a new and complex section to the code (section 470) aimed solely at disallowing the tax benefits from these exotic transactions, along with any future iterations on the same theme. That statutory patch, however, inadvertently swept into its maw thousands of ordinary business

partnerships, to the point where the IRS and the Treasury Department were forced to announce unilaterally that they would not enforce the new statute against partnerships, pending a congressional fix.

In fall 2006 a technical corrections bill with the promised fix to the 2004 patch was proposed, but as of mid-2007 it still has not been enacted. Many private sector organizations argue that the fix is insufficiently comprehensive, while the congressional staff who developed the original 2004 patch worry that the fix may itself inadvertently lead to some as-yet-undeveloped abuse inspired by the original leasing schemes.

This story is not unique: it has been repeated literally hundreds of times over the twenty years since the 1986 tax reform. The story helps to illustrate both the need under the present system for frequent tax legislation (to patch the code

whenever taxpayers develop new schemes to exploit long-term fissures in its underlying logic) and the Sisyphean nature of the undertaking. The story also illustrates the inevitable result, which is a system that grows more rococo in its complexity with every year. The tax code's original logic is lost as patch after patch is applied to address unintended consequences; these patches in turn often contradict each other, and sometimes they unintentionally even open pathways for new avoidance strategies. Taxpayers devote more and more energy to avoiding the pitfalls of increasingly incoherent rules, but neither they nor the IRS can predict how the tax code will evolve to address new forms of business or new financial innovations, because the original logic has become so obscured. And each year the pattern repeats itself, because the difficult but essential task of rethinking the fundamental tenets that underlie the model is postponed yet again.

The tax code's original logic is lost as patch after patch is applied to address unintended consequences.

II. The Economic Components of Capital Income

To understand the purpose and design of the Business Enterprise Income Tax, it is helpful to review briefly how tax economists today measure and analyze income earned on capital invested in a business. Recent academic work has brought new clarity to the understanding of the components of capital income; in turn, these academic insights can usefully be employed in designing a practical new approach to taxing capital income.

The hallmark of an ideal income tax—the critical characteristic that distinguishes it from, say, an ideal consumption tax (for example, a value added tax)—is that, by design, an ideal income tax burdens (taxes) all of a taxpayer’s returns to capital.¹ (Both types of tax burden returns to labor, and both reach at least some returns to capital, but only an income tax burdens all returns to capital.) A successful *business* income tax system therefore is one that, above all, measures comprehensively and taxes consistently a taxpayer’s returns to capital.

Modern economic literature basically divides the returns to capital invested in a business into three categories (Weisbach 2004). First are time-value-of-money returns (herein described as “normal” returns), which represent the core risk-free return from postponing consumption of one’s wealth. 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.) Finally, there are what economists call “economic rents” or (even more confusingly) “inframarginal returns”—the supersized returns that come from a unique and exclusive market position or asset, such as a valuable patent or trade name.

One very important attribute of a well-designed *income* tax is that it systematically measures and taxes normal returns—the dull, plodding, interest-like returns that one might expect to earn, for example, by investing in a savings account or a Treasury bond. Indeed, this is the key difference between the ideal income tax and the ideal consumption tax: by design, the former taxes time-value-of-money returns, whereas the latter exempts them from the tax base. It turns out, unsurprisingly, that the current tax code does an absolutely terrible job of this, reflecting the modest understanding of the importance of taxing these returns when the tax model was first constructed some ninety years ago. More surprisingly, however, systematically measuring and taxing these time-value returns is much more difficult than it appears. Much of the irreducible complexity of any business tax system stems from this fact.

Economists traditionally equate capital (and therefore the measurement of returns to capital) with “real” assets, 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. If one focuses exclusively on real assets and economic concepts of income, then by definition, an investment in a “marginal” asset is one that generates net economic income each year equal to the normal return applied to the investor’s unrecovered investment.² This almost self-evident observation means that, in a world consisting entirely of direct equity-funded investments in real assets, one would calculate normal returns on investment—and taxable business income—solely through economically accurate depreciation schedules. This thought in

1. Throughout, this paper uses the term “capital” in its narrow, traditional sense and not, for example, as incorporating human capital.
 2. To take the two extremes, if the normal return is 5 percent, an investor that invests \$100 in a perpetual machine can expect to receive cash flow (and net income) each year of \$5. An investor in a machine that is worthless after one year must receive \$105 in cash flow from that machine, which, after application of \$100 in depreciation, leaves the investor with the same \$5 of income—and \$100 to invest in a new machine.

turn is surprising to many noneconomists, who associate time-value-of-money concepts exclusively with financial instruments, and who think of depreciation as some arbitrary allowance that is wholly unrelated to measuring an investor's normal returns.

An ideal income tax system 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). Second, the tax system must permit recovery of the cost of such investments through economic depreciation schedules—that is, schedules that comport with the actual depreciation in value of those assets from year to year. Viewed from this perspective, accelerated depreciation systems “encourage” overinvestment in real assets for the simple reason that, by design, they undertax the returns from those investments relative to economic measures of income.³

Unfortunately for this simple presentation, taxpayers do not invest their capital exclusively in real assets; they also acquire financial assets, such as stocks, bonds, options, and other, more obscure instruments. Economists sometimes ignore financial assets as background noise, on the theory that financial assets in the aggregate are simply indirect claims against all the real capital invested in business. No practical income tax system, however, ignores financial assets. The current tax code therefore taxes businesses on the returns derived from capital invested in real assets (through capitalization and depreciation rules) and taxes households on the income derived from capital invested in financial assets.⁴

One very difficult challenge in designing a business tax system is to decide how 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—to advance the fundamental objective of imposing a single compre-

A successful business income tax measures comprehensively and taxes consistently a taxpayer's returns to capital.

hensive and constant tax burden on normal returns. As the Congressional Budget Office data summarized later in this paper demonstrate, the current tax system fails utterly in this critical exercise. This conclusion in turn is unsurprising, in light of the fact that the tax code's intellectual underpinnings predate the modern economic understanding of income tax systems by some four generations.

There is no simple answer to the coordination and allocation dilemma, although virtually every possible permutation has been explored. Yet the exercise of coordination and allocation between investors holding financial assets and business enterprises holding real assets is critically important if the resulting system is to be economically neutral—that is, if it is to impose a comparable tax burden on all returns to capital, regardless of the form in which an investment is made. The Business Enterprise Income Tax sets out to do exactly this.

3. This discussion ignores for this purpose the distorting effects of inflation.

4. Obviously, businesses can also hold financial assets, but that observation can be deferred until later, when detailed implementation rules are considered.

III. The Business Enterprise Income Tax in a Nutshell

The BEIT superficially resembles the current corporate income tax, but the underlying architecture is completely overhauled to yield a tax system that is economically neutral (returns to capital are burdened consistently) and imposes much lower tax rates on business firms than current law’s 35 percent corporate income tax rate. The working hypothesis is that the new business enterprise tax rate could be in the range of 25 to 28 percent, while maintaining revenue neutrality compared with current law.

The thinking behind the BEIT starts from the pragmatic premise that every business decision today is informed to some extent by its tax consequences. As a result, the only way to get tax planning (and its evil stepchild, tax avoidance) out of the business decisionmaking process is to abandon current law’s multiple and frequently elective tax regimes (each turning on largely formal differences from the others). The BEIT therefore replaces all the formalistic distinctions of the current tax code with a single set of tax rules for each stage of a business enterprise’s life cycle:

- Choosing the form of business enterprise
- Capitalizing the enterprise
- Operating the enterprise, including selling or acquiring business assets or other enterprises.

To implement these themes, under the BEIT every form of business enterprise—sole proprietorship, partnership, or corporation—would be taxed identically, and every investor in a business enterprise would be taxed identically on his or her investments, whether the instrument is called “debt,” “equity,” or anything else. By taxing debt the same as equity, for example, the BEIT would free a firm to capitalize its business in whatever fashion advances its business agenda and lowers its cash costs, rather

than that which simply minimizes its tax liabilities. This paper refers to this ideal as a *featureless tax topography* (see section VI).

The BEIT’s centerpiece is a *comprehensive* and *coordinated* system for taxing time-value-of-money returns, called the cost of capital allowance (COCA) system. Very generally, the COCA rules would replace current tax law’s different treatment of debt capital, equity capital, and the various species of financial derivatives with a uniform allowance for issuers of these instruments—that is, a uniform deduction for an assumed cost of raising money from investors—and a mandatory income inclusion (measured using similar principles, but not the same base, as the deduction afforded issuers) for investors.

Under the COCA regime, a company (technically, a *business enterprise*) would deduct each year a time-value-of-money (interest) charge on *all* of the capital invested in its business, regardless of whether the company raised that capital by issuing debt or equity. This COCA deduction would replace current law’s deductions for interest expense. For example, if corporation X had \$1,000 in assets, and the COCA rate were 6 percent, the corporation would deduct \$60 as its COCA, in lieu of claiming any interest expense or other deductions for the cost of raising capital. Business enterprises would continue to claim depreciation deductions as well as COCA deductions, just as under current law they claim both interest and depreciation deductions.

For their part, investors would include in income every year an *anticipated* time-value-of-money return (at the same COCA rate) on their financial investments, regardless of whether they actually receive that return in cash, and regardless of the performance of the enterprises in which they have invested. For example, if an investor in the same corporation X paid \$1,200 in the secondary mar-

ket for the stock and debt of corporation X, that investor would report \$72 in income (6 percent of \$1,200) in the first year of owning that instrument, regardless of whether corporation X paid the investor that amount in cash. (The example assumes that corporation X does not pay *more* than \$72 in cash in respect of the instrument; if it does, the investor would face a small incremental tax described later in this paper.)

As this example implies, investor-level calculations would be based simply on the investor's tax basis (that is, cost) in an investment, not on the issuer's COCA expense deduction. Investor-level income calculations therefore would not require mark-to-market valuations, pass-through allocations of issuer results, or other financial information beyond simple arithmetic. The COCA system would rely on the BEIT's other operating rules as a platform from which to apply the COCA calculations.

The fundamental design goals of the COCA system (in conjunction with the BEIT's other rules) are to tax economic rents and risky returns entirely (or nearly so) at the business enterprise level, and to tax anticipated time-value-of-money (normal) returns once and only once on a current basis at the investor level, where those returns are easier to identify and tax.⁵ The COCA system would thus achieve tax *integration*, by eliminating double taxation of corporate profits, and would also achieve a more constant tax burden, by eliminating much nontaxation of corporate profits.⁶ Moreover, through its emphasis on taxing anticipated time-value-of-money returns rather than current-year cash receipts (or expenses), the COCA system would for the first time comprehensively and accurately measure (and tax) that critical component of capital income.

The Cost of Capital Allowance System in Operation

Issuers. In the COCA environment, a business enterprise would deduct each year a uniform cost of capital allowance, designed to represent a basic time-value-of-money cost to the issuer of raising capital from investors. The deduction would thus replace current law's deductions for interest expense (or losses on financial derivatives). The cost of capital allowance would represent the entirety of an issuer's deduction for the cost of the capital invested in its business; the issuer would not obtain any additional deduction if it actually paid cash interest (or dividends) to investors in excess of the COCA deduction.

A business enterprise's COCA deduction would equal the aggregate tax basis (cost) of its assets, multiplied by an officially established time-value-of-money rate of return for the year. That rate would be published regularly by the IRS (just as the "Applicable Federal Rate" is today) and set by reference to the one-year Treasury note rate (by way of an example, the one-year Treasury rate plus 1 percent).⁷ The issuer's aggregate tax basis in its assets in turn represents the aggregate capital invested in its business (at least for tax purposes). As a result, a business enterprise would obtain a deduction for *all* of the capital deployed in its business, regardless of how that capital was raised. Because the COCA deduction would look only to an issuer's aggregate tax basis in its assets, rather than to the terms of any financial instruments issued to raise the cash to acquire those assets, an equity-funded issuer would obtain exactly the same COCA deduction as a debt-funded issuer.

An issuer's cost of capital allowance would relate only to its cost of raising capital from investors.

5. Section IV expands on this critical point. See also Kleinbard (2007a).

6. The COCA system retains the flexibility to impose some modest residual double taxation at the investor level (the tax on excess distributions).

7. As described in annex A, it might be desirable in practice to specify two COCA rates: one for financial obligations maturing within the next year, and another for financial capital invested for longer terms.

Depreciation methods would therefore be unaffected. Nonetheless, the interaction of the COCA rules and business asset depreciation would have the critically important effect of neutralizing the present value to the government of a firm's tax obligations with respect to the capitalization and depreciation methods that it might employ: faster depreciation means less remaining tax basis in business assets and smaller COCA deductions for the future. (This important point is developed in section VI and annex B.)

Investors. An investor's basic income inclusion in a given year in respect of an investment in a business enterprise would simply be the same COCA *rate* used to calculate an issuer's COCA deduction, multiplied by the investor's tax basis (cost) in the investment.⁸ This amount, termed the *minimum inclusion*, would be includible in the investor's income regardless of whether it was actually paid, and regardless of the profitability of the issuer. The minimum inclusion would be taxed at ordinary income tax rates. If the investor actually received cash distributions from the issuer (as interest or dividends), the receipt of that cash would be tax-free to the extent of current or prior minimum inclusion accruals.

The COCA system thus would tax investors each year on their *expected* returns on their investments.⁹ The underlying theory is that the minimum inclusion represents the minimum financial return that any rational investor would anticipate earning over time on his or her investment. It may be that in any given year an investment actually earns less than the *minimum inclusion*, or even loses money. The COCA system nonetheless would require that tax be paid on the minimum inclusion, because the investor's decision to hold that poorly performing investment is itself an investment decision, and investors must be presumed to act rationally. That is, it is appropriate for the tax system to assume that

investors make investment decisions (including the decision to hold an existing investment) out of a desire to make money, not out of the sort of emotional loyalty that Chicago Cubs fans show to their favorite team.

Putting the investor and issuer sides of the COCA together, investors would include normal (time-value-of-money) returns in their income, and business enterprises would include risky returns and economic rents in theirs.¹⁰ The sum of these three inclusions approximates as closely as is reasonably possible all of the economic income from operating a business, while avoiding any overlap of tax bases that could lead to double taxation.

The combined tax base of the COCA system as described to this point approximates economic income, but it inevitably falls a little short of economic perfection, for two principal reasons. First, it must be expected that in practice some business tax preferences (other than accelerated depreciation, which the COCA system in fact neutralizes) will continue to survive. Second, economists will argue that investors' minimum inclusions should be determined by looking to the market values of financial instruments, which of course is impractical.¹¹ Since investors make money over time, and less than 100 percent of all financial assets are sold each year, aggregate minimum inclusions will tend to lag a bit behind the theoretical ideal amount. The end result should, however, be orders of magnitude closer to ideal measures of economic income than are the results reached under current law.

To address these issues, and to respond to traditional fairness and ability-to-pay concerns, the COCA system would also impose a *small* (for example, 10 percent) additional tax, termed the *excess distributions* tax, on an investor's gains beyond time-value-of-money returns. This tax can be conceptualized as a

8. Special rules described in annex A would ensure that COCA works seamlessly with financial derivatives.

9. For an early and influential proposal to rely on expected returns as the basis for taxing capital income, see Shuldiner (1992).

10. Annex A describes the tax rules that would apply to one business enterprise's minority investment in another.

11. See Kleinbard (2007a). If in fact it were possible to accurately mark to market *all* financial assets at the end of every year, one could simply rely on year-to-year changes in those market values to determine the business tax base.

rough-and-ready compensatory tax that reflects the following: any tax preferences (that is, any deviations from income tax ideals) not otherwise addressed by the BEIT (in particular, other than depreciation, which is neutralized through the COCA mechanism, as discussed further in section VI); the use of investors' historical tax basis (cost) rather than market values as the base for calculating minimum inclusions; and an acknowledgment of traditional ability-to-pay concerns.

To summarize: an investor would pay tax annually at ordinary income tax rates on his or her minimum inclusion income. Most actual cash distributions would be treated as tax-free payments of current or past minimum inclusion income. Some large cash distributions (whether denominated as interest, dividends, or otherwise) and what today are called capital gains would also be taxed, but only at the low excess distributions rate. As a result, the tax on minimum inclusion income would represent the great preponderance of a typical investor's tax liability in respect of his or her financial investments.

The COCA system would further provide that any loss recognized by an investor on the sale of a financial asset would be currently deductible against ordinary income, to the extent of the investor's aggregate prior minimum inclusions on that asset.¹² This rule would apply *regardless* of whether the investor received those prior minimum inclusions in cash.¹³ Any loss of "principal"—that is, of some or all of the investor's original investment—generally would not be deductible, just as any gain would not be taxed beyond the small excess distributions tax. (A special rule described in section VII would grant an investor a loss deduction in connection with certain business enterprise acquisitions of unprofit-

able target companies.) The result would be a more economically neutral investment environment than provided by current law's capital loss limitation rules, because under the COCA system economic losses attributable to prior time-value-of-money inclusions could be deducted against unrelated income, not just investment gains.

A comprehensive example. A simple but comprehensive example is desirable here. Imagine that Investor pays \$1,000 to Issuer (a newly formed business enterprise with no other assets) 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). Issuer then immediately purchases an asset that is depreciated on a five-year straight-line basis (that is, at the rate of \$200 per year). Assume that the COCA rate is 6 percent in every year.

Issuer's COCA deductions each year would equal the sum of the tax bases of all its assets, multiplied by the COCA rate. Assuming for this example a simple rule that looks only to asset basis at the start of the year, Issuer's COCA deduction for its \$1,000 asset would equal \$60 in year 1, \$48 in year 2, and so on. (Issuer would also obtain a COCA deduction for any asset basis attributable to any net cash generated by the asset and retained by Issuer.) At the end of five years, Issuer's tax basis in the asset would be reduced to zero, and Issuer would no longer obtain any COCA deductions in respect thereof.

Investor, meanwhile, continues to own her Issuer security. Each year she would include in ordinary income a 6 percent yield (\$60 in the first year) on her tax basis in that instrument. If, in year 1, Issuer happens to distribute exactly \$60 to Investor

12. As described in annex A, losses attributable to prior excess distributions would also be partially deductible, in a manner that reverses the tax consequences of the prior income inclusions on that investment.

13. In other words, losses are always deductible to the extent necessary to wipe out prior income from the security. For example, imagine that an investor purchases investment A and investment B each for \$1,000. Investment A pays a 6 percent annual cash return; investment B pays no current-year cash return (for example, it could be the common stock of a corporation that pays no dividends). Assume the COCA rate is also 6 percent. At the end of year 1, the investor sells investment A for \$950 and investment B for \$1,000. The investor will realize a \$50 loss on investment A (\$1,000 tax basis less the \$950 sales price), and a \$60 loss on investment B (\$1,060 tax basis—reflecting the accrued minimum inclusion—less the \$1,000 sales price). Both losses are fully deductible, because the \$50 loss in each case is less than the \$60 of minimum inclusion income earned in respect of the security.

in respect of that security, Investor would include that \$60 in taxable income at ordinary income tax rates. If Issuer distributes nothing, Investor would still include \$60 in income for year 1 in respect of that investment, which would be presumed to have increased in value to \$1,060. If Issuer continues its policy of not distributing cash, Investor would include \$64 in income in year 2 (6 percent of her \$1,060 tax basis), and so on, to reflect a constant yield on her presumptively more valuable investment.

If Issuer makes no current cash distribution, and Investor sells the security at the end of year 1 for \$1,200 (when her tax basis has grown to \$1,060), her first \$60 of sales proceeds would be treated as a tax-free payment of prior minimum inclusions, and the remaining \$140 of gain would be taxed only at excess distributions rates. The new Investor, having paid \$1,200 for the security, would now recognize \$72 of minimum inclusion income in his first year of ownership. Issuer's COCA deductions would continue unaffected. Conversely, if Investor sells her security at the end of year 2 for her original cost of \$1,000, she would recognize an ordinary loss of \$124 (reversing her year 1 minimum inclusion of \$60 and her year 2 minimum inclusion of \$64).

Although the COCA system would require some recordkeeping and arithmetic, it is feasible in ways that “accruals” (universal mark-to-market) taxation and other ideal systems are not. In particular, each investor would always have readily at hand the information required to calculate tax liability, because all that he or she would need to know would be the current published COCA rate and his or her tax basis in the investment.¹⁴ Critically, the investor would require no special information from prior holders of the asset or from the issuer.

The Business Enterprise Income Tax's Other Rules

The following paragraphs briefly describe the principal components of the BEIT, other than the COCA system, as they would apply to large business enterprises. (Some special rules for small businesses and financial services firms are summarized later.) Annex B develops these principles in greater detail.

- All business enterprises would be taxed the same, regardless of their form (for example, sole proprietorship, partnership, or corporation), and would be taxed as entities separate from their owners. Entrepreneurs thus would be free to choose whatever form of business organization they wished, with no collateral tax consequences. The basic tax system would look much like today's corporate income tax, in that the entity tax would roughly follow current rules for taxing corporations, subject to the substitution of the COCA mechanism for interest expense deductions and the other major modifications described below. In addition, of course, investors would be taxed on normal investment returns via the new COCA mechanism. The BEIT thus would preserve the present two-level tax system, which would minimize the transition revaluations of financial assets in the secondary markets that would follow from rewriting the tax system to impose the entirety of the business tax burden either on investors or on issuers. The two levels of tax, however, would for the first time be coordinated and integrated.

- Enterprise-level tax rates would be substantially lower than the current corporate income tax rate (25 to 28 percent, under the working hypothesis, rather than 35 percent today), as a result of both the COCA system's comprehensive taxation of normal returns and the base-broadening features described below.

14. In practice, it is anticipated that financial intermediaries will perform most of these recordkeeping and arithmetic requirements, at least for instruments traded in the public capital markets.

■ The business enterprise tax base would be broadened by reforming certain important but technical business tax accounting rules and industry-specific preferences (such as LIFO inventory accounting, like-kind exchanges, percentage depletion, most energy credits, and the domestic production deduction). The largest base-broadening component, however, would be the COCA system for taxing returns on investment.

■ “Superconsolidation” for tax purposes would be mandatory for affiliated enterprises. All subsidiaries would be treated as part of the parent company, as in financial accounting, rather than as under today’s impenetrable consolidated return tax rules. Consolidation in general would be measured at the 50 percent level (that is, entities in which one company has a greater than 50 percent stake would be deemed affiliates of that company) and by reference to all of a company’s long-term financial instruments (with tie-breaker rules to prevent the same entity being treated as the affiliate of more than one parent). This rule would both eliminate substantial complexity and serve as a foundation from which to apply the COCA system.

■ All rules relating to tax-free organizations and reorganizations would be replaced with a much simpler “tax-neutral” acquisition system, in which *all* acquisitions of business assets or business enterprises—basically, all incorporation transactions, or all entries to or exits from a superconsolidated group—would be treated as taxable asset acquisitions. As a result, when one business enterprise acquires control over another, so that the target company becomes part of the acquiror’s superconsolidated group, the tax fiction would be that the target company has sold its assets and liquidated, thereby triggering a taxable event to investors as well. For the reasons developed in section VI and

annex B (basically relating to the fact that the BEIT as applied at the business enterprise level by itself functions like a consumption tax), this approach would *not* result in double taxation or an impediment to business combinations.¹⁵ Like the superconsolidation rule, the “tax-neutral” acquisition system would serve as a foundation on which the COCA system can be erected.

■ For essentially the same reasons as those described in respect of the repeal of the tax-free reorganization rules, it also is recommended that death be treated as a realization event for a decedent’s financial assets within the scope of the cost of capital allowance system. This change would have only a modest immediate income tax consequence (limited to the excess distributions rate applied to an investor’s gain), but it would have the more important result of “resetting the clock” for taxpayers’ *future* minimum inclusions, by marking to market financial assets at death. The idea here is that the COCA system’s theoretical imperfection attributable to its use of cost, rather than market value, as the basis for determining minimum inclusions should have an absolute limit of one generation.

■ Treatment of losses would be tax neutral. All losses sustained by a business enterprise in respect of real assets would be fully deductible against ordinary income. For the reasons developed in annex B (again relating to the BEIT’s unique hybrid structure as a business enterprise-level consumption tax with an investor-level income tax “add-back”), the usual income tax concerns that enterprises will cherry-pick which tax losses to harvest and which gains to defer would not apply. To preserve full economic neutrality, a business enterprise’s unused net operating loss carryovers would compound from year to year at the COCA rate. (As previously described, investor losses also would be essentially tax neutral.)

15. Earlier presentations of the BEIT wrongly posited that business enterprises would require a special reduced tax rate system applicable to business asset sales, to preserve neutrality between sellers and buyers of business assets. The author’s error was to confuse the fact that the BEIT in the *aggregate* is an income tax with the fact that, applied simply at the business enterprise level, it functions like a consumption tax. See section VI and annex B.

■ As described in more detail in section VIII, the superconsolidation rules would extend to international income. As a result, the BEIT would eliminate the “deferral” of active foreign income from current U.S. tax.¹⁶ (The BEIT in this respect is the perfect mirror image of a territorial system, which would exempt overseas income from U.S. tax.) At the same time, the BEIT would eliminate the allocation of U.S. interest expense (which would become COCA deductions) against foreign income—the principal source of “excess foreign tax credit” problems for U.S. multinationals. The BEIT of course also would substantially reduce the tax rate on global income. Finally, global superconsolidation also means that foreign losses would become currently deductible in the United States, thereby restoring neutrality to the U.S. tax analysis of foreign direct investment.

The combination of taxing all businesses as entities, the superconsolidation rule, and the tax-neutral acquisition rules would work together to measure a business enterprise’s real asset tax basis consistently, and to introduce as many realization events as possible, consistent with the practical constraints of imperfect information about values in the absence of a measurable transaction. For example, these three rules would ensure that the tax basis in real assets is determined in the same manner for acquisitions of control through the purchase of a target’s stock as for direct purchases of the target’s business assets. As a result, these three rules would form a robust foundation on which to construct the cost of capital allowance system.

The combination of taxing
all businesses as entities, the
superconsolidation rule, and the
tax-neutral acquisition rules would
work together to measure a
business enterprise’s real asset tax
basis consistently.

16. This theme is developed in more detail in Kleinbard (2007b).

IV. Economic and Policy Implications of the Cost of Capital Allowance System

The Business Enterprise Income Tax would offer several advantages over the current system for taxing business income. Besides eliminating many of the artificial distinctions in the tax code that lead to distortions in businesses' decisionmaking, the new system would enable a lowering of business tax rates (without, however, shifting the burden of taxation from capital to labor) and would provide businesses with the predictability of tax outcomes that they require in order to make sound business decisions.

Economic Analysis

The cost of capital allowance system should largely eliminate the role of tax engineering in shaping a business enterprise's capital structure, because the enterprise's COCA deduction would be unaffected by the labels attached to the financial capital instruments that it issues. Capital in turn should be efficiently priced, because the system would largely integrate the treatment of providers and users of capital. The COCA system distinguishes in a logical and consistent manner between ordinary, time-value-of-money returns (minimum inclusions) and extraordinary returns (excess distributions). Including a current time-value return on all financial instruments reduces the opportunities for indefinite deferral and its concomitant distortive effects of understating income and locking in investments.¹⁷ Finally, the replacement of today's corporate-level capital loss limitations with rules allowing a business enterprise fully to utilize losses from sales of real assets would eliminate a substantial economic distortion that today limits the attractiveness of risky investments.

Unlike some other proposals for integrating business enterprise and investor taxation, the COCA system would place the nominal incidence of taxing

the time-value-of-money returns on capital—the distinguishing feature of an income tax—on the shoulders of investors rather than of issuers. Doing so has two important benefits. First, financial capital instruments are likely to turn over more rapidly than real assets (other than inventories). As a result, investors' aggregate tax bases (current tax cost) in these instruments should reflect economic measures of income more closely than do business enterprises' aggregate bases in their real assets. Second, nonbusinesses have relatively few options for sheltering their time-value-of-money returns from tax; in particular, depreciation rules generally are not relevant to measuring income derived from financial investments.

At a deeper level, economists familiar with the modern consumption tax literature will recognize that the COCA, when combined with the tax depreciation of investments in business assets, effectively operates at the business enterprise level as a progressive consumption tax of the income type, as contemplated by the late David Bradford (2005). This result is deliberate. It means that normal (time-value-of-money) returns would not be taxed at the business enterprise level, but that risky returns and economic rents would. Unlike a consumption tax, however, the BEIT in fact would tax income, *including* normal returns: those returns would be captured solely at the investor level, through the minimum inclusion mechanism, as explained above.

The BEIT thus can be conceptualized as a consumption tax at the business enterprise level (that is, a tax that deliberately excludes time-value-of-money returns from its base) that is converted back into an income tax through the investor-level minimum inclusion mechanism. This design choice sounds unnecessarily convoluted, but in fact it has profoundly positive consequences for the practical

17. Admittedly, the COCA system would retain some of current law's "lock-in" problems. See section VI.

implementation of a comprehensive income tax. In particular, it is this novel hybrid structure that enables the BEIT, unlike existing income taxes, to measure and tax income accurately regardless of the depreciation methods employed by business enterprises, to dispense with the arcana of “tax-free” organization and reorganization rules, and to permit business enterprises to sell assets at a loss without exposing the IRS to the whipsaw of taxpayers harvesting their tax losses today while deferring their unrealized gains to future years. Section VI and the annexes develop these themes in more detail.

Distributional Consequences

This paper’s fundamental focus is on developing a comprehensive, fair, and administrable business tax base, not on advocating any specific apportionment of tax liabilities between businesses and households, or between capital and labor. The paper’s recommendations thus are politically neutral, so long as one accepts the necessity or desirability of an income tax that burdens capital at all. Nonetheless, the BEIT is intended to have three important distributional consequences.¹⁸

First, the expectation is that, under the BEIT, a business enterprise would face *lower* marginal U.S. tax rates (and in most cases lower average tax rates) than under current law. The current U.S. corporate tax rate is simply out of step with the rates of company tax imposed by other capital-exporting countries (Sullivan 2006). Very recently, for example, the United Kingdom announced plans to reduce its corporate income tax rate to 28 percent. U.S. businesses would benefit directly from a similar reduction in the rate imposed on them as business enterprises. Indeed, it can be argued that there is real urgency to reducing the U.S. corporate income tax rate (while raising the same amount of aggregate tax on returns to capital

owned by Americans), to preserve the global competitiveness of U.S. multinationals.

This assertion does *not* mean, however, that the BEIT necessarily contemplates a reduction in the tax burden imposed on capital relative to labor. The total tax burden that the BEIT imposes on capital is the *sum* of enterprise-level and investor taxes—in particular, the minimum inclusions of normal returns. The same point could be made about current law, but there it rings hollow, because current law fails so miserably at collecting tax on normal returns on business capital. Under the COCA system, by contrast, substantial tax would be collected at the investor level that escapes collection today. Thus the BEIT would tend to shift more of the tax on business income onto the shoulders of investors at the same time that it relieves companies of some of that burden.

The designers of most income tax systems typically set the business enterprise (corporate) tax rate to roughly equal the maximum individual income tax rate. The reasoning behind this decision is that if enterprise-level tax rates are materially lower than those imposed on investors, investors will use corporations as tax shelters, by leaving their money in corporate solution, where it can compound at a higher after-tax rate of return.

By contrast, this paper proposes that tax rates on business enterprise be set materially lower than the maximum tax rates on individual investors. The BEIT can withstand this divergence in rates by virtue of its minimum inclusion system, which would tax individual investors each year on a deemed compounded return even if they were to “park” all their cash in a corporate entity. Moreover, the deemed distribution system described in Section VII in respect of “collective investment vehicles” could be

18. In the short term, the BEIT can be expected to raise the tax burden on very highly leveraged business enterprises (by capping what today are interest expense deductions at the COCA rate), and to reduce dramatically the tax burden on unleveraged companies (both through its basic rate reduction and through a COCA deduction that would apply to capital financed with equity as well as debt). Over time, however, business enterprises would revise their capital structures to more closely track their cash financing needs, rather than to follow tax minimization strategies. With the exception of a few industries (such as real estate), it is difficult to predict a pattern to any such transitional distributional consequences across broad categories of businesses.

extended to privately held business enterprises, thereby ensuring that individuals' tax bases would be stepped up to reflect any substantial capital gains realized by a business enterprise in which they were investors.

Finally, the BEIT is expected to add progressivity to the income tax system, without any change in individual income tax rates. The reason is that the COCA system is intended to coexist with broad saving incentives—for example, the savings incentives available under current law or those recommended by the President's Advisory Panel on Tax Reform's proposals (2005). COCA would be largely invisible, therefore, to middle-class households, because substantially all of their financial assets would be held in tax-deferred accounts. As a result, the capital tax burden would fall only on the wealthiest taxpayers, because in general they are the only taxpayers with significant financial investments not sheltered by tax-deferred savings plans. These are the very investors who today can afford expensive tax and financial planning services, and who can rely on the anomalies of current law (such as the tax-free step-up of the asset basis at death) to defer taxation in respect of much of their investment returns, or cause that income to be taxed at preferential rates. The COCA system is intended to function as a reasonably airtight mechanism to collect current tax from just these investors. And since the distribution of wealth in this country is even more skewed than that of income, the net consequence of an effective investor-level tax on returns to capital would be to add significant progressivity to the tax system.

Simplicity and Uncertainty

The BEIT contains very few tax distinctions that turn on choices among different forms of organization, capitalization, or transaction. As a result, the proposal would achieve much greater predictability and consistency of results than does current law. The proposal is not, however, particularly simple, in the sense that its detailed rules can be reduced to

a few paragraphs or compliance reduced to annually mailing in a postcard.

Simplicity is rightly an overriding goal in designing an income tax system for individuals, particularly one that (like the U.S. system) relies on self-assessment. Businesses, however, have accounting and other systems and expertise that households typically do not. (Small businesses, of course, are an intermediate case and are considered later in this paper.) Business firms value *predictability* more than simplicity, because predictability reduces the uncertainty of possible outcomes when evaluating risks and rewards from any business initiative, which is what businesspeople do. Thus, rational businesses prefer a tax system that requires a reasonable amount of recordkeeping or several arithmetic operations, provided that those rules are universally applied and known in advance, to a tax system that is described as a one-step “EZ” solution, but in which that single step involves throwing a dart at a board marked with every possible tax outcome.

The BEIT therefore accepts a certain amount of straightforward recordkeeping and simple arithmetical calculations as the price of a system that is materially fairer and more economically neutral than current law. Because the information required to calculate tax liability under the BEIT is already known to each taxpayer (the taxpayer's basis in its investments or business assets), the BEIT fundamentally is *feasible* for both taxpayers to comply with and the tax administration to implement and administer. The BEIT does not, for example, require mark-to-market valuations of illiquid investments or the pass-through of corporate income information to thousands of public investors. Different readers may have differing opinions as to the political salability of the BEIT, but these opinions should not cloud the fact that, if there were the political will to legislate it, the BEIT on balance would be administratively simpler, and conceptually infinitely more consistent, than the current tax rules for taxing business income.

V. How Bad Is The Current Tax System?

The Business Enterprise Income Tax represents truly fundamental business income tax reform. No matter how carefully designed, transition to the new system would be painful for some and confusing for many. Even if it were agreed that the BEIT would be superior to the current business income tax, it therefore is fair to ask whether the current situation is so dire as to justify jettisoning current law in favor of an entirely new business tax model. Unfortunately, the answer is that the present system for taxing business income is in crisis. The evidence surrounds us, if we are sensitive to its signals.

In the domestic context we are all familiar with the phenomenon of corporate tax shelters, which then-Secretary of the Treasury Lawrence Summers identified in 2000 as “the most serious compliance issue threatening the American tax system today.” In response, federal courts of appeal have concluded that numerous household names in the corporate world, including General Electric, Dow Chemical, and Colgate-Palmolive, have engaged in “abusive” or “sham” transactions to reduce their corporate tax liabilities (*TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006) [General Electric]; *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998) [*Colgate-Palmolive*]).¹⁹

Further evidence of the instability of the current tax system is the fact that the public capital markets are populated with all sorts of unnatural financial instruments bearing exotic names like “E-CAPS” and “Feline PRIDES,” whose purpose is to arbitrage differences in the tax treatment of economically

similar financial returns when incorporated into formally different instruments, or, alternatively, to arbitrage differences in tax, financial accounting, and rating agency standards. These exotic instruments often accomplish their intended objectives under current tax law, but that is not the relevant question. The right question is, how have we allowed ourselves to develop a business tax system that impels financial engineers to create the tax equivalent of a genetically engineered beast with the head of a giraffe and the body of a zebra?

Even without regard to such exotica, virtually the entirety of the U.S. capital markets could fairly be listed as a “tax expenditure” relative to the modern economic understanding of how to measure income, yet the current interpretation of tax expenditure, colored by decades-old norms employed to categorize the taxation of financial instruments, accepts the status quo as unexceptionable.²⁰ For example, businesses are encouraged to overleverage their capital structures, because interest paid on debt capital is deductible, while dividends paid on equity are not. At the same time, the capital markets are supremely efficient at matching issuers and investors so as to minimize the tax liabilities of each. One result is that investors in business debt obligations in many cases are tax-exempt institutions, thereby ensuring in practice that the tax system collects tax on overleveraged businesses neither from businesses nor from investors.

On the international front, the IRS is now grappling with a variety of “transfer pricing” cases, in which taxpayers, whether U.S.- or foreign-based, seek to reduce their U.S. tax liabilities by shifting

19. A recent review of the data on corporate tax receipts concluded that “The recent surge in corporate tax revenue has been accompanied by a decline in estimated effective corporate tax rates that is not explained by changes in tax law. . . . That decline . . . might be due to any number of relatively benign factors, . . . [b]ut we must also consider the possibility that aggressive tax planning is on the rise” (Sullivan, 2007).

20. “Tax expenditures” are defined by statute as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability” (2 U.S.C. § 622 2007).

U.S. profits to low-taxed non-U.S. affiliates. Staggering sums of money are involved. For example, Merck & Co. recently revealed that it is contesting allegations of illegal transfer pricing brought against it by the IRS and the Canadian tax administration totaling some \$5.6 billion. (Jesse Drucker, “Merck to Pay \$2.3 Billion in Tax Case,” *Wall Street Journal*, February 15, 2007, p. A4.) And a front-page story in the *Wall Street Journal* in 2005 revealed how Microsoft Corporation uses an Irish subsidiary to hold certain high-value Microsoft intangible assets, thereby reducing Microsoft’s federal tax bill by roughly \$500 million every year (Glenn R. Simpson, “Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe,” November 7, 2005, p. A1).

Quantifying the Crisis

Two significant recent studies by the Congressional Budget Office (CBO 2005, 2006) document what a dismal job the current tax code does of measuring comprehensively and taxing consistently a taxpayer’s return on its capital.²¹ Taken as a whole, these data demonstrate that the current tax system is hopelessly inefficient, in that it distorts economic decisionmaking by encouraging (or, more accurately, positively begging) corporations to fund their new investments with debt rather than equity, and by imposing very different actual tax burdens on the different types of assets that businesses acquire.

The CBO papers show that the marginal effective *total* tax rate on corporate income—that is, the “all in” tax rate on a prospective marginal investment, *including* the tax burdens imposed on investors in respect of their receipt of interest and dividend income—is around 26.3 percent, compared with a statutory corporate marginal tax rate (not reflecting incremental

investor-level taxes) of 35 percent. The marginal effective total tax rate on capital invested in *non*corporate businesses is much lower—20.6 percent. This difference by itself points to a fundamental weakness of the current system, namely, the differing tax burdens that the tax code imposes on capital invested in different legal forms of business entities.²²

The same figures also point to another source of concern, which is the large discrepancy between the statutory corporate tax rate and the effective marginal total tax rate on corporate investment (that is, the difference between nominal and actual tax burdens on a corporate investment’s projected economic income). If the United States had a perfect corporate income tax that in turn was perfectly integrated with investor-level taxation (so that there was no double taxation of corporate profits, for example), one would expect the marginal effective total tax rate and the statutory corporate rate to be identical. Whenever statutory and marginal effective tax burdens diverge so sharply, it is a reliable signal that base broadening is required to close the gap.

The CBO analysis also demonstrates that the current business tax system imposes wildly divergent tax burdens on marginal investments, attributable both to differences in the taxation of different funding sources (for example, debt versus equity) and to differences in the tax treatment of different asset classes (for example, depreciation rules). Equity-funded corporate capital investments are taxed at a marginal effective total (all-in) tax rate of 36.1 percent (slightly higher than the statutory corporate rate of 35 percent because of investor-level taxes), whereas debt-financed investments face a *negative* 6.4 percent rate—a 42.5-percentage-point swing.²³ And there is a 12.3-percentage-point difference

21. CBO (2006) essentially describes the methodologies underlying the numbers presented in CBO (2005).

22. One can argue that many small businesses are unincorporated, and that the rate difference reflects a congressional decision to tax small businesses more lightly. If that is the justification, it is a poorly directed incentive, because the tax benefits of adopting a noncorporate business structure are freely available to very large enterprises as well as to small ones.

23. The 26.3 percent marginal effective total tax rate on corporate investments is the weighted average of these two rates, weighted by the CBO (2006, p. 47) to reflect the relative amount of debt financing by American corporations (roughly 41.3 percent of the total capital invested in corporations). The negative tax rate on debt-financed investments stems in part from the fact that while corporate borrowers invariably obtain tax deductions for the interest that they incur, the correlative interest income often escapes taxation, because it is earned by a tax-exempt entity.

between the effective total tax rate imposed on a marginal investment at the 25th percentile of “real” asset classes (ranked in order of tax burden) and that imposed at the 75th percentile—that is, between the top and the bottom of the middle half of all “real” assets. This fluctuating burden on investments in real assets is attributable primarily to the current tax system’s inconsistent rules for capitalizing expenses and depreciating investments in real assets.

The Underlying Problem

Corporate tax shelters, exotic capital markets instruments, and aggressive transfer pricing policies all present serious (if different) challenges to tax administration, but the reality is that these are symptoms, not the disease itself. The underlying problem is a business tax system built on foundations that have not been reexamined since the original developers designed its basic architecture some four generations ago. These foundations, in turn, are inconsistent with modern business practices and current economic thinking.

Simply stated, the current tax system is incoherent. 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. Even without regard to “corporate tax shelters” and the like, the U.S. system for taxing business income is thus fundamentally rotten at its core: it can neither measure nor tax consistently the most straightforward returns to capital invested in U.S. businesses.

This point can be seen in the data just summarized and can further be illustrated with a paradigmatic case. At least in theory, the Internal Revenue Code taxes the normal returns on real assets owned by a corporation and financed by issuing debt only at the level of the financial asset investor, by giving the issuer of the debt (and owner of the real asset) an interest deduction and requiring the investor to include that amount in income. In reality, however, the tax code often does not tax those returns to capital at all, because investors in debt securities frequently are tax-exempt institutions. Indeed, given that the issuer might be entitled to accelerated depreciation on the asset acquired with the debt financing, the total tax burden on the normal returns on the capital directly and indirectly invested in that real asset can turn negative, just as the CBO data show.

Conversely, the tax code nominally taxes normal returns to corporate equity twice, in the sense that it taxes corporations on their earnings, and stockholders on the dividends they receive. The problem with this is not the two levels of taxation as

The U.S. system for taxing business income is fundamentally flawed at its core: it can neither measure nor tax consistently the most straightforward returns to capital invested in U.S. businesses.

such—imposing tax on stockholders and corporations each at 50 percent of the appropriate tax rate is no worse than imposing 100 percent of that appropriate tax on one but not the other—but rather the difference in the aggregate tax burden, when compared with the case of debt capital.

Cutting the other way, the tax code taxes investors in corporate stock only on their cash receipts (and then at reduced rates), whether realized as dividends or as capital gains, but taxes bondholders on their time-value-of-money returns, even if the associated cash is not distributed until some future year (so-called “original issue discount”). This “deferral” benefit associated with low-dividend stocks drives the incremental tax burden imposed on this type of corporate equity (over and above the tax burdens imposed on the corporation) closer to zero. As a result, the aggregate tax burden imposed on corporate income owned indirectly as corporate equity in practice can converge on the tax imposed on the corporation’s returns on its real assets, which may have a relatively high or low burden, depending on the applicable depreciation rules and other enterprise-level tax preferences.²⁴ And all this is before one even considers the special coordination issues raised by sales of financial assets, or of business assets, or of entire business enterprises.

The Systemic Failings of the Tax Code’s Current Structure

The CBO data summarized earlier, as amplified by the discussion just above, point to three unambiguous and important economic failings of the current business income tax. First, 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. Second, the tax burden imposed on equity investments in different classes of real assets also varies, because the net income from those investments (gross revenue less depreciation expenses) is measured inconsistently. Third, the tax burden imposed on different *indirect* claims on real assets—that is, financial investments—varies most dramatically of all. Each of these three failings has a similar consequence: it distorts economic decisionmak-

ing. Money is overinvested in tax-favored asset classes or financial investment types, relative to what would occur under an ideal income tax that burdened all returns to capital equally.

The first 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 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 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.

24. Indeed, the CBO data cited earlier show an all-in effective tax rate (including shareholder taxes) on investment in corporate equity that is very close to the nominal statutory tax rate on corporate income alone.

There is no satisfactory economic explanation for the differing tax burdens imposed on the various legal forms of conducting a business.

Over the decades the Internal Revenue Code has extended this mode of thought without any reexamination of its basic 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 Exxon/Mobil.

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. In practice, this bad intellectual habit goes a long way toward explaining 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.

The second failing—the differing tax burdens imposed on investments in different classes of real assets—is largely the result of imperfect tax rules governing the calculation of a taxpayer's true investment in a real asset (that is, which outlays are ordinary expenses, and which should be capitalized in the cost of that real asset) and the depreciation

schedule for that investment. (Inflation has additional distorting effects.) These problems are notoriously difficult to correct in practice, both because of categorization and measurement difficulties, and because depreciation schedules are irresistible objects of political attention, to the point where the tax system has for decades now given up even the pretense of conforming tax and economic depreciation schedules.

The third failing—the wildly inconsistent tax burdens imposed on different financial instruments (that is, on indirect interests in real assets)—reflects at least five important (and related) underlying structural problems in the tax code. The first is the bad habit described above, in which outmoded social and legal norms, not economic considerations, define the contours of each investment cubbyhole. Thus debt is different from equity, it is said, because a debtor makes an unqualified promise to repay a debt, whereas an investor's equity is exposed to the risk of the business. As a result, debt of a low-quality issuer is treated according to the debt ideal type, and preferred stock issued by an AAA-rated corporation is treated as equity, even if the actual likelihood of repayment of the preferred stock greatly exceeds that of the junk debt.

The second reason for the present tax code's extraordinarily poor performance in taxing returns on financial instruments is that it has not adopted a single coherent model for taxing time-value-of-money returns. The tax code generally does a fairly good job of appreciating the importance of measuring and collecting tax on those returns derived from investing in debt instruments (except for the pervasive structural issue of tax-exempt investors), but it lacks any comparable ability to spot the same sorts of returns when they are received through investing in non-fixed income investments, such as stock.

The third, related reason for current law's incoherence is that 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 (Kleinbard 2007a).

Fourth, the tax system makes only a desultory effort to integrate the income taxation of financial instrument holders—the indirect owners of a business’s real assets—with the income taxation of the business enterprise itself. The best-known example of this issue is the double taxation of dividend income, already mentioned, in which income is subject to tax at the corporate level and again when distributed as a dividend to shareholders in the corporation. Fewer taxpayers object, however, to the equally common phenomenon of zero taxation of interest income, when a corporation pays deductible interest to a tax-exempt recipient. And fewer still stop to observe (for example) that dividend income that is paid out of nonincome (in an economic sense), as a result of accelerated tax depreciation, is taxed at some intermediate effective rate.

Finally, the income taxation of financial instruments, in particular, is bedeviled by the problem of the “realization principle,” under which the economic returns on some forms of financial instruments (basically, most investments other than debt) are not taxed until the taxpayer receives those returns in cash. For example, an individual who invests in the common stock of a corporation recognizes no taxable income unless (and then only to the extent that) he or she receives a dividend or sells the stock.

The commonsense intuition that tax liability should be deferred until cash is received unfortunately conflicts directly with economic logic. The easiest way to see why is to imagine that the common stock in the above example appreciates in value at precisely the normal rate of return, and to assume that the corporation pays no tax (so as to isolate the *realization* problem from the *integration* issue of coordinating corporate and shareholder-level taxes). The shareholder ultimately will pay tax upon selling that stock, and the gain the shareholder reports will in turn reflect the compounded growth in the stock’s value, but by deferring the tax liability the investor effectively will have reduced the tax burden imposed on that investment.²⁵

25. More specifically, the deferral of tax liability in this example is the economic equivalent of exempting from tax the compounding element of the investor’s return. See Halperin (1986).

VI. How the Cost of Capital Allowance Rehabilitates the Business Income Tax

One understandable reaction to all the recitals of how badly the current tax system measures and taxes time-value-of-money returns, and of the many reasons for its failings, is to conclude that the entire undertaking is hopeless. By happy coincidence, there is a rational alternative to the income tax, in the form of various implementations of a consumption tax—from a retail sales tax, to a value-added tax, to the late David Bradford’s elegant “X-Tax.” By definition, a consumption tax does not tax time-value-of-money returns, and therefore many difficulties identified in the preceding section disappear in a consumption tax environment (possibly to be replaced by other difficulties).

Even if one could develop a perfect implementation of an income tax, many economists would prefer a consumption tax, because they see income taxes as imposing an economic inefficiency—a distortion—by favoring current consumption over future consumption. Interestingly, however, Bradford, who arguably thought at least as much and as cogently about the issue as any other researcher, came in his late work to advocate a consumption tax primarily because of the almost random burdens imposed on capital income by the contemporary income tax, not the potential efficiency gains to be achieved by eliminating the distortions that even an ideal income tax system imposes on the timing of consumption decisions.²⁶

This paper, by contrast, attempts to rehabilitate the income tax, for various reasons that include revenue requirements, perceptions of fairness, transition problems, and tax rate progressivity. Such an undertaking, however, must address the economic

distortions deeply embedded in current law, as described in the preceding section.²⁷ In particular, a rehabilitated business income tax must satisfy five fundamental objectives:

- It must measure normal (time-value-of-money) returns comprehensively and tax them consistently.
- It must integrate the taxation of real and financial assets, so that the appropriate aggregate tax burden is imposed on the sum of the two.
- It must make the income tax more resilient to imperfections in its capitalization and depreciation rules.
- It must mitigate the distortions attendant on the realization doctrine.
- It must expunge the current tax law’s engrained bad habit of thought of defining substantive tax consequences by reference to outmoded legal and social norms.

This section describes in a bit more detail how the cost of capital allowance component of the Business Enterprise Income Tax addresses these five fundamental business income tax rehabilitation objectives. In brief, this section demonstrates that the COCA system simultaneously serves as a reasonably accurate device for measuring and taxing returns to capital, a mechanism for integrating investor and business enterprise tax burdens, a system for neutralizing the effect of economically imperfect capitalization and depreciation rules (as

26. Bradford (2005, pp. 14-15) writes, “I would put at the top of the list of [Bradford’s consumption tax’s] potential accomplishments removing myriad technical features of the present tax system”

27. It is possible to design a progressive consumption tax (see Shaviro 2004), but it would require high nominal tax rates. Because capital is not owned in proportion to incomes, but rather disproportionately by the highest-income households, it is much easier to preserve moderate nominal tax rates and still achieve a progressive rate structure if the rate base includes currently the returns to capital—the classic income tax.

well as neutralizing the consequences of business asset sales), an arrangement for mitigating the distortions attendant on the realization doctrine, and a system that treats consistently all financial capital instruments and all types of business enterprises, regardless of the names attached to those instruments or forms of organization.²⁸

For the sake of simplicity, the discussion in this section considers only a single business enterprise that is not subject to any special tax regime (for example, that applicable to financial institutions), and all of whose investors are U.S. taxpayers. Later sections and the annexes extend the basic insights developed here to superconsolidated groups, mergers and acquisitions, tax-exempt investors, and international investments.

Comprehensively Measure and Tax Time-Value-of-Money Returns

The COCA system would successfully capture the time-value-of-money returns attributable to capital invested in business operations, as a direct consequence of the minimum inclusion system, through which investors would be taxed each year on the normal return on their capital invested in business enterprises, even when that return is not distributed in cash or otherwise visibly “earned.” By placing the measurement and collection of these time-value-of-money returns on the shoulders of investors, the COCA system improves the likelihood of tax being collected on that income, because investors have fewer tax preferences available to them than do issuers; in particular, the tax basis (carrying value) of investors’ financial assets is not reduced by depreciation deductions, whereas a business enterprise’s tax basis in its real assets is. In addition, if one accepts the premise that financial capital instruments turn over more rapidly than do noninventory real assets, then moving the taxation of normal returns to the investor level will more closely approximate taxing those returns as applied to a true economic

(that is, mark-to-market) measure of capital investment. Finally, adopting this hybrid approach, in which normal returns are *excluded* from the business enterprise level tax base, enables the BEIT (unlike the current income tax or other income tax reform proposals) to address the formerly insuperable problems of measuring such returns on capital invested in real assets.

The investor level is thus the superior base (compared with the issuer level) on which to calculate normal returns. It is not the perfect income tax base (only universal mark-to-market taxation would achieve that ideal), but it is reasonably close, particularly when compared with the chaotic mess that current law makes of taxing capital income. (The proposed supplemental excess distributions tax is designed to serve as a rough-and-ready compensatory tax for this unavoidable imperfection, among other factors.)

Unlike other fundamental income tax reform proposals, the COCA system would apply in an evenhanded way to investments in both financial derivatives (such as options, forward contracts, futures contracts, and swaps) and their underlying financial assets (stocks and bonds). The aggregate size of the derivative markets is well into the hundreds of trillions of dollars, and although that number is inflated by the fact that it reflects “notional” principal amounts, the actual cash capital tied up in derivatives contracts (the gross mark-to-market valuation of all contracts) remains a multi-trillion-dollar figure. By extending its principles to derivatives, the COCA system would accurately measure aggregate time-value-of-money returns for all the capital invested in business enterprises, and it would ensure neutrality across different competing investment choices.

The BEIT would capture both risky returns and economic rents through the tax imposed on business enterprises on their entire incomes, less a normal return

28. The themes of this section are developed in more detail in Kleinbard (2007a), from which this discussion is excerpted.

on their assets (the COCA deduction). As described earlier, the taxable business entity rules, superconsolidation rules, and tax-neutral acquisition rules would work together to provide a uniform foundation on which to erect the COCA system and to measure profits that exceed normal returns. In addition, other base-broadening measures are contemplated, including the correction of some significant and longstanding tax accounting issues (such as last-in, first-out inventory accounting and percentage depletion), and more recent partial tax holidays (such as most energy credits and the domestic production deduction).

Achieve Effective Integration

The COCA system would achieve rough-and-ready tax integration without relying on elaborate “imputation credits,” “excess distribution accounts,” or other devices that have been implemented or proposed around the world. Investors would pay tax on their minimum inclusions on all capital invested in businesses, and businesses would deduct their cost of capital allowance, in both cases at the same rate and without regard to current cash distributions. Meanwhile, risky returns and economic rents would be taxed at the business enterprise level, and only to a minor (and deliberate) extent, through the excess distributions tax, again at the investor level.

The COCA system admittedly would veer from perfect tax integration, because the tax on excess distributions, although low, would be a pure double tax. As previously described, however, the excess distributions tax is conceived as a pragmatic compensatory tax that addresses the systematic understatement of minimum inclusions (because an investor’s historical tax basis in an investment, rather than the investment’s current market value, would be used as the base from which to apply the tax), any residual tax preferences at the business enterprise level (other than accelerated asset depreciation, which the COCA system automatically neutralizes), and the general worldview that those who are extraordinarily lucky should contribute some of their good fortune back to the community.

It might be thought that the COCA system falls short of the tax integration ideal in one other respect, namely, that investors’ aggregate time-value-of-money inclusions in each year (their minimum inclusions) are likely to exceed issuers’ aggregate COCA deductions. This observation is correct, but the result, paradoxically, is consistent with integration goals. A business enterprise’s COCA deductions might lag behind the collective minimum inclusions of its investors for either of two reasons. First, the enterprise might have enjoyed accelerated tax depreciation of its real assets. Since (as the next subsection explains) the COCA system in fact neutralizes the effects of accelerated depreciation, this explanation for a gap between COCA deductions and minimum inclusions should not trouble us.

The second reason is that a business enterprise may create a valuable asset that will earn increased revenue in the future, leading financial markets to capitalize this value creation into the market prices of the business enterprise’s outstanding financial capital instruments. Google, Inc., is a perfect example: as of mid-2007, its book value is roughly \$17 billion and its market capitalization \$150 billion. The capitalized value reflected in market trading prices for an issuer’s securities represents the present value of future economic rents—that is what it means to have created value in excess of cost less economic depreciation. Under the BEIT’s allocation of tax burdens, we want to tax these future rents at the business enterprise level, and so it is appropriate that the business enterprise *not* have a tax shield (in the form of a COCA) that would exempt those supersized future returns from tax.

At the investor level, the aim is to tax normal returns. An investor who pays the market price for Google stock today in effect is purchasing the future income stream that the market believes that Google has created, but is doing so after the original risks have been taken and that value has been created.

The net effect is that Google will pay tax over time on the rents that it has created, and new investors who pay today's market price will recognize minimum inclusion income on their investment in what is to them a relatively predictable existing asset. Today's disparity between "inside" and "outside" tax bases (between Google's tax basis in its assets and investors' aggregate tax basis in their investments in Google) just reflects the fact that rents have been created but not yet taxed.

Neutralize the Consequences of Imperfect Depreciation Rules

As described earlier, an income tax system that attempts to collect time-value-of-money returns to capital at the business enterprise level will succeed only if that system first requires the capitalization of all "expenses" that in economic reality are a cost of creating a new productive asset, and then requires that the depreciation deductions for that investment track economic depreciation rates. No known corporate or other business income tax system in the world comes close to achieving this result, and for that reason alone all current systems fall far short of the economic ideal in their taxation of time-value-of-money returns.

Because the COCA deduction is calculated by reference to a business enterprise's aggregate asset basis, the COCA system effectively neutralizes distortions attributable to overfast or overslow depreciation. Thus (to take the two extremes), an issuer that deducted rather than capitalized an expenditure would thereby obtain an immediate tax deduction but would forfeit any COCA deduction with respect to the capital so invested. Conversely, an issuer that treated that same cost as a nondepreciable capital expenditure would

never obtain a depreciation deduction but would receive in return a COCA deduction in respect of that investment in perpetuity. So long as the COCA rate approximated normal returns, the net result in both cases would be that the present value of the sum of the business enterprise's COCA deductions and depreciation deductions would remain a constant percentage of the enterprise's capital (measured at historical cost), *regardless* of the depreciation and capitalization rules the enterprise employed.²⁹

By contrast, the tax base for *investors'* minimum inclusions would reflect the actual capital that they have invested (as reflected by market transactions), not the after-depreciation net book value of the business entity. As a result, COCA's self-righting mechanism with respect to the depreciation of real assets is *not* undone at the investor level.

The COCA system thus mitigates at the issuer level the consequences of the tax system's errors in its basic depreciation schedules and capitalization rules. At the same time, the COCA system measures investor-level time-value-of-money income inclusions in a simple and straightforward manner, in contrast to current law's noneconomic and inconsistent multiplicity of rules for different types of financial instruments.

Another way of phrasing the relationship between the tax depreciation of real assets and the COCA system is that, at the business enterprise level, the combination of COCA and asset depreciation—whatever the depreciation method used—will always equal the *exclusion* from income tax of a time-value rate of return on the enterprise's economic capital (albeit measured at

29. Although the present value to a business enterprise of the sum of its COCA expense and depreciation deductions may remain constant, the enterprise's cash flow may differ from period to period. Thus, in the COCA system, Congress rationally might decide to retain accelerated depreciation methods, to help the cash flows of companies making investments in productive machinery, but (in contrast to current law) doing so would not reduce the present value of the tax revenue to be collected over time.

historical cost, and assuming that the COCA rate is properly set at the time-value rate of return).³⁰ This of course is precisely the appropriate, integrated result we want to achieve: 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.³¹

The BEIT thus functions like the *sum* of a consumption tax (a tax that excludes normal returns) at the business enterprise level and a special-purpose income tax (the tax on normal returns) at the investor level. The combination is an integrated income tax: the sum of normal returns, risky returns, and economic rents is taxed once. Moreover, the mechanical implementation of that integrated result employs the superior tax base from which to measure normal returns (the investor tax basis), compared with alternatives that attempt to do so at the business enterprise level

and that therefore must deal with the insoluble problem of noneconomic depreciation.

The COCA system's success at neutralizing the tax effects of different real asset tax depreciation systems is simply one consequence of the fact that, from the perspective of a business enterprise, the BEIT functions as a consumption tax—that is, a tax that deliberately excludes normal returns. In a consumption tax system, asset sales also are tax neutral: the tax on the seller's gain from the sale of a real asset is offset economically by the buyer's effective tax deduction of the purchase price (which, in the BEIT, is obtained through the economic equivalent of the sum of future depreciation deductions and future COCA deductions on the unrecovered balance). This is why the BEIT can dispense with rules governing tax-free organizations and reorganizations, as well as rules limiting a business enterprise's ability to harvest tax losses from its investments in real assets whenever it

30. In the special case where all capital investments are currently expensed, the result essentially equates to an illustration of the famous “Cary Brown theorem” (Brown 1948), in which deducting an investment's cost is demonstrated to exactly equal exempting a normal rate of return on that investment from tax.

This combination of depreciation and a COCA-like system was explicitly adopted in the proposed Allowance for Corporate Equity (ACE) system for purposes of designing a *consumption* tax. See, generally, Devereux and Freeman (1992). The BEIT, by contrast, is an *income* tax: investors are taxed on their time-value-of-money returns through the minimum inclusion system, and the COCA deduction at the issuer level functions in this respect simply as a sort of integration device. Under the ACE, corporations would receive a tax deduction equal to a notional cost of equity, calculated in a manner similar to the COCA deduction (but applied to “shareholders' funds,” not all assets), and would continue to deduct actual interest expense. Distributions to shareholders would in some fashion be exempt from tax; the result would be exemption of tax on normal returns from tax, which is the hallmark of a consumption tax. The proponents of the ACE became a bit vague, however, when discussing how preference items would be handled and capital gains taxed.

Unlike COCA, the ACE would apply only to corporations and would retain a distinction between debt and equity: actual interest expense on the former would be deductible, whereas notional capital charges could be deducted in respect of the latter. The limitation of the ACE to one class of business entities and the preservation of the debt-equity distinction are fundamental weaknesses of the proposal. Also in contrast to COCA, there is at least some modest real-world experience with an ACE. See, for example, Keen and King (2002).

31. This observation leads to a powerful question: Why not retain the COCA concept for investors but dispense with it at the business enterprise level? If the result is equivalent, why not just disallow all deductions to issuers on their outstanding financial capital instruments, and permit issuers to deduct all investments as they are made? There are several good reasons not to do so.

First, as David Bradford (1985, p. 23) pointed out in the consumption tax context, a COCA-plus-depreciation system has the great merit over a simple asset expensing rule of mitigating the effects of changes in tax rates. Second, a key component of the COCA system is to encourage a featureless topography, described earlier, by having one universal set of tax rules that apply to financial derivatives as well as to the underlying securities. Unlike the case of physical securities 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 again. At the same time, a derivative in fact can move substantial amounts of cash from one party to the other during the life of the instrument. The COCA system therefore seems to be a necessary (or at least convenient) part of taxing derivative instruments. The importance of preserving a featureless topography in turn requires that no important distinction be introduced between the tax consequences of cash flows in respect of a derivative, on the one hand, or a stock or bond, on the other.

Finally, there are important ancillary reasons to prefer retaining COCA plus depreciation for issuers over adopting a simpler asset expensing solution. If the COCA rate in fact were to diverge from the normal rate of return, the COCA-plus-depreciation system would retain a closer resemblance to the status quo of relative tax burdens across different industries than would an expensing solution. In addition, the combination of deductions for depreciation and financial capital under the BEIT and COCA can roughly be analogized to current law's deductions for depreciation and interest expense. The BEIT's political prospects in turn could be enhanced by presenting it as building on well-understood current tax concepts.

chooses. Annex B expands on this point with some numerical examples.

Mitigate the Adverse Effects of the Realization Doctrine

An ideal income tax would embrace what economists term “accruals” taxation, in which a taxpayer’s assets (and liabilities) would be revalued each year to their current fair market value. (Tax practitioners, to avoid confusion with the “accrual” method of tax accounting, prefer the more descriptive phrase “mark-to-market taxation.”) Comprehensive accruals taxation by definition ensures the accurate taxation of returns to capital, but just as obviously is not administratively feasible. Instead, the tax code has always relied on the “realization doctrine,” under which changes in the value of an investment are ignored for tax purposes until that asset is sold or exchanged, at which time the resulting gain or loss becomes crystallized for tax purposes.

This principle, however, permits taxpayers to achieve tax results that diverge substantially from economic notions of income, by realizing losses promptly, while letting gains roll over from year to year. Some analysts have concluded that the entire income tax enterprise is irredeemably flawed by vir-

tue of its heavy reliance on the realization doctrine, whereas others have proposed various partial accruals solutions for taxing publicly traded assets or the like in the hands of investors.

The BEIT draws on a range of proven tax strategies already deployed in the tax code to reduce the scope of the realization dilemma to a manageably small level. Most directly, the minimum inclusion system would require an investor to include time-value-of-money returns in taxable income every year, even if that income is not currently received in cash. The minimum inclusion system is patterned to a great extent on current law’s “original issue discount” rules for the taxation of debt instruments. As a result, the minimum inclusion system will pass constitutional muster.³² Moreover, investors and securities brokers alike can implement it.

The COCA system also contemplates the direct adoption of accruals taxation where feasible. Thus, financial institutions (which today employ sophisticated mark-to-market models to value their portfolios, to compensate their employees, to manage their business, and—in the case of dealer activities—to report earnings to shareholders) would be required to use accruals taxation for all their financial assets *and* liabilities; they would then be entitled to a COCA

32. See *Gaffney v. Commissioner*, 73 T.C.M. 2912 (1997); cf. *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965). More generally, the U.S. Constitution does not require current law’s overpunctilious regard for the realization doctrine. Indeed, a number of provisions of current law require recognition of income before a taxpayer has actually received that income. None has been subject to serious challenge, and several have been specifically upheld by appellate courts as constitutional.

- Taxpayers’ constitutional challenges to estimated tax requirements, which require the payment of tax before the determination of a taxpayer’s ultimate tax liability, have been rejected by the courts. See, for example, *Beacham v. Commissioner*, 28 T.C. 598 (1957), affirmed by 255 F.2d 103 (5th Cir. 1958), which held that additions to income tax for failure to pay estimated tax by the stipulated due dates and for substantial underestimation of estimated tax do not violate the due process clause of the Fifth Amendment.
- Sections 551 and 951, which require that U.S. shareholders in foreign personal holding companies and controlled foreign corporations include in income certain undistributed income earned by the corporation, were upheld as constitutional decades ago. See *Eder v. Commissioner* 138 F.2d 27 (2nd Cir. 1943), which upheld the constitutionality of the then-applicable provisions concerning foreign personal holding companies, which required the taxpayers to report the undistributed net income of their Colombian corporation as income, even though, under Colombian law, they were unable to receive such income in the United States in excess of \$1,000 per month; *Garlock Inc. v. Commissioner*, 58 T.C. 423 (1972), affirmed by 489 F.2d 197 (2nd Cir. 1973); and *Estate of Whitlock v. Commissioner*, 59 T.C. 490, (1972), affirmed in part and reversed in part by 494 F.2d 1297 (10th Cir. 1974), which held that taxation of U.S. shareholders on undistributed income of a “controlled foreign corporation” as defined in section 957(a) is not unconstitutional.
- Section 1256, which requires taxpayers to mark certain futures and options contracts to market annually, was upheld as constitutional in 1993. See *Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993).
- The clear academic consensus is that the realization rule has become nothing more than a rule of administrative convenience rather than a constitutional imperative. Edward Zelinsky (1997, p. 861) writes: “While the rule of realization has traditionally been fundamental to the federal income tax, the rule today is in low repute. Over the years, the judiciary has progressively demoted the precept of realization from a once lofty station Most recently, the Supreme Court has reduced the realization requirement further, depriving it of any substantive content.”

deduction on their net basis in real (nonfinancial) assets, plus the net positive mark-to-market value of their financial assets.³³ Similarly, active securities traders would be permitted to elect mark-to-market taxation, just as they can today, in lieu of the minimum inclusion/excess distributions system.

The BEIT proposal also contemplates the elimination of all tax-free incorporation, reorganization, and exchange rules.³⁴ Instead, every acquisition by one business enterprise of a controlling interest in another would be deemed an asset sale by the target, followed by its liquidation—thereby triggering a realization event for the target’s investors. Although the result is a bit counterintuitive, this “all-recognition” regime should not inhibit merger and acquisition activity, for the reasons developed in annex B.

The BEIT thus moves the income taxation of business enterprises closer to a new ideal of a *featureless tax topography*.

Finally, an ideal implementation of the BEIT, at least, would treat death as a realization event for a decedent’s financial assets within the scope of the cost of capital allowance system. As a result, in every case accruals taxation would be achieved no less frequently than once per generation.

Admittedly, the BEIT does not solve every problem created by the realization doctrine. A discussion later in this paper describes why some investor-level loss harvesting and gain deferral strategies would remain extant even in the world of the BEIT.

Expunge Cubbyhole Thinking

The BEIT overcomes “cubbyhole” thinking by rejecting the relevance for tax purposes of different legal forms of doing business (for example, corporation versus partnership), different legal forms of financing that business (debt versus equity), and different legal forms of acquiring control over business assets (“taxable” asset acquisitions versus “tax-free” stock acquisitions). At every turn the BEIT rejects special pleadings for differentiation, except in the most pressing exigencies.

The BEIT thus moves the income taxation of business enterprises closer to a new ideal of a *featureless tax topography*, an environment encumbered by as few special tax rules, exceptions to those rules, and anti-avoidance glosses on the exceptions to the rules as is practical. Every distinguishing feature of the present tax landscape (such as the debt-equity divide) brings with it economic distortions (why should debt capital be subject to one level of tax, and equity to two?), elaborate policing regimes (how does one define “debt” anyway?), abuses, patches to respond to these abuses, and so on, until the system collapses of its own weight. The art of rehabilitating the business tax system is to develop a proposal that is economically neutral (that burdens all business capital similarly), rational and predictable in application (so that it is not simply a negative lottery, in which “winners” pay arbitrary amounts of tax), and at the same time as dull and featureless as possible.

The BEIT versus the Comprehensive Business Income Tax

The best-known fundamental business tax reform proposal of the last fifteen years is the U.S. Treasury

33. See section VII for an explanation of this approach. On the distortions that would follow from applying mark-to-market principles to bank lending, in particular, if liabilities were not also subject to periodic revaluations, see Kleinbard and Evans (1997).

34. Technically, current law categorizes all these exchanges as “realization” events but nonetheless excuses them from income “recognition,” that is, from having any current tax consequence.

Department's 1992 "Comprehensive Business Income Tax" (CBIT). The BEIT, and in particular its COCA system, is superior to CBIT in important theoretical and practical respects.

Most important, the COCA system's allocation of the incidence of tax between investors and issuers is technically superior to the CBIT's mechanism for taxing time-value-of-money returns (see Kleinbard 2007a). The CBIT proposed to tax business enterprises (rather than investors, as under COCA) on the normal returns to capital invested in those enterprises. It would have done so by disallowing all business interest expense deductions; in a perfect implementation of the CBIT, the correlative rule would be that investors would earn all their cash returns free of tax, because tax would already have been paid on normal returns, risky returns, and rents at the business enterprise level.

Disallowing interest deductions would certainly be a simple reform to adopt. The CBIT ran directly into the obvious problem, however, that no known income tax has ever successfully measured the normal return to real capital, because of the twin difficulties of distinguishing current expenses from capitalizable expenses, and of devising economically accurate real asset depreciation schedules. Moreover, if this paper is correct that, on balance, financial assets turn over more rapidly than do depreciable real assets, the CBIT would have relied on comparatively stale data to determine the amount of capital invested in a business.

The CBIT's basic mechanism for measuring and taxing normal returns to capital thus was simple, but unavoidably inaccurate. The CBIT's designers recognized the problem and suggested a vaguely developed "compensatory tax" as a solution. This tax would have been imposed on issuers when they distributed to investors cash that was deemed not

already to have been assessed the right amount of enterprise-level tax, or alternatively, on investors when they received such distributions. Either would have been a practical disaster, and the whole idea of the compensatory tax raises the question, if one can accurately measure normal returns on real assets (as the compensatory tax would require), why not just tax the correct amount in the first place?

The COCA system proposed in this paper, by contrast, does accurately measure normal returns to capital. It does so by virtue of its COCA deduction at the issuer level, which—critically—combines with *any* depreciation schedule to yield an exclusion of normal returns from tax at the business enterprise level, and through its minimum inclusion mechanism at the investor level, where depreciation is irrelevant and where more rapid market turnover means that the cost data on which the system relies are as current as possible.

The CBIT suffered from other deficiencies as well. For example, it did not integrate the taxation of financial derivatives into its proposals; in light of the size of those markets, this lacuna cannot be treated as a rounding error. Nor did the CBIT specify whether capital gains taxes would still be imposed on financial investments or, if so, how those rules would be coordinated with the rules for cash distributions. It also did not address the anomalies of the current hodgepodge of tax rules for mergers and acquisitions, or for tax consolidation. Finally, the CBIT would have caused major price dislocations in the capital markets, by turning corporate securities into essentially tax-exempt assets.

The BEIT addresses these concerns. Its rules would extend to financial derivatives as well as to stocks and bonds. The excess distributions tax would be coordinated with the other rules for taxing returns to capital.³⁵ The BEIT would sweep aside the arcana

35. As noted previously, the excess distributions tax can be viewed as a sort of compensatory tax, along the lines of the compensatory tax for which this paper criticizes the CBIT. The difference is that, in the BEIT, the excess distributions tax plays a minor (indeed, wholly optional) role, to address political as well as second-order technical concerns, whereas the success of the CBIT in taxing normal returns hinged entirely on its compensatory tax.

of “tax-free reorganizations” and the like, without inhibiting the formation of business combinations. And the BEIT would minimize price dislocations in the capital markets, by continuing the pattern of current law in which investors are taxed on some measure of their returns.

For the same reason, the COCA system would not crowd out municipal bond issuers; tax-exempt municipal bonds could be preserved as a privileged investment class under the BEIT. By contrast, in a CBIT-type regime, state and local governments would have been required to pay materially higher interest rates, because of the huge increase in tax-exempt securities competing for investor dollars.

Principal Technical Disadvantages of the Cost of Capital Allowance System

The Business Enterprise Income Tax would be a substantial improvement over current law, but it does suffer from at least two important defects. First, the BEIT would retain some of the investor-level lock-in problems that trouble economists about the current tax system.³⁶ Second, the BEIT can be expected to encourage tax-sensitive investors to search for alternative investments that are not subject to the minimum inclusion system.

The lock-in problem refers to the phenomenon under current law where an investor would like to sell investment A and purchase investment B, but does not do so because of the capital gains tax that would be imposed on the sale. At first blush, the BEIT manages to avoid this problem. If one imagines for the sake of simplicity an ideal BEIT, in which the excess distributions tax is thought unnecessary and therefore is not implemented, an investor’s sale of investment A at a gain would not trigger any immediate tax liability (nor would a loss convey any tax benefit), because all that an investor would include in taxable income in respect of his or her financial investments would be the time-value-of-money

returns, not any capital gains. Tax considerations therefore would not appear to distort the investor’s investment decisions.

Unfortunately, however, this analysis is incomplete. Even if the BEIT were implemented with the excess distributions tax rate set to zero, investors still would be encouraged to sell their loss positions and hold onto their winners. Their reason is that the sale of investment A at a gain would “step up” the investor’s tax basis in any replacement investment B to the sale price of investment A, thus subjecting the investor to higher *future* minimum inclusions in respect of investment B than were recognized in respect of investment A. (Conversely, an investor with an unrealized loss would be encouraged to sell that investment, to lower his or her future minimum inclusion income on the replacement asset purchased with the proceeds.) The BEIT thus would cast at least some lock-in shadow over an investor’s economic decisionmaking. An ideal implementation of the CBIT, by contrast (that is, one in which there were no capital gains tax) would contain no lock-in distortions at the investor level.

Over extended investment horizons, the BEIT would earn its way out of the lock-in problem, because the compounding of accrued minimum inclusions would eventually bring an investor’s tax basis in a financial investment closer to its market value. Moreover, the BEIT has been designed to increase the number of investor-level realization events when compared with current law (by eliminating tax-free reorganizations, treating death as a realization event, and so on). As a result, economic distortions attributable to the lock-in phenomenon should be smaller under the BEIT than under current law. Moreover, it would be odd to prefer the CBIT over the BEIT because of this one second-order advantage, when the CBIT completely fails the principal goal of the entire exercise, which is to measure and tax income from capital

36. The BEIT has no lock-in issue in respect of real assets held by a business enterprise, because, as already noted, at the enterprise level the BEIT functions as a consumption tax, and consumption taxes are neutral with respect to asset sales.

in a comprehensive and accurate manner. Finally, one could envision limiting the scope of the problem by treating borrowings secured by appreciated investments and other non-realization “monetization” transactions as deemed sales for tax purposes. (This effectively would expand the current deemed sale anti-abuse provision of the Internal Revenue Code.) On balance, however, the BEIT accepts some residual lock-in distortions as a necessary price for an easily administrable (that is, cost-based) income tax system.

The other side of the lock-in problem with respect to gains is the phenomenon of “wash sales” in respect of losses, where investors sell an investment to claim a tax loss but immediately reacquire the security to continue their economic investment. Just as the COCA system’s lock-in issue for investors with appreciated investments relates primarily to future minimum inclusions, so too does the COCA’s vulnerability with respect to wash sale strategies. In the loss scenario, an investor with an unrealized loss in respect of an investment that he or she wishes to continue to hold would look to currently claim that loss for tax purposes in order to step down his or her cost basis for the investment, and thereby reduce his or her future minimum inclusions. The gain side has a more profound impact on economic behavior, while the loss side presents more of a classic anti-tax avoidance issue.

The Internal Revenue Code has for many years contained an anti-wash sale provision. The COCA system would need to retain that rule, and also update it to enhance its effectiveness, so as to preserve the normal returns tax base.

The second problem—that of investors seeking out investments not subject to the minimum inclusion system—demonstrates once again the consequences of a tax topography that is not perfectly featureless. In this case the disturbance is the dividing line between financial investments and other uses of capital from which a profit might be derived. There

On balance, the BEIT accepts some residual lock-in distortions as a necessary price for an easily administrable (that is, cost-based) income tax system.

are solutions to this problem, but none of them is perfect. Basically, the goal must be to make alternative investments sufficiently unattractive after tax to encourage investors to retain their existing preference for financial investments. For example, section 408(m) of the Internal Revenue Code today contains a comprehensive definition of “collectibles.” Gains from the sale of such assets could be taxed at higher than normal rates, either directly or by recourse to rules based on the current rules for “passive foreign investment companies,” under which gain is deemed to accrue ratably over the taxpayer’s holding period for an asset, and an additional “interest” charge is assessed as if the tax on that ratable gain were in fact overdue.

Real estate investing would be covered directly by the BEIT (that is, owning and operating real estate for sale or rent would constitute a business enterprise), so no special rule would be required. Owner-occupied housing, however, could pose a significant problem. To prevent an explosion of still greater overinvestment in owner-occupied homes than at present, it probably would be necessary to scale back the tax benefits of home ownership. In particular, it would appear that, to avoid significant distortions in behavior, the tax system could not both continue the home mortgage interest deduction and at the same time exempt gains from home sales from the COCA system. The best of the relatively unpalatable solutions here probably would be to abandon (or at least lower the cap on) the home mortgage deduction, rather than to impose some sort of punitive tax rate on gains realized from selling one’s home.

VII. Application of the COCA System to Special Situations

The rules laid out in the preceding sections address most forms of business organization in most industries, as well as most investors.

This section describes how the Business Enterprise Income Tax system might be modified to address certain special circumstances.

Tax-Exempt Investors and Life Insurance

Even in an ideal implementation of the BEIT, normal returns on investments held by tax-exempt investors would escape taxation.³⁷ This observation, however, does not point to a flaw in the proposal (except to the extent that making explicit structural issues embedded in the larger tax system can be labeled a flaw),³⁸ but it does raise squarely the question of what roles tax-exempt organizations should play in any income tax system.

If one assumes for a moment that tax-exempts should be unaffected by the adoption of the new tax system, the cost of capital allowance system would still be preferable to current law from an economic efficiency perspective. The reason is simply that the current tax code contains a wide variety of high-deduction, high-inclusion financial instruments (such as high-yield debt) and low-deduction, low-inclusion instruments (such as common stock bearing “qualified dividend income”). The capital markets are supremely efficient at matching the issuers of the former class of assets with tax-exempt investors, and the issuers of the latter class with taxable investors. The end result is systematic tax minimization, and at the same time distortions in individual investment decisions, because the after-tax consequences of

investments fluctuate so widely when compared to their before-tax consequences.

The existence of tax-exempt investors under the BEIT would produce a net revenue loss to the extent of the capital they hold, just as under current law, but that revenue loss would no longer distort economic behavior, as reflected in the types of financial instruments offered by issuers or the relative prices of those instruments to investors. This follows from the fact that issuers would obtain the same annual deduction on every type of capital-raising instrument, and investors would face a constant tax rate (which might be zero, or might be the maximum rate) across all potential forms of financial capital investments.

The COCA system thus would improve economic efficiency in a world that contains tax-exempt investors. It is an entirely separate question—and one only peripherally related to a business income tax proposal—how large the tax-exempt investor capital base should be. Nonetheless, it is possible to offer a few observations.

For purposes of analysis it is desirable to divide the world of tax-exempt investors into two categories: pension plans and charities. The case for continued tax exemption of pension plans is completely persuasive. The COCA system is intended rigorously to collect tax on time-value-of-money returns. For all the reasons advocated by proponents of a consumption tax, however, there is a broad consensus today that it is desirable to exempt from income tax the returns on deferred consumption (savings) needed to fund reasonable retirement incomes and similar savings requirements of U.S. individual tax-

37. The term “tax-exempt investor” refers here to pension plans, charities, and the like. Section VIII considers the taxation of foreign investors.

38. The Treasury Department’s 1992 CBIT proposal did a better job of making the issue less explicit (by shifting the tax on normal returns to the business enterprise), but it is unrealistic to believe that this optical difference would have avoided the same political issue from being joined.

payers (such as for extraordinary medical expenses). A comprehensive income tax on all normal returns to capital invested in business, combined with a carefully targeted exemption from that system (that is, consumption tax treatment) for reasonable levels of retirement savings and the like, squarely balances the competing objectives of a comprehensive income tax and economic fairness to middle-class retirement savings. This combination is straightforward to implement, for example through tax-deductible savings programs like current-law IRAs, with a reasonably high cap on annual contributions (and rollovers of unused caps to subsequent years), or alternatively through a tax credit system for contributions to qualifying savings accounts.

In practice, the combination of the COCA system with consumption tax treatment of a reasonable level of retirement savings means that material tax liability for minimum inclusions and excess distributions would fall only on the shoulders of those taxpayers with significant investments in financial capital instruments beyond amounts held through retirement accounts—that is, the rich. If one concludes that the minimum inclusion/excess distribution system would raise more revenue than does the tax collected today on the capital income of wealthy individuals (which seems highly probable), the practical economic effect of the COCA system should be to add significant progressivity to the income taxation of America's wealthiest individuals.

The taxation of charitable institutions is a more difficult policy question. One can take it as given for this purpose that forgoing the collection of income tax on charitable contributions serves an important social agenda that should be preserved. The issue here is different: What should be the tax status of amounts contributed to charity today, but spent on charitable endeavors tomorrow (or several decades hence)? In other words, what is the appropriate tax treatment of amounts held and invested by charities—their endowments? The is-

sue is not trivial: Harvard University alone, for example, had an endowment of some \$26 billion at the end of 2005.³⁹

If the desire is to preserve the present value of amounts contributed to charity today but not spent for many decades, then the current system is analytically appropriate: exempting from tax the returns from investing a charitable contribution does not distort the charity's decision whether to apply the money to its charitable endeavors today or defer that consumption until a future date. Conversely, if one envisions charitable contributions as funding current, socially important expenditures, then one might favor imposing an income tax on the returns to charitable endowments, precisely to encourage charities at the margin to spend rather than hoard the contributions they receive.

The BEIT system can accommodate any resolution of this political and social question. Returns to charities can be exempted from COCA's tax burdens or can be fully subject to tax. In either case the neutrality of investment allocations across different financial instruments would be preserved, because issuers' COCA deductions would remain constant, regardless of the terms of the financial capital instruments they sell to investors, and each investor would face a constant tax rate in respect of its returns from its investment. Alternatively, compromise positions could be adopted. For example, charities could be exempted from paying tax on minimum inclusions, but required to pay tax on "home runs" (excess distributions)—or vice versa. The important point for this paper is simply that adopting the BEIT does not presuppose any one answer to these questions.

Under current law, whole life insurance and annuities occupy a sort of halfway house, in which investments made under the contract are not deductible, but the resulting investment returns are not subject to current taxation (and, if received as

39. See "Harvard's Endowment Funds" (www.hno.harvard.edu/guide/finance/index.html).

death benefits, are wholly exempt from tax). The recommended implementation of the BEIT is that all tax benefits for retirement-type savings be channeled through qualified retirement plans, however structured. In this view the buildup of assets associated with whole life and annuity products would be taxed currently under the COCA system. Again, however, this is a social and political issue whose resolution the COCA system does not preordain.

Inflation

Economists point out that the current tax code does not properly address the distorting effects of inflation on the measurement of the income tax base. By itself, the BEIT does not address this important issue at all. As in the case of tax-exempt investors, however, BEIT and COCA can accommodate whatever solution best embodies the resolution of the important social and political issues that inflation-proofing the tax system raises.⁴⁰ The merits of the COCA system therefore should be judged independently of the merits of adding to the tax model an inflation-proofing module.

Specialized Industries and Circumstances

As described earlier, the BEIT has as one of its objectives a featureless tax topography. As a result, the BEIT countenances rough justice for all as the norm, for which a low tax rate, administrative predictability, and much greater economic neutrality in application are the offsetting benefits. Nonetheless, special rules are warranted in a few cases.

Small businesses. The BEIT treats a business as an entity separate from the business's owner or owners. As a result, even a sole proprietor would be treated as simultaneously a business enterprise (the

proprietorship) and the owner of that enterprise. Without a special rule, the business enterprise would have a COCA deduction, and the individual owner would have minimum inclusion income; if the sole proprietorship were unprofitable, the result would be a useless deduction at the enterprise level and taxable income to the individual owner.

The solution is simply to forgo imposing tax on the individual sole proprietor as an owner, and (as the price thereof) to disallow all COCA expense deductions to the proprietorship as a separate entity. Similarly, one could easily introduce special regimes to encourage investment in slightly larger (but still small) businesses, for example by allowing business enterprises a higher COCA expense deduction on, say, the first \$5 million of their capital, without affecting minimum inclusions for that small business's owners.

Financial institutions. The COCA system works rough justice, but when applied to financial institutions, rough justice would produce income measures that diverge unacceptably from economic norms. The simple reason is that, for financial institutions, money in effect is their stock in trade. Moreover, unlike other industries, financial services firms typically operate with debt-to-equity ratios of 20:1 or 30:1. As a result, the BEIT's treatment of a financial services firm's cost of capital must be more precisely calibrated than in the general case.

The solution, as noted earlier, is to put all financial services firms (including active securities traders) on a mandatory mark-to-market system in respect of both their financial assets *and* their liabilities, and to then provide a COCA deduction on the firm's net tax basis in nonfinancial assets, plus the net mark-to-market value of all of its financial assets.⁴¹ The idea here is, first, to capture all of the financial insti-

40. This author, for example, believes that inflation is a great social evil, and that inflation-proofing the tax system should be rejected precisely because it would partially immunize the one social class (capital owners) who should be expected to resist inflation's spread as a political matter.

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

tution's income (through comprehensive mark-to-market accounting) and then to provide a deduction of an amount that reflects a normal return on the institution's net capital, so as not to overtax financial institutions relative to other businesses. (Standard implementations of mark-to-market systems effectively give a deduction for interest payments, but not for payments on equity.)

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

Unprofitable companies. To preserve economic neutrality, the net operating loss carryovers of an unprofitable business enterprise would compound from period to period at the COCA rate. To prevent completely noncommercial results, firms that enter bankruptcy proceedings would not obtain COCA deductions while those proceedings were pending, and investors in those firms would not be required to recognize minimum inclusion income.

One consequence of the BEIT's tax-neutral asset acquisition rules is that every acquisition of an unprofitable company (or any other business enterprise) would always be analyzed for tax purposes as a purchase of assets, followed by a liquidation of the acquired company. Under current-law income tax principles, the result would be a forfeiture of existing loss carryovers, which if not modified would introduce an economic distortion into the decision whether to pursue such an acquisition.⁴²

A variety of solutions can be designed to address this issue. To an economist, the immediate answer is that enterprise-level tax loss carryovers should be fully refundable, or at least should compound (as they in fact would under the BEIT) and be fully transferable in acquisitions. If one assumes that the political process will reject this approach as redolent of trafficking in tax losses, another solution will be required. The tentative recommendation is to accept the analogy to current law, and therefore to require both acquiror and target to forfeit the target's tax loss carryovers following the acquisition (and after taking into account the deemed sale of all of the target's assets), but then to mitigate that result by permitting a surrogate deduction at the investor level. This surrogate tax benefit would permit investors in the target company to claim, in this one circumstance, an ordinary tax deduction for any loss they might suffer on the deemed disposition of their interests in the loss company.

Mutual funds and personal holding companies. The BEIT contemplates that the tax code's rules for entities like current-law "regulated investment companies" (mutual funds), real estate investment trusts, and investment partnerships would all be consolidated into a single *collective investment vehicle* category. Vehicles that fell into this category would be taxed much as mutual funds are taxed today: The collective investment vehicle would not be treated as a business enterprise, but rather as an investor. It would track its own minimum inclusions and excess distributions solely for purposes of the special deemed distribution rule described below, but it would not itself pay any tax in respect of its minimum inclusion income or any excess distributions it receives.

Investors would recognize minimum inclusion income on their investment in the collective investment vehicle just as they would for any investment

42. The other predictable distortion is that unprofitable companies would be viewed as attractive platforms from which to acquire profitable business enterprises, because the tax-neutral asset acquisition rules would not (without more) affect the survival of net operating loss carryovers of a loss company when it is the acquiror rather than the target. The solution here is to preserve current-law (section 382) principles for the limited case of the acquisition of control (short of consolidation) of an unprofitable company by a group of investors. Those principles basically limit an investor's return on those "purchased" net operating loss carryovers to a specified time-value-of-money return.

in a business enterprise. As noted, the collective investment vehicle would track its own cost basis in investments and profits from sales; in turn it would be treated as distributing to investors in cash any excess distributions (measured at the vehicle level) received by the vehicle, even if the cash is retained by the vehicle—in which case the investor’s tax basis in the investment would increase to that extent. The deemed distribution would be treated as paid to whichever investors would have a claim to the cash proceeds if the vehicle hypothetically were to be liquidated at that time.

This deemed distribution mechanism would enable investors with different tax bases and prior minimum inclusion accruals to calculate their own excess distributions tax liability, if any. It also would mark to market an investor’s tax basis in the securities of a collective investment vehicle to reflect profits realized by the vehicle and in turn retained by it, thereby ensuring that *future* minimum inclusions would reflect these retained investment profits. The result would be to achieve neutrality between a collective investment vehicle whose policy it is to distribute realized gains to its investors, and an otherwise identical vehicle whose policy is to retain and reinvest those profits.

The deemed distribution mechanism described above would also be a useful mechanism for dealing with “personal holding companies”—more generally, any business enterprise employed by investors to hold indirectly investments that, in a tax-free world, would be made by those investors in their own names, but that, in the BEIT environment, are held by a business enterprise, to take advantage of its lower tax rates. (Section VIII also relies on the same solution to address the analogous problem of what today are called “passive foreign investment companies.”) The current-law definition of a “personal holding company” would be materially expanded, however, so that the deemed distribution mechanism would apply in more cases—for example, to any privately held business enterprise whose aggregate tax basis in financial instruments owned by it makes up more than 10 percent of its aggregate tax basis in all its assets, and to any publicly held company the majority of whose assets were investment assets, or the majority of whose income was investment income. In such cases, the investment portfolio effectively would be taxed as a separate collective investment vehicle, and the rest of the company as a standard business enterprise.

**The deemed distribution
mechanism would achieve
neutrality between a collective
investment vehicle which
distributed gains to its investors
and one which retained and
reinvested those profits.**

VIII. International Aspects

Like any income tax, the BEIT must develop rules that address four types of cross-border investment: foreign direct investment by U.S. business enterprises, foreign portfolio investment by U.S. investors, direct investment in the United States by foreign business enterprises, and portfolio investments in the United States by foreign investors. A separate, recently published paper (Kleinbard 2007b) analyzes the background issues with respect to the first two types. This section briefly summarizes that paper's conclusions and extends the analysis to investments by foreign investors in U.S. direct or portfolio holdings.

Outbound Investment

Foreign direct investment by U.S. enterprises abroad. The foreign direct investment aspects of the BEIT begin with the “superconsolidation” described in section III and in annex B. This idea is intended to apply globally. As a result, the BEIT would treat foreign subsidiaries as if they were branches of the parent company rather than separate corporations. The most obvious consequence would be the end of tax deferral on unrepatriated active income earned by foreign subsidiaries (and with it the need to maintain rules to distinguish between “active” income and “subpart F” income). Another immediate consequence would be to vastly attenuate the relevance to the United States of transfer pricing issues for outbound investments. In light of the great importance to tax administration of transfer pricing cases under current law, the global superconsolidation contemplated by the BEIT would have a dramatically positive effect on the evenhandedness with which the income tax would apply in practice. Global superconsolidation also means that foreign losses would be deductible

in the United States as they are incurred, thereby restoring true neutrality in application when compared with current law and with the many proposals over the years to end deferral.

The BEIT divides all investments in business enterprises into two categories: controlling interests (which would trigger the superconsolidation rules) and other interests (which would give rise to current taxable income through the minimum inclusion mechanism). As a result, current law's concept of a “controlled foreign corporation” that is controlled by, say, three unrelated U.S. investors in equal proportions would no longer exist. Each investor would pay tax each year on its minimum inclusion amount, without regard to cash distributions, just as that investor would in respect of an investment in a U.S. firm.

By themselves, the international aspects of the BEIT could fairly be described as economically neutral in respect of transfer pricing, repatriation decisions, and the location of risky investments, but on balance anti-competitive. (Kleinbard 2007b) The BEIT contains two other critical design elements, however, that revise that calculus to yield a system that fair-minded business people should agree is pro-competitive. The first, and more important, is much lower enterprise-level tax rates: as mentioned above, a rate of 25 to 28 percent is the goal, which the BEIT could achieve through systematic base broadening at the enterprise level and systematic capturing of normal returns at the investor level. The second design element is the repeal of the allocation of domestic interest expense deductions against foreign income for purposes of calculating a U.S. business enterprise's allowable foreign tax credit in respect of its international operations.⁴³

43. Kleinbard (2007b, p. 562) attempts to demonstrate that the repeal of expense allocation would not lead to tax arbitrage, in which the U.S. tax base is eroded through borrowing in the United States and equity funding of foreign investments. Because the point is counterintuitive, it is desirable to expand on it a bit more; annex C does just that.

Outbound portfolio investment. The COCA system achieves neutrality between U.S. portfolio investors investing in either U.S.-based multinational firms or foreign-based firms—between, say, investing in ExxonMobil and investing in BP—by the simple expedient of applying its minimum inclusion rules equally to all portfolio investments, whether in foreign or in U.S. companies. The COCA also achieves source neutrality at the level of U.S. portfolio investors in U.S. firms by not discriminating (through compensatory taxes or otherwise) against those firms with foreign earnings in favor of those with wholly domestic earnings.

As emphasized throughout this paper, under the BEIT, U.S. portfolio investors would be taxed currently on time-value-of-money returns on all of their investments through the minimum inclusion mechanism. As a result, organizing a new business enterprise outside the United States would not reduce the immediate U.S. tax burden on U.S. portfolio investors in that enterprise. Of course, the minimum inclusion device does not address the tax savings that might follow (and ultimately be enjoyed by U.S. investors) at the business enterprise level in respect of the new enterprise's non-U.S. income, if the average tax rate on that income is lower than the U.S. business enterprise rate. (By the same token, the BEIT does not create the problem either: it exists today in an even more dramatic form.) The first-order answer here lies in rethinking the definition of a business enterprise's residence.⁴⁴ The next subsection proposes some additional rules to ensure that U.S. taxpayers cannot use foreign holding companies to reduce their U.S. tax liability.

The BEIT also attempts to introduce some rough tax neutrality between majority and minority investments by U.S. multinationals in foreign joint ventures. The BEIT's superconsolidation rules

are meant to apply to majority-owned affiliates, which would mean, for example, that the income derived from a 51 percent-owned foreign joint venture would be taxed in its entirety by the United States.⁴⁵ By contrast, the income earned by a minority-owned foreign joint venture that did not conduct business in the United States would not be subject to U.S. net income tax. Under the BEIT, however, the U.S. multinational investor would be required to pay ordinary income tax each year on its minimum inclusion amounts, regardless of cash distributions, as well as on any excess distributions it might receive. This rule erodes at least to some modest extent current law's cliff effect, in which U.S.-controlled joint ventures are subject to subpart F but minority-owned ones are not.

In sum, time-value-of-money returns earned by U.S. citizens and permanent residents would be subject to the COCA regime, regardless of whether the investment is made in a U.S. or a foreign firm. This result preserves neutrality in investment decisions by U.S. investors and reflects the basic theme that the normal returns on all capital invested by U.S. nonbusinesses in business ventures should be subject to U.S. tax. At the same time, the BEIT's superconsolidation principles mean that U.S. resident business enterprises would be taxed on their risky returns and economic rents, regardless of whether domestic or foreign investors provide the capital that finance those enterprises.

Inbound Investment

The immediately preceding discussion emphasized that, under the BEIT, tax would be collected on minimum inclusions and excess distributions from all U.S. investors, regardless of the residence of the business entities in which they invest. It also explained that the BEIT would impose tax on

44. See Staff of the Joint Committee on Taxation (2005), which proposes changes to the current law for determining corporate residency because the law as it now stands "is artificial, and allows certain foreign corporations that are economically similar or identical to U.S. corporations to avoid being taxed like U.S. corporations."

45. One can imagine special rules to deal with this case if the results under the general rule were thought inappropriate. For example, one could have a special rule that raised the affiliation test for foreign entities to 60 or 65 percent, provided that the minority interests were themselves not publicly traded and were foreign owned.

U.S.-resident business entities in respect of their risky returns and economic rents, regardless of the residence of the investors who finance those businesses.

The logical corollary of these points is that foreign investors should be wholly exempt from tax under the BEIT. By carving out foreign investors, the ultimate reach of U.S. tax on time-value-of-money returns would be measured by the aggregate capital invested by U.S. residents in business endeavors. This is a reasonable view of the appropriate reach of the U.S. tax system.

This approach also reflects two unavoidable commercial realities. First, withholding tax (the mechanism by which jurisdictions collect tax from non-resident investors) has become increasingly porous, largely because many types of derivative instruments are now available that act as perfect substitutes for investing in the underlying securities. Second, this approach reflects the reality that, in a world of open economies, investors are able to earn normal returns from many sources. In this environment, imposing U.S. tax on foreign portfolio investors would simply raise the cost of capital to U.S. firms.

A U.S. person who invests indirectly in a U.S. business enterprise through a foreign intermediary would be subject to U.S. tax under the BEIT, because the COCA rules would apply to that investor. As described in the discussion of outbound investments, however, the BEIT, without further refinements, would leave open the possibility that a foreign investment vehicle that invested in U.S. financial capital instruments could reinvest any (tax-

free) excess distributions it received in additional financial capital instruments of U.S. issuers. The reinvestment in turn would not trigger any step-up in minimum inclusions or excess distributions tax for U.S. investors who do not sell their investment in that foreign vehicle.⁴⁶ As noted earlier, this same phenomenon exists today to the extent that current law's "passive foreign investment company" rules are successfully navigated.

The first response should be the adoption of a better definition of what constitutes a U.S.-resident business enterprise. In addition, foreign investment vehicles (whether or not publicly traded) could be subjected to the collective investment vehicle regime described earlier for purposes of determining a U.S. investor's excess distributions (and resulting stepped-up tax basis for minimum inclusion purposes). This solution would have the advantage of applying a single set of rules to all indirect investments, whether through collective investment vehicles or through offshore holding companies. As an alternative, the tax code today contains reasonably well developed rules (the "passive foreign investment company" rules) for dealing with this fact pattern. These could be carried over to the new system.

The BEIT is not relevant for non-business enterprise issuers of financial instruments. As a result, regardless of how one decides to treat foreign portfolio investors in U.S. businesses, the U.S. Treasury Department, in particular, would continue to pay interest on its debt obligations held by foreign investors free of withholding tax, relying on current law's portfolio interest rules.

46. The same problem does not exist for reinvested amounts equal to accrued minimum inclusions earned by the foreign investment vehicle, because a U.S. investor's annual minimum inclusion in respect of an investment in that offshore vehicle will compound at the same rate.

IX. Transition Issues

Transition issues are extremely important for any fundamental tax reform proposal, because the new tax system not only will create winners and losers going forward, but also will have direct effects on existing stores of wealth. Indeed, one of the principal sources of the potential revenue attributable to a switch to a consumption tax is the double taxation of existing wealth: once under the income tax system as it was earned, and again under the consumption tax system as that wealth is spent. Economists call this double tax “efficient,” by which they mean that it is unavoidable and easily collected; existing holders of financial assets can be expected to use other adjectives, of which “larcenous” is no doubt the most polite.

A proposal to reform the current tax code, while keeping it an income tax, obviously poses fewer transition issues than does a proposal to switch from an income to a consumption tax, but that does not mean the issues are trivial. An overnight switch to the COCA system, for example, could literally bankrupt highly leveraged companies. For this reason the BEIT proposal contemplates different transition rules for its non-COCA components (the uniform entity-level tax, superconsolidation principles, and the revised regime for acquisition of business assets and enterprises), on the one hand, and the COCA system, on the other.

It does not appear feasible to make the BEIT’s non-COCA rules work under a phase-in model. They therefore would have to apply in toto as of a specified date. Since in many respects the rules are simplifications and rationalizations of current law, their immediate application to existing operations should not cause irreparable harm to taxpayers.

The COCA system, by contrast, could be phased in, by specifying a multiyear period over which the interest expense deduction scales down and the COCA deduction ramps up. This would give businesses time to revamp their capital structures to reflect the new environment, in which debt financing would no longer receive a tax incentive.

Transition issues for investors are more debatable. The recommendation, however, is that the minimum inclusion/excess distributions system simply be adopted in toto as of a specified date near the end of the COCA deduction phase-in period. Unrealized gains in respect of financial capital instruments as of the transition date could be addressed by a variety of solutions. The fairest would be a one-time marking to market of such instruments (accepting for this purpose the necessary imperfection of many resulting “marks”). Tax on any unrealized gain would continue to be deferred but would be taxed at pre-BEIT capital gains tax rates on ultimate sale. Mark-to-market values on the conversion date would form the starting point for investors’ minimum inclusion calculations.

These brief suggestions are not meant to be comprehensive. Obviously, if the BEIT is thought to be attractive, a great deal of work on transition issues will be required; that work will be more enthusiastically undertaken, however, once one has some sense that this is a system that at least some people would like to transition to. Fortunately, because the BEIT remains fundamentally an *income* tax, the most difficult transition issues that consumption taxes pose (for example, the double taxation of existing wealth) are removed from the table.

References

- Bradford, David. 2005. A tax system for the twenty-first century. In *Toward Fundamental Tax Reform*, eds. Alan J. Auerbach and Kevin A. Hassett. Washington, DC: American Enterprise Institute for Public Policy Research.
- Brown, E. Cary. 1948. Business-income taxation and investment incentives. In *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen*. New York: W. W. Norton.
- Congressional Budget Office. 2005. *Taxing Capital Income: Effective Rates and Approaches to Reform*. Washington, DC.
- _____. 2006. *Computing Effective Tax Rates on Capital Income*. Washington, DC.
- Devereux, Michael, with Harold Freeman. 1992. A general neutral profits tax. *Fiscal Studies* 12(3): 1-15.
- Halperin, Daniel I. 1986. Interest in disguise: Taxing the “time value of money.” *Yale Law Journal* 95(3): 506-52.
- Keen, Michael, and John King. 2002. The Croatian profit tax: An ACE in practice. *Fiscal Studies* 23(3): 401-18.
- Kleinbard, Edward. 2007a. Designing an income tax on capital. In *Taxing Capital Income*. eds. Henry Aaron, Leonard E. Burman, and Eugene Steuerle. Washington, DC: Urban Institute Press.
- _____. 2007b. Throw territorial taxation from the train. *Tax Notes* 114: 547.
- Kleinbard, Edward, and Thomas L. Evans. 1997. The role of mark-to-market accounting in a realization-based income tax system. *Taxes* 79: 788.
- President’s Advisory Panel on Federal Tax Reform. 2005. *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System*. Washington, DC (November).
- Shaviro, Daniel N. 2004. Replacing the income tax with a progressive consumption tax. *Tax Notes* 103: 91 (April 5).
- Shuldiner, Reed. 1992. A general approach to the taxation of financial instruments. *Texas Law Review* 71: 243.
- Staff of the Joint Committee on Taxation. 2005. *Options to Improve Tax Compliance and Reform Tax Expenditures*. JCS-02-05, 2005 TNT 18-18, pp. 178-81 (January 27). Washington, DC.
- Sullivan, Martin A. 2006. On corporate tax reform, Europe surpasses the U.S. *Tax Notes* 111: 992 (May 29).
- Weisbach, David. 2004. The (non)taxation of risk. *Tax Law Review* 58: 1.
- Zelinsky, Edward A. 1997. For realization: Income taxation, sectoral accretionism, and the virtue of attainable virtues. *Cardozo Law Review* 19: 861, 873.

Annex A: Mechanics of the Cost of Capital Allowance

A. Scope of the Business Enterprise Income Tax

Under the Business Enterprise Income Tax, all business enterprises would be taxed under a single system based generally on today's rules for the taxation of ordinary ("C") corporations, but with the important modifications described below. As a result, any business enterprise, whether organized as a corporation, a partnership, or an unincorporated activity of an individual, would be taxed as a separate entity. (As applied to sole proprietorships and partnerships, the resulting system thus is loosely analogous to New York City's Unincorporated Business Tax.)

For these purposes, all income-producing activities would be characterized either as investment or as business activities. Most individuals who today are traders in securities would fall on the investment side of the new definition.

All collective investment funds, however organized, would be taxed under a single system different from the rules for business enterprises. (See section VII.) These collective investment vehicle rules of necessity would be more flexible than today's regulated investment company regime. Entities that "failed" the collective investment fund rules, including true professional traders, such as hedge funds (and a small minority of individual traders), would be taxed as business enterprises. Leasing and real estate development activities generally would be treated as *per se* business activities; a collective investment fund, however, would be permitted to engage in net leasing of real estate.

Every business enterprise would constitute one taxpayer, even if it conducted multiple lines of busi-

ness. An actual branch of an enterprise would be taxed as part of that enterprise; a "disregarded entity" subsidiary under current law would be handled through the consolidation rules described in annex B. A self-employed individual directly engaged in business for her own account would also constitute a single business enterprise, again regardless of how many different businesses she operated. Finally, and as described in more detail in annex B, a consolidated group of business enterprises would comprise a single business enterprise.

By way of an example, if three individuals organized an equal partnership to conduct a business, that partnership would constitute an entity subject to the BEIT. If a corporation that was itself engaged in business also invested in that partnership, the corporation and the partnership would each separately be taxed on its own business income, and the corporation would also be taxed on its returns from its investment in the partnership (as described below).

The COCA system applies only to *financial capital instruments*, a term used to signify any form of financial claim against (or measured by) the earnings, assets, or liabilities of a business enterprise. The COCA system thus would *not* apply to U.S. Treasury securities, because those instruments are not financial claims against a business enterprise.^a This limitation has little practical impact, because governments do not sell equity or (in general) complex financial derivative contracts, and we know today how to construct an income tax on straightforward debt instruments. By the same token, the term *financial capital instruments* also is intended to exclude ordinary trade receivables and payables of a business enterprise: again, no special tax regime is needed to address these short-term relationships that arise directly from these dealings in real assets

a. In some ultimate sense, claims against the government can be described as indirect claims against other households and businesses, but that argument is too diffuse, and the connection too attenuated, to have any practical significance for designing an income tax.

(or that arise in the settlement process for transfers of financial assets).

B. The COCA Rate

The COCA rate is intended to reflect what economists call “normal” returns, which means that the rate should be set at (or at least near) a risk-free rate of return. The actual COCA rate should be set by statute to vary with, for example, one-year Treasury rates. The actual rate would reflect political and revenue considerations, but (to choose an arbitrary stalking horse) might be something like the one-year Treasury rate plus 100 basis points. A slightly more sophisticated variant might offer a significantly higher allowance for the first few million dollars of capital, stepping down under a schedule as a business enterprise’s total capital exceeded specified thresholds, to mirror (very approximately) the fact that very large enterprises usually are more creditworthy than very small ones.

Within the business community, there would be immediate individual winners (equity-financed entities and entities with high credit ratings) and losers (highly leveraged enterprises and those with the weakest credit). All business enterprises would enjoy the benefits of the substantial reduction in tax rates from today’s corporate income tax rate.

The yield curve typically is steepest at the very shortest end of the maturity spectrum. It might be argued that a single COCA rate would introduce distortions in the capital markets, by encouraging issuers to rely excessively on financing through very short dated obligations (for example, commercial paper), on the theory that the issuer’s before-tax costs thereby would be minimized, while its tax deduction would remain constant. The COCA system could be modified to address that concern, by employing one rate, for example, for all financial capital instruments maturing in one year or less, and another rate for all others.

More empirical work would be required before determining whether it would be necessary to do

so. Issuers today face many practical constraints on their ability to finance themselves solely at the short end of the maturity spectrum: their own liquidity concerns, their desire to lock in favorable long-term financing rates, and rating agency constraints. Moreover, and as described below, the COCA proposal contemplates that investors effectively would measure their investment income by applying the same COCA rate to the amount of those investments; any tax savings to issuers thus should constitute a tax detriment to investors and therefore be reflected in pricing.

In the abstract, the COCA system might seem vulnerable to tax arbitrage. Imagine, for example, that a business enterprise issued a five-year, zero-coupon, contingent-payment debt instrument for \$100. Over the life of the instrument, the issuer would obtain COCA deductions totaling \$20 for the \$100 of cash received at the outset. Further assume that, at maturity, the contingency has no value, and the issuer therefore retires the bond for \$100. The issuer will have obtained COCA deductions over the five-year life of the instrument for the asset basis attributable to the instrument’s issue price, but in effect has paid nothing for them. Should that trouble us? The appropriate answer is no. The COCA system does *not* tie deductions to returns on specific liabilities. The fisc’s protection is the marketplace: the initial investors in that instrument believed the bond to offer attractive positive returns, and over the broad spectrum of business investments those expectations will prove correct. Phrased differently, if it is clear at the outset that the issuer will not pay contingent interest greater than the COCA/minimum inclusion rate, investors will not buy the security in the first place.

C. Application to Issuers

Under the COCA system, a business enterprise (other than a financial institution) would deduct each year an annual allowance for the financial capital invested in it, measured as a rate equal to a fixed percentage over one-year Treasuries multiplied by the issuer’s total capital. No further deductions

would be available to the issuer if its actual payments to investors exceed the annual COCA rate.^b

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

The COCA deduction would be in addition to, not in place of, asset depreciation. As a result, nonfinancial (real) assets that today are depreciable (or amortizable) would remain so under the COCA system. The effect of depreciation is to reduce the asset basis, which means in turn (all other factors being equal) that a business enterprise's COCA deductions will decrease as it depreciates its nonfinancial assets. The relationship among depreciation, the BEIT's treatment of asset sales, and the COCA regime is explored in the text in section VI and in annex B.

Financial assets are nondepreciable, but they nonetheless remain assets and therefore would enter into a business enterprise's COCA base. As a result, a business enterprise would obtain a COCA deduction for its tax basis in a portfolio investment made by it, and (as described below) it would include in income from that investment at least a "minimum inclusion" (as described below) equal to the same amount. The net result is that there would be no tax at the business enterprise level on investments,

unless the returns on those investments exceeded the COCA/minimum inclusion rate.

Under the COCA system, issuers would no longer face a tax imperative to employ as much debt financing as possible or to issue complex financial instruments that are designed to give issuers tax-deductible interest expense in respect of contingent returns. Instead, issuers would seek to minimize the *economic* cost of their financial capital, secure in the knowledge that there is no tax component to that calculus.

D. Application to Investors

The COCA system requires holders to include each year in ordinary income a *minimum inclusion*, which equals *each investor's* tax basis in its investments in business enterprises multiplied by the COCA rate for that year. (The tax treatment of tax-exempt investors is discussed in the text in section VII.) Minimum inclusions would be taxed currently at ordinary income rates, regardless of whether actually received in cash and regardless of the economic performance of the issuer in that year.^d If those minimum inclusions are not actually paid, the accrued but unpaid amount would be added to a taxpayer's basis in its investment (that is, unpaid minimum inclusions would accrue and compound at the COCA/minimum inclusion rate).^e

The minimum inclusion rules applicable to holders of financial capital instruments look only to a holder's tax basis in the instruments it owns to determine the holder's income inclusions. As a result, the

b. Similarly, an issuer would have no income inclusion if its cash payments are lower than the COCA rate and would recognize neither income nor loss on the retirement of a financial capital instrument.

c. As a consequence, every distribution by an issuer in respect of its financial capital would reduce the issuer's tax basis in an asset (here, cash and cash equivalents) and therefore automatically would reduce the issuer's COCA deductions in future periods.

d. Under a special rule, minimum inclusion accruals (and the issuer's COCA deductions) would be suspended so long as an issuer was in bankruptcy reorganization proceedings.

e. As noted above, 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) includes in income the minimum inclusion on that financial capital instrument (that is, its tax basis in that instrument multiplied by the published COCA rate); it also claims a COCA deduction for its own cost of capital, which equals its aggregate tax basis for all of its assets (including financial capital instruments that it owned) multiplied by the COCA rate. As a result, a business enterprise incurs no net tax liability to the extent of the minimum inclusion on financial capital instruments that it holds as an investor. This rule would not apply within a consolidated group, because the consolidated group is treated as a single business enterprise.

aggregate of investors' minimum inclusions would *not* equal the sum of issuers' COCA deductions, and in fact it would generally exceed those deductions, for two reasons. First, 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 is reflected in market prices for the enterprise's securities).

In addition to minimum inclusions, an investor would be required to include in income his or her *excess distributions*, which basically represent gain on the sale of a financial capital instrument *or* cash distributions that exceed current and prior accrued minimum inclusions. Gains from dealings in other property—that is, property other than business assets and financial capital instruments—would be taxed at ordinary income rates, subject to a possible special punitive rate for investments in collectibles.

Excess distributions would be taxed at a low rate (for example, 10 percent). The actual excess distribution rate again would reflect political and revenue considerations, but because the excess distributions tax is intended to serve only as a supplemental tax (with business enterprises in general bearing the tax on inframarginal returns), it is important that this tax rate remain low.

Cash distributions received by a holder of financial capital in a business enterprise from that enterprise would be treated first as tax-free returns of prior accruals of minimum inclusions, and then as excess distributions. (Excess distributions, unlike minimum inclusions, thus always represent cash received by an investor.) Just as a holder's tax basis in a financial capital instrument would increase for any minimum inclusions, so would it decrease by any distributions treated as tax-free returns of prior minimum inclusions.

On the sale or termination of a financial capital instrument, an investor would incur no tax on any gain beyond the relatively small excess distributions tax. An investor's losses would first be deductible at excess distribution rates (as explained in the next sentence), to the extent the holder received prior excess distributions. To ensure that losses in fact are utilizable, the BEIT "tax effects" the size of a loss, rather than, for example, providing that losses that reverse prior excess distributions from one investment may only be used to offset excess distributions on another investment. If, for example, one assumes that an investor's marginal tax rate on ordinary income is 30 percent, that excess distributions are taxed at a 10 percent rate, and that an investor suffers a \$300 loss attributable to prior excess distributions that the investor has received, the investor would claim a \$100 loss ($10/30 \times \300) against her unrelated ordinary income for the year.

Any remaining losses would be deductible at minimum inclusion rates, to the extent of the investor's aggregate prior minimum inclusions, *regardless* of whether those prior minimum inclusions had been received in cash by the holder. Any residual losses (which would represent losses of original principal) would not be deductible, just as gains would not be taxable (beyond the small excess distributions tax).

Without capital loss-type limitations, taxpayers in theory would be able to "cherry pick" losses, but in the new environment the extent of that cherry-picking would largely be limited, because the bulk of an investor's returns (his or her minimum inclusions) would occur regardless of the cash received. As explained in the text, most cherry-picking would relate to lowering future minimum inclusion income rather than obtaining an immediate tax benefit.

By way of example of the treatment of losses, imagine that the ordinary income tax rate is set at 45 percent, the excess distribution rate at 15 percent, and the relevant COCA rate for the year is 6 percent. Assume that a taxpayer invests \$1,000 in a business enterprise and receives no distributions. At the end of year 1, the taxpayer would

include \$60 in income. Assume that the taxpayer then sells the investment for \$940. The first \$60 of loss (in effect, from the adjusted tax basis of \$1,060 to \$1,000) offsets prior minimum inclusions of \$60 and is deductible at the 45 percent rate. The next \$60 of loss is not deductible.

One source of a great deal of the complexity in current law's taxation of financial instruments is the desire to distinguish returns *on* investment from returns of investment. Both the "earnings and profits" concept applicable to corporate stock and some of the tax rules for complex debt instruments address that concern. The COCA system dispenses with the "earnings and profits" concept and instead taxes all returns during the life of an instrument as returns on investment (either as nonincludible payments of prior minimum inclusions or as excess distributions).^f Mergers, acquisitions of one enterprise by another, liquidations, and so forth would all be treated as sales of the investors' interests in that enterprise; thus, if enterprise A buys sufficient control of enterprise B such that B becomes consolidated with A, the tax fiction is that B has sold all of its assets to A and then liquidated, thereby triggering a sale for all of B's investors. Investors would recognize gain or loss through the standard mechanism of reducing sales proceeds by the adjusted basis.

Securities dealers and other financial institutions subject to the mark-to-market system described in the text (section VII) would not be subject to any excess distributions tax on minority interests in other business enterprises, because they would be subject to tax at full rates on all of their income in respect of such securities.

The COCA system should not have any cascading tax problem associated with minimum inclusions that pass through several levels of unaffiliated business enterprises. A business enterprise that is a

holder of a financial capital instrument in a lower-tier business enterprise, and which thereby must include in income the minimum inclusion associated with that instrument, would also have *capital* of its own tied up in that investment and therefore would obtain a COCA deduction to reflect that incremental capital.

To prevent cascading tax burdens on excess distributions, it might be thought desirable to exempt business enterprises from the excess distributions tax. The problem with doing so, however, is that investors would then just choose to hold investments in enterprise A through enterprise B, so as to defer indefinitely any excess distributions tax in respect of enterprise A until an investor sold his or her interest in enterprise B (at which time the sales price presumably would reflect the excess distributions received by enterprise B in respect of enterprise A).

One could attempt to address the cascading tax issue while still responding to this first problem by providing that the first recipient of an excess distribution must pay the tax thereon, regardless of whether the recipient is a business enterprise, and then apply a limited "franking" system, under which excess distributions that have been taxed in the hands of one business enterprise effectively could be distributed tax-free to other business enterprises, and ultimately to investors. Experience teaches, however, that franking systems employed by other jurisdictions typically give rise both to great complexity and to tax-driven trading to capture the franking benefit. Moreover, such a system would still encourage taxpayers to hold investments in enterprise A through enterprise B, so as to keep down the aggregate tax basis of their investments when excess distributions from enterprise A are received by enterprise B and reinvested in enterprise C.

In the end it may be more desirable to countenance multiple levels of tax on excess distribu-

f. Under a special "amortizing debt" rule, distributions made on any fixed-term instrument that provides for the reduction of the holder's claim against the business enterprise during the life of the instrument would be respected to that extent as returns of principal, so long as the ongoing contractual return on the instrument is reasonably related to that contractual reduction of the holder's claim against the issuer.

tions, on the theory that the knowledge of ultimate multiple taxation would discourage investors from relying on structures like that outlined above to minimize the aggregate tax basis on which their future minimum inclusions would be calculated. To further limit the value of any such stratagems, one could adopt rules requiring that any privately held business enterprise (other than a mark-to-market institution) more than 10 percent of whose assets are investment assets (or any publicly-held company, the majority of whose assets are investment assets or income is investment income) would be taxed as if it were a collective investment vehicle in respect of those investment portfolios; as explained in the text (section VII), this would have the effect of “pushing up” excess distribution to investors in that business enterprise, for purposes of calculating their own excess distributions and future minimum inclusions.

The COCA system applicable to investors requires no special recordkeeping by the issuer or information from prior holders of an asset. In particular, every investor’s calculations of its minimum inclusions and excess distributions would be based on information already in the investor’s hands; no minimum inclusion or excess distribution accounts would carry over from a prior third-party investor from which the current investor has purchased a security. The COCA system applicable to holders admittedly would require significant recordkeeping by each holder, but that recordkeeping would be mathematically straightforward and, if reflected on each year’s tax return, could be kept up-to-date even by individual investors. More realistically, brokers could be expected (or required) to maintain that information for customers.

The result would be a time-value-of-money income inclusion system that uses the best possible information—market prices for securities that actually change hands—to identify the total capital invested in a business, without introducing the overwhelming administrative complexities of a pure mark-to-market system. In the absence of current market sales, financial assets effectively would be presumed to increase in value annually at the COCA rate, less

any actual distributions.

E. Financial Derivatives

Financial derivatives bedevil any income tax system, for several reasons: the same (or at least structurally similar) instruments can be used in completely different contexts, for example as a hedge of a liability or of an asset; a single derivative contains both an investment component and a “fair bet” component, in proportions that can vary dramatically from derivative to derivative; and the same instrument can constitute an economic liability one day and an asset the next.

It is vitally important that the taxation of derivatives not depart dramatically from the taxation of the underlying financial capital instruments. Accordingly, the proposal for financial derivatives is as follows:

1. Current law’s tax hedge accounting principles would be preserved (and expanded). The tax hedge accounting rules would take precedence over the mark-to-market rule and the general rule below and could be invoked by either taxpayers or the fisc. So, for example, if a business enterprise has issued fixed-rate debt and now wants to swap that fixed coupon into floating, the swap would be treated as relating to the business enterprise’s cost of capital; as a result, the business enterprise would recognize neither income nor expense in respect of that liability hedge. Similarly, hedges of inventory-type property would be taxed at ordinary income rates, and the timing of hedge gains and losses would be matched with the timing of gains and losses from the inventory-type property.
2. Dealers and professional traders in financial instruments would be subject to mandatory mark-to-market accounting (and full ordinary tax rates) for all financial derivatives held or issued by them (as well as all financial capital instruments held by them). The hedge accounting rules described immediately above would, however, take priority, to address traditional liability hedging.

3. Financial derivatives held by taxpayers that are not dealers or professional traders and that are not covered by tax hedge accounting principles would be taxed under an asset/liability model. The calculations described below would be performed on a contract-by-contract basis. The basic theme is to treat a derivative contract each year as an asset or a liability and then to apply the COCA rules to the resulting instrument.

Under the asset/liability model, a taxpayer's net cash *outflow* on a financial derivative contract in the first year of that contract would be treated as a nondeductible investment in that contract. That investment in turn would attract a minimum inclusion thereafter. Subsequent cash outflows would add to the taxpayer's investment in the contract. The taxpayer's investment in the contract would create an asset on the taxpayer's balance sheet. If one imagines that those cash outflows are funded out of cash on hand, it is easy to see that the taxpayer's annual COCA deduction would remain unaffected (that is, the taxpayer simply has substituted an investment in the contract for cash on hand).

Cash *inflows* received by the taxpayer in a subsequent year would be treated first as returns of prior accrued minimum inclusions, then as nontaxable returns of capital, and finally as a liability of the taxpayer (*a derivative liability*). Similarly, the counterparty to that hypothetical swap would record a liability in the first year of the swap equal to the net cash inflow on that swap. The excess distribution rules would be triggered only at maturity or termination of the contract.

As explained earlier, the COCA system effectively ignores an issuer's actual cash flows on its "regular" financial liabilities, such as corporate stock or debt; instead an issuer would obtain an arbitrary COCA deduction measured by the sum of its bases in all its assets. Cash received by a taxpayer in respect of a derivative liability would also increase the taxpayer's asset basis by the cash received, and

therefore its COCA deduction, but because financial derivatives combine elements of both capital investments and pure bets, the tax rules for handling the termination of derivative contracts would differ slightly from those applicable to traditional capital instruments.

At termination, parties to a financial derivative would recognize a gain or a loss. A gain would be taxed at excess distribution rates; a loss would be deductible at minimum inclusion rates (to the extent of prior minimum inclusions) and then at excess distribution rates. (In the case of a derivative liability, the gain or loss would be computed by comparing the amount of that recorded liability with the amount the taxpayer in fact is required to pay.) From the perspective of a taxpayer with a net *gain* in a financial derivative contract at termination, that result is directly analogous to the rules that would apply to the sale of a traditional capital instrument. For a taxpayer with a *loss*, however, the result would be different.

Under the general COCA system, an issuer would not recognize gain or loss on retirement of its outstanding traditional capital obligations (for example, debt it had issued). Taxpayers would, however, recognize gain *or* loss on the termination of derivatives. The reasoning here is that it is desirable to preserve a symmetry in tax results for traditional financial derivatives, such as an on-market interest rate swap, where the contract is a "fair bet" at the outset. The unfortunate consequence of this rule, however, is that it requires developing a bright line to distinguish derivative instruments from traditional capital instruments.

Imagine, for example, that Buyer paid \$50 for a three-year European-style option written by Writer on the S&P 500. Also imagine that the aggregate minimum inclusions on that \$50 investment over the contract's three-year life were \$10, and that at maturity the contract paid either (a) \$80 or (b) zero. Buyer would recognize \$10 of ordinary income over the life of the option, and its

adjusted tax basis in the contract would be \$60. At maturity, in case (a) Buyer would recognize \$20 in excess distributions. In case (b) Buyer would recognize \$10 of ordinary loss (the first dollars of loss always reverse prior minimum inclusions) and then \$50 of additional loss, deductible at excess distribution rates.

Writer would record a \$50 liability at the outset. As with other liabilities, no deduction would arise directly from that fact, but Writer's aggregate basis in its assets *would* increase by \$50, which would create a larger COCA deduction.

At maturity, in case (a) Writer would recognize \$30 of loss, deductible at excess distribution rates. In case (b) Writer would recognize \$50 of gain; that

gain would be taxed at excess distribution rates.

The proposed rules for financial derivatives admittedly are complex. In effect, the reason is that the COCA system assumes that "ordinary" financial capital instruments (such as corporate stock and debt) in fact are primarily instruments for raising capital, the financial returns from which over time bear some relationship to the time value of money as applied to that capital. Financial derivatives, by contrast, often contain both significant capital investment components and pure bets; the simplifying assumptions underlying the COCA base case fall down in those circumstances. In practice, however, it is likely that the exceptions (hedge accounting and mark-to-market) would swallow the rule for most taxpayers.

Annex B: The BEIT's Rules for Taxing Affiliated Groups, Business Acquisitions, and Business Losses

A. Superconsolidation

The Business Enterprise Income Tax adopts “true” consolidation principles (which this paper describes as *superconsolidation*) for affiliated business enterprises. In other words, affiliated enterprises (regardless of their legal form) are treated as part of one single business enterprise, and the separate tax attributes of consolidated subsidiaries no longer are tracked. This is precisely how financial consolidation works today, but it is completely different from the current tax understanding of consolidation. The current tax code tracks the separate income, assets, and operations of each member of a consolidated group and then makes fiendishly complicated adjustments to reflect intra-group transactions, all in contemplation of the (often remote) possibility that the stock of an affiliate might one day be sold and the tax attributes of that subsidiary then become relevant again. Nonpractitioners no doubt will see this change as a small point, but current law’s treatment of consolidated groups is infinitely more complex than is commonly understood, with the predictable consequences of both tremendous compliance costs and tax avoidance strategies designed to game those complex rules.^g

More specifically, under the BEIT, two or more enterprises would mandatorily consolidate when held through a common chain of ownership, defined as *either*:

(i) the ownership of more than 50 percent of a business enterprise’s total financial capital (which

for this purpose would exclude all instruments with maturities at the time of acquisition or issuance of one year or less) *and* 25 percent or more of all financial capital instruments entitled to vote for the enterprise’s board of directors (or analogous body);

or

(ii) the ownership of 80 percent or more of the total voting power of all financial capital instruments entitled to vote for the enterprise’s board of directors (or analogous body) *and* 20 percent or more of the enterprise’s total financial capital.

It would be possible technically for a single business enterprise to be affiliated with two different parents under the above rules. In those cases, rule (ii) would take priority over rule (i).

The consequences of tax consolidation under the BEIT would be similar to financial accounting consolidation today. The consolidated group would be treated as a single business enterprise, and no significance would be attached to the separate judicial status of any part of the consolidated business enterprise. As a result, the sale of a corporate subsidiary from a consolidated group would *always* be treated as an asset sale, even if the buyer were the public (for example, in an IPO carveout of the subsidiary).

Minority investors in a consolidated subsidiary would be treated as investors in the entire consolidated group—that is, there would be no difference

g. In fact, of thirty-one types of transactions that the Internal Revenue Service listed in 2005 as “abusive,” thirteen were the direct result of the manipulation of the carryover basis or consolidated return rules, or inconsistencies in the rules applicable to different types of entities—all of which are directly resolved by the non-COCA components of the BEIT.

in tax treatment between minority investors in a consolidated subsidiary and investors in the common parent, except for the timing of excess distributions (which would follow the timing of whenever those excess distributions actually were made).

B. Tax-Neutral Acquisitions

The BEIT would repeal all “tax-free” organization and reorganization rules. Instead, all transfers of business assets would be treated as asset sales nominally taxable at ordinary tax rates. Moreover, all acquisitions of control of a business enterprise, regardless of the legal form of that business enterprise, would be taxed as asset acquisitions of the target, with any gain or loss recognized both by the target and by the owners of the target’s financial capital instruments.

These acquisition rules for business assets and business enterprises are necessary to coordinate with the superconsolidation principles described above (by eliminating entity-level tax attributes following acquisitions). They also advance the income tax objectives of the BEIT by increasing the number of realization events at the investor level.

Under these principles, the acquisition of control of a target company that is not itself a member of a consolidated group would be analyzed as a taxable sale by the target company of its assets, followed by a liquidating distribution by the target company of its (after-tax) sales proceeds to its investors. Those investors in turn would be taxed, if at all, at the low excess distribution rate. This taxing pattern is analogous to the taxation of a “forward cash merger” under current law. The acquisition of a target company out of a consolidated group would be taxed as a straightforward asset sale by the selling group, because business enterprises have no separate tax identity under the superconsolidation rules.

The trigger for these acquisition accounting rules would be the same as the threshold for consolidation, described above. As a result, the tax-neutral acquisition rules would be triggered whenever a business enterprise entered or left tax consolidation.^h

If a target company itself held investments in non-consolidated business enterprises, it would pay tax on any previously unrealized gain on the financial capital instrument that it held. The target would also pay tax on its inventory-type property (what today is called section 1221 property) at ordinary income rates, just as it would pay on any gain from the sale of business assets.

To a reader trained in the current income tax system, the acquisition rules summarized above might appear inappropriately to discourage corporate merger and acquisition activity, because every acquisition would be a “taxable” one, and moreover would be subject to “double taxation” (at both the enterprise and the investor level). In fact, this concern is largely an optical illusion.

The explanation of the paradox is that, when viewed solely at the enterprise level (that is, without regard to investor-level minimum inclusions), the BEIT is a consumption tax: the combination of the COCA and depreciation deductions work to exempt the normal return from tax. It is well known that, under a consumption tax, asset sales are tax neutral; that is, they effectively are not burdened by tax. The easiest way to see this is to imagine a consumption tax where capital expenditures are immediately expensed and there is no COCA allowance.ⁱ

Imagine that corporation A buys a widget for \$100 and later sells it for \$150 to corporation B. Corporation A has a zero basis in the widget (having obtained an immediate \$100 deduction on purchasing it) and therefore recognizes \$150 of gain on the

h. The rules would also be triggered by in-kind excess distributions or liquidation.

i. In the BEIT, the sum of COCA and depreciation has the same present value as immediate expensing and no COCA, so the example is a fair one.

sale. Corporation B, however, obtains an immediate deduction of \$150 for the purchase. So long as the two companies face the same tax rates, there is no net tax raised from the sale of the widget, and the parties can reflect the nominal tax burden by simply adjusting the purchase price.^j

At the enterprise level, therefore, making every acquisition a “taxable” one has no aggregate tax consequence. The same is not strictly true at the investor level. First, investors who do very well would incur an excess distributions tax liability. (This is one reason why it is important to keep the excess distributions tax rate low.) Second, any step-up in an investor’s tax basis in her investment assets (for example, through the reinvestment of profits) would increase that investor’s *future* minimum inclusion income. As a result, there would be some tax cost to investors, but not business enterprises, from abandoning all tax-free mergers and the like.

The BEIT relies on two factors to overcome this tax friction. First, the bulk of investors’ tax costs from a taxable business combination would come in the form of increased *future* minimum inclusions, which as a practical matter would be less daunting to most investors than writing out a large immediate check to the IRS.

Second, the BEIT effectively relies to its advantage on the classic corporate agency problem (the fact that corporate managers often act in their own interest rather than in the interest of the firm’s owners). Here corporate managers face an environment in which, from their perspective, there are no tax frictions or limitations of any kind on corporate ac-

quisition or divestiture activity. The BEIT relies on this fact to predict that managers will pursue those business combinations or sales that are in the before-tax best interest of the firm, and that investor tax consequences will not materially affect managers’ business decisionmaking.

C. Business Losses

The academic literature that inspired this paper’s analytical division of business income into normal returns, risky returns, and economic rents (super-sized returns) emphasizes the critical importance of treating business losses symmetrically with gains.^k An ideal consumption tax requires this condition, and, as repeatedly noted, at the business enterprise level the BEIT is intended to function as a consumption tax. Moreover, the logical tax treatment of risky returns, whether under an income or a consumption tax, presupposes full loss utilization.^l

To economists, the simple response to these observations is that business losses should give rise to immediate cash refunds from the government. In practice, however, this idea is likely to be impolitic. The BEIT therefore accomplishes the same economic result in a more politically palatable fashion, by compounding a business enterprise’s unused tax loss carryovers at the COCA rate.

This solution then leads to the question of what to do with a target company’s tax loss carryovers when it is acquired. As previously described, the tax fiction in this case is that, regardless of the form of the acquisition, the target is deemed to sell its assets and

j. This result does *not* hold under the current corporate income tax, because the seller’s immediate gain is matched against the buyer’s *future* depreciation deductions, which have a lower present value.

k. Weisbach (2004); For example, if corporation B, the purchaser of the widget for \$150 in the example in the preceding section, cannot obtain the full tax benefit of its \$150 deduction, corporation A’s sale of that widget to corporation B no longer would inevitably be tax neutral.

l. Kleinbard (2007a). The basic insight is that a risky investment, once stripped of its normal returns, is simply a bet. So long as losses are fully utilizable, that bet in turn can be analogized to having the IRS as a silent partner both for winning and for losing bets. If, however, the IRS is a silent partner for winners but does not share in losers, taxpayers will not place bets—will not make risky investments—in the real world that they would have made in a world without taxes. This in turn would introduce an important economic inefficiency into business decisionmaking.

liquidate. Under current income tax norms, that constructive asset sale would cause the target to forfeit its existing tax loss carryovers. The question here is, what should the rule be under the BEIT?

The economist's answer again is straightforward: the target's losses should carry over to the acquiring superconsolidated group. The analysis becomes less obvious, however, when a business enterprise (which for this purpose might be a superconsolidated group) sells less than all of its assets (for example, a division, or the stock of a corporate subsidiary). Should the seller's tax loss carryovers be apportioned in some way between seller and buyer? And if so, how? By reference to the relative values of seller's business that are sold and retained? By guesstimating what portion of seller's tax loss carryovers relate to the division or subsidiary that is being sold (remembering that, under the BEIT, those tax attributes would no longer otherwise be tracked)?

An economist would answer that the questions themselves miss the point, and that any allocation of tax losses is acceptable, provided that the rules are clear, so that the parties can price the value of those losses into their transaction. The problem, however, is that this point of view will be understood (correctly) as making tax loss carryovers fully saleable, albeit only in the context of a larger business asset transfer. The Congress and the IRS have a long history of vigorously campaigning to prevent "trafficking" in tax loss carryovers, and if full refundability is thought politically impossible, it must be expected that full transferability also will be rejected.

In light of these practical considerations, the tentative recommendation is for the BEIT to follow conventional thinking and require the forfeiture of a target company's tax loss carryovers when its assets or controlling interests are acquired by another business enterprise. If a company sells less than all of its assets (for example, if it sells a subsidiary or a division), the seller's loss carryovers would remain entirely with the seller. The current anti-loss trafficking rules of the Internal Revenue Code (section 382) would survive, but as a practical matter they would be relevant only to those cases where a group of investors seeks to acquire collective (non-consolidated) control of a loss company to use it as a platform for future acquisitions. These existing anti-trafficking rules effectively limit the value of "purchased" tax loss carryovers to a COCA-like annual return.

Finally, a special rule would redress the economic inefficiency that otherwise would follow from denying a disastrous business effort the benefit of its tax losses when it ultimately is sold or liquidated, and at the same time denying investors losses on all financial investments in the enterprise. This special rule would permit *investors* in an unprofitable company to claim an ordinary loss for any otherwise nondeductible losses arising from the constructive sale of their investments upon the sale or actual liquidation of the company. The idea is that in this circumstance the value of the loss would not disappear, but instead would "migrate" from the business enterprise to its investors (or at least to those who have not previously lost faith and sold their investment in the marketplace).

Annex C: Interest (COCA) Expense Allocation for Foreign Tax Credit Purposes Under the BEIT

This annex, along with Kleinbard (2007b), shows why the Business Enterprise Income Tax's cost of capital allowance system should not be subject to the same expense allocation rules for foreign tax credit calculation purposes as is interest expense under the current Internal Revenue Code. Very generally, a U.S. firm today can claim a tax credit (a dollar-for-dollar reduction in its U.S. tax liability) for foreign income taxes that it pays, subject to a cap, referred to as the foreign tax credit limitation. That limitation is the product of a taxpayer's tentative (pre-credit) U.S. tax liability and a fraction, the numerator of which is the taxpayer's foreign source taxable income, and the denominator of which is its worldwide taxable income.

The purpose of the foreign tax credit limitation is to limit a taxpayer's ability to claim foreign tax credits to an amount equal to what the U.S. tax would have been on that foreign income. This preserves the U.S. *domestic* tax base from erosion through high foreign tax rates. To accomplish this purpose, the Internal Revenue Code applies the limitation fraction by employing U.S. measures of gross and net income, not foreign law calculations.

Moreover, the United States treats certain domestic U.S. expenses—most importantly, interest expense—as supporting all of a taxpayer's worldwide assets. The Internal Revenue Code therefore requires U.S. firms to allocate some of their domestic interest expense deductions against foreign source income (thereby raising their effective foreign tax rate for limitation fraction purposes, because those deductions of course are not recognized for foreign tax law purposes). This allocation in general is performed in proportion to relative asset values (or tax basis) inside and outside the United States.

The question considered here is, should COCA deductions similarly be allocated under the BEIT? The answer, surprisingly, is no.

The argument is easiest to follow if one makes two simplifying assumptions. First, assume that U.S. firms raise their capital in the United States. (This of course is not strictly accurate in practice.) Also for simplicity, ignore the fact that aggregate investor-level minimum inclusion income technically is not identical in amount to an enterprise's COCA deduction (even though each is calculated at the same rate), because investors' tax bases in their investments will differ from an enterprise's basis in its assets. (In practice, this fact tends to tilt the balance of the analysis described below in favor of the United States, but at least to some extent is roughly cancelled out by the extent of foreign investment in U.S. firms.) This second simplifying assumption means that investors' aggregate minimum inclusion income will equal issuers' aggregate COCA deductions. Assuming identical income tax rates, the net result (under these simplifying assumptions) is that the tax administration is in the same place as if the tax system simply disallowed interest expense deductions. If one accepts all these simplifying assumptions for purposes of the example, then to this extent the BEIT puts a U.S. firm effectively in the same position as if it were entirely equity funded under current law. The tax code does not allocate any "expense" today in that situation, so why should the BEIT? This rhetorical question is designed, of course, to illustrate the general point that the COCA deduction is really not an expense; it is a kind of income allocation/integration device as between issuers and investors.

The argument can be further illustrated by an example. Imagine that Globalco earns 12 percent on assets of \$1,000, before any COCA or interest expense deduction. Assume that the COCA rate is 5 percent and that the income tax rate in the United States and in Freedonia is 35 percent on both enterprises and investors.

If all of Globalco's investments are in the United States, then it will have \$120 in gross income (12 percent x \$1,000), a \$50 COCA deduction (5 percent x \$1,000), and \$70 in taxable income. It will therefore pay an enterprise tax of \$24.50, all to the United States. In addition, Globalco's investors (assumed to be U.S. residents and to have a basis of \$1,000 in their Globalco investments) have \$50 of minimum inclusion income (5 percent x \$1,000), on which they pay tax of \$17.50. As a result, the U.S. Treasury collects a total of \$42 from Globalco and its owners.

Now imagine that everything is the same as before, except that Globalco has 40 percent of its assets and income in Freedonia and obtains no Freedonian tax deduction for any interest expense or other cost of capital. (Since the BEIT does not distinguish between debt and equity, all of the above would apply with equal force to a U.S. issuer that borrowed in the United States and invested in equity of a foreign subsidiary.) Globalco will report \$48 (\$400 x 12 percent) in Freedonian gross and taxable income and will pay \$16.80 in Freedonian tax. Globalco's tentative U.S. tax liability is the same as before (\$24.50), but it gets a foreign tax credit of \$16.80. As a result, Globalco's residual U.S. tax bill is \$7.70. Meanwhile, U.S. investors in Globalco still pay \$17.50 in minimum inclusion tax liabilities. The net result is that, at a time when 60 percent of Globalco's pre-COCA income is derived in the United States, Globalco and its investors together pay (\$7.70 + \$17.50 =) \$25.20 to the U.S. Treasury

and \$16.80 to Freedonia. In turn, 60 percent of \$42 of global tax is \$25.20. Globalco's tax liability properly reflects its pre-COCA split in income.

Finally, imagine that Globalco makes a \$200 incremental investment in Freedonia, all funded from Globalco's head office in the United States, by way of it selling new securities to (by assumption) U.S. investors. Globalco now has \$1,200 in assets, half in the United States and half in Freedonia. Globalco's COCA deduction increases to \$60. Globalco's global gross income is now \$144, on which (after COCA) it owes \$29.40 in tentative U.S. tax. It pays \$25.20 to Freedonia (35 percent tax on \$72 of income) and has \$4.20 of residual U.S. tax liability at the enterprise level. Globalco's investors (again presumed to be all located in the United States under our simplifying assumptions) now pay minimum inclusion tax of \$21 (\$1,200 x 5 percent x 35 percent), with the net result that Globalco and its owners pay \$25.20 to the U.S. Treasury and \$25.20 to the Freedonian treasury. Again, the post-foreign tax credit tax receipts of the U.S. Treasury are proportionate to the pre-COCA income of Globalco derived in the United States.

One interesting practical problem, not highlighted in the example, is that a U.S. firm with extensive foreign operations will find itself with excess foreign tax credits quite quickly if it chooses to fund its foreign operations entirely with nondeductible equity. This limits the consequences of any mistakes in logic or assumptions in the argument.

Author

EDWARD D. KLEINBARD

Partner, Cleary Gottlieb Steen & Hamilton LLP

Widely recognized as a leading tax lawyer in the United States, Kleinbard is consistently listed in *The International Who's Who of Corporate Tax Lawyers*, *International Tax Review's* "World Tax" yearbook, Chambers USA *America's Leading Lawyers for Business*, and Chambers Global *The World's Leading Lawyers*. Mr. Kleinbard regularly publishes on tax matters, including "Competitive Convergence in the Financial Services Markets" in *Taxes*, and the following recent articles in *Tax Notes*: "A Holistic Approach to Business Tax Reform"; "Is It Time to Liquidate LIFO?"; and "Throw Territorial Taxation from the Train." Mr. Kleinbard was a visiting lecturer at Yale Law School for the Spring Semester of 2007, where he taught a course on the taxation of financial products and markets. He also regularly lectures at New York University, Practising Law Institute and similar conferences. Mr. Kleinbard received a J.D. degree in 1976 from Yale Law School, where he was an articles editor of the *Law Journal*, and he received an M.A. degree and an undergraduate degree from Brown University in 1973.

Acknowledgments

I am very grateful for the suggestions and comments that I received from formal and informal reviewers of this paper and its immediate predecessor on the same topic. I owe special thanks for the valuable contributions of Henry Aaron, Rosanne Altshuler, Alan Auerbach, Leonard Burman, Mihir Desai, Jason Furman, Daniel Halperin, Michael Keen, Peter Orszag, Diane Ring, Leslie Samuels, Daniel Shaviro, Eugene Steurle and Jon Talisman. I remain solely responsible for any errors in this presentation.



ADVISORY COUNCIL

GEORGE A. AKERLOF

Koshland Professor of Economics, University of California, Berkeley and 2001 Nobel Laureate in Economics

ROGER C. ALTMAN

Chairman, Evercore Partners

HOWARD P. BERKOWITZ

Managing Director, BlackRock
Chief Executive Officer, BlackRock HPB Management

ALAN S. BLINDER

Gordon S. Rentschler Memorial Professor of Economics, Princeton University

TIMOTHY C. COLLINS

Senior Managing Director and Chief Executive Officer, Ripplewood Holdings, LLC

ROBERT E. CUMBY

Professor of Economics, School of Foreign Service, Georgetown University

PETER A. DIAMOND

Institute Professor, Massachusetts Institute of Technology

JOHN DOERR

Partner, Kleiner Perkins Caufield & Byers

CHRISTOPHER EDLEY, JR.

Dean and Professor, Boalt School of Law – University of California, Berkeley

BLAIR W. EFFRON

Partner, Centerview Partners, LLC

JUDY FEDER

Dean and Professor, Georgetown Public Policy Institute

HAROLD FORD

Vice Chairman, Merrill Lynch

MARK T. GALLOGLY

Managing Principal, Centerbridge Partners

MICHAEL D. GRANOFF

Chief Executive Officer, Pomona Capital

GLENN H. HUTCHINS

Founder and Managing Director, Silver Lake Partners

JAMES A. JOHNSON

Vice Chairman, Perseus, LLC and
Former Chair, Brookings Board of Trustees

NANCY KILLEFER

Senior Director, McKinsey & Co.

JACOB J. LEW

Managing Director and Chief Operating Officer,
Citigroup Global Wealth Management

ERIC MINDICH

Chief Executive Officer,
Eton Park Capital Management

SUZANNE NORA JOHNSON

Senior Director and Former Vice Chairman
The Goldman Sachs Group, Inc.

RICHARD PERRY

Chief Executive Officer, Perry Capital

STEVEN RATTNER

Managing Principal, Quadrangle Group, LLC

ROBERT REISCHAUER

President, Urban Institute

ALICE M. RIVLIN

Senior Fellow, The Brookings Institution and
Director of the Brookings Washington Research Program

CECILIA E. ROUSE

Professor of Economics and Public Affairs,
Princeton University

ROBERT E. RUBIN

Director and Chairman of the Executive Committee,
Citigroup Inc.

RALPH L. SCHLOSSTEIN

President, BlackRock, Inc.

GENE SPERLING

Senior Fellow for Economic Policy,
Center for American Progress

THOMAS F. STEYER

Senior Managing Partner,
Farallon Capital Management

LAWRENCE H. SUMMERS

Charles W. Eliot University Professor,
Harvard University

LAURA D'ANDREA TYSON

Professor, Haas School of Business,
University of California, Berkeley

WILLIAM A. VON MUEFFLING

President and CIO, Cantillon Capital Management, LLC

DANIEL B. ZWIRN

Managing Partner, D.B. Zwirn & Co.

JASON FURMAN

Director

THE
HAMILTON
PROJECT

THE BROOKINGS INSTITUTION
1775 Massachusetts Ave., NW, Washington, DC 20036
(202) 797-6279 ■ www.hamiltonproject.org

