

Rehabilitating the Business Income Tax



THE AMERICAN SYSTEM for taxing business income is broken. Business tax laws and regulations are tremendously complicated, lead to inefficient choices by business leaders and investors, and raise much less revenue than might be expected given statutory tax rates. This complexity forces businesses to spend tens of billions of dollars on tax compliance and creates myriad opportunities for tax avoidance. Furthermore, inefficient choices result from tax rates that differ arbitrarily depending on the type of income-earning asset, how the asset is financed, where it is located, and how the business is organized. Consequently, U.S. corporate tax revenue is the fourth lowest as a share of GDP among the Organization for Economic Cooperation and Development (OECD) member countries, although the U.S. statutory corporate tax rate is the second highest in the OECD.

In a new discussion paper released by The Hamilton Project, Edward Kleinbard of Cleary Gottlieb Steen & Hamilton LLP proposes a comprehensive reform of the business income tax. Kleinbard's proposed Business Enterprise Income Tax, or BEIT, uses a consistent, logical framework to make the tax system simpler, fairer, and more efficient. Under the BEIT, the tax code for the first time would impose a constant burden on returns from investing capital in a business operation. In addition, many of the arbitrary distinctions between various forms of business organization or investment would cease to have tax implications. The result would be a system integrated at the corporate and the individual levels that taxes all business income once and only once.

THE CHALLENGE

A successful system for taxing business income would measure income comprehensively and tax that income consistently, regardless of whether that income is reinvested in the business or distributed to investors and regardless of the form in which that business is organized or in which an investment is made. The current system falls short on all of these counts. Because the system lacks a coherent logical structure grounded in economic principles, it is vulnerable to manipulation and creates significant economic distortions. Scattered attempts have been made over time to remedy the system's shortcomings, resulting in a patchwork of rules that is increasingly complex, unpredictable, and inefficient. At the same time, globalization and the increased sophistication of the financial system have accentuated the system's intrinsic shortcomings.

The failings of the current business tax code include the following:

Distortion of business decisionmaking. By imposing different tax rates for similar economic outcomes, the system distorts business decisionmaking, as tax strategy takes priority over assessing market risks and returns. Examples include:

- **Financing methods.** Under current law, business interest payments on debt are tax deductible while dividends on equity are not. With interest and dividend receipts taxable for some investors and not others (such as tax-exempt institutions), debt-financed investments may escape tax entirely and equity-financed investments may be double-taxed. The result is a dramatic disparity: according to the Congressional Budget Office, corporate investments financed with equity are effectively taxed at 36 percent while those financed with debt face a *negative* effective rate. To the extent this leads corporations to overlever-

age themselves, it can increase financial fragility throughout the economy and worsen corporate governance.

- **Organizational forms.** Today's tax code imposes different rules on businesses with different organizational forms, largely on the basis of nineteenth-century legal and social norms. In particular, corporations are taxed at a higher rate than partnerships, which are viewed as pass-through vehicles rather than as independent taxable entities.
- **Asset markets.** Owing primarily to problems in measuring depreciation, the current system imposes very different tax rates on income earned by different types of physical assets. For example, investments in manufacturing structures are effectively taxed at 32 percent while analogous investments in mining structures are taxed at 10 percent.

High and rising tax avoidance. Tax shelters and other mechanisms for reducing tax obligations have proliferated, as businesses use financial engineering to exploit the tax code's uneven treatment of economically similar entities and activities. Several nationally known businesses have been caught engaging in "abusive" or "sham" transactions to reduce their tax liabilities, and new financial instruments have been created to take advantage of differences in tax treatment stemming from formal labels rather than economic distinctions. On the international front, businesses have manipulated transfer pricing between subsidiaries to shift reported profits to foreign territories with lower tax rates. These and other problems with international business income taxation have become so acute that the Joint Committee on Taxation estimates that eliminating all federal taxes on overseas profits—and the associated deductions and credits—would actually raise revenue.

High and rising compliance costs. Over time, business taxpayers have devoted more and more energy to following increasingly convoluted tax rules. Together, they now spend an estimated \$40 billion a year on tax compliance. Meanwhile logical inconsistencies and periodic attempts to plug obvious loopholes have led to a lack of coherence in the system, meaning that businesses have increasing difficulty assessing the likely tax treatment of new types of business activities or financial structures.

Diminishing corporate tax revenue. With today's vigorous pace of financial innovation and increasing globalization, an ever more byzantine set of tax rules is making the business tax system dangerously obsolete. Corporate taxes as a share of corporate profits have fallen considerably during the past two decades—without any reduction in the statutory tax rate—and now stand at their lowest point since World War II.

The Business Enterprise Income Tax

A NEW APPROACH

This untenable situation requires a major rethinking of business income taxation. Kleinbard's BEIT proposal addresses these problems by creating a new approach to taxing business income that is consistent with economic analysis as well as with business and financial realities. The fundamental principle underlying the BEIT is that an income tax should tax all returns to capital in a comprehensive and systematic manner, regardless of the form of that capital or who receives the returns.

Kleinbard's analysis begins with the idea that the return investors receive on capital invested in a business consists of three parts. First, capital earns a "normal" return, which he defines as a risk-free rate that represents the time value of money. Second, capital may earn a "risky" return, which is posi-

Corporate taxes as a share of corporate profits stand at their lowest point since World War II.

tive on average but uncertain and carries the risk of economic losses. Third, capital may earn economic rent: a "supersized" return arising from a unique market position or other exclusive advantage.

The current tax system does not tax these types of return consistently. One root cause of this inconsistency is that some financial instruments give rise to deductible payments by a business while others are tax-preferred in the hands of investors. The capital markets are very efficient at matching the tax profiles of businesses and investors to minimize the private sector's aggregate tax liabilities.

A second cause of this inconsistency is that returns on financial assets are taxed only when "realized"—when taxpayers receive the returns in cash. Because gains therefore compound on a tax-free basis for varying periods, the effective tax rate on the normal return to capital is also varying and uncertain. A third root cause is the imperfect integration between taxation at the enterprise level and at the individual level. The result, as discussed above, is that some capital income is effectively taxed more than once and some not at all.

In contrast with the current failed system, Kleinbard's BEIT taxes all forms of capital income in a coherent way. It achieves comprehensive taxation by integrating taxes at the corporate and the individual levels, ensuring that all income is taxed once and only once. This goal is achieved by taxing investors (and not businesses) on the normal return to capital and taxing businesses only on the risky and super-

Key Highlights

The Challenge

The American system for taxing business income is broken and creates a variety of problems:

- **Distortion of business decisionmaking**, fueled by different tax treatment depending on method of financing, form of organization, and type of physical assets
- **High and rising compliance costs** for increasingly haphazard and unpredictable rules
- **High and rising tax avoidance** through sham transactions, financial engineering, transfer pricing manipulation, and other mechanisms
- **Falling corporate tax revenue** as a share of corporate profits, despite a steady tax rate

A New Approach

The BEIT proposal is consistent with economic principles and business realities.

Comprehensive taxation

- The BEIT integrates taxes at the corporate and individual levels, ensuring that all income is taxed once and only once.
- Investors would be taxed on normal returns to capital and businesses would be taxed only on their risky and supersized returns.

Consistent taxation

- The COCA mechanism allows for consistent taxation of all types of returns, whether normal or risky and regardless of whether cash is distributed.
- Businesses would deduct the normal return to capital and pay tax on remaining income. Investors would pay tax on anticipated normal returns.

Coherent taxation

- The BEIT would replace artificial distinctions in the tax code with rules based on real economic differences.

sized returns. (Kleinbard includes a small incremental tax on investors as well, designed to compensate for some otherwise unavoidable undertaxation of investors in a practical tax system, as well as to address traditional ability-to-pay concerns.) The key mechanism is a “cost of capital allowance” (COCA), described further below, which allows businesses to deduct the normal return to capital as an expense before calculating their tax. This tax integration makes the overall tax burden more consistent across different business organizational forms and different financial structures. Moreover, because individuals pay tax on their COCA income inclusions regardless of when they realize gains, the tax burden does not arbitrarily depend on the timing of realization.

The BEIT also replaces many artificial distinctions in the tax code with rules based on real economic differences. With the basic framework of the current tax system essentially unchanged for ninety years, conventional labels like “debt” and “equity” are increasingly irrelevant in a world where financial innovation has created a large array of derivatives and other financial instruments. The BEIT removes arbitrary tax advantages for particular asset classes, financial instruments, and legal forms of business organization, aiming at what Kleinbard calls a *featureless tax topography*.

These changes in the taxation of business income would greatly reduce the cost of compliance with the tax code and the scope for tax avoidance. They also would have profound effects on the efficiency of business decisionmaking, the fairness of the burden of capital taxation, and the ability of the business tax system to raise the intended revenue. Kleinbard gives the rough estimate that the BEIT could raise the same revenue with significantly lower statutory rates (25 to 28 percent compared to 35 percent today).

Despite the BEIT’s novel design and its jettisoning of many flawed elements of the current tax code, Kleinbard asserts that the BEIT is evolutionary

and charts a feasible way forward. For example, the BEIT's techniques for measuring income and collecting tax are all used in today's tax code and have been vetted through real-world experience.

In addition, the BEIT's allocation of tax liabilities between investors and businesses is roughly analogous to the two levels of tax imposed under current law. In theory, Kleinbard's objectives could be met by imposing tax solely on businesses, or on investors, or by sharing the tax burden in some fashion between them. In practice, however, the BEIT's allocation of tax liabilities serves two important agendas. First, by emulating (in an approximate sense) the current distribution of tax liabilities, Kleinbard mitigates the costs of transition to the BEIT. Second, the BEIT's specific allocation of tax liabilities between investors and businesses is consistent with Kleinbard's goals to tax business income no more and no less than once, and to do so comprehensively and consistently. The BEIT uses to its advantage differences between investor and business level tax bases to optimize the BEIT's measurement and taxation of business income by taxing each base on the component of income that the base is best suited to measure.

How the BEIT Works

The heart of the BEIT is the cost of capital allowance system. This system integrates taxation at the enterprise and individual levels, and it taxes anticipated returns rather than realized returns. The COCA system relies on a COCA rate that should approximate the risk-free return to capital, such as the rate on one-year Treasury notes. Under the BEIT, businesses and individuals would calculate their tax liabilities based on the current COCA rate and their tax basis in capital investments.

The business perspective. Businesses would receive a deduction equal to the COCA rate multiplied by the value of capital invested in the busi-

The proposal replaces many artificial distinctions in the tax code with rules based on real economic differences.

ness, regardless of how that capital is financed. This deduction represents the time-value-of-money portion of the return to capital. Businesses would receive no additional deductions for paying interest or dividends to investors. An important advantage of this approach is the elimination of any tax benefit from depreciating capital more quickly. As capital depreciates, so would the firm's asset base and, correspondingly, its COCA deduction. Businesses would be taxed on their entire income less the COCA deduction. Thus they would be exempt from taxation on normal returns but pay tax on risky and supersized returns.

Because the BEIT would be more systematic than the current tax code, businesses could comply more easily. In addition, because the BEIT has a clear logical structure, businesses would enjoy greater certainty about the tax risks and rewards of initiatives they are considering.

The individual perspective. Individuals who invest in business capital would pay tax on their normal returns, defined as the COCA rate times the value of their investment in the business. (Although novel in this context, this approach is similar to current law's taxation of "original issue discount.") These normal returns, called the "minimum inclusion," would be included in taxable income regardless of whether the investment is profitable and whether the return is realized in cash. Any cash returns—for example, gains from selling shares of stock—would therefore be tax-free up to the level of cumulative minimum inclusions. Cash returns above that level would face

The Business Enterprise Income Tax ensures that all capital income is taxed once and only once.

a small “excess distributions” tax, and cash losses would be deductible from income to the extent of the investor’s cumulative minimum inclusions.

The BEIT would require relatively straightforward calculations and recordkeeping by individual taxpayers, avoiding some of the complexities that have plagued other corporate tax integration proposals. For example, the preceding calculations involve no complicated mark-to-market valuations of illiquid investments and no pass-through of information on corporate income to investors.

Economists distinguish between an income tax (which taxes all income, including capital income and labor income) and a consumption tax (equivalent to a tax on labor income but not on normal returns to capital income). From this perspective Kleinbard’s business-level tax is like a pure consumption tax because it allows businesses to deduct normal returns to capital. But because the BEIT measures and taxes normal returns at the investor level, it captures each of the three components of income (normal returns, risky returns, and super-sized returns) once and only once, achieving the status of an integrated *income* tax.

Other aspects. Kleinbard’s paper offers additional important details that go beyond the BEIT’s mechanics, including the following:

- The BEIT includes rules for “superconsolidation,” through which all subsidiaries, domestic and international, are treated as part of their par-

ent companies for tax purposes. This approach obviates the need for “consolidated return” tax rules that add much complexity to the system today. The approach also reduces problems associated with international transfer pricing by eliminating loopholes that allow companies to exclude “active foreign income” from U.S. taxation.

- The BEIT replaces the complicated reorganization rules in current tax law with a much simpler, tax-neutral system. All acquisitions by businesses of assets or other businesses—including incorporation transactions and entries into and exits from superconsolidated groups—are treated the same as other asset transactions under the COCA scheme. This arrangement has important administrative advantages: it reduces tax-planning opportunities, harmonizes tax rules for all asset transactions, and eliminates complex asset-tracking rules. In addition, by virtue of the BEIT’s unique status as a business enterprise-level consumption tax plus an investor-level income tax, the BEIT neither discourages business acquisitions (as would repeal of current reorganization rules) nor encourages them (as current law does).
- All businesses and investors would benefit from a lower tax rate, greater administrative predictability, and economic neutrality. However, special tax treatment under the BEIT could be warranted for some entities. Kleinbard describes some modifications of the basic BEIT rules that might be appropriate for small businesses, financial institutions, unprofitable companies, and mutual funds.
- Finally, Kleinbard’s paper offers guidance on a feasible transition path from the current tax system to the BEIT. Although the transition would inevitably be somewhat complicated and should not occur overnight, Kleinbard explains that it is less daunting in its administrative and economic

repercussions than the prospect of continuing under the current tax system, or converting to a consumption tax.

CONCLUSION

The current system of taxing business income is outdated, increasingly complex, inefficient, and ineffective at raising revenue. At a fundamental level, the current system does not treat all capital income consistently. Instead it applies different tax rates to assets of different types, financed in different ways, and located in different places, and to parts of enterprises with different organizational forms. As a result, too many decisions by businesses and investors are driven by tax considerations rather than by market risks and opportunities. The transition to a global economy and the emergence of increasingly sophisticated financial instruments have worsened these disparities and increased the distortions to business and investor decisionmaking. Moreover, incremental efforts to modernize the tax system and reduce tax avoidance have added to the massive tangle of complex regulations that invite tax avoidance.

Proponents of a consumption tax often point to these problems and distortions and advocate eliminating all taxes on capital income. However, the BEIT proposal shows that the severe flaws in the current system can be resolved while continuing to tax capital income in a consistent manner that is efficient, fair, reasonably simple, and resistant to tax avoidance. The BEIT provides a viable way forward for the faltering U.S. business tax system.

Learn More About This Proposal

This policy brief is based on The Hamilton Project discussion paper, *Rehabilitating the Business Income Tax*, which was authored by:

EDWARD D. KLEINBARD

Partner, Cleary Gottlieb Steen & Hamilton LLP

Kleinbard is widely recognized as a leading tax lawyer in the United States and regularly publishes on tax matters. He was a visiting lecturer at Yale Law School for the spring semester of 2007 and regularly lectures at New York University, Practising Law Institute and similar conferences.

Additional Hamilton Project Proposals

Additional Hamilton Project discussion papers and policy briefs on tax reform can be found at www.hamiltonproject.org, including:

- **Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment**

This proposal addresses the perverse incentives and potential for abuses created by the current international tax system by using “formulary apportionment” to tax worldwide rather than country-specific income. The goal is to reduce complexity, close loopholes, and either lower corporate tax rates or raise tax revenues.

- **Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax**

Replacing the estate tax with an inheritance tax, with inheritances included in taxable income and taxes paid by the heir, would better reflect taxpayer ability to pay, encourage broader giving, and affect even fewer people than today.

- **Achieving Progressive Tax Reform in an Increasingly Global Economy**

As inequality has widened, the tax system has become less progressive, due to both recent policy changes and the failure to modernize taxation in light of the challenges posed by globalization and financial innovation. This strategy paper offers six principles to guide progressive tax reform in today’s global economy.

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 Hamilton Project Update

A periodic newsletter from The Hamilton Project is available for e-mail delivery. Subscribe at www.hamiltonproject.org.

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.

THE BROOKINGS INSTITUTION

1775 Massachusetts Avenue NW, Washington, DC 20036
info@hamiltonproject.org ■ 202.797.6279

Copyright © 2007 The Brookings Institution

THE HAMILTON PROJECT ADVISORY COUNCIL

GEORGE A. AKERLOF
 Koshland Professor of Economics, University of California, Berkeley
 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

