Rehabilitating the Business Income Tax

The Hamilton Project Discussion Paper

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The Corporate Tax System is Reaching the Crisis Stage

- Unsustainably high nominal rates (35%).
  - U.K. just reduced to 28%.
  - And Germany just dropped to 29.8%.

- Disappearing base.
  - Accelerated depreciation.
  - Mysterious migration of high-value intangibles to Ireland.
  - Uncountable preferences, subsidies and incentives.

- Astounding complexity.

- The result: A complete mess
  - Tax-distorted business decision-making.
  - Misallocation of resources.
  - Significant continuing business tax avoidance problems.
  - Inadequate tax revenues, relative to corporate income.
What Can Be Done?

- *Don’t* think in terms of tax rules for different entities and financial instruments.
- *Do* think in terms of the components of capital income:
  - Normal (time value of money) returns
  - Risky returns
  - Economic rents (supersized returns)
- Tax system must measure each component of capital income accurately and tax it once.
- The Business Enterprise Income Tax (BEIT) does that by:
  - Adopting one set of tax rules for each stage of a business life cycle
    - Choosing the form of a business enterprise.
    - Capitalizing the enterprise.
    - Selling/acquiring business assets or entire business enterprises.
  - Employing a new Cost of Capital (COCA) system for taxing capital returns to
The COCA component is the heart of the BEIT, because COCA is the vehicle for measuring and taxing returns to capital:
- Tax normal (time value of money) returns to investors.
- Tax risky returns and rents to business enterprises.

To an economist, this means that BEIT/COCA functions as:
- An enterprise level consumption tax (because normal returns are excluded); PLUS
- An investor-level add-on income tax on normal returns.

Sum of the components equals a single tax on all capital income.

Resulting base broadening allows for a significant reduction in applicable business tax rates (~ 25% - 28%).
Mechanics of COCA

- A business enterprise deducts each year a uniform Cost of Capital Allowance
  - Allowance = COCA rate (e.g., 1-year Treasuries + 1%) x enterprise’s aggregate tax basis (cost) for all its assets.
  - COCA allowance replaces interest expense deduction.
  - COCA allowance gives equal deduction for debt and equity funding.

- Investors include in income each year a Minimum Inclusion, equal to the COCA rate x an investor’s tax basis in his/her financial investments in a business enterprise.
  - Replaces current law inclusions of interest and divided income
  - Includible even if not received in cash.
  - Cash payments treated as returns of current or prior Minimum Inclusions.
  - Losses reverse prior inclusions.
  - Roughly similar to current law “original issue discount.”
Fundamental Advantages of COCA’s Allocation of Tax Burdens

- Normal returns are taxed where they are easiest to measure.
  - Taxation of normal returns is the essence of an income tax, but is very difficult to accomplish under current law or under other reform proposals.
  - The tax base for measuring normal returns is not distorted by accelerated depreciation, and financial investments turn over more quickly than non-inventory real assets, meaning that investor’s cost basis is closer to fair market value than is firm’s cost basis for its real assets.

- Business enterprises function in an economically-neutral environment.
  - Distorting effects of accelerated depreciation are neutralized.
  - All acquisitions are “taxable,” but there is no net tax cost to “taxable” sales in a *de facto* consumption tax environment.

- Resulting system is roughly analogous to current law’s division of corporate tax, thereby easing transition issues.