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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.
      (All businesses taxed as entities — no more partnership taxation)
    - Capitalizing the enterprise.
      (Same tax rules apply to stock, debt and derivatives)
    - Selling/acquiring business assets or entire business enterprises.
      (No more tax-free acquisitions)
  - Employing a new Cost of Capital (COCA) system for taxing capital returns to

The Cost of Capital Allowance System

- 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.