

Business Taxes Reinvented: A Term Sheet

by Edward D. Kleinbard

Reprinted from *Tax Notes*, August 21, 2017, p. 999

Business Taxes Reinvented: A Term Sheet

by Edward D. Kleinbard



Edward D. Kleinbard

Edward D. Kleinbard is the Robert C. Packard Trustee Chair in Law at the University of Southern California Gould School of Law, a fellow at the Century Foundation, and the author of *We Are Better Than This: How Government Should Spend Our Money* (2014).

In this article, Kleinbard argues that his dual business enterprise income tax, or Dual BEIT, satisfies the objectives of policymakers from both parties for comprehensive business tax reform that can serve as the platform for economic growth while collecting appropriate levels of tax revenue.

Copyright 2017 Edward D. Kleinbard.
All rights reserved.

This short overview and the accompanying term sheet make the case that my proposed dual business enterprise income tax (Dual BEIT) satisfies the objectives of policymakers from both parties for comprehensive business tax reform that can serve as the platform for economic growth while collecting appropriate levels of tax revenue. The arguments are developed further in two papers.¹

The Dual BEIT has three properties that should commend it to policymakers. First, it is truly comprehensive, in that its rules encompass not just net business profits earned by firms (whether incorporated or not) but also the income earned by investors in those firms. The Dual BEIT thus is a consistent and

comprehensive tax system encompassing all forms of capital income, not just business profits. In effect, the Dual BEIT is an integrated business tax system without any of the complex and problematic mechanisms usually employed.

Second, the Dual BEIT is a pro-growth tax system that is mindful of the importance of maintaining a progressive income tax, both to ensure adequate tax revenues and to allocate tax burdens in a way that fairly reflects individuals' ability to pay. The key idea here is that firms get the economic equivalent of expensing all investments. The underlying economics thus are similar to the House blueprint. Firms pay tax on their economic rents — profits above a reasonably expected risk-adjusted marginal investment return (the "normal" return) — at a flat rate of, for example, 25 percent.

At the same time, individual investors must include in income every year the same expected normal return on investment, regardless of whether they receive it in cash from the firm in which they invest. They do so, however, at a flat tax rate (for example, 25 percent) that is the same as the business profits tax rate and lower than the top rate on labor income. Investors generally are not subject to any capital gains tax on gains beyond their expected normal return.

The effective economic burden of a flat rate tax on expected reinvested normal returns that are imposed and collected annually increases over time. The ability to defer consumption indefinitely is an attribute possessed only by the most affluent, so in operation the investor income tax is progressive over the relevant margin of time.

Third, the Dual BEIT uses simple and familiar mechanics. Its cost of capital allowance (COCA) is

¹Edward D. Kleinbard, "Capital Taxation in an Age of Inequality," 90 So. Cal. L. Rev. 593 (2017); and Kleinbard, "The Right Tax at the Right Time," Fla. Tax Rev. (coming).

I. Dual Business Enterprise Income Tax Highlights

- Comprehensive single tax on business capital income, shared between firm and investors
- Unlike swap of VAT for corporate tax, understandable as reform of current principles
 - Visible firm-level tax retained
 - Unlike the House blueprint, transition issues straightforward to manage
- No Border Adjustable Tax
- Identical rules for all forms of business organizations and all forms of investments
 - Small business easily accommodated within overall framework
- Firms taxed only on economic rents (supersized returns) — similar to cash flow tax
 - A “profits-only” tax
 - Mechanism is new “cost of capital allowance” (COCA)
- Profits-only firm tax means marginal investments taxed at zero effective rate
 - Similar economics to the House blueprint
- Investors taxed only on reasonably expected (“normal”) returns,^a no capital gains tax
 - Taxed annually through simple mechanical device regardless of cash received
- Economic rents and normal returns taxed at same capital income rate
 - Impossible to distinguish the two in practice
 - Taxing normal returns annually in fact means a progressive rate over the relevant margin of time
- Minimizes importance of realization principle without using mark-to-market
- Achieves investor-firm integration without baggage of imputation credit schemes, etc.
 - Requires no information coordination between investors and firms
- Fixes normal return tax burden on the least mobile taxpayers — ultimate investors
- Firm’s capital structures unaffected by tax considerations — no “debt bias”
- U.S. investors face same investor-level tax on U.S. and foreign investment
- Foreign investors face no U.S. tax on normal returns from U.S. investments
 - United States becomes a particularly attractive investment climate
 - No WTO or treaty issues
- Profit shifting reduced to a minimum through worldwide consolidation
 - But still “competitive” through moderate profits-only tax structure
 - Foreign tax credit preserved, subject to U.S. base erosion protections
- Mergers and acquisitions are tax free in present-value terms
- Labor/miscellaneous income at progressive marginal rates
- Mechanism for distinguishing labor from capital income in case of participating controlling owners (PCOs) minimizes opportunities to game the system

^aSee Section VI for discussion of technical terms like “normal” returns.

roughly analogous to interest deductions but includes a deduction for equity-financed investment, as well. It does not rely on a border-

adjustable tax or the like. Individuals are taxed under rules drawn directly from current law (for example, the original issue discount rules).

II. Dual BEIT Foundations

- All business enterprises should be taxed identically
 - No reason to distinguish between different legal forms of organization
 - Limit special rules for specific industries to the most exigent cases
 - Same rules should apply to private and publicly traded firms
 - Small business should be accommodated, but they are not the same as passsthroughs
- All investments in business enterprises should be taxed identically
 - Labels like “debt” and “equity” can minimize taxes across cases, having little economic difference
 - Earnings stripping and economic fragility from “debt bias”
 - Pervasive role of tax-exempt sector important but distinct policy issue
 - Investor tax must be coordinated with firm tax to produce one consistent burden on all capital income from business sources
 - Realization principles must be minimized to achieve consistency
- The firm is the best level at which to tax economic rents
 - Easily measured through cash flow tax or COCA mechanism
- The firm is a poor level at which to measure and tax normal returns
 - Would require depreciation rules mirroring economic depreciation, and accurately capitalizing and amortizing investments in intangible assets of all stripes
 - The latter in particular is virtually impossible in practice
- Normal returns on business investment *can* be measured and taxed annually to investors
 - Taxable return = *expected* risk-adjusted normal return + eventual true-up
 - Mechanism must not rely on annual mark-to-market because that introduces major economic distortions in the decision when to take a firm public
- Normal returns to business enterprises are risk-adjusted normal returns
 - Risk-free rate not relevant to firm decision-making
- A flat rate firm-level tax on rents is consistent with theory for taxing returns to risk
 - Often impossible to distinguish firm rents from normal returns from returns to risk
- A flat rate investor tax on normal returns is progressive in practice
 - Taxing normal returns annually is progressive over the relevant margin of time
 - Doing so at the same rate as COCA deduction creates a useful political economy tension
- Taxing business capital income at lower rate than labor income is useful compromise
 - Reflects differing elasticities and political economy of “competitiveness”
 - But requires labor-capital income centrifuge to distinguish the two in hands of owner-entrepreneur

III. Dual Business Enterprise Term Sheet

The term sheet that follows summarize the mechanics of the Dual BEIT in sufficient detail to enable policymakers and analysts to understand

its operation and to determine for themselves its feasibility.²

² When in conflict, the Term Sheets’ specifications supersede those in “The Right Tax at the Right Time,” posted online. *Supra* note 1. Developments include the treatment of derivatives, rents and royalties, and PCOs. The published version of that article will be revised to reflect this term sheet.

Revisions since the first posting of that article primarily relate to:

1. significant refinements to the taxation of PCOs to better coordinate sales and distributions and to better ensure that returns to a PCO’s actual capital investment are treated consistently with capital invested by a passive investor;
2. suggestions for an optional entrepreneurship allowance, to reflect policymakers’ preferences for lower tax rates on entrepreneurs or small business; and
3. transition rules.

A. Business Enterprise Tax

Covered Taxpayers	<ul style="list-style-type: none"> • All U.S. business enterprises except microfirms; special modifications financial institutions • See “International Tax Considerations” for definition of U.S. enterprise
Design of Tax	<ul style="list-style-type: none"> • Flat rate annual tax on economic rents through capital account allowance mechanism
Tentative Tax Rate (illustrative)	<ul style="list-style-type: none"> • 25 percent
Tax Base	<ul style="list-style-type: none"> • Worldwide superconsolidation — see below • Interest deduction replaced by COCA deduction covering debt and equity • Rents + royalties are generally deductible; special antiabuse rules for insiders • Depreciation deductions continue • Net operating losses compound at COCA rate
Cost of Capital Allowance (COCA)	<ul style="list-style-type: none"> • Excludes from tax base the economy-wide average risk-adjusted normal rate of return • Deduction = statutory formula rate * adjusted basis (cost) of assets • <i>E.g.</i>, one-year T-bills + 300 basis points, applied to firm’s business capital • Preferences for small business (<i>e.g.</i>, higher COCA rate on first \$X million of capital) • One COCA rate for all industries
Superconsolidation	<ul style="list-style-type: none"> • Group defined as 50.01 percent ownership • Treat group as single taxpayer • Applies to worldwide subsidiaries; losses anywhere offset gains anywhere in group • Stock basis in subsidiaries ignored — see below • No need for intercompany transaction rules
Asset Sale Rules	<ul style="list-style-type: none"> • Repeals all tax-free reorganization rules: seller tax on asset sales = PV of Buyer’s future COCA/depreciation deductions • Purchase of stock of subsidiary = sale/purchase of subsidiary’s assets

B. Investor Taxation (General)

Covered Taxpayers	<ul style="list-style-type: none"> • All U.S. investors in business enterprises • Applies to investments in all public or private firms, whether U.S. or foreign
Investor Income Tax	<ul style="list-style-type: none"> • Tax rate * Includible Amounts
Tentative Tax Rate (illustrative)	<ul style="list-style-type: none"> • 25 percent

Includible Amounts	<ul style="list-style-type: none"> • Goal is to include average risk-adjusted normal rate of return in investor tax base • Includible Amounts = COCA allowance * investor's adjusted tax basis in business enterprise investments • Starting tax basis — purchase price or, for a gift or bequest, FMV • OID principles apply; Includible Amounts > cash distribution = more basis • Cash distributions not taxed, reduce basis
Investor Gains and Losses	<ul style="list-style-type: none"> • Gains not taxed: Rollover of sales proceeds to new investment of course resets basis at FMV • On realization basis, loss deduction (at Dual BEIT rate), up to amount of prior Includible Amounts • Loss rule constitutionally required • Excess losses ignored (like gains) • Broader sales rules required to prevent one-way downward mark-to-market • Mark-to-market on death
Business Enterprise Portfolio Investment in Another Business Enterprise	<ul style="list-style-type: none"> • Business enterprise treated as investor but gets COCA deduction for capital invested in that portfolio investment
Investments in Government Securities, Bank Deposits, and Securitized Mortgages	<ul style="list-style-type: none"> • Dual BEIT rate but on current law basis (including capital gain at Dual BEIT rate)
Nonbusiness Loans to Individuals, etc.	<ul style="list-style-type: none"> • Labor/miscellaneous income rates on current law basis (including capital gain)
Gains From Collectibles (section 408(m)), Precious Metals, Homes, etc.	<ul style="list-style-type: none"> • Ordinary income rates on current law basis (including capital gain)
Derivatives	<ul style="list-style-type: none"> • See "Special Industries and Circumstances"
Owner/Entrepreneur Overlap	<ul style="list-style-type: none"> • See "Participating Controlling Owners" in Section C
Tax-Exempt Institutions	<ul style="list-style-type: none"> • Should be taxed on Includible Amounts, but admittedly unlikely • Compromise at discounted rate of 12.5 percent? • Derivatives activity other than investment hedges = unrelated business taxable income

C. Labor-Capital Income Centrifuge — Overview

Participating Controlling Owner (PCO)	<ul style="list-style-type: none"> • PCO = "material participant" (section 469) in the management of a firm who owns at least 5 percent of the firm, and when ≥ 50 percent of the enterprise is owned by five or fewer such material participants (section 542) • Constructive ownership rules apply
--	--

Salaries Paid to PCO	<ul style="list-style-type: none"> • Deductible by firm, includible in PCO's income under labor income progressive rate schedule • Self-help through salary preserves progressive labor tax rates from reach of excess distributions tax
Rents + Royalties Received by PCO	<ul style="list-style-type: none"> • Treated as labor income; gain realized on transfer also treated as additional labor income
Centrifuge Overview	<ul style="list-style-type: none"> • PCO's returns on capital invested in firm = deemed labor returns to the extent they exceed 3x the PCO's Includible Amounts, but taxed in two different ways • Deemed labor returns attributable to current firm earnings treated in present-value terms as if distributed as salary in current year, and aggregate tax = maximum labor rate • Deemed labor returns to PCO not (yet) reflected in firm profits (for example, from sale of firm) taxed in aggregate at capital tax rate <ul style="list-style-type: none"> • A concession to political economy preference for entrepreneurship • 1x Includible Amounts treated as taxable capital income, like any other investment • 2x treated as extraordinary (tax-free) returns on capital • Remainder taxed as deemed labor returns, as above • Ties tax-free returns on capital to amount of capital actually invested, not to share of firm capital or income • PCO's great idea requiring no capital = labor income taxed at split rate based on whether realized yet at firm level • And PCO's great idea requiring large investment by PCO split into pure capital and labor components first
Timing of Deemed Labor Returns and Tax Rates Thereon	<ul style="list-style-type: none"> • To extent reflected in share of current-year firm after-tax profits, taxed to PCO in present-value terms in current year through "Basis Bump" and Includible Amounts thereon (function as interest charge) <ul style="list-style-type: none"> • Tax rate in aggregate = labor income tax rate • In other cases, as realized by PCO <ul style="list-style-type: none"> • Aggregate tax rate = capital income tax rate (ignoring any possible future firm tax on business profits)

D. Labor-Capital Income Centrifuge – Mechanics I

PCO Extraordinary Capital Return Account	<ul style="list-style-type: none"> • PCO Extraordinary Capital Return Account = notional account to which is added each year ($2 \times$ PCO's Includible Amount on actual capital invested in firm), less PCO's share of firm's net investment income • Firm NII carveout addresses gratuitous capital stuffing • Account accumulates and is credited with COCA rate on outstanding balance • COCA credit not treated as taxable income to PCO
---	--

PCO Basis Bump Account (Undistributed After-Tax Profits)	<ul style="list-style-type: none"> • PCO Basis Bump Account = notional account to which is added each year (specified fraction * PCO's share of firm's after-tax income for year), less 3x PCO's Includible Amount for year • Basis Bump Account accumulates and earns <i>taxable</i> COCA rate, like actual capital investment • Specified fraction = $(LT - CT) / [CT \times (1 - CT)]$, where LT and CT are the maximum labor tax and capital tax rates, respectively; stays constant unless rates change; coordinates firm and excess distributions tax so that sum equals maximum labor tax rate • PCO's share of firm's after-tax income determined by actual and constructive ownership • Taxable Includible Amounts on Basis Bump = interest charge on deferred distributions to PCO out of current firm after-tax income not credited as returns to capital
Allocations of Distributions From Firm to PCO (Distribution Waterfall)	<ul style="list-style-type: none"> • Distributions from firm to PCO (including stock repurchases) are allocable to (and reduce) PCO's accounts in following order: <ul style="list-style-type: none"> • current + accumulated Includible Amounts • actual capital (basis) invested in firm • PCO Extraordinary Capital Return Account • Basis Bump Account • Additional Returns • Additional Returns = remaining distributions
Excess Distributions Tax	<ul style="list-style-type: none"> • Excess Distributions from firm to PCO (including stock repurchases) taxed to PCO at <i>capital</i> tax rate • Excess Distributions = distributions that reduce PCO Basis Bump account + Additional Returns • Excess Distribution aggregate tax on distributions attributable to PCO basis bump account + firm tax = tax at maximum <i>labor</i> tax rate

E. Labor-Capital Income Centrifuge – Mechanics II

Sales and Other Dispositions by PCO	<ul style="list-style-type: none"> • PCO's gain on sale determined without regard to Basis Bump • PCO's gain treated as deemed distribution from firm • Triggering Distribution Waterfall • Excess Distributions tax triggered on deemed distribution of Basis Bump + Additional Returns • Gain attributable to extraordinary capital return account remains tax free
Additional Basis Bump (Optional)	<ul style="list-style-type: none"> • Extra Basis Bump for PCOs on multiple rounds of private equity financings and on initial public offerings at new price • Would essentially crystallize as labor income taxed at labor rates capitalized value of firm at that time

Summary: PCO Tax Regime in Absence of Special Rules	<ul style="list-style-type: none"> • PCO taxed (1) as any other investor for actual capital invested in firm, up to 3x Includible Amounts; then (2) to extent firm has earned income, at maximum labor income rate, in present-value terms in year earned by firm (through Includible Amounts on Basis Bump); then (3) at capital rates to extent returns not reflected (yet) in firm income • PCO undertaxed relative to explicit labor income to extent PCO's returns exceed 3x Includible Amounts but are not (yet) attributable to after-tax firm income, so some subsidy contemplated • Again, PCO will use self-help through salary payments to preserve progressive labor tax rate on lower income brackets • Deemed salary-reinvestment election possible here
---	--

F. Small Business and Entrepreneurs

Optional Entrepreneurship Allowance	<ul style="list-style-type: none"> • If desired, entrepreneurship can be explicitly subsidized further through lower tax rate on first \$X of Excess Distributions to a PCO (including deemed Excess Distributions on sale) • Should be capped at some reasonable amount • Reflects common belief that entrepreneurship should be subsidized through the tax system and limits that subsidy to actual entrepreneurs (PCOs)
Small Business	<ul style="list-style-type: none"> • As previously noted, small business would receive higher COCA allowance on first \$X of capital • This creates explicit subsidy because investor tax base on Includible Amounts not affected

G. Labor Income; Tax Base Patches

Covered Taxpayers	<ul style="list-style-type: none"> • U.S. individuals, as under current law
Tax Structure and Rates	<ul style="list-style-type: none"> • Progressive rate structure on income other than capital income • Tentative top rate = 40 percent to 45 percent • Retain "making work pay" credits (earned income tax credit, etc.)
Tax Base	<ul style="list-style-type: none"> • Cleaned-up current law • Cap retirement plans at, for example, \$3 million • Eliminate (1) personal itemized deductions (or turn into credit at 15 percent rate), (2) exclusion for employer-sponsored insurance (as part of health reform)

H. International Tax Considerations

International Tax Design	<ul style="list-style-type: none"> • Worldwide, residence-based profits tax
U.S. Enterprises	<ul style="list-style-type: none"> • Taxed on consolidated worldwide income, including all subsidiaries, wherever located • U.S enterprise defined by mind and management as well as place of incorporation (Doggett bills) • New rebuttable presumption that a firm using the U.S. dollar as its functional currency and with some management presence in United States is a U.S. firm

Foreign Tax Credit for U.S. Enterprises	<ul style="list-style-type: none"> • FTC for foreign income or profits taxes on superconsolidated group, subject to section 904(d)-type limitation • Limitation = [(foreign BEIT tax base)/(firm's worldwide BEIT tax base)] * tentative U.S. tax • Limitation applied on country-by-country basis • Allows limited crediting of foreign tax on normal returns against tentative U.S. tax on those foreign returns • Protects U.S. tax base on U.S. income
Foreign BEIT Tax Base	<ul style="list-style-type: none"> • Determined using U.S. BEIT principles • Applies COCA deduction to the firm's basis in foreign business assets; no local interest deduction
Earnings Stripping	<ul style="list-style-type: none"> • Disallow rent and royalty payments to related parties (other than PCOs) not already eliminated in superconsolidation
U.S. Investors in Foreign Enterprises	<ul style="list-style-type: none"> • Includible Amounts operate identically to an investment in a U.S. firm • Direct FTC available
Foreign Investors in U.S. Enterprises	<ul style="list-style-type: none"> • No U.S. tax on normal returns, distributions, or capital gains; no effect on firm's COCA deduction

I. Special Industries and Circumstances

Financial Services Firms	<ul style="list-style-type: none"> • Mark-to-market system for both financial assets and financial liabilities • COCA deduction on firm's net tax basis in nonfinancial assets, plus positive mark-to-market value of its financial assets, net of liabilities • MTM acceptable here because firms already perform this for internal and financial accounting purposes
Derivatives Used by Business Enterprises in Ordinary Course of Business	<ul style="list-style-type: none"> • Three-tier priority rules • Tier 1: hedge accounting <ul style="list-style-type: none"> • Liability hedges folded into liabilities; no immediate tax consequences; gains/losses ultimately increase/reduce assets • Gains/losses on inventory asset hedges under same timing rules as inventories hedged • Tier 2: Mark-to-market system for professional dealers and traders in derivatives or underlyings <ul style="list-style-type: none"> • Net gain or loss in tax base • Net asset value attracts COCA deduction • Tier 3: Other uses taxed under new asset/liability model <ul style="list-style-type: none"> • Outflows = reduction in liability, if any, then investments in contract (attract Includible Amounts and offsetting COCA deduction) • Inflows = recovery of basis in contract, if any, then liability
Derivatives Outside Business Use (Including Investors)	<ul style="list-style-type: none"> • Tier 1: Hedges of investment assets <ul style="list-style-type: none"> • Gain/loss adjusts basis in asset • Tier 2: Asset/Liability model <ul style="list-style-type: none"> • As above, but no offsetting COCA deduction for investment in contract • Delta 1 contracts treated as investment in underlying asset
Other Special Rules	<ul style="list-style-type: none"> • Borrowing secured by investment when borrowing > basis resets that basis to amount borrowed • Expanded Wash sale rule to prevent one-way mark-to-market

J. Transition

Firm-Level Non-COCA Rules (for example, superconsolidation)	<ul style="list-style-type: none"> • On enactment
Existing International, Permanently Reinvested Earnings	<ul style="list-style-type: none"> • Taxable on enactment at 20 percent (with prorated FTC) • Tax payable over five years without interest charge
Firm-Level COCA Allowance	<ul style="list-style-type: none"> • Over eight-year post-enactment transition period, deduction is weighted average of old-law interest deduction and new COCA deduction. Example: <ul style="list-style-type: none"> • Year 1 deduction: 100 percent old-law interest deduction • Year 2: (87.5 percent * old-law interest deduction) + (12.5 percent * COCA allowance) • Year 3: (75 percent * old-law interest deduction) + (25 percent * COCA allowance) • Etc. • Old-law interest deduction capped at net interest expense on date of enactment (no post-enactment padding of old-law interest deduction) • Election to accelerate adoption of full COCA system
Investor Taxation	<ul style="list-style-type: none"> • Years beginning after date of enactment will be subject to Includible Amounts system • One-time mark-to-market on date of enactment for purposes of establishing baseline cost for Includible Amount calculations • Mark-to-market is always imperfect, but: <ul style="list-style-type: none"> • Once-a-century reset, not an annual distinction between traded and non-traded properties; • required of all assets today when estate tax applies; • as assets turn over, imperfections in original mark-to-market wash out; and • Same rule as that adopted on introduction of the income tax in 1913 (section 1053)

IV. Dual Business Enterprise Income Tax Example

A. Worldwide Sprockets Balance Sheet

Dual Business Enterprise Income Tax Example Worldwide Sprockets Balance Sheet

Assets		Liabilities	
Current assets		Current liabilities	
Cash	\$100.00	Accounts payable	
Accounts receivable	\$200.00	Short-term notes	
		Current portion of long-term notes	
Inventory	\$300.00	Interest payable	
		Taxes payable	
		Accrued payroll	
Total current assets	<u>\$600.00</u>	Total current liabilities	<u>\$750.00</u>
Fixed assets		Fixed liabilities	
Land	\$200.00	Mortgage	
Buildings (less accumulated depreciation)	\$1,000.00	Other long-term liabilities	\$750.00
		Total long-term liabilities	<u>\$750.00</u>
Plant and equipment (less accumulated depreciation)	\$800.00	Shareholders' equity	
Furniture and fixtures (less accumulated depreciation)	<u>\$400.00</u>	Capital stock	\$500.00
Total net fixed assets	<u>\$2,400.00</u>	Retained earnings	<u>\$1,000.00</u>
		Total shareholders' equity	<u>\$1,500.00</u>
Total assets	<u><u>\$3,000.00</u></u>	Total liabilities	<u><u>\$3,000.00</u></u>

Assume COCA rate = 8 percent

Investors A and B each own 10 percent of the stock of WWS. Investor A has tax basis of \$200 in her investment; Investor B recently bought more, and has a \$400 tax basis in his investment; Investor C has made long-term loan to WWS of \$750, which bears interest at 6% per annum.

WWS calculates its COCA deduction by looking to the sum of its adjusted tax bases in its assets (generally, cost less accumulated depreciation). Because balance sheets balance, this equals sum of debt and equity invested in WWS. WWS claims tax depreciation, plus a COCA deduction of \$240 [8% * total adjusted basis in assets of \$3,000]. WWS does not deduct interest expense.

Investor A includes \$16 in income (8% COCA rate * her basis in her stock investment).

Investor B includes \$32 in income (8% COCA rate * his basis in his stock investment).

Investor C includes \$60 in income (8% COCA rate * his basis in his loan investment in WWS).

WWS pays \$45 to Investor C as interest (6% interest rate) and distributes dividends totaling \$100 to shareholders (\$10 to each of investors A and B).

Investor A's tax basis goes up by \$16 income inclusion, down by \$10 dividend, = \$206 basis at start of next year. If A reinvests her \$10 dividend, that attracts future income inclusion.

Investor B's tax basis goes up by \$32 income inclusion, down by \$10 dividend, = \$422 basis.

Investor C's tax basis goes up by \$60 income inclusion, down by \$45 interest paid, = \$765 basis.

V. High-Level Comparisons

A. House Blueprint

- Blueprint was a cash flow tax for all business firms (with exceptions for some assets)
 - Similar to Dual BEIT in economics here — zero percent tax on marginal investments
- But Blueprint illogically offered discounted all-in tax rate to unincorporated firms
 - Confused small businesses with unincorporated businesses
 - Dual BEIT applies same rules to all business firms, while recognizing small business needs
- Blueprint taxes dividends and capital gains to individuals at one-half ordinary rates
 - No explicit coordination or integration with firm taxation
 - Increased effective tax rate on rents, at price of severe lock-in problems
 - Imposed inconsistent tax on normal returns, depending on distributions and sales
 - Dual BEIT taxes normal (reasonably expected) returns at same tax rate as firms, no tax on capital gains. Tax imposed at consistent rate regardless of distributions or sales
- Blueprint introduced novel destination-based international tax system (since walked back)
 - With (now-abandoned) border-adjustable tax
- Substantially vitiated transfer pricing abuses by U.S. and foreign firms
 - Made residence of firm irrelevant for U.S. tax purposes
 - Made U.S. a zero-tax environment for foreign firms to site production for reimportation to their home countries
 - Border-adjustable tax scored as \$1 trillion revenue pick-up inside the budget window
 - A bit of an accounting trick, but nonetheless real for budget purposes
 - Border-adjustable tax was highly controversial
 - Confusion over whether foreign exchange rates would fully adjust
 - Multitrillion-dollar wealth loss to U.S. investors if foreign exchange rates did adjust
 - Probable WTO violations
 - Probable foreign jurisdiction strategic responses
- Dual BEIT also vitiated abuses by firms
 - For U.S. firms, relies on true worldwide superconsolidation
 - Requires defining what is a “U.S.” company (see Term Sheet)
 - But not “uncompetitive”; tax is profits-only tax, and FTCs are available
 - No systematic foreign exchange rate effects
 - So no “import tax” fears or systematic wealth transfers from the United States
 - No WTO issues
- Blueprint poses difficult transition issues for economy, regardless of border-adjustable tax

B. Toder-Viard Proposal

- The Toder-Viard proposal adopts radically different regimes for publicly traded and closely held firms
 - Dual BEIT points in opposite direction: Forms of accessing capital should not change tax environment; address genuine small business as such
- Public firms face low-rate (15 percent) income (not profits) tax and shareholder mark-to-market
 - Public firm shareholders face ordinary tax rates on dividends
 - With imputation credits for underlying corporate tax paid
 - Imputation credit systems have been largely rejected in other countries as susceptible to abuse (dividend washing)
 - Public firm shareholders face full mark-to-market annual tax at ordinary rates
 - With very complex “smoothing” rules to mitigate market volatility
 - Smoothed mark-to-market losses deductible against labor income
 - Interest deductible to firm and fully includible to investors
 - Earnings stripping constraints?
 - Debt bias redoubled by shareholder mark-to-market?
 - Goal seems to be taxation of capital income at same rate as labor income
 - And favorable environment for foreign investment in the United States by moving most tax to U.S. investor level
 - Dual BEIT similar here, in offering profits-only tax to foreign investors
 - But Dual BEIT designed to tax capital income at lower rate
- All “closely-held” firms taxed as partnerships
 - Definition not related to size, so very large private firms taxed as private
 - Definition seems underdeveloped relative to modern venture capital/private equity financing
 - Uber: About \$11.5 billion in capital from 14 rounds of venture capital and private equity investors
 - Initial public offering: Capital gains tax on all shareholders, including on retained shares
 - Special discounted tax rate on this one-time mark-to-market (25 percent of ordinary rate)
 - Notwithstanding discounted rate, will have profound effect on decision to go public
 - Dual BEIT makes no important distinctions between public and private firms
- Toder-Viard international rules same as current law
 - Relies on low corporate rate to mitigate lockout/deferral issues
 - And base erosion
 - But many U.S. firms today have single-digit foreign effective tax rates
 - Shareholder mark-to-market applies to investments in foreign companies, too

VI. The Components of Capital Income

The conceptual analysis of capital income is inherently complex, made more so by some technical vocabulary and by different meanings attaching to the same words. It nonetheless is important to have some familiarity with the issues, to avoid being confused by labels, and to be able to compare different proposals fairly.

Capital income includes, by way of example, interest and dividend income, property rental income, royalties, capital gains, and (to an economist) the imputed rental income of owner-occupied housing. Capital income also includes most net business income. Firms bring both labor and capital to bear in generating net income; at least in the case of publicly held corporations, however, the labor component is fully compensated and deducted from the business tax base. As a result, the remaining business tax base contains only capital income.

Very generally, economists divide capital income into three parts: normal returns, risky returns, and rents.³ To an economist, all capital earns at least a normal return. Normal returns are often (incompletely) explained as the pure return to waiting, or time-value-of-money returns. These represent the core risk-free return from postponing consumption of one's wealth. Investing in a Treasury bond is as close to a pure risk-free return as one is likely to find.

As used in the above sense, "normal" returns mean risk-free returns. But in the business context, this is too narrow a construct. The more relevant concept is that of risk-adjusted normal returns. The idea here is to capture the market-clearing *anticipated* yield for generally available investments of a given risk profile. If treasuries yield 5 percent, and BBB-rated bonds yield 8 percent, both are normal returns in their respective risk classes.⁴

The tax law and business people use the term "profits" to mean business revenues minus expenses. Economists, by contrast, use it to mean capital income above and beyond normal returns.

For reasons summarized in "Capital Taxation in an Age of Inequality," economists analyze a tax system that permits the expensing of investments by firms as exempting the firm's normal returns from tax. The resulting tax base can be called a profits-only tax base. Consumption taxes like a VAT or retail sales tax are examples of profits-only taxes because all capital inputs are expensed.

The second component of capital income in the standard analysis is risky returns, the higher returns that one expects to obtain as compensation for accepting the risk of uncertain rewards. Looking prospectively, risky returns are measured by the risk premium associated with an investment, as reflected in its expected return less the risk-free normal return. (In the example of BBB-rated bonds just given, the risk premium is 3 percent.) What this means is that viewed prospectively, risky returns often are better described as risk-adjusted normal returns. Actual after-the-fact (ex post) risky returns, of course, will vary considerably from this expected return and often will be negative. Tax systems generally look backward rather than forward to measure tax liability, so one of the great challenges in tax system design is how to relate actual risky outcomes with their prospective (ex ante) expected returns.

Finally, taxpayers also can earn economic rents or inframarginal returns — the supersized returns that come from a unique and exclusive market position or asset, such as a valuable patent or trade name. Rental income from renting an undeveloped lot for use as a parking lot typically would represent a normal return on one's capital; economic rents, by contrast, are jumbo returns that are not attributable simply to taking on large amounts of risk.

Economists all agree that in theory, economic rents can bear a relatively high tax rate without distorting taxpayer behavior. The reason is simple: Even after tax, a sure-thing supersized return is more attractive than other investment alternatives. Economists also agree that in an imaginary "ideal" income tax, after-the-fact (ex post) risky returns are not taxed at all. The theory again is simple. Think of risky returns as bets against known odds. If an income tax is suddenly imposed, a taxpayer can just scale up her bet to leave her with the same after-tax outcomes as would apply in a world without taxes.

³ Kleinbard, "Capital Taxation," *supra* note 1, at 602-610.

⁴ The Dual BEIT papers, *supra* note 1, use the term "normal returns" to mean risk-adjusted normal returns. Kleinbard, "The Right Tax," *supra* note 1, at Part IV.

But the requirements for such an ideal tax are rigorous: Among other conditions, risky returns must be taxed at a flat rate (so scaling up produces the same outcomes in all cases), and the government must offer immediate refunds to unlucky taxpayers who lose money on their risky investments.

The theoretical controversy surrounds the wisdom of taxing normal returns. I summarize the issues in “Capital Taxation in an Age of Inequality” and explain why taxing normal returns is consistent with modern theory, and why doing so is a necessary component of responding to accelerating income and wealth inequality. The article further argues that taxing normal returns (that is, ex ante risk-adjusted returns) through a flat tax is sensible. First, doing so preserves the symmetry necessary to tax after-the-fact (ex post) risky returns accurately. Second, because the Dual BEIT measures and collects tax on anticipated (ex ante) normal returns every year at the investor level, the tax burden as a share of total returns increases the longer an investment is held. This is why I describe the Dual BEIT’s investor taxation as progressive along the relevant margin of time.

The Dual BEIT imposes a profits-only tax on firms at the same flat rate.⁵ Basically, theory is all very nice, but it turns out to be impossible in practice to distinguish among risk-adjusted normal returns, ex-post returns to risk, and true economic rents. The Dual BEIT opts in favor of a simple system that is neutral regarding risk (by virtue of the flat rate and a time-value-of-money annual uplift to net operating losses), and that is highly competitive by world norms (because firms do not pay tax on their normal returns), at the cost of leaving on the table some theoretical additional tax on economic rents (were they identifiable incrementally from “risky” returns).

In sum, the Dual BEIT imposes a profits-only tax on firms and a tax on anticipated risk-adjusted normal returns to investors, all at the same tax rate and using the same method to measure normal returns (to exclude them from the firm’s tax base and include them in investors’). The result is a single tax on all of capital income. ■

⁵ See Kleinbard, “Capital Taxation,” *supra* note 1, at Part V.

taxnotes®

Worldwide Tax Treaties



The world of tax is constantly changing.

Stay current with the most comprehensive treaty coverage, including more than 12,200 treaties.

Worldwide Tax Treaties is the only source to include treaties, protocols, and integrated links to related developments and legislative history, as well as the full version of the latest OECD model convention and commentary.

taxnotes.com/treaties

Be ready for what happens next.