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THE RIGHT TAX AT THE RIGHT TIME

by

Edward D. Kleinbard*

ABSTRACT

The companion paper to this (Capital Taxation in an Age of Inequality) argues that a moderate flat rate (proportional) income tax on capital, measured and collected annually, has attractive theoretical and political economy properties that can be harnessed in actual tax instrument design. This Article continues the analysis by specifying in detail how such a tax might be designed.

The idea of the Dual Business Enterprise Income Tax, or Dual BEIT, is to offer business enterprises a neutral profits tax environment in which to operate. To do so, normal returns to capital are exempt from tax by means of an annual capital account allowance, termed the Cost of Capital Allowance (COCA). In turn, investors in firms include in income each year the same COCA rate, applied to their respective tax bases in their investments. The result is a single tax on capital income (rents plus normal returns), where the tax on normal returns is imposed directly on the least mobile class of taxpayers. Labor income continues to be taxed at progressive tax rates.

This Article develops in detail the design of the Dual BEIT, at a level of specificity that permits readers to judge the real-world

* I thank my research assistant, James Lyon, and the many professional colleagues who have offered suggestions with respect to this Article. These include Rosanne Altshuler, Alan Auerbach, Joseph Bankman, Kimberly Clausing, Patrick Driessen, Michael Devereux, Mark Gergen, Daniel Hemel, Emmanuel Saez, Daniel Shaviro, and Gabriel Zucman, as well as participants at several workshops and presentations. I alone am responsible for the inevitable errors that remain.

plausibility of the proposal.[†] In doing so, the Article focuses particularly closely on three design issues. First, because labor is taxed at progressive rates and the top rate exceeds the capital income tax rate, the Dual BEIT must specify a labor-capital income tax centrifuge to tease apart labor from capital income when the two are intertwined in respect of the owner-entrepreneur of a closely held firm. Second, the Article considers the theory and practice behind the choice of the COCA rate: that is, the Article inquires into just what should be meant by a “normal” return to capital. Third, the Article specifies an international tax regime that should be attractive to firm managers yet robust to stateless income gaming.

Throughout, the emphasis is on developing pragmatic technical solutions that are implementable without profound transition issues, that are administrable, and that fairly balance theoretical desiderata against political economy realities.

Note: This Article was prepared prior to the consideration by Congress in late 2017 of the Tax Cuts and Jobs Act (TCJA). The Article therefore does not address any of the provisions of that legislation. In general, however, the TCJA can be summarized as a useful example of capital income tax reform done exceedingly badly.

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[†] The proposals made in this Article conform to those outlined in Edward D. Kleinbard, *Business Taxes Reinvented: A Term Sheet*, 156 TAX NOTES 999 (Aug. 21, 2017).

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I. INTRODUCTION

A. From Theory to Practice

A companion paper (*Capital Taxation in an Age of Inequality*¹) argues that a relatively low flat rate tax on business capital income, measured and collected annually, is a desirable instrument for U.S. federal fiscal policy, and in practical application dominates progressive consumption tax proposals. Economic theory does not proscribe taxing capital income, once real-world considerations like the importance of gratuitous transfers of capital are considered. Further, political economy considerations strongly support using a well-designed capital income tax as an important constituent fiscal policy instrument, both to raise substantial revenues and as a targeted inequality remediation device.

Capital Taxation in an Age of Inequality explains the desirability of imposing a flat rate tax on all instances of business capital income, measured and collected annually. As a proportional tax, a flat rate capital income tax applies at the same marginal and effective rates to both

1. Edward D. Kleinbard, *Capital Taxation in an Age of Inequality*, 90 S. CAL. L. REV. 593 (2017) [hereinafter, Kleinbard, *Capital Taxation*].

ex post income and ex post losses, thereby preserving the symmetry on which rests the theoretical analysis of returns to risk. This is an essential feature if the resulting tax is not to distort ex ante investment decisions. In particular, the theory of why a cash flow tax operates to exempt normal returns from tax is that the expensing of investment makes the government an undivided proportional co-investor in that investment: a progressive tax structure destroys that neutral co-investment ex post and therefore burdens investment decisions ex ante.

As a political economy matter, a flat rate capital income tax measured and collected annually operates as a progressive tax in application: because only high-ability taxpayers or those who are the beneficiaries of gratuitous transfers can afford indefinite deferral of consumption, the increasing “tax wedge” on savings over time introduces a measure of top bracket progressivity along the margin of time. In other words, what many economists view as the fatal flaw of capital income taxation (the increasing tax wedge over time) in fact is a feature, not a bug. A low flat capital income rate actually imposed annually may thus offer some efficiency gains when compared with an “ideal” progressive consumption tax strawman, while still being progressive in fact.

An annual capital income tax fits with American Constitutional constraints that would bedevil an annual wealth tax. Further, it is more robust to legislative panic (or pandering) in the face of recessions or other developments than is any system (including the estate tax) that relies on collecting tax decades in arrears. The 2004 tax holiday for “repatriating” offshore, low-taxed earnings held by foreign subsidiaries of U.S. multinational firms demonstrates the fragility of any taxing scheme that allows inchoate tax liabilities to accrue over an extended time period;² like a reservoir behind a dam, all those contingent tax revenues can be flooded away in a single breach of the system.

While the case for a higher tax rate on economic rents is easy to make in theory, *Capital Taxation in an Age of Inequality* demonstrates that it is difficult to implement in practice, particularly when one remembers that firms and investors in those firms make investment decisions at different points in time. For example, a firm might capture economic rents through the extension of its market-dominant core intangibles, but

2. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422(a), 118 Stat. 1418, 1514–19 (codified at I.R.C. § 965 (2004)).

to a late-arriving investor in the firm's stock, those firm-level rents would be priced as normal returns.³

The corporate income tax today is a flat rate tax in practice.⁴ A flat rate tax on business capital income therefore operates as an incremental extension of current tax policies and, thus, minimizes transition issues and dislocations to asset prices. By taxing all business capital income in whatever form derived (that is, regardless of entity type, form of financing, or nature of industry) in a consistent manner, such a tax also minimizes allocative distortions resulting from current law's uneven application of capital taxation.

Finally, there is no reason, beyond pure coincidence, why an ideal income tax should burden labor income and capital income under an identical rate schedule.⁵ The elasticities of labor and capital taxable income, and the elasticities of real labor and capital supply in the face

3. Kleinbard, *Capital Taxation*, *supra* note 1, at 675–77.

4. I.R.C. § 11 (2017). The nominal graduated rate structure laid out in § 11(b)(1) is rendered nugatory in practice by the recapture of any benefits, as laid out in the flush language at the end of that paragraph.

5. Expanding on this point, it also can be said that there is no reason why normal returns to capital and economic rents should be taxed at the same rate. To the contrary, standard economic logic would point to a higher rate on economic rents—arguably, a rate even higher than top labor tax rates. Further, recent research supports the claim that the importance of economic rents is increasing in the modern economy. *See, e.g.*, Robin Boadway, *Tax Policy for a Rent-Rich Economy*, 41 CANADIAN PUB. POL'Y 253, 257–59 (2015); Laura Power & Austin Frerick, *Have Excess Returns to Corporations Been Increasing Over Time?* 2 (Treas. Dep't, Office of Tax Analysis, Working Paper No. 111, 2016), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-111.pdf>; Jason Furman & Peter Orszag, Presentation at “A Just Society” Centennial Event in Honor of Joseph Stiglitz, Columbia University: A Firm-Level Perspective on the Role of Rents in the Rise in Inequality (Oct. 16, 2015), <http://gabriel-zucman.eu/files/teaching/FurmanOrszag15.pdf>.

Kleinbard, *Capital Taxation*, *supra* note 1, at 675–82, considers this question and reluctantly concludes that it is very difficult to design a practical capital tax system that distinguishes between rents and ex ante, risk-adjusted normal returns. *Cf.* Wolfgang Schön, *International Taxation of Risk*, 68 BULL. FOR INT'L TAX'N 280, 282 (2014) ([“I”]t is hard to distinguish in practice between an infra-marginal profit which stems from the exploitation of a monopolistic asset (i.e. an economic rent) and a profit which simply represents the volatile outcome of risk (like a lottery gain).”).

of taxation, are not identical to one another, and the role played by each in the economy and in social structures also differ. As suggested above, a flat (proportional) tax on capital income will operate as progressive along the relevant margin of time, but that reasoning does not extend to labor income. From the other direction, and particularly in light of the relatively inelastic real labor responses to tax rates in the range with which we have recent experience, an explicit progressive tax rate structure on labor income whose top rates are greater than those applied to capital income both raises necessary revenues and does so in a way that satisfies political economy income inequality concerns.

This Article takes the reasoning and the conclusions of *Capital Taxation in an Age of Inequality* as prologue, and extends that paper by specifying in reasonable detail the design of the flat rate, uniformly applied capital income tax that I have in mind. The proposed tax—called the Dual Business Enterprise Income Tax, or Dual BEIT (where “BEIT” is pronounced “bite,” as in a tax bite)—builds on earlier work of mine but is substantially amended and restated from its earliest iterations. A third article, *Business Taxes Reinvented*, comprises a comprehensive term sheet summarizing the mechanical rules of the Dual BEIT.⁶ That article serves as a complement to this longer narrative explanation; its term sheet appears here as the Appendix to this Article.

The BEIT half of the Dual BEIT is a robust technology for measuring explicit returns to capital, but it is agnostic about tax rates and does not by itself address the issue of labor income masquerading as capital income. The dual income tax structure adds a conscious commitment to different tax rates on capital and labor income—for example, 25% on the former and 40% on the latter (ignoring lower tax rate brackets on lower incomes). Marrying the two themes yields the Dual BEIT.

U.S. academic and policy circles are awash in proposals that generally might fall under the rubric of business tax reform. The Dual BEIT differs from some competing ideas in its breadth, as it covers all forms of business organization and all forms of financing a business; in

The Dual BEIT project therefore adopts a flat rate on all instances of capital income. Nonetheless, one could argue that the Dual BEIT ought to adopt a higher (but still flat) tax rate on business enterprises than on the ex ante expected normal returns taxed to investors. The Dual BEIT can easily accommodate that friendly amendment, if it has political economy salience.

6. Edward D. Kleinbard, *Business Taxes Reinvented: A Term Sheet*, 156 TAX NOTES 999 (Aug. 21, 2017).

its depth, in that it encompasses and coordinates firm and investor taxation; and in its practicality, as it requires very little by way of new information exchange or collection.

More generally, it is incumbent on proponents of new tax structures intended for actual implementation to specify their proposals in sufficient detail that their operation and administrability can be assessed. This is surprisingly difficult work, and while that work might be described by some as tax engineering rather than physics (or as mere lawyers' work, to put things more directly), it is what separates tax policy chatter from feasible legislation. *Business Taxes Reinvented* and this Article are my efforts to summarize succinctly the operation of the Dual BEIT, at a level of specificity that would enable the tax writing committee staff in Congress to turn the proposal into legislative language. Some proposals currently in the marketplace of tax policy ideas do not satisfy this standard and remain largely abstractions.

This Article therefore describes the Dual BEIT sufficiently that its operation and practical implications are laid bare. I think of this Article as providing a complete foundation from which a first draft of legislation could be produced. In doing so, there is a risk that readers will confuse some of the inevitable design details with conceptual complexity, or will view a detail as to which they might come to a different conclusion as evidence that the entire structure is faulty. I ask such readers for forbearance and urge that this effort to think through important design details not be held against the Dual BEIT when compared to other ideas whose detailed implementations remain unexplored.

B. Capital Income Is the Issue

1. Capital Income Taxation in Theory

Capital Taxation in an Age of Inequality makes the case that public finance theory, and in particular the well-known Atkinson-Stiglitz Theorem, does not proscribe capital income taxation in the real world.⁷ In particular, and as that article develops, about half of the capital stock today is the result of gratuitous transfers (gifts and bequests) from prior generations. This fact alone vitiates the relevance of the Atkinson-Stiglitz Theorem as policy advice, as both Atkinson and Stiglitz have

7. Kleinbard, *Capital Taxation*, *supra* note 1, at 641–44.

observed in their own work.⁸ What is more, capital income is a major driver of increasing income inequality, and, of course, the current top-weighted distribution of capital itself essentially defines wealth inequality. As these points are developed at length in the prior paper, there is no reason to restate them further here.

Income and wealth inequality are real and troubling phenomena.⁹ Extraordinary income and wealth inequality strain our social fabric, insulate some from the consequences of policies that affect all the rest of us, and at the same time offer the opportunity to shape those policies through the application of wealth to political agendas. What is

8. See ANTHONY B. ATKINSON, *INEQUALITY: WHAT CAN BE DONE?* (2015); JOSEPH E. STIGLITZ, *THE PRICE OF INEQUALITY* (2012); see also Kleinbard, *Capital Taxation*, *supra* note 1, at 641–44.

9. An important paper made available since the preparation of *Capital Taxation in an Age of Inequality* is Thomas Piketty, Emmanuel Saez & Gabriel Zucman, *Distributional National Accounts: Methods and Estimates for the United States* (Nat'l Bureau of Econ. Research, Working Paper No. 22945, 2016), <http://www.nber.org/papers/w22945.pdf>. That paper is the first comprehensive effort to distribute the entirety of U.S. national income, as reported in the National Income and Product Accounts (of which Gross Domestic Product is the best-known line item), to individuals. The paper finds that the pretax income of individuals in the 50th to 90th income percentiles grew somewhat more quickly from 1980 to 2014 than is suggested by tax or Survey of Consumer Finances data, but that, as in earlier studies by the same authors, the incomes of the very highest income percentiles outstripped all others. What is more, this phenomenon has evolved since the last two decades of the 20th century from one driven primarily by greatly skewed growth in labor incomes to one driven by capital income—making the agenda of this Article and *Capital Taxation in an Age of Inequality* to develop a more effective capital income taxation regime all the more urgent.

Two other recent helpful articles are Edward J. McCaffery, *Taxing Wealth Seriously*, 70 TAX L. REV. 305 (2017), and Mark P. Gergen, *How to Tax Capital*, 70 TAX L. REV. 1, 6–14, 18–30 (2016). McCaffery, for example, summarizes the data as demonstrating that: “America has great wealth and great wealth inequality. The problem of wealth inequality is getting worse, notwithstanding a tax system that is supposed to redistribute wealth.” McCaffery, *supra*, at 329. Gergen focuses in particular on the proportion of income-producing wealth held by Americans in the form of publicly traded securities and concludes that publicly traded securities of all sorts account for about 75–80% of such wealth. Gergen, *supra*, at 6.

more, promoting a low-tax, high-inequality society actually is a low-growth prescription. As recent work by the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) have made clear, the high-growth path for affluent economies is a conscious policy of “inclusive growth.”¹⁰ This contemplates in particular sufficient tax revenues to fund investments in the human capital of all citizens, principally in the form of education and healthcare. To remove capital income from the reach of taxation would narrow the tax base too much and would blunt fiscal policy as an instrument through which a country’s most affluent citizens are called on to invest in the country’s long-term economic growth through the inclusive channels just mentioned.

As in *Capital Taxation in an Age of Inequality*, I use the term “capital income” here to comprise all returns to capital, in the narrow, traditional sense of that term.¹¹ Capital income includes, by way of example, interest and dividend income, property rental income, royalties,

10. See Kleinbard, *Capital Taxation*, *supra* note 1, at 656–58 (discussing publications from the IMF and OECD). For a recent, general survey of the relationship between tax policy and growth, see William G. Gale & Andrew A. Samwick, *Effects of Income Tax Changes on Economic Growth* (Brookings Inst. Report, 2016), https://www.brookings.edu/wp-content/uploads/2016/07/09_Effects_Income_Tax_Changes_Economic_Growth_Gale_Samwick.pdf. The theme of government’s role in facilitating “inclusive growth” is broader than tax policy alone, because it requires considering the growth implications of the investment channels available to the government (e.g., in education and healthcare) as well as the tax instruments by which those investments would be financed. Åsa Johansson, *Public Finance, Economic Growth and Inequality: A Survey of the Literature* (OECD Economics Department Working Paper No. 1346, 2016), <https://www.oecd.org/eco/Public-finance-economic-growth-and-inequality-a-survey-of-the-evidence.pdf>, is a recent high-speed survey of this broader field. Oddly, and despite its extensive references, Johansson’s paper overlooks the IMF papers referenced in Kleinbard, *Capital Taxation*, *supra* note 1, at 599. Johansson’s paper is primarily a summary of a great deal of sometimes conflicting analysis; understandably, her conclusions have a Goldilocks flavor to them: Government should be neither too big nor too small; it should be more rather than less efficient at delivering its objectives; and so on.

11. Thus, as used in both Articles, the term “capital” does not include human capital.

capital gains, and (although not implicated by the Dual BEIT) 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. Net business income after accounting for labor inputs thus is simply one important instance of capital income, not a separate category of income. (The problem of the closely held business, whose owner-entrepreneur puts both her own capital and her labor to work such that the net income of the firm cannot through simple inspection be divided into labor and capital income components, is addressed through the new “labor-capital income centrifuge” discussed later in this Article.¹²)

The standard presentation in the legal tax literature basically divides the returns to capital into three categories.¹³ First are “normal” returns, usually explained as the pure return to waiting, or time-value-of-money returns. These are usually presented as the core risk-free return from postponing consumption of one’s wealth that one might expect to earn, for example, by investing in a Treasury bond. As discussed in Part III, however, this is an incomplete formulation: normal returns also include ex ante returns to risk, where those risk opportunities are

12. See *infra* Part IV.

13. See Kleinbard, *Capital Taxation*, *supra* note 1, at 602–04; see also Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); John R. Brooks II, *Taxation, Risk, and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax*, 66 TAX L. REV. 255, 261 n.25 (2013); Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 23 (1996); Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993); Edward D. Kleinbard, *Designing an Income Tax on Capital*, in TAXING CAPITAL INCOME 165, 168 (Henry J. Aaron et al. eds., 2007) [hereinafter Kleinbard, *Designing*]; David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1 (2004); Lawrence Zelenak, *The Sometimes-Taxation of the Returns to Risk-Bearing Under a Progressive Income Tax*, 59 SMU L. REV. 879 (2006); Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91 (2004).

replicable—that is, where an investment can be described as a marginal investment. To an economist, all business capital earns at least a normal return.

The standard presentation next describes risky returns, the higher returns that one expects to obtain as compensation for accepting the risk of uncertain rewards. From an *ex ante* perspective, risky returns are measured by the risk premium associated with an investment, as reflected in its expected return less the risk-free normal return. Actual *ex post* risky returns, of course, will vary considerably from this expected return and often will be negative. Part III argues that *ex ante* returns to risk—that is, a firm's set of marginal investment opportunities—in fact constitute (risk-adjusted) normal returns. The concept of “risky” returns might better be limited either to returns to true uncertainty,¹⁴ or to *ex post* returns to risk, because tax systems generally operate *ex post*. One of the great difficulties in designing an income tax on capital is ensuring that the taxation of *ex post* returns to risk does not distort *ex ante* marginal investment decisions.

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.¹⁵ 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 quanta of risk.

In this Article, I follow economists in using the word “profits” to mean returns over and above risk-adjusted, *ex ante* normal returns.¹⁶ This means that in ideal implementations the term encompasses only economic rents (again, when measured from an *ex ante* perspective).

14. See Kleinbard, *Capital Taxation*, *supra* note 1, at 669–70, 677–82.

15. See Robert H. Wessel, *A Note on Economic Rent*, 57 AM. ECON. REV. 1221, 1223 (1967) (“The traditional rent concept also enables us to divide, conceptually at least, factor compensation into two parts, payments which induce factors to work and surplus which only confers a greater reward for work which would have been done anyway.”).

16. See, e.g., Jennifer Gravelle, *Corporate Tax Incidence with Excess Profits* (2015), <https://www.ntanet.org/wp-content/uploads/proceedings/2015/160-gravelle-corporate-tax-incidence-effect.pdf>.

Economists often equate capital (and therefore the measurement of returns to capital) with “real” assets employed in a business, 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 that constitute indirect claims against those real assets. But at a more practical level, any income tax must address the fact that from the perspective of any one taxpayer, capital income might be earned in respect of investments in real assets, financial assets, or both.

Coordinating the taxation of returns to real and financial assets is one of the great challenges in designing an income tax on capital. For example, a corporate income tax reform proposal that does not consider the impact of the taxation of dividends and interest paid by the corporation to the ultimate individual stakeholders, or the impact of capital gains realized on a disposition of an interest in a firm, fails ab initio in constructing a coherent business capital income tax. Therefore, throughout this Article, “capital” comprises both real and financial assets.

As is well known, the standard presentation in the literature is that the difference between a capital income tax and a profits tax (including a cash flow tax or a consumption tax) is that only the former burdens normal returns. The standard presentation concludes that both burden economic rents and that neither burdens pure returns to risk. Because the Dual BEIT is intended to operate as a capital income tax, its success will be measured as a function of its ability to measure and tax normal returns accurately (as it happens, at the level of investors in firms, rather than the firms themselves). As the next subsection suggests, when compared to current law this is a low bar to clear.

2. Capital and Labor Income Taxation in Practice

In policy circles today, “corporate” or, alternatively, “business” income tax reform is a hot topic. But “business income” is an underspecified tax concept, and reform proposals often are framed so narrowly as to vitiate their own objectives. The challenge in designing a “business income” tax is to measure comprehensively and tax consistently taxpayers’ returns on the capital they invest in businesses of all shapes and sizes, regardless of legal labels or traditional accounting norms.

When policymakers speak of business income, therefore, what they should mean is *capital income* from business investment. Only a

holistic focus on capital income can lead to consistent tax burdens on that income, regardless of the formal labels attached to its different practical iterations (the entity vs. its stakeholders, debt vs. equity, and so on).

There are only two important kinds of income: returns from labor and returns from capital. When tax law professors in the United States teach Tax I, we like to discuss treasure trove cases like that involving cash stuffed into a piano bought at a second-hand shop,¹⁷ but these are not important contributors to national output.

I submit that we know a good deal about how to tax labor income, and in general do a pretty good job of it. If we fail, we do so largely by choice. (The mischaracterization under U.S. law of “carried interest” as capital income is an obvious example.¹⁸) But when it comes to taxing capital income, we perform very poorly. We are inconsistent in how we measure capital income, depending on the formal labels that different investments take, and we likewise are inconsistent in the tax rates we apply to the capital income that does come to our attention.

In brief, capital income taxation in the United States today is incoherent in both theory and application.¹⁹ The United States taxes returns to capital at wildly varying 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. The U.S. system for taxing capital income is thus fundamentally rotten at its core: it can neither measure nor tax consistently the most straightforward returns to real or financial capital.²⁰

17. See Reg. § 1.61–14; *Cesarini v. United States*, 428 F.2d 812 (1970).

18. See *infra* note 48 and accompanying text.

19. See generally Kleinbard, *Designing*, *supra* note 13, at 165–205; Edward D. Kleinbard, *Rehabilitating the Business Income Tax* (Hamilton Project at Brookings Inst., Discussion Paper No. 2007-09, 2007), <https://www.brookings.edu/wp-content/uploads/2016/06/200706kleinbard.pdf> [hereinafter Kleinbard, *Rehabilitating*].

20. Interest income earned by a taxpaying investor is the great exception (i.e., I.R.C. § 1271 et seq.); those rules are largely rational in their measurement of this form of capital income—if inflation is set to one side.

Both the Congressional Budget Office (CBO)²¹ and the U.S. Treasury Department²² have closely studied how the United States taxes capital income in practice. For example, in a landmark 2005 study, the CBO found that the effective marginal *total* tax rate on corporate income—that is, the “all in” tax rate on a prospective marginal investment, *including* the aggregate tax burdens imposed on the interest, dividend income, and capital gains of investors, taking into account their tax posture and relative size—was around 26.3%, compared with a statutory marginal rate on corporate income alone of 35%.²³ The effective marginal total tax rate on capital invested in *noncorporate* businesses was much lower—20.6%.²⁴ That difference points to a fundamental weakness of the current system, which is the differing tax burden the Internal Revenue Code (Code) imposes on capital invested in different legal forms of business.²⁵ In 2014, another study by the CBO came to

21. CONG. BUDGET OFFICE, TAXING CAPITAL INCOME: EFFECTIVE MARGINAL TAX RATES UNDER 2014 LAW AND SELECTED POLICY OPTIONS (2014), <https://www.cbo.gov/sites/default/files/113th-congress-2013-2014/reports/49817-taxingcapitalincome0.pdf> [hereinafter CBO 2014]; CONG. BUDGET OFFICE, COMPUTING EFFECTIVE TAX RATES ON CAPITAL INCOME (2006), <https://www.cbo.gov/sites/default/files/109th-congress-2005-2006/reports/12-18-taxrates.pdf> [hereinafter CBO 2006]; CONG. BUDGET OFFICE, TAXING CAPITAL INCOME: EFFECTIVE RATES AND APPROACHES TO REFORM (2005), <https://www.cbo.gov/sites/default/files/109th-congress-2005-2006/reports/10-18-tax.pdf> [hereinafter CBO 2005].

22. *See generally*, e.g., TREAS. DEP'T, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS: BACKGROUND PAPER (2007), <https://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf>. The Treasury Department has repeated its analysis with more recent data in WHITE HOUSE & TREAS. DEP'T, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM: AN UPDATE (2016), <https://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf> [hereinafter THE PRESIDENT'S 2016 FRAMEWORK UPDATE]. This document updated WHITE HOUSE & TREAS. DEP'T, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 8 (Feb. 2012), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-Report-Business-Tax-Reform-2012.pdf> [hereinafter THE PRESIDENT'S 2012 FRAMEWORK].

23. CBO 2005, *supra* note 21, at 7–9.

24. *Id.* at 8.

25. One can argue that many small businesses are unincorporated and that the rate difference noted in the text in turn reflects a Congressional decision to tax small businesses more lightly. If that is the justification, it is a

broadly similar results, except that 2014 tax rates were somewhat higher across the board, so that the all-in corporate effective marginal tax rate for a firm with a typical capital structure was 31%, and 27% for unincorporated businesses.²⁶

Second, the CBO and Treasury analyses demonstrate that our current business tax system imposes wildly divergent burdens on marginal investments depending on funding source (debt vs. equity) and asset class. Using just the CBO's 2005 figures, equity-funded corporate capital investments were taxed at a marginal effective total tax rate of 36.1% (higher than the statutory rate of 35% because of investor-level taxes), while debt-financed investments faced a *negative* 6.4% rate—a 42.5 percentage point swing.²⁷ (A negative marginal tax rate implies that after-tax returns exceed pretax returns, so that the tax system actually subsidizes the cost of the investment.²⁸) And there was a 12.3 percentage point difference between the effective total tax rate imposed on a marginal investment in the 25th percentile of asset classes (ranked in order of tax burden) and that imposed on the 75th percentile—that is, between the top and the bottom of the middle half of all assets.²⁹ Again,

poorly directed incentive, as the tax benefits from adopting a noncorporate business structure are freely available to very large enterprises as well as small ones.

26. CBO 2014, *supra* note 21, at 9–10.

27. CBO 2005, *supra* note 21, at 8.

28. The driver of this outcome is that the marginal investment in question (typically debt-financed property eligible for accelerated depreciation) generates a loss for tax purposes, which loss is presumed to be used to offset tax on a different equity-funded marginal investment by the taxpayer. Although the Treasury does not literally write out a check to a taxpayer as to an isolated marginal investment with a negative effective marginal tax rate, the substantive result is the same, because a taxpayer is presumed to act rationally and to pair such an investment with an equity-funded one. CBO 2014, *supra* note 21, at 18 n.30.

29. The 26.3% effective marginal total tax rate on corporate investments is the weighted average of those two rates, weighted by the CBO to reflect the relative amount of debt financing by American corporations (roughly 41.3% of the total capital invested in corporations). CBO 2006, *supra* note 21, at 47.

THE PRESIDENT'S 2012 FRAMEWORK, *supra* note 22, at 5, 6 tbl.3, concluded that debt-financed investment in equipment faced an effective marginal tax rate in 2011 of *negative* 60%. Presumably this extraordinary figure reflects the availability of 100% expensing ("bonus depreciation") in that year.

CBO's 2014 conclusions are broadly similar, as are those of the U.S. Treasury. And both studies concluded that returns to owner-occupied housing (the largest physical asset class) enjoy a negative tax rate environment.³⁰

A more common response to the abject failures of capital income taxation today is to suggest that the U.S. tax system is a combination of comprehensive income and consumption tax themes, but this simply reduces to an observation that sometimes the United States taxes capital income (or some components thereof), and sometimes it does not. Moreover, the observation fails to capture the extraordinary variations in the burdens that the U.S. tax system imposes today on capital income, depending either on the nature of the real asset deployed in a business or on the other, more formal, characteristics mentioned above. Most fundamentally, the formulation says nothing useful about when capital income taxation should be turned off and when turned on—and if turned on, at what effective marginal tax rate.

Labor income comprises the great bulk (on the order of two-thirds) of national income as measured by the National Income and Product Accounts and by Internal Revenue Service (IRS) aggregate taxable income data. Labor is today taxed under progressive rate schedules that top out in percentage terms in the low 40s (looking at federal rates only, and including post-2012 payroll and net investment income taxes³¹).

Most academic work agrees that within reasonable parameters actual labor effort is not very elastic in its response to tax rates.³² Reported taxable income, however, is more elastic.³³ The elasticity of taxable income (as opposed to labor effort) is not a fact of nature, but rather an acknowledgment of some structural shortcomings in the Code or its administration, most of which can be addressed.³⁴

For comparison, THE PRESIDENT'S 2016 FRAMEWORK UPDATE, *supra* note 22, at 8, 9 fig.2, found that the effective marginal corporate tax rate on such an investment was negative 38.9% in 2015.

30. THE PRESIDENT'S 2012 FRAMEWORK, *supra* note 22, at 22 tbl.A2; CBO 2014, *supra* note 21, at 10 tbl.2.

31. See I.R.C. §§ 1, 1411, 3101.

32. See, e.g., JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES* 183–91 (5th ed. 2017); Michael P. Keane, *Labor Supply and Taxes: A Survey*, 49 J. ECON. LITERATURE 961 (2011).

33. See, e.g., SLEMROD & BAKIJA, *supra* note 32, at 217–23.

34. Audit enforcement of small business income reporting, and in particular cash income, can be increased from its current low ebb; personal itemized

Real capital income is more elastic to tax rates than is labor effort, for the simple reason that taxpayers always have available a tax-induced response to high capital income rates that cannot be addressed through technical reforms to the Code, which is to consume rather than to save. Putting real savings effects to one side, the elasticity of reported taxable capital income also is highly elastic because under current law taxpayers have many tax-exempt or tax-deferred investment opportunities available to them.

It frequently is reported that pass-through firms now account for more than half of all U.S. domestic business income.³⁵ That figure, however, compares incommensurate numbers along two different margins. First, corporate income earned by taxable C corporations (which in turn are largely publicly held enterprises) has little residual labor income embedded in it, because what employees do not explicitly claim as their own reverts to shareholders. The income of pass-through firms nominally labeled as capital income, by contrast, in large (but indeterminate) measure comprises a return to the labor inputs of those firms' owner-entrepreneurs. Official statistics obscure the fact that owner-entrepreneurs have broad ability to characterize income from their own firms either as labor or capital income to minimize their tax liability.³⁶ Second, many official statistics record as "business" income the income earned by passive investors in actively managed investment funds organized as pass-through vehicles, such as hedge funds.³⁷

deductions can be curbed; limits can be placed on the size of tax-deferred plans of all stripes, including both qualified plans and nonqualified stock options; and the John Edwards/Newt Gingrich loophole, discussed *infra* note 36, could be closed, so that all income above the relevant statutory threshold is treated either as net investment income, employment income, or self-employment income.

35. For a recent summary of the IRS data comparing C corporation and pass-through employment and net income, see Scott Greenberg, *Pass-Through Businesses: Data and Policy* (Tax Found. Fiscal Fact No. 536, 2017), <https://files.taxfoundation.org/20170124162950/Tax-Foundation-FF5361.pdf>.

36. The well-known "John Edwards/Newt Gingrich" tax stratagem to avoid Medicare payroll taxes on most earnings through an S corporation is a prominent example. See Edward D. Kleinbard, *Corporate Capital and Labor Stuffing in the New Tax Rate Environment* 17–20 (Univ. of S. Calif., Ctr. in Law, Econ. & Org., Research Paper Series No. C13-5, 2013), <http://ssrn.com/abstract=2239360> [hereinafter, Kleinbard, *Capital and Labor Stuffing*].

37. See for example an important paper by Michael Cooper et al., *Business in the United States: Who Owns It and How Much Tax Do They Pay?*

The pervasive presence of pass-through businesses in the domestic economy and the extreme flexibility by which owner-managers can designate their incomes as business earnings or as personal labor income mean that a dual income tax structure requires the development of a robust labor-capital income centrifuge—that is, a method for separating the net income of the owner-entrepreneur by reference to economic function rather than to arbitrary self-labeling. This is the great vulnerability of dual income taxes generally: a poorly designed labor-capital income centrifuge dooms a large portion of the overall capital income tax system, particularly in a country like the United States where pass-through business structures already are so well entrenched.

Regardless of the conflation of labor and capital income in the typical pass-through business controlled by owner-entrepreneurs, the large role of pass-through businesses in the domestic economy suggests that their treatment is as important to a well-designed capital income tax regime as is the taxation of corporate income. In this regard, it is impossible to look at the modern S corporation or limited liability company and discern any basis on which to draw tax distinctions when compared to the treatment of taxable C corporations. All offer limited liability, free transferability of ownership interests, centralization of management, and perpetual life not tied to the lifetime of any natural person who is an owner. While small businesses generally are organized as pass-throughs, small business is a category distinct from pass-through businesses more generally.³⁸ If small business deserves tax subsidies of some sort, those subsidies should be targeted by reference to a firm's size or income, not its organizational structure.

(Nat'l Bureau of Econ. Research, Working Paper No. 21651, 2015), <http://www.nber.org/papers/w21651.pdf>. This paper is a methodological tour de force, in linking pass-through firm income to that of individual owners but appears to suffer from the important limitation of treating a passive investor's share of an actively managed investment portfolio held by a pass-through vehicle as business rather than as investment income.

38. Matthew Knittel et al., *Methodology to Identify Small Businesses* 5–6 (Treas. Dep't, Office of Tax Analysis, Technical Paper No. 4, 2011), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/TP-4.pdf>; see also Cooper et al., *supra* note 37, at 3 (arguing that the business income of pass-through vehicles is even more concentrated in the top end of the individual income distribution than is corporate income).

C. Structural Obstacles to a Functioning Capital Income Tax

Simply measuring capital income is famously difficult in theory, and nearly impossible in contemporary practice. The debt-equity distinction, the realization doctrine, the difficulty in distinguishing capital investment from current expense, and the opacity of the capital income actually earned every period conspire to make the taxation of capital income extremely difficult. Indeed, one principled argument in favor of cash flow taxes (which abandon any effort to reach normal returns) is that the whole endeavor to measure and tax capital income is hopeless, so that giving up and concentrating on other tax instruments usefully conserves legislative and administrative energies for battles that can be won.

This Article stands in opposition to that argument. To do better requires uprooting at least six deeply engrained practical hurdles in our tax system.

First, we must confront the realization doctrine. The realization doctrine in practice means that the taxation of capital gain is essentially optional on the part of the taxpayer. More generally, “deferral” (the consequence of reliance on the realization doctrine) directly undercuts the entire objective of capital income taxation: it effectively exempts from tax the compounding of simple interest returns on an investment held for a period of time.³⁹

Second, we must deal with the debt-equity distinction, under which completely different income measurement tools apply to financial instruments that might be economically similar but that give rise to different formal legal rights and obligations. 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.

The IMF, among others, has done important recent work demonstrating the systematic “debt bias” introduced by income tax systems that allow deductions for interest on debt obligations.⁴⁰ In light of the

39. See Kleinbard, *Capital & Labor Stuffing*, *supra* note 36, at 26–32.

40. IMF, Fiscal Affairs Dep’t, *Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy* 1 (June 12, 2009), <https://www.imf.org>

large amount of tax-exempt institutional investment, and the ease with which financial engineers can package equity-type returns within an instrument treated as indebtedness for tax purposes, tax revenue collections suffer, normal returns escape taxation, and firms' capital structures become more fragile as a result of their appetite for increased leverage.⁴¹

Third, we must address the (non)coordination of firm and investor-level measures of the same real incomes. One very difficult challenge in designing an income tax system that properly measures capital income is 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 and earning net business income—to advance the fundamental objective of imposing a single comprehensive and constant tax burden on returns to capital generally and on normal returns in particular. The current tax system fails utterly in this critical exercise.

Fourth, we must address our arbitrary tax depreciation and expense capitalization rules.⁴² This sounds excessively tedious, but depreciation and capitalization go to the heart of whether capital income, in the form of net business profits on firm income tax returns, is accurately measured. Systematically measuring and taxing these time-value returns is much more difficult than it appears. Much of the complexity of any business income tax stems from this fact; proposals that essentially assume away the issue (e.g., the U.S. Treasury's 1992 CBIT proposal)⁴³ thus evade the heart of the problem.

A firm-level income tax will properly measure and tax normal returns on real assets only if two conditions are satisfied. First, the tax system must develop comprehensive rules to capitalize, rather than

/external/np/pp/eng/2009/061209.pdf; Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF Staff Discussion Note SDN/11/11 (May 3, 2011), <https://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf>.

41. IMF, Fiscal Affairs Dep't, *Tax Policy, Leverage and Macroeconomic Stability* (Oct. 7, 2016), <https://www.imf.org/external/np/pp/eng/2016/100716.pdf>.

42. See I.R.C. §§ 168, 179, 197, 263, 263A; Reg. § 1.263(a)–1 et seq.; Reg. § 1.263A-1 et seq.

43. TREAS. DEP'T, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 39–60 (1992), <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf>. CBIT is discussed, *infra*, in Section VIII.B.2.

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). The tendency to permit expensing of costs that properly should be capitalized is pervasive in the current tax system. For example, all advertising expenses are currently deductible, even if they are incurred to develop a valuable brand name.⁴⁴ Taxpayers also can elect to expense research and development costs (or alternatively to claim a special tax credit in respect thereof), even when that work yields valuable patents or applications.⁴⁵ Second, once initial investments in real assets are properly captured, those investments must be depreciated or amortized on schedules that accord with the economic diminution of those assets.⁴⁶

Fifth, accepting the conclusions of the companion article that capital and labor incomes should be taxed under the Dual BEIT at different rates, we face a new and important question: how do we distinguish the two? For example, an entrepreneurial chef decides to open a new restaurant. She invests her life's savings of \$500,000, and works there 16 hours a day, 6 days a week, taking out no salary. Five years later, the restaurant is a great success, due in part to her culinary skill. What fraction of the current annual profits is attributable to her labor contributions, and what to the capital she has invested? When a few years later she sells the restaurant, including its name and associated goodwill, how much of the gain attributable to those intangible assets is a return to capital, and how much to labor? The latter question is particularly fraught, because we know the answer under current law: the entirety of the chef's gain attributable to those self-created intangible assets constitutes long-term capital gain.⁴⁷ In this way, labor income of an owner-entrepreneur is systematically converted to capital income.

44. See Reg. § 1.263(a)–4(b); Rev. Rul. 92–80, 1992–2 C.B. 57.

45. See I.R.C. §§ 41, 174.

46. See Paul A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964).

47. See I.R.C. § 197(c)(2), (f)(7); I.R.C. § 1221(a)(2). The former collapsible corporation rules stand as a lone counterexample, but probably would not apply to the mature business described in the text, and in any event the statute was repealed. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302(e)(4)(A), 117 Stat. 752, 763 (repealing former I.R.C. § 341); American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102, 126 Stat. 2313, 2318–19 (2013) (permanently extending the repeal). It has a loose analogy in the partnership tax arena, in § 751's rules relating to

These points were particularly underappreciated until the controversy surrounding the taxation of “carried interest” received by investment fund managers focused policymakers on the issue.⁴⁸ If capital and labor incomes are taxed on different schedules (which in fact we do today, sometimes), we need an administratively reliable means to distinguish labor from capital income in cases where the two are hopelessly intermingled.

The problem is pervasive whenever an owner-manager earns net business income attributable to the combination of her personal effort and the capital she puts at risk. So long as different tax rules are applied to labor income and capital income, this indissolubly intermingled income is likely to be characterized by taxpayers in whichever way minimizes their tax liabilities (currently, as capital income).

Finally, reimagining capital income taxation requires rejecting many deeply engrained modes of thought relating to the institutional foundations of our income tax. Even without regard to the problems just described, 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. This 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 Code has always attempted to categorize all business activity into a few discrete cubbyholes, each with its own operative rules.⁴⁹ 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,

unrealized receivables, but again those rules would not reach the intangible assets described in the text.

48. See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008). The term “carried interest” refers to the shares of an investment partnership’s capital gains that are awarded to fund managers in return for their agreement to run the investment partnership; that is, carried interest represents a profits interest in the partnership disproportionate to capital interests.

49. See Edward D. Kleinbard, *Taxing Convertible Debt: A Layman's Perspective*, 56 SMU L. REV. 453, 467 (2003); Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1348–61 (1991).

accounting and social norms, not economic considerations. For example, the Code observes that Entrepreneur A has organized her business as a partnership, whereas Entrepreneur B has formed a corporation. The 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 Code then relies on outmoded norms, not economic insight, to develop the substantive tax rules applicable to each conceptual 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.

Over the decades the Code has extended this mode of thought without any reexamination of its premises. As a consequence, the pass-through model today applies even to well-capitalized limited liability companies that are indistinguishable from corporations in their protection of investors from entity-level liabilities and in their governance structures. The net result is that a limited liability company with dozens or even hundreds of members (or for that matter a handful of corporate owners only) 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 Apple Inc.

The differing taxation of different forms of business enterprises is just one example. The same point can be made about most financial instruments, or the poor targeting of preferential capital gains tax rates, which turn out to have nothing to do with “double taxation” or the like. As one simple example of the latter, when interest rates decrease, the value of an outstanding bond increases, because the present value of the future interest receipts now exceeds the rate that borrowers need to pay on a new investment. But when a taxpayer sells a U.S. Treasury bond held for more than one year at a profit attributable to just such a decline in rates, the gain is treated as long-term capital gain, notwithstanding that the gain reflects payments received today in lieu of future interest income.

This bad intellectual habit of building the tax system on the shoulders of outdated social and legal norms explains why the 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. This mode of thought alternatively bewilders and infuriates economists, because it has almost nothing to do with economic logic.

D. Criteria for Measuring the Success of a Capital Income Tax

1. An Annual Flat Rate Tax

Capital Taxation in an Age of Inequality recommends a capital income tax imposed at a flat rate, measured and collected annually, and disconnected from the rate structure for labor income. Section I.A. has quickly summarized some of the reasoning behind this recommendation, and as noted there, this Article begins by embracing this goal.

It is worthwhile to emphasize why political economy considerations counsel in favor of the annual taxation of capital income, rather than retrospective tax structures that can be designed to have the same present value through the imposition of deemed interest charges in the calculation of tax due.⁵⁰ There are two reasons: one relates to the trustworthiness of individual taxpayers to recollect correctly how long they have owned securities (which in the case of public companies, but arguably not private ones, is susceptible to third party reporting), the other, which to me is the more fundamental, is simply that Congress has shown itself to be an untrustworthy guardian of deferred tax revenues. The 2004 repatriation tax holiday is the most obvious and egregious example; through that holiday, U.S. multinational firms had the opportunity to repatriate to the United States offshore low-taxed earnings at a nominal rate of 5.25%, and an effective rate near 3.5%—precisely one-tenth the tax rate that was the condition imposed for the deferral of tax in the first place.⁵¹ The 2001–2003 tax cuts on accrued but unrealized capital gains can be adduced as another such example, as can the one-year repeal of the estate tax, or the 2005 amendment to the Code permitting

50. See Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991); cf. James Kwak, *Reducing Inequality with a Retrospective Tax on Capital*, 25 CORNELL J.L. & PUB. POL'Y 191 (2015).

51. See Edward D. Kleinbard & Patrick Driessen, *A Revenue Estimate Case Study: The Repatriation Holiday Revisited*, 120 TAX NOTES 1191, 1200 (Sept. 22, 2008).

high-income taxpayers to convert from a traditional IRA to a Roth IRA without penalty (beyond income tax in respect of earnings inside the IRA), beginning in 2010.⁵²

A retrospective tax whose measure includes an embedded interest charge compounds not only the putative tax bill, but also the likelihood of an escape hatch suddenly opening. Many members of Congress are unlikely to understand why a nominal tax rate of, say, 60 or 70% (or higher) is appropriate for gain derived from an asset held for many decades; indeed, many will argue for the opposite result, that the social payoffs to patient investing are sufficiently large as to justify lower rates than those imposed on assets held for just a year or two. In turn, the risk of a holiday from retrospective tax rates becomes even more acute when one imagines the question arising in a year like 2009, when the economy was in the depths of the Great Recession, and a one-time tax holiday could be spun as just the sort of economic stimulus that the country required.

2. Applied Consistently and Comprehensively

A business capital income tax should look past formalisms and apply consistent tax rates to all capital income, however earned. Normal returns, for example, should be taxed as such, regardless of whether labeled marginal returns to investment in a business asset, or interest income; capital income of unincorporated and corporate firms should bear the same tax burdens, and so on. This ambitious goal means that a successful business capital income tax system should make no distinctions based on the legal type of entity engaged in business, or in the different legal modes of expressing the rights and obligations of stakeholders and firms—that is, since debt and equity can often substitute for one another in a firm's capital structure, the tax system should not yield different burdens depending on which is chosen, and instead capital structures should reflect non-tax market considerations.

Because firms and investors are separate juridical persons, all this requires some sort of effective business-investor tax integration strategy, so that normal returns, returns to risk, and rents are each taxed consistently when looking holistically at aggregate outcomes, regardless again of the legal form of the relationships or the juridical person

52. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 512, 120 Stat. 345, 365–66 (2005).

(firm or investor) recognizing the income. This does not, however, require a formal corporate dividend imputation or similar scheme. Indeed, many such structures either are insufficiently ambitious, and leave in situ a debt bias or distinctions between corporate and noncorporate forms of business organization, or reach too far, and claw back business tax incentives in one context that might be available in the other.⁵³

3. *A Feasible Labor-Capital Income Centrifuge*

Like any dual income tax,⁵⁴ in which capital income is taxed under a different schedule from labor income, the Dual BEIT depends entirely on what I term a labor-capital income tax centrifuge—a mechanism to tease apart net business income, particularly in the context of an owner-manager of a closely held business, into its constituent labor and capital income components. Part IV of this Article proposes such a mechanism.

A dual income tax accentuates the difficulties in distinguishing capital from labor income in appropriate cases, but the issue of course is present in current law, chiefly by virtue of the preferential tax rates afforded capital gains. The issue has largely been ignored, as the earlier example of the chef who sells her restaurant for a price that reflects self-developed goodwill and tradename value was intended to illustrate. The Dual BEIT at least attempts to address the issue head-on.

4. *A Featureless Tax Topography*⁵⁵

Every peak or canyon in the topography of tax institution design is problematic: it either invites gaming up to the border between one set of rules and another, or it leads to substantially different results for economically similar situations. Congress often seeks to grasp perfection, by expounding rules for smaller and smaller subsets of affected

53. See Edward D. Kleinbard, *The Trojan Horse of Corporate Integration*, 152 TAX NOTES 957 (Aug. 15, 2016) [hereinafter, Kleinbard, *The Trojan Horse*].

54. See Edward D. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 NW. J.L. & SOC. POL'Y 41 (2010) [hereinafter, Kleinbard, *An American Dual Income Tax*].

55. I proposed this terminology in Kleinbard, *Designing*, *supra* note 13, at 172.

taxpayers, and in doing so is the enemy of the good, because the end result is excessive complexity, unintended consequences from the intersection of those complex rules, and excessively enthusiastic tax gaming.

The proposals made here, by contrast, draw sharp distinctions in outcomes as sparingly as possible. The author is confident that Congress can and will respond to the resulting rough justice with ever more reified rules, but there is no tax system that is immune to this institutional instinct. The best that can be done is to start with a tax design that relies on as few major distinctions as possible, to deny the legislature footholds from which to erect ever more complex scaffolding.

Examples of the sort of sharp dividing lines that would prove troublesome in practice include proposals that apply different tax systems to public and private firms.⁵⁶ Section VIII.B., below, considers briefly reform proposals to tax investors in public firms on a mark-to-market basis. These proposals of necessity adopt a completely different scheme for non-public firms, and in doing so create the potential for distortions at least as great as those attributable today to the debt-equity distinction. The growth in private equity firms and similar alternative funding sources means that it is not inevitable that a private firm become publicly listed as the business grows; rounds of private investor funding

56. See, e.g., Gergen, *supra* note 9; Eric Toder & Alan D. Viard, *Replacing Corporate Tax Revenues with a Mark-to-Market Tax on Shareholder Income*, 69 NAT'L TAX J. 701 (2016). Gergen's thoughtful article reviews much of the recent tax law and policy literature. Gergen recommends a periodic wealth tax on ownership interests in public firms. Toder and Viard are closer to the many proposals that have been made over the years for mark-to-market income taxation on the values of interests in public firms. Each in turn of necessity proposes a complementary tax regime for privately held firms. In Gergen's case, for example, that complementary scheme uses BEIT-style mechanics (original cost, plus deemed return, minus cash distributions) to estimate the current value of an investment but then applies a uniform wealth tax rate (in his example, 80 basis points per annum) to the value of all investments, both publicly traded (determined by reference to market values) and privately held (determined as above). Gergen, *supra* note 9, at 1–6. (The private firm tax would apply only to equity interests, not to all investments in the firm. *Id.* at 3.) Gergen further imposes that wealth tax on firms rather than on investors in those firms. *Id.* at 2. Putting to one side the shift of the nominal incidence to the firm, and the critical issue of loss deductions, Gergen's wealth tax on privately held investments is functionally the same as the Dual BEIT's capital income tax on investors measured by a deemed return.

can replace the public capital markets, thereby offering successful new firms low cost options to choose whichever tax regime is to their advantage.

The paradigmatic example here is Uber Technologies Inc., a firm valued at tens of billions of dollars, but which remains privately held. Uber is said to have gone through 14 rounds of venture capital and private equity financings.⁵⁷ Uber's corporate finance strategy today seems extreme, but it stands as a stark reminder to the ability of firms to avoid crossing the line from private to public ownership if doing so conveys important tax advantages, particularly to founders.

5. Resistant to Base Meddling

A capital income tax system should be as resistant as possible to Congressional interventions and accretions. No tax legislation can be wholly immune to Congressional enthusiasms for tweaks, refinements, and exceptions, but experience argues for a simple system, even at the expense of perfection. It further argues in particular for a system that obviates the importance of depreciation and capitalization, either through expensing or (as in the Dual BEIT) an expensing-equivalent deduction. Proposals like the Comprehensive Business Income Tax ("CBIT"), as suggested by the U.S. Treasury many years ago,⁵⁸ discussed briefly in Section VIII, below, rely entirely on a firm's business income tax base being correctly specified to accomplish their economic objectives of imposing a uniform tax on capital income. This requires not only the adoption of economic depreciation models, but also comprehensive expense capitalization rules. Even the best intentioned of Congresses over the years has found it impossible to resist the call of accelerated depreciation, and no Congress has been fully committed to comprehensive expense capitalization, as the kerfuffle surrounding Chairman Dave Camp's proposal to capitalize some advertising expenses demonstrates.⁵⁹

57. *Uber (Company)*, WIKIPEDIA, [https://en.wikipedia.org/wiki/Uber_\(company\)](https://en.wikipedia.org/wiki/Uber_(company)) (last visited Nov. 8, 2017).

58. TREAS. DEP'T, INTEGRATION, *supra* note 43, at 2.

59. Tax Reform Act of 2014, H.R.1, 113th Cong. § 3110 (2014), <https://www.congress.gov/113/bills/hr1/BILLS-113hr1ih.pdf>; *see also, e.g.*, Shawn Tully, *A Really Bad Idea: Attacking the Tax Deduction on Ads*, FORTUNE (Apr. 4, 2014), <http://fortune.com/2014/04/04/a-really-bad-idea-attacking-the-tax-deduction-on-ads/>.

6. Extensible to All Financial Instruments

A successful capital income tax regime must incorporate rules that achieve the regime's overall objectives, taking into account the great variety of instruments representing claims against firms that are available in the capital markets, the ingenuity of those markets in tailoring new instruments to arbitrage tax rules, and the presence of exchange traded and private financial derivative contracts that can replicate virtually any conceivable capital markets instrument cash flow.

7. Minimal Recordkeeping and Coordination Requirements

A practical capital income tax system must be administrable when deployed to millions of taxpayers. This argues that the system should keep to a minimum investor-level recordkeeping requirements—particularly requirements that might stretch over many years. Current law suffers from this in respect of tax basis in an investment, which is essentially irrelevant to most investors unless and until the time comes to sell that investment. Relatively recent basis reporting requirements for some publicly traded securities—fiercely resisted by the securities industries, and implemented only over a painfully slow transition period—point to how information technology can help here, but the smaller the requirements to retain information of no immediate application, the better. Further, a tax regime should require minimal direct coordination between firms and investors: readers are familiar with the nuisance and the anxiety that comes from trying to retain all the IRS Form 1099s that arrive in one's mailbox at different times. Again technology could help—that is the intuition behind the ReadyReturn initiative,⁶⁰ which would send taxpayers prepopulated draft tax returns containing information currently provided to the IRS by third parties—but third party information, however communicated, sometimes is wrong or must be amended, to the great confusion and consternation of investors.

For example, pass-through models of business capital income taxation suffer acutely from information coordination problems, because it is impossible to allocate the income of firms to their investors in real time, yet stocks can be bought and resold in milliseconds. Similarly,

60. Joseph Bankman, *Using Technology to Simplify Filing*, 61 NAT'L TAX J. 773 (2008); Joseph Bankman, *Simple Filing for Average Citizens: The California ReadyReturn*, 107 TAX NOTES 1431 (June 13, 2005).

dividend imputation corporate integration schemes must have in place rules to address subsequent adjustments in corporate tax liability after imputation credits have been awarded, to handle investors who receive dividends and sell their stock before year end, and so on. And retrospective taxation puts a premium on the verification of the tenor of an investor's ownership, not just her gross sales proceeds.

To be clear, none of these issues is insurmountable, particularly in light of the power of information technology. But proponents of arrangements that pose these sorts of issues must specify their resolution at a level of detail that permits the evaluation of what these information collection or coordination requirements actually would entail in practice, and what tax avoidance or arbitrage opportunities they might present.

8. Clear Constitutional and Treaty Compliance

Fundamental capital income tax reform is a heavy lift, to borrow an inside-the-Beltway phrase. Despite bipartisan interest in corporate tax reform in particular, neither house of Congress has passed legislation that might fit this description in recent memory. Given the political reality that capital income tax reform is likely to remain a once-a-generation effort, it is important that any proposal rest on firm Constitutional footings. This calls into question in particular annual wealth taxes and the like, because they probably run afoul of Constitutional characterization as "direct" taxes that require apportionment among the states, thereby rendering them impossible to implement.⁶¹ At a minimum, it is incumbent on proponents of plans that raise a Constitutional issue to offer a cogent defense, so that policymakers can judge whether the political costs of voting for major legislation with losers as well as winners is worthwhile.

61. U.S. CONST. art. 1, § 2, cl. 3; *id.* amend. XVI; see Kleinbard, *Capital Taxation*, *supra* note 1, at 662–66. Gergen, *supra* note 9, arguably avoids the Constitutional issue by imposing his wealth tax on firms rather than on individuals, but in light of some features of the proposal (including the residual liability of investors for the tax, if the firm fails to pay it), his proposal appears to operate more as a withholding tax paid on behalf of shareholders than as a tax on the firm itself. *Id.* at 2.

Further, although more controversially, it is highly desirable that any major capital income tax reform effort be compliant with the many multilateral trade treaties to which the United States is a party, under the auspices of the World Trade Organization. Bilateral tax treaties are amended all the time, but the WTO's networks of trade treaties are revised at a pace that makes the Congress of the United States look nimble by comparison. The WTO treaties are the foundation of the global economy's open markets, from which the United States has gained much, and contain enforcement mechanisms that have been applied in the past. The United States found to its chagrin in the Domestic International Sales Corporation and Foreign Sales Corporation cases that the WTO can interpret its treaties in ways that directly reject U.S. domestic tax legislation, and in doing so impose fines on the United States, in the form of authorizing the imposition of compensatory tariffs by other countries—in the FSC case, \$4 billion of such penalties.⁶² Again, proponents willing to run this risk have an obligation to lay out a legal defense of their proposals, and a workable scenario for what should happen should the United States lose its case.

II. KEY FEATURES OF THE DUAL BEIT

A. High Level Overview

1. Introduction to the Dual BEIT⁶³

The analysis begins with the fundamental observation that the difference between a capital income tax and a profits-only tax is that the former

62. The history is briefly summarized in DAVID L. BRUMBAUGH, CONG. RESEARCH SERV., RS20746, EXPORT TAX BENEFITS AND THE WTO: FOREIGN SALES CORPORATIONS AND THE EXTRATERRITORIAL REPLACEMENT PROVISIONS 2–4 (2003), <https://fas.org/asmp/resources/govern/crs-RS20746.pdf>.

63. I first presented the “Business Enterprise Income Tax” and “Cost of Capital Allowance” ideas in 2007; their embryonic form dates back to 1989. Kleinbard, *Designing*, *supra* note 13, at 178; Edward D. Kleinbard, *Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System*, 67 *Taxes* 943, 947 (1989) [hereinafter Kleinbard, *Beyond Good*]; Kleinbard, *Rehabilitating*, *supra* note 19. The details of the Dual BEIT as summarized in this Article supersede those presented in these earlier contributions.

burdens normal returns, while the latter by design exempts them. How can we systematically tax ex ante, risk-adjusted normal returns, while preserving neutrality in the taxation of profits, in a world of small firms and big ones, private and public, partnerships and corporations, debt financing and equity funding?

The Dual BEIT answers this challenge by imposing a profits-only tax on firms and a complementary tax on the normal returns of investors.⁶⁴ The two taxes together sum up to a single tax on capital

For readers familiar with the earlier papers, the major developments include:

- The adoption of the dual income tax structure, in which capital income and labor income are taxed under two different rate schedules. As suggested above, this has important theoretical and practical implications.
- To implement the dual income tax structure, the development of a novel “labor-capital income centrifuge” to tease apart the two kinds of income when they are intermingled, as in the case of the owner-entrepreneur of a closely held firm.
- The explicit adoption of a consistent flat rate capital income tax rate on all forms of business capital income. This is consistent in practice with distributional concerns and preserves neutrality in the taxation of risky investments.
- A more complete articulation of a theory for taxing the international income of multinational enterprises and its instantiation in the Dual BEIT.
- The abandonment of a second-level tax on extraordinary capital gains (itself the product of a misguided intuition as to the political climate at the time it was suggested).

64. The Ur-BEIT dates back to 1989. Kleinbard, *Beyond Good*, *supra* note 63, 955–61.

Noël B. Cunningham & Mitchell L. Engler, *Prescription for Corporate Income Tax Reform: A Corporate Consumption Tax*, 66 TAX L. REV. 445 (2013), provides a very helpful overview of consumption taxes generally and of, in particular, various proposals to convert the corporate income tax into a consumption tax. I disagree, however, with their suggestion that the Includible Amounts calculations that investors must perform is complicated. *Id.* at 483 n.154. To the contrary, it is mechanical, arithmetic, and easily reflected in tax preparation software. (In fairness to Cunningham and Engler, however, they were reacting in part to a more complicated two-tier, investor-level tax

income, because from an ex ante perspective, capital income comprises only risk-adjusted normal returns and rents.

The Dual BEIT employs only a handful of new mechanical components, built on top of existing income tax concepts. Because the Dual BEIT is a capital income tax, rather than a profits-only tax (including here a consumption tax) that substitutes for current law capital income taxation, and because its mechanisms are straightforward extensions of current tax instruments, the implementation of the Dual BEIT, when compared to other major reform proposals, should mitigate transition issues, reduce price dislocations for existing real and financial capital assets, and make the proposal tractable for policymakers.

As explained below, the Dual BEIT applies to all business enterprises, except true micro-firms (e.g., a sole proprietorship). The Dual BEIT employs a capital account allowance to create a profits tax base for a firm's business income.⁶⁵ A capital account allowance is simply a deduction equal to a specified rate of return applied to the entirety of a firm's assets. The combination of a capital account allowance and depreciation (regardless of the depreciation/capitalization rules adopted) can be understood as the economic equivalent of a cash flow tax (i.e., expensing), but with some favorable political economy features summarized below. Consistent with my prior work, I use the term "Cost of Capital Allowance" (COCA) to describe the Dual BEIT's firm-level capital account allowance.⁶⁶

that I had suggested in 2007, out of a misguided notion that this is what the tax policy marketplace demanded.)

I much prefer to use the phrases "economic rents" or "profits-only" to denominate an entity tax that exempts normal returns and to reserve "consumption tax" for taxes that in fact are designed nominally to burden consumption. Both exempt normal returns, but consumption taxes, like value added taxes, also include labor inputs in their tax base.

65. "Capital Account Allowance" is the terminology used, for example, in Robin Boadway & Jean-François Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada* 45 (Mowat Centre, Research No. 88, 2014), https://mowatcentre.ca/wp-content/uploads/publications/88_corporate_tax_reform.pdf. Other authors use synonymous terms, like "allowance for corporate capital." For reasons of consistency with my prior work, I use "Cost of Capital Allowance" (COCA).

66. See Kleinbard, *Beyond Good*, *supra* note 63. As summarized in note 63 and more generally in the text of this Article, the actual proposal made there has been superseded by subsequent work.

As in the case of well-designed cash flow taxes, interest expense no longer is deductible under the Dual BEIT, because permitting such a deduction creates negative tax rates (higher after-tax profits than pre-tax ones) on marginal debt-financed investments.

Unlike a standalone profits-only tax, the Dual BEIT is designed to operate as a coordinated and comprehensive tax on business income. The missing piece that must be added to economic profits (rents) earned by the firm to turn a profits-only tax into an income tax—basically, normal returns—is accomplished by requiring *investors* in business enterprises to include the same COCA rate, applied this time to their unrecovered investments in business firms, in income every year. This tax on investors' *ex ante*, anticipated normal returns is the only tax to which ordinary investors are subject; capital gains, for example, are no longer taxable to them.

In sum, the BEIT mechanism is designed to tax at the firm level the economic profits (rents) and net *ex post* returns to pure risk taking earned by business enterprises, and to tax at the investor level the normal returns to capital.⁶⁷ The combination of firm and investor taxes accomplishes *de facto* business income tax integration and a single level of tax on normal returns, imposed on the least mobile class of capital owners. It is this allocation of returns (normal returns only to investors; profits to firms) and the consistent use of the same capital account allowance type mechanism to accomplish both these results that are the novel contributions of the BEIT mechanism.

A recent paper by Laura Power and Austin Frerick of the Treasury's Office of Tax Analysis concluded that roughly 25% of corporate profits (in the accounting sense) in the period 2003–2013 reflected risk-free returns to capital and 75% reflected “excess” returns.⁶⁸ I argue in Part III, below, that the overall normal return to business capital in fact is a weighted, risk-adjusted return, which is somewhat greater than the risk-free rate. The work of Power and Frerick, however, can be seen as putting a floor on the amount of corporate accounting profits that would be excluded from business enterprise-level tax under the Dual BEIT or any other profits-only tax.

67. This can also be phrased as taxing *ex ante*, risk-adjusted normal returns to investors, and profits to firms.

68. Power & Frerick, *supra* note 5, at 7; *see also* Cunningham & Engler, *supra* note 64, 482 n.146.

The BEIT mechanism divides the taxation of capital income between firms and investors because the firm is an ideal level at which to measure economic profits (primarily due to the impossibility of getting depreciation and expense capitalization rules remotely right) but a poor one at which to measure normal returns. On the other hand, depreciation and capitalization issues, which bedevil the measurement of normal returns to firms, are irrelevant to investors holding indirect claims on those real assets; as a result, normal returns are best measured at the investor level.

The BEIT mechanism measures returns to capital consistently, no matter the form of the business organization through which they are earned or the label of the financial instrument through which an investor holds her claim. It also automatically coordinates investor and firm income in a manner that is parsimonious with regard to the information that the two must share. And the BEIT does not rely on administratively unreasonable mechanisms, like aligning tax depreciation with economic depreciation, taxing investors in some firms but not others on a “pass-through” basis, or relying on mark-to-market taxation of investors in public but not privately held firms. The BEIT thus contemplates a relatively featureless tax topography, rather than one pockmarked by distinctive peaks and rifts in the form of bright-line distinctions between different modes of calculating the tax base (e.g., public vs. privately held firms).

2. The “Dual” in Dual BEIT

The Dual BEIT comprises more than the BEIT mechanism. The “dual” part of the name reflects the proposal’s debt to Nordic dual income taxes.⁶⁹ Their fundamental insight was that there is no economic or policy reason to assume that an ideal income tax would burden labor income and capital income under the identical tax rate schedule. In turn, the

69. For the different iterations of Nordic dual income taxes, see Kleinbard, *An American Dual Income Tax*, *supra* note 54. Part IV briefly summarizes some of that paper’s findings. For additional background, see Forum, *Dual Income*, CESIFO DICE REP., Autumn 2004, at 3, 3–30 (comprising contributions by Robin Boadway, Vidar Christiansen, Christoph Spengel, Wolfgang Wiegand, and Margit Schratzenstaller); and Wolfgang Eggert & Bernd Genser, *Dual Income Taxation in EU Member Countries*, CESIFO DICE REP., Spring 2005, at 41.

Nordic countries, led by Norway, developed first-generation, administratively plausible mechanisms for separating capital from labor income in difficult cases.

Dual income tax systems are income taxes that explicitly reject the ideal of a single rate of tax on all income from whatever source derived, and instead adopt a two-pronged, schedular design that imposes different rates on capital income, on the one hand, and on all other income (principally, labor income), on the other.⁷⁰ In its simplest form, a dual income tax adopts a relatively low flat rate of tax on capital income, and progressive rates on labor income, where the highest labor income rate is materially greater than the flat capital income rate, but other rate structures are possible.

The BEIT mechanism by itself is largely agnostic about tax rates. The concept originally was conceived primarily as a vehicle for the accurate measurement of capital income, and it can be adjusted to tax normal returns, on the one hand, and economic profits, on the other, at the same or different rates, which rates in turn can be the same as or different from those applied to labor income. This is where the dual income tax features of the Dual BEIT come into play. Dual income tax principles rely on a device for accurately teasing apart labor and capital income in those cases where they otherwise form an indissoluble matrix, and a theoretical hook on which to hang a reasoned view of the appropriate tax burden on all capital income. The BEIT picks up from there and ensures that all capital income is taxed once, and only once, through its consistent and comprehensive design of the tax base.

A dual income tax, in which capital income is taxed on a different and lower rate schedule from the top rate on labor income, brings squarely to the front the necessity of developing a new tax tool, a “labor-capital income centrifuge,” to tease apart labor and capital income when they are commingled in the hands of the small business owner-entrepreneur (or other cases). The Nordic countries experimented with different designs to accomplish this, but none was sophisticated enough to handle the task adequately. Part IV explores this important issue in more detail.

70. Eggert & Genser, *supra* note 69, at 43 (“The [dual income tax] is a schedular tax regime which divides total income into capital and labour income and regards them as different tax bases.”). In practice, a dual income tax can be implemented in such a manner that there is no risk of some unspecified type of income failing to be taxed under either schedule.

Dual income tax systems by themselves do not assure that capital income is measured accurately. That is, other than in the one area of segregating capital from labor income, dual income tax concepts by themselves do not operationalize a capital income tax. That is the purpose of the BEIT part of things. The “dual” component relates to tax rates and to identifying capital income when it is intermingled with labor income. As a logical matter, its labor-capital income centrifuge is the first step in measuring Dual BEIT liability, because the centrifuge separates out labor income from the total capital income tax base (the actual object of the Dual BEIT) when the two are intermingled. The BEIT component is the mechanism for allocating and measuring firms’ aggregate annual capital income base in a comprehensive and consistent manner, once the base has been refined to remove labor income.

3. Operationalizing the Dual BEIT

Implementing the Dual BEIT requires only three irreducible new tax instruments. First, the Dual BEIT relies on a new labor-capital income centrifuge; this is the subject of Part IV. Second, the Dual BEIT adopts a firm-level profits-only tax through its COCA deduction (capital account allowance mechanism) and applies that mechanism to all business enterprises (other than micro-firms). The principal theoretical issue in this regard is how to measure the economy-wide, ex ante, risk-adjusted normal return (in my running example in this Article, one-year Treasuries plus 300 basis points). That is the subject of Part III. And third, the Dual BEIT applies that same ex ante anticipated normal return measure to investors, to add back to the aggregate tax base normal returns from business.

Many recent tax reform proposals have relied on a cash flow (expensing) mechanism, along with the disallowance of interest expense deductions, to create a profits-only tax base for firms.⁷¹ A cash flow tax is one instance of a profits-only firm tax, because a well-designed one does not burden normal returns. “An ideal firm-level cash flow tax looks very much like an income tax, except that firms are permitted an immediate deduction for any business investments that they make and must

71. H. WAYS & MEANS COMM., 114TH CONG., A BETTER WAY: OUR VISION FOR A CONFIDENT AMERICA 23, 26 (June 24, 2016), http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf [hereinafter, A BETTER WAY].

include in income all returns in respect of that investment, including the return of the original amount invested.”⁷²

A cash flow tax, however, is just one available mechanism to implement a profits-only firm tax while still preserving income tax-like optics (in particular, annual tax returns that look to receipts and expenses to determine a tax base). Another approach to designing a profits-only tax base for firms is to introduce a new tax deduction that is designed explicitly to exempt a normal return from tax.⁷³ Under the standard interpretation of the components of capital income, a deduction that offsets a firm’s normal returns from invested capital leaves only profits (rents) in the tax base because, under the standard interpretation, pure returns to risk, in the form of capital-free bets, are taxed neither by an income nor a profits tax.⁷⁴

These cash flow equivalent forms of profits taxes rely on a capital account allowance, an “allowance for corporate equity” (ACE), or the like, to exempt from tax a firm’s ex ante, risk-adjusted normal returns.⁷⁵

72. Kleinbard, *Capital Taxation*, *supra* note 1, at 606.

73. DAVID F. BRADFORD, *THE X TAX IN THE WORLD ECONOMY: GOING GLOBAL WITH A SIMPLE, PROGRESSIVE TAX* 26–30 (2004).

74. See the discussion in Part III.A., *infra*.

75. The term “Allowance for Corporate Equity” (ACE) was proposed by the Institute for Fiscal Studies in 1991, and Michael Devereux and Harold Freeman. IFS CAPITAL TAXES GRP., INST. FOR FISCAL STUDIES, *EQUITY FOR COMPANIES: A CORPORATION TAX FOR THE 1990s* (1991), <https://www.ifs.org.uk/comms/comm26.pdf>; Michael P. Devereux & Harold Freeman, *A General Neutral Profits Tax*, FISCAL STUD., Aug. 1991, at 1, 1–15.

For more recent general overviews of ACE regimes, see Ruud A. de Mooij & Michael P. Devereux, *An Applied Analysis of ACE and CBIT reforms in the EU*, 18 INT’L TAX & PUB. FIN. 93 (2011); Michael P. Devereux, *Issues in the Design of Taxes on Corporate Profit*, 65 NAT’L TAX J. 709 (2012); Alexander Klemm, *Allowances for Corporate Equity in Practice*, 53 CESIFO ECON. STUD. 229 (2007); Geerten M.M. Michielse, Ruud de Mooij & Charlotte Van Peteghem, *Allowances for Corporate Equity*, in *TAX DESIGN ISSUES WORLD-WIDE* 121, 121–40 (Geerten M.M. Michielse & Victor Thuronyi eds., 2015).

The Dual BEIT has a fundamentally different agenda from the ACE (or comparable) systems proposed by Devereux and others. The ACE originally was conceived by them as an alternative mechanism for implementing a *profits-only* tax: corporations would receive a tax deduction equal to a notional cost of equity, calculated in a manner similar to the COCA deduction (applied, however, to “shareholders’ funds,” not all assets), and would continue to deduct actual interest expense. Distributions to shareholders would in some fashion

An allowance for corporate equity, for example, does so by combining a firm's deduction of its actual interest expense with a notional deduction for a deemed normal return on the firm's equity capital.

A capital account allowance, or similar cash flow equivalent implementation of a profits-only tax, has a great political economy advantage over actual cash flow taxes: easier transition from current law, because existing investment in real assets—i.e., tax basis—at the time of migration to the new regime does not become useless.⁷⁶ Additional political economy advantages include rough similarity in the minds of businesspeople to interest expense deductibility, the retention of the familiar concept of depreciation (while immunizing the tax system from the caprices of the depreciation or expensing rules adopted from time to time by Congress), and substantially reduced gaming opportunities when compared to expensing around the dates of changes in tax rates.⁷⁷

A cash flow tax and a profits-only tax implemented through a capital account allowance share one irresistible political economy advantage over current-law, business income taxes. Under either, firm

be exempt from tax; like the Treasury Department's CBIT proposal from 1992, the proponents of ACE became a bit vague when discussing how preference items would be handled and capital gains taxed. ACE proposals were not intended to advance the taxation of financial derivatives at all. Like COCA, however, ACE deductions for notional capital charges corrected for errors in company-level depreciation practices. Devereux & Freeman, *supra*, at 5.

Unlike both CBIT and COCA, ACE applied only to corporations and retained a distinction between debt and equity: actual interest expense on the former would be deductible, while notional capital charges could be deducted in respect of the latter. The limitation of ACE to one class of business entities and the preservation of the debt-equity distinction seem to be fundamental weaknesses of the proposal.

76. Conversely, if depreciation deductions on existing basis are continued until they run off, what then of interest expense? Or revenue projections? The point here is simply that the radical difference in the timing of deductions between a cash flow tax and a capital account allowance make the transition from a standard corporate income tax more difficult in the former case than in the latter.

77. See DAVID F. BRADFORD, FUNDAMENTAL ISSUES IN CONSUMPTION TAXATION 36 (1996); BRADFORD, *supra* note 73, at 26–30; David F. Bradford, *Transition to and Tax-Rate Flexibility in a Cash-Flow-Type Tax*, 12 TAX POL'Y & ECON. 151 (1998); Christian Keuschnigg & Martin D. Dietz, *A Growth Oriented Dual Income Tax*, 14 INT'L TAX & PUB. FIN. 191, 197 (2007).

managers will operate under a profits-only tax regime, thereby responding to their perennial pleas for a more “competitive” business tax system.⁷⁸ At the same time, the Dual BEIT offers this “competitive” business tax environment without sacrificing the revenues or progressivity issues associated with a move to a pure profits-only tax environment, because the Dual BEIT restores the overall tax system to an income tax, through taxing the normal returns forgone at the firm level to relatively immobile investors in firms.

Capital account allowances (like the Dual BEIT’s COCA deduction) and ACE systems point in approximately the same direction. Unlike ACE systems, however, a capital account allowance provides firms with a constant measure of relief for their business investments, regardless of whether those investments are financed with debt or equity, or for that matter whether assets are leased, licensed, or owned.⁷⁹ The capital account allowance approach thus removes the temptation to issue equity-flavored debt instruments, a temptation that still remains in ACE systems where the “interest” rate on the hybrid instrument exceeds the ACE allowance.

Profits-only taxes relying on an ACE mechanism are not simply an academic daydream. Several countries have adopted ACE systems as their corporate tax regimes.⁸⁰ And in October 2016, the European

78. Based on some of the debates surrounding the “Blueprint” released in 2016 by the House Ways and Means Committee (A BETTER WAY, *supra* note 71, at 23, 26), it might be the case that some managers have not yet fully internalized how attractive it would be for the tax base of their firms to exclude risk-adjusted normal returns, but a deeper appreciation will no doubt come with a little more exposure to the idea.

79. See Devereux, *supra* note 75, and Kleinbard, *Rehabilitating*, *supra* note 19, which specify some of the difficulties inherent in constructing an ACE to replicate the economics of a cash flow tax.

80. Croatia was the first to implement a full ACE regime from 1994 to 2000 with a notional deduction for a deemed normal return on the firm’s equity capital. See Klemm, *supra* note 75, at 230, 237–38. Austria had a partial ACE regime from 2000 to 2004, taxing at a reduced rate notional return on new equity capital. *Id.* at 235 tbl.1. Italy also implemented a regime similar to Austria’s, in which notional return on new equity capital was taxed at a lower rate whereas profits were taxed at a higher rate. *Id.* at 235–37. Since 2006, Belgium has used a full ACE regime with a deductible notional rate of return applied to a firm’s equity, where the notional return is set at a 10-year government bond rate, measured as of two years previous to the year in question.

Commission announced that it would re-launch its “Common Consolidated Corporate Tax Base” (CCCTB) initiative, this time incorporating an ACE.⁸¹ The CCCTB initiative is designed to create a uniform tax *base* for all large European companies; each Member State will then set its own tax *rates* to be applied to corporate income attributable to such country under the principles of the CCCTB. The draft CCCTB statute introduces a new “Allowance for growth and investment,” which appears to operate as an ACE applicable to net new equity (that is, increases in a firm’s equity after the effective date of the CCCTB regime).⁸² The ACE rate will be the European Central Bank’s benchmark 10-year bond, plus 2% (or 2%, if the benchmark bond’s yield is negative).⁸³

The capital account allowance implemented in the Dual BEIT (the COCA) parts company with an ACE by dispensing with a deduction for interest and instead providing a single tax deduction for all of a firm’s invested capital, whether financed through debt or equity. In my implementation, the COCA is a deduction equal to an annually adjusted rate set by formula (as an arbitrary example, one-year Treasury Bills plus 300 basis points)⁸⁴ applied to the entirety of a firm’s business capital.

The history and impact of the Belgian ACE system is reviewed in Jozef Konings, Cathy Lecocq, Bruno Merlevede & Robrecht Vandendriessche, *The Role of an Allowance for Corporate Equity for the Capital Structure and Employment in Multinational Enterprises: An Evaluation of the Notional Interest Deduction in Belgium* (VIVES Policy Paper, 2016), https://feb.kuleuven.be/VIVES/publicaties/beleidspapers/BP/bp2016/VIVES_beleidspaper_18-NID. Since 1996, Brazil has used a partial ACE regime where notional interest is deductible when paid out to shareholders. See Klemm, *supra* note 75, at 238–39.

81. European Commission Press Release IP/16/3471, Commission Proposes Major Corporate Tax Reform for EU (Oct. 25, 2016), http://europa.eu/rapid/press-release_IP-16-3471_en.htm; see also Sijbren Cnossen, *Corporation Taxes in the European Union: Slowly Moving Toward Comprehensive Business Income Taxation?* INT’L TAX & PUB. FIN.: ONLINE FIRST 2 (Aug. 2017), <https://link.springer.com/content/pdf/10.1007%2Fs10797-017-9471-2.pdf>.

82. *Commission Proposal for a Council Directive on a Common Corporate Tax Base*, at 27–28, COM (2016) 685 final (Oct. 25, 2016), https://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_685_en.pdf.

83. *Id.* at 28.

84. The reasons why the COCA rate should be a risk-adjusted normal return, rather than a risk-free normal return, are discussed in Part III, *infra*. It is worth noting here, however, that this is consistent with the European Commission’s proposal just described in the text.

At the firm level, then, the Dual BEIT looks superficially much like the current income tax. The Dual BEIT taxes all business operations identically by treating all enterprises, regardless of legal form, as taxpaying entities subject to the same rules. The COCA deduction replaces a deduction for interest and, because it applies to the entirety of a firm's business capital, makes irrelevant for tax purposes the firm's capital structure or mode of obtaining control over real assets. A business enterprise continues to claim depreciation deductions, but, because those deductions reduce the firm's capital, the Dual BEIT also renders moot the depreciation schedule chosen: at any moment in time, the present value of future depreciation deductions in respect of an asset and future COCA deductions in respect of that asset sum to the same figure.

Allowances would be made for small businesses (through graduated tax rates and higher capital account allowances). Genuinely micro-scaled businesses with a handful of investors could be taxed in the same manner as S corporations are today.

The Dual BEIT would apply to all business enterprises beyond micro-firms without regard to their legal form. In the United States in particular, with its profusion of unincorporated businesses, taxing all firms as entities is necessary to define the tax base consistently across different forms of business organization that compete directly with one another.⁸⁵ Moreover, as explained in Part V, a profits-tax environment permits radical simplification of otherwise esoteric corners of the law, like tax-free business combinations.

The third irreducible feature of the Dual BEIT is its taxation of the normal returns to business capital investment. To operationalize this, the Dual BEIT imposes at an investor level a tax on normal returns (and no other returns), measured only by the investor's tax basis (cost) in her financial assets multiplied by the same COCA rate used by firms to exclude normal returns from tax at their level. The investor tax on normal returns restores the combination of the two levels of income tax (firm and investor) to a single income tax on capital, which by definition burdens normal returns as well as profits.

More specifically, investors include in income annually an amount equal to the same COCA rate multiplied by *their* adjusted tax basis in their business enterprise investments (the Includible Amount).

85. The importance of this foundation is described in Kleinbard, *Rehabilitating*, *supra* note 19, and Kleinbard, *Designing*, *supra* note 13. Exceptions would be made for genuinely micro-scale businesses.

(The Dutch “presumptive capital income tax” or “Box 3 tax” is comparable.)⁸⁶ Includible Amounts function much like original issue discount under current U.S. tax law: the investor’s tax basis goes up by the amount of her Includible Amount and down in respect of cash received on her investment (e.g., dividends or interest). Cash returns thus are relevant only insofar as they affect an investor’s remaining tax basis in her investment. Sales or any other disposition of investments (including by gift or bequest) have no immediate tax consequence, but the new owner of the investment (whether by purchase, gift, or bequest) would take a purchase price/fair market value basis in the investment, from which the new owner’s Includible Amounts would be calculated in future periods.

As an ideal tax matter, tax-exempt institutions would fall under the Includible Amounts investor tax regime just described. I recognize, however, that this is not a probable practical outcome. The proposal made here is to impose tax on the normal returns of tax-exempt investors at one-half the tax rate applicable to others. This would not apply to retirement accounts (i.e., they would remain fully exempt), but the aggregate size of tax-privileged retirement accounts would be capped at some aspirational but not entirely irrational figure (for example, \$5 million). To the extent that tax-exempt institutions remain wholly tax-exempt, one can nonetheless take comfort in the fact that the effective tax rate on firms’ leveraged investments in equipment, where the leverage is provided by tax-exempts, will have been brought up from negative tax rates (i.e., circumstances where after-tax returns exceed pretax returns) to

86. Bert Brys, *The Box System in the Netherlands: An Alternative?*, 45 *REFLETS ET PERSPECTIVES DE LA VIE ÉCONOMIQUE*, no. 3, 2006, at 39, 42; Sijbren Cnossen & Lans Bovenberg, *The Dutch Presumptive Capital Income Tax: Find or Failure?*, in *PUBLIC FINANCE AND PUBLIC POLICY IN THE NEW CENTURY* 241 (Sijbren Cnossen & Hans-Werner Sinn eds., 2003); Sijbren Cnossen & Lans Bovenberg, *Fundamental Tax Reform in the Netherlands*, 7 *INT’L TAX & PUB. FIN.* 471, 472–74 (2001); Henk Vording & Allard O. Lubbers, *The Netherlands Presumptive Income Tax on Portfolio Investment: Background, Aims and Effects*, 60 *BULL. FOR INT’L TAX.* 327, 330–31 (2006).

The Dutch presumptive tax system was revised to take effect as of January 1, 2017. In particular, the flat tax rate in place since the adoption of the system in 2001 was viewed as regressive; the system now imposes higher rates on higher brackets of wealth. IMF, *Kingdom of the Netherlands—Netherlands: Selected Issues*, Country Report 16/46, 5–10 (Feb. 2016), <https://www.imf.org/external/pubs/ft/scr/2016/cr1646.pdf> (in particular, note 8, explains the concerns and the elements of the new system).

zero, and debt-financed assets yielding economic rents will face a positive tax liability, rather than zero.

Under the Dual BEIT, an investor's deemed normal return (i.e., the Includible Amount) is includible in taxable income regardless of whether it is received in cash; more generally, the BEIT *ignores* actual cash flows on financial investments, except to use them as adjustments to basis (cost). Obviously, an income inclusion equal to a specified interest rate applied to a financial asset, which in turn is taxed at a specified tax rate, could be reduced to a simple annual wealth tax on that asset, but to deal with U.S. Constitutional constraints on direct wealth taxation, the BEIT rejects that framing and further permits a loss deduction on sale equal to any prior income inclusions not ultimately received in cash. As explained in *Capital Taxation in an Age of Inequality*, this last feature is both necessary and sufficient to keep the Dual BEIT from being derailed at the beginning by serious Constitutional challenges. Beyond that, however, the concept of capital gains or losses disappears.

Current law will continue to measure the amount of an investor's non-business interest income, which in turn will be taxed at the same flat capital income tax rate as is applied to investor-level business capital income. Thus, interest income from Treasury securities would be measured as under current law. The Code in fact does a very credible job of applying original issue discount principles consistently to such securities. All other instances of capital income (rents or royalties, for example) would be deemed to arise in the conduct of a business; their treatment is outlined in Part VI.

As just outlined, the Dual BEIT's basic operation is quite straightforward, although its implementation in specific settings (such as cross-border investment) necessarily requires additional explication. To make the presentation tractable, Sections II.B and C assume away some of these incremental issues, in order to present in a bit more detail the application of the Dual BEIT to a publicly held industrial firm with entirely domestic operations and investors. By ignoring the problem of the mixed income of an owner-entrepreneur in a privately held firm, I can defer until Part IV a discussion of the Dual BEIT's mechanism for teasing apart labor and capital income in such circumstances. Part III then considers in detail the specification of the Dual BEIT's Cost of Capital Allowance. Getting the COCA rate a bit wrong is not fatal to the tax system as a whole in the sense that it would still function to a first approximation as a capital income tax, but the efficiency of the system

does require that the COCA be reasonably accurate. Parts V and VI extend the analysis to cross-border income and to special industries and circumstances.

4. More on Firm-Level Computations

Under the Dual BEIT, a “business enterprise” (which term encompasses both corporations and unincorporated businesses) deducts each year its COCA—an annual allowance for the financial capital invested in it, measured at a specified rate multiplied by the issuer’s total capital. The COCA allowance replaces current law’s deductions for interest expense and is available regardless of whether any amount is distributed to investors. No further deductions are available to the issuer even if payments to investors exceed the annual COCA rate. As a result, any extraordinary returns (returns above the COCA rate) are taxed at the business enterprise level.

Because the COCA deduction is not tied to actual payments to investors, or to any particular mode of financing a business, issuers no longer will face a tax imperative to employ as much debt financing as possible or to issue complex financial instruments designed to give issuers tax-deductible interest expense in respect of contingent returns. Instead, issuers will minimize the *economic* cost of their financial capital, secure in the knowledge that there is no tax component to that calculation.

The annual COCA rate is set by statute at a formula rate that varies with one-year government debt rates, plus a spread, designed to approximate a typical firm’s overall cost of capital.⁸⁷ In this Article, I use one-year Treasuries plus 300 basis points simply to illustrate what I have in mind, but more empirical work needs to be done to refine the formula. In any event, the formula would be an annual rate adjusted automatically in accordance with the mechanism adopted in the enacting legislation.

87. Part III, *infra*, explains why I believe that a risk-free government bond rate without a spread is not the right rate to use. For the moment, however, consider that the ACE, a widely studied form of profits-only tax, and one that actually has been implemented by several countries (*see supra* note 80), essentially reaches the same result I do, as an ACE provides an allowance for capital comprising the sum of a firm’s actual interest expense plus an additional allowance in respect of equity capital.

For the reasons developed in Part III of this Article, the COCA rate should not be a riskless rate of return, but rather one that reflects an average risk-adjusted return. Special concessionary rates would apply to the smallest firms, which accords with the fact that their cost of capital is higher than that of more established ones.

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

Real assets that today are depreciable (or amortizable) would remain so under the COCA system. Since the effect of depreciation is to reduce asset basis, a business enterprise's COCA deductions would decrease as it depreciates its nonfinancial assets. Thus, the COCA deduction is in addition to, not in place of, asset depreciation.⁸⁸ Section VI.A expands on the relationship between COCA deductions and depreciation as well as firms with net operating losses.

5. More on Investor Income Inclusions

The Dual BEIT requires all investors in business enterprises, including (in an ideal world, at least) tax-exempt institutions, to include each year in ordinary income an "Includible Amount," which equals each investor's tax basis in its investments in business enterprises multiplied by

88. 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) would be treated like any other investor in respect of that asset, and therefore would be required to follow the income inclusion rules described below, including recognizing in income each year the Includible Amount on that financial capital instrument (that is, the business enterprise's tax basis in that instrument multiplied by the COCA rate). At the same time, financial capital instruments owned by a business enterprise constitute part of that enterprise's asset base and therefore would also enter into a business enterprise's COCA expense calculations. A business enterprise would obtain a COCA deduction for its tax basis in a portfolio investment and would include in income from that investment its Includible Amount equal to the same amount. The net result is that there would be no tax at the business enterprise level on interfirm investments.

the COCA rate for that year. This is designed of course to represent a deemed normal return on investments in business enterprises.

Under the Dual BEIT, Includible Amounts generally are taxed currently at flat capital income rates (in the running example in this Article, 25%), regardless of the amount received in cash. If those Includible Amounts are not received, the accrued but unpaid amount is added to a taxpayer's basis in its investment and compounded at the COCA/Includible Amount rate each year. This is essentially identical to how original issue discount operates today.

An investor's starting tax basis in an investment is her purchase price, or, in the case of a transfer by gift or bequest, the instrument's fair market value. That is, death is a realization event; as in any reset of basis under the investor provisions of the Dual BEIT, the consequence is to redetermine tax basis for the purpose of future Includible Amount calculations, but not to impose any current-year tax.

Cash distributions are treated simply as reductions in an investor's tax basis in her investments. Cash distributions in excess of basis are not themselves taxed, but if those cash distributions are invested in new investments, the new investments will attract Includible Amounts. The result is similar to existing U.S. tax rules for original issue discount debt instruments: the investor includes in income yield x on the investment (where yield here is the COCA rate), and treats cash flows as returns of previously taxed yield, and then as returns of principal.

The concept of capital gains no longer would be relevant, as the capital income tax rate applied to the investor's Includible Amount constitutes the full extent of the investor's tax liability. The Dual BEIT of course can accommodate exceptions for retirement savings (up to a lifetime cap of, as previously suggested, \$5 million), and graduated tax rates for those taxpayers whose labor income is taxed below the capital income flat rate.

The Dual BEIT places the taxation of normal returns on investors for three reasons. First, an important intuition undergirding the proposal is that financial capital instruments turn over more rapidly than do noninventory real assets. As a result, investors' tax bases in their financial capital instruments should reflect more closely economic measures of income than do business enterprises' bases in their real assets. Second, investors do not have tax preferences, like accelerated depreciation, that are reflected in their tax bases in their financial investment assets. As a result, financial investors do not face conceptually difficult questions relating to capitalizing or depreciating their investments.

Third, as discussed in Part VII, moving the taxation of normal returns to the investor level has helpful political economy knock-on effects in an international context.

Holders of financial capital instruments calculate their Includible Amounts by reference to their tax bases in the instruments they own. As a result, the aggregate of investors' Includible Amounts will *not* equal the sum of issuers' COCA deductions, and generally will exceed those deductions, for two reasons. First, the intuition here is that 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. (Remember here as well that under the Dual BEIT *all* realization events, including what today are tax-free reorganizations, reset an investor's basis to market value for purposes of determining future Includible Amounts, while firms have zero present value tax consequences.) 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 would be reflected in market prices for the enterprise's securities).

The COCA system applicable to holders requires no special recordkeeping by the issuer or information from prior holders. In particular, calculations are personal to each investor; Includible Amount accounts do not carry over from a prior third-party investor from which the current investor purchased that security, or alternatively received the security as a gift or bequest. In the first case, the new owner begins with her purchase price as her basis for measuring her Includible Amounts; in the second, the donee or recipient of a bequest takes a fair market value starting basis.

The COCA system applicable to holders admittedly requires some modest recordkeeping by each holder, but that recordkeeping would be mathematically straightforward and, because it would be reflected on each year's tax return, can be kept up to date by an individual investor simply referring to her prior year's return. Modern tax preparation software will make this even easier, again because all the requisite information is personal to the taxpayer. As a result, investors would not find themselves in the common predicament today of trying to reconstruct the basis of stock received as a Christmas present forty years earlier.

A simple example is desirable here. Imagine that Investor pays \$1,000 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). Assume for simplicity that the COCA rate is 6% every year. Issuer immediately purchases an asset that is depreciated on a five-year, straight-line schedule. Issuer's COCA deductions each year will equal the COCA rate applied to the tax bases of all its assets. Assuming for this example a simple rule that looks only to asset basis at the start of the year, Issuer's COCA deduction for this asset will equal \$60 in year one, \$48 in year two,⁸⁹ and so on. (Issuer also will obtain a COCA deduction for any asset basis attributable to any net cash the asset generates and Issuer retains.) At the end of five years, Issuer's tax basis in the asset will be zero, and Issuer will no longer obtain any COCA deductions.

Investor, meanwhile, continues to own his Issuer security. Each year, Investor takes into ordinary income a 6% yield on his tax basis in his financial capital instrument. If Issuer happens to distribute exactly \$60 a year to Investor in respect of that security, Investor will include that \$60 a year in income—not because \$60 represents the cash received, but because Investor's tax basis in the asset remains constant (it goes up by \$60 in Includible Amounts, and down by \$60 in respect of cash distributions). If Issuer distributes nothing, Investor will include \$60 in year 1, \$64 in year two (6% of \$1,060 tax basis), and so on. If Issuer makes no current cash distribution and Investor sells the security at the end of year one for \$1,200, Investor pockets the cash without further tax. New Investor will now recognize \$72 of minimum inclusion income in her first year of ownership (\$1,200 x 6%). Issuer's COCA deductions continue unaffected.

One important source of inefficiency in current capital income tax design is the “lock-in” problem experienced by investors, in which an investor with substantial unrealized appreciation in respect of an investment continues to hold that investment to avoid triggering capital gains tax liability when she would prefer to sell it. (The problem of course is compounded in the United States by the fact that capital gains tax is forgiven in respect of the unrealized appreciation on assets held at death.⁹⁰)

The Dual BEIT mitigates the lock-in phenomenon, because the Dual BEIT simply does not impose any investor tax beyond that on

89. Six percent multiplied by the asset's year two opening tax basis of \$800 (i.e., the original \$1,000 cost basis, minus the first year's depreciation). In practice, the Dual BEIT would employ conventions to average tax basis over the course of a year.

90. I.R.C. § 1014.

Includible Amounts. As a result, the decision whether to hold an investment or to sell it and finance consumption with the proceeds is unaffected by immediate tax considerations (including cash flow concerns relating to paying any current tax). In another sense, however, the Dual BEIT retains an unwanted lock-in incentive problem. Here, it is not the capital gains as such, but rather the fact that if one investment is sold at a gain to purchase another investment, the new investment will have a higher tax basis than will the old one, and therefore will attract greater Includible Amounts.

The Dual BEIT thus does not wholly eliminate the lock-in problem, but it does ameliorate it in several respects. First, the fact that Includible Amounts are added to basis and compound means that the gap between the market value and tax basis of an investment security will tend to converge over time (albeit very slowly in some cases). Second, the Dual BEIT is designed to trigger investor-level realization events as often as possible (as when one business enterprise merges with another or on the transfer of financial investment assets by gift or bequest). The hope is that in this way the incentive problem will not be hugely problematic.

The Dual BEIT would apply to all business financial investments made by U.S. investors, regardless of where the underlying firm is domiciled or does business. As a result, U.S. resident investors will bear the full burden of the capital income tax on the normal returns to all their portfolio investments, wherever located. This means that there will be no significant incremental distortion along the margins of their portfolio investment decisions.

The Dual BEIT's income inclusion rules would not apply to foreign investors (for example, through a withholding tax). In part this reflects my view that investor-level taxation should be exclusively residence-based, in accordance with the idea that investors are largely immobile but have a world of investment opportunities. The United States should tax the worldwide income of U.S. investors, and Freedonia do the same for Freedonian investors, so that each jurisdiction establishes a neutral tax environment for its own citizens in which to allocate their investment funds across all possible investments.⁹¹ It also reflects

91. Relying in part on the unique role of the U.S. dollar, economist Patrick Driessen comes to the opposite conclusion. Patrick Driessen, *Free Riding, Liability Reassigning, and Mislabeling in Reforms*, 156 TAX NOTES 113 (July 3, 2017). Driessen urges a greater role for U.S. withholding on income paid to foreign investors on financial claims held by them. *Id.* at 113–14.

experience in respect of interest withholding predating the U.S. portfolio interest rules, as well as more recent experience with withholding on derivatives, and non-U.S. withholding.⁹² All this points in the same direction, which is that withholding on financial instruments is often evaded through difficult to detect “washing” or other arrangements, or alternatively through combinations of domestic instruments and derivatives.

Tax-exempt investors pose a problem for all capital tax systems for the self-evident reason that the very nature of tax-exemption here includes exemption from capital income taxes. It is possible to make heroic but futile gestures to the effect that tax-exempt institutions should be taxed under the Dual BEIT, or any other business tax reform proposal, in the same manner as other investors, but Congress for a century has embraced a conflicting policy vector. Proposals that move tax liability to the business entity level, on the theory that the tax-exempt sector will not notice the implicit tax burden, sadly underestimate their legislative opponents. Section VI.B.2 proposes that institutions that today are tax-exempt, other than retirement plans, be taxed on their risk-adjusted normal returns (their Includible Amounts) at one-half the standard rate, but the efficiency and equity gains of adopting the Dual BEIT do not rest on winning this particular legislative battle.

The Dual BEIT serves as a comprehensive income tax on capital invested in business enterprises, whether domestic or foreign. As such, its intended scope does not reach interest income earned from non-business borrowers—in particular, the U.S. Treasury. Part VI returns to this, but the expectation is that current law would continue to apply to such debt instruments, but income therefrom would be taxed at the same flat capital income rate applicable to the BEIT (in the running example in this Article, 25%).

B. Tax Rates and Revenues

The Dual BEIT can accommodate many different tax rate structures. In general, however, the important choices are two: should the investor and business enterprise-level tax rates be identical or different, and what should the rate(s) be?

92. See, e.g., Peter E. Pront & Roger M. Zaitzeff, *Repeal of the United States Withholding Tax on Interest Paid to Foreigners*, 3 INT’L TAX & BUS. LAW. 191 (1986); Jasper L. Cummings, *Withholding on Cross-Border Derivatives*, 2013 TAX NOTES TODAY 48-2 (Mar. 12, 2013).

Both for theoretical and practical reasons, flat rate capital income taxation makes a great deal of sense.⁹³ At the firm level, a flat rate profits-only tax is necessary to treat returns to risk symmetrically and thereby provide a neutral tax environment for risk-taking. At the individual investor level, wealth is highly concentrated, which means that in practice (and particularly after excluding reasonable contributions to retirement plans) progressive tax rate structures are irrelevant to marginal investment decisions. But to embrace flat rate capital income taxes does not resolve what those firm and investor rates should be.

A strong theoretical argument can be made that the firm-level tax rate should be higher than that imposed on investors, because it is designed to burden economic rents. Rents generally can absorb higher taxes than can normal returns without distorting economic behavior, because even after tax the returns to rents exceed those necessary to induce the economic activity in the first instance.

In practical political economy terms, however, the designer of a capital income tax does not have a free hand at choosing capital income rates, for two related reasons. First, corporate income tax rates are subject to worldwide competition across jurisdictions. Second, firms have greater mobility than do investors in the situs of their activities or residence.⁹⁴ The trend has been to lower corporate rates, so that in most major OECD economies other than the United States the headline rate is now in the mid-20s.⁹⁵

93. Kleinbard, *Capital Taxation*, *supra* note 1, at 660–82.

94. I argue in Section V.B, *infra*, that the mobility of corporate residence is overstated in some of the literature, but even I do not assert that predestination is at work in the selection of the residence of each and every multinational firm.

95. *Statutory Corporate Income Tax Rate*, OECD, http://stats.oecd.org/viewhtml.aspx?datasetcode=TABLE_III&lang=en (last visited Nov. 8, 2017); *see also* Devereux, *supra* note 75, at 714 fig.1.

These data of course reflect only headline tax rates. The effective tax rates of U.S. multinational firms, for example, are much lower than would be implied by the 35% statutory rate. Kimberly A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond*, 69 NAT'L TAX J. 905, 908 (2016); Matthew Gardner, Robert S. McIntyre & Richard Phillips, *The 35 Percent Corporate Tax Myth: Corporate Tax Avoidance by Fortune 500 Companies, 2008 to 2015*, at 7–9 (Inst. on Tax'n & Econ. Policy, Mar. 2017), <https://itep.org/wp-content/uploads/35percentfullreport.pdf>.

The corporate income tax in turn is probably the largest single capital income tax; it thus serves to anchor firm-level tax rates under the Dual BEIT. What is more, the worldwide tax consolidation that I recommend in Part V counsels strongly in favor of a moderate, firm-level headline rate.⁹⁶ And while a profits-only tax provides a more favorable operating environment for firms than does a true income tax, current practice in depreciation, capitalization, and interest expense deductibility is so dispersed among major OECD economies as to make this line of argument less salient to policymakers and business people than might at first seem to be the case.

In addition, it must be acknowledged that the Dual BEIT is not a theoretically perfect tax on economic rents at the firm level, for the simple reason that it does not provide an immediate refund of losses.⁹⁷ The Dual BEIT does augment net operating loss carryovers by applying the COCA rate to unused losses, but firms still are at risk that either they (or their losses) will expire before those losses are absorbed.

Neither is the COCA rate a perfect instantiation of risk-adjusted normal returns as applied to all firms in all cases. It is designed to do rough justice and to be simple in application, but some firms will find that the returns to their marginal investment activities will not be entirely shielded from tax. This argues for moderation in taxation at the firm level.

Moderation again is the watchword for taxing normal returns to investors. Most important, the Dual BEIT imposes its investor-level tax annually, without regard to cash receipts. As developed in *Capital Taxation in an Age of Inequality*, this design element makes the effective tax rate on reinvested savings increase with time, when compared with current law's realization-based approach.⁹⁸ This is the key to the progressivity of the tax, because only the affluent can afford the indefinite deferral of consumption implied by long-term savings, once retirement contributions have been removed from the picture. As the earlier article phrased things, in the Dual BEIT the "tax wedge" derided by many economists becomes "a feature, rather than a bug."⁹⁹ But in turn this counsels in favor of a tax rate lower than that imposed on labor income.

96. See Kleinbard, *Capital Taxation*, *supra* note 1, at 619–23.

97. See *infra* notes 114–119 and accompanying text.

98. See Kleinbard, *Capital Taxation*, *supra* note 1, at 600.

99. *Id.*

The literature on the elasticity of domestic savings in response to tax rates is famously mixed,¹⁰⁰ but to a significant extent this reflects the many alternative uses of money, including investing in fine art, collectibles, raw land, or owner-occupied housing. In addition, it must be remembered that the Dual BEIT, like the original issue discount rules, can impose tax in advance of the receipt of cash. I am not particularly sensitive to liquidity concerns, but on information and belief, many policymakers are. Because the Dual BEIT contemplates exempting the normal returns of foreign investors from U.S. tax, it may well be that the tax rate applicable to domestic savers will affect firms' cost of capital less than might first be supposed, but again it is unlikely that policymakers will gravitate to the argument that higher rates can be tolerated because in such circumstances the tax system will encourage the foreign ownership of domestic firms.

Finally, there are political economy virtues within the Dual BEIT's structure to applying the same tax rate to firms and investors. Doing so makes the overall thrust of the proposal as a single comprehensive tax on capital income more salient. Further, if the COCA formula (for example, one-year Treasuries plus 300 basis points) overstates normal returns at the firm level (where they are excluded from income), the same mechanism will include a comparable amount at the investor level. Some harm is done, but that harm is minimized when the tax rates are identical.

For simplicity, this Article therefore proposes a flat corporate (technically, business enterprise) profits-only tax rate of 25%, and an identical tax rate on the taxable capital income of individual investors.¹⁰¹ (I ignore here any exclusion from the Dual BEIT for micro-businesses or lower tax rates for small businesses within the Dual BEIT.) Labor income would be taxed on a progressive schedule whose top rate is substantially higher (e.g., 40 or 45%). This decision of course introduces the need for the labor-capital income centrifuge described in Part IV.

100. JONATHAN GRUBER, *PUBLIC FINANCE AND PUBLIC POLICY* 685–90 (5th ed. 2016).

101. It is perfectly feasible to implement the Dual BEIT with a lower tax rate on low-income taxpayers, so that 25% (to continue with that example) is a ceiling rate. This Article largely abstracts from this issue for the simple reason that capital income is a prerequisite of owning capital, which by definition the poor do not possess in great quantity.

To emphasize, I recognize the case for taxing rents at higher rates than this, but I also recognize the political economy resonance of not burdening entrepreneurship, the political economy demands of worldwide competition in headline business tax rates, the inability actually to identify rents in practice, and the importance in tax design of symmetry in the treatment of gains and losses across the blurred lines of returns to risk, returns to uncertainty, and rents.

My reasoning on tax rate structures can fairly be accused of mixing normative and political economy motivations, but I wear this concern lightly. The entirety of the Dual BEIT—or any other exercise in real-world tax instrument design—mixes normative and political economy motivations. The Dual BEIT is intended as an implementable proposal that dominates current law along many margins and that is more administrable, more comprehensive, and better grounded in theory than are other policy proposals that have recently been mooted. Academic readers who disdain such messy compromises should bear in mind that taxation, unlike biology, is not a phenomenon separate from its instantiation in legal and social institutions. Theory here must serve the ultimate goal of improving those institutions as they are lived.

More work remains to be done on the tax revenue and distributional implications of the Dual BEIT. Nonetheless, Patrick Driessen, a former revenue economist with Congress's Joint Committee on Taxation, has undertaken some preliminary investigations, and has concluded that it is likely that a Dual BEIT employing the tax rates suggested here by way of example is likely to be roughly revenue and distributionally neutral when compared with current law.¹⁰² Driessen emphasizes that the revenue consequences of the Dual BEIT are quite sensitive to the COCA rate; in his calculations, he used a COCA rate of 8%, which is higher than that suggested here (one-year Treasuries plus 300 basis points). (The greater the COCA rate, the lower the aggregate tax revenues collected in Driessen's model.) All this gives me some confidence that the Dual BEIT is an idea worth pursuing in the arena of actual legislative debate.

C. Transition from Current Law to the Dual BEIT

Transition issues bedevil all fundamental tax reform proposals. A new tax system will not only create future winners and losers but will also

102. Patrick Driessen, *Dual BEIT's Effects on Revenue and Distribution*, 156 TAX NOTES 1015 (Aug. 21, 2017).

affect current stores of wealth. Nonetheless, a transition from a badly implemented capital income tax system to a better one should minimize those issues when compared with the issues associated with moving from capital income taxation to a consumption base.¹⁰³ The relative prices of some real and financial capital assets may change, as effective tax rates are made more neutral, but this is no different than a change in cost recovery methods, or any of the other tweaks to the income tax that markets have absorbed. And whatever the magnitude of those changes, they will be less than would occur in a switch to a consumption tax. In particular, existing basis in real and financial assets will remain relevant under the BEIT, which is not the case in most consumption tax proposals.

The Dual BEIT thus avoids the fraught question of whether existing stores of wealth should be double taxed, as would be the case in the transition to a consumption tax without elaborate transition rules. (In turn, much of the efficiency gain associated with the move to a consumption tax is derived from *not* providing such transition relief.) Readers can reasonably disagree with some of my specific proposals below, but the key thought is that, because the Dual BEIT remains an income tax, its transition issues should be more tractable than those implicit in a move to a consumption tax as the principal instrument in U.S. tax policy.

Nonetheless, the remaining transition issues are not trivial. An overnight switch to COCA, for example, could literally bankrupt highly leveraged companies. The Dual BEIT proposal therefore contemplates different transition rules for its non-COCA components (uniform entity-level profits tax, true consolidation principles, and a revised business asset and acquisition regime), on the one hand, and COCA, on the other.

The Dual BEIT's firm-level non-COCA rules do not appear to work under a phase-in model and therefore must apply *in toto* as of a specified date. Since in many respects the rules are simplifications of current law, applying them immediately to operations should not cause irreparable harm to taxpayers. These would include, in particular, the new statutory tax rate and the superconsolidation rules described in Part V, with its attendant international tax implications, and the repeal of the tax-free reorganization rules.

103. DANIEL SHAVIRO, WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY 171-97 (2000).

The COCA allowance, by contrast, can be phased in by specifying a multiyear period over which the interest expense deduction scales down and the COCA deduction ramps up. The specific proposal is an 8-year transition, during which a firm deducts a declining percentage of its interest expense (capped at net interest expense on the date of enactment, to prevent padding of old-law interest deductions) and an increasing percentage of its COCA deduction. Thus, in the first year after enactment, firms would deduct 100% of their interest expense. In the second year, they would deduct 87.5% of their interest expense and 12.5% of their COCA deduction. In the third year, the figures would be 75% and 25%, respectively, and so on. Firms should be permitted to elect to accelerate the adoption of the full COCA allowance; this is particularly important in connection with the abandonment of the tax-free reorganization rules.

U.S.-based multinationals today hold roughly \$2.6 trillion in earnings that have been subject to low rates of foreign taxation and have not yet been included in U.S. taxable income.¹⁰⁴ The transition treatment of these “permanently reinvested earnings” has received a great deal of attention. It is clear to almost every policymaker that post-reform international tax policy will be difficult enough without keeping alive a zombie-like attribute of prior law; as a result, there is a clear consensus to tax the existing stockpile of low-taxed offshore earnings as part of the transition to a new system.¹⁰⁵

104. *Fortune 500 Companies Hold a Record \$2.6 Trillion Offshore*, INST. ON TAX’N & ECON. POL’Y (Mar. 28, 2017), http://itep.org/itep_reports/2017/03/fortune-500-companies-hold-a-record-26-trillion-offshore.php.

105. Dave Camp’s “Tax Reform Act of 2014,” *supra* note 59, would have adopted a territorial tax system under which 95% of dividends paid by a foreign corporation to a U.S. corporate shareholder holding 10% or more of the foreign corporation’s stock would have been exempt from U.S. taxation. See H. Comm. on Ways & Means, 113th Cong., Tax Reform Act of 2014: Discussion Draft: Section-by-Section Summary, at title IV, https://waysandmeans.house.gov/UploadedFiles/Ways_and_Means_Section_by_Section_Summary_FINAL_022614.pdf. Former President Obama proposed a 19% minimum tax on foreign income and a 14% transition tax on previously untaxed foreign income. *Obama FY 2016 Budget Proposes Minimum Tax on Foreign Income and Adds Other Significant International Proposals*, PwC TAX INSIGHTS FROM INT’L TAX SERV. (Feb. 12, 2015), <https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-obama-fy-2016-budget-proposes-minimum-tax-foreign-income.pdf>. The House Blueprint, written by the House majority of

From an economist's perspective, this is a rare opportunity to impose an efficient tax, because it will relate entirely to past accumulations of income and will be irrelevant to future behavior. This counsels in favor of a high tax rate; many policymakers, however, surrounded by the constant blandishments of the multinational firms themselves, seem to favor unconscionably low rates. In the end, this is a purely political and revenue issue; I suspect that in the end the figure will be a plug number chosen by the Congressional tax-writing committees to achieve their overall revenue objectives.

My own starting point is a 20% tax on all offshore earnings, with a prorated foreign tax credit (as was done in 2004 under section 965's one-year tax holiday¹⁰⁶). Former Chairman of the House Ways and Means Committee Dave Camp in his 2014 comprehensive tax reform proposal introduced the idea of a split tax rate, with a lower rate on earnings reinvested in real assets outside the United States than that imposed on earnings held in financial investment assets.¹⁰⁷ There is undeniable appeal to this suggestion, which, were the decision mine, I would accept by way of a friendly amendment. Regardless, my proposal is that firms would be given a five-year period over which to pay their tax bill in respect of their offshore earnings on a prorated basis, without an interest charge, to reflect liquidity concerns.

The transition to the new tax regime for investors must be adopted *in toto* as of a specified date. The proposal therefore is to move immediately to the new Includible Amounts system for years beginning after the date of enactment.

It is critically important in this regard to incorporate a one-time mark-to-market for *all* business investments as of the date of enactment. This one-time event resets basis but triggers no immediate gain or loss recognition. That is, this mark-to-market event captures unrealized capital gains as of the date of enactment (by converting current law's deferred capital gains tax into an annual tax on Includible Amounts measured by reference to an investor's reset tax basis). It also permits an effective deduction for pre-enactment capital losses, by the same reasoning.

the 114th Congress, would provide a 100% exemption for dividends received from foreign subsidiaries. A BETTER WAY, *supra* note 71, at 28.

106. See § 965(d)(1); IRS Notice 2005-64, *Foreign Tax Credit and Other Guidance under Section 965*, 2005-2 C.B. 471.

107. Tax Reform Act of 2014, *supra* note 59, § 4003.

I fully appreciate the irony in my proposing a universal mark-to-market on enactment for all investments in business firms, while at the same time going to such great lengths not to rely on mark-to-market solutions for the ongoing operation of the Dual BEIT. But the proposal here is a once-a-century reset in tax basis, not an annual point of contention (or opportunity for tax avoidance) between taxpayers and the IRS. Among the most affluent, a once-a-generation valuation of investments in privately held firms already is required by the estate tax. Because the revaluation would be universal in application, it would not distort ongoing corporate finance decisions as to whether to become a public firm. As assets turn over, any imperfections in year-of-enactment valuations would disappear, but we would at least start from a tax base somewhat closer to reality than would be the case were we not to implement this once-a-century reset in tax basis. Finally, I observe that this is the rule adopted on the introduction of the income tax in 1913.¹⁰⁸

III. WHAT IS A NORMAL RETURN, ANYWAY?

A. Role of COCA Rate

The COCA rate is the mechanism that makes the Dual BEIT a neutral profits-only tax at the firm level and that measures normal (taxable) returns to investors. As described in Part II, the COCA mechanism does this by affording a firm an annual deduction equal to the aggregate capital invested in the firm multiplied by the COCA rate, which is designed to reflect an economy-wide, risk-adjusted normal return to business capital. From the other direction, the Dual BEIT requires investors to include in income each year the amount of their unrecovered investments in firms multiplied by the same COCA rate. It obviously follows from this that specifying the COCA rate, and in particular justifying the COCA rate as a risk-adjusted normal return, is essential to the intended operation of the Dual BEIT.

Capital Taxation in an Age of Inequality briefly recounts the standard decomposition of capital income into normal returns, risky returns, and economic rents, as well as the standard explanation of why an ideal business cash flow tax does not burden normal returns, while

108. I.R.C. § 1053.

an ideal income tax does—and why neither burdens risky returns.¹⁰⁹ A business cash flow tax is the best-known and most closely studied example of a practical profits-only tax. In order to illumine what COCA rate is required to produce economic equivalence, it therefore is helpful to consider why a cash flow tax operates as a profits-only tax.¹¹⁰

To repeat some of the discussion from that earlier article, under the “Cary Brown Theorem,” the step of permitting the full expensing of a firm’s capital investments is understood to exempt from tax the firm’s normal returns on its investments.¹¹¹ The tax benefit afforded by

109. Kleinbard, *Capital Taxation*, *supra* note 1, at 605–10, 624–26, 675–78. As used in the literature referenced here, an “ideal” income tax is understood to comprise a comprehensive Haig–Simons income tax, with one tax rate schedule for both labor and capital income. For more complete references to the relevant tax law and public finance literature on the treatment of risky returns, see, for example, Brooks, *supra* note 13, at 255 nn.2–6; Theodore Sims, *Capital Income, Risky Investments, and Income and Cash Flow Taxation*, 67 TAX L. REV. 3, 3 nn.2–5 (2014); David Hasen, *The Treatment of Risk-Taking Under an Income Tax*, 1 n.1 (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2544565.

110. Schön, *supra* note 5, offers an extremely interesting overview of the intersection between the economic theory of risk-taking and how that relates both to multinational firms’ intra-firm allocations of actual risk and to tax-driven profit shifting. Mitchell A. Kane, *Risk and Redistribution in Open and Closed Economies*, 92 VA. L. REV. 867 (2006) is to similar effect.

Schön rightly concludes that ex ante measures of risk allocation within a multinational group are easily gamed through information asymmetries between firms and taxing jurisdictions, and that tax systems must therefore rely on ex post, “commensurate with the income”-type rules to protect their base. Schön, *supra* note 5, at 292. Here, however, the focus is not on intrafirm risk allocations across borders but rather on the appropriate measure of an economy-wide, ex ante normal return to real investment. Moreover, the “superconsolidation” international tax environment proposed in Part V, *infra*, vitiates most of the issue motivating Schön, at least from the perspective of the United States as a residence country. The analysis presented here is not intended to inform the allocation of economic profits or ex post returns to risk to the United States when it is a source country.

111. Cary Brown demonstrated that, under certain plausible assumptions, expensing an investment that yields normal returns is the same as exempting the investment’s yield from tax. E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in INCOME, EMPLOYMENT AND PUBLIC

the immediate write-off of marginal investments yielding a normal return under a cash flow tax means that the government theoretically funds the scaling up (or, alternatively, “grossing up”) of a firm’s marginal investments without cost to the firm, to the point where the firm’s after-tax and pretax yields on its marginal investments are equivalent.

In contrast, an ideal income tax does not permit an investor to deduct the amount of an investment when made, but instead requires that the investment be capitalized; as a result, the tax system does not provide any mechanism by which the taxpayer, in the face of the imposition of an income tax, can scale up without cost her investment yielding normal returns. It follows that the income tax burdens normal returns, while a cash flow (or other profits tax) does not.¹¹²

The consensus view is that this is the only important difference between a well-designed income tax and a cash flow or other profits-only tax: by design, the former taxes time-value-of-money returns, whereas the latter exempts them from the tax base. The measure of success of a capital income tax under this view is its ability to measure and tax normal returns consistently.

The contrasting treatments of normal returns under income and consumption taxes are well-settled. The bulk of legal academic work in this area therefore has focused on the treatment of risky returns. Again the scale-up strategy takes central stage, but the analysis becomes more complex than in the case of a simple investment in an asset bearing normal returns, because the investor in the models considered in the legal literature invariably holds two assets—a risk-free asset (which may or may not have positive returns ascribed to it in the model) and a risky one, where the scaling up of the risky asset in response to the

POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300, 309–10 (1948). What is today called the Cary Brown Theorem was introduced to tax law specialists by William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). This of course exactly describes how a cash flow tax operates. By expensing all investments, therefore, it is said that a cash flow tax exempts from tax the normal return on those investments.

112. See Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?*, 47 TAX L. REV. 377 (1992); Bankman & Weisbach, *supra* note 13, at 1433–36; Joseph Bankman & David A. Weisbach, *Consumption Taxation Is Still Superior to Income Taxation*, 60 STAN. L. REV. 789 (2007); Shaviro, *supra* note 13, at 91–113.

introduction of taxation is funded by the sale of the risk-free investment.¹¹³ The risky asset has known alternative payouts and therefore has no element of uncertainty associated with its returns. Many of the apparent differences in results hinge on the fact that authors make different assumptions as to whether the risk-free asset earns any positive return at all; in some cases, authors seem to shift their assumptions on this key point as they work from example to example.

This stream of analysis can be traced to a 1944 paper by Domar and Musgrave,¹¹⁴ and entered the tax law literature through an early paper by Alvin Warren.¹¹⁵ The analysis was extended by Bankman and Griffith, Cunningham, and many others, and reached its apogee in David Weisbach's influential paper, *The (Non)Taxation of Risk*.¹¹⁶ The idea in every case was that when moving from a nontax environment to one that purported to tax risk, an investor could rearrange her investments by scaling up her risky investment, typically by selling some of her risk-free investment, and thereby avoid the tax burden on returns to risk.¹¹⁷

Louis Kaplow extended the analysis by considering the question, where will all these new risky investments come from? That is, the scaling up strategy requires that the investor be able to buy more of the same risky investment at the same price as the original investment, but in the absence of some new seller entering the market, the additional demand for such assets would push up price. Kaplow showed that, at least in an idealized model, the government itself could be that new seller. That is, the imposition of a tax on risky returns (in the presence of full loss offsets) can be analyzed as the government buying a slice of every risky investment; if one hypothesizes that the government has no

113. See Cunningham, *supra* note 13; Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1 (1996); Weisbach, *supra* note 13.

114. See Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388 (1944).

115. See Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980).

116. Weisbach, *supra* note 13; see also Bankman & Griffith, *supra* note 112; Cunningham, *supra* note 13.

117. The "scaling-up" strategy is thus deployed in two different contexts: in profits-only taxes, to avoid tax on normal returns, and in both ideal income and profits-only taxes, to avoid tax on ex post returns to risk. Warren, Jr., *supra* note 113, explores these two different applications of the scaling-up principle.

interest in holding all those assets, it could in turn sell them short into the marketplace, thereby ensuring a general equilibrium result in which scaling up had no effect on prices.¹¹⁸

Once the general equilibrium problem was solved, at least in theory, it followed that a cash flow tax would not burden risky returns any more than it did riskless (normal) returns, because the Cary Brown Theorem could operate to scale up both normal and risky returns—assuming again, for emphasis, that the risky investment could, conceptually at least, be scaled up without affecting the price of the investment and that the tax system treated losses symmetrically with gains, which requires both a refund mechanism and a proportional tax.¹¹⁹

What is more, if the risky investments in question are pure bets (for example, derivatives in which no variation margin is required), then (under the assumption made in the models that investors have unlimited borrowing capacity and, therefore, constant creditworthiness) the income tax analysis is the same as in the cash flow tax case. Under the assumption that there is no cost to scaling up, an investor can do so under an income tax as well as under a cash flow tax and thereby neutralize the effect of the imposition of the tax on returns to risk.

When, however, the risky assets have capital invested in them, then the income tax scale-up story becomes more complex, because the investor incurs a cost to scaling up—the government does not provide a hypothetical interest-free loan, as in the cash flow tax case. As noted earlier, the setup in the models invariably assumes that the investor starts by holding two assets, a risk-free asset yielding normal returns and a

118. Louis Kaplow, *Taxation and Risk: A General Equilibrium Perspective*, 47 NAT'L TAX J. 789, 790–91 (1994).

119. See Weisbach, *supra* note 13, at 33–35. Neutrality is achieved only if firms have an absolute certainty of recovering from the government the tax benefit of losses, which requires either immediate refundability (a nonstarter everywhere as a practical matter) or an interest charge and ultimate refundability on windup of the business. Stephen R. Bond & Michael P. Devereux, *Generalized R-Based and S-Based Taxes Under Uncertainty*, 87 J. PUB. ECON. 1291, 1296 (2003); Stephen R. Bond & Michael P. Devereux, *On the Design of a Neutral Business Tax Under Uncertainty*, 58 J. PUB. ECON. 57, 69–70 (1995) [hereinafter Bond & Devereux, *On the Design*]; Peter Birch Sørensen, *Dual Income Taxation: Why and How?*, 61 FINANZARCHIV 559, 574 (2005) [hereinafter Sørensen, *Dual Income Taxation*]; Peter Birch Sørensen, *Neutral Taxation of Shareholder Income*, 12 INT'L TAX & PUB. FIN. 777, 784–86 (2005) [hereinafter Sørensen, *Neutral Taxation*].

risky one. The investor funds the additional scale-up of the risky asset required to restore her pretax risk profile by selling the risk-free one. Further, the models usually assume that the investor can borrow at the risk-free normal rate of return.

From these assumptions, the conclusion usually is phrased that the investor under an income tax bears tax on the normal return (here understood to mean the return on riskless assets) on the entirety of her invested capital, whether she invests in riskless or risky assets.¹²⁰ This conclusion can be explained in a variety of ways, but the simplest is that a risky asset must have an expected return greater than the normal return, so that all risky assets can be decomposed into a pure capital investment, bearing a *riskless* normal return, stapled to a risky bet.¹²¹ The former component is taxed, just as a straightforward investment in riskless assets is taxed, and the latter component is not, by virtue of scaling up the size of the risky bet. The investor who sells the riskless asset to increase her investment in the risky one cannot escape tax on the normal return to capital implicit in all the capital she has invested.¹²²

120. Sims describes this as the “conventional wisdom.” Sims, *supra* note 109, at 4 n.7; *see also* Shaviro, *supra* note 13.

121. This decomposition has echoes in the Black-Scholes option pricing model. *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973).

122. A recent wave of academic papers in this area takes issue with the scaling-up story as a matter of economic logic. Theodore Sims and John Brooks both emphasize that the wealth effect of the income tax means that the investor cannot simply replicate the same risk profile after tax as she could in a world without tax, even though the variance of her returns on her risky investment (after scale-up and after tax) would be constant, because in all states of the world she will be poorer—the same investment has become less attractive, and she therefore would decline to scale up, at least to the full extent necessary to hold her after-tax amount at risk constant. Brooks, *supra* note 13, at 257; Sims, *supra* note 109, at 20–26.

Brooks goes on to consider the implications of modern portfolio theory, which incorporates the fact that most people are more loss averse than they are risk averse, and therefore weight the risk of loss more heavily than the prospect for gain. Again, the consequence is that rational investors would not fully scale up (because doing so exposes them to the possibility of a greater absolute after-tax loss), and to the extent they do not fully scale up in the presence of an income tax, the pure risk component of their investment does bear a tax burden. Brooks, *supra* note 13, at 269–84.

B. Normal Returns Are Not Necessarily Riskless Returns

The formulation described at the end of the last Section conflates normal returns with riskless ones. Often, this conflation follows from the models themselves, which for simplicity assume that an investor can borrow at the risk-free rate (or funds new risky investments by selling risk-free assets). The narrowest instance of the time value of money is a government-bond risk-free return, but the normal return to business capital is a more elusive concept than this one case, because it also encompasses the ex ante expected return on a marginal investment by a firm. Thus, a recent working paper published by the OECD noted that:

While there is no universally accepted meaning of the expressions normal and excess returns, a common thread in these references is the implicit agreement that a normal return should include a risk element. In the absence of a specific definition, the normal rate of return on equity is often linked to a risk-free rate of return or the interest an investor would receive from holding a

David Hasen, among other points, adds to Sims and Brooks by making the sensible observation that it is unrealistic to imagine that the government imposes a tax on risky returns only to undo the consequences of that tax by selling the risky assets short. He further relates the government's risk profile to its budget constraints; once one allows revenues to fluctuate with returns to risk (financed when necessary by riskless government borrowing), there is no logical reason for the government to sell risk short, and the general equilibrium conditions specified by Kaplow may not hold. Indeed, Hasen concludes that extensive real-world government borrowing can be construed as the government selling the *riskless* asset short and retaining an interest through the tax system in risky ones. Hasen, *supra* note 109.

What follows from these recent papers is that the conventional wisdom—that an income tax, like a profits tax, does not burden the pure return to risk, but rather only the normal return—may be an incomplete picture, although more work (including empirical research) would be desirable here. Rational investors have good reason not to scale up completely, and government behaves precisely the opposite of what general equilibrium theory requires, by selling fixed returns short (borrowing more money) and retaining volatile tax returns. Even under the conventional view, normal returns may be higher than is generally supposed, because the relevant metric should be the yield on medium-term rather than on short-term government obligations.

long-term government bond. Investors are unlikely to consider this a fair measure for the opportunity cost of the next best alternative investment. Equally, a firm is not likely to consider this a fair return when returns are generated by active management and services provided.¹²³

Firms exist to take risk, and their cost of capital reflects this fact. From a firm's perspective, when looking at a new marginal investment, the normal return can only mean the *risky* return whose ex ante anticipated returns will just cover its own existing cost of capital (which in turn reflects the composition of its assets, until equilibrium is reached); anything less means that it is engaged in systematic negative arbitrage (when viewed from the perspective of the asset), since its own capital will be priced by investors at some spread to riskless government bonds, as is any other risky asset.¹²⁴

Noël Cunningham pointed in this direction in an early article in this field, in which he demonstrated that under an ideal income tax and the scaling-up strategy described earlier, a firm that financed the scaling up of its risky investment at market rates of interest (that is, at rates above the riskless rate), incurred a tax cost (and revenue to the government) equal to the after-tax cost of that borrowing.¹²⁵

123. See Hayley Reynolds & Thomas Neubig, *Distinguishing Between "Normal" and "Excess" Returns for Tax Policy* 6 (OECD Taxation Working Papers No. 28, 2016), <http://www.oecd-ilibrary.org/docserver/download/5jln6jct58vd-en.pdf?expires=1510237989&id=id&accname=guest&checksum=47A003D652C61F2F260D279DA70289C5>.

124. An exotic exception would be a securities dealer borrowing on a short-term basis to hold government bonds, and using secured "repo" financing, which has a special creditor-friendly status under bankruptcy law, to do so. See 11 U.S.C. § 362(f)(7) (Lexis 2017); *id.* § 546(f); *id.* § 559; see also Steven L. Schwarcz & Ori Sharon, *The Bankruptcy Law Safe Harbor for Derivatives: A Path Dependence Analysis*, 71 WASH. & LEE L. REV. 1715 (2014); Steven L. Schwarcz, *Derivatives and Collateral: Balancing Remedies and Systemic Risk*, 2015 U. ILL. L. REV. 699 (2015).

125. See Cunningham, *supra* note 13. A more complete description of the income tax burden on risky returns within the confines of the models in this strand of the literature is that the burden equals the after-tax cost of scaling-up plus any tax on the returns to the scaled-down investment.

Brooks, *supra* note 13, points in this direction as well. When dealing with a firm that scales up a risky investment by issuing equity rather than

A more general formulation is that an income tax burdens a firm's *risk-adjusted normal returns*—that is to say, its marginal returns—whatever they might be, in light of the firm's overall exposure to risk. As Ethan Yale has observed, in efficient markets ex ante expected returns to risk and normal riskless returns are fair trades for one another: from the perspective of ex ante opportunities, expected *returns* increase with risk, but the market *value* of that expected return is the same as that of the riskless government investment.¹²⁶ An investor with \$1,000 to invest might choose to buy a government bond yielding 2%, or 20 shares of common stock of a corporation with an attractive but untested business plan that the market values at \$50/share. The latter might have an *expected* return of 7%, but its value remains \$1,000. In this second use, the normal return is a risk-adjusted normal return.

To emphasize, the two assets have different ex ante expected payouts (to compensate for the assumption of risk), and different ex post actual returns, but equivalent values. For example, if the government were to auction off a perpetual “outperformance” contract on risky investments, in which a perfectly creditworthy buyer would receive all tax revenues above the riskless threshold but would pay to the government all shortfalls below that rate (including immediate refunds in respect of losses), the winning bid should be approximately zero. But equivalence in value is not the metric by which to establish the COCA rate, for the reasons described below.

All tax systems, of course, tax ex post results, not ex ante expectations. Given that a firm's investment outcomes will diverge from ex ante expectations in all cases involving the assumption of risk, how can we relate a tax on ex post outcomes to pretax, ex ante expected returns from that same investment? The answer is that we would ideally choose an ex post business firm-level tax that leads to the same ex ante investments as would occur in a world without that firm-level tax. A proportional (flat rate) tax system, full credit for losses (or as close to

debt, the preferred description explains the apparent anomaly that a cash flow tax and an income tax appear to produce the same after-tax result. The difference is that in the cash flow tax the scaling-up is authentically costless, while in the income tax case the burden to the firm is the cost of that equity. In turn, the returns to that equity will appear as revenue to the government at the investor level.

126. See Ethan Yale, *Investment Risk and Deferred Compensation*, 62 TAX L. REV. 377, 390–91 (2009).

that as possible), and an exemption from tax for ex ante anticipated marginal returns does the trick. Only in such a system does a firm hold the same portfolio of investments in a world with the tax as in a world without it.

That is exactly the outcome envisioned by a cash flow business tax or, alternatively, by the firm-level operation of the Dual BEIT (or other capital account allowance profits tax).¹²⁷ But to accomplish this, the Dual BEIT, or any capital account allowance, must offer an allowance sufficient to exempt from tax the entirety of a firm's ex ante marginal expected returns. These in turn will always exceed risk-free returns, because that is what it means to be in business.

In other words, the standard analysis of why a cash flow tax is a profits tax relies on the scaling-up metaphor presented earlier, but that analysis does not, by itself, describe what it is that the firm is scaling up. The answer cannot be that the hypothetical firm is loading up on government bonds. It is clear that the scaling-up analysis cannot apply to rents, because any rational firm would already have exhausted its opportunities to capture them, but that observation does not mean that a firm's only available marginal investment is a riskless one. To the contrary, firms have a great many risk-adjusted marginal investments available to them, and the choice of which to make reflects the firm's appetite for risk, as mediated through investors' tolerance for accepting that risk (in turn reflected in the firm's cost of capital).

To summarize, a firm does not invest in risk-free assets, just as its own cost of capital will never equal the government's risk-free rate. And from the firm's perspective, its cost of capital (which is to say, the minimum return demanded by investors in the firm) is an existential priority to the firm. From inside the perspective of the firm, its own cost of capital is riskless, in the sense that the firm itself cannot survive without covering that cost. The investor's risky investment thus is the firm's existential imperative.

127. The fact that investors (savers) are taxed on their returns may affect the supply of investment capital (subject to the usual observation that investment abhors a vacuum, and capital from outside the United States would flow into the country until global after-tax returns were equalized) but does not change the portfolio of what a firm would invest in, up to the limit of the cost of its capital. See Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003).

C. Application to the COCA Rate

The distinction between riskless returns and risk-adjusted normal returns—that is to say, a firm’s marginal returns—becomes important when implementing a profits tax through any capital account allowance framework (including the Cost of Capital Allowance Mechanism employed by the Dual BEIT) or, for that matter, an Allowance for Corporate Equity (ACE), which provides a firm with full interest deductions plus an additional allowance in respect of its equity capital. A cash flow tax affords taxpayers costless scaling-up through expensing, in which government can be viewed as purchasing a share of each asset outright. Allowances for corporate capital instead offer taxpayers a direct government subsidy for the marginal cost of capital expended to acquire the asset. For the two systems to be economic equivalents, the subsidy rate must be specified by reference to some assumed return on marginal investments or cost of finance such that taxpayers could obtain the same costless scaling up available through expensing in a cash flow tax.

A cash flow tax has the great virtue of completely sidestepping the issue of what constitutes a normal return. The scaling up principle simply permits a firm to scale-up its marginal investment, whatever that investment may be. In practice the marginal investment will bear a risk-adjusted, *ex ante* expected return greater than the riskless return.

Because a capital account allowance like the COCA deduction is designed to have the same value to a firm as expensing, which is to say the ability to scale up its marginal investment without cost so as to produce a zero effective marginal tax rate on that investment, the allowance must be specified at a rate commensurate with a firm’s marginal cost of finance (which in equilibrium also should be the return on a marginal investment).

It would follow that each firm should have its own COCA rate, determined by reference to the riskiness of its own assets and the marginal cost of its next investment. But I see no way to instantiate such a principle. Here, the perfect ought not to be the enemy of the good. The Dual BEIT is intended to operate as a practical and easily implementable tax, and this requires an objectively determined COCA rate with broad application. If the COCA rate chosen represents an economy-wide, average marginal cost of funds (or, to say the same thing from the other direction, the typical firm’s *ex ante* anticipated returns from a marginal investment), rough justice will be served. This, combined with a moderate rate of taxation (see Section II.B), would constitute a profound

improvement over current law's high statutory rate, debt bias, dependence on accelerated depreciation and non-capitalization, and so on, in permitting firms to operate in an environment that is reasonably close to one that exempts firms' *ex ante*, risk-adjusted normal returns from tax.

The Dual BEIT therefore rejects hypothetical firm-by-firm or industry-by-industry calculations of the marginal cost of capital in favor of a rough approximation of a typical firm's cost of funds. For purposes of illustration, this Article uses as this rough approximation a COCA rate of one-year Treasuries plus 300 basis points.

As noted in Section II.C, the Dual BEIT mitigates the concern that the COCA rate formula will miss the mark by using the same COCA rate for firms and investors. If the COCA rate is too low from a firm's perspective, because its investments are quite risky, then by the same token investors will enjoy a somewhat lower annual income inclusion than would be the case if their expected returns were measured more granularly. At an economy-wide level, these distinctions should more or less cancel out, and, provided that the tax rate is not particularly high, any attendant distortions within a firm's decision calculus should not be all that large.

Much of the relevant literature in this field instead recommends that a cost of capital allowance should reflect a riskless rate of return.¹²⁸

128. In particular, it frequently is assumed that the relevant measure, as applied to the United States, is the (inflation adjusted) return on short-term Treasury Bills—from which follows the observation that the income tax burden on normal returns is basically inconsequential. Bankman & Griffith, *supra* note 112, at 387–90; Cunningham, *supra* note 13, at 21 & n.23; Zelenak, *supra* note 13, at 880 (observing that inflation-adjusted average return on Treasury Bills from 1926–2004 was 0.7%). A separate question in the literature begins by assuming that a normal return is a government bond return (on the theory that this is as close to a riskless investment as can be obtained), but then asks whether the relevant comparison is to a short-term or long-term government instrument. The Mirrlees Review, for example, concluded that the relevant comparison is to a medium-term government bond rate. INST. FOR FISCAL STUDIES, TAX BY DESIGN: THE MIRRLEES REVIEW 298, 302 (2011), <https://www.ifs.org.uk/publications/5353> [hereinafter MIRRLEES REV.] (The Mirrlees Review was a comprehensive rethink by some of the world's leading public finance economists, and chaired by Sir James Mirrlees, of the lessons for actual tax policies to be drawn from the current state of the art in public finance economic analyses.) In this regard, Lawrence Zelenak observed in his 2006 article that the historic return on inflation-protected ten-year Treasury

In some cases, this assertion reflects the misapprehension that a normal return necessarily is a riskless one, thereby assuming the conclusion.¹²⁹ (As noted, this misapprehension often follows from the extension to policy of assumptions in models that for simplicity assume that a firm

bonds then had been in the range of 1.725% to 4.338%. Zelenak, *supra* note 13, at 889–90. More recent data for ten-year inflation-protected Treasury bonds indicate generally declining rates (in line with lower U.S. inflation expectations), from 1.375% in July 2008 to 0.375% in July 2017. See *TIPS/CPI Data*, TREAS. DIRECT, <https://www.treasurydirect.gov/instit/annceresult/tipsdpi/tipsdpi.htm> (last visited Nov. 30, 2017).

129. At the same time, the term “normal return” is sometimes used (more appropriately, in this context) as synonymous with a firm’s marginal cost of capital, or alternatively (and equivalently) the minimum expected return required for an investment to break even. Thus, the Mirrlees Review refers to “the normal or required rate of return on investments financed by equity,” MIRRLEES REV., *supra* note 128, at 437, (by which it presumably means a risk-adjusted return, *id.* at 436–67), and observes that exempting the “normal return on corporate investments” from tax means that “[corporate] [m]arginal investments, which just earn the minimum required rate of return in the absence of tax, remain marginal investments in the presence of the tax.” *Id.* at 419. Again, this latter usage implicitly looks to a firm’s cost of capital, not the government’s.

To similar effect, Peter Birch Sørensen writes:

By definition, rents are “pure profits” in excess of the going market rate of return on capital. For debt capital, the normal return is the market rate of interest on debt in the relevant risk class, and for equity it is the required market rate of return on stocks with the relevant risk characteristics. If markets for risk pooling are underdeveloped, the required risk premia will tend to be higher, and so will the normal return.

Peter Birch Sørensen, *Can Capital Income Taxes Survive? And Should They?*, 53 CESIFO ECON. STUD. 172, 176 (2007).

This again is a risk-adjusted concept of a normal return, viewed from the perspective of a firm’s cost of capital. As one final example, Alvin Warren offers two competing definitions of “normal returns,” as either “riskless returns,” or alternatively as “what the investor could earn on [a] marginal investment,” which in the latter case could equal the investor’s own cost of borrowing (through an investment taking the form of a reduction thereof). Warren, Jr., *supra* note 113, at 5.

borrow at the risk-free rate, or sells risk-free assets to fund the scaling up feature.) In other cases, however, the reasoning relies on a different point of confusion, by misapprehending the value to a firm of its “tax receivable”—the present value to the firm of its future capital account allowances.

Boadway and Tremblay, for example, in an excellent review of business tax reform in the Canadian context, argue that a Capital Account Allowance mechanism like the COCA should employ the government risk-free rate.¹³⁰ Their reasoning relies on the belief that the government’s promise of future capital account allowances—the tax receivable—is the same as any other government IOU (abstracting from political risk as to future tax law) and therefore should yield the same rate as a government bond.¹³¹

The intuition is attractive but, in the end, is simply an imperfect metaphor. A firm’s tax receivable—the promise of future tax deductions through the COCA system—is a claim against the government, and thus in a creditworthiness sense can be analogized to holding a notional government bond (abstracting from political risk as to future tax law, as Boadway and Tremblay note). The difficulty with this metaphor, however, is that firms have no choice but to hold this risk-free receivable. That is, unlike an actual Treasury security, the notional stream of government subsidy *cannot* be monetized through sale or rehypothecation any more than can future depreciation deductions under an income tax.¹³²

If firms could somehow monetize their claims to future capital account allowances, then in fact they could reduce those claims to cash

130. See Boadway & Tremblay, *supra* note 65, at 45.

131. See Bond & Devereux, *On the Design*, *supra* note 119.

132. Admittedly, a trading market in tax receivables could be created by statute, although I am not aware of any capital account allowance proposal that has thought through how such a market would be designed and function. In light, however, of the enormous political pushback to “safe harbor leasing,” which was a brief and inglorious experiment along similar lines in the United States (enacted in 1981 and repealed two years later), it does not seem profitable to tie the fate of the Dual BEIT or any other capital account allowance system to the parallel creation of a free trading market in tax receivables, especially when an alternative mechanism is at hand. On the safe harbor leasing pushback, see, for example, Alvin C. Warren, Jr. & Alan J. Auerbach, *Tax Policy and Equipment Leasing After TEFRA*, 96 HARV. L. REV. 1579 (1983).

equal in value to the cost of the marginal investment they actually wish to make. By doing so, they would put themselves in the same position as they would have enjoyed in a cash flow tax. But firms cannot do so; there is no market in tax receivables, because a tax receivable cannot be stripped from the property to which it relates in order to be sold or collateralized. This in turn means that a firm's marginal investment must be financed at the firm's marginal cost of finance—and firms do not finance their operations at the risk-free rate.

In this connection, it should be noted that an ACE, which often is described as a form of profits-only taxation, yields a government subsidy far greater than a risk-free rate because, under an ACE, a firm deducts its actual cost of debt capital plus a statutory allowance in respect of equity capital. The ACE mechanism cannot be correct as a matter of theory while at the same time a neutral capital account allowance is conceptualized as a risk-free rate.

In short, the risk-free notional government bond embodied as a tax receivable might have a theoretical value equal to the risk-adjusted normal return on the assets in which a firm invests, but a firm's actual cost of capital will follow from its risk profile, and that always will be higher than a risk-free investment. A firm therefore will go broke quickly by investing in notional risk-free assets with liabilities (its capital structure) priced as risky investments to the holders of those investments. Perhaps for this reason David Bradford contemplated a capital account allowance set at rates close to an issuer's cost of funds, to reflect some of these pragmatic issues: "Conceptually, the interest rate called for is the one that would make the taxpayer indifferent between expensing and capitalization with interest allowance (in a constant tax rate environment)."¹³³

The neutral COCA rate therefore must be one that just covers the cost of investing in assets with similar risk characteristics, which is to say, a representative weighted average cost of capital for domestic firms. That formulation admittedly is imperfect, because a particular firm's cost of capital will depend on the riskiness of the particular portfolio of investments that it makes, but it seems to be as close as can be

133. See David F. Bradford, *A Tax System for the Twenty-First Century*, in TOWARD FUNDAMENTAL TAX REFORM 11, 23 (Alan J. Auerbach & Kevin A. Hassett eds., 2005); see also DAVID F. BRADFORD, *Transition to and Tax-Rate Flexibility in a Cash Flow-Type Tax*, in TAXATION, WEALTH, AND SAVING 311–321 (MIT Press 2000).

expected of an administrable tax. As a result, the COCA, and other allowances for corporate capital, will always suffer from the problem that a statutory allowance of this nature will never be perfectly attuned to each firm's circumstances.

The higher cost of capital to small firms can be recognized through special concessionary higher Cost of Capital Allowance rates. By way of example, the first \$10 million of firm capital might enjoy a higher COCA rate, without any offsetting, higher Includible Amounts being included in the income of investors. (The subsidy rate in turn could be phased out for firms with significantly more capital, in a manner analogous to how Code section 11(b) operates to flatten the corporate income tax progressive rate structure.) This idea does fairly reflect the much higher costs of financing to which small firms are subject.

More generally, the system is adaptable to a range of policy and political economy concerns. In this regard, a system whose design cannot easily accommodate special concessionary rates for small business is not a system likely to be enacted into actual law.

As suggested above, the COCA rate used to calculate investors' Includible Amounts should be the same as the base COCA rate used by business enterprises. This has three great advantages. First, the rate should be to a first degree of approximation a good estimate of real-world normal returns. Second, using the same COCA rate, along with one base tax rate on both business income and Includible Amounts, minimizes the economic distortions and risk to the fisc of getting that rate wrong. Third, legislatures should find it relatively easy to approximate an appropriate COCA formula simply by weighing the whines of investors against the opportuning of firms, until their volumes are in balance.¹³⁴

134. In the absence of an anti-abuse mechanism, one might speculate that firms would be established to invest only in Treasury securities. Following the recommendations in Part II, such a firm would obtain a COCA deduction greater than Treasury rates but have income inclusions only at the Treasury rate. Not all investors would find this structure attractive relative to owning the Treasuries outright, because were an investor simply to purchase a Treasury obligation herself, her annual income inclusion would be limited to the Treasury's actual interest rather than the higher COCA rate. Nonetheless, such a firm might be expected to trade like a closed-end government bond mutual fund and therefore have a low cost of capital; this would suggest that it might generate annual losses available for other activities. If this is thought to be problematic, the most straightforward solution is to limit a firm's COCA deduction in respect of non-business financial assets (e.g., Treasury securities)

IV. THE LABOR-CAPITAL INCOME CENTRIFUGE

A. Version 1.0

The BEIT mechanism summarized in Part II is designed to impose an annual tax on capital income in a reasonably comprehensive and consistent way, while preserving existing income tax norms as much as possible, and adopting as featureless a tax topography as the complexities of our modern economy permit. The dual income tax part of the Dual BEIT signals this project's commitment to a different tax schedule for capital and labor income—in particular, for the reasons developed in the companion paper, a moderate flat rate on capital income (for example, 25%) and higher graduated rates on labor income. But this in turn requires an explicit tool for segregating labor from capital income—what this Article calls a labor-capital income centrifuge.

A labor-capital income centrifuge is necessary because without one, an owner-entrepreneur of a closely held firm will face strong incentives to pay herself as small a salary as possible, in order to treat the bulk of her total income as capital income taxed within the firm at a 25% rate (to continue that example). The U.S. Treasury is exposed to this issue today, in the form of the Edwards–Gingrich Medicare tax avoidance stratagem that has attracted considerable attention, and which has proved resistant to attack using the conventional means available to the IRS.¹³⁵ From the other direction, a labor-capital income centrifuge is unnecessary if the business enterprise tax rate is set at the top labor income marginal rate, but for the reasons summarized in Section II.B, the Dual BEIT proceeds with a more moderate rate on firm income.

Norway has been the leader in designing dual income taxes; over the years it has implemented different systems that alternatively have taxed all capital income at one flat rate, or that more recently have taxed normal returns at a low rate while endeavoring to tax economic rents at basically the top rate on labor income.¹³⁶ In doing

to the yield actually earned on those securities (the obverse of today's arbitrage regulations for state and local governments that seek to borrow at tax-exempt bond rates and invest in Treasury securities).

135. See Kleinbard, *Capital & Labor Stuffing*, *supra* note 36, at 17–19.

136. See Kleinbard, *An American Dual Income Tax*, *supra* note 54; see also Sørensen, *Neutral Taxation*, *supra* note 119. There is a large public finance literature (predominantly authored by European economists) on the

so, Norway was forced to develop labor-capital income centrifuges of varying design and institutional success.¹³⁷

theory and practice of dual income taxes, much of which is summarized in the article just cited. Three helpful brief papers are Robin Boadway, *The Dual Income Tax System—An Overview*, CESIFO DICE REP., Autumn 2004, at 3; Eggert & Genser, *supra* note 69, at 41; Sørensen, *Dual Income Taxation*, *supra* note 119.

137. See Kleinbard, *An American Dual Income Tax*, *supra* note 54, at 65, n.117. The OECD Economic Surveys: Norway 2012 report summarizes succinctly the economic case for dual income taxation. *OECD Economic Surveys: Norway 2012*, at 70–74 (Feb. 2012), http://www.oecd-ilibrary.org/economics/oecd-economic-surveys-norway-2012_eco_surveys-nor-2012-en [hereinafter, *OECD 2012 Norway Survey*].

Putting to one side the technical issues in Norway's original labor-capital income centrifuge, the first generation of the Norwegian dual income tax attempted to reach a uniform flat tax on capital income by relying on an accurate specification of a firm's income tax base (as did the U.S. Treasury's Comprehensive Business Income Tax, TREAS. DEP'T, INTEGRATION, *supra* note 43), and marrying that to a dividend imputation system (so that dividends ideally would not be double taxed), and providing that other capital income of an investor (such as interest income) would be eligible for the same flat rate as that imposed on firms. It also employed a complex basis adjustment mechanism (called the "RISK" mechanism, which had nothing to do with the English word "risk") effectively to give investors a ratcheting stock basis (up or down) reflecting corporate retained profits or losses, to avoid a double tax when stock was sold at a gain. Mechanically, the original dual income tax operated principally by taxing all income from whatever source derived at a flat rate (28%), and then imposing a surtax on labor incomes above a certain level.

The current Norwegian implementation of its dual income tax introduces a novel variant, the "rate of return allowance" (RRA). The RRA system turns the proposal in this article upside down, by taxing normal returns to the firm, taxing inframarginal returns to the firm at the same rate as normal returns, and then in effect imposing a surtax on economic profits when realized at the investor level. See Sørensen, *Neutral Taxation*, *supra* note 119, at 783–84.

More specifically, the RRA dual income tax system taxes all capital income, including corporate net income, at one flat rate (28%) but deliberately imposes a double tax on corporate dividends and capital gains, *after* taking into account an investor-level deduction for a normal rate of return (the RRA). The net result is that interest and other forms of capital income generally are taxed at 28%; corporate net income is taxed at 28% at the corporate level; dividends and capital gains from the sale of stock are tax-exempt in the hands of investors to the extent of a normal return on their investments; and

The United States also has made only desultory efforts to disentangle labor from capital income. Our rules disallowing deductions for excessive compensation paid to owner-entrepreneurs are one example, but are highly subjective in application and point only in one direction. The opposite problem, which I call “labor stuffing,” is not addressed.¹³⁸ The more one looks, in fact, the more acute (and understudied) the

those dividends or capital gains are fully subject to another 28% tax to the extent they exceed that normal return. This brings the tax on such income to a level similar to the highest tax rate on labor income.

The idea is twofold. First, it solves what I call the “labor stuffing” problem that bedeviled the first iteration of the Norwegian dual income tax, by taxing any extractions from corporate solution at rates closely comparable to labor tax rates. (“Labor stuffing” is the problem that, whenever firm income is taxed at lower effective tax rates than individual labor income, owner-entrepreneurs of closely held firms will have an incentive to recast their labor inputs as returns on their capital in the firm.) Kleinbard, *Capital & Labor Stuffing*, *supra* note 36. The labor stuffing problem under the first Norwegian dual income tax system was not technical, but rather political—the labor-capital income centrifuge rules by design were easily evaded. Under the new system, an owner-entrepreneur’s returns to labor will be taxed twice, once at the firm level, and once at the individual level (assuming the returns exceed the normal return to the individual’s capital investment).

Second, the new system taxes economic rents at close to labor rates. This is its chief policy virtue, as the labor stuffing problems under the original system could easily have been solved by more adroit legislative drafting. It does so by virtue of the fact that dividends and capital gains attributable to inframarginal returns are unshielded from the second-level investor tax. Both Kleinbard, *An American Dual Income Tax*, *supra* note 54, and *OECD 2012 Norway Survey*, *supra*, raise objections to the new system, including the introduction of asymmetrical payoffs, and the fact that, if inflation is taken into account, normal returns may be taxed at rates comparable to those imposed on economic rents. The firm-level tax system is as vulnerable as any other to getting asset capitalization and depreciation wrong, and further is susceptible to overleveraging (subject only to a limited anti-abuse rule). Finally, the OECD review pointed out that a system like the BEIT has very important advantages over the RRA approach, in that it moves the tax-exemption for normal returns to the firm level. In the case of open economies this makes the system’s exemption of normal returns available to all investors, including foreign investors, which is not true of the exemption for normal returns offered to Norwegian domestic investors.

138. Kleinbard, *Capital & Labor Stuffing*, *supra* note 36.

problem is under current law. “Carried interest” is one particular instantiation of the phenomenon, but probably not the most important in aggregate size. The example given earlier of the hard-working chef who turns her labor into her restaurant’s goodwill, on which she can realize returns taxed as capital gain when she sells her restaurant, is a much more typical fact pattern that raises the same basic question.

It is possible to do better than any of the existing precedents. The starting point—a labor-capital income centrifuge, version 1.0—might resemble the mechanism adopted (at least for a period of time) by Norway, in which a reasonable return to capital is imputed, and the remaining income treated as labor income. The idea of this form of labor-capital income centrifuge is that, in those cases where markets cannot be expected reliably to separate labor from capital income—that is, in the case of closely held companies—an owner-manager of a firm determines the portion of her total returns that are attributable to her capital invested in the firm by multiplying that capital by a fraction (which typically could be determined by a formula tied to one-year government securities); the result would be the deemed return to capital, and the entirety of the remainder a deemed return to her labor. Actual Nordic implementations rapidly grew more complex—for example, to deal with whether the asset base should be a net or gross asset concept, and how to determine when a company was sufficiently closely held as to invoke the labor-capital income centrifuge—but as these questions have been considered in great detail elsewhere, they will not be repeated here.¹³⁹

Widely held firms would be presumed to compensate employees fully; as a result, no further emendation to the BEIT principles outlined earlier would be needed. In particular, the labor-capital income centrifuge would not apply.¹⁴⁰ As a result, all of a widely held firm’s

139. *Id.*

140. This distinction is consistent with Nordic models. The late Steve Jobs might be offered as an exception that proves the rule in light of his nominal cash compensation. In fact, he received substantial deferred compensation in the form of stock options. See Palash Ghosh, *Steve Jobs: \$1 Annual Salary, No Perks, But Lots of Shares*, INT’L BUS. TIMES (Aug. 26, 2011, 7:42 AM), <http://www.ibtimes.com/steve-jobs-1-annual-salary-no-perks-lots-shares-305190>; Erick Schonfeld, *Steve Jobs on the Value of Stock Options*, TECHCRUNCH (Apr 25, 2009), <https://techcrunch.com/2009/04/25/steve-jobs-on-the-value-of-stock-options/>. To the extent that he in fact was undercompensated for his

post-compensation income would be treated as capital income. The COCA allowance, in conjunction with depreciation, would be employed simply to separate out the normal return component and to tax that component at the firm level at an effective rate of zero.

Closely held firms would be subject to a different regime, but one with the same ultimate objective. The COCA mechanism would be applied to a closely held firm in the same general manner as under the standard BEIT: the firm would multiply its tax basis in its assets by the COCA rate. The resulting figure, however, would now be used for a slightly different purpose—not simply to provide (in conjunction with depreciation) an effective firm-level deduction for normal returns to capital, but rather to separate the closely held firm's income into capital and labor components.

A labor-capital income centrifuge along the lines summarized above has several major drawbacks. First, it violates the strong preference for a featureless tax topography by distinguishing sharply between private and public firms. A public firm like Facebook Inc., with a founder who actively manages the business and still owns a large percentage of its stock, might be mischaracterized under this division. It certainly would incentivize startups to become public as soon as possible, to turn off the special income recharacterization rule. Further, the Nordic-style rule summarized above is an all-or-nothing rule: that is, it recharacterizes all of an affected private firm's income beyond normal returns (as determined through the COCA style mechanism) as labor income. This will be wrong in fact in many cases and will be unfair in every case to investors in such firms who are not owner-managers.

B. Version 2.0

A superior labor-capital income centrifuge can be developed along the following lines. First, business enterprises would all be taxed identically—that is, income at the firm level would not be re-characterized as labor income, and all firms would face the same profits-only tax (in the running example, at a 25% tax rate). Public and private firms would face the same tax system and the same tax rates.

services, and thereby enriched other shareholders, that income in fact became their capital income and would be reflected in their Includible Amounts as those shares turned over.

The statute would define a new class of individual: a Participating Controlling Owner. Again, resorting to U.S. tax shorthand, a “Participating Controlling Owner” would be defined as a material participant in the management of a business enterprise who owns at least 5% of the enterprise (by vote or value), and where 50% or more of the ownership of such enterprise (by vote or value) is owned by five or fewer such material participants. The definition would not turn on whether a firm were privately held or a public company.

Both parts of this compound definition are drawn from existing U.S. tax rules; redeploying existing standards gives comfort that the detailed rules in fact can be drafted and administered. “Material participation” is a concept embodied in Code section 469, which sets out rules limiting the deductibility of losses incurred in the “passive” participation in a trade or business. The concentrated ownership standard is drawn from the personal holding company rules of section 542. The 5% ownership threshold is intended to simplify compliance by weeding out from the class of employees who might be subject to the operative rules described below those with relatively small ownership interests.

One aspect of tax system design that the United States does very well (and that the Nordic countries, for example, handled quite poorly) is to incorporate broad “attribution” rules in ownership standards. The purpose of these attribution rules (phrased for convenience with respect to corporate stock) is to treat a party as owning shares actually owned by another, where, by virtue of a personal relationship (parents and children) or impersonal ownership (individual and corporation owned by that individual), doing so accords with commercial reality. What is more, in their most fulsome form these rules treat stock constructively owned by one party as actually owned by that party for purposes of reattributing the stock yet again. The Code is festooned with these sorts of attribution rules;¹⁴¹ the point here is not to engage in statutory drafting but rather to signal that incorporating these principles is central to the proposal.¹⁴²

141. *E.g.*, I.R.C. §§ 267, 318, 544.

142. When applied in their usual settings, these attribution rules can cause multiple parties to be treated as owners of the same shares. For example, mother, father, and adult daughter all participate materially in the management of Firm X; daughter owns 30% of the firm, and mother and father own

If an individual is a Participating Controlling Owner (PCO), then special rules apply to the PCO's returns from her investment in her firm. These are set out immediately below. Explicit wage income paid to a PCO is taxed as such—includible in labor income rates to the PCO and deductible by the firm. This permits the successful PCO to utilize the lower brackets of the progressive labor income rate schedule. The special rules are relevant only to amounts characterized as returns on investment.

The special PCO rules are best understood by taking a step back to see their overall thrust before diving into the details. The basic idea is to divide returns (other than explicit salary) derived by a PCO from her firm into three buckets. It is helpful to think of the proposal here as a waterfall, where returns flow into one bucket until it is full, and then spill over into the next bucket down. For all these purposes, a PCO's gain on a secondary market sale is treated as a constructive firm distribution and therefore is not simply ignored, as is the case for other investors.

The first bucket treats a distribution (including gains on sales) received by a PCO over and above the annual Includible Amounts that apply to any investor as a fair incremental return on the PCO's risky capital invested in her firm—but only up to a specified ceiling (as described below). The idea is to recognize that a PCO should be entitled to get at least some return on her risky capital investment over and above a normal return that is treated no differently than a passive investor's returns on a successful investment—that is, as simply a tax-free return of capital. This first bucket therefore comprises “pure” capital income.

The second bucket treats a distribution effectively as retained labor income of the PCO that has been stored at the business enterprise.

none. The usual attribution rules would treat mother, father and daughter as *each* owning 30% of Firm *X*, thereby subjecting it to the special Participating Controlling Owner rules. This obviously is not intended, and so one would adopt a rule under which stock actually or constructively owned by one material participant will not be treated as constructively owned by another material participant. The rule would have a failsafe that when all the attributing was finished, no more than 100% of the firm's ownership interests could be accounted for. This sort of thing actually borders on commonplace in U.S. tax law practice.

For distribution amounts falling into this category, the rules are designed to impose an aggregate tax equivalent (in present value terms) to the maximum labor income rate, but to coordinate the timing of that tax payment with the PCO's actual receipt of the corresponding cash distribution (or sales proceeds).

The third bucket contains a PCO's claim to expected *future* firm income, which is to say capital gains realized by the PCO (most commonly, by the sale of her interest in the firm in a secondary market transaction) over and above amounts falling into the first two buckets. In the common case, this bucket would comprise capital gains realized by a PCO selling her loss-making firm for a large market valuation. This capital gain is taxed at the general capital income rate (in the running example, 25%).

The first bucket in this "Distribution Waterfall" simply recognizes that a PCO might supply significant capital as well as labor to her firm. To this extent, some portion of the aggregate distributions (again, including constructive distributions in the form of secondary market sales) should be taxed like those of any other investor. The answer cannot be that all returns are so characterized, however, because then there would be no labor-capital income centrifuge in operation at all. But neither should the answer be that none of a PCO's returns is attributable to actual investment, because that might not be factually accurate. So the proposal is to adopt an arbitrary rule that a PCO's returns on capital in an amount equal to three times a PCO's Includible Amounts each year are treated as returns received in respect of capital investment. The first slice of Includible Amounts would be taxed as such (i.e., at capital rates), and the remaining multiple (twice Includible Amounts) would be treated as a tax-free, extraordinary capital return on investment, as in the case of any passive investor.

This tripling of Includible Amounts as the amount attributable to invested capital is arbitrary, but in practice also is likely to be unimportant. Most PCOs who generate truly remarkable returns will do so in respect of their unique labor contributions, in circumstances where their capital investments are small in absolute terms. Thus, the arbitrary nature of this allocation is expected to have only modest real-world implications.

The second bucket of the Distribution Waterfall captures the idea that if a successful firm holds current year after-tax earnings attributable to a PCO's ownership claims above and beyond amounts already earmarked as returns on the PCO's capital, those firm earnings should be

treated as the economic equivalent of current year labor income of the PCO. As described below, the PCO constructively is taxed in a present value sense in the current year on her share of the firm's *pretax* earnings.

For simplicity, deemed labor income falling into the second bucket is taxed at all-in rates equal to the maximum labor income tax rate. This is not unfair, in that the PCO and her firm have available to them the self-help remedy of paying actual wages to fill the steps of the progressive labor tax brackets. Amounts falling into this second bucket of the Distribution Waterfall would be treated as labor income for payroll tax purposes as well.

Finally, there is a third possibility, which is that the PCO receives actual or constructive distributions over and above (i) her deemed returns on her actual capital investment, plus (ii) her deemed receipt of labor income out of actual firm after-tax profits. This is the familiar Horatio Alger story of our times of the founder of the loss-making "unicorn" who sells the firm for \$1 billion (or more). Here, the proposal is to tax the lucky founder at the capital income rate on a realization basis. (This will emerge as the only exception to the rule that capital gains-type concepts are not relevant in the Dual BEIT.) This imposes a low apparent tax on these heroes for our times (capital rather than labor income tax rates), but in theory at least the government can collect more tax than at the second step in the Distribution Waterfall, because when at some future date the firm does earn the income that formed the basis of its unicorn valuation, that firm income (less a COCA allowance on any actual firm capital) will be fully subject to tax at capital rates. The combination of the two unmitigated capital income/profits taxes reflects the uncertainty of the timing or ultimate realization of those firm earnings.

Implementing this three-tiered Distribution Waterfall requires some careful engineering, but nothing exceptional by Code standards. (Again, I recognize the irony in this formulation.) As an initial matter, a PCO includes in income each year her Includible Amounts attributable to her actual investment in her firm, just as does any other investor. The first bucket in the Distribution Waterfall extends the return to actual capital to include possible returns to risk. This is implemented by introducing a new term of art, a PCO's Extraordinary Capital Return Account. This is a notional account to which is added each year (before considering distributions) (1) an amount equal to twice the PCO's Includible (i.e., taxable) Amounts in respect of her actual investment in the firm, less (2) the PCO's share of the firm's net investment income (defined in a manner

analogous to Code section 1411). The point of the subtraction is to prevent a PCO from simply inserting her savings accounts into her firm, to convert what would otherwise be labor income into tax-free capital income.¹⁴³

The Extraordinary Capital Return Account accumulates and earns a COCA return each year, but this amount is not includible in income. The non-inclusion in the PCO's income is consistent with the treatment of profits (in the colloquial sense) realized by a passive investor over and above his Includible Amounts.

The second bucket in the Distribution Waterfall also requires another new term of art, the Basis Bump Account. The Basis Bump Account operates to put the PCO in the same economic position as if her share of her firm's *pretax* profits for a year (after payments of explicit salary) were distributed and taxable to her in the year the firm earns the income, at all-in rates equal to the maximum rate on labor income.

The Basis Bump Account is a second notional account, to which is added each year a "Specified Fraction" (defined below) multiplied by the PCO's share of *after-profits tax* firm income for the year (ignoring for this purpose any actual distributions by the firm in the current year), less three times her Includible Amount for the year.¹⁴⁴ A PCO is taxed on actual or constructive distributions (i.e., from secondary market sales) out of the Basis Bump Account at the general capital income tax rate (25% in the running example). The Specified Fraction and the non-deductibility to a firm of a distribution paid to a PCO act together to bring the total tax paid by both parties to the maximum labor tax rate on the firm's *pretax* earnings, as explained below. The Basis Bump is treated

143. This rule is not needed in respect of passive investors earning only capital income returns from a firm, because any savings held through a firm would be subject to the same tax as if held directly. It is the combination of labor and capital income, and the trebling of Includible Amounts as the portion treated as capital income, that creates the necessity for a special rule here.

144. The PCO's share of firm after-tax profits is determined by reference to her ownership interest in the firm (actually and constructively owned). Attribution priority rules will be needed to prevent related PCOs from being attributed the same fraction of firm income multiple times. That is, if Mother and Son each own 50% of a firm and both are PCOs, each will be treated as owning 50% of the firm for this purpose, not (as under current Code § 318) 100%.

as “real” basis for purposes of attracting taxable Includible Amounts in subsequent years; this operates as an interest charge on a firm’s after-profits tax earnings attributable to a PCO that are not distributed to her in the year earned. Distributions out of the Basis Bump Account and Includible Amounts attributable thereto constitute taxable labor income for all payroll tax purposes.¹⁴⁵

The Basis Bump mechanism is a bit unintuitive but aims to tax the PCO at labor income rates on the *pretax* earnings of her firm to which she has a claim; to do this requires considering both firm taxes (which would *not* have been paid if explicit salary had been paid out to the PCO) and PCO-level taxes. At the same time, the mechanism permits the PCO to defer the bulk of her cash tax liability in respect of her Basis Bump Account until those amounts actually are received by her; that is, the PCO is not treated as if her share of after-tax earnings in fact were distributed to her each year.

The Specified Fraction would be $[(LT - CT) \div [CT \times (1 - CT)]]$, where LT and CT are the maximum labor tax and capital tax rates, respectively. Where the labor tax rate is 40% and the capital tax rate is 25%, under the formula, the individual would be subject to a basis bump of 80% of her share of firm post-profits tax income. If tax rates do not change, neither would the specified percentage.

This seemingly arcane provision, along with the implicit interest charge on outstanding balances in the Basis Bump Account (via the Includible Amounts mechanism), together operate to ensure that the aggregate present value of tax imposed on a PCO and her firm is the same as would be paid had the firm made deductible payments of wages taxable at the maximum labor income rate. In the absence of this Specified Fraction haircut, the sum of the two capital taxes would exceed the burden on deductible wage payments.

To make all this work, cash realized by the PCO from an actual or constructive distribution (i.e., a secondary market sale) that is attributable to the Basis Bump Account first reduces accumulated Includible Amounts in the Basis Bump Account; these amounts have already been taxed, and so to this extent the distribution is tax-free. Remaining distributions up to the Specified Fraction of earnings that have been added to the Basis Bump are taxed at the *capital* income rate and reduce the

145. This formulation understates amounts that should be treated as subject to the payroll tax, in that the BEIT profits tax paid by the firm is not itself subject to the payroll tax.

remaining balance in the “principal” of the Basis Bump Account. (For convenience, this tax is described below as the Excess Distributions Tax; this is one of two components of that tax.)

The amount of any actual or constructive distribution equal to $[(1 - \text{Specified Fraction}) \times \text{firm after-profits tax income}]$ {i.e., 20%, using the numbers above} has been excused from tax at the PCO level to bring the total tax burden down to the maximum labor income tax rate. This amount therefore is tax-free when received by the PCO and is not treated as falling into the third bucket in the Distribution Waterfall.

A current year distribution to a PCO of amounts tentatively attributed to the Basis Bump Account (that is, after taking into account the first bucket in the waterfall) thus effectively is taxed at the maximum labor income rate, once both firm and PCO tax liabilities are considered. The amount (after adjustment by the Specified Fraction) goes into the Account momentarily, and then comes out as a distribution that is taxed at capital income rates. The sum of the two taxes equals the maximum labor income tax rate.

Any amounts attributable to the Basis Bump Account that are not distributed in the current year also are taxed when distributed at capital income rates, but are subject to a currently taxed (and compounded) interest charge at the COCA rate (i.e., as Includible Amounts), until received by the PCO. This creates the same present value tax burden as in the current distribution case but aligns the cash tax expense more closely with the PCO’s receipt of a cash distribution.

For example, imagine that a PCO puts \$1 into a wholly owned firm. The firm develops a new app, attributable in fact to the work of the PCO. The firm earns \$100,000 after all business deductions but before the COCA. Here, the COCA would be zero, because the firm has no basis in assets. The firm would pay \$25,000 in tax and be left with \$75,000 after tax. The PCO would receive a Basis Bump of \$60,000, computed as $[80\% \text{ (the Specified Fraction)} \times 100\% \text{ (the PCO's ownership stake)} \times \$75,000 \text{ (the after-tax amount)}]$ —\$0 (three times her Includible Amount).

If the firm were immediately to distribute to the PCO its after-tax earnings of \$75,000 in the current year, \$60,000 of that amount would fall into the second bucket and be taxed to the PCO currently as capital income, at the 25% rate, for a \$15,000 tax bill—which, when added to the \$25,000 in firm tax, yields an all-in rate of 40% on the \$100,000 of post-profits tax income. (First bucket amounts in this example

would be *de minimis*, given negligible Includible Amounts on the PCO's \$1 of invested capital.) The \$15,000 received by the PCO over and above the momentary Basis Bump that arises by virtue of the Specified Fraction's haircut to the PCO's share of firm after-tax earnings is received tax-free by the PCO and is used by her to pay her tax bill. She is left with \$60,000—the same as receiving \$100,000 in taxable wages, deductible by her firm.

If on the other hand no distribution were made by the firm, the PCO would not pay any immediate tax on the \$60,000 Basis Bump as such, but would pay tax at the 25% capital income rate in perpetuity (all other things being equal) on future Includible Amounts attributable to her increased basis of \$60,000. That is the same as taxing her \$60,000 at 25% today, or \$15,000. As a result, the present value of the total tax paid is \$40,000—the \$25,000 (firm profits-only tax), plus \$15,000 (in present value terms) investor-level tax—the same as the labor tax rate.

When the dust settles, an amount equal to three times this year's Includible Amount in respect of capital actually invested by the PCO is earmarked as a return on that actual capital investment, whether or not actually earned by the firm or distributed to the PCO in the current year, and treated either as (taxable) ordinary Includible Amounts or as (nontaxable) extraordinary returns on capital. The PCO's remaining share of firm after-tax earnings becomes taxed in economic substance (when considered from an all-in perspective) at current labor income rates.

The third bucket in the Distribution Waterfall (returns realized by a PCO not attributable to firm earnings) does not require any exotic new defined term, although for convenience it is described as Additional Returns. The only tax collected at the time the PCO cashes in her stake in her unicorn firm (again on the theory that there have been no after-tax earnings) is a single level of capital income tax imposed on the PCO, on the highly plausible theory that these Additional Returns are attributable to the PCO's labor contributions and therefore should not be treated the same as a passive investor's (exempt) capital gains. The firm's profits-only taxes come later—or so the purchaser devoutly hopes.

These three concepts work together through the operation of the Distribution Waterfall and an "Excess Distributions tax." The Distribution Waterfall draws on the five categories of PCO accounts to specify the treatment of distributions from a firm to a PCO. It provides that such

distributions are allocated to (and reduce) the PCO's accounts in the following order:

- The PCO's current and accumulated Includible Amounts (including Includible Amounts attributable to the Basis Bump account);
- Actual capital (basis) invested in the firm;
- The PCO's Extraordinary Capital Return Account;
- The PCO's Basis Bump Account (and then to the tax-free return of the portion of firm after-tax income that is not added to the Basis Bump account); and, finally,
- Additional Returns

The first three tiers of distributions are tax-free to the PCO (as previously taxed income, as a return of basis, or as her special, deemed extraordinary return on actual investment). The last two, however—that is, amounts attributable to the PCO's Basis Bump Account and Additional Returns—are taxable to the PCO at *capital* income rates by virtue of the new Excess Distributions tax. This applies only to PCOs, and only to distributions allocated to these two categories. The first of these (the Basis Bump Account) is tax-effected by virtue of the Specified Fraction described earlier, so that the combination of the tax actually imposed in respect of the Basis Bump Account and firm-level taxes equals in present value terms a single tax equivalent to the payment of current-year wages. The second (Additional Returns) is not tax-effected.

As noted earlier, secondary market sales by a PCO are folded into the Distribution Waterfall by treating the proceeds as deemed distributions. More specifically, a PCO's gain on sale is determined by looking only to her "real" basis (original capital investment plus net Includible Amounts thereon). This gain is then run through the Distribution Waterfall as if it had been distributed by the firm. The result is that the Excess Distributions tax would be triggered (and paid by the PCO) on the deemed distribution of the PCO's Basis Bump Account and Additional Returns. Gain attributable to her Extraordinary Capital Return Account would remain tax-free.

Since, by definition, Additional Returns constitute returns over and above amounts attributable to the actual capital invested in a firm, the Excess Distributions tax as applied to Additional Returns imposes a

greater aggregate tax liability on the PCO and her firm, considered as a unit, than does the usual application of the Dual BEIT. If one imagines a firm comprising only passive investors, with \$1 of capital and a \$1 billion market valuation, the aggregate tax burden imposed on the firm and its investors would be simply a profits-only firm tax (at such time as the firm had profits), even if investors were to sell their interests for \$1 billion. (Of course the purchaser of those interests would recognize greater Includible Amounts going forward, but as described below the firm's assets would be revalued to \$1 billion, so that the firm would then obtain COCA relief from that base.) The Excess Distributions tax imposes an extra layer of tax in the one case where a PCO is in the mix, but only to the extent of the PCO's interest in the firm and the generation of Additional Returns.

It might be argued that as a logical matter, the PCO's Additional Returns should be taxed immediately at labor income rates, and the firm should receive an adjustment to its tax base at some future point to reflect a deemed, earlier year wage payment (i.e., the converse of the Basis Bump Account treatment). I nonetheless much prefer the proposal made here. It creates an apparent tax preference for entrepreneurial gains that will resonate with policymakers and that appears to follow from current law treatment of capital gains on the sale of a business. Further, the realization by the unicorn firm of future profits is itself uncertain. The imposition of a capital income tax today and a possible profits-only tax in the future fits neatly with the expectations of non-specialists. On the other hand, if future profits are certain to materialize, the Excess Distributions tax on Additional Amounts actually can be argued to be too high a tax rate, as it is not tax-effected in the same way that the Specified Fraction tax-effects the Basis Bump Account.

The Participating Controlling Owner mechanism sounds complex, but it is a great deal simpler than the current consolidated return regulations or, for that matter, private contract project finance structured loan agreements. It has the great advantage of not drawing any distinctions between private and public firms (that is, the mechanism can continue indefinitely, provided that the material participation and ownership concentration standards are satisfied, regardless of whether the company is publicly held). It focuses on material participation as a requirement and does not apply to rents or other profits earned by a firm with concentrated ownership and great business acumen. And most important, it does not subject passive investors to any incremental

tax burden. I therefore believe it is the key to implementing a practical labor-capital income centrifuge.¹⁴⁶

C. Special Rules to Reward (or Tax) Entrepreneurs

The labor-capital income centrifuge described above is designed to offer owner-entrepreneurs an attractive tax environment while still collecting an appropriate amount of tax. In particular, the 25% capital income tax rate on cashing out is intended to resonate with entrepreneurs and policymakers alike as akin to current law's capital gain preference.

Nonetheless, attractive might not be good enough—policymakers might be expected to demand a truly beautiful tax regime for entrepreneurs. The Dual BEIT is flexible enough to handle that. As a straightforward example, the first \$5 million of Additional Returns (or whatever level is desired) could be subject to tax rates below the standard capital income rate. This is not a recommendation so much as it is a reminder that the Dual BEIT is a very flexible tax instrument.

In addition, small businesses (which, to emphasize, are not necessarily commensurate with owner-entrepreneur controlled firms or with pass-throughs) can be subsidized through preferential COCA rates on their capital, without any correlative increase in the Includible Amounts of investors in those firms.

From the opposite direction, the labor-capital income centrifuge described above can be criticized as going too easy on some of the most successful owner-entrepreneurs, in that the system requires either after-tax firm income or some sort of cashing out to trigger income inclusions to the owner-entrepreneur beyond those attributable to his (usually modest) cash investment. For tech firms and the like, firm income does not appear to be a prerequisite to stratospheric valuation, and so the owner-entrepreneur of such a firm who lives modestly (that is, does not demand

146. One further rule that should be adopted would be to treat any “monetization” of stock by a PCO, through borrowings secured directly or indirectly by the owner's stock as a mark-to-market event in respect of all of the PCO's investment, thereby creating the basis to which the COCA/Includible Amounts regime could apply. Such a mark-to-market event would not raise difficult valuation issues given that the lending institution must express an opinion on value in conjunction with its extension of credit.

large distributions) and who does not cash out would not feel the sting of significant taxable income. (On the other hand, he also would not feel the balm of luxuriant consumption.) One can think of this scenario as the Mark Zuckerberg problem.

Readers familiar with the multiple “rounds” of financing now considered standard practice in Silicon Valley, as venture capital investors are replaced over time by layers upon layers of private equity firms, will appreciate the byzantine (and deep-pocketed) forms of private market equity financing deployed in practice. Each such round typically sets an explicit enterprise valuation on the firm. One response to the Mark Zuckerberg problem, then, would be to add to the machinery of the labor-capital income centrifuge a mark-to-market Basis Bump for Participating Controlling Owners at the time of each “round” of private financing, as well as when the firm goes public.¹⁴⁷ The Basis Bump would be limited to PCOs in the firm. I list this as an optional idea, because it would have distortionary effects on firm financing decisions (strongly preferring internal cash flow over external funding, for example) and might be difficult to implement with sufficient specificity. Again, this suggestion points to the flexibility of the Dual BEIT as a tax instrument.

Finally, a PCO could seek to avoid the PCO rules described above by licensing self-created intangible assets to his controlled firm, rather than contributing them to capital, and then claiming capital income treatment on the resulting royalty stream. The proposal here is to treat any such royalties as labor income earned by the PCO, with all the attendant tax implications that follow. See Section VI.A.4, below.

V. SUPERCONSOLIDATION AND ITS IMPLICATIONS

Part II of this Article described the basic operation of the Dual BEIT, including tax rates and transition issues. Part III laid out my reasoning for why the COCA rate should be a risk-adjusted, ex ante normal return, not a risk-free return. Part IV explained the design goals and implementation of the labor-capital income centrifuge, which is so central to the functioning of any dual income tax that it requires careful elaboration.

147. I thank Gabriel Zucman of the University of California, Berkeley, for this suggestion.

This Part V now considers in detail the other crucial aspect of the Dual BEIT's firm-level tax design: superconsolidation. Part VI drills down on some remaining Dual BEIT mechanics.

A. Consolidated Tax Returns vs. Superconsolidation

Economists usually consider a business cash flow tax (or its equivalent, a capital account allowance system like the Dual BEIT) as providing efficiency gains by creating a tax rate of zero on marginal business investments, thereby ensuring that the scale of business investment is the same in a world with the tax as in a hypothetical Arcadian tax-free environment. Taking this as true, it nonetheless vastly understates the efficiency gains (in the broadest sense of the term) attendant on moving to a profits-only firm tax.

A profits-only tax offers the opportunity to rid the Code of two of its most frustrating subspecialties: the consolidated tax return rules and the tax-free reorganization provisions. Both are artifacts of an income tax, where "inside" (asset) and "outside" (stock) tax basis are rigorously and separately tracked, and both become irrelevant in a profits-only tax, because inside basis essentially disappears as a relevant concept. I apply this insight to adopt financial accounting style consolidation, which abandons the entire concept of the separate existence of corporate subsidiaries and which accordingly views all acquisitions (stock or asset, taxable or "tax-free") as actual or constructive asset purchases. Non-practitioners will find it difficult to grasp just how much complexity is swept away in the immediately preceding sentences.

To emphasize the profound differences between the consolidation proposed here and current law consolidated tax returns, I term this comprehensive true consolidation "superconsolidation." I further extend this true consolidation by applying it in a geographic sense as well, by imposing the Dual BEIT to a worldwide tax base. I make my case for this in Section V.B, below, but I acknowledge that superconsolidation could theoretically be applied on a "water's edge" basis, at the cost of greatly increased complexity and tax avoidance potential.

The current Code's consolidated tax return rules are a nightmarish web of arcane provisions and contra-provisions, understood by a handful of reigning experts (if at all). As one example, the leading tax treatise in the area has a single chapter totaling over 300 pages in length addressed to what rational observers would think would be a trivial issue—the tax consequences of sales of goods and services among

different corporate members of the same affiliated group.¹⁴⁸ In true consolidation, as practiced by financial accountants and as proposed here, the entire chapter would be meaningless, as such sales would themselves have no consequence at the consolidated firm level.

What explains this apparently perverse complexity? The answer is simply that the consolidated return rules consolidate some bottom line results (like the taxable income of Member A against the losses of Member B), but more generally reflect the corporate income tax's fundamental axiom that the separate existence and tax accounting attributes of each corporation and its owners' interest in that corporation must be maintained, even when those corporations are joined under a common parent company. As a result, the outside (stock) basis of each subsidiary (and the inside tax attributes of the subsidiary, including asset basis) is carefully tracked, against the eventuality that perhaps one day the stock of that subsidiary might be sold outside the consolidated group.

The tax-free reorganization rules are a similarly perverse exercise. Here one starts again with the corporate income tax's fundamental axiom of the separation of the activities of the firm from the investments made by its owners, and adds to that the basis recovery and timing mismatches between purchaser and seller inherent in an income tax system. Take the simplest possible case: a corporation sells to another firm for \$100 a machine that the seller has depreciated to zero. The selling firm recognizes \$100 of taxable gain, and the purchaser claims \$100 in depreciation deductions, but by design the two do not offset, because the seller's gain is includible in income today and the purchaser's depreciation deductions are claimed only over time. (That is how the purchaser's normal returns are taxed in respect of its investments in real assets, assuming that the depreciation rules follow economic depreciation.) Further, because of the corporate tax system's rigorous separation of the firm and its owners, the selling firm's distribution of the after-tax proceeds of that asset sale is taxed again to shareholders.

The entire tax-free reorganization apparatus exists to ameliorate these results, but only in those carefully specified circumstances where Congress concluded that the rigorous application of the corporate tax's underlying principles were unfairly harsh or unduly burdened

148. JERRED G. BLANCHARD, JR. ET AL., *FEDERAL INCOME TAXATION OF CORPORATIONS FILING CONSOLIDATED RETURNS* chs. 31–34 (Matthew Bender, rev. ed. 2017).

rational business acquisitions that had some identifiable qualitative difference from a simple sale for cash.¹⁴⁹

A profits-only business tax makes asset tax basis meaningless (more accurately as applied to the Dual BEIT, it makes the present value of the sum of asset basis and COCA allowances constant, regardless of the depreciation method chosen) and sweeps away timing mismatches between seller's gain and buyer's expensing. This is easiest to see in a cash flow business tax (which employs expensing, one extreme end of the depreciation spectrum), but Section VI.A reviews why the same is true for a capital account allowance system like the Dual BEIT.

To take an easy case, imagine a 25% business cash flow tax. A business enterprise that holds a depreciable asset with a tax basis of zero and a market price of \$100¹⁵⁰ sells that asset to Buyer for \$100, incurring \$25 of tax on the sale. (In a business cash flow tax, all business assets have a tax basis of zero, so the concept can generally be ignored.) Buyer, however, receives a conceptual \$25 refund on the purchase (through immediate expensing of the purchase). As a result, Seller and Buyer will be in the same aggregate after-tax position as if the cash sale were called a tax-free reorganization. Seller will hold \$75 in cash, and Buyer will have incurred a \$75 net cost for the asset. (If Buyer were determined to spend \$100 after-tax, it would need to buy business assets worth \$133 pretax.) The same analysis applies to the Dual BEIT, except that one must look at the present value of Buyer's tax savings and compare those to Seller's cost: as Section VI.A shows, the two are identical.

Business asset tax basis is always zero in a business cash flow tax, but a capital account allowance gets to the same place through the application of that allowance to business asset tax basis. Like a cash flow tax, then, the Dual BEIT can treat every group of enterprises with a common parent as a single agglomeration of assets, just as is done in

149. *Cf. Marr v. United States*, 268 U.S. 536 (1925) (redomiciliation of General Motors from New Jersey to Delaware held a taxable event for shareholders, in response to which, Congress adopted the first reorganization rules).

150. The market price can be stated as a pretax market-clearing price of \$100, or as a *net* [after-tax] price of \$75—the cash that sellers demand to receive in their pockets when the dust settles, and that buyers are willing to part with. Implicit in this description of the asset as having a net market value of \$75 is the thought that the marginal buyers and sellers of such assets are taxable business enterprises that can take advantage of the value of COCA deductions.

financial accounting today. The tax basis of a parent company in the stock of its subsidiaries is entirely ignored, and asset basis exists only to generate a stream of COCA deductions having the same economic effect as Day 1 expensing.

There is no particular reason for current law's restriction of consolidation to subsidiaries that are at least 80% controlled by a parent company. The Dual BEIT instead adopts the same 50.01% standard employed in financial accounting.¹⁵¹ This will have great benefit in respect of the transparency of tax footnotes in public firm financial statements, because for the first time the same constellation of operations will be consolidated for financial statement and U.S. federal tax purposes.

In the place of current law, Dual BEIT treats identically every acquisition of direct or indirect control over business assets. Direct asset sales by firms, mergers, or other consolidations of one firm into another, and acquisitions of control of the stock of one firm by another, are all

151. See Kleinbard, *Rehabilitating*, *supra* note 19, at 54, for more detail on this and other aspects of superconsolidation. Specifically, under the proposal made there, 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).

treated as an actual or constructive sale of the seller's (or target firm's) business assets. This result holds whether the transaction is for cash or for acquiror stock and whether structured as a purchase of assets, controlling interest in the stock of a target company, or a merger: all are treated as actual or constructive asset purchases. To the same effect, every disposition out of a consolidated group is treated as an asset sale.

To elaborate, every acquisition by one business enterprise of control of another business enterprise through the acquisition of the latter's stock is treated as a constructive asset sale by the target, the assimilation of target's assets into the buyer's superconsolidated group, and a liquidation distribution by target to its investors. Within a superconsolidated group, tax basis in corporate subsidiary stock no longer exists, and tax basis in business assets, when combined with depreciation, always has the same present value as the value of expensing on Day 1.

In the Dual BEIT, investor-level taxes sit neatly on top. Every stock acquisition or merger in which a target firm is absorbed into a superconsolidated group is treated as a realization event to investors in the target firm. Because the deemed asset sales have no net present value tax cost to the two firms, and because investors have no tax liability beyond their future Includible Amounts, the net economic effect of these rules is simply to "reset the clock" on investors' tax bases in their financial interests.¹⁵² This has a real tax impact in present value terms but has no current cash tax cost, because investor capital gains and losses in respect of interests in business enterprises generally are no longer a relevant concept.¹⁵³

The last few paragraphs can be illustrated by an example. Assume that Tiny Target Co. has been capitalized entirely with one class of stock and that Tiny Target holds two assets: a depreciable tangible asset with a tax basis of zero and a pretax market price of \$75, and a self-created intangible asset with a basis of zero and a pretax market price of \$25. (The case where Tiny Target has basis in an asset—a feature of the Dual BEIT but not a cash-flow tax—is considered below.) Global Group Inc. would pay \$100 to directly purchase these assets, because, after taking into account the operation of the expensing-equivalent COCA

152. *Id.*

153. The two exceptions are (1) a sale by a PCO, as described in Part IV, above, and (2) a sale at a loss by a Tiny Target shareholder whose tax basis reflected net Includible Amounts accrued in respect of that investment.

system, Global Group Inc.'s after-tax cost would be \$75. (By the same token, Tiny Target would net \$75 on the sale.)

Instead, Global Group Inc. buys all of the stock of Tiny Target through a tender offer to shareholders for \$75. This figure reflects the fact that the aggregate value of investors' claims against Tiny Target (that is, the stock of Tiny Target) should trade at an amount equal to the *after-tax* market prices of Tiny Target's assets (\$75) to reflect the tax cost of selling the assets. This conclusion is consistent with the fact that, if Tiny Target were to sell its assets and liquidate, shareholders would receive \$75 net on that liquidation, without any further immediate cash tax cost.

More generally, one can say that in the Dual BEIT environment, the market price of a business asset would be a *pretax* price (here, \$100). On the other hand, the market price of equity in a business enterprise (the junior-most investor claim, however denominated) would be an *after-tax* price (here, \$75). The next few paragraphs show how the Dual BEIT rules transpose one into the other.

Notwithstanding that the Tiny Target transaction was structured as a stock purchase, the Dual BEIT would treat the deal as a *constructive* sale of Tiny Target's assets to Global Buyer for a "grossed up" sales price of \$100: that is, every stock acquisition would be characterized as an asset acquisition at a purchase price of 133% of the stock's price (assuming a 25% tax rate). The same tax results for Tiny Target and Global Group as described in the earlier example above would then follow—that is, a \$25 tax bill to Tiny Target and \$25 in present value of new COCA deductions to Global Group. (Things get a little more refined once one considers the possibility that Tiny Target might have basis in its assets; that refinement is addressed below.) Global Group would actually pay the Tiny Target tax bill, as its successor in interest, under general tax transferee liability principles.¹⁵⁴

Shareholders in general would not recognize gain or loss on the transaction; the only immediate consequence would be a reset of the tax basis of any investment assets bought by the Tiny Target shareholders with the proceeds from selling their Tiny Target stock. Going forward, the tax basis of the stock of Tiny Target in the hands of Global Group would be a completely irrelevant concept: for all purposes, Tiny Target's assets would be assimilated into the larger aggregation of Global Group's various businesses.

154. I.R.C. § 6901.

The same result would obtain if Global Group acquired the stock (or assets) of Tiny Target in exchange for Global Group stock: that is, there would be no tax-free reorganization applicable here (or anywhere else), and the only immediate consequence would be that Tiny Target shareholders would take a fair market value basis in the Global Group stock for purposes of future Includible Amount calculations.

In the immediately preceding example, there was no net tax bill at the business enterprise level on an aggregate basis. Tiny Target's tax cost equaled Global Group's tax savings. As in a cash flow tax, the present value of Global Group's net investment (including COCA deductions) to obtain Tiny Target's assets was only \$75 (the price actually paid to shareholders), which is to say that if (in contrast to the above example) what Global Group wanted was to make \$100 in net *after-tax* investments in real assets, it could afford to buy assets with market prices totaling \$133.

When a target company has tax basis in its assets, a slightly more complex analysis applies under any capital account allowance system, but the economic outcome is identical. As a mechanical matter, business cash flow taxes have the easier time of it here, because in a cash flow tax there is no such concept as tax basis in respect of business assets (or phrased alternatively, such tax basis always is zero). Perhaps because capital account allowance systems invariably are described as identical in present value terms to a cash flow tax, the technical rules required to conform stock and asset deals under a capital account allowance system, where basis remains relevant, have not received much attention.

It is helpful to calibrate one's thinking here by first considering the paradigmatic case, which is an actual sale by Tiny Target of its assets to Global Group, followed by the liquidation of Tiny Target. Imagine that Tiny Target had a tax basis of \$40 in its tangible depreciable asset. Under these facts, Global Group would still buy the Tiny Target assets for \$100 (that is, their pretax value remains unchanged). Because Tiny Target in fact has a \$40 basis in its business assets, Tiny Target would recognize only \$60 in gain (not \$100), and pay \$15 in tax (not \$25), leaving it with \$85 in actual cash proceeds. Shareholders would receive the \$85 free of any further immediate cash tax liability.

Generalizing further, if markets are efficient and Tiny Target's \$40 basis in its business assets is well understood, one might expect the stock of Tiny Target to trade at \$85, not \$75—which by happy coincidence is the result reached in the paradigmatic asset sale and liquidation case. One can conceptualize things as if, when Tiny Target has tax

basis in any of its assets, it in fact holds three assets, not two, where the third asset comprises a tax receivable from the government in the form of the tax value of its remaining tax basis. Here, Tiny Target's tax receivable equals its basis in its business assets (\$40) multiplied by the tax rate (25%), or \$10.

To operationalize this outcome when the stock of Tiny Target is acquired requires a few arithmetic steps. Readers coming from a policy background will be appalled at the complexity. Tax lawyers will yawn and say, of course, we just need to apply some of the apparatus of Code section 338 here.¹⁵⁵

Returning to the example, Global Group would buy the stock of Tiny Target, presumptively for \$85. How do we transpose that \$85 stock purchase price into a constructive asset transaction?

As just noted, Tiny Target can be viewed as owning three assets—the tangible property, the intangible property, and a \$10 hypothetical tax receivable (the tax savings attributable to its \$40 basis in the tangible asset). Meanwhile, at the end of the day, Global Group is buying only the two real assets. That is, Global Group's tax benefits (its COCA deductions) stem from its basis in its assets, not from any measure of Tiny Target's tax bill. Tiny Target and its shareholders conceptually cash out the benefit of the tax receivable, rather than sell it.

The hypothetical tax receivable is the key here. Global Group's stock purchase is treated as a constructive asset purchase, where Global Group's *after-tax* purchase price for the real assets is the price paid by Global Group for the stock, *less* the value of the tax receivable—or \$75 (\$85 stock purchase price less \$10 tax receivable). Global Group's pretax purchase price is 133% of that \$75 ($1/(1-T)$), or \$100. Global Group treats the stock purchase as a constructive asset purchase for \$100. Tiny Target—or more accurately, Global Group as successor in interest to Tiny Target—pays \$15 in tax, leaving Tiny Target constructively

155. Tax lawyers will further recognize that the example that follows does not fully plumb the depths of concepts like the calculation of the “adjusted grossed-up basis” that Global Group would take in the assets of Tiny Target. *Cf.* Reg. § 1.338–5. The point here is simply that the relevant mechanical steps have been fully articulated in the § 338 regulations. Those regulations are tiresome, but they also are comprehensible and accessible to tax lawyers generally. Their principles can be applied without difficulty to the superconsolidation environment contemplated in this Article.

with \$85, which is the amount paid to shareholders. And as an arithmetic check, the \$85 paid by Global Group to shareholders, plus the \$15 tax bill it assumes, equals a total pretax investment of \$100.

When the dust settles, Tiny Target shareholders net \$85 and Global Group has a \$75 after-tax cost for the Tiny Target assets. This seeming incongruity when compared with a cash flow tax simply represents the fact that here Tiny Target still holds a \$10 tax receivable at the time of the transaction, representing the tax value of its unrecovered investment in business assets. In a cash flow tax, by contrast, the hypothetical tax receivable always is reduced immediately to cash at the time a business asset is purchased and expensed.

The same general principles as those outlined above would apply under the Dual BEIT if Global Group, using the same facts as immediately above, were to acquire for \$51 a controlling stake of 60% of Tiny Target (that is $\$85 \times .6$), rather than all its stock. The purchase price would first be “grossed up” to reflect the entire enterprise value, and then the same mechanical steps would be applied. Minority shareholders in Tiny Target would have no immediate tax consequences from the sale but would reset their tax basis going forward to the market value of the Global Group consideration paid for the controlling interest, thereby changing their Includible Amounts going forward. Minority shareholders in Tiny Target would retain whatever corporate law rights they have, but from a tax point of view would be in a position analogous to holders of “letter stock” in Global Group—that is, as having returns linked to performance of a designated sub-unit of the consolidated whole.

*B. The Dual BEIT in International Application:
A Residence-Based Tax*

The availability of superconsolidation under a profits-only tax like the Dual BEIT, and with it close conformity to financial accounting principles of consolidation (but not to the measure of net income), further opens the possibility of extending that regime along a geographic margin, to incorporate worldwide tax superconsolidation. The reason to do so, however, is not a preference for tidiness, but rather that a worldwide consolidated profits-only tax system is the best practical tax regime through which to achieve a reasonably neutral transnational business tax environment while balancing the competitiveness cries of the corporate community against the tax avoidance opportunities facilitated by current law, all against the need for a stable and administrable solution.

To emphasize at the outset, a worldwide tax superconsolidation proposal is not the same as the many “full inclusion” ideas that have been proposed, for the simple reason that true worldwide superconsolidation means that foreign operating losses can offset domestic operating income. Full inclusion proposals invariably are one-sided, requiring the inclusion of foreign subsidiaries’ profits but not permitting the direct utilization of foreign subsidiaries’ losses. The tax treatment of losses is extremely important to efficiency concerns, especially given long-term trends in ever greater year-to-year dispersion in firm operating results.¹⁵⁶ The worldwide superconsolidation developed below therefore begins from a more economically neutral stance than is sometimes supposed.

Most tax administrations and academics agree that corporate income tax systems today are largely dysfunctional in measuring and taxing appropriately the income of multinational enterprises. One problem is income shifting from business operations in the jurisdiction in which the multinational enterprise is domiciled to low-tax foreign countries. A related problem is “stateless income,” which is income derived by a multinational enterprise from business activities in a country other than its ultimate domicile but which is subject to tax only in a jurisdiction that is neither that ultimate domicile nor the location of the customers or the factors of production through which the income was derived.¹⁵⁷

The pervasiveness of stateless income tax planning upends standard characterizations of how U.S. tax law operates, as well as the case for the United States to move to a territorial tax system, unless accompanied by strong anti-abuse rules. U.S. tax rules do not operate as a worldwide system but rather as an ersatz variant on territorial systems, with hidden benefits and costs when compared with standard territorial regimes. That claim holds whether one analyzes the rules as a cash tax matter or through the lens of financial accounting standards. Under current law, effective foreign tax rates do not disadvantage U.S. multinational companies when compared with their territorial-based competitors.

156. Alan J. Auerbach, *Why Have Corporate Tax Revenues Declined? Another Look*, 53 CESIFO ECON. STUD. 153 (2007).

157. See Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011) [hereinafter Kleinbard, *Lessons*]; Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011) [hereinafter Kleinbard, *Stateless Income*].

Stateless income prefers U.S.-based multinational companies over domestic ones by allowing the former to capture tax rents, or low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. Other important features of stateless income include the dissolution of any coherence to the concept of geographic source (in turn, the exclusive basis for the allocation of taxing authority in territorial tax systems); the systematic bias toward offshore rather than domestic investment; the bias in favor of investment in high-tax foreign countries to provide the raw feedstock for the generation of low-tax foreign income in other countries; the erosion of the U.S. domestic tax base through debt-financed tax arbitrage; many instances of deadweight loss; and, unique to the United States, the exacerbation of the lockout phenomenon, under which the price that U.S. companies pay to enjoy the benefits of dramatically low foreign tax rates is the accumulation of extraordinary amounts of earnings (about \$2.6 trillion) and cash outside the United States.¹⁵⁸

U.S. policymakers and observers sometimes think the United States should not object if U.S.-based multinational companies successfully game the tax laws of foreign jurisdictions in which they do business, but the preceding paragraph demonstrates why the United States would lose if it were to follow that strategy. By generating tax rents through moving income from high-tax foreign countries in which they actually do business to low-tax jurisdictions, U.S. multinational companies have an incentive to locate real investment in high-tax foreign countries. And by leaving their global interest expenses, in particular in the United States, without significant tax constraints, U.S.-based multinationals in turn can erode the U.S. tax payable on their domestic operations.

At the request of the G-20 countries, the OECD embarked on an urgent project to develop comprehensive recommendations to address “Base Erosion and Profit Shifting,” and the United States in May 2015 announced major proposed revisions to its model income tax treaty to address stateless income.¹⁵⁹ A 2015 study by the Congressional Research

158. Jeff Sommer, *A Stranded \$2 Trillion Overseas Stash Gets Closer to Coming Home*, N. Y. TIMES (Nov. 4, 2016), <https://www.nytimes.com/2016/11/06/your-money/strategies-corporate-cash-repatriation-bipartisan-consensus.html?mcubz=3>.

159. See OECD, *Explanatory Statement: 2015 Final Reports* (2015), <https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>; OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances: Action 6:*

Service found that in 2012, about one-half of all international earnings of U.S. firms (\$600 billion out of \$1.2 trillion) was attributable to seven countries ordinarily considered tax havens.¹⁶⁰ That same report found that base erosion and profit shifting was a global sport, not confined to U.S.-domiciled firms. To the same effect, recent work by Kimberly Clausing has estimated the U.S. tax revenue lost to profit shifting exceeds \$100 billion per year.¹⁶¹

More recently, the Competition Commission of the European Union (EU) in 2016 concluded that Apple Inc. had been the recipient of illegal state aid from Ireland, in the form of a tax transfer pricing agreement that permitted an Irish subsidiary of Apple that functioned as Apple's principal sales subsidiary in Europe to enjoy extremely low Irish effective tax rates—in fact, below 1%.¹⁶² The controversy surrounding whether EU competition law was an appropriate policy instrument in this case overshadowed the Competition Commission's substantive tax findings, which were that the Irish subsidiary in question derived most

2015 Final Report (2015), <http://dx.doi.org/10.1787/9789264241695-en>; OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status: Action 7: 2015 Final Report* (2015), <http://dx.doi.org/10.1787/9789264241220-en>.

160. MARK P. KEIGHTLEY & JEFFREY M. STUPAK, CONG. RESEARCH SERV., R44013, CORPORATE TAX BASE EROSION AND PROFIT SHIFTING (BEPS): AN EXAMINATION OF THE DATA (2015), <https://fas.org/sgp/crs/misc/R44013.pdf>.

161. Clausing, *supra* note at 95; Kimberly A. Clausing, *Profit Shifting and U.S. Corporate Tax Policy Reform* (Wash. Ctr. for Equitable Growth, 2016), <http://equitablegrowth.org/report/profit-shifting-and-u-s-corporate-tax-policy-reform/>.

162. European Commission Press Release IP/16/2923, State Aid: Ireland Gave Illegal Tax Benefits to Apple Worth Up to €13 Billion (Aug. 30, 2016), http://europa.eu/rapid/press-release_IP-16-2923_en.htm (negative decision, with recovery); see also Edward Kleinbard, *Apple's Ireland Tax Avoidance Should Spur Major Reforms*, HILL (Sept. 6, 2016, 8:30 AM), <http://thehill.com/blogs/pundits-blog/finance/294453-apples-ireland-tax-avoidance-should-spur-major-reforms> [hereinafter Kleinbard, *Apple's Tax Avoidance*]; Edward Kleinbard, *The Myths Behind Apple's Manufactured Tax Crisis*, FIN. TIMES (Sept. 6, 2016), <https://www.ft.com/content/ece4da3c-72bc-11e6-bf48-b372cdb1043a>. The Competition Commission's 2014 preliminary analysis can be found in European Commission Press Release IP/16/2923, *supra*. See also European Commission Press Release IP/17/3702, State Aid: Commission Refers Ireland to Court for Failure to Recover Illegal Tax Benefits from Apple Worth Up to €13 Billion (Oct. 4, 2017), http://europa.eu/rapid/press-release_IP-17-3702_en.htm.

of Apple's income from the entirety of its European operations and paid very little tax anywhere; by one estimate, Apple paid tax to all foreign jurisdictions combined on \$200 billion of profits at an effective rate of about 4% per year over a ten-year period.¹⁶³

As these examples suggest, there is a widespread consensus that existing "arm's-length pricing" tools are insufficient for the task confronting tax administrations and that new tax instruments are required.¹⁶⁴ In the United States, the tax-writing committees of the Congress have over the last several years released discussion drafts of comprehensive revisions to the U.S. corporate tax system that would lower corporate statutory rates and make other major changes and, more relevantly here, would rewrite the tax rules applicable to the international income of U.S.-based multinationals.¹⁶⁵ Similarly, the President's 2016 Fiscal Year Budget proposed to rewrite these same rules, in ways that were not that far apart from the most comprehensive proposal made by the Republican Party (the discussion draft released by former House Ways and Means Committee chairman Dave Camp).¹⁶⁶

Very generally, the thrust of these legislative proposals is for the United States to adopt a "territorial" tax system for outbound foreign direct investment but to couple that approach with stringent anti-avoidance provisions.¹⁶⁷ In particular, the President's 2016 Fiscal Year Budget proposed that the United States impose a country-by-country, 19%

163. Kleinbard, *Apple's Tax Avoidance*, *supra* note 162. Calculations by *Financial Times* highlight how the tech group concentrates profits in ultra-low tax Irish subsidiaries. See Vanessa Houlder et al., *Apple's EU Tax Dispute Explained: The Consequences of the Commission's Complaint and the Wider Implications of its Ruling*, *FIN. TIMES* (Aug. 30, 2016), <https://www.ft.com/content/3e0172a0-6e1b-11e6-9ac1-1055824ca907> (calculating 4% effective total foreign tax rate over ten-year period); Vanessa Houlder, *Apple's €13bn Bill Swamps its EU Tax Filings*, *FIN. TIMES* (Aug. 31, 2016), <https://www.ft.com/content/5c1ee628-6f10-11e6-a0c9-1365ce54b926>.

164. To the same effect is Schön, *supra* note 5. Schön demonstrates that intragroup allocations of risk, fueled by information asymmetries, lead to tax-driven profit shifting that existing tax instruments cannot untangle. At one blow, worldwide consolidation resolves this information asymmetry between taxpayer and fiscal authority.

165. See Edward D. Kleinbard, *Why Corporate Tax Reform Can Happen*, 146 *TAX NOTES* 91 (Apr. 6, 2015).

166. See *id.* at 93.

167. See *id.* at 95–96.

profits tax as a minimum tax on the income of U.S. controlled foreign corporations.¹⁶⁸ (The 2014 Camp proposal recommended a minimum tax as one possible anti-abuse rule as well.¹⁶⁹) The minimum tax would operate as a soak-up tax, bringing the effective tax rate on the foreign operations of a U.S. multinational up to the level of the 19% profits tax in each country in which it did business. In practice, this floor would operate as a ceiling: tax directors at U.S. multinationals would not long hold their jobs if they consistently missed that target. Of course, a minimum tax like this in fact is a worldwide, residence-based tax system, and so one has the ironic result of an ostensible territorial tax system protected from the easy gaming that follows from simplistic territorial designs by a worldwide, residence-based, country-by-country minimum tax that in practice will be the binding policy.

While these proposals were framed as income taxes, similar transfer pricing problems can arise in value added taxes or profits taxes. David Bradford struggled to develop a workable origin-based framework for the international aspects of his X Tax, but the results were complex and uncertain of success.¹⁷⁰ Destination-based value added taxes, or the destination-based cash flow tax described in Section VIII.C, largely avoid exposure to transfer pricing problems but arguably surrender too much taxing jurisdiction when applied to the United States, whose technology, pharmaceutical, and other firms have led the world in the development of highly valuable intangibles in recent decades.¹⁷¹

168. *See id.* at 98–99.

169. Tax Reform Act of 2014, *supra* note 59, § 4003.

170. Compare BRADFORD, *supra* note 73, with David Weisbach, *Does the X Tax Mark the Spot?*, 56 SMU L. REV. 201 (2003) (criticizing the X Tax's international operation). ROBERT CARROLL & ALAN D. VIARD, PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED 111–14 (2012) describes the transfer pricing abuses to which the origin-based X Tax could be subject, but concludes that the solutions proposed by Bradford are feasible.

171. It can be argued that the apparent gratuitous surrender of taxing jurisdiction over exports of high-value intangibles in a destination-based VAT or cash flow tax is not in fact a loss to the U.S. fisc, because the returns from those intangibles ultimately will fund consumption by the firm's owners, and to the extent they are U.S. persons, the United States will capture that revenue through increased consumption in the United States. This has merit, but overlooks the significant minority interests held by foreign investors. As applied to a company like Microsoft or Facebook, the question here ultimately is whether a rigorous consumption base is appropriate, or whether instead we

For these reasons, I believe it useful to explore another fundamental direction in international tax design that is stable, that does not involve perpetuating the lock-out effect of current law, and that constrains stateless income planning—a worldwide, residence-based profits tax.

Under the proposed international tax module of the Dual BEIT, a U.S.-resident multinational business enterprise would be taxed on the profits arising from its superconsolidated worldwide income, including all of its subsidiaries wherever located. This rule mirrors how a multinational firm today presents its activities to investors through the lens of financial accounting. By virtue of true worldwide consolidation, all group income and assets would be treated as owned by the U.S. parent for purposes of its U.S. tax bill, and intercompany interest, rents, royalties,

can fairly treat those companies as entirely U.S. juridical persons, notwithstanding their global stock ownership, in order to assert at least residual taxing jurisdiction over the entirety of their value added. Tax law academics have been quick to deride the concept of a firm having a nationality, but outside of tax law there is much less confusion.

Another way to pose the question is to begin with the iron law of trade economics that the present value of a country's exports must equal the present value of its imports. (Phrased alternatively, exports have value because they pay for imports; any other theory is an expression of long-discredited mercantilism by another name.) CARROLL & VIARD, *supra* note 170, at 106–07. Then the question is, how should one apply this principle to a U.S. firm that generates economic rents on exports, but where the firm itself is (for example) 20% owned by foreign investors? Are 100% of the firm's sales outside the United States properly viewed as exports, or only 80%? The firm itself is an actor, with its own imports. Moreover, the firm employs the U.S. dollar as its functional currency, and in this respect the firm is in the same position as a U.S. individual: purchases of imports require foreign currency, and sales of U.S. exports require the foreign purchaser to obtain U.S. dollars. At the same time, however, its owners ultimately reap the benefits of the economic rents it captures. The Dual BEIT effectively treats this firm as entirely an U.S. resident.

Destination-based frameworks are one logical approach when applied to value added or cash flow taxes. Harry Grubert has convincingly argued, however, that they are internally inconsistent in important respects when married to income taxes. Harry Grubert, *Destination-Based Income Taxes: A Mismatch Made in Heaven?*, 69 TAX L. REV. 43 (2015). One way to see the problem is to ask why normal returns to capital (the unique identifier of an income tax) should belong to the jurisdiction of consumption, rather than the jurisdiction of production or ownership of the capital asset in question.

or dividends would be ignored. Foreign losses would be immediately deductible in the United States, which leads to more neutral after-tax outcomes from returns to risk.

At the outset, it must be acknowledged that such a tax falls into neither the pure destination nor pure origin cubbyholes through which most profits taxes (including value added taxes) are analyzed.¹⁷² Nonetheless, if one accepts that corporate residence is stickier than is sometimes supposed, it is not clear why this novelty is fatal. It is driven from one direction by the limits of destination-based profits taxes, and from the other direction by the political economy necessity that standard “territorial” tax proposals are easily gamed, and that the result of such gaming is the capture of “tax rents”—that is, the capture in a low-tax country of returns priced under the expectation that they would be taxed in a high-tax country.¹⁷³ This in turn paradoxically creates an incentive to situate real investments in high-tax foreign countries, as the raw feedstock for the tax rents capture machinery.¹⁷⁴

Put another way, a worldwide, residence-based profits tax can be rephrased as a territorial tax with a per-country minimum tax as an anti-abuse rule, where the minimum tax happens to be imposed at the same rate and on the same base as the domestic tax (net of foreign taxes). This statement is less facetious than it may at first appear because the purpose of the minimum tax is not to collect revenues so much as it is to vitiate the returns to planning strategies designed to capture tax rents. The foreign tax credit preserves the primacy of source country taxation, which is a concept firmly embedded in existing international tax norms.

Unlike destination-based profits taxes (Section VIII.C), a worldwide, residence-based profits tax retains residual taxing jurisdiction over the export of high-value intangible assets, which after all are the drivers of most real economic rents in the modern economy. Unlike

172. As between the two, worldwide profits tax consolidation can best be seen as an extension of origin-based profits tax frameworks, in which an irrebuttable presumption is employed that rent-bearing intangible assets of a firm ultimately have their origin in the home country jurisdiction and, therefore, can appropriately be reached by a residual residence-based tax. This, for example, is entirely consistent with Apple Inc.’s claims in connection with its EU State Aid case as to where that firm’s core intangible assets are developed, even today. See *supra* notes 162–163 and accompanying text.

173. See Kleinbard, *Stateless Income*, *supra* note 157.

174. *Id.*

origin-based profits taxes along the lines of Bradford's X Tax, worldwide tax consolidation exposes the fisc to very little in the way of tax gaming. And finally, because the tax is a profits tax, and one imposed at middling tax rates, the worldwide consolidation approach recommended for the Dual BEIT should introduce very little in the way of deadweight loss: by virtue of the foreign tax credit, foreign direct investment is not discouraged, and, by virtue of the worldwide design, foreign direct investment is not encouraged vis-à-vis domestic investment. It is true that the system might impose a higher tax burden on genuine investment in low-tax Freedonia than would be the case in a destination-based or pure territorial tax system, but this complaint should be tempered by inspection as to how much real investment (in the form of property, plant and equipment, or employees) actually takes place in the tax havens currently favored by U.S. multinational firms.

It is true that a comprehensive, worldwide superconsolidation regime puts pressure on what it means to be a "U.S." as opposed to a foreign firm, which pressure does not exist in the Destination-Based Cash Flow Tax, discussed in section VIII.C. It has been suggested that the identity of a firm's residence as the United States is as artificial as is the construct of "source" under current international tax norms. This is an overstatement today, and one that in any event is made less fraught by the Dual BEIT, because the firm-level tax will become an attraction, rather than a source of frustration, for U.S. enterprises.¹⁷⁵ Most of us are not confused that General Electric should be viewed as "American," or Philips Electronics as "Dutch." Similarly, no person or institution except the tax law is so confused as to think that Mylan, headquartered in Minneapolis, and with a predominantly U.S. shareholder base, is in substance an Irish corporation. At the same time, there is little evidence that new U.S. business enterprises are organized in foreign jurisdictions.¹⁷⁶

175. For a summary of the issue under current law, and straightforward suggestions for clarifying corporate residence, see Kleinbard, *Lessons, supra* note 157, and Edward D. Kleinbard, *Competitiveness Has Nothing to Do With It*, 144 TAX NOTES 1055 (Sept. 1, 2014) [hereinafter Kleinbard, *Competitiveness*]. For a contrasting point of view see Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 TAX L. REV. 155, 178 (2007).

176. See Susan C. Morse, *Startup Ltd.: Tax Planning and Initial Incorporation Location*, 14 FLA. TAX REV. 319 (2013).

The U.S. definition of residence is outmoded in not embracing a “mind and management” alternative leg to the analysis, but that is easily remedied.¹⁷⁷ To this can be added a new rebuttable presumption that firms that employ the U.S. dollar as their functional currency and that have some managerial presence in the United States are U.S. residents for tax purposes. Too many critics are too quick to overlook the practical power of presumptions such as this.

Once normal returns are “kicked upstairs” to investors, the entire question becomes less urgent, because the remaining tax base is neutral in the technical sense, and moderate (if this Article’s recommendations are heeded) as applied to profits. When combined with robust anti-inversion rules, the result is an environment in which there would remain little incentive for a foreign firm to acquire a U.S. one simply to create value by liberating the U.S. firm from the reach of the Dual BEIT.

At one blow, and without further international coordination, the returns to stateless income planning across foreign jurisdictions would be vitiated, because low-taxed foreign income would be taxed on a current basis in the United States. Moreover, because the Dual BEIT contemplates that all business enterprises, however organized, would be subject to the same tax regime, there is no risk of tax arbitrage across different forms of business organization within the United States. Finally, the residence basis for the firm-level tax in the Dual BEIT does not require any coordination across countries or international clearing houses to transfer tax payments collected by one country to another.¹⁷⁸ These are all sound practical reasons to prefer a true worldwide tax system relying on full global tax consolidation.

The Dual BEIT is a profits-only tax, and that principle would apply from a U.S. perspective to the entirety of the group’s operations, so that normal returns wherever earned would be exempt from U.S. tax. In turn, the Dual BEIT contemplates that U.S. investors would include in income their Includible Amounts in respect of all financial investments, whether in a U.S. or a foreign firm. This moves the core of capital income taxation to the least mobile taxpayers (resident

177. Cf. International Tax Competitiveness Act of 2010, H.R. 5328, 111th Cong. § 2.

178. Cf. Michael Devereux & Rita de la Feria, *Designing and Implementing a Destination-Based Corporate Tax* (Oxford Univ. Ctr. for Bus. Tax’n, Working Paper No. 14/07, 2014), <http://eureka.sbs.ox.ac.uk/5081/1/WP1407.pdf>.

individuals) and presents a uniform tax environment for domestic investors, so that portfolio investment decisions are not systematically distorted.¹⁷⁹

Foreign investors in U.S. firms will obtain the full benefit of U.S. profits-only business taxation, because that is the base of the business enterprise tax, and those foreign investors will not be subject to U.S. Includible Amount taxation or compensatory withholding taxes. This makes investment in U.S. domestic business operations attractive to foreign investors and U.S. investors alike—particularly if the U.S. profits-only tax rate is in the range suggested by this Article (around 25%). Thus, unlike the U.S. Treasury's 1992 CBIT,¹⁸⁰ shifting the taxation of normal returns to investors leads to neutrality in cross-border portfolio investment decisions, in both directions.

The Dual BEIT contemplates that U.S. enterprises would obtain a foreign tax credit against foreign income or profits taxes, subject to the same ceiling that applies today, under which a foreign tax credit can only be used up to the tentative U.S. tax on that foreign income. This is the “foreign tax credit limitation” of section 904(d).

As applied to the Dual BEIT, the foreign tax credit limitation would be measured by a fraction, the numerator of which is the firm's foreign profits tax base, and the denominator of which is the firm's worldwide profits tax base, determined under the same principles. In order to address vestigial stateless income planning opportunities, this foreign tax credit would be applied on a country-by-country basis.¹⁸¹

A U.S. firm's foreign profits tax base employed to measure the availability of foreign tax credits would be determined using U.S. tax principles in general, including the disallowance of all local interest expense, and would apply the COCA deduction attributable to the firm's

179. Obviously different jurisdictions will impose different business entity level effective tax rates, but that is both true today and unavoidable. The point in the text is that U.S. investors' decisions to buy one or another post-business tax income streams will not be distorted by the Dual BEIT.

180. TREAS. DEP'T, INTEGRATION, *supra* note 43.

181. This actually parallels recent U.S. proposals to “backstop” a territorial tax system with a country-by-country minimum tax. In practice the combination of foreign taxes and this minimum tax would produce an effective tax rate on all current non-U.S. income of a U.S. group no lower than the minimum tax rate, combined with country-by-country foreign tax credits.

basis in foreign business assets as so determined.¹⁸² The result is that a U.S. multinational enterprise would apportion its COCA expense for foreign tax credit limitation purposes to its worldwide assets based on its real investments in each country.

The ultimate idea is that foreign income taxes on normal returns technically could be credited against U.S. taxes on foreign economic profits, but foreign taxes on normal returns would not offset U.S. taxes on U.S. profits. In practice, however, foreign taxes paid on foreign normal returns would be utilizable to reduce a tentative U.S. tax bill only where the foreign operations generated profits as well as normal returns, and where the blended foreign tax rate were sufficiently low that the total foreign tax burden on the sum of normal returns and profits were lower than the U.S. tentative tax on those foreign profits alone.

It is true that multinational firms might find themselves with excess foreign tax credits, particularly if foreign countries retain firm-level taxes on normal returns, but I have reluctantly concluded that this is largely unavoidable. No unilateral tax system can create international harmony out of disharmonious competing tax regimes.¹⁸³

182. The international application of the COCA deduction should not be problematic as an administrative matter. The COCA deduction is calculated in respect of investment (basis) in business assets, and those assets generally have a known location. Moreover, the firm itself has detailed records of its costs. It would, however, be desirable to explore in more detail the viability of following local tax law depreciation rules in calculating the COCA deduction attributable to a jurisdiction. The reason for this hybrid approach would be that to use U.S. tax depreciation accounting rules here might create unnecessary volatility in foreign effective tax rates.

183. One of my original concerns in an early version of the BEIT had been to minimize the risk that an enterprise would face tax on its normal returns anywhere in the world, in particular by systematically incurring excess foreign tax credits attributable to taxation of foreign normal returns. I therefore conceived an overgenerous foreign tax credit system, under which foreign taxes on foreign normal returns could in some cases offset tax otherwise due the United States in respect of U.S.-source profits. The particular mechanism to accomplish this was to treat a U.S. firm's worldwide COCA deduction as allocable entirely against U.S. domestic source income for purposes of determining the effective tax rate imposed by the United States on foreign income.

The prospect that a U.S. firm operating in the new profits-only tax environment could in some cases obtain a tax credit for income taxes paid to a foreign jurisdiction in respect of foreign normal returns requires elaboration. The basic rationale is that normal returns attributable to foreign operations are not tax-exempt at all, at least in the hands of U.S. investors. A U.S. investor will include in income as Includible Amounts a normal return on the entirety of her investment in a multinational firm, which investment has gone to fund the enterprise's foreign as well as domestic assets. The U.S. investor's Includible Amounts are not sheltered by any foreign tax credits at the investor level.¹⁸⁴ As a result, normal returns on financial investment indirectly representing the entirety of a multinational enterprise's asset base are fully subject to U.S. taxation when owned by U.S. investors.

In turn, the foreign tax credit limitation operates to ensure that foreign income taxes on foreign normal returns do not reduce a U.S.

I have come to the view that this was a mistake, and instead here propose that foreign taxes on foreign normal returns can be used as tax credits only against foreign profits. In particular, I have focused more closely on the implications flowing from the idea that in a small open economy, a tax on normal returns should lead to a reduction of investment and an increase in pretax yield, to preserve a constant global post-tax normal return. (Some of these implications are developed in Kleinbard, *Lessons, supra* note 157.) As a result, the incidence of such a tax would not come to rest on the multinational enterprise doing business in that small open economy, but rather on labor in that country. If this is correct, then there is no reason to feel sympathy for firms that find themselves unable to claim a foreign tax credit in respect of taxes whose incidence did not fall on them in the first place.

The discussion in the text also has benefitted from rereading an exchange of letters with Alvin Warren of Harvard Law School. Edward D. Kleinbard, *BEIT Proponent Kleinbard Responds to Warren's Critique*, 118 TAX NOTES 1043 (Mar. 3, 2008); Daniel Shaviro, *Why the BEIT Proposal Shouldn't Be Discounted*, 118 TAX NOTES 1048 (Mar. 3, 2008); Alvin C. Warren, *The Business Enterprise Income Tax: A First Appraisal*, 118 TAX NOTES 921 (Feb. 25, 2008); *see also* Warren, Jr., *supra* note 113. I have taken both my own work on the pervasiveness of stateless income today and Professor Warren's concerns to heart in revising my earlier suggestions here.

184. An exception might be made for withholding taxes on dividends from foreign corporations, to preserve neutrality in post-enterprise tax investment environments.

firm's tax liabilities in respect of economic rents. To the contrary, it means that in practice U.S. firms often will face excess tax credits, in the absence of self-help.

For example, imagine that a U.S. firm, all of whose owners are U.S. individuals, earns \$100 in the United States and \$100 in Freedonia, before COCA. It has \$1,000 of assets in each country, and a total COCA deduction (at 4%) of \$80. (The firm thus has earned significant profits.) The firm's net U.S. tax base on its global operations is \$120; assuming a 25% tax rate, its pre-foreign tax credit tax bill will be \$30. Meanwhile, if the U.S. owners happen also to have \$2,000 invested in the firm, their Includible Amounts will be \$80, and their tax bill \$20, for a total integrated tax charge of \$50.

Imagine that Freedonia taxes the firm \$25 (i.e., 25% of \$100), because Freedonia employs a corporate income tax, and the firm is equity funded (and holds perpetual assets—the most extreme case). If that amount were fully creditable, the total integrated tax bill would remain \$50, but Freedonia would capture \$25, and the United States only \$5, of firm-level tax.¹⁸⁵ Here is where the foreign tax credit limitation comes into play. The Freedonian tax bill would be creditable only to the extent of \$15, calculated as $\$60/\120 multiplied by \$30. Total firm taxes would rise to \$40 and the total integrated tax bill to \$60.

The U.S. firm would be required to employ self-help to reduce its tax bill back to \$30—for example, by capitalizing its investment in Freedonia in part with intercompany debt, the interest on which is deductible in Freedonia. (Since the United States would employ worldwide tax superconsolidation, under which intercompany interest payments would be ignored, this would have no U.S. tax meaning.) The practical risk is double taxation, even with the foreign tax credit. This is particularly the case with a country-by-country foreign tax credit, but that restriction is needed to remove any incentive to produce large streams of low-taxed foreign-source rents to absorb excess foreign tax credits from operations elsewhere.

Now imagine the same facts, except that Freedonian operations earn only a normal return of \$40, on which tax is due of \$10. The U.S. profits-only tax on this would be zero, after the COCA deduction. What should the foreign tax credit be? If the \$10 were allowable as a

185. This essentially tracks an example suggested by Professor Warren. *See* Warren, Jr., *supra* note 113.

credit, it would offset \$10 of the tentative \$15 U.S. tax on U.S. profits, leaving a U.S. tax bill of \$5 and a Freedomian tax bill of \$10. If the foreign tax credit is zero, then total taxes rise to \$60, as in the first part of the example. (That is, the normal return from Freedomian operations in either case is subject to firm-level tax.)

On the one hand, allowing the credit in full would preserve a system under which the total integrated tax burden would remain \$50—or, phrased alternatively, under which normal returns are taxed once, and once only, to investors. On the other hand, if U.S. investors made portfolio investments in a standalone Freedomian firm with exactly the same income and assets as the Freedomian operations of the U.S. multinational in this example, those U.S. investors would face a firm that incurred the same \$10 enterprise-level tax, and would pay \$10 of tax in respect of Includible Amounts to boot.

In the end, the second argument is more convincing: it is not sustainable to use the foreign tax credit system to hold U.S. portfolio investors harmless from a tax charge that their firm would suffer if it were a standalone foreign operation, because then the United States effectively would subsidize foreign countries for not reforming their tax systems to profits-only taxes.¹⁸⁶ The good news is that, at least today, a U.S.-based multinational enterprise could use intercompany debt and similar techniques to strip the Freedomian tax base to a Dual BEIT-level equivalent. (Stripping further than that would serve no purpose, since the Dual BEIT would apply to any Freedomian income unsheltered by Freedomian tax.)

The international tax regime contemplated above can be implemented unilaterally. It creates a neutral profits-only U.S. domestic business tax environment that is available to both U.S. and international portfolio investors. It does not incrementally burden foreign normal returns of a U.S. multinational group, and thereby again is a neutral investment platform for U.S. and foreign portfolio investors (when “neutral” here is understood to mean comparable in result to a portfolio investment in a standalone firm domiciled in the foreign jurisdiction in question). And it substantially vitiates any opportunities for stateless income tax planning. Provided that the U.S. profits-only tax rate is not greatly disproportionate to world norms, investment in U.S. business operations

186. This is a different way of phrasing the conclusion urged by Professor Warren in the exchange of letters in 2008 (*see supra* note 183). It remains the case, however, that tax-exempt investors are a red herring here.

and in U.S. multinational business enterprises should face more neutral and more attractive tax environments than currently is the case.

VI. DRILLING DOWN ON THE DUAL BEIT'S MECHANICS

Parts II through V described the major building blocks of the Dual BEIT. This Part VI adds discussions of some important ancillary considerations not already covered.

A. Firm-Level Computations

1. Coordination between COCA and Asset Depreciation Rules

The COCA system operates alongside, not in place of, standard asset depreciation rules. Because a business enterprise's aggregate asset basis is used to calculate the COCA deduction, the COCA system effectively mitigates distortions attributable to too fast or too slow depreciation, to yield a neutral tax base. This is a well-known result in public finance literature¹⁸⁷ but worth explaining in a little more detail for a wider audience.

Consider two extremes. In the first, an issuer that deducts rather than capitalizes an expenditure forfeits any COCA deduction with respect to the capital invested, but obtains the neutral result of a cash flow tax. In the second, an issuer that treats that same cost as a non-depreciable capital expenditure receives a COCA deduction in perpetuity. The net result of this self-correcting mechanism is that the present value of the sum of a business enterprise's COCA and depreciation deductions will remain a constant percentage of the enterprise's capital (measured as historic cost), *regardless* of the depreciation and capitalization rules the business employs.¹⁸⁸ This is precisely the result desired: exemption of a normal rate of return from tax at the business enterprise level, and

187. BRADFORD, *supra* note 73, at 28–30; Robin Boadway & Neil Bruce, *A General Proposition on the Design of a Neutral Business Tax*, 24 J. PUB. ECON. 231 (1984).

188. BRADFORD, *supra* note 73, argues that economic theory requires that basis for this purpose be measured by the current market value of an asset; that might be right, but is more than can be expected from a practical tax system, particularly one so deeply imbued with century-old accounting norms as its perspective on income definition and measurement.

(separately and unrelated to any depreciation schedule) inclusion of a normal return on investment at the investor level.

The self-correcting behavior of the Dual BEIT's COCA mechanism (or any other capital account allowance) also means that the question of which expenses ought to be capitalized loses almost all its sting. Properly capitalizable expenses that nonetheless are deductible achieve cash flow results directly; correctly capitalized amounts obtain the same present value in tax savings through the combination of the COCA and depreciation.¹⁸⁹

This observation in turn leads to a question: why not retain the COCA concept to measure normal returns to investors but dispense with it at the business enterprise level? If the result is equivalent, why not disallow all deductions on financial capital instruments and permit issuers to expense all investments as they are made?

There are several good reasons not to do so. First, as the late David Bradford pointed out, a COCA/depreciation system has the advantage over a simple asset expensing rule of mitigating the effects of changes in tax rates, because unlike expensing, the value to an issuer of the "tax receivable" it holds (the stream of future COCA deductions) depends on future tax rates.¹⁹⁰

Second, the Dual BEIT's combination of deductions for depreciation and financial capital can roughly be analogized to the current law's deductions for depreciation and interest expense. The continuation of depreciation deductions within the Dual BEIT in particular aligns tax and financial accounting concepts of income, thereby making interpretation of the tax footnote in financial statements easier to understand. I also believe that presenting the BEIT as building on well understood tax concepts is helpful as a political economy matter.¹⁹¹ Further, because the COCA system spreads out its exemption for the risk-adjusted normal return over time, it is less likely to lead to the problem of firms

189. Second order differences of course do remain, such as cash flow considerations and exposure to subsequent changes in tax rates, as discussed in the next few paragraphs in the text.

190. BRADFORD, *supra* note 73.

191. Conversely, there might be merit in exploring a simple expensing rule within BEIT/COCA for small businesses because administrative and systems considerations are more important for small companies than for large firms.

with perennial losses than is an expensing system. This was a major concern in the 2016–17 debate surrounding the expensing portion of the House “Blueprint” proposed by Speaker Paul Ryan.¹⁹²

2. Business Enterprise Portfolio Investments in Another Business Enterprise

Superconsolidation eliminates any concept of an investment in the securities of another affiliate within the superconsolidated group. A firm may, however, hold a portfolio investment in another firm that falls below the superconsolidation threshold. In such a case, the investing firm wears two hats: as investor and as a business firm eligible for its own COCA deduction. As investor, the firm includes in income Includible Amounts. As a business enterprise, it deducts a COCA allowance, in each case measured against the same tax basis (cost). As a result, there is no net tax bill, and no cascading of tax costs for indirect investments in one firm held through other firms.

3. Mutual Funds and Personal Holding Companies

The rule for portfolio instruments just described could be seen as protecting a mutual fund or similar investment vehicle from taxation, but in light of their importance in the economy, and to deal more comprehensively with issues of retained earnings, it is better to address them directly. The proposal is to create a new class of entities, termed Collective Investment Vehicles (CIVs), comprising what today are regulated investment companies (mutual funds), real estate investment trusts, and other vehicles the majority of whose assets comprise investment assets. (See below, however, on the constructive division of certain business enterprises into a CIV and a residual business firm.)

The basic idea is that a CIV would be treated as an investor rather than as a business enterprise. The CIV would track its Includible Amounts in respect of its investments but, unlike other investors, would not pay tax on those Includible Amounts. As a result, the CIV would be functionally tax-exempt. Moreover, because a CIV is not itself a business enterprise,

192. A BETTER WAY, *supra* note 71. In fairness, the problem there was compounded by the Blueprint’s Border Adjustability Tax, which by itself would have placed exporting firms in a perennial loss situation.

an investor in a CIV would not include in her income any Includible Amounts in respect of her investment under the usual BEIT rules.

Instead, a Collective Investment Vehicle would be treated as distributing its own Includible Amounts to its investors annually, regardless of cash distributions, based on their respective claims against the CIV. The constructive income distribution would be fully taxable to the investor and increase her tax basis in her CIV interest; actual cash distributions from the CIV would decrease her tax basis.¹⁹³ The difference between the CIV rule and the usual Includible Amount rules is that in the case of a CIV investor, his Includible Amounts are measured at the CIV level, not by reference to each investor's tax basis in his CIV shares. This is consistent with current mutual fund taxation.

The CIV rules would extend beyond traditional regulated investment companies (mutual funds) and similar institutions to reach personal holding companies, foreign passive investment companies, private equity firms, or any substantial investment activity nested inside a business enterprise. Specifically, in the case of any business enterprise whose aggregate tax basis in financial instruments held for investment exceeded 20% of its aggregate tax basis in all its assets, or whose investment income exceeded 20% of aggregate firm income before COCA allowance, the investment assets would be treated as a standalone Collective Investment Vehicle, and the residual assets and operations as a business enterprise.

Hedge funds straddle the conceptual divisions contemplated above. Depending on a firm's particular mode of operation, a hedge fund can be a very active *trader* in securities (a professional trader, in other words) without being characterized as a *dealer* in those securities.¹⁹⁴ Here it would be wrong as a policy matter to exempt supranormal returns

193. This proposal means that the tax rules for CIVs would not be required for their intended operation to mandate a minimum level of distributions from a CIV to its owners each year, in contrast to current law's requirement that a regulated investment company distribute to shareholders at least 90% of its net investment income annually. I.R.C. § 852(a). Of course, if it is thought that the annual distribution requirement serves an independent social purpose, it can be retained on that basis.

194. See, e.g., *Kemon v. Comm'r*, 16 T.C. 1026 (1951); cf. I.R.C. § 475(f) (permitting "traders" in securities to elect to be treated under the same mark-to-market rules as those applicable to securities dealers).

from entity tax, particularly given that hedge funds often position themselves as capturing some magical “alpha” visible only to them.

As a result, the business enterprise rather than Collective Investment Vehicle rules would apply to any entity that is a professional trader, as defined under current (surprisingly well-developed) law.¹⁹⁵ In the case of a fund that crosses the tax line from investor to professional trader, but whose operations in economic substance are closer to those of an investor, the COCA allowance at the firm level would lead to little or no business enterprise tax, and the only net addition to the tax base would be an investor’s inclusion of Includible Amounts.

4. Rents and Royalties

Rents and royalties (in the tax, not economic, sense) are payments for the temporary use of property.¹⁹⁶ Putting to one side prepaid leases or other unusual terms,¹⁹⁷ the rent paid corresponds to the value conveyed for the period in question. As such, there is no capital investment in a standard commercial lease and no reason why rents and royalties paid to third parties should not be deductible in the same manner as any other noncapital expense for a period. The Dual BEIT so provides (with the superconsolidation regime described in Part V effectively eliminating such items among affiliates). From the other direction, the Dual BEIT contemplates that rent and royalty income earned outside the context of a business enterprise constitutes miscellaneous capital income.

On the other hand, a Participating Controlling Owner could seek to avoid recharacterization under the labor-capital income centrifuge of some returns by withholding core self-created intangible assets and then licensing them to her controlled enterprise. For this reason, the Dual BEIT treats all rents and royalties received by a Participating Controlling Owner as her labor income, taxable to the PCO under the progressive labor income rate schedule.

195. See, e.g., *Estate of Yaeger v. Comm’r*, 889 F.2d 29 (2d Cir. 1989); *Hart v. Comm’r*, T.C. Memo 1997–11; *Kemon*, 16 T.C. at 1026.

196. This paragraph relates to what tax lawyers term “true leases,” not purchase money mortgages cast in lease terms.

197. I.R.C. § 467 provides elaborate rules for “flattening out” such lease terms and converting their payment schedules into constant annual amounts.

5. Business Losses

The Dual BEIT contemplates that a business enterprise's net operating losses would compound each year at the COCA rate. This rule preserves economic neutrality in the timing of income and loss recognition where a loss produces only a nonrefundable net operating loss carryover. If a firm were to liquidate (for example, through bankruptcy) with an unused balance of net operating losses, theory would dictate that those losses be refunded, but practical experience suggests that this is a highly improbable outcome for a legislature to endorse. It appears to subsidize foolish investments as opposed to sensible risky ones, and it would incentivize firms at the cusp of bankruptcy to throw in the towel to claim their refund. These are the sorts of imperfections that one must accept as the price of descending from the Olympian heights of academia to actual policy recommendations.

B. Investor Taxation of Normal Returns

1. The Special Problem of Investor Losses

As developed in *Capital Taxation in an Age of Inequality*, the U.S. Constitution presents a special issue for investor-level taxation. It is likely that even today an annual wealth tax, even if limited to a taxpayer's business investments, would be viewed as a "direct" tax (in the Constitutional sense) requiring apportionment among the states, which is impossible to implement (because it would impose different tax rates on residents of different states, depending on their relative wealth). And in turn, an annual "income" tax that takes the form of a simple deemed return on investment is at risk of being characterized as an impermissible stealth form of direct tax on property.¹⁹⁸

The only response is to permit an investor who sells an investment at a loss, relative to the investor's adjusted tax basis, to claim a loss deduction (at the capital income tax rate), up to the amount of prior Includible Amounts. Losses beyond this amount (losses of principal) would be ignored, just as capital gains are ignored. Current law's wash

198. *Pollock v. Farmers Loan & Tr. Co.*, 157 U.S. 429 (1895), *vacated*, 158 U.S. 601 (1895). For all the criticism leveled at the case, it has never been overruled, and the facts here, where the income in question is completely notional in its measurement, surely would be at risk.

sale rules would be retained, but beyond this restraint, the loss deduction (adjusted to reflect the allowable tax rate) effectively could offset current year labor income. Administratively, the loss allowance could be implemented as a 25% tax credit and made refundable or eligible for carryback/carryover.

This loss allowance rule should be sufficient to distinguish the Dual BEIT from a wealth tax, where diminutions in value never trigger rebates of prior taxes on the property's former higher value. It also can be justified as a normative matter, because the imputed return mechanism of Includible Amounts is meant to serve as an administrable approximation of the normal returns that an investor expects to earn; where the expectation is definitively unmet, then reversing the prior inclusions can be argued to be appropriate.¹⁹⁹

The extent of any economic distortions attendant on this rule would depend to a significant extent on the tax treatment of a firm's bankruptcy. If, for example, on the bankruptcy of a firm its net operating loss carryovers were to disappear, then the investor loss allowance rule would be easier to justify.

A rule permitting taxpayers to wash out prior Includible Amounts by recognizing losses would subject the Treasury to the same sort of asymmetrical loss harvesting strategies that are standard practice today.²⁰⁰ To some extent, the Constitutional imperative makes this inevitable,²⁰¹ but the result can be mitigated by enacting more robust wash sale rules that are triggered by the purchase of "substantially similar" rather than "substantially identical" securities.²⁰²

199. If the reason for the investor-level loss is that the business enterprise has incurred losses, then it is true that the firm will have a net operating loss at the same time that the investor has a loss on sale of her interest in the firm, but that is not a doubling of the loss: the latter reduces the sum of firm and investor income back to zero, and the former records losses from the starting point of original capital invested in the enterprise.

200. Mark P. Gergen, *The Effects of Price Volatility and Strategic Trading Under Realization, Expected Return and Retrospective Taxation*, 49 TAX L. REV. 209 (1994); Edward D. Kleinbard & Thomas L. Evans, *The Role of Mark-to-Market Taxation in a Realization-Based Tax System*, 75 TAXES 788 (1997); Erika W. Nijenhuis, *Wash Sales Then and Now*, 82 TAXES 181 (2004); David M. Schizer, *Scrubbing the Wash Sales Rules*, 82 TAXES 67 (2004).

201. See *infra* Section VI.B.1.

202. Compare I.R.C. § 1091 (substantially identical standard for wash sales), with I.R.C. § 1092 (substantially similar standard for straddles).

2. Tax-Exempt Investors

The issue of tax-exempt institutions pervades current law and every reform proposal as well. Some, like the U.S. Treasury's Comprehensive Business Income Tax proposal of 1992, hide the ball for a minute by moving all business taxation to the firm level, but no rational person can expect the ultimate political outcome to turn on such cosmetic matters. I therefore have always accepted the likelihood that the Dual BEIT, when implemented in practice, would offer a preference to tax-exempt investors in respect of Includible Amounts, notwithstanding that I would prefer a different outcome.²⁰³

Logically, one should distinguish here between retirement plans and charities. A retirement plan permits an individual to avoid capital income taxation over the period his funds are invested in such a plan, and by doing so enables the individual to enjoy a constant present value of lifetime consumption, regardless of the annual consumption pattern that such individual adopts.²⁰⁴ As previously outlined in the text, the Dual BEIT contemplates retaining retirement plans for just such purposes, capped at some reasonable amount (as a stalking horse, \$5 million).

Charities, by contrast, enjoy the benefit of double deductions. Contributions to qualifying tax-exempts are deductible, but endowment earnings are permanently free of tax, and, of course, amounts spent out of endowments for the charity's charitable purpose are not subject to tax.²⁰⁵ The result is essentially akin to a Roth IRA in which contributions

203. Particularly in light of the Dual BEIT's taxation of investors only on Includible Amounts (that is, risk-adjusted normal returns), both traditional IRAs and Roth IRAs here get to the same place: that is, capturing economic rents inside a traditional IRA is not taxed worse than capturing those rents inside a Roth IRA.

204. For example, money invested in a traditional IRA is subject to a form of cash flow taxation, which has the economic consequence of exempting normal returns from tax during the term the money is so held; money invested in a Roth IRA is not deductible when invested, but the earnings are not taxed when they are extracted. Insofar as normal returns are concerned, the two get to the same place (ignoring effective differences in annual contribution limits). Today however economic rents accrue tax-free inside a Roth IRA but not inside a traditional IRA.

205. See I.R.C. §§ 170, 4942; cf. I.R.C. § 511 et seq.

are tax-deductible—a compounding of benefits that in the retirement field has not yet occurred even to Congress.

Nonetheless, political economy realities must be recognized. The Dual BEIT proposal made in this Article therefore contemplates a tax rate on the Includible Amounts of tax-exempt institutions other than (capped) retirement plans of one-half the standard (25%) rate. This certainly does rough justice, in that these institutions will benefit from the lower business enterprise tax rate, but it must be acknowledged that history is not on the side of this reform.²⁰⁶

Even if the decision is made to exempt entirely from the Dual BEIT's investor taxation system the income of tax-exempt institutions, the resulting subsidy should not influence the actual behavior of business enterprises. In contrast to current law, the Dual BEIT does not offer investors any form of cross-investor tax arbitrage opportunity through the form of the securities they acquire (for example, placing taxable debt instruments with tax-exempt investors and low-dividend equities with affluent individuals). Nor does the Dual BEIT create an inducement for tax-exempt investors to invest in firms with one mix of income as opposed to another, because the tax consequences for holders on one hand and issuers on the other do not turn on the label of the financial instrument. By the same token, the taxation of issuers does not depend in any way on the composition of the firm's investors. The result is that, even if the subsidy of tax-exempt institutions is maintained in the Dual BEIT, the subsidy should not affect a firm's financing or investment decisions, whether in respect of the capitalization of the firm or in the firm's decisions as to where to invest. Similarly, the Dual BEIT does not encourage firms to make foreign direct investments at the expense of U.S. ones to generate tax-favored income streams for U.S. tax-exempt investors.

Finally, the overall tax burden on debt provided by tax-exempts to finance equipment purchases by business enterprises will rise from the negative effective marginal tax rates enjoyed by users of that financing today—to zero. And debt-financed rent-bearing assets held by a business enterprise will pay tax at the business enterprise rate, rather than zero, as can be true today.

206. For a targeted rule characterizing certain financial derivatives activities by tax-exempts as unrelated business taxable income, see *infra* Section VI.C.1. This targeted rule is feasible under current law and the Dual BEIT alike.

3. Inflation

This Article does not address how adjustments for inflation could be incorporated into the Dual BEIT proposal, although I believe that the Dual BEIT is sufficiently flexible in its design to include a solution. In part, this decision reflects the luxury of current times, in which inflation is not (and has not been for several years) of any immediate concern. And in part it reflects both the length of this Article and the sad lesson learned by the author from past iterations of this general theme, which is that overly fulsome explanations of all possible issues convince readers that the idea is simply too complex, rather than fill them with admiration for the care that the author has expended.

In practice, most tax systems today are vulnerable to base measurement problems attributable to inflation, including the income tax regimes in force in major economies, as well as alternative capital income tax proposals. Nor are profits-only taxes necessarily exempt: even a simple value added tax can expose a firm to tax on phantom inflation income if there is any appreciable lag between when the time inputs are purchased and outputs are sold. I therefore think it appropriate for a prospectus of this sort to defer the topic of inflation adjustments until a point further along the implementation path for the Dual BEIT.

C. Special Industries and Circumstances

1. Financial Institutions and Products

An earlier paper on a preliminary iteration of the business enterprise income tax²⁰⁷ described in detail how the Dual BEIT would apply to financial institutions, insurance companies, micro businesses, financial derivatives, and other special cases.²⁰⁸ In retrospect, this author ruefully

207. Kleinbard, *Rehabilitating*, *supra* note 19, at 36–40.

208. The earlier proposal contained tax rate suggestions, drawn arbitrarily from then-current analogies, but its focus was on working through the technical operation and implications of the BEIT mechanism.

The current Dual BEIT proposal differs from that earlier work in many important respects, including by fully specifying proposed tax rates (as to which the original proposal was largely indifferent), coming to grips with the labor-capital income dilemma, and dropping an earlier surtax on investors' extraordinary returns. That surtax was included originally for tactical political

acknowledges that over-specifying a proposal leads to reader fatigue or nitpicking rather than to admiration and adoption. For these reasons, I incorporate here by reference from that earlier paper its specification of the Dual BEIT's application to special cases like those listed above. Mutual funds and similar institutions are addressed in Section VI.A.3.

Notwithstanding my own good advice to myself, it might be helpful to make a few quick observations. As applied to financial institutions, the rough justice of the Dual BEIT's COCA mechanism is simply not sufficiently granular. For financial institutions, money is their stock in trade, and for all relevant purposes (managerial, regulatory, investor relations) such firms operate in an entirely or largely mark-to-market environment.

The solution 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 financial liabilities, and to then provide a COCA deduction on the firm's net tax basis in non-financial assets, plus the net mark-to-market value of all of its financial assets.²⁰⁹ The idea here is, first, to capture all of the financial institution'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 an allowance for 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.

economy reasons, but this author now realizes that he misread the political climate in this respect. Nonetheless, the technical solutions proposed therein generally continue to be relevant.

209. As applied to financial services firms, the BEIT thus would function much like an ACE system. 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).

The BEIT component of the Dual BEIT can be extended to financial derivatives, to assure conformity in outcomes between investments in derivatives and investments in “physicals” (stocks and bonds).²¹⁰ Unlike the latter instruments, 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. At the same time, a derivative can move substantial cash from one party to the other. The COCA system therefore can form the basis of a consistent approach to the taxation of derivative instruments, including the returns to capital embedded in them.

Specifically, the proposal for the use of derivatives by business enterprises in the ordinary course of business contemplates a three-tiered set of priority rules, in the same manner that financial accounting today imposes a three-tiered set of valuation rules for derivatives. Tier 1 comprises any derivative that serves as a hedge of liabilities or ordinary business assets—concepts already embodied in Code section 1221(b)(2) and the relevant Treasury regulations.²¹¹ The proposal contemplates that liability hedges are folded into those liabilities and therefore have no immediate tax consequences. Any gains or losses ultimately increase or reduce a firm’s assets and accordingly affect its COCA deductions going forward. Ordinary asset hedges (e.g., inventory hedges) are taxed under the same timing rules as the assets being hedged; simplifying, these hedges simply change the sales prices of the hedged assets.

Tier 2 comprises professional dealers and traders in derivatives or underlying securities or commodities. Here the idea is the same as that outlined for financial institutions generally: all such activities are subject to mark-to-market, the resulting gain or loss is included in the business enterprise’s tax base, and the enterprise obtains a COCA deduction in respect of the net asset value of all such mark-to-market activities.

Tier 3 comprises derivatives held in other contexts—for example, by an insurance company “hedging” the flows on some of its investment assets. Here, a new asset/liability model is applied. Outflows under the derivative are treated first as a reduction in liability under the contract (see the next sentence), and then as investments in the contract, attracting Includible Amounts in respect of the investment and an offsetting COCA deduction for the new asset. Inflows under the derivative contract are treated first as a recovery of basis in the contract and then

210. Kleinbard, *Rehabilitating*, *supra* note 19, at 51–53.

211. Reg. § 1.1221–2.

as a liability. (Assets purchased with any inflows, of course, attract COCA deductions.)²¹² Finally, “Delta 1” contracts (those that mimic precisely the movements on the underlying security or commodity to which the derivative relates) would be treated as direct investments in the underlying.²¹³

Finally, a tax-exempt institution that engages in derivatives activity, other than clearly identified hedges (in the colloquial, not technical tax, sense) of investment positions, would be treated as deriving unrelated business taxable income from that activity. This would prevent the use of tax-exempts to serve as tax-indifferent counterparties in cases that might advantage taxable business enterprises.

Outside the context of derivatives, one more new rule would be desirable under the Dual BEIT—or for that matter current law. A taxpayer who borrows money secured by an investment asset, where the amount borrowed exceeds the taxpayer’s basis in the asset, will trigger a realization event in respect of that investment. As always, there is no immediate tax consequence from this basis reset, but future Includible Amounts will reflect the new tax basis.

2. Non-Business Capital Income

The Dual BEIT is a comprehensive income tax on capital invested in the business sector. This means that it does not reach two hugely important forms of capital investment: investments in government securities or bank deposits, and investments in owner-occupied housing.

The proposal is to continue existing law addressing the taxation of bank deposits, U.S. government securities, and other securities not issued by business enterprises (e.g., foreign governments, or state and local governments), and rental and royalty income earned outside

212. For illustrative examples of the Tier 3 rules in action, see Kleinbard, *Rehabilitating*, *supra* note 19, at 51–53.

213. I thank Daniel Hemel for inspiring this tweak to the proposals for handling derivatives. Consider his review of an early draft of this Article: Daniel Hemel, *Weekly SSRN Tax Article Review and Roundup*, TAXPROFBLOG (Dec. 9, 2016), http://taxprof.typepad.com/taxprof_blog/2016/12/weekly-1.html. Hemel’s other concerns (the taxation of what today are tax-exempt institutions and gains recognized by Participating Controlling Owners on the sale of their stock in advance of the firm’s recognizing income) have been addressed as well.

the context of a business enterprise.²¹⁴ This means that income in respect of such assets (including capital gains) would be taxed at the capital income rate (25% in the running example).

Current law does a good job of measuring capital income on debt instruments in general, at least where those instruments do not have embedded equity features. Current law's exclusion from income of municipal bond interest is mistargeted, but that mistargeting can be addressed separately from the issues considered in this Article.

My proposal for the taxation of owner-occupied housing is brutally simple, yet a step forward in the efficient allocation of capital investment. I propose, as I have developed elsewhere, that personal itemized deductions, including those relating to owner-occupied housing, be scaled back, at first to a 15% effective tax rate deduction (that is, to a 15% credit), and then over the course of years to zero.²¹⁵ I further propose retaining current law's inclusion in the tax base of capital gain on the sale of an owner occupied home, subject to the \$500,000 exclusion provided by current law²¹⁶ (purely as a political accommodation, in the latter case).

The Dual BEIT's mechanism *could* be extended to the imputed rental value of owner-occupied housing—indeed, Norway did just that under its dual income tax for a few years—but the political economy hurdles to simply explaining the concept of imputed rental income, much less legislating it, are so self-evidently daunting as to make that enterprise an impediment to enacting any change at all.

The idea then is to move towards a world where imputed rents on owner-occupied housing are taxed approximately at a zero rate (up to the exclusion, at least). This sounds defeatist, but in fact would be a significant efficiency enhancement over current law, where such investments enjoy a negative tax rate.

Gains above the exclusion in respect of owner-occupied housing, gains from collectibles, gains on non-business loans to individuals, and gains from any other unspecified assets would all be taxed at full progressive (labor income) tax rates, employing current law timing rules.

214. See *supra* Section VI.A.4 for a special exception for rental and royalty income earned by a Participating Controlling Owner.

215. See Edward D. Kleinbard & Joseph Rosenberg, *The Better Base Case*, 135 TAX NOTES 1237 (2012).

216. I.R.C. § 121. The amount is \$250,000 for non-joint returns.

VII. EVALUATING THE DUAL BEIT

A. In General

Parents make bad evaluators of their offspring, but I nonetheless submit that the Dual BEIT, as just summarized, would be a very substantial improvement over current law capital income taxation and dominates other capital income tax proposals once those are sufficiently fleshed out to make a fair comparison possible. Of course, one must first accept the desirability of an annually measured and collected flat tax on capital income, but that is the job of *Capital Taxation in an Age of Inequality*.

First, the Dual BEIT is comprehensive, in that it reaches all forms of business organizations and all forms of investments therein.

Second, it yields consistent measures of normal returns. Unlike other comprehensive capital income tax proposals, the BEIT mechanism splits the taxation of returns to capital by taxing time-value-of-money (normal) returns only at the investor level, while taxing profits (in the broadest sense—that is, including returns to risk, returns to uncertainty, and rents) at the business enterprise level. By doing so, the BEIT mechanism sidesteps the problems that plague the U.S. Treasury's 1992 Comprehensive Business Income Tax²¹⁷ and similar comprehensive entity-only income tax proposals, all of which accurately tax normal returns only if they get capitalization and depreciation precisely right—an unrealistic practical and political expectation.

Third, the BEIT mechanism seeks to reduce the realization principle to its smallest possible component. By taxing normal returns to investors rather than business enterprises, and by imputing those returns, the BEIT takes advantage of the intuition that investment assets turn over more rapidly than do noninventory real assets, so that the *base* for determining normal returns is closer to the economic ideal. For the same reasons, the BEIT repeals all the tax-free organization and reorganization rules. The result is a system where reported taxable income tracks economic income more closely than under current law.

Specifically, the Dual BEIT makes every gratuitous transfer, business merger, or the like an occasion to revalue investors' basis in the financial assets they hold, and it measures Includible Amounts under quasi-original issue discount principles. Borrowing against appreciated securities also would be treated as a revaluation opportunity. As a result,

217. TREAS. DEP'T, INTEGRATION, *supra* note 43.

the Scylla and Charybdis of capital income taxation (the debt-equity distinction and our fulsome reliance on the realization doctrine) are largely disarmed.

Fourth, the Dual BEIT achieves investor-firm integration, without any of the baggage associated with imputation credit schemes or the like.²¹⁸ The COCA mechanism accomplishes this without requiring that investor income turn on any aspect of firm-level tax liability. To the extent that investor Includible Amounts exceed firms' aggregate COCA deductions, that is a feature, not a bug: it would reflect the greater velocity of investors' trading in securities than firms' trading in their income-producing real assets (to that extent mitigating the relevance of the realization doctrine in the measurement of normal returns), and the fact that firms will have traded off COCA deductions for immediate expensing of self-developed intangibles.

Fifth, the Dual BEIT offers a surprisingly featureless tax topography, which minimizes both tax gaming and occasions of comparative unfairness. Importantly, it does not rely on different tax regimes for private and public firms, or for debt and equity.

Sixth, the Dual BEIT is very parsimonious in the information it requires of investors in particular, and it imposes no investor-firm coordination requirements at all.

Seventh, by moving the taxation of normal returns to the investor level, the Dual BEIT fixes that burden on the least capital-mobile taxpayers—individual investors rather than multinational firms. At the same time, the individual investor level is a cleaner canvas on which to calculate taxable normal returns, because neither depreciation nor other business tax incentives are relevant.

Finally, the Dual BEIT embodies several very attractive political economy characteristics. Most important in this regard, the Dual BEIT will be compelling to firm managers: firms (and thus the managers of firms) will face a comprehensive profits tax system, in which normal returns to capital are exempt from tax. As a result, firms' capital structures will no longer be distorted by tax considerations; mergers and acquisitions—including all-cash deals—will be tax-free in present value terms at the firm level; and marginal investments will bear zero firm-level tax. Managers thus will enter a tax land of milk and honey, in which their perennial pleas for a more “competitive” business tax system will have been answered, while still preserving a coherent and genuinely

218. Kleinbard, *The Trojan Horse*, *supra* note 53, at 962.

neutral business tax base.²¹⁹ And while it is true that investors will in some cases face a tax liability without the receipt of cash, most firms can be expected to adjust their cash payout policies to address this; in return, investors will face capital gains tax rates of zero.

B. Efficiency Considerations

Like any profits-only tax, the firm-level component of the Dual BEIT affords business enterprises a neutral environment along the margins of how tax might affect the scale of investment (its effective marginal tax rate is zero) and the capital structure of the firm.²²⁰ In the latter respect, the Dual BEIT, like an actual cash flow tax or other capital account allowance mechanisms, is superior to an ACE, because it is not at risk of financial legerdemain employing equity-flavored debt instruments or the like to enhance the total deductions available in respect of a firm's capital. The firm-level component of the Dual BEIT also is efficient along the margin of the choice of form of business organization, because all firms are subject to the same regime.

When applied to multinational activities, tax systems generally face a Hobson's choice between the unattainable (accurate geographic sourcing of income) and the arbitrary (worldwide tax consolidation).²²¹ Worldwide tax superconsolidation, as envisioned for the Dual BEIT, shares with destination-based cash flow taxes the great merit of being relatively robust to "stateless income" planning by multinational firms.²²² In both cases, the idea is that there are no payoffs to doing so, in the former case because the income is taxed in the residence country regardless, and in the latter case because only the destinations of sales drive the allocation of taxing responsibilities.

Worldwide tax superconsolidation, where the tax rate itself is quite moderate by world norms, operates more as a "territorial" tax system with a very robust floor on stateless income gaming than it does an assertion of taxing jurisdiction over profits arising in important market economies with markedly lower tax rates. Admittedly there are some exceptions to this observation. In particular, in the case of worldwide tax consolidation employing country-by-country foreign tax credits, a

219. Kleinbard, *Competitiveness*, *supra* note 175.

220. See Devereux, *supra* note 75, at 709–30.

221. See Kleinbard, *Lessons*, *supra* note 157.

222. See *id.*

U.S. multinational doing business in a country (Freedonia) with systematically higher business enterprise tax rates than the U.S. rate would face incentives to use stateless income planning to bring its foreign tax rate in Freedonia down to the U.S. effective rate.²²³ If such strategies retain vitality, the worldwide system puts a hard floor on their use, because there is no utility in driving rates below the U.S. rate.

Viewed from a worldwide efficiency perspective, once stateless income has been ruled out of the picture, there might nonetheless appear to be a distortion along the margins of real investment in this example, because U.S. firms would prefer to locate investment in the lower-taxed United States rather than in Freedonia. In many cases this fact pattern will boil down to the case that Freedonian normal returns will be taxed by Freedonia, whereas the ideal in the Dual BEIT is that normal returns are not burdened at the firm level. The short answers are, first, that no unilateral tax system can achieve worldwide harmony, and, second, because Freedonian normal returns tax will be paid by all firms conducting business in Freedonia, that rate logically should be reflected in (higher) Freedonian pretax returns. If that in fact is the case, then a U.S. firm is fully compensated by the market for the Freedonian tax.²²⁴

Conversely, if Freedonia enjoys systematically lower effective tax rates on firm income than does the United States, then a worldwide tax consolidation system would seem to distort investment decisions by imposing a higher global tax rate on that income than that enjoyed by Freedonian competitors. This concern is overstated, however, where, as here, the Dual BEIT is a profits-only tax. If there are rents to be captured in Freedonia, they will remain attractive even after a U.S. profits-only tax.

Worldwide tax superconsolidation admittedly places great stress on the fiction of corporate residence, as discussed in Section V.B and at length elsewhere.²²⁵ Very briefly, however, at least as applied to the United States today, corporate residence is rarely difficult to discern. The case of corporate inversions does not disprove this assertion, but rather reminds us of the many failings of the U.S. tax legislative process. A more appropriate definition of corporate residence is straightforward as

223. The same actually is true of a territorial tax system: multinational enterprises will still be incentivized to shift income from high-tax to low-tax countries to reduce their global tax bills.

224. Kleinbard, *Lessons*, *supra* note 157, develops this in detail.

225. *Id.*

a drafting matter.²²⁶ Moreover, it remains the case that U.S.-domiciled firms ultimately are overwhelmingly owned by U.S. persons.²²⁷ This means that a profits-only worldwide tax will fall predominantly on profits accruing to U.S. persons. And, unlike a destination-based cash flow tax, a worldwide consolidated profits-only tax can obtain reasonable allocations of tax revenue collection without needing to imagine any form of international cooperation.

At the investor level, the Dual BEIT contemplates that U.S. resident investors will bear the full burden of the capital income tax on the normal returns to all their portfolio investments, wherever the underlying business enterprise is located. As a result, the Dual BEIT introduces no incremental distortion along the margins of their portfolio investment decisions. This result is consistent with the normative view advanced earlier that residence taxation should be the exclusive burden imposed on the portfolio investments of individuals, who have a world of alternative investments from which to choose. It also is consistent with the practical difficulties in imposing withholding tax on portfolio income flows and with the global trend to reduce such barriers through unilateral law and treaties.

Because foreign portfolio investors in U.S. corporations will face a domestic profits-only tax, and no U.S. investor-level tax, those foreign investors will enjoy the benefits of investing in U.S. domestic operations without facing any direct or indirect U.S. burden on normal returns. Other capital income tax solutions, like CBIT, that attempt to measure and impose tax on normal returns at the firm level burden foreign portfolio investors. The result from both outbound and inbound portfolio investment perspectives will be a more attractive environment for investment in the United States and a reduction in the impetus to move capital out of the United States.²²⁸

226. Kleinbard, *Competitiveness*, *supra* note 175. As noted earlier, to this should be added a presumption that firms employing the U.S. dollar as their functional currency, and with some managerial contacts in the United States, should be treated as U.S. residents.

227. Kleinbard, *Lessons*, *supra* note 157.

228. OECD 2012 Norway Survey, *supra* note 137, at 87. Rosanne Altshuler, Benjamin H. Harris, and Eric Toder (*Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX REV. 355 (2010)) expand on this important point.

C. Incidence

There is a rich literature on the incidence of the corporate income tax.²²⁹ This literature generally agrees that there are three possible groups of individuals on whom the burden of a corporate income tax conceivably could come to rest: capital owners generally, labor, and consumers. Most of the literature concludes that the corporate income tax is not shifted to consumers, because of competition from noncorporate and foreign vendors. Further, the literature generally agrees that, in the case of a small open economy, the burden of a corporate income tax imposed on a marginal investment yielding normal returns is shifted entirely to labor, because the effect of the tax is simply to reduce the available pool of investment capital until pretax investment yields rise sufficiently to offer investors the required after-tax rate of return on capital. Beyond that, consensus is more difficult to find.

A good deal of the literature assumes away the issue when it models the corporate income tax as a tax on normal returns; as applied to U.S. multinational enterprises, it might be more accurate to think of the corporate income tax today as closer to a tax on rents (including “tax rents” of the sort I describe elsewhere²³⁰). In turn, there is no reason to think that a tax on rents is shifted to labor, because the mechanism described above, of money finding its own global level in after-tax normal

229. For some recent contributions, see JOINT COMM. ON TAX’N, 113TH CONG., JCX-14-13, MODELING THE DISTRIBUTION OF TAXES ON BUSINESS INCOME (2013) [hereinafter JCT, MODELING]; Altshuler et al., *supra* note 228; Kimberly A. Clausing, *In Search of Corporate Tax Incidence*, 65 TAX L. REV. 433 (2012); Kimberly A. Clausing, *Who Pays the Corporate Tax in a Global Economy?*, 66 NAT’L TAX J. 151 (2013) [hereinafter Clausing, *Who Pays*]; Jennifer C. Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, 66 NAT’L TAX J. 185 (2013); Arnold C. Harberger, *Corporation Tax Incidence: Reflections on What Is Known, Unknown and Unknowable*, in FUNDAMENTAL TAX REFORM: ISSUES, CHOICES AND IMPLICATIONS 283, 283–307 (John W. Diamond & George R. Zodrow eds., 2008). A helpful recent summary of the literature in the context of a specific public policy perspective is Chye-Ching Huang & Brandon DeBot, *Corporate Tax Cuts Skew to Shareholders and CEOs, Not Workers as Administration Claims* (Ctr. on Budget & Policy Priorities, Aug. 2017), <https://www.cbpp.org/research/federal-tax/corporate-tax-cuts-skew-to-shareholders-and-ceos-not-workers-as-administration>.

230. Kleinbard, *Lessons*, *supra* note 157.

returns through changes in country-level investment pools across fungible marginal business investments, by definition does not apply to profits, which are not fungible. Profits, and the incidence of taxes imposed on profits, are properties of capital owners.

If in fact the incidence of the firm-level component of the Dual BEIT fell on labor, then the whole thrust of the project would be misplaced, because it would simply do indirectly what could be accomplished directly through fine-tuning a labor income tax. But because the firm-level Dual BEIT is a tax on profits, not normal returns, its incidence should fall on the owners of capital and, in particular, on the historic owners of the firms generating such rents.²³¹ Moreover, as applied to the United States, there are persuasive arguments that the U.S. economy does not behave like a small open economy. Economists generally agree that in a simple model of a small open economy, looking at a firm earning marginal returns, the incidence of a corporate income tax would fall on labor rather than capital, but empirical evidence, particularly relating to the operation of the U.S. economy within the larger global economy, point to the conclusion that capital owners in fact bear the great preponderance of the burden of the U.S. corporate income tax. This conclusion is made more forceful in the case of any profits tax, including the Dual BEIT, because by definition rents are a property of capital ownership that capital owners do not share with labor.²³²

231. The Harberger closed economy model in which all capital bears the corporate income tax is relevant to normal returns but not to rents. The latter are unique to specific firms. See Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL'Y ECON. 215 (1962); cf. Harberger, *supra* note 229.

232. Clausing, *Who Pays*, *supra* note 229; Gravelle, *supra* note 229; In preparing distributional analyses of the burden of the corporate tax under current law, as well as the distributional consequences of proposed changes to current tax law, the Congressional Budget Office and the Staff of the Joint Committee on Taxation both attribute 75% of the burden of the corporate income tax to owners of capital. The Treasury Department attributes 82% of the burden of the corporate income tax to capital owners. See JCT, MODELING, *supra* note 229 (summarizing the work of all three agencies). The nonpartisan Tax Policy Center treats 20% of the corporate income tax burden as falling on labor, 20% on the normal return to all capital, and 60% on the supernormal returns to corporate equity (shareholders). James R. Nunns, *How TPC Distributes the Corporate Income Tax*, TAX POL'Y CTR. (Sept. 13, 2012), <http://www.taxpolicycenter.org/publications/how-tpc-distributes-corporate-income-tax/full>.

As a result, the incidence of the Dual BEIT should fall predominantly on owners of domestic business capital (the investors in financial claims against firms), because firms themselves face an effective marginal tax rate of zero on new investments yielding normal returns. In turn, the investor-level tax on Includible Amounts is in economic substance close to (but a Constitutional whisker away from) a periodic tax on domestic owners of capital, and as such the incidence should fall on those domestic capital owners (the investors in financial claims against firms). Like any tax on savings, the Dual BEIT conceivably may affect the quantum total savings by domestic owners of capital, depending on competing income and substitution effects, but an individual-level tax of this sort does not necessarily create a capital vacuum for investments in attractive U.S. business opportunities, because foreign investors (to whom the income inclusion rules would not apply) will make up any shortfall in domestic savings.²³³

VIII. COMPETING SOLUTIONS

Because capital income taxation long ago fell out of academic favor, at least in U.S. law schools, relatively little work was done for several decades in rethinking how we might better define the capital income tax base.²³⁴ In recent years, however, several broad capital income tax reform proposals have been offered, and corporate income tax reform ideas (particularly in respect of the taxation of the returns to U.S. corporations' foreign direct investment) are a hardy perennial. Those ideas that are focused on flows rather than stocks (that is, income rather than wealth taxes) typically run into one of three impediments: they rely on measuring accurately normal returns to real capital; they rely on devices (such as "mark-to-market" taxation of publicly traded financial assets) where information is imperfect and where the resulting system introduces sharp divisions between different modes of taxation applicable to different taxpayers that compete directly in the marketplace; or they are so incompletely specified that their administrability is untestable. This Part VIII briefly signals why I believe the Dual BEIT to be a more attractive policy instrument.

233. Desai & Hines, *supra* note 127, at 496.

234. DANIEL N. SHAVIRO, *DECODING THE CORPORATE INCOME TAX* (2009), is an important exception.

A. *Wealth and Bequest Taxes*

An ideal capital income tax can be viewed as approximating an indirect form of annual wealth tax. The intuition is simply that wealth, when invested, ordinarily should yield normal returns (again, which means risk-adjusted normal returns), and a tax on normal returns therefore can, through appropriate rate-setting, approximate a tax on the wealth itself. This principle is reflected, for example, in the Dutch tax system's tax on investment capital.²³⁵

There does not appear to be any practical advantage, however, to implementing a wealth tax over an income tax on normal returns, given government's great difficulty in directly observing or valuing wealth (stock) rather than income (flows) in the hands of savers.²³⁶ As a political economy matter, taxing flows always has the advantage of resolving taxpayers' cash flow difficulties (although admittedly the Dual BEIT can run afoul of this observation). And in the United States, a national direct wealth tax probably would violate the U.S. Constitution: indeed, the Supreme Court case that struck down the late 19th century federal income tax did so precisely on the basis that a capital income

235. See *supra* note 86 for a description of the Dutch "presumptive income" or "box" tax.

236. Miranda Perry Fleischer, *Not So Fast: The Hidden Difficulties of Taxing Wealth*, WEALTH: NOMOS LVIII, at 261 (Jack Knight & Melissa Schwartzberg eds., 2017), and Miranda Perry Fleischer, *Divide and Conquer: Using an Accessions Tax to Combat Dynastic Wealth Transfers*, 57 B.C. L. REV. 913 (2016), summarize the theoretical reasons why a wealth tax might be desirable and review the practical issues raised by different instantiations of wealth taxes. Perry Fleischer concludes that an accessions tax would be the best targeted and practical form of wealth taxation. By happy coincidence, it would be Constitutional as well. As developed in the paragraphs that follow, I support Perry Fleischer's conclusions, but see an accessions or bequests tax as most useful when very narrowly targeted at the largest fortunes. An income tax on capital, measured and collected annually through the Includible Amounts mechanism, should do the bulk of the heavy lifting.

In 2016, *Boston College Law Review* published an issue devoted to wealth taxation, of which Perry Fleischer's article cited above was one article. The entire issue is an important contribution to the question of whether, why, and how wealth ought to be taxed. Symposium, *The Centennial of the Estate and Gift Tax: Perspectives and Recommendations*, 57 B.C. L. REV. 801 (2016), <http://lawdigitalcommons.bc.edu/bclr/vol57/iss3/>.

tax was an indirect means of taxing capital, which Congress could not do directly without apportionment.²³⁷ (*Capital Taxation in an Age of Inequality* discusses this in more detail.²³⁸) For all these reasons, there appears to be little reason to pursue annual taxes framed as wealth taxes in preference to annual capital income taxes.²³⁹

237. *Pollock v. Farmers Loan & Tr. Co.*, 157 U.S. 429 (1895), *vacated*, 158 U.S. 601 (1895). The decision has been vigorously criticized from the day it was handed down; the best response to the Supreme Court would have been that framing matters, particularly when dealing with terms that have no real substantive meaning in economics. The particular issue was resolved through a Constitutional amendment authorizing a federal income tax. U.S. CONST. amend. XVI.

It must be remembered here that, given the opportunity in *National Federation of Independent Business v. Sebelius*, 567 U.S. 519, 571 (2012), expressly to repudiate any continuing relevance of *Pollock* to the Constitutional distinction between “direct” taxes (which must be apportioned among the states in accordance with their relative populations) and indirect taxes, Chief Justice Roberts chose to do exactly the opposite, and to insert into his majority opinion a citation implying that *Pollock* retained at least some continuing vitality.

238. Kleinbard, *Capital Taxation*, *supra* note 1, at 615.

239. Gergen, *supra* note 9, argues for a periodic wealth tax measured as a fraction of the mark-to-market value of publicly traded investments in firms. The tax would be imposed on the firm itself, although investors would be subject to secondary liability if the firm failed to pay the tax. *See supra* notes 56, 61. Gergen’s article explicitly abstracts from the Constitutional issue. Gergen, *supra* note 9, at 3. I take the contrary view that a capital tax proposal will be embraced by policymakers only if they believe that their efforts to enact it will bear fruit in legislation that is robust to Constitutional challenge.

The principal concession that the Dual BEIT’s design makes to distinguish it from a wealth tax is the Dual BEIT’s allowance for investor loss deductions to the extent of prior Includible Amounts. A wealth tax, by contrast, would not contemplate any rebates if values first increased (thereby leading to higher wealth taxes) but ultimately fell. To my mind, this feature is the critical distinction between income taxes on capital and wealth taxes on that capital.

By placing the nominal tax remittance obligation on the firm, Gergen’s proposal has the merit of making it easier to extend that tax to institutional investors that today are tax-exempt. (This is true as well for the Treasury’s 1992 CBIT proposal, *supra* note 43.) I am skeptical, however, that the tax-exempt

In theory, one fairly could compare potential economic efficiency gains from taxing bequests or accessions rather than lifetime capital income, but in practice, in the United States at least, “death taxes” are even more politically fraught than are lifetime capital income taxes. What is more, bequest taxation is susceptible both to outright evasion (the Van Gogh that mysteriously disappears while the owner is on his deathbed) and to complex avoidance strategies that are at least as difficult to address as is capital income taxation.

Moreover, in the United States, broad-based bequest taxation essentially would function as a new tax, in that only about 11,000 federal estate tax returns are filed annually by taxable estates; in turn, only about 5,000 show an actual tax liability.²⁴⁰ Edward McCaffery has succinctly described the efficacy of the current estate tax: “Most important, the gift and estate or unified wealth transfer tax system is *not* taxing wealth seriously. The estate tax has long been essentially a ‘voluntary tax,’ as it was dubbed in 1977. It is easily avoided with fairly standard

sector is so easily thrown off the scent, and I believe that, however framed, the issue will be resolved through direct confrontation in the political process. Debates in other jurisdictions over the years on corporate tax integration proposals, while not perfectly on point, have tended to support my hypothesis. Cf. Kleinbard, *The Trojan Horse*, *supra* note 53.

Because Gergen’s principal tax is framed as a “securities tax” on publicly traded securities, it requires what Gergen terms a “complementary tax” for privately held firms. He does so by adopting some of the mechanics of the BEIT for these cases, a move with which this author surely cannot disagree. Basically, Gergen imputes a value to a private firm’s equity securities by assuming that they earn what I would term the COCA rate, and using the BEIT’s mechanics to keep a running tally of the value of that equity. (The complementary tax, unlike the publicly traded securities tax, would not apply to debt instruments. Gergen, *supra* note 9.) Gergen then applies his wealth tax to the imputed value of equity securities.

Gergen’s complementary tax, of course, is necessary for his proposal to be comprehensive in scope. It does, however, undercut any possible Constitutional argument (to be clear, not relied on by Gergen) that the proposal is a kind of excise tax on the privilege of accessing public capital markets.

240. *SOI Tax Stats—Estate Tax Statistics Filing Year Table 1*, IRS.gov, <https://www.irs.gov/statistics/soi-tax-stats-estate-tax-statistics-filing-year-table-1> (last updated Oct. 6, 2017). I acknowledge of course that this number is kept artificially low by aggressive tax planning, which in turn incurs real deadweight loss.

planning techniques.”²⁴¹ Gift and estate tax collections today run on the order of magnitude of \$30 billion/year—less than 1% of the total federal tax revenues collected annually.²⁴² This raises difficult economic efficiency transition issues (because long-term assets held at the time of introduction ultimately will be subject to both income and broad-based bequest taxation), beyond the politically charged question of broad-based “death taxes.”

Finally, an estate tax operates as an ex post excise tax, and therefore the tax rate that must be imposed will always be substantially higher than that necessary to raise equivalent revenues through a periodic income tax. And, as with any tax that allows the deferral of an individual’s contingent tax liability for many decades, a bequest tax is susceptible to swings in political perspectives, putting at risk accruals of wealth under prior law.

As more fully developed in *Capital Taxation in an Age of Inequality*, bequest or accessions taxes serve as a useful adjunct to annual income taxation. It is particularly well-suited as an instrument to address the very largest wealth concentrations and fully deserves a comprehensive overhaul to serve this independent social objective.²⁴³ The income tax, however, is better equipped to handle the bulk of the load: it reaches essentially every potential taxpayer, and it today already raises substantial sums through capital income taxation (including the corporate

241. McCaffery, *supra* note 9, at 326.

242. JOINT COMM. ON TAX’N, 115TH CONG., JCX-36-17, OVERVIEW OF THE FEDERAL TAX SYSTEM AND POLICY CONSIDERATIONS RELATED TO TAX REFORM 54 (2017) (showing estimated estate and gift tax collections for 2017 as totaling 0.7% of estimated federal tax revenues for that year).

243. In his recent article on the challenges posed to tax policy by wealth inequality, Edward McCaffery agrees with the assessment that a functional estate tax would constitute essentially a new tax and would face substantial practical and political headwinds, and that another tax instrument must do the heavy lifting. McCaffery, *supra* note 9, at 370. He is even less optimistic than am I that a successful estate or wealth tax could be enacted as a companion to that principal tax instrument, in light of the mobility of capital and the grim determination of many affluent taxpayers to engage in elaborate estate tax schemes. *Id.* His recommendation, as in his earlier work, is a progressive consumption tax. For the reasons developed in the companion article, I come to the conclusion that a capital income tax is a superior tax instrument for (in McCaffery’s elegant phrasing) taxing wealth seriously. Kleinbard, *Capital Taxation*, *supra* note 1, at 666–74.

income tax). As such, it is baked into asset prices, and the transition to the Dual BEIT would therefore not be so traumatic as would the shift to a broad-based estate and gift tax. Here is an instance where it is better to work with two tax instruments rather than one,²⁴⁴ reserving the estate tax for the narrower purpose of establishing a significantly higher marginal tax rate on capital (and hence capital income) of the very wealthiest Americans.

In this regard, it should be remembered that under the Dual BEIT, death is a realization event for investors. As is true for any reset of basis under the investor provisions of the Dual BEIT, tax basis is re-determined for purposes of future Includible Amount calculations, but no current year tax is imposed. The present value of the tax to be imposed on the bump in future Includible Amounts, however, is equivalent to a current-year capital income tax on a decedent's unrealized gain in respect of an investment. The economic result is identical to an income tax on unrealized gains at death, but there is no immediate and salient "death tax" due in this regard. I submit that this formulation is much more likely to survive the tax legislative process than are proposals to make death a realization and taxable recognition event under current income tax principles. Again, the second instrument of estate taxation would sit on top of this in those limited circumstances to which the estate tax would apply.

B. Alternative Income Tax Proposals

1. Pass-Through Models

One cluster of capital income tax proposals argues that directly taxing financial capital instruments is a waste of time: why not instead simply apportion business income in some fashion to all stakeholders, in accordance with their relative claims? This is a "pass-through" approach to taxing business capital income.

A pass-through model of taxing business income retains all the problems of current law's income mismeasurement attributable to the realization principle at the entity level. The pass-through model simply distributes that mismeasured income to investors. In this model, enterprise-level real asset depreciation reasserts itself as the means by which

244. David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355 (2015).

time-value returns are taxed, because it determines in part the aggregate taxable income to be divided. As a result, the pass-through model will tax normal returns accurately only if that model adopts economically perfect capitalization and depreciation rules for purchased and self-created tangible and intangible assets. Decades of experience with the political and administrative process have demonstrated the fragility of that assumption, as well as the administrative difficulties in distinguishing annual expenses from the capitalizable costs of self-developed intangibles.

Further, in the United States, the taxation of publicly traded partnerships provides administrative experience with this approach. That experience teaches us that full pass-through models are extraordinarily complex to implement, largely because of the difficulties of relating income realization at the entity level (where income from the business first is determined) to realization events at the investor level, through secondary market trading in those partnership interests. When ownership interests are traded in time spans of a few seconds, or less, the pass-through model breaks down completely. Many firms do not have systems to generate income figures on a daily basis, if that were the relevant time period to be allocated. “Hot potato” rules that allocate the income of a firm to the investor owning its stock at an appointed day or hour invite tax arbitrage. These are very difficult problems to resolve, as can be seen in the taxation of publicly traded master limited partnerships today but would of course be greatly exacerbated if extended to all publicly traded securities.

2. *Entity-Driven Tax Models*

Some of the leading capital income tax reform ideas that have been proposed, such as the “Comprehensive Business Income Tax” (CBIT), proposed by the U.S. Treasury Department in 1992, assume away the actual problem, by postulating that the tax base (e.g., business net income) is accurately measured and presenting the issue as one simply of coordination between firms and investors. (The same is true for pass-through models, as just discussed.) CBIT, for example, was a proposal to tax all the components of capital income, including normal returns, at the business enterprise level, and (implicitly, because this side was never fully specified) to exempt normal returns at the investor level.²⁴⁵ To accomplish

245. TREAS. DEP’T, INTEGRATION, *supra* note 43, at 39–60.

this, CBIT would disallow all interest expense deductions and would offer no allowance for corporate capital beyond (ideally, economic) depreciation.

In a helpful comparison of CBIT to ACE systems (and by implication, profits taxes more generally), Ruud de Mooij and Michael Devereux summarized the consensus public finance view of the relative merits of the two as follows:

Among the two, economists typically favour ACE. This system grants equity holders a certain allowance equal to a notional risk-free return. This is attractive as it reduces the effective marginal tax rate to zero, implying that ACE is a tax on economic rent. As such, it does not distort decisions about the scale of investment, though even a tax on economic rent can affect discrete investment choices that depend on an effective average tax rate. A potential disadvantage of ACE is that its narrower tax base reduces corporate tax revenue, and thus requires higher tax rates to yield the same revenue.

By contrast, CBIT disallows the exemption of interest. It turns the corporate income tax into a broad-based tax on capital at the level of the firm. This raises the overall cost of capital so that investment declines. The broadening of the base under CBIT will raise corporate tax revenue and, if revenue is to be maintained, allows for a lower corporate tax rate. A lower rate will typically not be sufficient to prevent a rise in the effective marginal tax rate, which is why CBIT has not gained the same popularity as ACE.²⁴⁶

Nonetheless, de Mooij and Devereux went on to argue that profit shifting by multinational firms in particular muddies the analysis, because it is highly responsive to statutory rates. The two therefore conclude that “it is attractive for individual countries to broaden their tax base and cut the rate, as under CBIT, as opposed to narrowing the tax base and raising the rate, as under ACE.”²⁴⁷

246. de Mooij & Devereux, *supra* note 75, at 94.

247. *Id.*

I submit that the Dual BEIT allows Messrs. de Mooij and Devereux, and all the rest of us, to eat our cake and have it too. The Dual BEIT can generally narrow the enterprise-level base without raising the rate—indeed, the current U.S. corporate system is so porous that the proposal here is to narrow the base and reduce the rate—because the imposition of a worldwide superconsolidation base responds to the system’s most egregious source of hemorrhaging, and because the imposition of a consistent tax on normal returns that actually is collected annually makes up any enterprise-level shortfall.

CBIT would have achieved its objectives only by getting what today is the corporate income tax exactly “right”—that is, to allow businesses a deduction only for economic depreciation, which is notoriously difficult to measure and impossible to maintain as a political matter. It would also require much subtler approaches to the capitalization of expenditures than has ever been the case in U.S. business taxation.²⁴⁸ This second point is even more confounding than the first. Recognizing CBIT’s limitations, its proponents argued for a magical “compensatory tax” scheme that would undo the imperfections in whatever business enterprise tax system Congress adopted, so as to produce, in the end, the same result as would be obtained under an ideal enterprise tax system in the first place.²⁴⁹ But such a magical compensatory tax would not eliminate the time-value benefit of compounding within a firm, and, more directly begs the question, if the magical compensatory tax were so easy to design and adopt, why would the firm-level tax be defective in the first place?

248. If tax depreciation perfectly tracked economic depreciation, and tax law could perfectly distinguish expenses that relate to the current period from expenses that should be capitalized, a business enterprise could simply use that depreciation to measure normal returns at the entity level. CBIT would then be an attractive avenue to explore for administrability reasons; under that alternative, the issuer would obtain *only* a depreciation deduction in respect of the capital deployed in its business, and investors would receive returns out of tax-paid earnings free of additional tax.

249. The CBIT’s compensatory tax was completely unspecified, in keeping with its *deus ex machina* character—leaving unanswered the question of how such a system could be fairly and practically applied across the broad spectrum of business enterprises. (There was also the not insignificant problem that the CBIT never addressed of how capital gains fit into the picture.) One might just as well have begun the CBIT presentation by writing, “Assume an ideal enterprise-level income tax. . . .”

What is more, by taxing normal returns at the firm level, CBIT makes its extension to international investment more fraught, by virtue of the mobility of capital within a multinational firm. Modern thinking points in the opposite direction, to tax normal returns at the investor level, both because those returns are easier to measure there and because individual investors are less mobile than is the capital of firms.²⁵⁰ The Dual BEIT reflects this modern thinking.

In a related vein, CBIT is a very unfavorable tax environment from a corporate manager's perspective, because it pushes the combined taxation of investors and firms down to the firm level. The political economy claims of an "uncompetitive" corporate tax system would be redoubled when compared with a firm profits tax. This point in turn is exacerbated still further when one looks at a firm through the lens of U.S. Generally Accepted Accounting Principles, because the firm's tax expense line would now include tax that today is imposed at the individual level. While this would be true of U.S. competitors as well, it would not necessarily be true for firms keeping their financial records under International Financial Reporting Standards.

Recently, the majority staff of the Senate Finance Committee has worked on a "corporate integration" tax proposal based on a dividends-paid deduction. I have written extensively elsewhere about this proposal, and need not repeat that analysis here.²⁵¹ Briefly, however, I summarized my understanding of the project as follows:

In reality, a dividends paid form of corporate integration would create more problems than it solves. It would not necessarily create parity between corporations and passthrough forms of business organizations regarding business tax preferences and incentives. It also by its

250. Harry Grubert & Rosanne Altshuler, *Shifting the Burden of Taxation from the Corporate to the Personal Level and Getting the Corporate Rate Down to 15 Percent*, 69 NAT'L TAX J. 643 (2016).

251. Kleinbard, *The Trojan Horse*, *supra* note 53. Michael J. Graetz and Alvin C. Warren, Jr., took a more positive view in *Integration of Corporate and Shareholder Taxes*, 69 NAT'L TAX J. 677 (2016). An earlier version of the Graetz and Warren paper was placed online as Yale Law & Economics Research Paper No. 540, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2780490&rec=1&srcabs=2776165&alg=1&pos=4##. Kleinbard, *The Trojan Horse*, *supra* note 53, considers the Graetz and Warren analysis.

terms would not create parity between distributed and retained earnings or between debt and equity. By the time optional bolt-on modules were added to deal with those important issues, the dividends paid proposal would increasingly resemble a Rube Goldberg construction, dominated both in theory and in elegance of implementation by any of several clean-sheet comprehensive capital income tax reform ideas. The withholding tax that is central to the plan might violate U.S. tax treaties regarding dividends paid to foreign investors, and would certainly violate tax treaties if it is extended to interest payments (as some proponents wish).²⁵²

In the present context, it is important to recognize that corporate integration proposals, whether implemented through a dividends-paid deduction or a shareholder imputation credit, suffer from the same problem as does CBIT—that is, of starting from a real tax base that is likely to be highly imperfect when viewed through normative capital income tax metrics. Integration models, like pass-through or entity-driven tax models, cannot measure capital income accurately without imagining a legislature with an uncanny ability and willingness to enact depreciation and capitalization rules that perfectly mirror economic reality. Compensatory taxes are exercises in magical thinking, or cumbersome ways of doing what could be done more directly through fundamentally different approaches.

3. *Mark-to-Market Models*

Another approach to a comprehensive solution is to tax returns to capital solely at the investor level, by requiring investors to value all their financial assets at the end of the year and tax those gains not already realized.²⁵³ Under this “mark-to-market” approach, business enterprises would not be taxed, because their economic income would be incorporated into prices, and thereby recognized currently by investors.

Nearly every such proposal limits its reach to publicly traded instruments, which creates sharp dichotomies with private enterprises

252. Kleinbard, *The Trojan Horse*, *supra* note 53, at 958–59.

253. See Kleinbard, *Capital Taxation*, *supra* note 1, at 596.

(and does not answer how capital income should be taxed in the second case). This sharp division into two separate regimes would introduce new instabilities into the Code—new mountains and valleys in the tax topography—at least as troublesome as current law’s debt-equity distinction, as the next few paragraphs illustrate. Administrative solutions should point in the opposite direction—to have as flat a tax topography as possible, to minimize taxpayer gaming opportunities to shoehorn themselves into whichever result minimizes their tax liabilities.

The intuition driving mark-to-market proposals is plain enough: the public trading of a firm’s securities provides new information not available when examining a privately held firm. This information in turn can be put to work to measure annual income more precisely, typically through a mark-to-market (“accruals,” in the language of economists) regime, and it seems a pity to throw this information away by ignoring it. But practical realities are far more complex.

As an accounting system, mark-to-market accounting itself raises interesting (and largely unexamined) conceptual issues. Even the mark-to-market accounting that should be easiest to implement—the application of that accounting method to the country’s largest securities dealers—has proven difficult in practice. (For example, should mark-to-market taxation of over-the-counter derivatives dealers include fluctuations in value attributable to changes in the dealer’s own credit rating?) The alternative idea of mark-to-market accounting at the *entity* level, and not separately taxing financial capital instrument holders, is even more problematic in that it would require annual valuations of real assets.

A firm might be public in a technical sense, but the market for its securities might be so thinly traded, or the proportion of the firm’s stock that is in the public float so small, as to call into question the accuracy of the prices of trades in those securities as a proxy for the value of the firm as a whole. For that matter, it must be remembered that there is a fundamental tension between mark-to-market valuations, on the one hand, and the annual tax accounting period, on the other. A mark-to-market valuation looks not only to changes in future projected cash flows or income but also to the discount rate to apply to those projections. The resulting valuation is real enough, of course, and does represent an accession to or diminution of wealth from one period to another (if the markets in question are a close enough proxy for the valuation of the firm as a whole), but by definition the magnitude of year-to-year fluctuations in mark-to-market valuations will be far greater than changes in

annual cash flows from the prior period to the current one.²⁵⁴ This in turn puts tremendous stress on how to handle tax losses to produce economically consistent outcomes (e.g., through immediate refunds), particularly in a period when government revenues might be far lower, and “automatic stabilizer” spending like unemployment insurance far higher, than in normal circumstances—just as happened in the Great Recession.

If the public firm regime is more attractive than a private one, firms will accelerate plans to go public with a small floatation, and capital markets will be overrun by the tax-induced, corporate living dead—firms that are public in only the most nominal of senses. If, as is more likely, the private firm environment is more congenial, then one must appreciate how radically the corporate finance environment has changed in recent years, through the proliferation of endless rounds of equity financing from private equity funds and other institutional investors. As described above with respect to Uber Technologies Inc.,²⁵⁵ in modern financial markets a global business enterprise with billions of dollars in annual revenues can remain a private firm essentially indefinitely.²⁵⁶

If the tax stakes are sufficiently high, the reasons that firms like Facebook go public—which are not to secure necessary equity financing, but rather to have a more attractive currency to offer employees through equity compensation plans and to use in acquisitions—could be overcome. Phrased differently, how much tax would Mark Zuckerberg choose to absorb for the privilege of being a public firm when no financial imperative required that outcome?

The work of Eric Toder and Alan Viard is an important recent example of a mark-to-market proposal.²⁵⁷ The concerns that motivate Toder and Viard are similar to those motivating my work here: an

254. Toder & Viard, *supra* note 56, at 714–21. Readers whose investments survived the Great Recession will no doubt recall how much more volatile were their assets’ mark-to-market valuations than were fluctuations in period-to-period cash returns on those investments.

255. See *supra* note 57 and accompanying text.

256. See *supra* the discussion in Section I.D.4.

257. Toder & Viard, *supra* note 56. A variant of this article was published as well on October 1, 2016, under the aegis of the Tax Policy Center, Eric Toder & Alan D. Viard, *Replacing Corporate Tax Revenues with a Mark to Market Tax on Shareholder Income*, TAX POL’Y CTR (Oct. 2016), <http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000949-Replacing-Corporate-Tax-Revenues-with-a-Mark-to-Market-Tax-on>

acknowledgment that current law is hopelessly muddled, particularly in respect of foreign direct investment; an effort to coordinate corporate and investor taxation; and a move to reduce the U.S. tax rate imposed directly on firms, while increasing that on investors. Toder and Viard part company with the Dual BEIT in relying on mark-to-market taxation for publicly traded equity (but not debt) investments in companies, while adopting pass-through taxation for “closely held” firms. The Dual BEIT, by contrast, goes to great lengths not to draw such distinctions between how firms access capital—equity or debt, public or private.

The Toder-Viard proposal contemplates a 15% corporate income tax (where “corporate” here is understood to mean publicly traded corporations only). As an income tax, it must still deal with all the depreciation and capitalization issues that bedevil business entity income taxes generally.

Toder and Viard suggest a mark-to-market system for equity investors in publicly traded firms, but at the same time dividends on stock are treated as ordinary income and carry imputation credits for underlying corporate taxes paid. As previously suggested, integration ideas sound very elegant but have at best a checkered history in actual application, including abusive “dividend washing” potential.²⁵⁸ For this reason, many countries that have experimented with corporate integration have abandoned it. In addition, imputation credit systems struggle mightily with how to handle corporate economic income to which no corporate tax liability attaches. In particular, since Toder and Viard retain a foreign tax credit system, U.S. firms facing a 15% U.S. income tax rate are likely to owe no tax in respect of foreign earnings. When those foreign earnings are redistributed as dividends, is the idea that shareholders should face ordinary income taxation without any offsetting credits?

Imputation tax credits and dividend taxation interact with mark-to-market taxation in ways that Toder and Viard might not have intended. If Alphonse purchases one share of World Wide Sprockets

-Shareholder-Income.pdf. Toder and Viard released earlier versions of their proposal in 2014 and June 2016.

258. Kleinbard, *The Trojan Horse*, *supra* note 53. “Dividend washing” here refers to the idea that shares migrate from foreign or tax-exempt holders that cannot use the imputation credits to taxable shareholders who can, under explicit or implicit buy-sell arrangements where the taxable investors, having captured the dividend credit, resell the stock at a loss.

stock for \$110 shortly before a dividend is declared, receives a dividend of \$10, and the stock then trades at its ex-dividend value of \$100 (because \$10 has left corporate solution), a mark-to-market system means that Alphonse has no net income—\$10 of dividend income is offset by \$10 in mark-to-market loss. As an economic matter this is correct, but it is not clear whether Toder and Viard intend this result. To the extent they do, it adds to the pressure that dividend washing schemes put on dividend imputation credit systems, because then taxable investors can “wash” the tax cost of receiving a dividend while retaining the credit, all without any stated or unstated arrangement to sell the stock at a certain price.

The Toder-Viard proposal is aimed at taxing shareholders in public firms at ordinary income rates—that is, at the same rate as labor income. But Toder and Viard do not develop a cohesive theory as to why this instance of capital income should be taxed at labor income rates. The Dual BEIT by contrast adopts the view that capital income, in whatever form, should be taxed at a flat rate (imposed and collected annually, as does a mark-to-market system) systematically lower than those imposed on top labor incomes.

Toder and Viard apply their mark-to-market rules not to all stockholders in publicly traded firms, but rather to publicly traded equity investments; this begs the question how private placements in public firms might be taxed. At the same time, Toder and Viard do not extend mark-to-market taxation to creditors in public companies. Instead, interest remains deductible to firms and includible at ordinary rates to taxable investors. Taxable creditors today can capture tax-preferred capital gains on the sale of corporate debt securities; it appears that Toder and Viard would revise current law to tax such gains as ordinary income, if the debt securities were publicly traded. But debt instruments would not be marked to market, thereby inviting firms to rely heavily on equity-flavored debt instruments (convertible bonds, etc.) to give taxable investors the most attractive possible after-tax returns while reducing the corporate tax base.

If tax-exempt investors (including foreign investors) continue in the Toder-Viard environment, then current law’s debt bias would remain, albeit in an attenuated form. Toder and Viard propose implementing a flat 15% tax on equity and debt investments by tax-exempt institutions, but it is not clear how they intend to treat foreign investors.²⁵⁹

259. The 15% tax would be imposed on equity investments by disallowing imputation credits, but this aspect requires that imputation credits

If the withholding tax on interest does not reach foreign investors, then current law's incentives for earnings stripping remains; if the withholding tax does apply to foreign investors, then there might be significant market responses, especially given that U.S. Treasuries presumably would remain tax-exempt.

Toder and Viard's international tax system is essentially the same as the current law's, relying on the low 15% U.S. tax rate to mitigate all the problems of the current system, such as the lockout of foreign earnings, deferral incentives, the erosion of the U.S. tax base, incentives to "invert," and so on. But many U.S.-based multinational firms today enjoy single digit foreign effective tax rates, and it is not clear why even a reduction to a 15% rate would be sufficient to change the behavior of the most aggressive U.S. firms.

Toder and Viard would treat "closely held" firms (by which they mean firms none of whose securities is publicly traded) as pass-through entities, without regard to their size. Their division between public and private enterprises is insensitive in particular to the modern corporate finance practice in the venture capital and private equity arena, as adverted to earlier with respect to Uber Technologies Inc.²⁶⁰

To their great credit, Toder and Viard not only recognize both the volatility issue and the substantial differences in outcomes between their regimes for public and private firms but suggest specific ameliorative policies. Nonetheless, the complexity of their "geometric smoothing" of mark-to-market volatility is a perfect example of how important it is, when moving from pure theory to actual policy advice, to work through how precisely that advice would be implemented in an administrable fashion, so that competing ideas can be compared fairly.

To the same effect, their proposal to tax founders on the shares they *retain* when a firm goes public leaves unanswered the specific rate to apply (although they do suggest some metrics here) and begs the question, why would a founder ever do this? Rounds of private equity financing deal with the firm's financing needs, and borrowing against one's appreciated stock position puts cash into the pockets of the founders. By introducing an enormous gulf in the tax topography,

track economic income, which often is not the case. The 15% tax would be collected on interest paid to tax-exempts through a new withholding tax.

260. The definition raises other second-order issues as well, such as the treatment of private placement securities in a public firm.

their proposal for mark-to-market taxation would distort taxpayer behavior in new, first-order ways.

C. A Novel Alternative: The Destination-Based Cash Flow Tax

1. In General

Recognizing the scope of the stateless income problem, Alan Auerbach and Michael Devereux have proposed in a series of papers a “destination-based cash flow tax” (DBCFT), one of whose chief aims is to deflate the returns to profit shifting.²⁶¹ The DBCFT idea has attracted tremendous attention, and its principles were reflected in the 2016 House Republican “Better Way” package of fiscal proposals, usually referred to as the “House Blueprint.”²⁶²

261. See Alan J. Auerbach, *A Modern Corporate Tax* (Hamilton Project at Brookings Inst., 2010), http://www.hamiltonproject.org/assets/legacy/files/downloads_and_links/FINAL_AuerbachPaper.pdf [hereinafter Auerbach, *Modern Corporate*]; Alan Auerbach, Michael P. Devereux, Michael Keen & John Vella, *Destination-Based Cash Flow Taxation*, (Oxford Univ. Ctr. for Bus. Tax’n, Working Paper No. 17/01 2017), https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_17/WP1701c.pdf; Alan J. Auerbach & Douglas Holtz-Eakin, *The Role of Border Adjustments in International Taxation* (Am. Action Forum, 2016), <https://www.americanactionforum.org/wp-content/uploads/2016/11/The-Role-of-Border-Adjustments-in-International-Taxation.pdf>; Devereux & de la Feria, *supra* note 178.

262. See A BETTER WAY, *supra* note 71. Analyses include JANE G. GRAVELLE, CONG. RESEARCH SERV., R44823, THE “BETTER WAY” HOUSE TAX PLAN: AN ECONOMIC ANALYSIS (2017), <https://fas.org/sgp/crs/misc/R44823.pdf>; Wei Cui, *Destination-Based Taxation in the House Republican Blueprint*, 152 TAX NOTES 1419 (Sept. 5, 2016); Martin A. Sullivan, *Difficulties with the House GOP’s Business Cash Flow Tax*, 152 TAX NOTES 771 (Aug. 8, 2016); Martin A. Sullivan, *GOP Plan Not So Easily Gamed*, 152 TAX NOTES 1060 (Aug. 22, 2016); Martin A. Sullivan, *A U.S. VAT May Be Closer Than You Think*, 152 TAX NOTES 1608 (Sept. 18, 2016); Alan D. Viard, *The Economic Effects of Border Adjustments*, 154 TAX NOTES 1029 (Feb. 20, 2017); Alan Auerbach, Laurence Kotlikoff & Darryl Koehler, *Assessing the House Republicans’ “A Better Way” Tax Reform* (June 21, 2017), <https://eml.berkeley.edu/~auerbach/Assessing%20the%20House%20Republican%20Tax%20Reform%20Plan%206-21-17.pdf>; Kyle Pomerleau & Stephen J. Entin, *The House GOP’s Destination-Based*

Notwithstanding the intellectual pedigree of the DBCFT, its substantial economic merits, and its embrace by the leadership of the House of Representatives, the DBCFT, or at least its core contribution, its destination base, has been abandoned by policymakers as of this writing, in light of withering criticism by some segments of the business community. To this observer, at least, some of that criticism in turn was a reaction to the overselling of the idea by some initial converts among policymakers. Nonetheless, it was disheartening that an idea this interesting should crash and burn in the heat of tax legislative sausage-making quite so quickly. Even so, it is useful to abstract from the political hullabaloo to consider briefly the underlying objectives of the DBCFT and how that proposal compares with the Dual BEIT.

The DBCFT is intended to operate as a business enterprise tax whose base constitutes economic rents attributable to the domestic *consumption* of all goods and services, wherever produced. It would replace the corporate income tax. Thus, while in some respects it can roughly be analogized to a value added tax (VAT), as discussed below, it is not intended as an additional tax on domestic consumption sitting on top of traditional business income taxes. Because the DBCFT is a business enterprise tax that reaches certain economic rents (those attributable to consumption inside the United States), it does not purport to inform policymaking decisions on the taxation of investors in business enterprises.

The DBCFT differs fundamentally from a VAT in that by design it burdens only economic rents, not labor. It accomplishes this by permitting an explicit deduction for domestic (but not foreign) labor inputs. (As explained below, once foreign currency price movements are taken into account, the DBCFT can be seen as offering an *implicit* deduction for foreign labor inputs as well.) This apparent discrimination in turn has been said by some to raise significant issues under global trade agreements, in particular those overseen by the World Trade Organization.

As its name implies, the DBCFT is a cash flow tax, and therefore operates as a firm-level profits tax, just as does the Dual BEIT. As such, the wholly domestic application of the DBCFT is unexceptional (and basically identical in economic effect to the Dual BEIT). Current expenses (including in respect of labor inputs) and capital costs alike

would be deductible, so that in ex ante terms the tax would fall on profits. Because both proposals are profits-only business enterprise taxes, neither structure burdens normal returns earned by a business enterprise. And because the cash flow design of the DBCFT reduces the effective marginal tax rate on business investment to zero, the DBCFT (like any other well-designed profits tax) disallows any deduction for net interest expense (interest expense net of interest income).

While both are profits taxes, the DBCFT differs from the Dual BEIT in a number of respects, of which two are of paramount importance.

First, the DBCFT's destination base allocates taxing jurisdiction strictly by reference to the ultimate jurisdiction in which goods are consumed. In this one respect, the DBCFT can be analogized to a VAT with border adjustments (the standard implementation around the world). The Dual BEIT, by contrast, imposes residence-based taxation on the economic profits of U.S. firms. As applied to the domestic activities of business enterprises, then, the DBCFT and the Dual BEIT have many similarities in their application, except that the Dual BEIT applies to domestic *production*, regardless of the location of ultimate consumption, while the DBCFT burdens domestic *consumption*, regardless of the place of production (or jurisdiction of the enterprise undertaking that production). This is an important distinction, with many implications, as developed below.

Second, the DBCFT is silent as to the coordination of its proposed business entity tax with investor-level taxation. *Capital Taxation in an Age of Inequality* argues that this coordination exercise is important, difficult, and, if handled poorly, the source of its own potential efficiency losses. More generally, that paper argues that capital income taxation is desirable, once properly situated against the political economy background of substantial income and wealth inequality.

This Section VIII.C briefly explains the operation of the DBCFT and, more particularly, its destination base (as implemented through border adjustments) for the purpose of contrasting the DBCFT to the superconsolidation provisions proposed by the Dual BEIT. As a result, the discussion ignores the World Trade Organization issues presented by the DBCFT,²⁶³ and some other ancillary matters.

263. See Reuven S. Avi-Yonah & Kimberly Clausing, *Problems with Destination-Based Corporate Taxes and the Ryan Blueprint* (Univ. of Mich.

Unlike a conventional VAT, the DBCFT permits firms to deduct the cost of domestic labor inputs. (Another way of saying this is that a conventional VAT burdens labor income at the flat VAT rate, collected from the employer; an income tax or the DBCFT burdens labor income at progressive tax rates, collected from the employee.) At the same time, the DBCFT follows VAT border-adjustment precedent by disallowing any deduction for the cost of imported goods, the value of which of course reflects foreign labor inputs, and by excluding (zero rating, if that is a helpful VAT reference) from income the value of any export.²⁶⁴ The result is that a U.S. firm whose production activities are in the United States, but all of whose output is exported, would run at a perpetual tax loss, because labor and capital inputs would all be deductible, and export sales would be excludable. Making a credible commitment to such a firm that it will obtain the use of these losses, while reassuring legislators that this is the intended result, and not a tax shelter, remains one of the practical challenges in implementing the DBCFT.

By virtue of its destination-based design and the deductibility of wages, the DBCFT's tax base becomes economic rents generated anywhere in the world that are attributable to domestic consumption.²⁶⁵ The location of production or asset ownership becomes irrelevant: rents generated in the United States but embodied in goods sold for export are not directly taxed by the United States, and rents from foreign ownership or production embodied in goods consumed in the United States are fully taxable in the United States.

The DBCFT thus is a novel hybrid. It is not an income tax, and it is not an origin-based cash flow like the firm-level component of the Dual BEIT or David Bradford's X Tax. It bears many similarities to a subtraction-method VAT (a form of VAT not often seen outside the laboratory), but like the X Tax differs in one fundamental respect, which is that in a conventional subtraction-method VAT, labor inputs (domestic or foreign) are nondeductible.

Law & Econ Research Paper No. 16-029, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2884903.

264. In the same fashion, royalties paid to a foreign affiliate to use foreign-owned intangibles in the United States would be disallowed as imports of services, and royalties received from foreign affiliates for the use of intangibles outside the United States would be excluded from the tax base.

265. The treatment of foreign labor inputs is discussed in the next subsection.

The DBCFT vitiates the returns to base erosion and profit shifting through its destination-based cross-border design. For simplicity, this design element can be analogized to how VATs are designed: exports are not taxed in the country of export, and intermediate goods imported into a country are not deductible by the business using them.²⁶⁶ (Alternatively, the non-deductibility of imports under the income tax optics of the DBCFT—that is, its subtraction method of calculating its tax base—can be rephrased as a tax on imports, as in a credit-invoice VAT.)

The theory at work in the DBCFT is that a cash flow tax creates a zero-rate business tax environment for normal returns from domestic operations (i.e., returns on marginal investments), and the destination-based extension eliminates any advantage to sourcing the location of production or the ownership of high-value intangible assets in low-tax jurisdictions. As Auerbach has written:

One might view this treatment of international transactions as a super territorial system—one that ignores not only activities that occur abroad, but also those going and coming. While a simple territorial system would worsen the transfer-pricing problem because it would encourage companies to shift the reported location of activity from the United States to low-tax countries, the two stages together would actually alleviate the problem, because such shifting would no longer be possible.²⁶⁷

The destination-based cash flow tax can further be understood as a rejection of standard instruments designed to isolate the geographic source of income:

Briefly, though, the determination of worldwide profit occurs in many locations and is dependent on many types of activities. For example, many aspects of firm activity, including headquarters, R&D, production, marketing, and finance could be located in different

266. Auerbach, *Modern Corporate*, *supra* note 261, at 10 (“The destination principle is already familiar in the context of taxation, because it is the approach used around the world in the implementation of value-added taxes (VATs).”).

267. *Id.*

places or more than one place. In addition, consumers and shareholders could be located throughout the world. There is simply no answer to the question: in which country is profit generated? All of these elements of the company's activities play a part in generating worldwide profit. The combination of them almost certainly plays an additional part. The idea on which the international tax system appears to be based—that the “source” of profit is where the various “productive” activities take place—is actually a historical burden that creates substantial institutional barriers to reform.²⁶⁸

The proposals substitute “destination” for “source” as the basis of allocating the right to tax, on the theory that destination jurisdictions have authority to do so, in the institutional sense, and that doing so is neutral in respect of the place of production, which has important efficiency gains. Alternatively, the destination-based cash flow tax can be seen as a territorial profits tax that relies on an apportionment formula to allocate profits across jurisdictions, which formula employs a single factor (place of consumption of a good) that does not create incentives for a firm to modify its business operations to reduce its tax liabilities.²⁶⁹

Because the location of production or the ownership of assets is irrelevant to its consumption tax base, the DBCFT generally obviates the relevance of a corporation's residence. While Section V.B argued that concerns in respect of this issue are overblown, it unquestionably is true that eliminating any relevance to this determination would be desirable, if otherwise costless.

A destination-based tax system is not the only stable international tax regime that obviates the relevance of stateless income gaming. As suggested in *The Lessons of Stateless Income*,²⁷⁰ there are in fact two approaches to the design of business taxes that are robust to international base erosion and profit shifting. One is a territorial system whose source rules or apportionment formula cannot be gamed (comprehensive destination-based profits-only taxes being one example, at least from the perspective of the residence country). The other stable solution stakes out the opposite corner: a residence-based worldwide

268. Devereux, *supra* note 75, at 725.

269. *Id.*

270. Kleinbard, *Lessons*, *supra* note 157.

“superconsolidation” tax system, as outlined in Part V of this Article. This is the approach proposed by the Dual BEIT.

2. Border Adjustments

The border adjustment feature of the DBCFT has engendered tremendous confusion on the part of proponents and opponents alike. Proponents, for example, promise exporters that the DBCFT will subsidize their U.S. production destined for foreign consumption, while simultaneously arguing to importers that currency rate adjustments will protect them from any adverse consequences. It is worth teasing this issue apart.

Economists are clear that a border-adjustable VAT does not in fact operate as an export subsidy or import penalty. The basic argument is simply that if trade is in equilibrium today, the imposition of a uniform tax on all domestic consumption will affect an individual’s budget constraint (just as a wage tax would) but not the relative prices of goods.²⁷¹ As a result, real prices should be unaffected by the introduction of a border-adjusted VAT: goods wherever produced will be taxed by the United States when consumed in the United States, and goods produced in the United States for export will be taxed only under the consumption tax of the country in which the goods are consumed.

The principal mechanisms by which real prices—the equilibrium in trade—are maintained after the introduction of a VAT are currency exchange rate adjustments. Thus, if foreign currency markets are open and liquid, economists would expect to see a prompt movement in currency exchange rates that preserves real relative prices of goods. If the United States, for example, imposes a 20% DBCFT, economists would expect to see the U.S. dollar appreciate 25% against foreign currencies.

In other words, if one were to imagine the first country to introduce a VAT, and compared trade between it and other countries before and after the introduction of the VAT, one might be surprised to observe that external trade flows were unaffected by the introduction of the VAT. Currency exchange rates would adjust, so that, while trade would be unaffected, the currency of the first country to introduce the VAT would rise relative to the currencies of its trading partners.²⁷² (As an aside, this

271. See BRADFORD, *supra* note 73, at 6–9; Alan D. Viard, *Border Tax Adjustments Won’t Stimulate Exports*, 122 TAX NOTES 1139 (Mar. 2, 2009).

272. See Viard, *supra* note 271. Carroll and Viard (*supra* note 170, at ch. 7) explain in similar terms the “illusion” of any alleged competitiveness

conundrum should be employed as a litmus test by every university career services office. Economists see intuitively why this must be so; tax lawyers remember reading that it is true, but cannot explain why; and policymakers neither remember nor believe that it could possibly be correct.)

From this, the argument continues, the concerns expressed above that the DBCFT might burden imports and subsidize exports must be mistaken: exchange rate adjustments will restore equilibrium.²⁷³ If this is true in practice, trade will be unaffected. If it is untrue in practice, then exports will be subsidized and imports penalized. Boeing will be advantaged, and Walmart disadvantaged. Economists point to Brexit's effect on sterling, and the U.S. presidential election's effect on the Mexican peso, as instances where currency rates did in fact promptly respond to events²⁷⁴—in both those cases, however, to threats to the prior trade equilibrium.

What follows from this argument as well is that the reason why foreign firms might rush to relocate production to the United States following the adoption of the House Blueprint is *not* that the DBCFT penalizes imports as such but rather that such a move eliminates *foreign*

effects from the introduction of a destination-based tax with border adjustments, and further shows the equivalence of origin- and destination-based consumption taxes in this regard. In the context of a simple one-period model, for example, they conclude that “[a]s measured in foreign currency, destination-based taxes raise [nominal] consumer prices, while origin-based taxes lower disposable income, but both taxes cause the same reduction in real disposable income.” *Id.* at 106.

The authors go on, however, to consider a number of cases where the simple exchange rate adjustment story can run into difficulty. One is the introduction of different tax rates on different industries. Another, relevant to a VAT but *not* the DBCFT or the Dual BEIT, is the stickiness of wage rates (in nominal terms). The Federal Reserve could be compelled on the introduction of a VAT to accept a one-time increase in nominal prices (inflation) as a mechanism to reduce wages, to reflect the fact that in a VAT the firm rather than workers is paying the tax on labor inputs. *Id.* at 166–70.

273. See sources cited *supra* note 272; see also CARROLL & VIARD, *supra* note 170; Auerbach & Holtz-Eakin, *supra* note 261.

274. See, e.g., *How Election Surprises Affected Exchange Rates*, FED. RES. BANK OF ST. LOUIS: ON THE ECONOMY BLOG (Mar. 20, 2017), <https://www.stlouisfed.org/on-the-economy/2017/march/election-surprises-affected-exchange-rates>.

income tax to which the exporter might otherwise be subject. That is, a Freedomian exporter of widgets to the United States for consumption therein generally faces the same U.S. tax regime as does a U.S. producer (subject to the observations below about labor tax rates) and, in addition, presumably faces Freedomian corporate income tax on the income generated by its Freedomian production. It is the foreign tax that the relocation eliminates, not an incremental U.S. one.

In other words, by relocating to the United States the production of goods destined for U.S. consumption, a foreign firm operating under a U.S. DBCFT would face tax only in the United States, while a foreign firm exporting to the United States would incur both U.S. tax (the import duty) and some positive home country tax cost by virtue of its origin-based tax system. This would be true regardless of the foreign country's tax rate, or regardless of the structure of that tax as an income tax or a cash flow tax. (Of course, the magnitude of the incentive would be affected by these factors.)

It also follows from this that the transition to a destination-based profits tax, and with it the appreciation in the U.S. dollar, will work a one-time very large wealth transfer from U.S. investors to foreign investors. Foreign investments held by U.S. investors overnight will be worth less in dollar terms, and U.S. investments held by Freedomian investors overnight will be worth more in Freedomian pfennig terms.²⁷⁵ Carroll and Viard have estimated that at the end of 2010 the wealth transfer attributable to the introduction of border adjustments without any transition relief would have amounted to a \$7.88 trillion loss to American investors and an \$8.85 trillion pickup in wealth for foreign investors.²⁷⁶ As of the time of this writing, I am reasonably

275. CARROLL & VIARD, *supra* note 170, at 109–11 (observing that the issue has received “surprisingly little attention”); Viard, *supra* note 271.

276. CARROLL & VIARD, *supra* note 170, 110–11. As previously noted, *id.* at 111–14 describes the transfer pricing abuses to which the origin-based X Tax could be subject, but concludes that the solutions proposed by Bradford are feasible. Those authors then conclude that an origin-based consumption tax system like the X Tax is to be preferred over a border-adjustable, destination-based system, because the former does not introduce the one-time wealth transfer described in the text. The Dual BEIT's recommended solution also avoids the one-time wealth transfer, and its worldwide superconsolidation regime is simple to implement and plainly robust to transfer pricing gaming.

confident that policymakers did not fully weigh the implications of this in the maelstrom of debate surrounding the DBCFT.²⁷⁷

To be clear, the entire operation of the DBCFT's destination base depends on the relative prices of currencies adjusting as theory predicts. The interaction of predicted foreign currency movements with the operation of the DBCFT's border adjustments plainly overwhelmed the cognitive absorption powers of policymakers and observers in 2017, and led both to over-optimistic promised benefits and over-stated concerns. In fairness, however, there also was considerable debate as to whether the predicted currency movements in fact would materialize, with academics largely lining up squarely behind the Auerbach-Devereux analysis, and forex market participants expressing great skepticism.

I cannot add anything to the fundamental debate over how forex markets in fact would respond to the adoption of a DBCFT, but to help future analysts understand the intended operation of the DBCFT, it might be helpful to set out a stylized example that begins with the premise that forex rates will adjust immediately and precisely as theory predicts. The contribution of the example rests in its reliance on the idea of *implicit taxation*—that is, a change in relative asset prices in light of taxation that shifts the ultimate incidence of taxation or nontaxation.²⁷⁸

Imagine that Countries A and B both impose a 20% origin-based cash flow tax. (This hypothetical starting point helps to isolate the effect of the destination basis.) Country C imposes no taxes (more accurately, Country C's tax structure has no bearing on this example). Countries A, B, and C employ different currencies, all of which trade at parity at the start, and are freely convertible into one another. For convenience, we might call the Country A currency the dollar, the Country B currency the pfennig, and the Country C currency the franc.

"Country A Autos," located in Country A, manufactures automobiles for export to Country C. "Country B Motors" is identical in all respects (including exporting to Country C and in its cost structure and

277. In fairness, these estimates of the wealth transfer implicit in the forex adjustments engendered by the introduction of the DBCFT look only to the implications of those forex movements. The reduction in corporate tax burden, if not offset by other moves within the tax reform in question, is a wealth-enhancing policy move for owners of corporate equity. So, too, are any efficiency gains attributable to the move to a profits-only tax environment.

278. Kleinbard, *Lessons*, *supra* note 157, at 118–23, explores the importance of implicit taxation as a tool in tax policy analysis.

gross margins), except that it is located in Country B. Country A Autos employs the dollar as its functional currency, and Country B Motors employs the pfennig. (By “functional currency” we mean the currency in which a firm keeps its accounts and reports its financial results to investors.) At the start, with the dollar and pfennig at parity, each of Country A Autos and Country B Motors manufactures an automobile for \$6,000 or P6,000, respectively, and sells each automobile in Country C for F10,000, reporting a profit of \$4,000 or P4,000, respectively.

Now Country A switches to a destination-based cash flow tax at the same 20% tax rate. As a result, the dollar appreciates 25% against the pfennig and the franc. That is, \$1 now buys P1.25 or F1.25 worth of goods. From the other direction, P1 or F1 is now worth \$0.80.

Following Country A's change in tax policy, Country B Motors continues to pay origin-based cash flow tax to Country B in respect of its sales to Country C—in the case of the sale of one automobile, P800 in tax, leaving it with P3,200 after tax. Country B Motors's position thus is unaffected by Country A's adoption of the destination-based form of a cash flow tax.

There are two components to the financial consequences to Country A Autos. First, assuming that F10,000 was the market clearing price in a competitive market in Country C, Country A's change in tax policy should not affect that price. Country A Autos therefore will continue to export automobiles to Country C at the F10,000 price, but F10,000 now will be worth only \$8,000 to Country A Autos. At first glance, this seems to imply that Country A Autos will recognize only \$2,000 in after-tax profits (\$8,000 revenues less \$6,000 Country A costs), but this overlooks the fact that Country A Autos will deduct its \$6,000 in costs, obtaining (in an ideal implementation), an immediate \$1,200 refund from Country A's Treasury. The sum of the refund and the net pretax profit of \$2,000 is \$3,200, just as Country A Autos realized before the policy change.

A helpful way to think about Country A Autos's results, and more generally why domestic Country A expenses should be deductible, even though export sales are tax-exempt (zero rated), is to apply the distributive property of multiplication. Under the origin-based tax, Country A Autos paid tax of $0.2(Revenues - Costs)$. This can be restated as $[0.2(Revenues) - 0.2(Costs)]$. After the introduction of the destination-based tax, Country A Autos will suffer a 20% *implicit* tax on its revenues, in the form of the currency exchange rate move, and receive a 20% *explicit* tax benefit, in the form of the refund check it receives,

for a total economic burden of $[0.2(Revenues) - 0.2(Costs)]$. The change in tax policy does not change Country A Autos's export incentives.

Country B Motors now considers relocating some production to Country A; to the extent it does, it will no longer be subject to the Country B origin-based cash flow tax. If Country B Motors does so (and abstracting of course from all other costs), Country B Motors also will earn \$3,200 after-tax, because it will earn export revenues (in dollar terms) of \$8,000, incur costs in dollars, and receive a refund thereon in dollars. But that \$3,200 is worth P4,000. So Country B Motors has a strong tax incentive to relocate to Country A, and thereby report P4,000 in after-tax profits in its functional currency (the pfennig), rather than P3,200. By relocating production to Country A, Country B Motors will have reduced its corporate tax rate to zero, measured in pfennig terms (its functional currency).

Finally, imagine that Country A moves from an origin-based cash flow tax to a destination-based cash flow tax, and Country A Autos is trying to decide whether to build a new plant in Country A or Country B, in either case for export to Country C. Country A's tax policy change should not affect the price of automobiles in Country C, or the pfennig-franc exchange ratio.

If Country A Autos builds the new plant in Country B, then for every automobile sold it will earn P4,000 pretax profit, pay P800 in tax, and be left with P3,200 after Country B tax, which sum can be repatriated to Country A without further tax cost. In dollar terms, which is the functional currency of Country A Motors, that P3,200 profit is worth \$2,560. If instead Country A Autos builds the new plant in Country A, then as in the preceding example Country A Autos will earn an after-tax profit of \$3,200. By virtue of paying Country B tax in the first fork in the example, Country A Autos is worse off than it would be if it built the new plant in Country A. Country A Autos thus has a clear tax incentive to build the new facility in Country A.

In sum, the unilateral adoption by the United States of a DBCFT would create a significant tax incentive to locate production in the United States, but not for some of the reasons advanced in the domestic U.S. debate (such as the notion that foreign labor inputs would be penalized). In the case of U.S. domestic consumption, a firm that located its production in the United States would presumptively eliminate any foreign jurisdiction origin-based tax that would be imposed on any production in that foreign country. And in the case of production intended for export from the United States, the same analysis holds, for the reasons described in the examples just offered. That is, if the United States were to adopt

a DBCFT, theory predicts that foreign firms serving their own domestic markets would find an advantage at the margin in relocating production to the United States and then reimporting the goods in question to their home countries. The increase in value of the U.S. dollar in this case would offer firms in other jurisdictions with different functional currencies the opportunity to take advantage of the U.S. dollar's appreciation, in local currency terms, and thereby emerge with no incremental corporate income or profits tax liability anywhere in the world.

In sum, if the United States alone were to replace its origin-based income tax with a DBCFT, that would serve as a tax inducement for foreign firms to relocate to the United States production destined for consumption anywhere in the world (including their home jurisdictions). Academic enthusiasts for the DBCFT find this to be a feature, not a bug, in that a move by one major economy would in this way put pressure on others to follow suit. But this optimistic picture fails to consider all the possible strategic responses by other jurisdictions to this aggressive move. In general, it seems improbable that the marginal tax advantage of the United States as the situs of production for goods destined for export back to the foreign parent company's home jurisdiction would long endure.

3. Destination-Based Tax or Superconsolidated Residence Tax?

Both the DBCFT and the Dual BEIT largely vitiate stateless income tax gaming. The former does so by making consumption the only factor in assigning taxing jurisdiction; the latter effectively does so by making the tax rate of the jurisdiction of the ultimate parent of a multinational group the ultimate irreducible tax bill.

Neither is completely watertight: VATs, for example, also rely on border adjustments and the location of ultimate consumption to assign taxing jurisdiction, but VATs are famously vulnerable to carousel frauds and similar evasions. From the other direction, the corporate residence of a multinational group is somewhat malleable, although I have argued strenuously in Part V that this malleability often is overstated by others. In particular, the U.S. experience with corporate inversions simply shines a light on the inadequacy of the technical definition of corporate residence currently embodied in the Code.²⁷⁹ This concern can be

279. I.R.C. §§ 7701(a)(4), 7874.

substantially vitiated, as suggested earlier, by adopting a mind and management test and a presumption that a firm that uses the U.S. dollar as its functional currency for public financial statements is a U.S. firm.

There are four principal clusters of reasons to prefer the Dual BEIT here. First, its adoption will have no first-order effects on forex rates, and it therefore does not expose the U.S. economy to the parade of horrors developed so vividly by political opponents of the DBCFT. For the same reason, it has no immediate negative wealth effects on U.S. persons holding foreign investment assets (or serendipitous wealth enhancements for foreign investors in U.S. assets).

The DBCFT, by contrast, depends entirely for its intended operation on very dramatic forex rate adjustments, with the inevitable wealth effects described earlier. More fundamentally, while the theory underlying those forex rate adjustments is clear enough, it is troubling to me, at least, that so many forex market participants and analysts lined up on the other side of this issue. It may be that all of them had unstated motivations that colored their analyses, but their collective notes of caution ought not simply to be dismissed.

Second, the DBCFT raises other large political economy issues that the Dual BEIT does not, particularly with regard to international tax policy comity. The World Trade Organization compliance issue (not discussed otherwise in this Article) is real and germane to a policymaker's calculus, as are the probable reactions of other jurisdictions to the unilateral adoption by the United States of the DBCFT. At the very least, it would seem imprudent to bank on a long-term competitive advantage for the United States as a place of production, based on the theory that it alone would impose a zero tax rate on domestic production aimed at foreign consumption.

The Dual BEIT is pro-“competitive” without introducing inter-jurisdictional international instability. It is a profits-only tax, but offers the possibility of at least partial tax credits for foreign income taxes incurred on those economic rents. It permits the immediate use of foreign losses against domestic profits, and it does not expose an export-oriented firm to the same magnitude of risk that its all-in tax burden (explicit and implicit) will depend so dramatically on the utilization of its perennial loss position.

Third, the Dual BEIT expressly coordinates the taxation of business enterprises and investors therein, to yield a single comprehensive tax on capital income, where the most mobile returns (normal returns) are assigned to the least mobile taxpayers (ultimate investors in firms). The DBCFT's designers are highly capable and no doubt could extend

their work to address this more ambitious agenda, but that work already has been done for the Dual BEIT, and if this Article is at all convincing, the Dual BEIT's success in this regard has already been demonstrated.

Finally, the Dual BEIT appears to offer a more manageable transition path than does the DBCFT. The phase-in of the business enterprise component of the Dual BEIT appears to be manageable and to preserve some value to interest expense deductibility long enough for firms to adjust their capital structures as needed.

IX. CONCLUSION

Capital Taxation in an Age of Inequality argued that a flat rate capital income tax measured and collected annually and imposed at a rate lower than the highest tax rate on labor incomes was an attractive tax instrument along several margins. Both modern theory and concern over increasing top-end inequality counsel in favor of capital income taxation. But at the same time, capital income should be taxed somewhat more lightly than labor income, to reflect the differing elasticities of capital and labor supply. More generally, there is no reason beyond coincidence why capital and labor income should be taxed on the same tax rate schedules.

A flat rate capital income tax preserves the symmetry on which the taxation of risk depends, and a capital tax measured and collected annually has the desirable attribute of increasing as a share of pretax income with the passage of time: that is, the "tax wedge" is a feature, not a bug, because only the most affluent can afford the indefinite deferral of consumption out of capital income. Genuine lifetime consumption smoothing can be addressed through retirement plans with which we all are familiar, provided that the aggregate amounts sheltered in this manner are capped at some reasonably aspirational amount.

This Article has demonstrated that the Dual BEIT instantiates these principles in a tax instrument that is feasible, imposes few administrative burdens, offers as featureless a tax topography as can reasonably be demanded, and is based on familiar tax concepts. The Article is long, not because the Dual BEIT is unusually convoluted within the universe of tax instruments, but because all tax instruments, once described at a level of detail sufficient to form the basis of legislative drafting, are complex. It may be that in my zeal to demonstrate that the Dual BEIT can accomplish its ambitious objective of replacing the entirety of current law's capital income tax rules (including the corporate income tax), I have erred on the side of drilling down one level below that which

holds the attention of the reader, but by the same token the completeness of the Dual BEIT's articulation might help to convince skeptics that the Dual BEIT really can accomplish the goals set out for it.

This Article has focused on three principal issues. First, like any capital account allowance system, the Dual BEIT must specify the "normal" return that is exempt from business enterprise tax (and, under the Dual BEIT but not pure profits-only taxes, included in the income of investors). Here, the Article has argued that the normal return does not equate to a risk-free return (as much prior literature has assumed). Instead, a "normal" return here is an approximation of an economy-wide, *ex ante*, risk-adjusted return on marginal business investments.

Second, the Article has developed a detailed explanation of a feasible labor-capital income centrifuge, to separate the labor from capital income when both are hopelessly comingled in the hands of an owner-entrepreneur. Given that over half of domestic business income in the United States today is booked as the income of privately held pass-through vehicles, the ability to distinguish reliably between labor and capital income goes to the heart of the viability of the dual income tax structure that the Dual BEIT has adopted. The proposals made here are the most complex in the overall presentation, but they all are mechanical in operation, require no subjective judgments, and can be reflected in standard tax preparation software.

And finally, this Article has proposed genuine "superconsolidation" of a business enterprise and its affiliates, in a manner more consistent with current financial accounting principles than the ersatz consolidated return tax rules with which specialists suffer today. The combination of a profits-only business enterprise tax environment and superconsolidation leads to a powerful simplification and rationalization of business taxation. All tax-free reorganization and similar principles can be dispensed with, and the concept of a firm's tax basis in the stock of an affiliate can disappear.

Superconsolidation further can be used as the basis for the Dual BEIT's foreign direct investment tax environment. In this construction, U.S.-based multinational enterprises are subject to a global U.S. profits-only tax, against which foreign tax credits may be claimed. Superconsolidation eliminates multinational firm stateless income tax gaming as effectively as does the Destination-Based Cash Flow Tax idea seriously mooted by the U.S. House of Representatives in 2016–17, without triggering significant foreign currency exchange rate movements. At the same time, the profits-only tax environment and a moderate tax rate address "competitiveness" concerns. And finally, superconsolidation

means that foreign losses may fully offset domestic income, which is not true under “full-inclusion” international tax reform alternatives—thereby enhancing the efficiency of the tax. Worldwide superconsolidation does put pressure on the definition of what constitutes a “U.S.” business enterprise, but the concern has been somewhat overstated in past, and this Article has made several suggestions (some old, one new) to refine the definition.

Finally, this Article has argued that the Dual BEIT dominates other tax reform ideas that are current in the marketplace. The Dual BEIT offers a very attractive profits-only tax environment for business enterprises; it makes the United States a particularly congenial location for inbound foreign direct investment; it collects tax on an annual basis on the normal returns of investors in business enterprises, consistently measured from year to year and from investor to investor; and it does all this without distinguishing public from private firms, pass-through vehicles from corporations, or debt from equity. Moreover, the Dual BEIT unquestionably is better-specified than are other extant business tax reform proposals. Readers will have to judge for themselves, but I submit that the Dual BEIT is ready to make the perilous journey from laboratory to the floor of the legislative sausage-making factory.

X. APPENDIX: DUAL BUSINESS ENTERPRISE SUMMARY TERM SHEET²⁸⁰**BUSINESS ENTERPRISE TAX**

Covered Taxpayers	<ul style="list-style-type: none"> • All U.S. business enterprises except micro-firms and certain 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%
Tax Base	<ul style="list-style-type: none"> • Worldwide superconsolidation—see below • Interest deduction replaced by COCA deduction covering debt and equity • Rents + royalties paid to 3rd parties + PCOs (below) are deductible • Depreciation deductions continue • NOLs compound at COCA rate
Cost of Capital Allowance (COCA)	<ul style="list-style-type: none"> • Excludes from tax base average risk-adjusted normal rate of return • Deduction = statutory formula rate × adjusted basis (cost) of assets • E.g.: 1-year T-bill rate plus 300 basis points, applied to firm’s business capital • Preferences for small business (e.g., higher COCA rate on first \$X million of capital) • No industry-specific rules

(continued)

280. The Appendix is a slight revision of Edward D. Kleinbard, *Business Taxes Reinvented: A Term Sheet*, *supra* note 6.

BUSINESS ENTERPRISE TAX (continued)

Superconsolidation	<ul style="list-style-type: none"> • Group defined as 50.01% ownership • Treat group as single taxpayer • Applies to worldwide subs; losses anywhere offset gains anywhere in group • Stock basis in subs 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 sub = sale/purchase of sub’s assets • Asset transfers from outside business enterprise = reset to FMV of asset basis and basis in investment

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 \times Includible Amounts
Tentative Tax Rate (Illustrative)	<ul style="list-style-type: none"> • 25%
Includible Amounts	<ul style="list-style-type: none"> • Goal is to include average risk-adjusted normal rate of return in Investor tax base • COCA allowance \times Investor’s adjusted tax basis in business enterprise investments • Starting tax basis = purchase price, or in the case of a gift or bequest, FMV • OID principles apply. Includible Amounts $>$ cash distribution = more basis • Cash distributions not taxed, reduce basis

(continued)

INVESTOR TAXATION (GENERAL) (continued)

Investor Gains & Losses	<ul style="list-style-type: none"> • Gains not taxed: rollover to new investment 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) • Wash sales rules required to prevent one-way downwards 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 cap gain @ Dual BEIT rate)
Non-Business Loans to Individuals, etc.	<ul style="list-style-type: none"> • Labor/miscellaneous income rates on current law basis (including cap gain)
Gains from Collectibles (§ 408(m)), Precious Metals, Homes, etc.	<ul style="list-style-type: none"> • Ordinary income rates on current law basis (including cap gain)
Derivatives	<ul style="list-style-type: none"> • See “Special Industries & Circumstances”
Owner/Entrepreneur Overlap	<ul style="list-style-type: none"> • See “Participating Controlling Owners”
Retirement Plans and Other Tax-Exempt Institutions	<ul style="list-style-type: none"> • Retirement plans are tax-exempt, but individual’s account capped at \$5 million • Other tax-exempts subject to Includible Amount tax at discounted rate of 12.5% • Derivatives activity other than investment hedges = UBTI

**INVESTOR TAXATION: PARTICIPATING CONTROLLING OWNERS
("LABOR-CAPITAL INCOME CENTRIFUGE")—OVERVIEW**

"Participating Controlling Owner" (PCO)	<ul style="list-style-type: none"> • PCO = "Material participant" (§ 469) in the management of a firm who owns at least 5% of the firm, and where $\geq 50\%$ of the enterprise is owned by 5 or fewer such material participants (§ 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 via 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 = additional labor income
Centrifuge Overview	<ul style="list-style-type: none"> • PCO's returns on capital invested in firm = deemed <i>labor</i> returns to extent they exceed 3x PCO's Includible Amounts, but taxed in two different ways • Deemed labor returns attributable to current firm earnings treated in PV terms as if distributed as salary in current year, and aggregate tax = max labor rate • Deemed labor returns to PCO not (yet) reflected in firm profits taxed in aggregate at capital tax rate <ul style="list-style-type: none"> • A concession to political economy preference for entrepreneurship • Labor return tax system admittedly arbitrary • 1x Includible Amounts treated as taxable capital income, like any other investment • 2x treated as extraordinary (tax-free) returns on capital • Ties tax-free returns on capital to amount of capital actually invested, not share of firm capital or income

(continued)

**INVESTOR TAXATION: PARTICIPATING CONTROLLING OWNERS
("LABOR-CAPITAL INCOME CENTRIFUGE")—OVERVIEW (continued)**

	<ul style="list-style-type: none"> • Great idea requiring no capital = labor income, taxed at split rate based on whether realized yet at firm level • And 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 as equivalent to current year tax in PV terms via "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"> • Tax rate in aggregate = capital income tax rate

**INVESTOR TAXATION: PARTICIPATING CONTROLLING OWNERS
("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 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 [$\text{Specified Fraction} \times (\text{PCO's share of firm's after-tax income for year})$], less $3 \times$ PCO's Includible Amount for year

(continued)

**INVESTOR TAXATION: PARTICIPATING CONTROLLING OWNERS
 (“LABOR-CAPITAL INCOME CENTRIFUGE”)—MECHANICS I (continued)**

- Basis Bump Account accumulates and earns *taxable* COCA rate, like actual capital investment
 - Specified Fraction = $(LT-CT) \div [CT \times (1-CT)]$, 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 max labor tax rate
 - PCO share of firm’s after-tax income determined by actual and constructive ownership
 - Taxable Includible Amounts on Basis Bump Account = 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”)**

- Distributions from firm to PCO (including stock repurchases) are allocable to (and reduce) PCO’s accounts in following order:
 - Current + accumulated Includible Amounts
 - Actual capital (basis) invested in firm
 - PCO Extraordinary Capital Return Account
 - PCO Basis Bump Account (and then tax-free return of income shielded by Specified Fraction)
 - Additional Returns
 - “Additional Returns” = remaining distributions
-

“Excess Distributions” Tax

- “Excess Distributions” from firm to PCO (incl. stock repurchases) taxed to PCO at *capital* tax rate
-

(continued)

**INVESTOR TAXATION: PARTICIPATING CONTROLLING OWNERS
 (“LABOR-CAPITAL INCOME CENTRIFUGE”)—MECHANICS I (continued)**

- “Excess Distributions” = Distributions that reduce PCO Basis Bump Account + Additional Returns
 - Excess Distribution tax on distributions attributable to PCO Basis Bump Account + firm-level tax = aggregate tax at max *labor* tax rate
-

**INVESTOR TAXATION: PARTICIPATING CONTROLLING OWNERS
 (“LABOR-CAPITAL INCOME CENTRIFUGE”)—MECHANICS II**

Sales and Other Dispositions by PCO	<ul style="list-style-type: none"> • PCO’s gain on sale determined w/o 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
[OPTIONAL] Additional Basis Bump	<ul style="list-style-type: none"> • Extra basis bump for PCOs on multiple rounds of private equity financings and on IPO 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 (i) as any other investor in respect of actual capital invested in firm, up to 3x Includible Amounts, then (ii) to extent firm has earned income, at max labor income rate, in PV terms in year earned by firm (via Includible Amounts on Basis Bump), then (iii) at capital rates to extent returns not reflected (yet) in firm income

(continued)

**INVESTOR TAXATION: PARTICIPATING CONTROLLING OWNERS
 (“LABOR-CAPITAL INCOME CENTRIFUGE”)—MECHANICS II (continued)**

- 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 already contemplated
 - Again, PCO will use self-help through salary payments to preserve progressive labor tax rates
 - Deemed salary/reinvestment election possible here
-

SPECIAL RULES FOR SMALL BUSINESS AND ENTREPRENEURSHIP

Optional Entrepreneurship Allowance

- 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

- 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
-

LABOR AND MISCELLANEOUS INCOME; TAX BASE REFINEMENTS

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 • Tentative top rate = 40–45% • Retain “making work pay” credits (EITC, etc.)
Tax Base	<ul style="list-style-type: none"> • Cleaned-up current law • Cap retirement plans at, e.g., \$3 million • Eliminate personal itemized deductions, employer-sponsored insurance (as part of health reform)

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 firm using U.S. dollar as its functional currency and with some management presence in U.S. 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 § 904(d) type limitation
	<ul style="list-style-type: none"> • 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

(continued)

INTERNATIONAL TAX CONSIDERATIONS (continued)

Earnings Stripping	<ul style="list-style-type: none"> • Disallow rent/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"> • Minimum Inclusion same as U.S. investment • FTC available subject to § 904(d) type limitation
Foreign Investors in U.S. Enterprises	<ul style="list-style-type: none"> • No U.S. tax on normal returns, distributions, or cap gains; no effect on firm's COCA deduction

SPECIAL INDUSTRIES AND CIRCUMSTANCES

Financial Services Firms	<ul style="list-style-type: none"> • Mark-to-market system in respect of both financial assets and financial liabilities • COCA deduction on firm's net tax basis in nonfinancial assets, plus MTM value of its financial assets net of liabilities
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/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)

(continued)

SPECIAL INDUSTRIES AND CIRCUMSTANCES (continued)

	<ul style="list-style-type: none"> • 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
Collective Investment Vehicles (“CIVs”)	<ul style="list-style-type: none"> • Mutual funds, REITs, etc., grouped as CIVs <ul style="list-style-type: none"> • CIV not treated as business enterprise • CIV deemed to distribute its Includible Amounts to investors; income and additional basis to them • Any investment assets comprising > 20% of a business enterprise’s assets treated as constructive CIV and taxed as such; residual taxed as business enterprise • Hedge funds, etc., that are professional traders (as contrasted to dealers or investors) taxed as business enterprises
Other Special Rules	<ul style="list-style-type: none"> • Borrowing secured by investment where borrowing > basis resets that basis • Wash sale rule to prevent one-way mark-to-market

TRANSITION

Firm-Level Non-COCA Rules (E.g., 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% (with prorated foreign tax credit) • Tax payable over 5 years without interest charge

(continued)

TRANSITION (continued)

Firm-Level COCA Allowance

- Over 8-year post-enactment transition period, deduction is weighted average of former law interest deduction and new COCA deduction
 - Year 1 deduction = 100% old law interest deduction,
 - Year 2: $(87.5\% \times \text{old interest deduction}) + (12.5\% \times \text{COCA allowance})$
 - Year 3: $(75\% \times \text{old law interest deduction}) + (25\% \times \text{COCA allowance})$
 - 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

- Years beginning after date of enactment subject to Includible Amounts system
 - One-time “mark-to-market” on date of enactment for purposes of establishing baseline cost for Includible Amount calculations (but no immediate tax)
 - MTM always is imperfect, but:
 - 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 MTM wash out
 - Same rule as that adopted on introduction of the income tax in 1913 (§ 1053)
-