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DESIGNING AN INCOME TAX ON CAPITAL

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The "Business Enterprise Income Tax," as proposed by the author in a paper earlier this year, attempts to reform fundamentally the income taxation of business income. One of the proposal's core components is a uniform "Cost of Capital Allowance" to govern the taxation of both issuers and investors in respect of all forms of financial capital instruments.

This paper considers in more detail the underlying reasoning that led to the design of the Business Enterprise Income Tax. In particular, this article takes as its starting point modern tax analytical literature on the differences between an ideal income tax and a consumption tax, and examines the implications of those insights for the design of a practical and comprehensive income tax on capital.

After considering other possibilities, the article demonstrates why a hybrid income tax — in which returns on financial capital are taxed at the investor level, and business income is taxed at the enterprise level — is the most robust approach to implementing a comprehensive and coherent income tax on capital. The article further argues that the particular implementation advocated by the author applies consistently to all forms of financial capital (including derivatives), is economically neutral (but for scaling issues), minimizes the distortive effects of non-economic depreciation rules, comports with international tax norms, and raises fewer transition issues than do most consumption tax proposals.

I. OUR CURRENT INCOME TAX ON FINANCIAL CAPITAL INSTRUMENTS.

A. The Current Crisis.

This paper addresses the income taxation of *financial capital instruments,* a term that the paper employs to signify any form of financial claim (debt, equity, options, swaps, or the like) against (or measured by) the earnings, assets or liabilities of a business enterprise.[1] The paper argues that our system for taxing business income and business capital is in complete disarray, that the underlying problems are so deeply embedded in the current structure as to require fundamental reforms, and that it is possible to envision a reform package that is both reasonably practical and reasonably consistent with the ideals of an income tax.

When dealing with something as important and pervasive as our income tax, radical solutions are appropriate only when the current system demonstrably is in crisis. As it happens, our rules for taxing financial capital instruments plainly satisfy this condition.

[1] The term "business enterprise" is itself defined later in this paper.

The evidence of the crisis is directly apparent in our capital markets, where each year or two sees the launch of a new and exotic financial capital instrument. The names of those instruments — "MIPs," "Feline PRIDES," "contingent convertible debt," "Income Deposit Securities," or August 2005's contribution, E-CAPS[2] — mean nothing outside a small circle of capital markets professionals, their advisors, and their regulators. To describe their terms would occupy the entire length allotted to this paper. Yet for all their exoticism, these financial capital instruments hold the clue to the fundamental, and irresolvable, tension in our current system for taxing financial capital instruments.

Very simply, every one of these instruments reflects a different strategy for making a tax pastry, in which some sort of traditional equity feature (whether equity in the literal sense, or the "equity credit" that credit rating agencies accord instruments whose optional payment characteristics make them at least somewhat equity-like to a credit analyst) is stuffed inside a debt wrapper.[3]

The reason for these unnatural concoctions — the fundamental source of instability and irrationality in our taxation of financial capital instruments — is the division in tax treatment between debt instruments and most everything else. Payments for the use of debt capital are currently deductible to the issuer, while payments for the use of equity capital are not. Holders of debt capital must include an appropriate time value of money return in income regardless of whether they have received any actual payments (that is, without regard to whether income is "realized," in the traditional sense); equity holders need not. A holder's returns on debt instruments that contemplate the possibility of contingent interest or principal payments are

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2 *Investment Dealer's Digest*, August 22, 2005 at 7.

3 Technically, in some cases the debt is the filling and the equity feature the wrapper, but the purpose and effect are the same. The difference between the two strategies reflects the fact that in some cases the wrapper is opaque, while in others it is tax-transparent.

treated entirely as ordinary income; contingent equity returns are both completely deferred until realized and taxed at preferential capital gains rates.

In sum, the primal flaw — what I think of as our tax original sin — is that we have today two parallel and incompatible income tax systems. In the debt model (which technically includes interest rate swaps and similar "notional principal contracts"), we afford issuers current ordinary deductions, and require current ordinary income inclusions of holders. In the "most everything else" model, we afford issuers no deductions at all for the capital deployed in their businesses, and we tax holders on a realization basis: sometimes at capital gains rates, sometimes at ordinary income rates, and sometimes (as is currently true of corporate dividends) at the same rate as capital gains, but with different secondary characteristics.[4]

Even this summary understates the problem, because within each category we have different approaches to the taxation of contingent cash flows. In the debt model, contingent cash flows generally are viewed as additional interest income or expense, taxed on realization principles, but at ordinary income rates. In the "most everything else" model, the same contingent cash flows — that is, flows identical in amount and triggered by precisely the same contingency — may be taxed at different rates, depending on the formal characteristics of the instrument (*e.g.*, corporate stock or forward contract). Similarly, the payor may get no deduction in respect of making such a payment (corporate stock), a capital loss (an option or forward contract written by an investor) or an ordinary loss (the same contract written by a dealer). And all that is before one contemplates the topsy-turvy world of exotic contingent payment swaps, where synthetic *lenders* can be treated as incurring interest *expense*!

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[4] Thus, capital losses do not offset dividend income, even though capital gains and dividend income are taxed at the same rates. Similarly, the sale of corporate stock with retained earnings gives rise to a capital gain; these same earnings, when distributed to investors as an extraordinary dividend, are taxed as dividends.

We thus do not today have any consensus in our tax system as to how to tax financial instruments that have contingent cash flows. Without that consensus, we cannot apply the fundamental tool of tax analysis to a new financial product — the process of analogizing — because we do not know which rule is the norm and which the exception. And of course we have no means of assuring that any of these competing tax regimes in fact advance income tax principles.

For many years this bipolar regime was thought to be untidy but almost tolerable, on the theory that issuers and investors had diametrically opposed tax interests, because favorable tax anomalies from one party's perspective would be balanced by equal and offsetting tax costs to the other. And yet one critically important class of financial capital instrument — corporate stock — *never* has enjoyed this bilateral treatment, because issuers obtain no deduction at all for the cost of equity capital. Moreover, the premise obviously is flawed: the capital markets include large numbers of taxable and tax-indifferent issuers and investors, and those markets are supremely efficient at pairing issuers and investors in ways that maximize their collective returns, and minimize revenues to the fisc.[5] As a result, the system has no self-righting mechanism: tax anomalies that subsidize the cost of issuing one form of security are not balanced by a commensurate incremental cost to holding that security as an investor.[6]

The resulting system still might be thought to be untidy but salvageable if only we broke down a complex or compound financial capital instruments into its basic constituent units, in

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5 Tax-indifferent participants include not only the usual list of tax-exempt entities and foreign institutions, but also mark-to-market taxpayers, for which the mark-to-market accounting system essentially overrides the various tax rules for different types of financial instruments.

6 It often is observed that the consequence of the prevalence of tax-indifferent investors and issuers is that corporate income may be taxed once, twice, or not at all (as is the case when interest is paid to a tax-exempt investor). More accurately, if one includes households that incur tax-deductible mortgage debt and use the proceeds to sustain higher investments in tax-favored retirement plans, we should add to that list the possibility of negative tax rates.

order then to tax that instrument as an agglomeration of those units. This premise also is fundamentally flawed. It does not address the continuing fundamental tax disincentives to organizing in corporate form, or to sell corporate equity. More directly, the premise assumes that there exist tax building blocks that cannot be further divided, but that belief is no more accurate than is the thought that a proton or neutron is indivisible. Thus, we all now understand that the economic equivalent of stock can be expressed as a bond plus two options, and 15 years ago Randall Kau demonstrated 13 different ways of creating a bond-like return without the inconvenience of using a debt instrument.[7] Finally, "bifurcation" (as this mode of analysis usually is labeled) raises difficult valuation issues, including in particular the problem of deciding to which elemental tax particle the synergies attributable to the compound instrument should be ascribed.

For all these reasons, after an extended flirtation with bifurcation in the 1980s, the tax system understandably rejected this approach to the taxation of financial instruments. Accordingly, we generally tax a complex or compound financial capital instrument as a unitary whole. The consequence of this approach is that in our current system the same promise to pay a fixed or contingent amount can take on completely different tax characteristics, depending on whether it represents the predominant or a minor theme in the overall financial instrument in which it is embedded.[8]

What, then, does our tax system do today when confronted by an exotic new financial capital instrument? We analyze that instrument by envisioning idealized types of financial

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[7] Randall K.C. Kau, "Carving Up Assets and Liabilities – Integration or Bifurcation of Financial Products," 68 *Taxes* 1003 (1990). *See also*, Kleinbard, "Beyond Good and Evil Debt and Debt Hedges: A Cost of Capital Allowance," 67 *Taxes* 12 (1989).

[8] In addition, a financial capital instrument (in particular, a financial derivative) can completely change its tax characteristics, both as to timing of income and the character of that income, when one of the context-based tax rules, such as the hedging rules of section 1221 and Treasury regulation section 1.446-3, are invoked.

instruments, and then using arguments based on analogy and correspondence as our principal analytical tools to determine which idealized type most closely resembles the new instrument under inspection — a process that I previously have described as the process of placing instruments into metaphysical cubbyholes, based on these points of correspondence.[9] Economists will be depressed to learn how small a role economics actually plays in defining these metaphysical cubbyholes. We do not, for example, define "debt" by reference to the actual probability of repayment (if we did, preferred stock issued by an AAA issuer would constitute debt), but rather to certain financial characteristics (*e.g.*, maturity, remedies on default, seniority in the capital structure), all or most of which are both visible on inspection of the instrument and comprehensible to the lawyers and accountants who effectively administer the system. It is not surprising that this process, which has its roots in 19th century notions of these idealized types of instruments, withers in the heat of 21st century financial engineering.

In brief, the system is well and truly broken. We draw an arbitrary conceptual line between those forms of financial capital that give rise to deductible expenses, and those that do not, and there is no underlying consensus on the normative income taxation of contingent returns. Ad-hoc Congressional responses to particular financial products have made matters worse, not better, because there is no coherence to those legislative fixes.[10] Modern financial engineering leads to more and more complex financial instruments, while at the same time the operative tax rules become more and more random in application and result. The system cannot be patched. Fundamental reform is the only appropriate response.

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9 Kleinbard, "Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System," 69 *Texas Law Rev*. 6 (1991).

10 For example, simply disallowing interest expense deductions to issuers of equity-flavored debt instruments does nothing to address the fundamental dichotomy of granting issuers a deduction for the cost of some kinds of capital, but not others, and at the same time distorts investors' capital allocation decisions, because those hybrid instruments remain classified as debt instruments from investors' perspectives.

B. Why Tax Returns to Capital?

One understandable reaction to the tax morass summarized above is to give up on the whole idea of taxing current returns to capital. This response does not mean surrendering to tax anarchy, but rather designing our tax base around *consumption*, rather than *income*. For better or worse, however, this paper focuses primarily on how we might go about reforming our income tax system to tax more rationally the returns to capital, not why an income tax (the hallmark of which is just this — the taxation of returns to capital) might be an appropriate tax base. This focus reflects not only my professional background in the design and taxation of capital market instruments and financial institutions, but also my feeble grasp of economic theory, including the enormous literature comparing consumption and income tax bases.[11] And yet a few words on the topic are appropriate here, if only to suggest some of the premises and prejudices that underlie my reasoning.

I conceive of a well-designed income tax as a wealth tax, which operates by taxing all lifetime accretions to wealth once (and only once) more or less concurrently with the *creation* of that wealth — subject, of course, to well-known distortions attributable to the practical constraints of the realization principle.[12] If every accretion to wealth is taxed once, the aggregate effect is to tax all wealth over a lifetime (other than gifts and bequests received).[13]

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[11] This acknowledgement of weakness should not, however, be construed as a commitment not to meddle in this debate in the future. If I can listen to economists trying to explain the corporate tax shelter phenomenon, then surely turnabout will be fair play.

[12] Constitutional imperatives do *not* require current law's over-punctilious implementation of the realization principle. The U.S. tax system has long utilized accrual methods of taxation (in the accounting, not the economic, sense of the word), and these methods were found to be constitutional as early as 1930. *See, e.g., Weed & Brother v. United States*, 69 Ct. Cl. 246 (1930). Soon thereafter, a surtax on undistributed income from a personal holding company was found constitutional in *Foley Sec. Corp. v. Commissioner*, 106 F.2d 731 (8th Cir. 1939).

A number of provisions of current law require income recognition prior to the time that a taxpayer has actually received the relevant income. None has been subject to serious challenge, and several have been specifically upheld as constitutional by appellate courts.

A well-designed consumption tax, by contrast, also seeks to tax wealth once, and only once, but defers the timing of that taxation until that wealth is withdrawn from investment activities and consumed. A consumption tax therefore does not directly tax the economic returns to capital, but instead taxes those returns as and when they are used to finance consumption. By

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- Taxpayers' constitutional challenges to estimated tax requirements, which require the payment of tax prior to the determination of a taxpayer's ultimate tax liability, have been rejected by the courts. *See, e.g., Beacham v. Commissioner*, 28 T.C. 598 (1957), *aff'd*, 255 F.2d 103 (5th Cir. 1958) (additions to income tax for failure to file an estimated tax return and for substantial underestimate of estimated tax do not violate the due process clause of the Fifth Amendment).

- Sections 551 and 951, which require that U.S. shareholders in foreign personal holding companies and controlled foreign corporations include in income certain undistributed income earned by the corporation, were upheld as constitutional decades ago. *See Eder v. Commissioner* 138 F. 2d 27 (2nd Cir. 1943) (upholding constitutionality of the then applicable provisions concerning foreign personal holding companies, which required the taxpayers to report the undistributed net income of their Colombian corporation as income, even though under Colombian law, they were unable to receive such income in the United States in excess of $1,000 per month); *Garlock Inc. v. Commissioner*, 58 T.C. 423 (1972), *aff'd* 489 F.2d 197 (2nd Cir. 1973); and *Estate of Whitlock v. Commissioner*, 59 T.C. 490, (1972), *aff'd in part and rev'd in part*, 494 F.2d 1297 (10th Cir. 1974) (taxation to United States shareholders of undistributed income of a "controlled foreign corporation" as defined in section 957(a) is not unconstitutional).

- Section 1256, which requires taxpayers to mark certain futures and options contracts to market annually, was upheld as constitutional in 1993. *Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993).

- Section 1272 requires taxpayers to include accrued but unpaid original issue discount in income. The Supreme Court ruled in 1965 that original issue discount was simply a form of interest. *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965). In 1997, the Tax Court rejected a cash-method taxpayer's argument that the original issue discount rules did not apply to him. *Gaffney v. Commissioner*, T.C. Memo 1997-249.

The clear academic consensus is that the realization rule has become nothing more than a rule of administrative convenience, rather than a constitutional imperative:

> "While the rule of realization has traditionally been fundamental to the federal income tax, the rule today is in low repute. Over the years, the judiciary has progressively demoted the precept of realization from a once lofty station . . . . Most recently, the Supreme Court has reduced the realization requirement further, depriving it of any substantive content."

Edward A. Zelinsky, "For Realization: Income Taxation, Sectoral Accretionism, And The Virtue Of Attainable Virtues," 19 *Cardozo L. Rev.* 861, 873 (1997).

[13] A well-designed income tax thus would treat gifts and bequests as realization events to the donor, thereby ensuring that an individual would include in income all accretions to his or her wealth over the individual's lifetime. A donee or legatee, by contrast, ought not to be subject to income tax on the receipt of that gift or bequest, because the wealth in question will already have been tax-paid. Again, the idea is that all wealth is taxed once, through a mechanism of taxing *accretions* to wealth as quickly as practicable following the period in which those accretions occur.

definition, a consumption tax has a smaller base than does a comparable income tax, and therefore must impose a higher nominal tax rate to raise the same current revenues.[14]

There is a large and sometimes heated literature analyzing which tax system is the more appropriate. Although it is fair to say that a great many academic thinkers currently prefer consumption taxes over income taxes, a case can be made for the contrary view.

The arguments supporting income taxes are strongest when policy issues that go beyond economics in its narrowest sense are considered, such as the corrosive effects on a democracy of great concentrations of wealth (and with that wealth, a concomitant concentration of power), and the vulnerability of a consumption tax both to evasion (because of its higher nominal rates) and to "one-time" tax holidays couched as incentives to kick-start the economy.[15] For example, the *New York Times* tells us that in Manhattan, the annual incomes of the richest 20 percent of the population are now more than *50 times* larger than the incomes of the bottom 20 percent of the population.[16] These figures are extraordinary, and the gap has widened dramatically (and consistently) over the last 20 years. However implemented, a consumption tax will increase the absolute disparity in incomes (and wealth) between our richest and poorest citizens. At what point does the fabric of our democratic society unravel from the resulting stress?

Conversely, consumption tax advocates argue persuasively that the current income tax raises little revenue from taxing returns to capital, and distorts investment and financing decisions. These criticisms plainly are valid; indeed, the defects of our current system for taxing

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[14] Shaviro, "Replacing the Income Tax with a Progressive Consumption Tax," 103 *Tax Notes* 91, 97 (April 5, 2004).

[15] Before dismissing the last point, readers should reflect carefully on the "Homeland Investment Act" provisions of the Internal Revenue Code (section 965), as enacted in 2004, that offer U.S. corporations a one-year nearly-free pass on repatriating their untaxed foreign income, in direct contravention of the "capital export neutrality" principles that were said to have shaped our international tax rules for the last 45 years.

[16] *New York Times*, September 4, 2005, at Sec. 1, Col. 1.

financial capital instruments are so pervasive as to impel some observers to embrace consumption taxes for that reason alone.

This paper assumes an income tax, and attempts, first, to identify the characteristics of a good system for taxing income from business enterprises and financial capital instruments, and then to propose a solution that embodies those characteristics. This paper thus does not purport to resolve the debate between advocates of income and consumption taxes. It is hoped, however, that the analysis and proposal that follow can rehabilitate the income tax to the point where policymakers can choose between income tax and consumption tax philosophies based on positive reasons, rather than today's existential despair.

II. ECONOMIC RETURNS TO CAPITAL AND TAX ORIGINAL SIN: CAPTURING THE TIME VALUE OF MONEY.

A. Modern Financial Theory.

A large body of tax academic literature has by now established several important propositions for the design of an income tax on financial capital. That literature divides the economic returns to capital into three buckets: a pure time value of money return (what economists call the "normal" return), risky returns (by which is meant returns from transactions that on a portfolio basis have an expected risk-adjusted return, but whose individual payoffs vary substantially from that expected return) and extraordinary returns — what is described in the literature as "economic rents," or (confusingly, to a layperson) "inframarginal" returns.[17] That literature then goes on to demonstrate that both an ideal consumption tax and an ideal income tax reach extraordinary returns. In contrast, a well-designed income tax taxes time value of money returns, but a consumption tax does not. Finally, the literature argues that neither system taxes risky returns — at least in a world where losses are fully deductible — because taxpayers can

[17] I prefer labeling them "Hello, Hamptons!" returns.

"scale up" the size of their bets to put themselves in the same position after-tax as they would have been had tax not been imposed.

The brevity of this summary should not belie the critical importance of these insights to a designer of an income tax. First and foremost, the literature confirms the primacy of taxing time value of money returns as the primary determinant of whether a tax system is a successful *income* tax. Second, the literature reminds us of the distortions that result from artificial limitations on the deductibility of losses (or the double inclusion of income). Finally, the literature largely assumes that extraordinary returns do not present a challenge to either an income tax or a consumption tax, because those extraordinary returns will be taxed under either system, and will bear the same effective tax rate whatever legal form those extraordinary returns might take. An actual tax system must be consistent with this assumption.

B. Time Value of Money Returns.

Part I of this paper has already hinted at how ignominiously our current tax system fails to honor the primary income tax imperative of taxing the time value of money. We simply ignore time-value concepts for many financial capital instruments (stock, options) — indeed, for most all such instruments other than debt (and notional principal contracts, like interest rate swaps). By contrast, our rules for taxing debt instruments (even debt paying contingent interest) honor time-value principles, but then we undo the value of all that effort by excusing enormous portions of our collective financial wealth from the income tax system. To do better, an income tax must systematically identify and then tax the time value of every component of every capital investment.

In an Edenic world of entirely equity-funded sole proprietorships, taxing the time value of money would come down simply to aligning tax depreciation with economic depreciation. In such a world, there would be no meaning to the term "financial capital instrument," and the

recovery of direct investment in real assets would be the mechanism by which we would tax time value of money returns. That is, if I were to invest in a marginal asset that throws off normal (time value of money) returns, and tax depreciation precisely follows economic depreciation, then my taxable income each year would equal the cash returns from the asset, less the economic depreciation on that asset, which would leave me with taxable income equal to the normal return multiplied by my unrecovered investment.

If we add to that world a simple borrowing, then permitting the owner of the asset to deduct the interest paid on that borrowing, and requiring the lender to include the interest in income, would continue to capture time value of money returns to all parties: to the owner through economic depreciation and interest expense, and to the lender through interest income.[18] This is the conceptual origin of the tax deductibility of interest expense.

This primitive model also was the first bite of the apple that led to our tax original sin of treating the cost of some forms of financial capital instrument as deductible, and others as not. Our fall from income tax grace was complete when this model was employed to explain the capital structure of corporations. As a result, "stockholders" were treated as the indirect owners of *all* of the enterprise, and "bondholders" as temporary renters of money.[19]

In a hypothetical world where corporate capital structures comprise only common stock and senior unsecured debt, all held by individual taxpayers, this approach *almost* could work. In the actual world, however, this simplistic model collapses under the weight of four

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[18] Again, if both the loan and the asset yield the same marginal returns, the result will be that the owner and the lender together include in income the time value of money on the capital they collectively invested.

[19] One can see this outmoded view of corporate capital structures at work as recently as the studies supporting the Institute of Fiscal Studies' 1991 "Allowance for Corporate Equity," which was premised on the view that "A company is owned by shareholders, who have a right to its assets and the income stream arising from them after paying all costs. These costs legitimately include the payment of interest to investors who have lent to the company." Devereux and Freeman, "A General Neutral Profits Tax," 13 *Fiscal Studies* 1 (1992).

overwhelming burdens. The first is the so-called classical corporate tax model. It is difficult to retrace today how the early designers of the income tax both adopted the view that corporate capital structures were analogous to individual owners and lenders, and embraced the completely inconsistent theme of treating a corporation as an entity separate from its owners, thereby insisting on double taxation of the economic income attributable to the corporation's owners (the shareholders, in this model).

If the classical corporate tax model were the only distorting factor, the double taxation of corporate earnings would substantially overtax returns to capital; as it is, the rapid adoption of fiscally transparent business enterprises, and the ubiquitous roles of tax-exempt entities in the capital markets, leads to systematic under-taxation that probably drowns out the over-taxing tendencies of the classical tax model. These tax-indifferent and tax-exempt investors, and fiscally transparent business entities, are the second obstacle to implementing the analogy of corporate capital structures to individual owners and lenders.

The third burden that the simplistic model must shoulder is the realization principle. The near-random application of revaluations to market values attendant on the realization principle leads to a mismeasurement of the economic capital actually deployed in a business, and therefore to the time value of money returns to that business.

The fourth burden is the one most directly relevant to this paper (the others having been well understood for many decades), which is that in our modern capital markets, it is not possible in practice to label one financial capital instrument as evidencing ownership of the underlying real assets, and all other instruments as evidencing (in effect) the rental of money for temporary periods — and even if it were, we have today no rules for consistently identifying the time value of money returns attributable to each. One needs only to ruminate for a moment on all the exotic

debt instruments currently afloat in the capital markets whose purpose (as described earlier) is to convey equity-like characteristics while being formally classified as debt, to conclude that a modern financial capital instruments are too complex and too varied to be characterized so simplistically.

The consequence of this last observation is that the premise underlying our entire model for the taxation of financial capital instruments is irredeemably flawed. That premise was that corporate shareholders could in some fashion be equated with sole proprietors, and all other financial capital instrument holders as receiving returns that were essentially pure time value of money returns. In the modern capital markets, by contrast, we have debt-like equity (term preferred stock) and equity-like debt (from convertible bond through all the exotica referred to earlier). We cannot treat the returns paid to all non-stockholders as in fact simply constituting time value of money returns, and from the other direction we cannot identify which class of financial instrument holders should be treated as the owners of an enterprise, and in turn recognize their normal returns through depreciation of real assets and deductions for payments made to other classes. The only solution is to abandon the premise that holders of claims against a business enterprise can easily be divided into 'owners' and 'lenders.'

C. Risky and Extraordinary Returns.

As described above, modern financial theory implies that we should focus our energies on taxing time value of money ("normal") returns if our goal is to design a successful income tax. By contrast, that theory urges us not to worry very much about taxing "risky" returns (which I understand to be the difference between actual returns and the expected value of an investment), because taxpayers can scale up their bets to produce whatever after-tax returns they want. This observation is subject to a number of conditions, of which the most important for the designer of an income tax is that losses be treated symmetrically with gains**.**

Our current income tax system of course completely fails this condition. Because we rely so heavily on our over-punctilious implementation of the realization principle to tax gains, including gains that properly are simply time value of money returns, we have no choice but to adopt mirror anti-recognition rules for losses (the capital loss limitation).[20] If we can improve the taxation of losses, without allowing taxpayers to cherry-pick the fisc to death on the gain side of things, then we will have substantially advanced the cause of designing a good income tax on financial capital instruments and business enterprises.

Modern financial theory also suggests that both a well-engineered income tax and a well-engineered consumption tax reach taxpayers' extraordinary, or supersized, returns — what economists like to call economic rents. Typically, they both do so by applying internally consistent (and functionally similar) rules for the taxation of business income (beyond the obvious differences between the two in the treatment of business investment, which goes to capturing time value returns), on the theory that supersized returns generally arise in the direct conduct of business enterprises. (To this, one should add royalty income from the licensing of intangibles.)

Because we function in an open and global economy, many of the best-known recent examples of extraordinary returns to capital (e.g., Microsoft) achieve their success on a global scale. This observation implies that the most important practical impediment to the proper income taxation of supersized profits is the perennial problem of intra-group cross-border transfer pricing abuses. The proposal offered in Part V of this paper is intended in part to reduce the scope of transfer pricing disputes with respect to the operating income of business enterprises. More to the point here, the tax problems associated with measuring and taxing

[20] The straddle loss deferral rules are different, or at least more precise; they take aim directly at explicit strategies designed to arbitrage the realization principle without taking substantial market risk.

extraordinary returns are not problems embedded in the taxation of financial capital instruments, other than assuring some form of coordination between direct and indirect claimants (e.g., a corporation and its securityholders) to the same extraordinary income.

III. DESIGN CRITERIA FOR A GOOD INCOME TAX.

Part I of this paper described the fundamental flaws in our current system for taxing returns to capital, and argued that these problems — in particular, the instability that follows from the basic distinction between debt and equity — cannot be addressed except through fundamental reform. Part II then reviewed the economic components of returns to capital, and briefly considered how the current system struggles to address the economic understanding. This Part III attempts to distill from the earlier discussion the criteria that should inform the design of a revised approach to the income taxation of returns to capital.

A. Identify and Tax Consistently the Different Economic Components of Returns to Capital.

The most important lesson from the prior discussion is that a good income tax must consistently identify and then tax appropriately the different economic components of returns to capital: time value of money ("normal") returns, risky returns, and extraordinary returns (or "economic rents"). The prior discussion also suggests that we should focus principally on correctly measuring and taxing time value of money returns — at least if we construct a tax system in which returns to financial capital instruments are taxed independently of the underlying incomes of the business enterprise against which those instruments are claims.

The first, obvious, conclusion to be drawn is that this objective cannot be satisfied so long as we insist on making arbitrary but fundamental tax distinctions between financial capital instruments with different formal characteristics. Consistency requires, for example, that an

investor's normal returns be taxed currently in some fashion, whether those returns are embedded in an instrument designated as debt or as equity.

Equally important, a comprehensive approach to the income taxation of returns to capital must extend to *all* instruments by which capital is put to work in a business enterprise. This means, in particular, that an income tax system cannot be described as comprehensive unless it reaches (and consistently addresses) financial derivatives (options, forwards, swaps and the entire panoply of more exotic notional principal contacts). The derivatives markets today embrace billions of dollars in actual capital, and the returns from those instruments mirror those from trillions of dollars of notional underlying "physicals" (stocks, bonds, commodities, etc.). Any new income tax system will simply recreate the current fissures between debt and equity if derivatives are not brought into the system on the same terms, and to the same extent, as the "physicals" to which they relate.

This last point can be generalized into the observation that a good income tax system will adopt a *featureless topography*. Every distinguishing feature of a tax landscape — the debt-equity divide of current law, the difference between financial and non-financial services in a consumption tax, or the difference between tradeable and nontradeable assets in most mark-to-market (or "accrual") income tax proposals — is in fact a fissure that invites abuse. The only solutions are to embrace the necessity of such distinguishing features, and with them the concomitant necessity of an endless circle of anti-abuse rules and new stratagems, or to design a system that introduces as few distinctive features as possible into the tax landscape.

A good income tax system must be more than comprehensive in scope; it must also have consistent and rational rules for taxing the different components of economic returns (normal, risky and extraordinary). Different designers might reach different conclusions as to whether

extraordinary and risky concerns should be taxed at what we today would call ordinary or capital gain rates, but all presumably would agree that normal returns should lead to ordinary income on as close to a current basis as possible. (For reasons described below, there presumably would also be close to unanimity that business users of capital should be permitted either no deduction for that normal return, or a full deduction, depending on the precise implementation strategy that is adopted.) The most important preliminary observation, however, is that a good income tax system will consistently identify the different economic components of returns to capital, and apply internally consistent rules to each.

B. Minimize the Effects of Realization.

As previously described, the fundamental distinctive characteristic of an income tax is that it taxes accretions to wealth more or less concurrently with the creation of that wealth. It follows from this fact that a principal design criterion for a revised income tax is to minimize in some fashion the distortions that follow from a slavish adherence to realization precepts. The Constitution does not demand our current implementation of the realization principle, and an income tax cannot achieve its objectives without restricting realization's scope in some fashion.

Some observers turn this point on its head, by concluding that realization is the *only* problem with the current income tax, and that a direct attack on realization therefore can solve all other problems as well. This paper, by contrast, begins with the debt-equity distinction as the tax original sin, and argues for minimizing the importance of realization wherever practicable. In part, the reason for this perspective is the conclusion reached later in this paper (and, I believe, generally shared by others) that a truly comprehensive income tax cannot wholly abandon realization precepts as a practical matter; in part, this perspective reflects the fact that at least some proposals to abandon realization principles do so only for a subset of investors, and would

still leave issuers caring deeply about whether the financial capital instruments they issued were described as debt or equity.

As pointed out in Part II, current law's broad embrace of realization principles effectively also requires elaborate loss limitation rules, to prevent taxpayer "cherry-picking" of losses, while letting gains remain unrealized. These loss limitation rules fundamentally distort economic behavior. An important consequence of reducing the scope of realization principles therefore would be that the income tax designer in turn could loosen current laws' artificial limitations on the deductibility of economic losses.

C. Embrace Economic Neutrality.

A well-designed income tax should be a neutral tax in the technical sense, except insofar as the tax affects the scale of investments in economic activities. That is, a neutral income tax should affect neither "the allocation of investment spending between different assets, nor the method by which this investment is financed."[21] A good consumption tax goes further, and leaves the absolute scale of investment unaffected, but this distinction is simply inherent in the difference between an income tax and a consumption tax.

In practice, there are several practical strands to the implementation of a neutral tax system. The system must be comprehensive and internally consistent, must reach accretions to wealth on a current basis, and must not disfavor economic losses — all points that already have been covered. In addition, the system must tax the returns to capital invested in a business enterprise once and only once: multiple levels of taxation or nontaxation violate neutrality principles. Neutrality also contemplates a constant tax burden, regardless of the legal form the

[21] Devereux and Freeman, *supra* n. 19, at 1.

associated income takes, and regardless of the legal form of the business enterprise earning that income.

In this regard, it usually is said that a well-engineered income tax system achieves *integration* between issuer and investor tax bases. Integration, however, properly understood, is not really an independent design criterion of a good income tax on capital, but rather the catch-all phrase for coordination mechanisms between the taxation of business enterprises, on the one hand, and holders of financial capital instruments, on the other, where the goals of that coordination are to capture time value of money returns once (the income principle) and only once (the neutrality principle). Since these topics have already been covered in detail, there is little point to reprising that discussion in the guise of analyzing the success of different systems at achieving integration goals.

Finally, the designer of an income tax system who strives for as neutral a system as practical should keep in mind the logical connection between depreciation of real assets, on the one hand, and the taxation of the financial capital instruments that represent the indirect claims on those real assets, on the other. For both political and practical reasons, tax depreciation of real assets often deviates significantly from economic depreciation. As we will see below, this fact introduces very substantial problems for designers of real-world income tax systems who hope to capture the normal returns to capital in the tax base they are constructing.

D. Comport with International Tax Norms.

All income tax systems struggle with the issues posed by international capital flows. At one level, these difficulties reflect the incompatibilities of different sovereign tax systems, not all of which are equally internally consistent or effective, and which in some cases have completely different design goals (*e.g.*, to tax consumption rather than income). At another level, the difficulties reflect the struggles for revenues between capital importing and capital exporting

countries, often expressed more politely as disagreements over the relative priority of residence and source as the basis for imposing tax. Finally, international capital flows can take the form either of direct investment or portfolio investment; tax systems often apply quite different rules to each (particularly when the effects of bilateral tax treaties are considered).

In particular, the designer of an income tax must bear in mind four different forms of international capital flows: foreign direct investment, foreign portfolio investment, inbound direct investment, and inbound portfolio investment. Given the liquidity of modern global capital markets, a system that does not produce consistent results consistent across all these different investment scenarios, and results that are consistent in turn with purely domestic investments, will lead to profoundly non-neutral results. This paper accordingly addresses these different international capital flows in the context of the paper's specific reform proposal, in Part V.

Against this backdrop, the best that can be expected of an income tax system for a large open economy like ours is that the system honor its internal principles to the extent consistent with existing international norms, and rely on the tax treaty process to achieve more theoretically satisfactory (and neutral) results.[22] It is particularly important that our internal tax system comport with global standards regarding the scope and application of bilateral tax treaties, because those agreements represent the only supranational coordination mechanism available to mitigate cross-border double taxation.[23]

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[22] One of the most puzzling political aspects of the global economy today is the great success of multilateral tariff agreements (e.g., GATT), but the complete lack of interest on the part of sovereigns in improving the neutrality and efficiency of capital flows through similar coordination of direct taxes.

[23] Most countries, including the United States, have adopted unilateral mechanisms to reduce international double taxation (in our case, the foreign tax credit), but in order to limit the erosion of the domestic tax base, those mechanisms typically are expected to be less than 100 percent successful on their own.

E. Address Inflation.

Many observers rightly note that most income tax systems do a bad job of addressing inflation; in particular, most systems tax as gains amounts that economists would all agree are simply the recovery of a taxpayer's original investment. From this, the usual response is to propose a basis indexation system, to tax only true economic returns to capital.

This paper does not follow this prevailing logic, although obviously an indexation system could be bolted onto the specific proposal made later. The reason is not simply dimwittedness, but rather a strongly-held (if idiosyncratic) belief that inflation is a great social evil, and that indexation is a polite word for partial immunization of the one social class (capital owners) who can be expected to resist its spread. This author, at least, therefore prefers to keep inflation squarely as a political and monetary policy issue, not a tax policy one.

F. Reduce Administrative Complexity.

Most tax reform proposals begin by listing the simplification of tax return preparation as a principal design goal. This criterion makes a great deal of sense when applied to the personal income tax, but is not nearly so important in the business tax setting, where minimal bookkeeping skills, at least, can be assumed. Indeed, business taxpayers are fully capable of making sophisticated cost-benefit analyses, and as a result positively embracing tax complexity, where they are confident that by doing so they will realize significant tax savings, net of the cost of absorbing that complexity.

Certainty of a tax's application, on the other hand, is very important in the business setting. The capital markets in particular behave as if they are very poor evaluators of tax risks, oscillating in a binary fashion from zero-weighting a contingent tax liability to assuming the worst. Tax certainty therefore is a valuable design criterion, but reducing bookkeeping or

recordkeeping burdens generally is not, so long as the imposition of those burdens directly advances one of the design criteria identified above.

IV. INCOME TAX REDEMPTIVE STRATEGIES.

There are several possible responses within the confines of an income tax to the observation that holders of many modern financial capital instruments cannot in fact be characterized either as indirect owners of real assets (who should recognize time value of money returns through economic depreciation on those real assets and deductions of time value payments to money lenders) or as simple renters of money (who should recognize time-value returns directly through the interest they charge). Each of these responses begins, in effect, by acknowledging that *all* investors in a business enterprise collectively own the enterprise in some indeterminate fashion, and then creates rules to identify and tax the time value of money component of their collective returns. This Part IV reviews briefly how the most important of these proposals address the problems and design criteria summarized to this point.

A. Investor-Level Solutions.

1. Pass-Through Models. One possible approach to designing a tax system to reach the time value of money returns on capital would be to attempt to return directly to the Edenic conditions imagined in Part II. This approach argues that, since the holders of financial capital instruments issued by a business enterprise collectively are the entirety of capital stakeholders in the enterprise, it is a waste of time to design a tax system that focuses on financial capital instruments as if they were real: why not instead simply apportion business income in some fashion to all these different stakeholders, in accordance with their relative claims? In this model, enterprise-level real asset depreciation reasserts itself as the means by which time-value returns are taxed, because that asset depreciation determines the aggregate taxable income to be divided among stakeholders.

We actually have some collective real-world experience with this approach, in the form of publicly traded partnerships, of which there are a few. The short report from the field is that full pass-through models are extraordinarily difficult to implement, even for publicly traded partnerships with relatively laconic secondary market trading (compared to, say, Google) and simple capital structures, because of the difficulties of relating income realization at the entity level (where income is first determined) to secondary market trading in those partnership interests.

At a deeper level, the pass-through model has other significant limitations. First, it does nothing at all to rationalize and confirm the taxation of financial derivatives — which for this purpose can be viewed as side bets on a business enterprise's income on assets — to the allocation of firm income to the holders of direct claims against the business enterprise.

Second, the pass-through model depends completely on correctly implementing business enterprise income taxation generally, and capitalization/depreciation rules in particular, to capture time value of money returns. Decades of experience with the political and administrative process have demonstrated to all of us the fragility of that assumption. Similarly, the taxation of business income has embedded in it the problem of income mismeasurement attributable to the realization principle; the pass-through model simply distributes that mismeasured income to investors.

Third, the pass-through model contains virtually insoluble problems in the implementation of the realization principle, given that realization events can occur at both the stakeholder level and at the entity level;[24] while the entity itself is not taxable, its income is the

[24] Not surprisingly, the Internal Revenue Code's partnership rules have an extraordinarily complex set of provisions (sections 734, 743 and 754, among others) to coordinate the two levels of realization events. Partnership tax experts tell me that those rules can work, sometimes, in the simplest cases (although I have

measure of what must be allocated among stakeholders. How, for example, should we treat an owner's capital gain on selling her stake in the entity at a time when the business enterprise's commensurate gain remains unrealized? And how should we treat the subsequent purchaser of that interest (who has paid after-tax dollars for that unrealized gain) when the business enterprise realizes the gain at the entity level?

For all these reasons, an investor pass-through model cannot serve as a practical platform from which to tax time value of money returns to capital. As we will see shortly, some of these same shortcomings apply with equal force to other, somewhat more realistic, proposals as well.

2. Mark-to-Market. Another approach to a comprehensive investor-level solution to taxing the time value of money returns to capital would be to tax all holders of financial capital instruments under a mark-to-market accounting system.[25] Under this approach, business enterprises would not be taxed, because the economic income attributable to them would be recognized currently by financial capital instrument holders through their mark-to-market accounting.

Even the most dewey-eyed of academics, however, recognizes the practical problems with such a proposal. Most fundamentally, nearly every such proposal limits its reach to publicly-traded instruments. This 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 destruction. Taxpayers would opt out of mark-to-market accounting through factual

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never been able to understand them); to my knowledge, no one believes that they can be implemented for a publicly traded partnership.

[25] Economists refer to this method of accounting as "accruals" taxation. This terminology is hopelessly confusing to people who practice tax law or who administer the Internal Revenue Code, because we use the term "accruals" in its accounting sense, meaning the recognition of an income or expense item when the future receipt of payment or the obligation to make a future payment is reasonably certain. To us, the opposite of "accrual" accounting is the "cash" method of accounting; *not* the realization principle.

argumentation, through non-traded blocker entities (both domestic and foreign), and through compound derivatives that were themselves not traded, but which conveyed the economic returns of traded underliers. The proposals also leave completely unanswered what tax system would apply to financial capital instruments that are *not* viewed as publicly-traded.

Moreover, implementing a mark-to-market accounting system requires resolving some important (and largely unexamined) conceptual issues.[26] Having spent the last five years of my professional practice on just this question, in the one context where one would expect that mark-to-market accounting would be easiest both to implement and to reach agreement between taxpayers and the Internal Revenue Service — the tax application of that accounting method to the country's largest securities dealers in respect of their own portfolios of financial derivatives — I concur emphatically that mark-to-market accounting for investors is not a practical general solution to taxing the time value of money.[27] The alternative — performing 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.[28]

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[26] For background on the topic, see Kleinbard and Evans, "The Role of a Mark-to-Market Accounting System in a Realization-Based Tax System," 79 *Taxes* 788 (1997); Kleinbard, "Some thoughts on Market Valuation of Derivatives, " 91 *Tax Notes* 7 (May 15, 2001); Kleinbard, "A Short Course in Valuing Derivatives," 94 *Tax Notes* 3 (January 21, 2002); Securities Industry Association, "Submission in Response to Advance Notice Regarding Safe Harbor Under Section 475," July 30, 2003, available through *Tax Notes Today* online at 2003 TNT 177-39.

[27] As an aside, mark-to-market accounting works at the investor level to tax the time value of money once and only once only if that accounting system is comprehensive (that is, applies to *all* holders of financial capital instruments in an enterprise) and exclusive (that is, the enterprise itself is not also subject to tax).

[28] Mark-to-market accounting works well for securities dealers precisely because their income is not significantly derived from real as well as financial assets. That accounting method today is flawed in that it applies only to dealers' assets, and not their liabilities, but because dealers fund themselves overwhelmingly with overnight financing, there is little practical distortion. Kleinbard and Evans, *supra* n. 26, at 811-12.

Another approach would be to tax entities on a constructive mark-to-market methodology that would treat the sum of the net fair market values of an entity's assets as equaling the market capitalization of the entity's stock. This approach raises very substantial practical issues, including all the problems described earlier in the text of identifying the genuine owners of a modern business enterprise with a complex capital structure. In addition, many business people can be expected to object that public equity prices are too

B. Entity-Level Solutions.

If we cannot design practical stakeholder-level systems to capture time value of money returns to capital, then perhaps the right approach is to forego the taxation of financial capital instruments entirely, and instead capture both time value of money returns and economic rents at the business enterprise level, by imposing a comprehensive entity-level income tax. An entity-level tax thus views the business enterprise as a surrogate for its collective financial capital instrument stakeholders. Implementation of this idea contemplates that the enterprise's tax depreciation would follow *economic* depreciation precepts, and that distributions to holders would be exempt from tax.

This effectively was the core theory behind the U.S. Treasury's 1992 proposal for a Comprehensive Business Income Tax ("CBIT"). CBIT would have treated *all* business enterprises as taxable entities, disallowed *all* interest expense deductions to business enterprises, and collected *all* tax on time value of money returns at the entity level.

As described below, the CBIT approach of treating all debt instruments in a manner similar to equity, by disallowing an issuer's interest expense, is one of two logical responses to the tax original sin of taxing debt differently from equity. The other logical response is to give an issuer some sort of deduction in respect of the equity component of its capital structure. Part V explores this alternative approach in some detail.

Despite the passage of time, the CBIT proposal remains an important landmark in the effort to develop a rational income tax system for financial capital instruments. First, it directly addressed the tax original sin of debt-equity distinctions. Second, it was developed by a team at the U.S. Treasury Department whose members embodied considerable experience in both the

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volatile to serve as a fair tax base for an entity, which, unlike a stockholder, cannot simply capture fluctuations in value through a sale of the asset being measured.

practical administration of the tax law and in tax economics. Third, the CBIT proposal was extensively documented, as part of a book-length study of possible income tax reforms. Fourth, the CBIT proposal was released at a time when academic interest had swung almost entirely to exploring the implications of replacing the income tax with a consumption tax.

As a result, CBIT arguably was the last comprehensive proposal to reform the *income* taxation of business enterprises and business income to receive general attention among tax policymakers. Perhaps for this very reason, CBIT was reprised in a presentation in May 2005 for the President's Advisory Panel on Tax Reform. CBIT was reprised even more directly in 2003, when President George W. Bush's Treasury Department offered its first proposal to lower the tax rate on corporate dividend income, the centerpiece of which was an "Excludable Distributions Account" concept borrowed directly form the original CBIT study.

Most policymakers today continue to view CBIT as an exemplar of a feasible and economically-sound proposal to reform the income taxation of business enterprises and business income. It therefore is almost inevitable that any new proposal along these lines must stand up to a direct comparison to CBIT.

The remainder of this Section IV.B tries to evaluate some of the fundamental design decisions made by the developers of CBIT against the analytic framework developed earlier in this paper. Every tax system, and every feasible tax reform proposal, embodies compromises; it is hoped that, by identifying explicitly CBIT's underlying compromises as reflected in its core architecture, we can decide whether CBIT (or any new proposal) comes close enough to satisfying our objectives to justify the significant implementation costs associated with such fundamental change.

Parts V and VI then complete the evaluation, by considering the strengths and weaknesses of an alternative comprehensive income tax proposal that starts from the same base — the necessity of treating debt and equity alike — but that adopts precisely the opposite strategy for obtaining that treatment. CBIT sought to implement debt-equity parity by treating debt more like equity (through disallowing an interest deduction). The alternative proposal does so by treating equity more like debt (by giving an issuer a deduction in respect of both). Since these are the two most logical, and complementary, strategies for addressing our tax original sin, developing and then comparing each approach to the other is a useful way to identify the relative merits of each.

Certainly, there is much to recommend in CBIT. CBIT would have applied consistent tax rules to all business enterprises, no matter what their legal form. With the recent surge in popularity of limited liability companies, including the peculiar tax notion of an entity that exists for all commercial law purposes, but that is wholly disregarded as an income tax matter, this insight has even more power today than it did in 1992. CBIT would have accomplished the integration of investor and entity-level tax, and would have assured that all business income in fact was taxed once, rather than not at all (assuming that some of the implementation issues described below were more fully developed); this again would have been a major contribution.

Nonetheless, CBIT's fundamental design decision to capture time value of money returns by taxing all business income at the business entity level forced the designers into a number of difficult compromises. In particular, this design decision ran afoul of two important problems already discussed in the context of pure pass-through models. First, this approach depended entirely on correctly implementing entity-level income taxation, particularly in respect of capitalization and depreciation rules. Second, the approach almost assured that income will be

mismeasured, because of the practical impossibility of finding a substitute for reliance on the realization principle to measure gains from real assets, and the relatively low rate of turnover in non-inventory real assets.[29]

The Treasury Department recognized these problems when it designed CBIT, but never fully resolved them. In brief, the developers of CBIT effectively acknowledged that enterprise income taxation would never be fully reformed, and then attempted to correct for that error through a vaguely developed notion of a compensating tax on entity-level preference income, which would take the form either of an actual entity-level tax on distributions, or the imposition of a compensatory tax on holders, in either case to the extent that holders were treated as receiving distributions that exceeded the issuer's available "Excludable Distributions Account."

The Treasury Department did not develop either compensatory tax in detail, which is odd, in light of the compensatory tax's central importance to correcting the systematic undertaxation of income that otherwise would result. A direct entity-level compensatory tax on certain distributions is reminiscent of the United Kingdom's then-extant Advance Corporation Tax. That tax clearly distorted U.K. companies'dividend distribution policies (by effectively imposing an incremental tax on distributions that were deemed paid out of untaxed profits), which was one of the factors leading to its abandonment. At a minimum, a direct compensatory tax would radically affect an issuer's cash distribution policies (thereby violating neutrality principles discussed later in this paper), and would exacerbate the coordination issues between stakeholder-level capital gains and the entity level tax discussed briefly below.

The alternative — passing through to holders a mix of taxable and tax-exempt income in respect of each cash distribution, depending on the fluctuating state of the issuer's Excludable

[29] An entity-level tax also violates the political admonition of Senator Connie Mack, Co-Chair of the President's Advisory Panel on Tax Reform, that an income tax should contain a visible investor-level tax on investment earnings. 2005 TNT 92-1 (*Tax Notes Today*, May 13, 2005).

Distributions Account — would introduce extraordinary volatility to securities prices, as investors reacted to an issuer's changing mix of preference and nonpreference items. It also is surprisingly difficult to draft and implement, as the George W. Bush administration discovered in 2003-04, when it reproposed a narrower version of the idea. Finally, it would raise difficult questions of how to allocate items of preference and nonpreference income among the different stakeholders in a business enterprise.

CBIT also never came to grips with investor-level capital gains. The Treasury proposal itself vacillated on how capital gains should be taxed, because the CBIT proposal focused on *distributions* from business enterprises. Treasury accordingly did not closely integrate the taxation of capital gain/loss with those distribution rules; the result would have been either a substantial continuing role for tax planning or complex coordination rules that have not yet been fully mapped out. More generally, the report never reconciled the difference in timing between holder-level realization events (where realization events are frequent) and enterprise-level realization events (where they are less frequent and lumpier).[30]

Finally, the CBIT proposal was too narrow, in that it proposed no rules for the taxation of financial derivatives, even though many derivatives have significant capital components. That oversight was surprising in 1992; but now, at a time when there are trillions of dollars in notional principal amount of outstanding derivative instruments, it is a serious flaw in the CBIT proposal.

Notwithstanding its shortcomings as originally proposed, CBIT plainly is a more productive starting point for an income tax on capital than are the investor-level (or pure entity

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[30] Consider, for example, an equity-funded enterprise whose sole asset is raw land that (conveniently) appreciates at the marginal rate of return. The enterprise itself will not recognize any taxable income in a year. If a shareholder sells stock at the end of the year for a gain that reflects that time-value return, how should the investor be taxed? Conversely, what if the enterprise were an active dealer in securities, and all of its assets were marked-to-market at year-end? The investor again sells at year-end, for an amount that directly reflects the income earned by the enterprise. What should be the result here?

level) models described earlier. With the benefit of hindsight, its limitations are more obvious than they were in 1992, but the questions remain, first, is it possible to do any better in the real world, and, second, if it is not, would the resulting income tax system be a credible alternative to a well-implemented consumption tax?

V. A HYBRID ALTERNATIVE: THE BUSINESS ENTERPRISE INCOME TAX.

A. The Business Enterprise Income Tax.

1. Overview. This Part V describes very briefly the key features of a different plan to reform the income taxation of business enterprises.[31] That proposal, termed the Business Enterprise Income Tax (the "BEIT"), includes as one of its core components a uniform "Cost of Capital Allowance" ("COCA") system, which is intended to govern the taxation of both private sector issuers and their investors in respect of all forms of financial capital instruments. Because of the central importance of CBIT to most discussions of business *income* tax reform over the last several years, the discussion that follows necessarily compares CBIT and the BEIT. Notwithstanding this rhetorical device, the BEIT ultimately must stand on its own as a viable candidate for the reform of our business tax system, in light of all the criteria developed earlier.

The reforms contemplated by the BEIT, and in particular its Cost of Capital Allowance system, would apply only to *business enterprises*, and it therefore is important to consider for a moment what is meant by that term. As already indicated, the term comprises only private sector for-profit activities. All such activities would be characterized either as

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[31] The plan is described in more detail in "The Business Enterprise Income Tax: A Prospectus," 106 *Tax Notes* 97 (January 3, 2005 (the "*BEIT Prospectus*")). The material contained therein also was presented to the President's Advisory Panel on Federal Tax Reform in a somewhat expanded form in May 2005 (the "*Tax Panel Presentation*"); that presentation is available online at http://www.taxreformpanel.gov/meetings/meeting-05_11-12_2005.shtml. As an historical footnote, a rudimentary COCA originally was proposed in 1989 in a deservedly obscure article titled "Beyond Good and Evil Debt And Debt Hedges: A Cost of Capital Allowance," 67 *Taxes* 12 (1989).

investment or business activities, with the BEIT applying only to the latter.[32] More generally, we have today an extensive body of law on when a taxpayer is engaged in a trade or business; the BEIT is intended to rest on that foundation, and treat any taxpayer (including an individual) that is engaged in a trade or business (subject to the special rules set out in the footnote) as a "business enterprise."

2. The Non-COCA Components of the BEIT in a Nutshell. The BEIT comprises three sets of reforms designed to redefine the income tax base applicable to business operations, and a fourth set of rules (the Cost of Capital Allowance system) that is intended to replace completely current law's treatment of different types of financial capital instruments (including derivatives) with a single comprehensive regime. The overall agenda of the BEIT is to reduce as far as possible the role of tax considerations in business thinking. The BEIT does so by replacing current law's multiple elective tax regimes with a single set of tax rules for each stage of a business enterprise's life cycle: choosing the form of a business enterprise, capitalizing that enterprise, and selling or acquiring business assets or entire business enterprises.

While this paper primarily addresses the taxation of financial capital instruments, the BEIT is intended to be tightly integrated. It therefore would be a mistake to think of COCA as independent of the other proposed reforms. Nonetheless, for the sake of clarity in presentation I summarize here the non-COCA components of the BEIT; the paper returns to the COCA itself in the next section.

[32] Most individuals who today are "traders" in securities would fall on the investment side of the definition. In addition, collective investment vehicles would be treated as investors, rather than business enterprises. Leasing and real estate development activities generally would be treated as *per se* business activities; a collective investment fund, however, would be permitted to engage in net leasing of real estate. Finally, hedge funds and other professional traders would be taxed as business enterprises, rather than collective investment vehicles.

Very briefly, the non-COCA components of the BEIT operate as follows: First, the BEIT imposes income tax on all business enterprises at the entity level. (As described below, in combination with the COCA, the result is a tax on economic rents at the entity level, and on normal returns at the investor level.) This means that partnerships and even sole proprietorships are taxed as separate entities. In this one respect, then, the BEIT is similar to the U.S. Treasury's CBIT proposal.

Second, the BEIT adopts "true" consolidation principles for affiliated business enterprises: that is, affiliated enterprises (regardless of their legal form) are treated as part of one single business enterprise, and the separate tax attributes of consolidated subsidiaries no longer are tracked. Non-practitioners no doubt believe that this is a small point, but current law's treatment of consolidated groups is infinitely more complex than is commonly understood, with the predictable consequences of both tremendous compliance costs and tax avoidance strategies designed to game those complex rules. In fact, of 31 types of transactions that the Internal Revenue Service has listed as "abusive" in recent years, 13 are the direct result of the manipulation of the carryover basis or consolidated return rules, or inconsistencies in the rules applicable to different types of entities — all of which are directly resolved by the non-COCA components of the BEIT. "True" consolidation, when combined with the uniform approach to business enterprises, also provides an appropriate base on which to apply the COCA.

Third, the BEIT repeals all "tax-free" organization and reorganization rules. Instead, all transfers of business assets (or the entry of an entity into a consolidated group) are treated as taxable asset sales (followed, in the case of the entry of an entity into a consolidated group, by the liquidation of the entity). This rule is necessary to coordinate with the true consolidation principles described briefly above (by eliminating entity-level tax attributes

following acquisitions), and further advances the income tax objectives of the BEIT by increasing the number of realization events.

To improve economic efficiency (by reducing any "lock-in" effects that would discourage transfers to the marginal owner), the new business asset/business entity transfer rules impose tax rates on those sales that are designed to be tax neutral — that is, the seller's income tax rate is determined by reference to the present value of the buyer's step-up (or step-down) in asset basis, which in turn is driven by the different depreciation periods for different asset classes. At the business entity level (but *not* at the investor level) the result economically is similar to making every acquisition of business assets or entities a carryover basis transaction, but this approach eliminates "loss duplication" tax avoidance trades, removes a great many administrative problems of tracking basis through former owners, and introduces more realization events at the investor level.

B. The Cost of Capital Allowance and Time Value of Money Returns.

1. Purpose. The Cost of Capital Allowance system is a hybrid. Very generally, the COCA system replaces current tax law's different treatment of debt capital, equity capital and the various species of derivatives with a uniform cost of capital allowance for issuers, and a mandatory income inclusion (measured using similar principles, but not the same base as the deduction afforded issuers) to investors.[33]

The Cost of Capital Allowance system applies only to *financial capital instruments*, which, as noted earlier, is a term this paper uses to signify any form of financial claim against (or measured by) the earnings, assets or liabilities of a business enterprise. The COCA system thus would *not* apply to U.S. Treasury securities, because those instruments are

[33] Some simple examples of the mechanisms described in the text appear in an Appendix.

not financial claims against a business enterprise.[34] This limitation has little practical impact, because governments do not sell equity, or (in general) complex financial derivative contracts, and we know today how to construct an income tax on straightforward debt instruments. By the same token, the term "financial capital instruments" also is intended to exclude ordinary trade receivables and payables of a business enterprise: again, no special tax regime is needed to address these short-term relationships that arise directly from dealings in real assets (or that arise in the settlement process for transfers of financial assets).

Like CBIT, the BEIT treats *all* business enterprises as taxable entities. Unlike CBIT, however, COCA shifts the nominal incidence of tax on time value of money returns on capital — the distinguishing feature of an income tax — to investors, to take advantage of the fact that non-businesses have relatively few tax preferences that might shelter that income from tax. (COCA also has an interesting self-righting mechanism described below that indirectly mitigates the consequences of errors in business enterprise capitalization or depreciation rules.) Finally, COCA tightly coordinates the two levels of tax through the adoption of a quasi-integration regime.[35]

The COCA regime should largely eliminate tax considerations in the capitalization of business enterprises, by providing issuers and investors alike with a uniform set of tax rules for all capital-raising activities, measured only by the amount of capital so raised. As a result, issuers should adopt in an after-tax world the same capital structure that they would propose in a world without taxes.

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[34] I appreciate that, in some ultimate sense, claims against the government can be described as indirect claims against other households and businesses, but that argument is too diffuse, and the connection too attenuated, to have any practical significance.

[35] COCA retains some modest residual double taxation at the investor level, both as a disguised minimum tax on business-level tax preferences and as an acknowledgement of traditional populist "ability to pay" sentiments.

2. Issuers. Under COCA, a business enterprise (other than financial institutions) deducts each year an annual allowance for the financial capital invested in it, measured as a rate equal to a fixed percentage over 1-year Treasuries multiplied by the issuer's total capital. No further deductions are available to the issuer if its actual payments to investors exceed the annual COCA rate.[36]

Since balance sheets in fact balance, the total tax-cognizable capital of a business enterprise (the right-hand side of a tax balance sheet) must equal the left-hand side (the total tax basis of the issuer's assets). 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.

Importantly, the COCA deduction is in addition to, not in place of, asset depreciation. A good income tax requires that tax asset depreciation track economic depreciation, but it is generally acknowledged that this goal is difficult to implement, both for technical and for political reasons. Because the COCA deduction is calculated by reference to aggregate asset basis, the COCA system effectively mitigates distortions attributable to over-fast or over-slow depreciation. Thus (to take the two extremes), an issuer that deducts the cost of an investment forfeits any COCA deduction with respect to the capital so invested, while an issuer that treats that same cost as a non-depreciable capital expenditure receives in return a COCA deduction in respect of that investment in perpetuity. This self-righting mechanism *is not* undone at the investor level, because (as described below) the tax base for investors' income inclusions reflects the actual capital they have invested, not the after-depreciation tax book value of the business entity.

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[36] Similarly, an issuer has no income inclusion if its cash payments are lower than the COCA rate, and will recognize neither income nor loss on the retirement of a financial capital instrument.

3. Investors. The COCA system (at least in its idealized form) requires *all* holders — *including* tax-exempt institutions — to include each year in ordinary income a "Minimum Inclusion," which equals each investor's tax basis in its investments in business enterprises multiplied by the COCA rate for that year. Basis is adjusted for these Minimum Inclusions, and cash distributions no greater than accrued Minimum Inclusions are treated as tax-free distributions that reduce basis.

In addition, an investor must include in income its "Excess Distributions," which basically equal gain on the sale of a financial capital instrument or cash distributions in excess of prior accrued Minimum Inclusions. Excess Distributions are taxed at a low rate (*e.g.*, 10–15%), and are not taxable at all in the hands of tax-exempt institutions.[37] Gains from dealings in other property — that is, property other than business assets (covered by the "tax-neutral" rates described in the preceding section) and financial capital instruments — are taxed at ordinary income rates.

An investor's losses are currently deductible, without regard to current law's capital loss limitation principles (although the straddle rules would continue to apply). The rates at which those losses are deductible vary, because losses are treated essentially as reversing prior income inclusions.[38] (The examples in the Appendix illustrate the principle in more detail.)

In practice, the aggregate of investors' Minimum Inclusions will not equal the sum of issuers' COCA deductions, because market trading in securities is likely to lead to more

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[37] The reasons for imposing any tax at all on Excess Distributions are summarized in note 35, above.

[38] Thus, imagine that ordinary income rates are set at 45 percent, Excess Inclusion rates at 15 percent, and the relevant COCA rate for the year is 6 percent. A taxpayer invests $1,000 in a business enterprise and receives no distributions. At the end of Year 1, the taxpayer includes $60 in income. The taxpayer then sells the investment for $940. The first $60 of loss (in effect, from the adjusted tax basis of $1,060 to $1,000) offsets prior Minimum Inclusions of $60, and is deductible at a 45-percent rate. The next $60 of loss is treated as the mirror of Excess Inclusion income, and therefore one-third of the loss (15/45) is deductible against ordinary income. The taxpayer thus reduces its tax liability by (45% x $60) + (45% x $20), or $36.

realization events at the investor level than at the issuer level. In addition, current law effectively permits business enterprises to deduct the cost of developing many intangibles; these immediate deductions reduce an enterprise's tax basis in its assets, but not the actual capital invested in the enterprise.

4. Derivatives. The COCA system taxes derivatives (which in practice can encompass significant capital-raising components) in a manner directly analogous to that applicable to "physical" securities. For reasons developed in the *BEIT Prospectus*, however, the applicable rules must be modified slightly in the case of losses arising from derivatives. This introduces an unfortunate tax distinction, under which it still is necessary to maintain a limited metaphysical infrastructure to define the difference between a derivative and a physical, but the consequences of drawing the line incorrectly are very much reduced, when compared, for example, to current law's debt/equity distinctions.[39]

5. Special Rules. The COCA system does not directly apply to financial institutions: instead, they are subject to mandatory mark-to-market accounting in respect of both their assets and their liabilities. Other investors can elect mark-to-market accounting for all financial capital instruments that they hold, thereby mitigating the effect of any potential Minimum Inclusions in excess of cash receipts, at the cost of accelerating Excess Distribution tax. A special rule applies for basis recovery from self-amortizing instruments; in all other cases, distributions to holders are presumed to be income. A special small-business rule mitigates the risk of current Minimum Inclusion income to, say, a sole proprietor while her sole proprietorship incurs COCA deductions that yield no current benefits, because of start-up losses. Finally,

[39] In addition, many taxpayers that make extensive use of derivatives, including all financial institutions, are taxed under COCA on a mark-to-market basis.

business-enterprise net operating losses would be grossed up each year by a time value of money factor.

6. Results. The COCA system should largely eliminate the role of tax engineering in shaping a business enterprise's capital structure, because the enterprise's COCA deduction is unaffected by the labels attached to the financial capital instruments that it issues. Capital in turn should be fairly priced, because the system produces largely integrated treatment of the providers and users of capital. The COCA system distinguishes in a logical and consistent manner between ordinary (time value of money) returns (Minimum Inclusions) and extraordinary returns (Excess Distributions). Including a current time value return on all financial instruments reduces the opportunities for indefinite deferral, and its concomitant distortive effects of understating income and locking in investments. Finally, the replacement of today's capital loss limitations with (tax-effected) full utilization of losses eliminates a substantial economic distortion that today limits the attractiveness of risky investments.[40]

C. COCA and Risky Returns.

The Cost of Capital Allowance system abolishes the difference between "capital" and "ordinary" returns, and instead simply taxes *all* distributions and gains in excess of an investor's

[40] COCA has some superficial similarities to the "Allowance for Corporate Equity" ("ACE") proposed by the Institute for Fiscal Studies in 1991, and summarized in Devereux and Freeman, *supra* n. 19, but the two systems have very different agendas. ACE was conceived as an alternative mechanism for implementing a *consumption* tax: corporations would receive a tax deduction equal to a notional cost of equity, calculated in a manner similar to the COCA deduction minus interest expense, and continue to deduct actual interest expense. Distributions to shareholders would in some fashion be exempt from tax; like the drafters of CBIT, however, the proponents of ACE became a bit vague when discussing how preference items would be handled, and capital gains taxed.

Like CBIT, ACE did not advance the taxation of financial derivatives at all. Like COCA, however, ACE deductions for notional capital charges tended to correct for errors in company-level depreciation practices.

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 strike this author as fundamental weaknesses of the proposal.

Unlike both CBIT and COCA, there is at least some modest real-world experience with ACE. *See, e.g.*, Keen and King, "The Croatian Profit Tax: An ACE in Practice," 23 *Fiscal Studies* 401 (2002).

Minimum Inclusions at a specified low rate. COCA, at least as currently envisioned, then goes one step further. Relying on the fact that the mandatory Minimum Inclusion rules mean that investors in fact report substantial ordinary income from their investments every year, COCA permits taxpayers to deduct truly economic losses on a current basis, although those losses would be deductible at tax-effected rates.

As proposed, COCA thus would permit taxpayers to cherry-pick their losses, while deferring unrealized gains that exceed their Minimum Inclusion income. The idea, however, is that the Minimum Inclusion system (which of course compounds, to the extent not paid out currently), together with the abolition of all tax-free organization and reorganization rules, will result in the current recognition of a large enough fraction of total economic income from financial capital instruments that the fisc can absorb the costs associated with residual cherry-picking opportunities.[41]

On a related front, the BEIT also contemplates that a business enterprise's net operating losses would compound each year at a time value of money rate (presumably, 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.[42]

Finally, readers who review the examples in the Appendix will see that COCA seeks to tax financial derivatives by dividing as precisely as possible the returns from such instruments into returns on invested capital (which is not necessarily a trivial asset, even when speaking of derivatives), and pure returns to risk (*i.e.*, bets). Each component is then separately taxed.

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41 If this hypothesis proves too optimistic, then one would reimpose an annual cap on such losses, but presumably that cap could be set at levels that are orders of magnitude higher (*e.g.*, 100 times as high) than the $3,000 per year of capital loss that current law permits an individual to use against ordinary income.

42 The same rule was advocated as part of the Allowance for Corporate Equity proposal. *See* Devereux and Freeman, *supra* n. 19, at 7.

D. COCA and Extraordinary Returns.

By definition, COCA is largely irrelevant to the taxation of extraordinary returns (economic rents); instead, the main responsibility for taxing those outsized returns falls on the existing tax system, as modified by the non-COCA elements of the BEIT.

The basic approach of the BEIT to the taxation of economic rents is to collect that tax at the business enterprise level. The BEIT's treatment of all businesses as separate taxable enterprises, subject to a single set of income tax rules, parallels CBIT in this respect. This approach, along with the other provisions of the BEIT described earlier and not found in CBIT (true consolidation, elimination of tax-free organization and reorganization rules) creates a uniform tax environment for all business endeavors, increases the number of realization events, and significantly reduces the prospects for tax mischief. The special issue of cross-border transfer pricing (a matter of great importance to the proper taxation of extraordinary returns0 is considered immediately below.

E. International Application of the BEIT.

1. Foreign Direct Investment. Our current system for taxing foreign direct investment by U.S. business enterprises is both schizophrenic and in disarray. A U.S. enterprise's ultimate protection from double taxation is the foreign tax credit, but the interest expense allocation rules, the foreign tax credit basket rules, and the overall foreign tax credit limitation itself all serve to restrict the credit's utility.[43]

At the same time, our subpart F "anti-deferral" rules (or "income acceleration" rules, depending on your political perspective) are both enormously complex and in a state of complete collapse, due in part to the system's inability to cope effectively with various "hybrid"

[43] It must be acknowledged, however, that Congress's 2004 amendments to the foreign tax credit rules very substantially help matters.

entities — entities that are taxed as fiscal transparencies in one jurisdiction and separate taxpayers in another. Deferral also vastly elevates the importance of cross-border transfer pricing issues,[44] and with that the compliance task facing the Internal Revenue Service.

U.S. corporate taxpayers obviously are very fond of deferral, but we should consider for a moment why that is so. My intuition (based simply on years of practice in the area, not surveys) is that the *cash* tax savings that result are nice, but do not explain the corporate fervor for deferral. Instead, the primary driver seems to be *financial* accounting principles. Financial accountants permit the lower tax rates imposed on "permanently reinvested" foreign earnings that are eligible for deferral (*i.e.*, are not taxed currently in the United States under subpart F) to be reflected in a company's financial statement tax provision, thereby lowering its "effective" tax rate — even though those earnings ultimately will be subject to incremental U.S. tax if and when distributed to the U.S. parent, and then to holders of its financial capital instruments. By comparison, the cash savings attributable to deferral are a second-order benefit.

Another important (although, again, second-order) benefit of deferral is that it facilitates foreign tax credit planning. I refer to this as the "Master Blender" phenomenon, in which the corporate tax director functions like the distiller of a complex tax whiskey, rectifying foreign tax credit problems by artfully blending reserve stocks of high-taxed and low-taxed deferred foreign earnings to produce a perfect 35 percent tax-rate blend of includible foreign income.

The BEIT's response to the current sorry state of affairs with respect to the U.S. taxation of foreign direct investment is to posit that, if (i) the financial accounting rules were different (so as to remove the primary driver for deferral), (ii) basic U.S. business entity tax rates

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[44] *See, e.g.*, *Bausch & Lomb v. Commissioner*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2nd Cir. 1991).

were reasonably low, and (iii) the U.S. foreign tax credit rules were less onerous, the deferral debate would largely wither. As a result, the BEIT proposal for foreign direct investment comprises (i) the full inclusion of foreign subsidiaries' income and loss (via the BEIT's super-consolidation rules) and (ii) the repeal of the rules allocating U.S. interest expense (now, COCA deductions) in calculating the foreign tax credit.

The result would be a vastly simpler system, and one in which transfer pricing issues recede greatly in importance, because artificially low intragroup transfer prices from the United States to a foreign affiliate would not reduce current U.S. tax liability.[45] This last point in turn should lead to a much more accurate inclusion of extraordinary returns (economic rents) in the tax base. The resulting system also would be consistent with international norms that grant priority to the source country in taxing income from foreign direct investments (through the U.S. foreign tax credit mechanism).

The repeal of any allocation of U.S. interest expense (now, COCA deductions) against foreign-source income reflects two facts. First, the immediate inclusion of a consolidated group's worldwide income means that the United States will collect currently its residual tax on all capital invested by the business enterprise. Second, the COCA system is an investor-issuer integration methodology at least as much as it is an interest expense substitute. For all the reasons suggested earlier, the relationships between financial capital instrument holders and business enterprises are too complex and too attenuated to treat the COCA deduction as simply an expense to be borne, in effect, by a subset of those investors (equity holders). Another way of expressing this thought is that, if a corporation were all-equity funded, and we achieved

[45] Transfer pricing would still be relevant in respect of the allocation of a multinational group's tax liabilities between its country of residence and the tax source countries in which it operated, but from the multinational enterprise's perspective this issue is much less exciting than is the prospect of indefinite reductions in the group's effective tax liabilities to the rates prevalent in some source countries.

integration by exempting shareholder dividends from tax, would anyone argue today (as the proponents of CBIT did in 1992) that we should impose an incremental compensatory tax to undercut the utility of the foreign tax credit?[46]

2. U.S. Portfolio Investors. The BEIT contemplates that the COCA system would apply to investments by U.S. persons in financial capital instruments issued by unaffiliated foreign business enterprises in exactly the same way that the regime applies to investments in domestic enterprises. Neutrality principles require this result, as do common sense and political realities.[47]

3. Foreign Portfolio Investors. The COCA system is premised on the idea that tax on time value of money returns should be collected from holders of financial capital instruments, not from business enterprises. It follows ineluctably from this fundamental design decision that foreign portfolio investors in U.S. business enterprises should be taxed currently on their Minimum Inclusion income.

This conclusion in turn creates an unavoidable practical conflict between the COCA system (which can tax income before distributions) and the withholding tax collection mechanisms by which we impose U.S. income tax on foreign portfolio investors, because those mechanisms require cash distributions to operate. This is one place where CBIT has the practical advantage over COCA.

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[46] CBIT's designers apparently believed that a compensatory tax was appropriate in this case because the Internal Revenue Code as then drafted (and, indeed, today) did not grant an indirect foreign tax credit to individuals. The Code *does*, however, grant the indirect credit to our principal vehicle for conducting business (the corporation). Since the whole purpose of CBIT and other integration proposals is to treat individual stakeholders as if they directly earned their share of business enterprise income, it is far more logical to assume in designing an integrated tax system that a tax credit that has always been available to prevent the double taxation of business income should remain available when that business income is taxed only once, rather than twice. Otherwise, one simply substitutes one form of distortive double taxation for another.

[47] Obviously, the BEIT as implemented will require some tweaking of the foreign tax credit rules to match foreign withholding tax credits with prior Minimum Inclusions.

The problem can be solved through a combination of "catch-up" withholding tax (with interest charges) on subsequent distributions and more extensive broker reporting *and withholding* on sales proceeds, although admittedly this solution will impose non-trivial administrative costs on the broker community. Over the longer term, bilateral tax treaties with countries where we are confident that investors' income in fact is taxed locally presumably will provide relief for foreign investors both from the withholding tax mechanism and from double taxation — just as those treaties do today. Because current law excepts "portfolio interest" income of foreign investors from U.S. tax without regard to treaty residence, while the BEIT/COCA system does not, it will be important in the era of BEIT for the United States to update and broaden the scope of its treaty network as quickly as possible.

The BEIT is not relevant for non-business enterprise issuers. The BEIT therefore contemplates that the U.S. Treasury, in particular, will continue to pay interest on its debt obligations held by foreign investors free of withholding tax, in reliance on current law's portfolio interest rules.

VI. MEASURING THE EFFECTIVENESS OF THE BEIT.

A. Neutrality of Results.

1. In General. The BEIT satisfies the condition of neutrality, except as to the absolute scale of economic activity. First, the BEIT taxes all business operations in an identical manner (by taxing enterprises, regardless of legal form, consistently). Second, it renders tax objectives irrelevant to the choice of an issuer's capital structure: whatever structure is most efficient in a world without taxes is also the ideal capital structure in the BEIT universe, because the issuer's Cost of Capital Allowance is determined only by reference to the amount of capital it employs, not the names attached to the securities it issues. Similarly, investors' tax

liabilities are driven by the amount of capital they invest and the cash returns they earn, not the label of the instruments they hold.

Third, the BEIT (unlike CBIT) is neutral in the sense that it takes a broad view of what constitutes an issuer's capital structure, by including all financial derivatives in its system, and conforming the rules for derivatives to those applicable to more traditional financial capital instruments. Fourth, the BEIT is largely "self-righting" for overly fast or slow tax depreciation of specific assets, by virtue of the interaction between a business enterprise's COCA deduction and its unrecovered adjusted tax basis.

The COCA system admittedly veers from strict neutrality in one respect, which is the tax it proposes on Excess Distributions. As previously described, that tax is not required by logic. Instead, the Excess Distribution tax is conceived as a rough and ready compensatory tax for any residual tax preferences at the business enterprise level, and a nod to the general worldview that those who are extraordinarily lucky[48] should contribute some of their good fortune back to the community.

COCA can also be argued to fail neutrality principles in one other respect, which is that investors' aggregate time value of money inclusions each year (their Minimum Inclusions) are likely to exceed issuers' aggregate COCA deductions. This phenomenon is largely attributable to the fact that business enterprises today are permitted to deduct currently expenditures that in fact give rise to long-lived intangible assets, which are reflected in enterprise value, but not the enterprise's tax balance sheet. This enterprise value in turn typically is reflected more promptly in investor tax balance sheets than it is at the issuer level, because the rate of turnover of holders of financial capital instruments exceeds the rate at which whole enterprises are bought and sold.

[48] The author has worked over the years with a great many men and women who have been extraordinarily fortunate in the world of commerce. What is fascinating is that, almost without exception, they describe themselves as very smart, or very industrious — but never very lucky.

In fact, the COCA system restores balance to the income tax, by effectively measuring time value of money *income* inclusions by reference to enterprise value. The realities of the realization principle and the practical difficulties of distinguishing true expenses from investments in intangible assets cause the enterprise-level deduction to lag behind. By the same token, however, enterprises enjoy both the current deduction of those expenses that arguably should be capitalized, and the deferral of economic gains that economically are reflected in secondary market trading prices for that enterprise's financial capital instruments.

2. Comparison to CBIT. The Cost of Capital Allowance system reaches time value of money returns directly, by making the centerpiece of the system the current taxation to holders of Minimum Inclusions (which are defined as time value returns on investment), and by providing a time-value deduction to business enterprises (the COCA deduction). There is one significant *disadvantage* to the COCA approach, when compared to CBIT, which is that COCA forces one to address directly the role of tax-exempt institutions in the capital markets, while CBIT hides the issue in the tax imposed on business enterprises.[49]

Against that, COCA has significant practical advantages over CBIT, including mitigating the distortions that result from tax preferences, in two important respects. First, most explicit tax preferences relate to business income. By putting time value of money income inclusions into the hands of investors, rather than business enterprises, COCA raises substantially the probability that the income in fact will be taxed (assuming, of course, that the holder is treated as a taxpayer in the first place).

[49] This author at least believes that, if CBIT ever were seriously proposed as legislation, tax-exempt institutions could be expected to stumble onto CBIT's indirect tax on their income, with all the same political repercussions of proposing a direct tax on their time value of money returns.

Second, and as described earlier, COCA has a very helpful self-righting mechanism at the business enterprise level; the interaction between the COCA deduction, on the one hand, and depreciation deductions, on the other, means that we can have an effective *incom*e tax even if our tax depreciation rules are flawed.

The realization principle bedevils any practical income tax system. COCA — and, more generally, the entire Business Enterprise Income Tax — attempts to address that problem wherever feasible. To that end, taxing time value of money returns at the investor level, rather than the issuer level (as CBIT would do), enhances the accuracy of those inclusions, because of the greater rate of turnover of financial assets compared to real assets, and the expectation that in the COCA system, some taxpayers at least will take advantage of the elective mark-to-market accounting system.

B. Susceptibility to Abuses.

Parents are not ideally situated to expound on their children's flaws, but notwithstanding this truism, I believe that COCA will be very difficult to game. The reason for this assertion is that COCA has been designed to adopt what this paper earlier termed a featureless topography – a tax landscape with almost no distinctive landmarks (and with them, special rules that taxpayers may wish either to embrace or avoid). Thus, under COCA, the legal form of a business enterprise, or an investment in that enterprise, has no effect on anyone's tax liability, and that principle extends to any transaction in which capital is placed in the service of a business enterprise, or risked in a side bet on the returns of that enterprise.

In addition, COCA (like CBIT) essentially forecloses all forms of traditional tax shelters, because business income is taxed exclusively at the business enterprise level. As a result, "business" losses from classic tax shelter activities (whether real estate, lithographic plates,

almond groves or high-tech windmills) cannot be passed through to individual investors in those activities for use in sheltering compensation or unrelated investment income.

One exception to the assertion that COCA envisions a featureless tax topography is that, under COCA, losses from derivatives are treated somewhat differently from losses that an issuer might recognize in respect of its "physical" liabilities (e.g., debt it has issued). If, however, one believes that a derivative ordinarily is a fair bet (once the time value component of its returns has been extracted and dealt with separately), it is difficult to see how this perturbation in the tax landscape could spawn a tax shelter industry.

It is also the case that COCA offers taxpayers the opportunity to "cherry-pick" losses, by removing current law's capital loss limitations, on the theory that they no longer are necessary in a world where normal returns are invariably recognized on a current basis. This proposal is not, however, strictly necessary: if experience warranted it, one could limit the absolute amount of losses deductible in a year.

More to the point, COCA will put additional pressure on policing "wash sales" – transactions in which a taxpayer purports to sell an investment to claim a loss, but in some fashion retains or reacquires an economic interest in the investment that purportedly was sold (as by selling an investment at a loss, and immediately repurchasing it at its current fair market value). Taxpayers under COCA will have two reasons to seek out wash sales: first, to obtain deductible losses, and second, to reduce future Minimum Inclusion income (by reducing the tax basis of the investment to its lower fair market value). We have anti-wash sale rules in place today,[50] but in light of the central importance they would assume under COCA, those rules certainly would require some significant refurbishing.

[50] The wash sale rules of section 1091 and the wash sale principles of the tax straddle regulations, Treas. Reg. Sec 1.1092(b)-1T.

C. Fairness.

A tax system might be resistant to abuse, but completely undesirable because it is unfair. For example, a carefully controlled tax lottery, in which tax liabilities were allocated by lot, would be (if one can forgive the pun) difficult to game, but palpably unfair. I suspect that COCA can more legitimately be criticized for the unfairness of some outcomes than for the widespread abuses it will invite.

One obvious unfair result would be the small business owner who discovers that he has Minimum Inclusion income, while his struggling start-up proprietorship incurs net operating losses. COCA already anticipates this fact pattern through a special rule that would permit a small business owner to offset his Minimum Inclusion income against his enterprise's losses, but it is easy to imagine sympathetic cases arising just on the wrong side of the line, wherever it might be drawn.

More generally, investors in a company that has suffered major business reverses will feel aggrieved, as they will continue to accrue Minimum Inclusion income based on the cost of their original investments, at a time when the recovery of those investments to those earlier levels will be highly speculative. Reminding such taxpayers that they can elect mark-to-market accounting for all, but not less than all, their marketable securities will be perceived as coercive. Moreover, a rule that shuts off Minimum Inclusion accruals when a business enterprise enters bankruptcy reorganization (which is the rule that currently is contemplated) will be perceived as pushing struggling companies into bankruptcy, if only to relieve their investors from unrealistic continuing Minimum Inclusion amounts.

All these observations are legitimate. One conceivably could try to draft special mitigating rules to address these sorts of fact patterns, but that impulse would reintroduce many of the abuse problems that COCA's featureless tax typography was designed to eliminate. In the

end, I would argue simply that these imperfect results are not sufficient to lead to the conclusion that COCA is not a good income tax system. Investing in a business enterprise is not like rooting for a favorite baseball team in lean years as well as fat ones: the decision to remain invested in a particular company is itself an investment decision, and so long as COCA permits the generous utilization of losses, any unfairness to an investor with unrealized losses is more a matter of perception that economic realty.

The BEIT/COCA regime also can be seen as unfair to certain industries, particularly the real estate industry, which today is accustomed both to relying on very high leverage for projects and to passing through to individual investors the tax losses that result from high interest and depreciation expenses to shelter their compensation or unrelated investment income. There is no pleasing answer to this complaint: it is easy to imagine that real estate development will become less attractive under BEIT/COCA than it is under current law. The ultimate question, though, is whether the new order can properly be described as unfair, or whether instead real estate today can be said to enjoy unfair tax subsidies. If, as many believe to be the case, the answer is the latter, then the introduction of BEIT/COCA can be viewed as enhancing, rather than decreasing, the overall fairness of the tax system

D. Administrative Burdens.

COCA unquestionably will add significantly to the administrative burdens that the tax system imposes on investors, because investors will be required to keep track of their accrued Minimum Inclusions, and to apply distributions correctly against prior accruals. As a practical matter, however, these recordkeeping obligations (which are not conceptually difficult, but which admittedly will be tedious) in most cases can be performed for investors by brokers, mutual funds and other market professionals. That does not mean that these services will be

free: there will be incremental costs that presumably will be reflected in increased custodial or management fees. Nonetheless, the cost *per investor* should be reasonably low, because brokers and other professionals will be able to build systems to capture and record the relevant data for their many thousands of customers.[51]

The brokerage industry also would be expected to carry an important responsibility in respect of withholding on proceeds (*e.g.*, from sales of securities paid to foreign investors), as the means of collecting tax on such investors' Minimum Inclusion income. This again will translate into higher custodial/management fees, with some resulting loss of liquidity.

E. International Considerations.

Although COCA will create administrative headaches for the broker community in extending withholding tax mechanisms to collect tax on foreign portfolio investors in U.S. financial capital instruments, COCA nonetheless has important advantages over CBIT as the basis for implementing an international income tax agenda.

First, COCA preserves the U.S. Treasury's ability to negotiate tax treaties with other countries, by imposing an investor-level tax on business income that can be reduced or waived in return for concessions from our treaty partners — just as is the case today. CBIT, by contrast, effectively would neuter Treasury's ability to negotiate treaties, unless one were to contemplate a world in which the U.S. Treasury wrote refund checks to foreign investors for underlying business taxes paid by a U.S. issuer — a system that some European countries have

[51] The securities industry today has widely divergent practices in assisting investors to track the tax bases of their investments. Some of the practical problems that the industry faces include having no way to validate a customer's starting basis when an account first is established, difficulty in sharing information between brokers using different technology platforms when an account is transferred, and difficulty in ascertaining how to treat various financial instruments and transactions, when the attendant tax disclosure indicates that the tax analysis under current law is itself ambiguous. A combination of mandatory basis reporting (as we have today for dividends and interest) and BEIT/COCA's simplified substantive rules for taxing financial capital instruments and business combinations should, however, make it feasible for individual investors to prepare accurate income tax returns in the COCA environment.

discovered is susceptible to tremendous tax gaming problems, as multiple "owners" claim refunds in respect of the same security. COCA thus comports more comfortably with current international norms, with regard both to the nominal incidence of tax and to the standard processes for reducing double taxation.

Second, at least as originally proposed by the U.S. Treasury, CBIT would have put investors in U.S. multinational enterprises in a worse position than those investors face under current law, because the CBIT proposal contemplated treating income from foreign operations that had borne foreign income tax as "preference income" in the hands of the U.S. parent. As a result, investors would face materially higher tax on dividend or interest income from a U.S. issuer that ultimately was financed out of foreign earnings (either via a company-level compensatory tax or direct incremental tax on that dividend or interest income) than those investors do today. At a minimum, such a system would reinforce current law's bias in favor of funding distributions through further U.S. borrowings, and continued retention of foreign earnings offshore.

VII. TRANSITION ISSUES.

Transition issues are extremely important in any fundamental tax reform proposal, because that new tax system not only will create winners and losers going forward, but also will have direct effects on existing stores of wealth. Indeed, one of the principal sources of the potential revenue attributable to a switch to a consumption tax is the double taxation of existing wealth (once under the income tax system as it was earned and again under the consumption tax system as that wealth is spent). Economists call this double tax "efficient," by which they mean it is unavoidable and easily collected: existing holders of financial assets can be expected to use other adjectives, of which "larcenous" is no doubt the most polite.

An *income* tax reform proposal obviously poses fewer transition issues than does a proposal to switch to a consumption tax, but that does not mean that the issues are trivial. An overnight switch to COCA, for example, could literally bankrupt highly leveraged companies. For this reason, the BEIT proposal contemplates different transition rules for its non-COCA components (uniform entity-level tax, true consolidation principles, and revised business asset/business enterprise acquisition regime), on the one hand, and COCA, on the other.

The BEIT'S non-COCA rules just cannot be made to work (at least by me) under a phase-in model, and therefore will simply have to apply *in toto* as of a specified date. Since in many respects the rules are simplifications and rationalizations of current law, immediate application of those rules to existing operations should not cause irreparable harm to taxpayers. The obvious exception to this assertion is the extension of entity-level taxation to business enterprises that today are taxed as fiscal transparencies; this issue is considered in the next paragraph.

COCA, 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 investor side is more debatable, but probably should simply be adopted *in toto* as of a specified date near the end of the business enterprise phase-in period. To avoid excessive dislocations to entities that today are fiscally transparent, taxpayers should be permitted to elect to move entirely into the COCA regime as early as they wish.

These brief suggestions are not meant to be comprehensive. Obviously, if the BEIT/COCA regime is thought to be attractive, a great deal of work on transition issues will be required: that work is more enthusiastically undertaken, however, once one has some sense that this is a system that at least some people would like to transition to. Fortunately, because the

BEIT/COCA system remains fundamentally an *income* tax system, the most difficult transition issues that consumption taxes pose (the taxation of existing wealth) are removed from the table.

In comparing transition issues under BEIT/COCA and CBIT, COCA would preserve investor-level income, and therefore should create more modest price dislocations for current holders of corporate stock or bonds than would CBIT (which would turn all existing corporate securities into tax-exempt securities). COCA also does *not* crowd out municipal bond issuers; by contrast, in a CBIT regime, state and local governments would be required to pay materially higher interest rates, because of the huge increase in tax-exempt securities competing for investor dollars.

VIII. CONCLUSIONS.

This paper has attempted to identify the design criteria for a good income tax: that is, one that taxes time value of money returns once and only once, and that otherwise is neutral, influencing neither the form of business organization nor the mix of financial capital instruments issued to finance that business. The paper identified CBIT and the BEIT as the two paradigms of practical approaches to this issue. The first approach seeks to shift the taxation of time value of money returns to the business enterprise, and the second (more consistently with current law) taxes time value of money returns at the investor level, and economic rents at the business enterprise level. Finally, the paper has attempted to demonstrate why the BEIT/COCA system is the superior practical approach, and has summarized how that approach could be implemented.

COCA moves the taxation of capital substantially closer to theoretical income tax norms in three critical respects. First, it treats all financial instruments consistently. Second, by requiring an investor to include "Minimum Inclusions" in income every year, regardless of cash distributions, COCA reduces the importance of the realization requirement in the taxation of financial instruments. Third, relying on those Minimum Inclusions to reduce cherry-picking

potential, COCA removes current law's capital loss limitation, and replaces it with full deductibility of economic losses (at appropriately tax-effected rates). By introducing this symmetry in the taxation of losses and gains, COCA contributes to the fair pricing of (and willingness to assume) risk.

COCA – Example

Opening of Year 1 Tax
Balance Sheet

Assets		**Liabilities and Equity**	
Cash	100	Short-term liabilities	100
Portfolio Investment	200	Long-term debt	200
Greasy Machinery	500	Funky contingent payment securities	200
Land	200		
	1,000	Preferred stock	100
		Common stock	400
			1,000

Assumptions

- COCA Rate = 5%
- No cash return on portfolio investment
- Operating business earns $130 EBITDA
- Cash payments to holders of all liabilities and equity = $46
- Tax depreciation on machinery = $50
- For simplicity, COCA calculations done once annually, using opening balance sheet

COCA – Example (cont'd)

- Year 1 Results
  - Income

Net income from operations	130	
Deemed returns on portfolio investment	10	
Total Gross Income		140

  - Deductions

COCA deduction	50
Depreciation	50
Total deductions	100
Taxable income	40
Tax @ 35%	14

  - Cash Flow

Net income from operations	130	
Less cash coupons on liabilities and equity		(46)
Less taxes		(14)
Net Cash Flow		70

Opening of Year 2 Tax Balance Sheet

Assets		**Liabilities and Equity**	
Cash	170	Short-term liabilities	100
Portfolio Investment	210	Long-term debt	200
Greasy Machinery	450	Funky contingent payment securities	200
Land	200	Preferred stock	100
	1,030	Common stock	430
			1,030

Notes
- Year 2 COCA = $51.50
- Issuer does not need to accrete any amount to liabilities for prior year's COCA expense, because no gain or loss on retirement of any liability or equity.

COCA – Holder Example

(Assume constant 5% COCA rate)

- Holder invests $1,000 in a security.
- First 3 years, no cash coupons, but Minimum Inclusion = $158.
  - Basis therefore = $1,158
- End of Year 3, cash distribution of $500.
  - $158 = tax-free return of accrued but unpaid Minimum Inclusions (Basis => $1,000)
  - $342 = Excess Distribution (taxable at reduced rates)
- Hold another 2 years, no cash coupons, but Minimum Inclusion = $103
  - Basis therefore = $1,103
- a) Sell for $1,303: $200 Excess Distribution.
  b) Sell for $1,000: ($103) loss, deductible at Excess Distribution rates.
  c) Sell for $403: ($700) total loss.
    – $342 at Excess Distribution rates
    – $261 at Minimum Inclusion rates
    – Remaining $97 at Excess Distribution rates

- First Priority: Tax hedge accounting principles.
  - Based on current law (e.g. Reg §1.1275-6).
  - Presumption that financial derivatives of a business enterprise that is a non-dealer/non-professional trader are balance sheet hedges, and as a result gain/loss is ignored (i.e., subsumed into general COCA regime, where cash coupons on financial capital instruments are ignored).
  - Taxpayer may affirmatively elect out.
- Second Priority: Mark-to-market.
  - Generally, mandatory regime for dealers/professional traders.
  - Dealers/traders may elect tax hedge accounting treatment for their liability hedges.
- Third Priority: Asset/Liability Model.
  - Treat all upfront, periodic and interim payments as (nondeductible) investments in the contract.
  - Apply COCA Minimum Inclusion/Deduction rules to resulting net 'Derivative Asset' or to increase in asset basis corresponding to 'Derivative Liability.'
  - Amount, and direction, of Derivative Asset/Liability fluctuates from year to year, with no consequence other than Minimum Inclusions on any net investment (and COCA deductions on assets).
  - At maturity/termination, 'settle up' by recognizing gain/loss.
  - Maturity/termination gain taxed at Excess Distribution rates.
  - Maturity/termination loss taxed identically to general COCA regime for holders (i.e., first deductible at Minimum Inclusion rates to extent of prior Minimum Inclusions, then Excess Distribution rates).
  - Result is identical to general COCA rules for gain, or for loss on Derivative Assets, but different for Derivative Liabilities (because gain/loss recognized).
  - Consequence is that a bright line test is still required to distinguish derivatives from financial capital investments.

COCA – Derivatives Example

(Assume COCA rate = 5%)

- X pays $50 to Y for 3-year option on S&P 500.
- X has Minimum Inclusions over 3-year life = $8 (rounded).
  - So X's basis at maturity = $58.
  - Y receives COCA deductions on cash proceeds – i.e., on assets, not directly on Derivative Liability.
- At maturity, contract pays either:
  - $88 – X recognizes $30 in Excess Distribution gain; Y recognizes $38 (not $30) in loss deductible at Excess Distribution rates.
  - $0 – X recognizes $8 loss deductible at Minimum Inclusion rates, $50 loss deductible at Excess Distribution rates; Y recognizes $50 gain
    (not $58), taxable at Excess Distribution rates.