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COLLOQUIUM ON TAX POLICY
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"The Sorry State of Capital Income Taxation"

Edward D. Kleinbard
USC Gould School of Law

March 6, 2012 (Tuesday)
NYU School of Law
Vanderbilt Hall-208
Time: 4:00-5:50pm
Number 7

SCHEDULE FOR 2012 NYU TAX POLICY COLLOQUIUM

(All sessions meet on Tuesdays from 4:00-5:50p.m. in Vanderbilt Hall-208, NYU Law School)

1. January 17 – Michelle Hanlon, MIT, Sloan School of Management. "Taking the Long Way Home: Offshore Investments in U.S. Equity and Debt Markets and U.S. Tax Evasion." (with Edward L. Maydew and Jacob R. Thornock).

2. January 24 – Amy Monahan, University of Minnesota Law School. "Will Employers Undermine Health Care Reform by Dumping Sick Employees?" (with Daniel Schwarcz).

3. January 31 – Alex Raskolnikov, Columbia Law School. "Accepting the Limits of Tax Law and Economics."

4. February 7 – Victor Fleischer, University of Colorado Law School. "Tax and the Boundaries of the Firm."

5. February 14 – Heather Field, Hastings College of Law. "Binding Choices: Tax Elections & Federal/State Conformity."

6. February 28 – Daniel Shaviro, New York University School of Law. "The Financial Transactions Tax Versus (?) the Financial Activities."

7. **March 6 – Edward Kleinbard, USC Gould School of Law. "The Sorry State of Capital Income Taxation."**

8. March 20 – Susan Morse, Hastings College of Law. "Worldwide Corporate Income Tax Consolidation and a Corporate Offshore Excise Tax."

9. March 27 – Stephen Shay, Harvard Law School. "Unpacking Territorial."

10. April 3 – Jon Bakija, Williams College Economics Department. "Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Date."

11. April 10 – Lane Kenworthy, University of Arizona Sociology Department. "Getting taxes right: What can we learn from the comparative evidence?"

12. April 17 – Yair Listokin, Yale Law School. "'I Like to Pay Taxes': Lessons of Philanthropy for Tax and Spending Policy." (with David Schizer).

13. April 24 – William Gale, Brookings Institution. "Fiscal Therapy."

14. May 1 – Rosanne Altshuler, Rutgers Economics Department, and Harry Grubert, U.S. Treasury Department. "A New View on International Tax Reform."

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The Sorry State of Capital Income Taxation

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Preliminary and incomplete draft – not for quotation or attribution.
Comments are welcomed.

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THE SORRY STATE OF CAPITAL INCOME TAXATION

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I. INTRODUCTION.

A. Overview.

This paper considers the sorry state of capital income taxation today, and why matters will get worse tomorrow. It does so as background for a larger project that calls for the fundamental revision (but not abandonment) of capital income taxation. This paper tries simply to demonstrate that the larger project's proposed reimplementation of capital income taxation addresses the particular problems identified here.

In thinking about the taxation of capital income, there are only a handful of important questions. Each in effect is a gating issue for the next:

- Why tax capital income at all?
- How can we accurately measure capital income?
- At what rate(s) should capital income be taxed?
- Assuming that capital and labor incomes are taxed at different rates, how do we distinguish the two?

This paper focuses primarily on the second of these points. It assumes the proverbial can opener – more particularly, the existence of capital income taxation. This of course is a controversial assumption, and is adopted here only for the sake of keeping this paper a manageable size. In fact, there are some plausible economic efficiency arguments for retaining a

tax on capital income, and powerful political economy reasons to do so, but they are developed elsewhere.[1]

The paper further assumes that capital income should be taxed consistently – that is, that capital income of the same species, however defined (e.g., normal returns, on the one hand, or economic rents, on the other) should be taxed at the same rate, regardless of the legal form in which that income is earned. This second assumption should less controversial.

B. The Larger Project.

The larger project of which this paper is a part concludes that a practical tax system should continue to tax capital income, but should do so at lower rates than those imposed on labor income. In other words, the "ideal" income tax, which ordinarily is understood to mean a system under which all income, from whatever source derived, is taxed under a single progressive rate schedule, is not ideal at all.

In particular, the project concludes that capital income generally should be taxed at one flat rate (ignoring some special cases) that is lower than the labor tax rates imposed on the highest labor incomes. This means that the project recommends a "dual income tax" for the

[1] The economic efficiency case is offered in James Banks and Peter Diamond, *The Base for Taxation*, in *Dimensions of Tax Design: The Mirrlees Review*, ch. 6 (2010); their conclusions are summarized at p. 634. A shorter presentation of the arguments is in James Mirrlees et al., *Tax By Design: The Mirrlees Review*, at 307 – 317 (concluding, however, that the efficiency arguments for taxing returns to household savings are not convincing).

A few of the political economy arguments are mentioned in Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010) at 45-48. Among those arguments are transition concerns, immediate revenue concerns and the risk of "tax holidays," along the lines of the repatriation holiday of section 965, adopted in 2004.

A related political economy point that the paper considers later is the level at which capital income tax is imposed (as between the firm and its investors). In closed economies, the only differences between the two levels at which tax might be imposed would be ones of administrative convenience. In open economies, by contrast, the capital of firms is generally much more mobile than is capital held by individual investors; the result is a strong preference in tax system design for moving capital income taxation from the firm level to the level of investors. (OECD Norway Survey; Altshuler et al on Progressive Tax and Capital Income; Griffith Hines and Sorensen chapter in Dimensions of Tax Design).

enactment of section 965 in 2004.

United States. Dual income tax systems are income taxes that explicitly reject the ideal of a single rate of tax on all income from whatever source derived, and instead impose different rates on capital income, on the one hand, and all other income (principally, labor income), on the other. Typically, a dual income tax adopts a relatively low flat rate of tax on capital income, and progressive rates on labor income, where the highest labor income rate is materially greater than the flat capital income rate, but other rate structures are possible.

A dual income tax in turn introduces a new imperative into the tax system, which is a reliable device to tease apart labor from capital income in those cases where the two are intermingled – most classically, in the case of a small business where an owner is also an active participant in the management of the business. I call these technologies "labor-capital income centrifuges."

As described in detail in a previous paper, dual income taxes have been implemented in a number of countries, most notably Norway.[2] These systems in fact developed labor-capital income centrifuges; their (partial) success is described in that earlier paper.

Dual income tax systems point towards one answer to the question of tax rates, and further resolve a specific element in defining the capital income tax base, which is the separation of capital income from the labor-capital matrix in which it often is found in nature. But dual income tax systems do not assure that capital income is measured accurately. That is, other than in the one area of segregating capital from labor income, dual income tax systems by themselves do not define the capital income base.

Measuring capital income – defining the base – is famously difficult in theory, and nearly impossible in contemporary practice. To do so requires overcoming at least four fundamental hurdles: the realization doctrine (under which the timing of capital income taxation is essentially optional on the part of the taxpayer), the debt-equity distinction (under which completely

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[2] Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010).

Very recently, the Organization of Economic Cooperation and Development reviewed Norway's dual income tax system. OECD, *OECD Economic Surveys: Norway 2012* (Feb. 2012) (hereinafter, *OECD 2012 Norway Survey*). That monograph summarizes succinctly the economic case for dual income taxation at 70-74.

different income measurement tools apply to financial instruments that might be economically similar, but that give rise to different formal legal rights and obligations), the (non)coordination of firm and investor-level measures of the same real incomes, and our arbitrary depreciation and expense capitalization rules. The last hurdle goes to the heart of whether net business income, as reflected for example on corporate income tax returns, is accurately measured.

Because capital income taxation long ago fell out of academic favor, very little work has been done in recent decades in rethinking how we might better define the capital income tax base. Moreover, some of the leading capital income tax reform ideas that have been proposed, such as the "Comprehensive Business Income Tax" (CBIT), proposed by the U.S. Treasury Department in 1992, assume away the problem, by assuming that the tax base (e.g., corporate net income) is accurately measured, and presenting the issue as one of coordination between firms and investors only.

It is possible to do better. That is the purpose of the "Business Enterprise Income Tax" (BEIT). The BEIT is a novel proposal for measuring capital income much more accurately than has been true in the past, but has only a handful of new components, built on top of existing income tax concepts.

First, all business enterprises (other than the very smallest) are taxed as entities.

Second, firm-level interest deductions are disallowed, and replaced by a new "Cost of Capital Allowance" (COCA). The annual COCA rate is set by statute at a fixed or formula rate that varies with 1-year Treasury rates. A firm's annual COCA deduction is simply its adjusted basis in its assets multiplied by the COCA rate. Thus, the COCA deduction is available regardless of whether a firm's real assets are financed with debt or equity.

Third, investors include in income annually an amount equal to the same COCA rate multiplied by *their* adjusted tax basis in their investments (the "Includible Amount") (in earlier presentations, the "Minimum Inclusion"). Includible Amounts function much like original issue discount: the investor's tax basis goes up by the amount of her Includible Amount, and down in respect of cash received on her investment (e.g., dividends or interest). Cash returns thus are relevant only insofar as they affect an investor's remaining tax basis in her investment.

In more formal terms, the BEIT is designed to tax economic rents and risky returns from business enterprises at the firm level, and "normal" returns to capital at the investor level. This means that all the components of capital income are taxed once, and only once.

Another way of describing matters is that the BEIT at the firm level is a consumption tax. The BEIT operates as a consumption tax because the COCA return on unrecovered basis has the same present value as a deduction for capital investment (assuming the COCA rate is set properly). The COCA mechanism has a number of practical advantages over current expensing, however.

More particularly, the BEIT can be explained at the firm level as a superior implementation of an "Allowance for Corporate Equity" (ACE) system of the sort actually adopted by some European countries, because unlike ACE systems the BEIT offers the same deduction (the COCA) regardless of whether real assets are financed with debt or equity. The BEIT thus removes the temptation to issue equity-flavored debt instruments, which still remains in ACE systems where the "interest" rate on the hybrid instrument exceeds the ACE allowance.

To this firm-level consumption tax the BEIT adds an investor level tax on normal returns, thereby restoring the combination of the two to an income tax on capital (which by definition burdens normal returns as well as economic rents and risky returns). It is this allocation of returns (normal returns only to investors; rents and risky returns to firms) and the use of the COCA mechanism to accomplish these results that are the novel contributions of the BEIT.

By definition, the BEIT eliminates the debt-equity distinction, neutralizes the importance of different depreciation or capitalization regimes, automatically coordinates firm-level and investor level incomes, and mitigates (but does not wholly eliminate) the consequences of the realization doctrine. What is more, the BEIT moves a large fraction of capital income to the level of investors, rather than firms, a development that has important helpful ramifications in light of the relative international mobility of capital, compared to people. For all these reasons, the BEIT is an extremely attractive vehicle for imposing a successful capital income tax.

At the same time, the BEIT by itself is largely agnostic about tax rates. The concept originally was conceived primarily as a vehicle for the accurate measurement of capital income, and it can be adjusted to tax normal returns, on the one hand, and rents and risky returns, on the other, at the same or different rates, which rates in turn can be the same as or different from those

applied to labor income. To a large extent, the original formulation's suggestions about tax rates in fact were motivated by the intuition that interest income on U.S. Treasury securities would remain taxed at "ordinary" (i.e., labor income) rates. Moreover, the BEIT as originally proposed was insensitive to the impetus that owner-entrepreneurs might have had to disguise the returns to their labor as capital income, in those cases where firm-level rents and risky returns were taxed at rates appreciably below those appertaining to labor income.

Dual income tax principles and the BEIT thus are complementary. The former offer a device for accurately teasing apart labor and capital income in those cases where they otherwise form an indissoluble matrix, and a theoretical platform from which to hang a theory of the appropriate tax burden on all capital income (including income derived from U.S. Treasury obligations). The BEIT picks up from there, and ensures that all capital income is taxed once, and only once, through its consistent and comprehensive design of the tax base.

Since the author has always maintained that the BEIT is pronounced "bite," one is tempted to refer to the combination of a dual income tax and the BEIT as the Dual BEIT, thereby engendering many smart remarks about the tax administration getting two BEITs at the apple. For lack of anything more memorable, that is the formulation that this paper employs.

C. Capital Income.

Capital income comprises all returns to capital, in the narrow, traditional sense of the term "capital."[3] Capital income includes, by way of example, interest and dividend income and capital gains. It also includes most net business income. Private firms of course bring both labor and capital to bear in generating net income; at least in the case of publicly-held corporations, however, the labor component is fully compensated and deducted from the business tax base. As a result, the remaining business tax base contains only capital income. (The problem of the closely held business, where an owner-entrepreneur puts both her own capital and her labor to work, and where the net income of the firm cannot through simple inspection be divided into labor and capital income components, is considered at length in this paper and the larger project.)

Economists traditionally equate capital (and therefore the measurement of returns to capital) with "real" assets employed in a business, by which they mean investments in tangible,

[3] Thus, at least for purposes of this paper, the term "capital" does not include human capital.

greasy machinery, or buildings, or land, or even intangible assets like patents, trademarks, or goodwill, but *not* financial assets such as stocks and bonds. In a more quotidian sense, however, capital income is earned in respect of investments in both real assets and financial assets that, in the broadest sense, are indirect claims on those real assets. Coordinating the taxation of returns to real and financial assets is one of the great challenges in designing an income tax on capital.

Relatively recent academic work has brought new clarity to the understanding of the components of capital income. In turn, these academic insights can usefully be employed in designing a capital income tax base.

This modern economic literature basically divides the returns to capital into three categories.[4] First are time-value-of-money returns (herein described as "normal" returns), which represent the core risk-free return from postponing consumption of one's wealth. To an economist, all capital earns this normal return. Second are risky returns, the higher returns that one expects to obtain for accepting the risk of uncertain rewards. (Actual risky returns, of course, may be negative in individual cases.) Finally, taxpayers also can earn what economists call "economic rents" or "inframarginal returns"—the supersized returns that come from a unique and exclusive market position or asset, such as a valuable patent or trade name.[5]

A well-designed *income* tax systematically measures and taxes normal returns—the dull, plodding, interest-like returns that one might expect to earn, for example, by investing in a savings account or a Treasury bond. Indeed, this is the key difference between a well-designed income tax and a consumption tax: by design, the former taxes time-value-of-money returns, whereas the latter exempts them from the tax base.[6] It turns out, unsurprisingly, that the current tax code does an absolutely terrible job measuring normal returns, perhaps reflecting the modest

[4] David Weisbach, The (non)taxation of risk. 58 *Tax Law Review* 1 (2004).

[5] Robert H. Wessel, *A Note on Economic Rent*, 57(5) American Economic Rev. 1221 (1967), at 1223 ("The traditional rent concept also allows to divide, conceptually at least, factor compensation into two parts, payments which induce factors to work and surplus which only confers a greater reward for work which would have been done anyway.").

[6] Edward McCaffery has shown that the combination of a postpaid consumption tax and progressive rates of tax on the amount consumed in a year can be viewed as taxing normal returns in a year of outsized consumption, when compared with the results reached under a "steady state" consumption model, in which savings are used to smooth lifetime consumption, rather than to finance a single year of consumption run riot. Edward McCaffery, A New Understanding of Tax, [cite].

understanding of the importance of taxing these returns when the tax model was first constructed some ninety years ago. More surprisingly, however, systematically measuring and taxing these time-value returns is much more difficult than it appears. Much of the complexity of any business income tax stems from this fact.

If one focuses exclusively on real assets and economic concepts of income, then by definition, an investment in a "marginal" asset is one that generates net economic income each year equal to the normal return applied to the investor's unrecovered investment.[7] This almost self-evident observation means that, in a world consisting entirely of direct equity-funded investments in real assets, one would calculate normal returns on investment—and taxable business income—solely through economically accurate depreciation schedules. This thought in turn is surprising to many noneconomists, who associate time-value-of-money concepts exclusively with financial instruments, and who think of depreciation as some arbitrary allowance that is wholly unrelated to measuring an investor's normal returns.

An income tax system will properly measure and tax time-value-of-money (normal) returns on real assets only if two conditions are satisfied. First, the tax system must develop comprehensive rules to capitalize, rather than deduct, expenditures that create or enhance the value of a real asset (for example, expenditures to build a factory or to establish a brand name). This problem is pervasive in the current tax system, where, for example, all advertising expenses are currently deductible, even if they are incurred to develop a valuable brand name.

Second, the tax system must permit recovery of the cost of such investments through economic depreciation schedules—that is, schedules that comport with the actual depreciation in value of those assets from year to year. Viewed from this perspective, accelerated depreciation systems "encourage" overinvestment in real assets for the simple reason that, by

[7] To take the two extremes, if the normal return is 5 percent, an investor that invests $100 in a perpetual machine can expect to receive cash flow (and net income) each year of $5. An investor in a machine that is worthless after one year must receive $105 in cash flow from that machine, which, after application of $100 in depreciation, leaves the investor with the same $5 of income—and $100 to invest in a new machine.

design, they undertax the returns from those investments relative to economic measures of income.[8]

Unfortunately for this simple presentation, taxpayers do not invest their capital exclusively in real assets; they also acquire financial assets, such as stocks, bonds, options, and other, more obscure instruments. Economists sometimes ignore financial assets as background noise, on the theory that financial assets in the aggregate are simply indirect claims against all the real capital invested in business. No practical income tax system, however, ignores financial assets. The current tax code therefore taxes businesses on the returns derived from capital invested in real assets (through capitalization and depreciation rules) and taxes households on the income derived from capital invested in financial assets.[9]

One very difficult challenge in designing an income tax system that properly measures capital income is to coordinate and allocate tax liabilities at these two different levels—the financial investor holding financial capital instruments, and the business enterprise investing in real assets and earning net business income—to advance the fundamental objective of imposing a single comprehensive and constant tax burden on normal returns. The current tax system fails utterly in this critical exercise.

There is no simple answer to the coordination and allocation dilemma, although virtually every possible permutation has been explored. Yet the exercise of coordination and allocation between investors holding financial assets and business enterprises holding real assets is critically important if the resulting system is to be economically neutral—that is, if it is to impose a comparable tax burden on all returns to capital, regardless of the form in which an investment is made.

[8] This discussion ignores for this purpose the distorting effects of inflation.

[9] Businesses also can hold financial assets, but that does not change the basic thrust of the argument.

II. THE SORRY STATE OF CAPITAL INCOME TAXATION TODAY.

A. The Capital Income Tax Rules.

Readers of this paper are familiar with the general outline of how the current tax code taxes capital income, and the tax arcana of the most complex financial derivatives are irrelevant to this story. Nonetheless, it is worth reminding readers of a few conspicuous failings of the current system.

1. Interest Income. Interest income in the hands of individual taxpayers of course is taxed at full ordinary (labor income) rates, and generally is deductible to business firms. The result thus can be described as achieving a kind of coordination between the usual tax position of firms that incur debt and individual investors therein. By the same token, the tax rate imposed on interest income often is intuitively seen as the rate to which all capital income should be subject, or, phrased alternatively, as the clearest practical articulation of the "ideal" income tax's efforts to tax labor and capital income at the same rates.

Interest income is not taxed in the hands of tax-exempt investors, including pension plans and most foreign investors. The capital markets are supremely efficient at matching issuers and investors to minimize the aggregate tax burdens of both combined. In my several decades of working with capital markets professionals, the working hypothesis was always that the marginal investor in corporate debt was a tax-exempt investor. To this extent, capital income from investment in real assets ultimately is not taxed at all.[10]

A slightly subtler problem that arises with interest income and expense is that current law is quite clumsy in determining when an instrument is so equity-flavored as to lose its status as a debt instrument. In general, it is possible to sweep into an instrument that is classified as indebtedness for tax purposes significant equity or commodity returns. As a result, it is inappropriate to equate debt returns with normal returns – even without regard to the credit risk element of different instruments.

[10] Canellos, Self-Help Integration.

2. Dividend Income. One of the important contributions of the Jobs and Growth Tax Relief Reconciliation Act of 2003[11] (the "2003 Tax Act") was to lower the tax rate on dividends received by individual taxpayers to 15 percent. This legislation was itself the outgrowth of a failed attempt to more precisely integrate the corporate income tax and individual taxation of returns on equity investments in corporations.

In fact, the failure of more precise integration systems is a worldwide phenomenon. Even before the European Court of Justice's rulings on the application of EU constitutional principles to corporate integration schemes made those arrangements infeasible, corporate integration systems were in decline in Europe, both because of rampant abuse (through the double claiming of imputation benefits, for example) and because imputation systems that did not pass through to investors key benefits accorded firms (e.g., tax exemption on foreign business income) found themselves at cross purposes. The U.K. "Advance Corporation Tax (ACT) mountain" was one such example.

The net result is that the tax burden nominally borne (that is, without regard to incidence debates) by individual shareholders in respect of dividend income varies as widely as do corporate effective tax rates. Since those rates in turn are widely dispersed, the total tax burden on dividend income is as well.

3. Capital Gains.

The 2003 Tax Act also reduced the tax rate on net capital gains recognized by individuals to 15 percent. Corporations are taxed at the same rate on capital gains as they are in respect of normal returns, even when those capital gains arise in respect of an equity investment in another firm.

The capital gains tax is famously poorly designed along several margins, including in particular its reliance on the realization doctrine and its insensitivity to inflation. The realization doctrine means that the capital gains tax in most circumstances is our only wholly optional tax.[12]

[11] PL. 108-27.

[12] A minority shareholder might, for example, find herself the unwitting seller of her shares in the context of a corporate acquisition.

That tax in turn can be avoided entirely by using appreciated financial assets as charitable contribution currency, or by holding those assets until death.

The most plausible popular argument for a capital gains tax preference – that it, like the dividend income tax, reflects a probable double tax on the same real capital income[13] – is completely unreflected in the design of the tax itself, because in fact the capital gains preference is available in respect of capital investments that have not and cannot encounter any double tax at all. In some instances, like collectibles and "unrecaptured depreciation" on certain investments in real property,[14] those preferential rates are not as low as the 15 percent residual rate currently available on most investments, but in other cases the 15 percent rate is fully available for assets unburdened in any sense by double taxation.

The most conspicuous example is U.S. Treasuries. If I buy a newly-issued $1000 Treasury bond at par when interest rates are 6 percent, and rates thereafter decline to 4 percent, I can sell that bond for a profit. This profit represents in effect the present value of the bond's 2 percent per annum return over the new prevailing interest rate, for the remaining life of the bond. If the bond has a ten-year life at the time of my sale, my profit will amount to about $164, which, if I have held the bond for the requisite long-term holding period at the time of sale, will be entirely long-term capital gain. So in this example I obtain long-term capital gain treatment, taxable at a 15 percent rate, where (i) I have not embarked on any entrepreneurial "risk-taking"

[13] This summary is not meant as an inquiry into every conceivable justification for the capital gains preference, but in brief the argument that the preference blunts the "bunching" effect that otherwise would obtain, because significant capital gains would propel the investor into higher tax brackets, falls prey to the fact that we no longer have steeply progressive marginal tax brackets, and that most capital gains are recognized by investors in the top quintile of taxpayers by incomes. (TPC Study.) The argument that the capital gains preference addresses the taxation of inflation, rather than economic gain, is vitiated by the fact that the preference is not keyed to the length of a taxpayer's holding period.

For these reasons the twin arguments usually employed by policymakers to explain the capital gains preference are that the preference mitigates double taxation and encourages "entrepreneurial risk-taking." The former argument has been addressed in the text, and the latter argument suffers from the flaws that, if risk-taking is our focus, the ability to utilize losses should dominate policy discussions, and that no effort usually is made to explain why risk-taking as such needs subsidizing. Alan Viard, [cite].

[14] Sections 1(h)(4) and 1(h)(6).

investment, at least as understood in the popular imagination,[15] (ii) the gain is transparently equivalent to the present value of a stream of future ordinary income taxable at labor rates (the excess of the bond's 6 percent interest rate over now-prevailing interest rates), and (iii) the issuer of the instrument most certainly is not subject to any tax at all.

A more common fact pattern, and one frequently muddled in the popular imagination, is the sale of a proprietorship or partnership interest. Again, those underlying assets (here, business firms conducted through fiscally transparent vehicles) are not double taxed, but gain attributable to them (most commonly, goodwill or similar intangibles, often created through the owner's own labor) is generally eligible for the capital gains preference.

In the case of the sale of an interest in a business firm, the capital gains tax is triply uncoordinated with the activities of the firm. First, as suggested immediately above, the firm itself may not be a taxpayer at all; in the case of corporations, this can be the result of deliberate strategies (the bread and butter of private equity firms, for example) to eliminate corporate tax through interest deductions from "levering up" the company.[16] Second, unlike dividend income, capital gains can run ahead of corporate profits. (By definition, taxable dividends come only from distributions out of current or accumulated "earnings and profits.) Sellers of Facebook stock in its upcoming IPO, for example, will recognize capital gains attributable to the expectation of future income at the firm level, which income of course is not (and may never be) reflected in the firm's taxable income. And when a corporation is also a portfolio investor, there is no coordination of any kind between capital gains recognized by the corporate shareholder and the income of the underlying firm, because corporations are not eligible for any capital gains preference.

4. <u>The Special Case of Disguised Labor Income</u>. The works of Victor Fleischer and others have focused both academic and popular attention on the taxation of "carried interests" (interests in future partnership profits).[17] To simplify matters, the carried interest controversy

[15] The acquisition of a fixed-rate investment always brings with it an opportunity cost, but in the sense ordinarily used to justify the long-term capital gains preference, the purchase of a U.S. Treasury bond would be seen as a "risk free" investment.

[16] Kleinbard, Mitt Romney's Marvelously Unburdened Income, Huffington Post.

[17] Victor Fleischer, *Two-And-Twenty*. Etc etc

revolves around the correct treatment of the general partner of an investment partnership where (i) that partner has a small capital investment in the firm and a larger share of firm profits, (ii) the partner commits to apply his or her expertise and time to manage the firm's investments, and (iii) the firm itself realizes only capital gains from the eventual sale of the portfolio companies it acquires.

Objectors to this result have pointed out that the capital gains preference rests on an implied assumption that the gain relates to a return on the taxpayer's capital, not a third party's capital. General partners in such ventures have pointed out that there was no general doctrine of law that required them to divide their economic returns into a return on their capital, earned at the same rate as the limited partners/investors earned a return on their capital invested in the firm, and a separate return on services they provided to the firm.

It is common for private equity sponsors to argue that they are entitled to capital gains rates on the sale by an investment partnership of its interest in a portfolio company for the same reason that an individual owner of a sole proprietorship is entitled to claim as a capital gain the profit realized by that owner on the sale of his business. But this sort of argument conflates the business of the general partners of a private equity firm (the successful operation of their investment firm) with the business operations of their firm (providing services to others). It is as if the proponents had forgotten that the owner of the local pizza restaurant might obtain capital gains treatment on the sale of her restaurant, but all the pizzas sold along the way were taxed at ordinary income rates.[18] Or to put matters more directly, these sorts of arguments might justify why owners of private equity firms are entitled, at least under current law, to capital gains tax rates when they take their firms public, but are completely orthogonal to the question of the tax rate that should be imposed on their investment firms in respect of the services those firms provide in the ordinary course of their business operations.[19]

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[18] Staff of Joint Committee on Taxation, Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I, JCX-62-07, Sept. 4, 2007, at 57-58.

[19] It apparently is the case that Bain Capital, which has been much in the news of late, has in some of its deals received carried interests of 30 percent, rather than the industry standard 20 percent, from its investment partnerships with third party investors. Governor Mitt Romney recently defended that result on the grounds that Bain Capital provided much more in the way of services to the portfolio companies that these investment partnerships acquired than do many other private equity firms, through the secondment of large numbers of Bain Capital specialists in various areas of finance and management.

Objectors more generally argued that legislation should develop just such a division between the labor and capital inputs of the general partners in these cases, to reflect the fact that owner-manager in this case was deriving income principally in return for services provided to the firm. Legislation in fact was introduced that would have accomplished this result, but to date has not been enacted into law; the draft legislation was the subject of intense debate, both on policy and on technical grounds.

The larger importance of the contributions of Fleischer and other scholars that have examined this area is that the attention brought to bear has sharpened our collective sensitivity to the pervasive phenomenon of returns to labor masquerading as returns to capital, usually in order to claim the capital gains preference. The owner of the pizza restaurant in the example given above is a typical case: her capital investment in the restaurant might be dwarfed by her labor investment, in the form of long hours working there while "drawing" a low salary, but policymakers reflexively assume that the entirety of her gain on the sale of the business (attributable to the goodwill/going concern value created primarily by her personal efforts) should constitute capital gain, because she is selling an asset (albeit one that was self-created), or as a subsidy for her "entrepreneurial" risk-taking or the like. This paper describes this pervasive issue of labor income becoming capitalized in asset values as "labor stuffing."

5. Net Business Income. As previously noted, in the case of any business firm where labor is fully compensated for its contributions to the firm (e.g., publicly held corporations), the residual taxable income of the firm represents capital income, because labor inputs have been deducted from the base. Firm net business income nominally is taxed at full (labor) rates, whether earned by corporations or fiscally transparent vehicles. But at the same time, policymakers have no great interest actually in measuring that net business income accurately. For example, the United States has offered business firms various iterations of "bonus depreciation" schedules (amounting to 50 percent or in some years 100 percent of an investment) for seven of the last ten years, and the current Administration has proposed to extend the

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This implicitly argues persuasively against the treatment of any returns on these carried interests as capital gain, an irony largely lost on both the Governor and his audience.

arrangement for all of 2012.[20] [More on revenue estimates of cost.] And of course the costs of developing many intangible assets are currently deductible, either as advertising expenses or through subsidies for research and development costs.

Finally, the tax rules applicable to foreign direct investment, which are extremely important to America's largest corporate taxpayers, have their own perverse features. These rules in general encourage a form of tax arbitrage, under which U.S. firms shift profits from both the United States and high-taxed foreign countries to very low-taxed foreign countries, while at the same time the firms situate their global borrowings (and hence the attendant tax deductions for interest) in the United States.[21]

6. Summary. The above brief recitation suggests the almost random quality of capital income taxation in the United States today. Interest income and net business income are both nominally taxed at the same rates as labor income, but capital markets efficiently direct much interest income into the hands of tax-indifferent investors, and the net business income tax base is deliberately mismeasured to "stimulate investment" or the like. Dividends and net capital gains generally are taxed in the hands of individual investors at substantially lower rates, but the taxation of capital gains in particular can lead to the conversion of interest income into preferential capital gains (the sale of a Treasury bond example), or, through "labor stuffing," the conversion of labor income into low-taxed capital income. And throughout, little or no effort is made to coordinate the taxation of real and financial investments. It is something of a miracle that the current Internal Revenue Code yields any positive tax on capital income at all. Yet as the next Section demonstrates, capital income accounts for about 40 percent of gross domestic income, and, surprisingly, we do collect enough tax on capital income that we would miss it, were it to be removed from the tax system.

[20] Binyamin Appelbaum, Tax Break Increases Deficit, But May Have a Silver Lining, New York Times, February 3, 2012,

[21] Kleinbard, The Lessons of Stateless Income; Kleinbard, Stateless Income.

B. The Aggregate Burden of Capital Income Taxation.

Roughly 60 percent of U.S. gross domestic income today is attributable to labor, and 40 percent to capital.[22] (This allocation is more heavily weighted towards capital income than was true a few decades ago, when the split might better have been summarized as 65 - 35.[23]) This means that we intuitively can expect the taxation of capital income to be relevant as a matter of government revenues, as well as having important economic efficiency consequences.

Turning first to revenues, in 2007 (that is, the last year before the major dislocations still reverberating through the economy) the corporate income tax alone (which of course is just one component of the federal tax burden on capital income) amounted to roughly 15 percent of total federal government receipts.[24] One relatively recent European cross-national study concluded that in 2004, when corporate income taxes amounted to 8.7 of all tax revenues in the United States (federal, state and local), personal capital income taxes amounted to another 7.5 percent, for a total of 16.2 percent of all tax revenues collected in the United States.[25] And a paper by Joel Slemrod summarizing his work with several colleagues concluded that, in pure revenue terms, federal revenues collected in 2004 in respect of marginal returns to capital — which his team measured by calculating the excess of the revenues collected by the *actual* income tax then in

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[22] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* (Jan. 2012), at Figure 2-8, p. 42 (labor income share of gross domestic income estimated to be roughly 60 percent in 2012 and 2017).

[23] Id, p. 41, n. 27. The CBO allocates 65 percent of proprietorship and partnership income to labor, and 35 percent to returns to capital, based on this older benchmark.

[24] In theory some portion of the corporate income tax could be a tax on labor income not extracted by the owners of closely held "C" corporations in the form of arm's length compensation rates (what this paper calls "labor stuffing"), but that behavior would be irrational in the current tax environment. Moreover, the great bulk of the corporate income tax is paid by large public corporations, where the occasion for labor stuffing is more attenuated.

It also is true, of course, that the corporate income tax base includes not simply returns to marginal investments, but also returns to risky ones (and hence includes the risk premium such investments demand) as well as rents, and that the latter two classes of capital income would also be taxed by a well-designed consumption tax, so this observation should not be misconstrued as suggesting that the revenues today collected through the corporate tax would entirely disappear in a consumption tax.

[25] Sorensen, "Can Capital Income Taxes Survive? And Should They?," 53 *CESifo Economic Studies* 172, 192-196 (2007).

effect (including the expiration of the 2003 bonus depreciation rules) over the revenues that would have been collected by an *ideal* consumption tax – amounted to about $89 billion for that one year.[26] I would submit that the difference in taxes that might be collected from an actual income tax when compared to an *actual* consumption tax (were such a comparison feasible) might be greater than that sum.

So, despite all the preferences and incentives of current law, in fact the United States today imposes significant levels of tax on capital income, whether understood in the broad sense to include returns to risk and economic rents, or in a narrower sense of including only marginal returns. And the design of those capital income taxes in turn has important efficiency consequences, discussed briefly below.

Notwithstanding the revenues collected in respect of capital income, the United States today taxes capital income at radically different effective rates, depending on the nature of the real assets employed in a business undertaking, the form of the business enterprise through which that undertaking is conducted, and the form of the financing raised to conduct that business.[27] Accelerated and "bonus" depreciation, the double taxation of returns to corporate equity—but not of returns to other forms of business organization—and the debt-equity distinction are all examples of the tax-induced distortions attendant on the current system for taxing investment income.[28] And at the same time, savers can opt out of current income taxation through tax-preferred savings vehicles, such as traditional and "Roth" Investment Retirement Accounts; these in turn function identically to postpaid and prepaid consumption taxes on the amounts deposited therein. These fluctuations in the tax burdens on marginal capital investments in turn can have substantial efficiency consequences.

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[26] Slemrod, "Does the United States Tax Capital Income?," in Aaron, Burman and Steuerle, eds., *Taxing Capital Income* (2007), ch. 1.

The Slemrod analysis is particularly interesting in its demonstration that, under the methodology that the paper summarizes, the U.S. tax burden on capital income has fluctuated very substantially over the last couple of decades. Id. at n. 14 (reporting a swing in incremental income tax collections over ideal consumption tax collections from negative $15.2 billion for 1983 to positive $108 billion in 1995).

[27] Kleinbard, "Rehabilitating the Business Income Tax," [cite]; Kleinbard, "Designing an Income Tax on Capital [cite].

[28] Id [cite].

Both the Congressional Budget Office[29] (CBO) and the U.S. Treasury Department[30] have closely studied how the United States taxes capital income in practice. Very recently, the Treasury Department has repeated its analysis with more recent data, in connection with the February 2012 release of The President's Framework for Business Tax Reform.[31] That recent report confirms the conclusions of its earlier studies.

The studies by CBO and the Treasury Department do not simply review statutory rates, but rather compare the present value of the taxes imposed on a marginal capital investment to the present value of the economic income that gives rise to that tax liability – that is, the effective marginal tax rate on capital. Their analyses are remarkable for how comparable their results are: each found that effective marginal tax rates on capital income range from negative rates (owner occupied housing and leveraged investments in depreciable equipment) to figures close to statutory marginal rates (equity investments in corporations). In short, the United States today imposes a very wide range of effective tax burdens on different forms of capital income.

The CBO papers are particularly helpful, because they lay out their methodologies in great detail, and because they look to aggregate tax burdens on capital income (that is, firm level plus investor level), based not on hypotheticals but on data as to the actual composition of the ownership of different types of financial assets. The CBO reports lead to two important sets of conclusions beyond the preliminary point that we in fact impose meaningful taxes on marginal capital income today.

First, the marginal effective *total* tax rate on corporate income — that is, the ''all in'' tax rate on a prospective marginal investment, *including* the aggregate tax burdens imposed on the interest, dividend income and capital gains of investors, taking into account their tax posture and relative size— is around 26.3 percent, compared with our statutory marginal rate of 35 percent. The marginal effective total tax rate on capital invested in *non*corporate businesses is much

[29] CBO (2005) and CBO (2006). Slemrod (2007) offers some criticisms of the CBO methodology, but in the end his ingenious approach and the CBO model produce roughly comparable numbers, as Slemrod points out. Slemrod (2007) at 16.

[30] Treasury (2007).

[31] The President's Framework for Business Tax Reform, A Joint Report by the White House and the Department of the Treasury, Feb. 2012 (hereinafter, *The President's 2012 Framework*) at 5.

lower — 20.6 percent. That difference alone points to a fundamental weakness of the current system, which is the differing tax burden the Code imposes on capital invested in different legal forms of business.[32]

Second, the CBO analysis demonstrates that our current business tax system imposes wildly divergent burden on marginal investments depending on funding source (debt vs. equity) and asset class. Equity-funded corporate capital investments are taxed at a marginal effective total tax rate of 36.1 percent (higher than the statutory rate of 35 percent because of investor-level taxes), while debt financed investments face a *negative* 6.4 percent rate — a 42.5 percentage point swing.[33] (A negative marginal tax rate implies that the tax system actually subsidizes the cost of the investment). And there is a 12.3 percentage point difference between the effective total tax rate imposed on a marginal investment in the 25th percentile of asset classes (ranked in order of tax burden) and that imposed on the 75th percentile—that is, between the top and the bottom of the middle half of all assets.

Putting these numbers together, the CBO's 2005 study concluded that the effective tax burden imposed on a hypothetical composite marginal investment (that is, one composed of dollar-weighted corporate, noncorporate business and housing components) was 13.8 percent if the 2001 and 2003 tax cuts were extended indefinitely, and 17.4 percent if those cuts were assumed to expire as originally scheduled.[34] Importantly, this figure reflects the negative tax burden imposed on owner-occupied housing (-5.1 percent or -5.7 percent, depending on

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[32] One can argue that many small businesses are unincorporated and that the rate difference noted in the text in turn reflects a congressional decision to tax small businesses more lightly. If that is the justification, it is a poorly directed incentive, as the tax benefits of adopting a noncorporate business structure are freely available to very large enterprises as well as small ones.

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

The President's 2012 Framework concludes that debt financed investment in equipment faced an effective marginal tax rate in 2011 of -60 percent. Presumably this extraordinary figure reflects the availability of 100 percent expensing ("bonus depreciation") in that year.

[34] CBO (2005) at 26. Slemrod's different approach yielded closely similar numbers. Slemrod (2007) at 12, 15, 25. It is important in making any comparison to ascertain whether a particular calculation assumed the expiration or continuation of the 2003 tax cuts, particularly bonus depreciation.

assumptions about the 2001/2003 tax cuts). Owner-occupied housing in turn at the time represented some $13.7 trillion in capital investment; the aggregate of all financial investments by households and nonprofits amounted to roughly $21.7 trillion.[35] If owner-occupied housing is removed from the analysis, then the blended effective tax burden on other marginal capital investments would be in the neighborhood of 23 percent or 28 percent, again depending on assumptions about the 2001/2003 tax cuts.[36]

The usual response is to observe that the U.S. tax system today is a combination of comprehensive income and consumption tax themes,[37] but this observation is completely unsatisfactory. First, it ignores the fact that ideal income and consumption taxes actually are identical, save for their treatment of normal returns to capital;[38] as a result, the formulation simply reduces to an observation that sometimes the United States taxes capital income (or some components thereof), and sometimes it does not. Moreover, the observation fails to capture the extraordinary variations in the burdens that the U.S. tax system imposes today on capital income, depending either on the nature of the real asset deployed in a business, or the other, more formal, characteristics mentioned above.

Most fundamentally, the formulation says nothing useful about when capital income taxation should be turned off, and when turned on—and if turned on, at what effective marginal tax rate. Policymakers require some sort of tax lodestone by which to steer their efforts, which instrument in turn must derive its properties from a clear conceptual foundation to a tax system. Exceptions must be made to accommodate practical implementation issues, or political necessities, but policymakers ought to know at least when they are making an exception, and when following the general rule.

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[35] CBO (2006) at 48, 57.

[36] The figures are the simple average of the corporate and noncorporate rates reported at CBO 2005, p. 26, on the theory that business profits in the United States are divided roughly 50-50 between the corporate and noncorporate sector.

[37] *See, e.g.*, [some article].

[38] Bankman and Weisbach, "The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax," [cite]. Normal returns are the returns earned on a risk-free marginal investment. They are the dull, plodding time value of money returns that are the basic unit of measurement of the return to waiting—that is, the compensation received for delaying consumption from today until tomorrow.

In summary, the United States does collect significant taxes on capital income; if the United States were to abandon capital income taxation entirely, the resulting shortfall in revenues would need to be made up from other sources, presumably labor income, whether directly or in the form of consumption taxes. Equally important, U.S. taxation of capital income is extraordinarily uneven, varying not only across classes of real investments, but also across different forms of legal organization and different forms of financing. The resulting dispersion in tax burdens distorts commercial and financing decisions at every turn. Policymakers in turn implicitly recognize that our relatively high marginal rates on capital income introduce economic inefficiencies, and respond with special tax regimes for favored assets, thereby compounding the problem. The case for the Dual Business Enterprise Income Tax should be heard against this backdrop of existential despair.

C. Conceptual Critique of the Current Sorry State of Affairs.

1. The Underlying Problem. The U.S. business tax system is built on foundations that have not been reexamined since the original developers designed its basic architecture some four generations ago. These foundations, in turn, are inconsistent with modern business practices and current economic thinking.

Simply stated, the current tax system is incoherent. As the data summarized above demonstrate, the United States taxes returns to capital at wildly varying and largely unpredictable rates, depending on such factors as accidents of history (the form in which a business might originally have been organized or capitalized), purely formal distinctions (the labeling of an investment as debt or equity), divergences between tax and economic depreciation, accidents in the timing of sales of financial or real assets, and the efficiency of the capital markets in matching tax-sensitive issuers with tax-indifferent investors or vice versa.

The root cause is a failure to approach the taxation of capital income as a holistic inquiry. The corporate income tax, investor taxes imposed on dividends, interest or capital gains, and taxes on unincorporated businesses are all just different aspects of a single phenomenon. The level at which tax is imposed matters very little, but what is important is that the total sums up to a consistent tax rate on returns to capital invested across different business organizations and business investments. By focusing on the *aggregate* effective tax rates that our tax code imposes

on capital — at the investor level as well as the firm level — we can see how well we are doing today, and whether a proposed rehabilitation improves matters.

By this measure, and even without regard to "corporate tax shelters" and the like, the U.S. system for taxing capital income is thus fundamentally rotten at its core: it can neither measure nor tax consistently the most straightforward returns to real or financial capital.[39] First, the tax burden imposed on different legal forms of conducting a business (for example, corporation versus partnership) is not constant, and there is no satisfactory economic explanation for the difference. Second, the tax burden imposed on equity investments in different classes of real assets also varies, because the net income from those investments (gross revenue less depreciation expenses) is measured inconsistently. Third, the tax burden imposed on different indirect claims on real assets—that is, financial investments—varies most dramatically of all. Each of these three failings has a similar consequence: it distorts economic decisionmaking. Money is overinvested in tax-favored asset classes or financial investment types, relative to what would occur under an ideal income tax that burdened all returns to capital equally.

The first failing—the differing tax burdens imposed on different legal forms of doing business— is a paradigmatic example of a crucial bad habit of thought that is the source of much of what ails the U.S. business tax system. Fundamentally, the tax code has always attempted to categorize all business activity into a few discrete cubbyholes, each with its own operative rules. These cubbyholes in turn are defined by recourse to intuitive understandings of the ideal types of each form of organization or each method of raising capital, based largely on nineteenth-century legal and social norms, not economic considerations.

For example, the tax code observes that Entrepreneur A has organized her business as a partnership, whereas Entrepreneur B has formed a corporation. The tax code responds, "The tax model must respect each choice. Rules must be developed for taxing partnerships that reflect the nature of partnerships, and different rules must be developed for taxing corporations that reflect the different nature of corporations—after all, there must be a reason why each entrepreneur chose the form he or she did." The end result is separate tax cubbyholes for "partnership" and "corporation."

[39] Interest income earned by a taxpaying investor is the great exception; those rules are rational.

The tax code then relies on outmoded social and legal norms, not economic insight, to develop the substantive tax rules applicable to each cubbyhole. The resulting rules reflect these antique viewpoints by assuming, for example, that partners are closely tied to one another through personal bonds, while their arrangements with each other lack institutional continuity. As a result, a partnership is not itself subject to tax, but instead is viewed as a simple pass-through vehicle.

Over the decades the Internal Revenue Code has extended this mode of thought without any reexamination of its premises. As a consequence, today the pass-through model applies even to limited liability companies, which, in their protection of investors from entity-level liabilities and in their governance structures, are indistinguishable from corporations. The net result is that a limited liability company with dozens or even hundreds of partners and a billion dollars of annual revenue is taxed under the same rules as are two partners operating the local dry cleaning establishment—and the local dry cleaning establishment, if it happened to organize itself as a corporation, is taxed as if it were ExxonMobil.

This mode of thought alternatively bewilders and infuriates economists, because it has almost nothing to do with economic logic. Notwithstanding this frustration, the phenomenon is real and pervasive. In practice, this bad intellectual habit goes a long way toward explaining why the tax code is riddled with so many seemingly inconsistent rules for economically similar investments or transactions, and why Congress and tax administrators continue to compound these inconsistencies.

The second failing—the differing tax burdens imposed on investments in different classes of real assets—is largely the result of imperfect tax rules governing the calculation of a taxpayer's true investment in a real asset (that is, which outlays are ordinary expenses, and which should be capitalized in the cost of that real asset) and the depreciation schedule for that investment. (Inflation has additional distorting effects.) These problems are notoriously difficult to correct in practice, both because of categorization and measurement difficulties, especially with regard to the capitalization of expenses, and because, as the saga of "bonus" depreciation demonstrates, depreciation schedules are irresistible objects of political attention, to the point where the tax system has for decades now given up even the pretense of conforming tax and economic depreciation schedules.

The third failing—the wildly inconsistent tax burdens imposed on different financial instruments (that is, on indirect interests in real assets)—reflects the fundamental problem of failing to think in holistic terms – of asking whether returns on financial capital are taxed at consistent rates regardless of the legal form through which they are earned. This in turn can be decomposed into at least five important (and related) underlying structural problems in the tax code.

The first is the bad habit described above, in which outmoded social and legal norms, not economic considerations, define the contours of each investment cubbyhole. Thus debt is different from equity, it is said, because a debtor makes an unqualified promise to repay a debt, and a debt holder has certain specified rights in bankruptcy proceedings, whereas a stockholder's investment is exposed to the risk of the business, and the investor has much more limited claims in bankruptcy. As a result, debt of a low-quality issuer is treated according to the debt ideal type, and preferred stock issued by an AAA-rated corporation is treated as equity, even if the actual likelihood of repayment of the preferred stock greatly exceeds that of the junk debt.

The second reason for the present tax code's extraordinarily poor performance in taxing returns on financial instruments is that it has not adopted a single coherent model for taxing time-value-of-money returns. The tax code generally does a fairly good job of appreciating the importance of measuring and collecting tax on those returns derived from investing in debt instruments (except for the pervasive structural issue of tax-exempt investors), but it lacks any comparable ability to spot the same sorts of returns when they are received through investing in non-fixed income investments, such as stock.

The third, related reason for current law's incoherence is that the tax model treats stockholders as the indirect owners of all of a business enterprise, and creditors as simply temporary lessors of money. This simplistic model collapses under the weight of overwhelming contrary factors in the modern world. Today, it often is not possible to label one financial capital instrument as evidencing ownership of the underlying real assets of a business enterprise, and all other instruments as evidencing the temporary rental of money

Fourth, the tax system makes only a desultory effort to integrate the income taxation of financial instrument holders—the indirect owners of a business's real assets—with the income taxation of the business enterprise itself. The best-known example of this issue is the double

taxation of dividend income, already mentioned, in which income is subject to tax at the corporate level and again when distributed as a dividend to shareholders in the corporation. Fewer taxpayers object, however, to the equally common phenomenon of zero taxation of interest income, when a corporation pays deductible interest to a tax-exempt recipient. And fewer still stop to observe (for example) that dividend income that is paid out of nonincome (in an economic sense), as a result of accelerated tax depreciation, is taxed at some intermediate effective rate.

Finally, the income taxation of financial instruments, in particular, is bedeviled by the problem of the "realization principle," under which the economic returns on some forms of financial instruments (basically, most investments other than debt) are not taxed until the taxpayer receives those returns in cash. For example, an individual who invests in the common stock of a corporation recognizes no taxable income unless (and then only to the extent that) he or she receives a dividend or sells the stock.

The commonsense intuition that tax liability should be deferred until cash is received unfortunately conflicts directly with economic logic. The easiest way to see why is to imagine that the common stock in the above example appreciates in value at precisely the normal rate of return, and to assume that the corporation pays no tax (so as to isolate the realization problem from the integration issue of coordinating corporate and shareholder-level taxes). The shareholder ultimately will pay tax upon selling that stock, and the gain the shareholder reports will in turn reflect the compounded growth in the stock's value, but by deferring the tax liability the investor effectively will have reduced the tax burden imposed on that investment.[40]

[40] Section IV discusses this in more detail.

III. IT JUST GETS WORSE TOMORROW.

A. Trends in Capital Income Tax Rates.

The future of capital income tax rates in the United States of course is uncertain, but nonetheless some possible trends might be suggested. First, there appears to be a surprising consensus that the statutory federal corporate income tax rate is too high. This consensus reflects the importance of non-U.S. multinational enterprises as competitors to U.S. firms, and the international mobility of corporate capital income in particular. [41] Certainly, there is abundant evidence that the U.S. statutory corporate income tax rate is higher than that of almost all other OECD countries, particularly in light of recent reductions by important trading partners (e.g., the United Kingdom). Whether U.S. *effective* corporate tax rates are outliers when compared to those of other countries has a much more ambiguous answer, but politicians of course tend to focus on "headline" (statutory) rates.[42]

To this end, the recently released *President's 2012 Framework* argues that U.S. statutory corporate tax rates are much higher than global norms, while at the same time corporate effective tax rates are similar to those of major trade partners.[43] The Framework maintains that "The trade-off of a higher statutory tax rate in exchange for a narrower tax base with numerous loopholes and subsidies is a poor one."[44] The Framework therefore recommends a reduction of the corporate tax rate, combined with base broadening; the Framework's proposed corporate tax rate is 25 percent for U.S. manufacturing businesses, and 28 percent for other U.S. corporate activities.

To the same effect, Dave Camp, Chairman of the House Ways and Means Committee, published in October 2011 a "discussion draft" outlining potential corporate income tax reform,

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[41] Treasury (2007); Hines (2009).

[42] If one conceives of the role of the multinational corporation as primarily a global platform from which to extract rents attributable to valuable intangibles, then in fact the marginal tax rate is the right place to focus, because by definition that is the tax rate imposed on rents.

[43] *President's 2012 Framework* at 2-3.

[44] Id. at 3.

which draft included a 25 percent corporate income tax rate.[45] That figure (or ones very close to it) has thus been recommended by leadership in both political parties, and has been repeated in so many other recommendations that at this point it has transcended the label of wishful thinking and has taken on the quality almost of a forgone conclusion.[46]

At the same time, the 2001 and 2003 Bush tax cuts are scheduled to expire at the end of 2012. President Obama has indicated his desire to see some of those cuts to be extended, but in particular his 2012 Budget contemplated that the maximum individual tax rate would return to 39.6 percent, and that the tax rate on capital gains and dividend income would increase to 20 percent. Moreover, beginning in 2013 investment income earned by high-income taxpayers will become subject to a new 3.8 percent tax; although described in the heading of Chapter 2A to Subtitle A of the Internal Revenue Code as a "Medicare contribution," in fact the tax will go to the Treasury's general revenues.

Abstracting from these proposals, the remainder of this paper assumes that in the near future the corporate income tax rate in fact will be reduced to a flat rate of 25 percent, that individual income tax rates generally will rise to a maximum rate of 40 percent, and that the tax rate imposed on an individual's net capital gain and dividend income will rise from 15 percent to 20 percent.[47] These figures of course are entirely hypothetical, but to this observer at least they are hypotheticals conditioned by plausible predictions.

The paper further assumes that all individuals will be subject to the maximum tax rate of 40 percent on income other than that derived from qualified dividends or net capital gains. This

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[45] The text of the proposal and a section-by-section summary are available at: http://waysandmeans.house.gov/taxreform/.

[46] [examples]. The author himself has jumped on this bandwagon, albeit with a different international tax regime in mind than that proposed by most industry commentators. Edward Kleinbard, The Lessons of Stateless Income, __ Tax L. Rev. __ (2012). [Domenici/Rivlin at 27 percent, etc]

It is true that the President has proposed in his 2013 Budget to allow the tax rates on dividend income to return to the same rates as those imposed on labor income, but early responses suggest a bipartisan dislike of the idea, at least in policy circles. This paper accordingly discounts the prospect that the United States will return to an environment in which net capital gains and dividends are taxed at widely different rates.

[47] In a paper on the same general topic as the ground covered in this Section, Daniel Halperin relied on the same informed hypotheticals. Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010).

simplifying assumption reflects the fact that sophisticated tax planning is largely the province of the affluent, as is the possession of significant amounts of investment capital. I further assume that any base broadening measures in respect of the real income of firms (for example, a move from accelerated to economic depreciation) would apply to both corporate and noncorporate firms in a consistent manner, so that the only difference (if any) would be in statutory rates.

Finally, in applying these hypothesized new rates, I assume that one price of the new corporate tax rate would be a repeal of current law's graduated tax rates on the first $10 million of corporate income.[48] Under current law, these graduated rates represent a very small cost in forgone revenues – about $3.2 billion a year – which implies that few C corporations today operate within the income levels where the graduated rates provide a benefit.[49] Whether the anticipated increase in the utilization of small-scale C corporations would more than outweigh the decrease in the value of graduated rates is an empirical question, but intuitively it seems

[48] The graduated rates are dramatically bottom weighted; for corporate taxable incomes above $75,000 but below $10 million, the benefit of the graduated rate brackets is a one percentage point difference in tax rates (34 percent versus the maximum corporate rate of 35 percent). Section 11(b). The benefits of the 15 and 25 percent graduated rate brackets are recaptured for C corporations with taxable incomes over $100,000; the benefit of the 34 percent rate bracket is recaptured for C corporations with taxable incomes over $15 million. Section 11(b).

[49] Staff of Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2011 – 2015, at 37 (JCS-1-12, Jan. 17, 2012).

unlikely that the elimination of these graduated rates would very materially change any of the analysis presented here. [50]

Since 2003 the taxation of capital income has relied on two important identities. First, individual and corporate tax rates are identical (the "income tax rate-pair identity"). (This identity of course actually predates 2003.) Second, net capital gain from the sale of stock and dividends are taxed at the same rate (the "toll charge rate-pair identity"). It is important to emphasize that, while we have experience with the former identity holding when the latter did not (for example, the 1993 – 2003 period), the tax rates hypothesized in this paper would, if enacted, mark the first time where the toll charge rate-pair identity would hold, but the income rate-pair identity would not. At the same time, however, the combination of a corporate tax rate of 25 percent and a dividend/capital gains tax rate of 20 percent would produce an "all-in" tax burden of 40 percent on corporate income, *if* currently distributed. Hence, unlike current law, a new identity would hold – that between currently-distributed corporate earnings (i.e., post-toll charge earnings) and labor income.

If legislation were enacted along these general lines, the result would be a material change in the relative tax burdens imposed on some of the major classes of capital income. The tax rate on interest income – the paradigmatic form of capital income, in that returns are directly proportionate to capital invested, and returns ordinarily reflect neither economic rents nor

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[50] For example, if the current corporate tax rate brackets were retained, but simply capped at 25 percent, the result would be a two-step corporate rate structure, in which corporate taxable income up to $50,000 would be taxed at 15 percent and income beyond that level at 25 percent; the 15 percent tax rate bracket in turn would be recaptured for corporate taxable incomes in excess of $100,000. Section 11(b). The net result would be a maximum tax savings of $5,000; firms earning either less than $50,000 or more than $100,000 would benefit less. This is such a small fraction of corporate income as to make the suggestion appear not worth the candle.

Conversely, this two-step rate structure could be retained, but applied using an expanded version of section 1551, under which the 15 percent rate bracket would be made available only if the combined incomes of a corporation and its controlling individual shareholders (determined by dividing the corporate income pro rata according to a shareholder's proportionate interest in the firm) fell below the requisite thresholds. The complexity of such a rule counsels against its adoption.

embedded personal services – would climb to 40 percent. So, too, would the tax rate on noncorporate business profits. As a result, the tax rate on partnership or S corporation net income would increase; moreover, an owner-manager of such an enterprise could not mitigate that rate through paying herself a higher salary.

The profits of a "C" corporation, by contrast, would enjoy a material decline in marginal statutory tax rates, although the *effective* tax burden conceivably could stay roughly constant or even increase, depending on the success of correlative base broadening measures. And dividend income and capital gains, while taxed at materially higher rates (20 percent rather than 15 percent) still would enjoy parity with each other, and a significant rate advantage when compared to other forms of capital income.

Of all these trends, the most interesting would be the sudden gap between corporate and noncorporate capital income tax rates.[51] One obvious reaction to such a development might be to incorporate existing noncorporate businesses; following the lead of existing S corporation payroll tax planning (described in Section IV, below), owner-managers of such C corporations would then pay themselves as modest a salary as their consciences and current consumption requirements permitted.

As already noted, the combination of a corporate tax rate of 25 percent and a dividend/capital gains tax rate of 20 percent produces an "all-in" tax burden of 40 percent on currently-distributed corporate income. As a result, an owner-manager would be no worse off by extracting enterprise earnings as current dividends than she would be if she extracted those earnings as salary (and under current law actually would come out ahead, thanks to the payroll tax avoidance aspects of the dividend strategy, described below) – or for that matter as interest income. The "double tax" on corporate earnings would have lost its sting.

In fact, far from being worse off or indifferent, the owner-manager in this environment would actually find that she could enhance her after-tax investment returns by investing capital through the corporate form. This paper describes this opportunity as "capital stuffing." Section

[51] This also is the focus of Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010).

IV, below, quantifies the potential benefits that could be derived from capital stuffing in more detail.

It is important to recognize that the tax rate ecosystem contemplated by this paper arguably will be *more* hospitable to capital stuffing than was true at many points in the past. The reason relates to the continued applicability of the toll charge rate-pair identity – the parity of dividend and capital gain tax rates, introduced in 2003. Section III amplifies this point as well.

The advantage of using a C corporation in the tax rate environment hypothesized above would extend not simply to returns to capital, but also to returns to labor, if those returns could be characterized for tax purposes as income of the corporate vehicle. This possibility would appear to go beyond any justification for lower corporate tax rates; instead, it would mean that some forms of labor income (labor income of the owner-manager) would be taxed at lower rates than other labor income, because the former class, but not the latter, effectively could be described for tax purposes as returns to capital rather than returns to labor. This point goes beyond "labor stuffing" as currently practiced, which looks simply to the possibility of converting labor income to capital gains on ultimate sale.

This last observation begs the question of whether the current Internal Revenue Code is prepared to handle a sudden reversal in tax planning objectives, by way of a reversion to half-forgotten strategies to recharacterize labor income as corporate profits. Section V begins the discussion of this labor stuffing problem.

B. Implications.

Like most countries, the United States today already has unconsciously adopted some elements of a dual income tax regime, in which some forms of capital income (e.g., capital gains on assets other than corporate stock) are taxed at essentially flat rates much lower than those imposed on labor income. Critically, however, the corporate income tax still employs the same maximum tax rate as does the personal income tax.

When that connection is broken, and the corporate income tax in particular becomes a flat tax imposed at significantly lower rates than those imposed on labor income, we will find ourselves drifting pell mell towards what in practice will be a dual income tax. The realistic

question therefore is not whether a dual income tax is a good idea, but whether we will choose to implement a thoughtful one.

The remainder of this paper demonstrates that, in the world towards which we appear to be drifting, in which corporate tax rates will have been reset to be meaningfully lower than those imposed on the labor income of individuals, it will be important that capital income earned directly by individuals (in particular, interest income) also be taxed at the same lower proportional tax rates as those imposed on corporations. Leaving directly-earned capital income taxed at the same rates as labor income will lead to unpoliceable problems of what this paper calls "capital stuffing" – overcapitalizing a corporation to obtain a lower-taxed environment for personal investments.

As previously suggested, our tax rules also are particularly underdeveloped in their ability to distinguish labor from capital income in the case of the "owner-manager" – an individual who both provides labor inputs to an enterprise and who owns some or all of that enterprise. The resulting confusion has been tolerable in an environment where labor and capital income bear the same statutory rates, but will rapidly become intolerable in a (reasonably foreseeable) future world where there is a significant gap between the statutory rates imposed on each. In the absence of some new statutory mechanism, an owner-manager, but not an employee, will also be able to engage in "labor stuffing" – that is, claiming as corporate (capital) income what in reality are returns to her labor, simply by choosing not to extract from her business arm's length compensation for her services.

Taxing capital income at a constant rate fully addresses the capital stuffing problem. Prior U.S. practice (as reflected in the personal holding company rules or the accumulated earnings tax) was unsatisfactory at policing the personal-corporate investment boundary, because prior rules could be gamed by changing the mix of income, or required elaborate "facts and circumstances" litigation to prove the government's case. And other solutions, like increasing the tax burden on dividends and capital gains, are not as well targeted, and have serious ancillary consequences for economic efficiency, by increasing "lock-in" problems.

The Dual Business Enterprise Income Tax addresses capital stuffing by taxing all returns to capital once, and only once, regardless of the form of the business enterprise in question. The Dual BEIT addresses labor stuffing by employing dual income tax principles to

distinguish labor from capital income, and thereby to restrict the ability of owner-managers to masquerade labor as capital income. The Dual BEIT thus resolves the principal practical problems towards which the tax system currently is drifting.

IV. THE CORPORATION AS TAX SHELTER: CAPITAL AND LABOR STUFFING.

A. The Capital Stuffing Opportunity.

The corporate tax rate and individual rates on interest income, dividend income and capital gains interact in complex ways to favor or disfavor the corporation as an investment vehicle, and to favor or disfavor different mechanisms for extracting corporate earnings. The first calculus relates to the phenomenon of what this paper refers to as capital stuffing: the deliberate use of the corporation as a tax-preferred vehicle to earn investment returns.

The second calculus describes the phenomenon of "lock-in," which refers to the economic inefficiencies that arise when the owner of a capital investment (most characteristically, a shareholder) in a tax-free environment would prefer to divest some or all of an investment, but instead is induced to retain the investment in order to minimize her tax liabilities (and thereby improve her after-tax returns).[52] Lock-in is a function of the realization system, and is made worse by an increase in capital gains rates.[53]

Consider an individual confronted under current law with the choice of making a marginal investment (i.e., one earning normal returns, taxed at ordinary income rates) directly in his own name or indirectly through a corporation. Logically, the investor would choose the former. In both cases, the return on the investment would be taxed at the same 35 percent rate, but in the second case the investor would face an additional "toll charge" of 15 percent when he sought to consume or redeploy his earnings, in the form of a dividend or capital gains tax.

In other words, if pre-tax investment opportunities are identical inside and outside the corporation, then the after-tax rate of return inside a corporation on an investment will be the same as investing that cash outside the corporation, but the corporate investment will bear a second quasi-excise tax at some point in time. This explains why in the current tax rate environment fiscally transparent business organizations (S corporations or partnerships) are superior forms for investing new equity into a business than is the traditional "C" corporation.

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[52] Encyclopedia of Tax Policy (capital gains heading).

[53] Auerbach 1998.

Now, however, consider the hypothetical new world of a 40 percent individual tax rate and a 25 percent corporate tax rate. A toll charge (in our hypothetical, 20 percent) will still apply when earnings are extracted from corporate solution. Nonetheless, by virtue of the fortuitous fact that under this tax rate combination corporate earnings, if currently distributed, bear the same post-toll charge aggregate tax as do earnings taxed at the full individual rate (that is, (0.8 x 0.75) = 0.6), the investor is never worse off stuffing cash into the corporation. Moreover, it turns out that the investor is better off the longer he leaves his money in the corporation, because those earnings will compound at a higher after-tax yield inside the corporation than they will outside the corporation. That higher after-tax yield on the corporation's original earnings – the higher after-tax interest on interest – is the net benefit to capital stuffing.

The three examples that follow explain this conclusion in the context of a simple model of investment and dividends. All these examples involve a timing choice for when to withdraw money from a corporation through a dividend. For this purpose, under both current law and the future tax rate environment hypothesized in this paper, a liquidation or sale at the end of the relevant time horizon functions the same as a dividend, because the tax rates on dividends and capital gains are identical, and because basis is recovered at the same point in time – the terminal date of the investment.

Midstream sales of part of the investment or other basis recovery techniques have a different analysis, described in the next subsection. So, too, the analysis contained in this subsection would change if capital gain and dividend tax rates were to diverge. Subsection C generalizes the discussion to deal with that case.

In attempting to quantify the benefits of capital stuffing, it is helpful to begin with an example that shows that there is no advantage to how one times the *distribution* of corporate income to an individual shareholder when personal investment tax rates and tax rates inside the corporation are the same.

> Example 1. Shareholder, an individual, owns 100 percent of newly-incorporated Corporation A, in which she invests $1000. The rate environment is current law (35 percent corporate and individual rates, 15 percent dividend and capital gains rates). Corporation A earns 10 percent pretax on its assets.
>
> Shareholder takes out the after-tax earnings as dividends and reinvests those amounts at 10 percent pretax in her own name. This means that she takes $55.25 in after-toll charge

dividends and invests them personally at 6.5 percent interest (after tax). After five years her total investment is $1314.58.

Conversely, if Shareholder simply leaves Corporation A's returns in the company, after five years Corporation A will grow in value to $1370.09. Shareholder pays dividend tax on the liquidation of Corporation A (limited to Corporation A's earnings of $370.09) – or, if you prefer, capital gains tax on her profit of $370.09 – of $55.51. Shareholder is left with $1314.58 – the same as the first case.

There is no magic here: it must be the case that, where (i) dividends and capital gains are taxed at the same rate, (ii) individual and corporate after-tax returns are the same, and (iii) the toll charge on extracting corporate earnings through a dividend distribution is inevitable, there is no advantage to retaining earnings inside the corporation and deferring the realization of taxes on the distribution of those earnings. In each case the tax burden grows at precisely the same rate inside and outside the corporation. Moreover, the dividend distribution tax (including a capital gains tax on liquidation of the firm) functions as a quasi-excise tax: it simply reduces the investor's pile of after-tax earnings by the same percentage, regardless of when collected, and therefore does not affect the rate of return on the investment.[54]

In algebraic terms, the commutative principle governs. Label the dividend tax rate as D_T and the post-income tax return on investment as R, whether earned by directly by Shareholder or Corporation A. Then for every $1 of post corporate tax income:

$$[\$1 \times (1 - D_T)] \times (1 + R)^n = [\$1 \times (1 + R)^n] \times (1 - D_T).$$

This is the key insight of the "New View" of dividend taxation.

For example, at the end of Year 1, Corporation A will have earned $65. If it distributes that amount immediately as a dividend, a $9.75 toll charge is paid; Shareholder receives $55.25, and can invest that sum at a 6.5 percent return. Imagine that Corporation A earmarks that $9.75 as an inchoate liability for the toll charge attributable to Year 1's income. If Corporation A retains its Year 1 earnings for a later dividend, then all $65 – that is, both the $55.25 that Shareholder could have obtained immediately, and the $9.75 that would have been paid as a toll charge – will grow inside the corporation at the same 6.5 percent rate. The size of the future distribution increases, as does the size of the future toll charge liability, but so too does the pot of

[54] Alvin Warren, *The Timing of Taxes*, 39 Nat'l Tax J. 499, 501 (1986).

money that Corporation A has notionally earmarked to pay that toll charge – and all increase at exactly the same rate of interest.

The same analysis applies to an investor puzzling over what to do with previously-accumulated earnings, as the next example shows.

> Example 2. Shareholder (an individual) owns 100 percent of Corporation Z for which he paid $800; Corporation Z has since accumulated $200 in retained earnings, and is worth $1000 today. The tax rate environment is current law.
>
> If Shareholder decides to extract his $200 in retained earnings today, he will pay a dividend toll charge of $30. If he then invests the remaining $170 in a personal investment, it will grow at a 6.5 percent yield to $232.91 after five years.
>
> Following the upfront dividend, Corporation Z still has $800 in assets. That $800 will grow inside the corporation to $1096.07 after the same five years, at the same 6.5 percent yield. If Shareholder then liquidates the company, he will recognize $296.07 in gain, on which he will pay $44.41 in tax, leaving him with $1051.66 of net liquidation proceeds. That amount, together with the balance of $232.91 in his personal account, totals $1284.57.
>
> If, on the other hand, Shareholder had refrained from taking out a dividend at the outset, the corporation's $1000 in assets would grow to $1370.09 after five years. After paying tax on his liquidation gain ($85.51 of tax on $570.09 of gain), the owner is left with the same $1284.57.

In other words, the $200 of earnings with which the example begins already bear an inchoate but unavoidable tax cost of $30. Imagine for a moment that one puts that $30 in a separate subaccount. One can pay the $30 toll charge now (by distributing the $200), or pay a larger toll charge later, but the timing of distributions will not affect the after-tax returns to the remaining $170. While the ultimate toll charge liability will grow from $30 at a rate of 6.5 percent (compounded), so too will the $30 in cash one notionally has set aside to pay that tax. Regardless of the timing of distributions, Shareholder will earn the same net return on the $170, and Shareholder *already* is notionally out of pocket the $30. (Again, this is the insight on which the "New View" of dividends is based.)

The next example shifts the analysis to the new rate environment hypothesized in this paper. It shows how lower tax rates inside the corporation create an advantage to capital stuffing – that is, reinvesting inside the corporation. The example then leads naturally into a general explanation of the quantification of that benefit.

Example 3: As in Example 1, Shareholder owns 100 percent of a newly-formed corporation, into which he invests $1000. Assume the new tax rate environment described earlier in the text, and that pre-tax interest rates are 10 percent.

Does it matter to Shareholder if he takes his after-tax profits out as current dividends, and reinvests those amounts for 10 years personally, or instead leaves the returns in the company for 10 years? In Example 1's world, the answer was no; here, though, the answer becomes yes.

In the new tax rate environment, if Shareholder never formed a corporation, and just invests $1000 directly, his after-tax yield is 6 percent. After 10 years, that investment would grow to $1790.80.

Instead Shareholder put the $1000 into a corporation. In the absence of any special rule, the $1000 investment will face an intra-corporate 25 percent tax rate, not the individual rate of 40 percent. As a result, the intra-corporate after-tax yield will be 7.5 percent, not 6 percent.

If Shareholder extracts his corporate earnings each year (for example, as a dividend) and reinvests that amount personally, his "all-in" after-tax yield drops back to 6 percent (7.5 percent less the 20 percent toll charge), and the corporate form would offer no tax shelter for this marginal capital investment.

If, however, Shareholder leaves the earnings in corporate solution, then an advantage does emerge. At the end of 10 years, the corporation will have accumulated a total of $2061.00. The owner-manager could then extract the $2061.00 at a cost of $212.20 ($1061.00 of gain or dividend x 20 percent) and have $1848.80 left after the toll charge – a superior result to the direct investment, to the extent of $58.00.

To what exactly is the $58 superior result attributable? It turns out that the owner's advantage is not in respect of the after-tax base earnings on the $1000 (6 percent after all taxes in each case, or $60/year), but rather in respect of the earnings on those earnings.[55]

One straightforward way to understand the bond mathematics here is to ignore the corporate form for a moment, and instead to visualize the owner-manager with $1000 invested through his corporation as in the same position as if he had an IRA account with an opening

[55] The next several paragraphs expand on a mode of presentation first developed in a pamphlet prepared by the Staff of the Joint Committee on Taxation, titled "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II," September 4, 2007 (JCX-63-07), at 6-7. As that pamphlet explains, the case considered here, the time value of deferring compensation income, and many other time value of money inquiries can all be understood by applying this same methodology of visualizing a prefunding of the flat-rate toll charge, whether denominated a dividend tax, a capital gains tax, or an income tax payable only at some future date.

For a somewhat similar explanation that reaches the same conclusion, see Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010) and Daniel Halperin, *Rethinking the Advantage of Tax Deferral*, 62 Tax Lawyer 535 (2009).

balance of $1000 that earned 7.5 percent interest, but as to which there was a 20 percent toll charge for withdrawing money. The taxpayer could notionally set aside in a subaccount within the IRA each year that 20 percent toll charge in respect of his $75/year return on his original $1000. Under our hypothetical, this means that he would set aside $15/year to fund the toll charge subaccount. The amount in his main IRA account (now $60 at the end of Year 1), and with it the owner's ultimate toll charge liability, would continue to compound at a rate of 7.5 percent, but so too would the prefunded amount in his toll charge subaccount. As a result, the prefunded toll charge subaccount would always keep pace with the owner's future toll charge liability.

What all this means, then, is that the owner has suffered a 20 percent cost on his yield on his original $1000 investment – his return on that $1000 is 6 percent ($60/year) after he prefunds the toll charge, not 7.5 percent ($75) – but he enjoys a *7.5 percent* return on the amounts deposited each year into his main IRA account ($60 each year) for however long he maintains the account. In other words, by using the notional IRA account (or, to return to the actual hypothetical, the corporate form) for 10 years, the owner effectively earns the *pre-toll charge* rate of compounding on the *after-toll charge* simple interest on his original investment.

The owner conceptually is depositing $60/year into a 10-year savings account that earns *7.5 percent* interest. By contrast, if the owner had invested in his own capacity, that $60/year savings account would earn only *6 percent* interest. The difference between the two hypothetical savings accounts compounded for 10 years is $58, the difference that we earlier saw between a 10-year individual investment and a 10-year corporate investment, followed by the extraction of the investment from corporate solution.

This, then, is the advantage of capital stuffing: it enables an individual to earn the pre-toll charge (but post-corporate tax) rate of return on his after-toll charge simple return on his original investment. And of course, the longer the individual's time horizon, the more dramatic this difference becomes.

The retention of earnings inside the corporation also would preserve for the owner-manager a free option: the option to capitalize on any future reduction in capital gain/dividend rates imposed on shareholders. (Since Congress's deliberations are relatively transparent, and since Congress has demonstrated a consistent distaste for retroactive tax increases, the risk of the

opposite result – an unanticipated increase in shareholder-level taxes – would appear to be remote.) Finally, if the owner-manager were patient enough to rely on the tax-free step-up in stock basis at death, the shareholder-level tax on extracting corporate earnings would disappear entirely. For all these reasons, therefore, in the tax rate environment hypothesized above, well-advised owner-managers would find a taxable corporation to be a superior vehicle for conducting business operations, compared with using a pass-through entity.

B. Disinvestment and Basis Recovery Strategies.

There is a missing element to the analysis in Examples 1 and 2, which both were based on the current tax rate environment. Under current law, where individual and corporate tax rates are the same, there is no positive value to capital stuffing; in fact, there is a substantial *cost* associated with it. In an environment where after-tax rates are the same inside and outside the corporation, it *always* pays to take one's money out of corporate solution as soon as possible, not for abstruse reasons of the tax burden on earnings on earnings, but rather simply to avoid accumulating any future inchoate toll charges on the annual return to the investor's principal.

For example, viewed at the outset, the decision of the Shareholder in Example 2 to leave *any* portion of his original investment in corporate solution would be illogical, because the timing of the crystallization of his tax liability in respect of the $200 in existing retained earnings would not change the present value of that liability ($30, at the outset of our example), and because he always would be better off earning 6.5 percent on his $800 of principal without the burden of any further dividend/capital gains toll charge, rather than earning the same 6.5 percent, less the friction of that toll charge.

> Example 4. Continuing where Example 2 left off, Shareholder simply liquidates the company at the outset. In this case, Shareholder would have $970 in after tax proceeds. That would grow in five years to $1,328.98. The difference in aggregate returns between this sum and the first case (where Shareholder extracted his $200 in earnings immediately but left his principal of $800 in the corporation) is $44.41, which of course is the toll charge imposed at the end of five years on the owner's earnings on the $800 that he left in corporate solution in the first case.
>
> For the same reason, if Shareholder for some reason wanted to take out just $200 today, he would be well-advised to do so by selling 1/5 of his stock, rather than by paying himself a dividend, simply because in the former transaction he would effectively recover immediately $160 of his principal (that is, his basis in the shares he sold), and thereby eliminate future toll charges on the investment of the $160.

That is, under current law, where individual and corporate tax rates are the same, there is no positive value to capital stuffing; in fact, there is a substantial *cost* associated with it. (The only exception is the oddball case of a zero basis investment.) In an environment where after-tax investment rates of return are the same inside and outside the corporation, it *always* pays to take one's money out of corporate solution as soon as possible, not for abstruse reasons of the tax burden on earnings on earnings, but rather simply to avoid accumulating any future inchoate but unavoidable toll charges on the annual return to the investor's principal.

Ironically, what this also means is that today, if an investor in corporate stock is confronted by a corporate investment whose after-corporate tax but pre-toll charge returns are unsatisfactory compared to what the investor could obtain, for example, in a direct investment, the investor is better off selling the stock immediately and reinvesting outside the corporate sector. In this case there is a tax-induced incentive to sell immediately, not a lock-in effect of the sort described in the next subsection.

The case described above can be seen as a special case of the utility of basis recovery. Once the decision to realize some but not all of an investment is made, it is beneficial to do so in a way that minimizes current income through recovering basis. By doing so, the investor maximizes her total investment during the entire investment horizon, to the extent the current return of basis gives the taxpayer the use of more money for the entire investment horizon.

That is, when and if a taxpayer wishes to extract earnings from a corporate investment, it is desirable to do so, whether at current or future tax rates, through a capital gain transaction, because doing so essentially is the opposite of a lock-in problem, as described in the next Subsection. By applying basis to reduce temporarily what otherwise would be taxable income on corporate distributions, the taxpayer obtains an advantage.[56] The advantage is temporary, in that the accelerated use of basis must be accounted for, but the taxpayer has the use of the tax saved for the term of the investment. Just as in the lock-in case when applied to a marginal investment the taxpayer has to prepay taxes already provided for him, so in the basis recovery

[56] The text obviously discounts the possibility of a world in which dividends are taxed at lower rates than capital gains on the sale of stock.

case the taxpayer is reducing tax that otherwise would be currently owed through a simple distribution.

C. Labor Stuffing.

1. Labor Stuffing Today. Every business enterprise represents the application of labor to capital, and the firm's resulting gross income is attributable to both factors, in proportions unique to each business. In the case of large publicly-held corporate enterprises, the division of gross income between labor and capital inputs is handled by the marketplace: employees do not own enough of the firm to manage matters by undercompensating their labor contributions, and in turn extracting income attributable in fact to their labor in the form of purported returns to capital. But in the arena of closely-held businesses, where firms often are dominated by owner-managers, exactly this phenomenon is possible and practiced, as the saga of S corporations and payroll taxes set out below demonstrates.

In the United States today almost exactly one-half of business profits are earned outside the corporate tax system (that is, by proprietorships, partnerships and S corporations).[57] Some of that income is attributable to large enterprises where there are sharp differences between the identities of owners and of workers, but many cases can be expected to follow the pattern of the owner-manager with significant freedom of choice in how her returns are denominated.

Since 1981, U.S. individual and corporate tax rates have been quite close to each other; what is more, in keeping with the general framework of a comprehensive income tax, individuals are taxed on one rate schedule – that is, no distinction is drawn between the labor income and capital income of an individual (other than the special cases of dividends, capital gains and tax-exempt municipal bond income). In consequence, an individual owner-manager's income is taxed at the same progressive rates, whether denominated as compensation or as a share of any pass-through entity's income, and the maximum rate imposed on that individual in turn is the same as the maximum rate that is imposed on a taxable "C" corporation.

This would suggest that there is little advantage to be obtained by an owner-entrepreneur masquerading labor income as returns to capital invested in her business, and indeed in the case of C corporation there would be a significant disadvantage (the quasi-excise tax on removing

[57] Treasury (2007).

earnings from the corporation for personal consumption uses). In fact, however, there are two well-known examples under current law where labor stuffing is routinely practiced. The first is the carried interest strategy briefly referenced earlier; that strategy relies on a taxpayer's ability to characterize his returns to his labor by reference to an entity's return to its capital.

A second example of an area in which the division of the owner-manager's returns between labor and capital income has been the subject of recent controversy relates to the *payroll* tax obligations of S corporation owner-managers. This often is described as the "John Edwards gambit," in homage to that former Presidential candidate – although, given that the same strategy apparently has been relied on as well by current Presidential candidate Newt Gingrich, its popular name may change in the near future.[58]

The basic idea is to organize one's labor-intensive business (speaking engagements and the sale of autographed books, recordings of lectures, etc., in the case of Mr. Gingrich) as an S corporation, and then to pay oneself as modest a salary as possible. Such an individual's federal *income* tax liability is unaffected by how he allocates the returns on his business between a stated salary paid by the S corporation and a distribution of the S corporation's net (after-salary) income as a dividend to himself: both streams of income flow directly to the individual owner-manager, where they are taxed at identical rates. For payroll tax purposes, however, the distinction matters; amounts paid to the owner-manager as "dividends" generally are not subject to any of the social contribution payroll taxes.[59] Conversely, if an owner-manager operated

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[58] See, e.g., David Cay Johnston, *Newt and the NEWT Act* (describing the avoidance strategy and the Narrowing Exceptions for Withholding Taxes (NEWT) Act introduced by Rep. Pete Stark on February 2, 2012), http://blogs.reuters.com/david-cay-johnston/2012/02/03/newt-and-the-newt-act/; Shamik Trivedi, *News Analysis: Shades of John Edwards in Gingrich Return,* Tax Notes Today, Jan. 24, 2012. Legislation to address this issue also was introduced in 2010. See Sam Goldfarb, *Critics Attack S Corp Payroll Tax Increase in House Extenders Bill*, Tax Notes Today, June 8, 2010, 2010 TNT 109-2.

John Edwards' use of an S corporation, from which he paid himself a modest salary in relation to the corporation's earnings from his personal services, spawned a large collection of articles and letters in 2004. See, e.g., Kenneth A. Gary, *Edwards's S Corporation Not an Abusive Tax Shelter*, 104 Tax Notes 365 (July 26, 2004); Kip Dellinger, *Edwards's S Corp Can Be Abusive Even If It's Not a Tax Shelter*, 104 Tax Notes 1092 (Sept. 6, 2004); Tom Daley, *Edwards's S Corporation, Medicare Tax, and Fair Share*, 104 Tax Notes 1577 (Sept. 27, 2004); Kip Dellinger, *Edwards's S Corp: The Beat Goes On*, 105 Tax Notes 253 (Oct. 11, 2004).

[59] Revenue Ruling 59-221, 1959-2 C.B. xx. Koski, "The Application of Employment Taxes to S Corporation Shareholders—What Is 'Unreasonably Low' Compensation?" 85 *Taxes* 19 (2007).

through an entity taxed as a partnership, the entirety of his business income would be characterized as self-employment income, regardless of whether she extracted it as compensation or as a distributive share of profits.[60] According to a 2009 Government Accountability Office report, "13 percent of S corporations paid 'inadequate wage compensation' in 2003 and 2004."[61]

The carried interest rules and the "John Edwards gambit" can be viewed as anomalies in current law. But it remains the case that many owner-entrepreneurs undercompensate their personal efforts. There are nontax explanations, of course – an exigent need for cash flow in the business, a desire to show better financial results to bank lenders, and the like. But there also are practical tax considerations that animate these results. These include the ability in practice to disguise personal consumption items as business expenses, the retention of what amounts, in effect, to a free option to take advantage of future tax rate developments, and the fact that the many tax subsidies for small and medium sized businesses drive down the effective tax rate on firm earnings, and thereby offer the owner-entrepreneur more attractive investment opportunities than portfolio investments outside the enterprise he controls.

2. Labor Stuffing Tomorrow. Once a decision is made to tax corporate income, in particular, at a rate materially lower than the general individual income rate schedule, then the question of how to separate labor from capital income passes beyond being simply an interesting intellectual exercise and becomes important as a revenue collection matter. The future tax rate ecosystem envisioned in this paper positively begs owner-managers to engage in labor stuffing – to understate their personal compensation for services rendered to their firm, and instead to retain the firm income attributable to those services for as long as possible at the firm's tax rate. The

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[60] There is some nominal ambiguity in current law with respect to limited liability companies and the like, because Code section 1402(a)(3) provides that self-employment income does not include a "distributive share of any item of income or loss of a *limited partner*, as such . . . ." (Emphasis supplied.) The rule dates to a time when limited liability companies did not exist, and when limited partners lost their limited liability if they performed services for their partnership. Proposed regulations would clarify that the entirety of a limited liability company member's income from such an entity will constitute self-employment income, unless the member performs 500 hours or less of work per year for the entity and has no power to contractually bind the firm. Prop. reg. section 1.1402(a)-2(g) and (h).

[61] Sam Goldfarb, Critics Attack S Corp Payroll Tax Increase in House Extenders Bill, Tax Notes Today, June 8, 2010, 2010 TNT 109-2.

reason, however, is *not* to convert labor income to capital income in the first instance (except insofar as payroll taxes are concerned), because any labor income not paid as salary will become subject to the dividend/capital gain toll charge, and the sum of the corporate tax and the toll charge equals the individual rate on salary income.

Instead, owner-managers will prefer to understate their compensation income because doing so will enable them to earn income on the capital retained by the firm at the new, lower, corporate after-tax rate of tax. As in the case of explicit capital stuffing, there will be no disadvantage to doing so, and the retained capital in turn does offer a tax advantage relative to capital held directly by the owner-entrepreneur.[62] Moreover, so long as payroll taxes remain relevant for higher-income taxpayers, there is an explicit tax rate advantage to labor stuffing.

In short, in the hypothesized future tax rate environment, and even without regard to payroll tax collections, labor stuffing will become capital stuffing. Owner-managers will be in the same position as if they paid themselves their full value in salary and then reinvested the after-tax amount in the corporation. They will use the C corporation as a tax shelter, not because of any income tax advantage in the first instance, but rather to take advantage of the lower-taxed environment in which their returns on their retained capital can compound (and lower payroll taxes).

In the future, then, the issue of distinguishing labor from capital income will be particularly important when two conditions are met: capital stuffing is attractive, and there are tactical advantages to doing so indirectly (through undercompensating oneself) rather than directly (by taking out salary and stuffing the after-labor tax amount back into the corporation). Payroll taxes are one reason to undercompensate oneself. Even focusing solely on income taxes, however, to the extent that capital stuffing is addressed through some of the clumsy traditional tools described below (e.g., the accumulated earnings tax), there may indeed be significant tactical reasons to prefer indirect to direct capital stuffing.

[62] This new impetus to engage in labor stuffing will exist in addition to any practical considerations, both nontax and tax, of the sort briefly identified in the preceding subsection.

D. Corporate Lock-In.

For many years economists have been troubled by the phenomenon of "lock-in," in which a taxpayer holds onto a suboptimal investment to improve his after-tax yield on the investment by deferring a realization event. Lock-in is a property of the realization principle, and therefore is directly tied to capital gain tax rates. Although the term ordinarily is applied from an investor's perspective, in the context of corporate stock it might also usefully be extended to include a corporation's aiding and abetting of the investor's tax planning, by the corporation retaining earnings to mitigate the effects of dividend taxation on investors in tax rate environments where dividends are taxed at higher rates than are capital gains. In each case, investment decisions are distorted relative to what they would be in a world without tax through the tax-induced deferral of gain recognition.

Outside the context of sales of corporate stock, distortions attendant on lock-in may in practice be mitigated or completely offset by conversion opportunities. For example, if an investor holds a Treasury bond bought at par more than one year ago, and interest rates sharply decline, the investor will earn unrealized income, because the value of the bond will increase. The investor can hold the bond and continue to receive ordinary interest income, albeit at higher than current market rates. Alternatively, she can sell the bond, and in doing so accelerate the present value of her greater than market rate future interest coupons into the current year (the lock-in dilemma), but at the same time reduce the tax liability on that amount to the 15 percent rate on net capital gain (the conversion opportunity). In many cases the latter can dominate the former.

The issue of corporate lock-in is related to the problem of capital stuffing, in that each encourages an investor to retain a corporate investment, but the two ultimately are different phenomena. The earlier discussion of capital stuffing in a rate environment conforming to this paper's basic hypothetical fact pattern demonstrated that the longer a marginal investment was retained in corporate solution, the bigger the advantage to capital stuffing. That advantage stems from the fact that, for a given investment, an investor can earn the post-corporate tax rate of return (rather than the individual post-tax rate of return) on the after-toll charge simple annual return to his investment, so long as the investment remains in corporate solution.

By contrast, lock-in arises because a sale of stock at a gain diminishes the investor's total investment by the amount of the tax the investor must pay the government. The tax paid "early" through a midstream sale in turn leads to a step-up in tax basis for the replacement asset, which reduces the investor's tax liability at the back end of her investment, but the investor loses for the remaining term of the investment any return on the amount paid as tax by virtue of the midstream sale.

The analytical framework developed for capital stuffing (the "prefunded" toll charge metaphor) therefore does not apply without further analysis, because in fact there is no prefunding of the midstream capital gains tax liability. The paper's prefunded toll charge metaphor essentially applies to only to the timing of *distributions* from corporate solution (together with the special case of a sale at the end of the investment term, which acts like a liquidating distribution). In other words, the analytical framework developed for capital stuffing operates as if dividend taxes or capital gains taxes on ultimate liquidation operated like a corporate-level withholding tax on distributions.

As applied to marginal investments, lock-in can be conceptualized as a voluntary prepayment by the investor of the toll charge for which taxes have already been set aside inside the corporation. Because there is no coordination mechanism to release those set-aside taxes inside the corporation or to forgive the shareholder-level tax, there is no "true up" until the liquidation of the investment.[63] For that reason, the investor simply loses the earnings on the "prepaid" capital gains taxes. The "principal" of the prepaid taxes is not permanently lost, but rather ultimately is recovered through the true-up mechanism of measuring gain or loss at the disposition of the investment against the stepped-up basis in the replacement investment.

The reduction in net investment attributable to midstream capital gains tax, and the attendant diminution in returns for the remainder of the investment, is the lock-in phenomenon. As applied to a marginal investment, it exists because Shareholder's gain on the switch in investments triggers a shareholder level tax without reducing the inchoate taxes that Shareholder is bearing inside the corporation. That is, Shareholder's corporate returns continue to reflect a

[63] Note that standard corporate-shareholder "integration" schemes do not resolve this problem, because they all assume that corporate earnings will be recognized and distributed before shares are sold. They thus do *not* address the temporary "doubling up" of tax payments at the heart of lock-in. The Norwegian RISK system, now repealed, was a principal exception.

notional set aside for future toll charges, without any coordination or reconciliation to reflect the early payment by Shareholder in his personal capacity of some of these taxes prior to the liquidation of his investment.

The ultimate driver of the lock-in phenomenon therefore is not capital gains taxes as such, but rather the lack of any coordination between the notionally prefunded toll charge and shareholder capital gains imposed on midstream sales, until the final settling up through termination of the investment.

The next example illustrates these points.

> Example 5: The facts are the same as in the second case in Example 1 (where returns are left inside Corporation A and current tax rates apply). At the end of two years, Shareholder switches her investment to Corporation B, which also earns 10 percent pretax on its assets. Is there a tax disincentive to do so? What, for example, would Shareholder's terminal value for the investment be after five years if Shareholder did or did not make the switch?
>
> In this case, Corporation A will have a value of $1134.23 after two years (that is, an after-tax corporate return of 6.5 percent per annum). Shareholder recognizes $1134.23 - $1000 or $134.23 in gain, on which she pays $20.13 in tax. Shareholder reinvests the remaining $1114.10 in Corporation Y. At the end of three more years (five total), that investment has grown to $1345.77. Shareholder recognizes $231.67 in gain ($1345.77 - $1114.10), on which she pays $34.75 in tax. Shareholder is left with $1311.02 – $3.56 less favorable an outcome than the two cases in Example 1.

This is an example of lock-in. By triggering a midstream tax, Shareholder has reduced her net investment for the last three years, and her total return at the end of five years reflects the loss of earnings on that forgone investment. More specifically, the $3.56 diminution in Shareholder's total returns represents two components: a 6.5 percent compounded return on $20.13 – the amount Shareholder paid in tax at the end of year two – or $4.19, ameliorated by the 15 percent quasi-excise tax that Shareholder did not have to pay at the end of Year 5 on these missing earnings.

The lock-in cost in Example 5 is premised on Shareholder retaining a corporate stock investment. As Example 4 demonstrated, that actually would be a foolish strategy under current tax rate environments.

> Example 6. The facts are the same as Example 5, except that after selling his stock in Corporation A, Shareholder invests directly in a marginal investment yielding 10 percent

pretax. Now the $1114.10 net proceeds earns 6.5 percent after-tax for three years. At the end of that period (five years total), Shareholder emerges with $1345.78, better than either Example 1 or Example 5.

In this case, the basis recovery/direct investment phenomenon dominates the outcome. Shareholder is better off selling at the end of Year 2, when he wakes up to the unnecessary toll charge he is incurring, and would be even better off if he woke up at the beginning of the five-year period.

While lock-in and capital stuffing are somewhat different phenomena, the capital stuffing analytical framework can be employed to explain the cost to an investor of the lock-in tax on a marginal investment. The next example shows this.

Example 7: Shareholder owns 100 percent of Corporation X, for which he paid $800; the corporation has since accumulated $200 in retained earnings, and is worth $1000 today. Corporation X earns 10 percent pretax on its assets. Shareholder wishes to switch his investment to Corporation Y, which also earns 10 percent pretax on its assets. The tax rate environment is the new environment hypothesized in this paper; in other respects, this Example essentially tracks Example 2.

If Shareholder simply holds Corporation X, it will grow in value over five years to $1435.63. When Shareholder then disposes of X, Shareholder will recognize $635.63 in gain, on which Shareholder will pay $127.13 in tax, leaving Shareholder with $1308.50.

Conversely, if Shareholder sells Corporation X today for $1000, Shareholder will recognize $200 in gain, and pay $40 in tax. Shareholder can take the remaining $960 and buy that much of Corporation Y. After five years, that investment will grow to $1378.20. After selling Corporation Y, Shareholder will have $418.20 in gain, on which Shareholder pays $83.64 in tax. Shareholder is left with $1294.56.

The $13.94 difference is attributable to the fact that, by virtue of the earlier sale of Corporation X, Shareholder has lost the return on the tax paid ($40) for the five-year period of Shareholder's continuing investment. More specifically, the $13.94 represents the lost opportunity to invest $40 for 5 years in Corporation Y for 5 years, where investments compound inside the firm at 7.5 percent per annum, offset in part by a 20 percent capital gains tax on the resulting hypothetical earnings ($17.43) that Shareholder did not have to pay.

The $13.94 can also be explained using the capital stuffing analytical framework: it represents Shareholder's basic post-toll charge return of 6 percent per annum on the $40 of investment that Shareholder has dissipated by paying his capital gains tax early ($2.40/year for five years, for a total of $12.00), which basic return in turn earns interest at the pre-toll charge

rate of 7.5 percent. In other words, like Example 1, the $13.94 can be seen as the value at the end of five years of a bank account into which $2.40 is deposited at the end of each year as new investment, and which account earns 7.5 percent interest. The difference is, now the government, not the taxpayer, owns the bank account. At the end of the term of the investment, the $40 "principal" is restored to the taxpayer, through a reduction in gain on the sale of the replacement investment attributable to the stepped-up basis in that asset, but he has lost the use of that money for the term of the investment.

The same reasoning would apply (with slightly different numbers, of course) if Shareholder had begun with a $1000 basis in his Corporation X stock. Imagine, for example, that Shareholder in fact began with a $1000 basis in Corporation X, and then either (a) maintained that investment for five years or (b) switched to Corporation Y after two years. In the first case Shareholder would have $1348.50 after tax at the end of five years, and in the second case $1342.48. The shareholder-level capital gains tax acts to reduce net investment for the last three years of the investment.

In practice in the current tax rate environment (where capital gains and dividends are taxed at the same low rate and corporate and personal income is taxed at the same rate) the lock-in phenomenon is not so much about the tax burden on investments that yield marginal returns as it is about investments that yield unexpected returns or rents.[64] For example, imagine that a fortunate investor invests $200 in a capital investment that happily yields $100/year. In a 10 percent interest rate environment, the market value of the investment is $1,000. If, however, the investor sells the investment for $1,000, he will recognize $800 in gain, on which he will pay $120 in tax, leaving him with $880. That $880 in turn can be invested in readily-available marginal investments that yield only $88/year, a diminution in wealth to the taxpayer equal to the return that he formerly obtained on his deferred tax liability.

By contrast, as the prior Subsection showed, in the current tax rate environment, when confronted with a corporate investment earning a marginal return, the right move is simply to disinvest from the corporate environment and earn the same return outside of corporate solution. To that extent, then, there is an incentive to sell immediately, not a lock-in effect. In the new rate environment hypothesized in this paper, by contrast, the problem of lock-in returns, because

[64] Kanemoto, "On the 'Lock-In' Effects of Capital Gains Taxation," 40 *J. of Urban Economics* 303 (1996).

there is an advantage to corporate marginal investments where income is retained inside the corporation over direct marginal investments with the same pre-tax yield; that benefit in turn brings with it the lock-in cost for a sale in the midstream of the investor's total investment horizon.

E. Summary.

The capital stuffing discussion in Subsection A., above, quantified the benefit of deferring corporate distributions in the new tax rate environment hypothesized in this paper, and developed a general expression of the benefit that can be applied to different tax rate scenarios (so long as capital gains and dividends are taxed at the same rate.) The disinvestment analysis in Subsection B. pointed out that, in the current tax rate environment, there always is an incentive to withdraw funds that are earning marginal returns from corporate investment, assuming identical pre-tax returns can be earned directly; that is not true in the new rate environment hypothesized in this paper. And if one is determined to trigger a realization event and reinvest the proceeds, it is better to recover basis sooner rather than later.

The lock-in discussion in Subsection D., by contrast, quantified the detriment to an investor of selling all of his investment in the stock of one corporation that earns marginal returns (and retains those returns) and reinvesting the after-tax proceeds in another corporation earning identical returns. Lock-in today logically is not a problem for marginal returns (because corporate disinvestment is the right strategy), but even under today's tax rate environment lock-in is a problem when applied to an investor fortunate enough to have unrealized supernormal returns on a corporate investment.

It is difficult to keep the capital stuffing phenomenon (differential returns driven by differences in tax rates inside and outside the corporation) separate from the lock-in phenomenon (reductions in net investment through midstream realization of shareholder gains). Moreover, the calculus of the relative costs and benefits of each constantly changes as tax rates change. For example, in the future tax rate environment hypothesized in this paper, taxpayers always earn a higher return on a marginal investment for however long it is left in the corporation: the capital stuffing impulse then dominates over a direct investment. But having chosen to make a marginal investment in corporate form, investors then will suffer the lock-in effect should they wish to

switch from one such investment to another. The lock-in effect never leaves the investor worse off than a direct investment, but does vitiate the advantage of the corporate investment.

In summary, the above examples imply that lock-in can still induce some distortions in the timing of shareholder gains in the case of corporations earning marginal returns (the 10 percent return freely available to all the corporations in the examples), when by virtue of tax rate differentials (that is, in the future, not today) there is a preference for corporate marginal investment, but that, now that dividends are taxed at the same rate as capital gains, pre-2003 law's additional tax-induced distortions to disfavor dividends and to defer all returns from a company until liquidation of an investment no longer apply. Moreover, the lock-in effect today is muted by low capital gain rates and low interest rates; the latter means that the forgone earnings on the conceptual prepayment of tax are themselves relatively small.

These observations regarding the non-existence of capital stuffing benefits and the nonexistence of the lock-in phenomenon when applied to marginal corporate investments under current law seem at first to turn accepted wisdom on its head. It may be, in fact, that many investors are stuck in pre-2003 thought patterns (when dividends were taxed much more heavily than capital gains), or are consumed by the prospect of the tax-free step-up at death.[65] But if one by hypothesis rules out the latter, the identity in each of the two tax rate pairs (dividends and capital gains, and inside and outside the corporation marginal investments) eliminates tax planning from the timing of the extraction from corporate solution of returns to *marginal investments*. One is left with a modest tax benefit from deferring capital gains realizations on supernormal returns (or conversely, economic cost from the misallocations of resources due to lock-in), mitigated in turn by low capital gains rates and low current interest rates.

The prior Subsections made two related points. First, in a world where capital gains and dividends are taxed at the same rates (the toll charge rate-pair identity), the advantage (if any) to deferring distributions from a corporation relates entirely to differentials in the corporate and individual tax rates. (For this purpose a liquidation of the investment is analytically a distribution, regardless of whether that termination transaction is formally a liquidation or a secondary market sale.) Where corporate tax rates are lower than individual tax rates, there is an

[65] Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010), also speculates on whether old modes of thought are at work here.

advantage to retaining assets in corporate solution. Where the differential is large enough (as it would be under the tax rate environment hypothesized in this paper, regardless of investment time horizon) or where the time horizon is long enough, there is an advantage to moving investment assets from individual ownership into corporate solution – what this paper terms capital stuffing. The measure of the advantage is the difference between (i) personal investment returns without diminution for any dividend/capital gain toll charge to (ii) the *pre-toll charge* compounding (at the corporation's post-tax rate of return) of the *after-toll charge* simple interest return on original investment.

Where the toll charge rate-pair identity is satisfied, and where individual and corporate tax rates are identical (the income tax rate-pair identity also is satisfied), there is no advantage to capital stuffing. To the contrary, there is a disadvantage, attributable to the needless imposition of a toll charge without any concomitant tax rate benefit. This dual rate-pair identity of course describes current law. Conversely, under the rate environment hypothesized in this paper, there *always* will be a benefit to capital stuffing.

The capital stuffing analytical framework explains the benefit, if any, to retaining assets in corporate solution. So long as both rate-pair identities are satisfied, there is no difference in returns between extracting corporate revenues as current dividends or deferring those amounts inside the corporation. (Nonetheless, both such cases are inferior to simply liquidating the investment from corporate solution immediately, to avoid future toll charges on future corporate earnings.)

Lock-in is the tax-induced incentive to retain a profitable corporate investment rather than to sell it and reinvest the proceeds elsewhere. In the case of marginal investments, lock-in can be visualized as a prepayment (or, if one prefers, duplicated payment) of taxes already provided for at the corporate level, with the consequence that the investor loses the value of any returns on the tax paid for the life of the continuing investment. "Pure" lock-in is a function of capital gains tax rates, but in practice other phenomena (like the favorable capital stuffing environment created by a lower corporate tax rate than individual rate) can create analogous behavioral responses.

The corollary to this mode of analysis is the point made in Subsection B. When and if a taxpayer wishes to extract earnings from a corporate investment, it is desirable to do so, even

with current tax rates, through a capital gain transaction, because doing so essentially is the opposite of a lock-in problem: by applying basis to reduce temporarily what otherwise would be taxable income on corporate distributions, the taxpayer obtains an advantage. The advantage is temporary, in that the accelerated use of basis must be accounted for, but the taxpayer has the use of the tax saved for the term of the investment. Just as in the lock-in case when applied to a marginal investment the taxpayer has to prepay taxes already provided for him, so in the basis recovery case the taxpayer is reducing tax that would otherwise be owed.

In short, lock-in counsels against selling appreciated corporate stock, but the basis recovery point argues that, once an investor has determined to extract cash from a corporate investment, a stock sale is the way to do it. The first goes to a tax-induced disincentive to divest; the second to the tax-induced preferred form of any predetermined disinvestment.

V. CURRENT TECHNOLOGIES TO ADDRESS CAPITAL AND LABOR STUFFING.

This Section V reviews the tools available under current law to respond to capital stuffing, lock-in and labor stuffing, as well as a few of the reform ideas posited to date that directly consider tax rate environments similar to those hypothesized in this paper. Having concluded that they are generally inadequate to the task, Section VI then explains how the Dual BEIT is a more comprehensive response to the problems.

A. Current Law Tools to Address Capital Stuffing and Lock-In.

1. Capital stuffing. Capital stuffing is not logically a problem today, because rational taxpayers seek to keep capital out of corporate solution. But the new tax rate ecosystem contemplated by this paper arguably will be *more* hospitable to capital stuffing than was true at many points in the past, thanks to the preservation of the toll charge rate-pair identity, combined with the divergence in the income tax rate-pair identity. By virtue of this fundamental change, individual taxpayers operating in the new tax rate environment will discover that they are *never* worse off investing through a corporation: they can always extract their corporate profits each year as a dividend, and suffer an "all-in" tax burden no different than if they had invested directly.

That was not true in the pre-1982 period. At that time, there was a tax benefit to the combination of earning income at corporate rates and then extracting those earnings as capital gains,[66] but a very large disadvantage to extracting corporate profits as dividend income. For this reason, individual tax planning for investment income focused obsessively on transforming ordinary income to capital gain, and in turn deferring those gains as long as possible (ideally, until death).

Capital gains remain ains privileged today (and in this paper's hypothesized future tax rate environment) for income earned directly by individuals. Individuals also will prefer to extract cash from corporate form through capital gains transactions, not because of any tax rate advantage, but to obtain the timing benefit of quicker basis recovery. But the stakes are more attenuated now than was true in the past, because the difference is now one only of timing (that

[66] For example, immediately before the Economic Recovery Tax Act of 1981, the highest tax bracket for individuals' investment income (including dividends) was 70 percent. Taxpayers earning investment income through a corporation could reduce that to roughly 61 percent if they extracted their earnings as capital gains (46 percent corporate tax and 28 percent capital gains tax).

is, dividend income is taxed at the same rate), and the absolute tax rate levels for dividend and capital gains are historically low.

The Internal Revenue Code today contains some safeguards against capital stuffing, principally the personal holding company and accumulated earnings tax. The next few paragraphs summarize these existing safeguards, and show why they are inadequate to protect the fisc from capital stuffing in the new tax rate ecosystem contemplated by this paper.

The Code today contains two principal means of limiting tax avoidance from capital stuffing: the personal holding company rules and the accumulated earnings tax rules. (The collapsible corporation rules actually were directed at a form of labor stuffing, not capital stuffing; those rules prevented the one-time conversion of unrealized returns to human labor into present capital gains.) The personal holding company rules are mechanical but incomplete to police capital stuffing in the new tax rate ecosystem; the accumulated earnings tax provisions rely on a facts and circumstances inquiry that renders them irrelevant to all but the clumsiest taxpayers.

The personal holding company provisions[67] impose a corporate-level penalty tax of 15 percent on any "undistributed personal holding company income" of a "personal holding company." The purpose of the provision is to compel affected corporations to distribute earnings currently.

A "personal holding company" is defined by reference to the character of its income and the concentration of its ownership. The ownership leg is satisfied when 50 percent or more (by value) of the stock of a corporation is owned by five or fewer individuals.[68] Ownership is determined under complex and comprehensive constructive ownership rules, so that, for example, stock owned by siblings, parents and children are all aggregated.[69] Those individuals need not act in concert, or technically even be aware of the others' existence

[67] Sections 541–47. In addition, investments in foreign investment companies might give rise to subpart F income (sections 951-965) or "excess distributions" taxed under the passive foreign investment company regime (sections 1291-1298).

[68] Section 542.

[69] Section 544.

The income leg of the definition of a personal holding company is satisfied if a corporation derives 60 percent or more of its income (other than capital or 1231 gains) from a long list of investment-type returns, including dividends, interest, and certain royalties. As can be imagined, there are numerous exceptions to the inclusion of certain categories of income in certain contexts. For example, banks, insurance companies and certain active lending or finance businesses all are exempt.

The personal holding company regime is complex and encrusted with exceptions that may not always make perfect policy sense, but it has the virtue of being mechanical in application. Nonetheless, its bright-line definitions make it inadequate to the task of policing capital stuffing. The ownership leg of the definition probably is broad enough to serve this enhanced purpose in respect of the classic small business, but leaves open the possibility of widely-held domestic corporations that function like investment companies but that elect not to be taxed as regulated investment companies for tax purposes – subject, of course, to navigating the accumulated earnings tax regime described below. Moreover, the income definition is plainly inadequate to police capital stuffing. For example, the 60 percent threshold on passive income invites capital stuffing in closely held businesses up to that bright line. And the exceptions invite a proliferation of closely held domestic reinsurance companies writing low-risk cover.

The accumulated earnings tax is a penalty tax of 15 percent imposed on a corporation that retains earnings "beyond the reasonable needs of the business."[70] This too is designed to compel corporations to distribute excess earnings, although the accumulated earnings tax rules themselves does not care whether a corporation distributes its excess earnings as dividends or as wages.[71]

The accumulated earnings tax offers no bright-line rule; a corporation's "reasonable needs" is a question of fact, thereby raising substantial administrability and compliance issues for

[70] Sections 531–37. See also See also Nelson J. Luria, "The Accumulated Earnings Tax," 76 *Yale L.J.* 793 (1967). As with PHCs, the 15 percent rate is equal to the individual dividend rate. Note that a corporation that is a PHC is not also subject to the AET; one 15 percent penalty is sufficient.

[71] See *Henry Van Hummell, Inc. v. Comm'r*, 364 F.2d 746, 751 (10th Cir. 1966) ("The controlling matter is the ultimate one—whether there was retained an unreasonable amount of profits or earnings. This is simply what the statute provides.")

both taxpayers and the Internal Revenue Service.[72] The fact that a company is a "mere investment company," however is prima facie evidence that the corporation has been formed or availed of for the prohibited purpose of permitting earnings and profits to accumulate instead of being distributed.[73]

Outside of the "mere investment company" case, the accumulated earnings tax thus requires the Internal Revenue Service to second-guess the motives of corporate management in retaining earnings. Regardless what standard is used—whether it is based on accounting ratios, the corporation's operating cycle (the so-called "Bardahl formula"), or any other rule of thumb[74]—application of the accumulated earnings tax will inevitably cause some economic inefficiencies (for example by encouraging the acquisition of a small active business solely to defeat the "mere investment company" label) while simultaneously applying unevenly (by virtue of the audit lottery) to similarly-situated taxpayers. In the end, the accumulated earnings tax largely rewards the creative writing of corporate minutes.

The accumulated earnings tax rules do present tax advisors with an interesting dilemma: if a taxpayer makes his corporation pay him only a small salary to both stuff capital in the corporation and convert labor income into capital income, does this trigger the accumulated earnings tax? On the one hand, an insubstantial salary may indicate that the corporation retained more profits than it needed, triggering the accumulated earnings tax.[75] On the other, small salaries may be adduced as evidence that the corporation needed to retain its profits as much as possible to avoid financial difficulty, so the accumulated earnings tax does not apply.[76]

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[72] See, e.g., Cataphote Corp. of Miss. v. United States, 535 F.2d 1225 (Ct. Cl. 1976). In *Cataphote*, the taxpayer claimed that $349,140 of accumulated earnings were necessary to pay for a fleet of trucks, but the court discounted this contention because of a lack of contemporaneous documentation. Id. at 1231. Instead, the court found that the taxpayer's reasonable needs for accumulated earnings were limited to about $45,000 in working capital and enough to pay for accrued but unpaid income tax liabilities. Id. at 1237.

[73] Section 533(b); section 532.

[74] See Luria (1967) for a discussion of various approaches that have been used.

[75] Atlas Tool Co. v. Comm'r, 614 F.2d 860, 870 (3d Cir. 1980).

[76] Simons-Eastern Co. v. United States, 354 F. Supp. 1003, 1011–12 (N.D. Ga. 1972).

2. Lock-In. The lock-in phenomenon in respect of corporate stock cannot be avoided in a realization-based classic corporate tax system, but its effects are reduced as capital gain tax rates are reduced. Current law therefore responds to lock-in through historically low tax rates on net capital gain from the sale of stock. That value in turn is undercut by the step-up in tax basis at death, which offers an escape from all capital gains taxes.

B. Responding to Labor Stuffing Under Existing Law.

The Internal Revenue Code today contains a few provisions that distinguish labor from capital income in order to convey a benefit on the former not available to the latter. For example, section 911 excludes from income a specified amount of an individual's "foreign earned income."[77] When applied to a U.S. owner-manager of a foreign business conducted as a proprietorship or tax partnership, the issue becomes how to determine the portion of the owner-manager's business income that qualifies for section 911's exclusion. Section 911(d)(2) unhelpfully answers the question by providing that, if both services and capital are income-producing factors, then "earned income" includes "a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business." The impulse that the measure of earned (or personal services) income should in some fashion be arbitrarily capped whenever capital is a material income-producing factor in turn has an ancient pedigree, dating back to World War I excess profit statutes.[78]

In practice, and as a matter of lore, it is probable that most taxpayers simply treat 30 percent of business profits as earned income. The arbitrariness of the rule means that he result may be excessive in some cases, and inadequate in others, but on balance one might expect that the cap applies inappropriately more frequently than taxpayers successfully employ it as a *de facto* floor to increase the earned income that they report on their tax returns. The section 911 regulations simply repeat the statute's admonition that, when capital is a material income-producing factor, a reasonable allowance for compensation constitutes section 911 earned

[77] Section 911(a).

[78] Asimow, "The Maximum Tax on Earned Income: The First Five Years," 27 *S. Cal Tax Inst*. 191, 229-231 (1975).

income, up to 30 percent of the firm's net income.[79] By analogy to a related area, capital employed in the business need only be "substantial" to subject taxpayers to the 30 percent of firm income cap, and there is very little learning on how substantiality might be measured across different businesses.[80]

In the case of an owner-manager of a corporation, section 911 offers no special rules for dividing labor from capital income. As a result, the division is left to the taxpayer, in the form of the amount of firm profits the owner-manager designates as compensation. The only constraint is section 911(b)(2)'s rule that compensation must be reasonable in amount.

A similar issue arises in respect of qualified employee benefit plans.[81] Those rules also convey benefits (the qualification of the income for an employee benefits plan) on the "earned income" of a self-employed individual. In turn, "earned income" for this purpose is defined as net earnings from self-employment for purposes of the self-employment tax, except that the net earnings must arise from a trade or business for which personal services of the taxpayer are a material income-producing factor.[82] This rule effectively treats all business income derived by a proprietor or owner-manager of a partnership as qualifying income: that is, there is no attempt to exclude from the definition of "earned income" any amount attributable to a fair return on capital.[83]

Conversely, in the case of the owner-manager of a corporation, only those amounts designated as compensation are treated as such for section 401 purposes. The only limitation

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[79] Treas. reg. sec. 1.911-3(b)(2). A special rule deems income from traditional professions, like law and medicine, as constituting earned income in its entirety. Treas. reg. sec. 1.911-3(b)(3).

[80] *Cf.* the rule in former Treas. reg. sec. 1.1348-3(a)(3)(ii) (1977), under the analogous maximum tax on earned income, discussed below ("Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business, as reflected, for example, by a substantial investment in inventories, plant, machinery, or other equipment."). See also Snyder, "Taxation with an Attitude: Can We Rationalize the Distinction Between 'Earned' and 'Unearned' Income?," 18 *Va. Tax Rev.* 241, 277-79 (1998).

[81] Section 401.

[82] Section 401(c)(2)(A).

[83] For the early history, which contained just such a limitation, see Asimow, "The Maximum Tax on Earned Income: The First Five Years," 27 *S. Cal Tax Inst.* 191, 230 (1975).

from this direction is the general point that only "reasonable" compensation is treated as such for tax purposes.

The same question arose under former section 1348, repealed in 1981. That section imposed a maximum tax rate of 50 percent on "earned income," at a time when the maximum individual tax rate on "unearned" income was 70 percent. Section 1348 generally followed the same rules reflected today in section 911, with all the obvious deficiencies noted, both in respect of the arbitrariness of the rule as applied to proprietorships and partnerships, and the considerable degree of electivity of the rule as applied to corporations.[84]

None of these rules appears to have been particularly successful at separating labor from capital income. The rule limiting labor income to 30 percent of firm income when capital is a material income-producing factor is plainly arbitrary, and in any event does not apply to corporations. And the qualified pension plan rule that treats all income from a proprietorship or partnership as labor income if in fact some of the income is labor income is just as arbitrary, although in the opposite direction: it systematically overstates labor income, just as the first rule systematically understates it. So the two rules are both systematically wrong and internally inconsistent.

None of the rules summarized above can be said to have as its purpose the segregation of labor from capital income for the purpose of preventing taxpayers from reclassifying what economically is labor income into what might be treated for tax purposes as capital income. The one specific anti-abuse rule in the Internal Revenue Code that can be said to have addressed this phenomenon of labor stuffing was section 341, the collapsible corporation rules; the provision was repealed in 2003.[85] That Code section was famously recondite, but for this purpose the key point is that it addressed cases where individuals formed corporations to create property through their labor (e.g., movies, or tract homes), and then sought to sell the corporate stock before the self-created property could generate significant ordinary income.

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[84] For the former rule, see Treas. reg. sec. 1.1348-3(a)(3)(i)(1977). For some sense of the tax planning opportunities and pitfalls of former section 1348's definition of "earned income," see Levy, "The Maximum Tax on Earned Income: An Inefficient and Inequitable Tax Shelter Deterrent," 53 *Notre Dame L. Rev.* 883, 898-910 (1977); Asimow, "The Maximum Tax on Earned Income: The First Five Years," 27 *S. Cal Tax Inst*. 191, 229 - 249 (1975).

[85] Former Section 341, repealed by P.L. 108-27, section 302(e)(4)(A).

Section 341 lost its sting when the Tax Reform Act of 1986 repealed the *General Utilities* doctrine, thereby subjecting to corporate-level tax the "build and liquidate" strategy at which the provision was aimed. Even in the new rate environment contemplated by this paper, it is not clear that an advantage would reemerge to the strategy, as the all-in tax on gain from the self-created property would equal the tax rate imposed on compensation income.

Moreover, even if section 341 were reenacted and rewritten to be comprehensible, it addressed an extremely narrow instance of labor stuffing. It simply would not reach the far more common case of the owner-manager of an operating company simply choosing not to draw a salary, and thereby leave compensation income to earn a superior investment returns inside the corporation.

Two instances where the distinction between labor and capital income does matter today illustrate how badly current law addresses the issue. The first is the well-known carried interest debate that exploded on the tax scene in 2007. The issue was briefly identified in Part II.

A second example of an area in which the division of the owner-manager's returns between labor and capital income has been the subject of recent controversy is the "John Edwards" payroll tax avoidance gambit described earlier. The informal position of the Internal Revenue Service is clear: when a shareholder of an S corporation performs services for the corporation, the owner-manager must be paid a "reasonable" salary, which compensation in turn of course is subject to social contribution payroll taxes.[86] The Internal Revenue Service has addressed the issue in more formal guidance only in the case where an owner-manager is paid dividends but receives no compensation income at all.[87]

The Internal Revenue Service may be whistling, if not in the dark, then at least at dusk, as almost all the reported cases deal with the easy case where an owner-manager draws no salary at all. In such circumstances, courts have recharacterized purported dividends as wages subject to

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[86] Internal Revenue Service release number FS-2008-25, August 2008. A 2010

[87] Rev. Rul. 74-44, 1974-1 C.B. 287. Some have questioned whether this ruling is still valid, given that it was issued before the 1982 revision to S corporation rules. See Thomas E. Fritz, "Flowthrough Entities and the Self-Employment Tax: Is It Time for a Uniform Standard?" 17 *Va. Tax Rev.* 811, 822 n.37 (1998).

payroll taxes.[88] By contrast, there appears to be only one reported case where the Internal Revenue Service has successfully asserted that the stated salary of an owner-manager who was very modest about the value of the services he provided to his S corporation constituted unreasonably low compensation income.[89] The ability of an S corporation's owner-manager to avoid the self-employment payroll taxes that apply to an-otherwise comparable partner is an important factor in explaining why S corporations continue to increase in popularity as a form of business organization.[90]

Even before the very recent *Watson* case, the confusion between the capital and labor income of S corporation owner-managers was well known to specialists. For example, the Staff of the Joint Committee on Taxation described the issue in detail in a 2005 report.[91] Moreover, the

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[88] See, e.g., *Joseph Radtke, S.C. v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); *Veterinary Surgical Constultants, P.C. v. Comm'r*, 117 T.C. 141 (2001); *Mike J. Graham Trucking, Inc. v. Comm'r*, 85 T.C.M. (CCH) 908 (2003); *Superior Proside, Inc. v. Comm'r*, 85 T.C.M. (CCH) 914 (2003); *Specialty Transp. & Delivery Serv. v. Comm'r,* 85 T.C.M. (CCH) 920 (2003); *Nu-Look Design, Inc. v. Comm'r*, 85 T.C.M. (CCH) 927 (2003); *Water-Pure Sys., Inc. v. Comm'r*, 85 T.C.M. (CCH) 934 (2003). Cf. Daley, *Edwards's S Corporation, Medicare Tax, and Fair Share,* xx Tax Notes 1577 (Sept. 27, 2004).

In *Joseph M. Grey Pub. Accountant, P.C. v. Comm'r*, 119 T.C. 121, 124–25 (2002), the Tax Court reclassified an owner of an S corporation who claimed also to be an independent contractor as in fact an employee, and thereby imposed payroll tax obligations on the compensation paid by the corporation.

For recent news articles, see David Cay Johnston, *Newt and the NEWT Act*, Feb. 3 2012, http://blogs.reuters.com/david-cay-johnston/2012/02/03/newt-and-the-newt-act/; Shamik Trivedi, *News Analysis: Shades of John Edwards in Gingrich Return,* Tax Notes Today, Jan. 24, 2012.

[89] *Watson v. United States*, No. 4:08-cv-00442 (S.D. Iowa 2010), aff'd, 8th Cir., No. 11-1589, 2/21/12, where the taxpayer paid himself a salary of $24,000/year and treated approximately $200,000/year as dividends; the District Court for the Southern District of Iowa held for the government that the salary Watson received was not reasonable compensation, and therefore imposed FICA tax on the dividends received (subject to relevant ceilings). The 8th Circuit affirmed, arguing that *Radtke* and similar cases in fact established a duty to pay reasonable compensation, at least for FICA purposes.

[90] Treasury (2007) at Table 3.2. In virtually every other respect, the limited liability company is a superior form in which to conduct business. For example, in the case of a limited liability company, and in contrast to the rules governing S corporations, there are no limits (short of becoming publicly-traded) on the number of the limited liability company's members, or on the identity of the members as individuals or other entities, there are no restrictions on the complexity of the capital structure of the entity, and complex partnership-style income allocations are possible. Yet the Treasury data cited above demonstrate that substantially more businesses (by number of businesses) are organized as S corporations than as partnerships and limited liability companies.

[91] (JCT Staff 2005 at 95-104).

tax revenues at stake are enormous. For example, the JCT Staff report referenced above concluded in 2005 that revising the law to treat S corporation owner-managers as partners, and clarifying that limited liability company members were liable for self-employment taxes, would raise over $57 billion over ten years. In the intervening time taxpayers' reliance on this strategy appears only to have increased. This suggests that the issue in fact may today be more important as a revenue matter than would be the revision of current law to treat some income derived from "carried interests" as labor income.

The question of what counts as "reasonable compensation" has primarily been addressed in a different context: the deductibility of unreasonably *high* wages paid by a C corporation. Small business owners running C corporations have, at times, sought to eliminate the double taxation of a C corporation's profits by setting the owner-entrepreneur's salary just high enough so that the corporation has no (or very little) taxable income. The IRS can step in to deny a deduction for some of the purported wages—any amounts that are not "reasonable"—and reclassify some of the payments as dividends, increasing the corporation's taxable income.[92] The standard applied in high-compensation cases is the "independent investor test,"[93] which considers a range of facts and circumstances.[94]

The reasonable compensation determination as applied presents obvious difficulties, not the least of which is the administrative and judicial burden of the determination and the unevenness of its application in practice. A fact and circumstances test cannot possibly be applied usefully to cover the gamut of American businesses, each with different market norms and special circumstances. Moreover, there is only one case to date that accepts the existence of an affirmative duty as a matter of law to pay a minimum reasonable level of compensation in the context of S corporations. Even if this legal standard were universally embraced, it cannot

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[92] See section 162(a)(1); Treas. Reg. section 1.162-7(b)(1) (1960).

[93] Koski (2007) at 23. This test has been used, for example, to reclassify as dividends some compensation paid to an owner-entrepreneur when his business suddenly experienced a tenfold increase in gross receipts. He had given himself a large pay increase, from $190,000 in one year to $4.3 million the next, $2 million of which the court reclassified as a dividend.

[94] See, e.g., Pepsi-Cola Bottling Co. of Salina v. Comm'r, 528 F.2d 176, 179 (10th Cir. 1975) (listing nine factors).

possibly be expected that the same test could usefully perform that task in the new rate environment, where the stakes will become even higher.

In summary, the Internal Revenue Code does not today contain any mechanism to address labor stuffing, and the Internal Revenue Service's efforts to police a facts and circumstances approach to measuring unreasonably low (or high) compensation has been no more successful than any other intensely fact-specific inquiry. Looking forward, it is difficult to envision how one could write a self-enforcing provision of law that would identify for taxpayers and the Internal Revenue Service alike what constitutes reasonable compensation in every instance. Another approach is needed.

C. Incremental Reform Proposals.

1. Responses to Capital Stuffing. The Internal Revenue Code's tools for addressing the capital stuffing problem as it existed in the decades before 1982, when corporate tax rates were materially lower than individual rates, demonstrate the practical futility of policing capital stuffing through rules designed to limit 'incorporated pocketbooks,' or 'unreasonable accumulations' of earnings. These regimes are likely to be, at best, uneven and imperfect policemen of the future capital stuffing problem that will plague the tax rate environment hypothesized in this paper. Another approach is needed.

One possible incremental response to the capital stuffing phenomenon is to reject the hypothesis, or more particularly to raise the tax rate on corporate distributions.[95] A dividend/capital gain toll charge can operate to remove the advantage of lower corporate income tax rates in respect of any specified holding period, but so long as the intra-corporate after-tax rate of return is higher than the outside rate of return, there exists a holding period sufficient to compensate for the higher toll charge. As a result, higher taxes on dividends and capital gains will also always be an imperfect solution to the phenomenon.

More important, higher toll charges by their nature will exacerbate lock-in problems, by inducing investors to hold onto their corporate investments as long as possible to enjoy the higher rate of return on their corporate capital (net of the notional set-aside to fund the toll

[95] Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010) comes to this conclusion.

charge). Moreover, as a matter political economy, there does not appear to be any great appetite to raise dividend and capital gains taxes beyond the 20 percent level mooted by the President. For all these reasons, capital stuffing should be addressed by a solution other than higher dividend and capital gains taxes.[96]

A better approach to the problem is to take a step back and ask why we would want to tax some capital income (e.g. corporate returns) at one rate and other capital income (returns earned directly or through a fiscally transparent vehicle) at a different rate. Efficiency argues for a consistent rate on all capital income, so that allocations of capital are not distorted across different real investments and legal forms of making those investments. Moreover, if capital income is to be taxed, it is likely that the most successful compromise between efficiency and immediate revenue concerns, as tempered by political economy considerations, will lie in the direction of a relatively low flat tax on capital income.[97]

The point here is not to make this case, as this paper has expressly assumed it. Rather, the point is to say that, in light of this ultimate goal, there is a straightforward answer to the problem of capital stuffing, which is to recognize that the problem lies in *overtaxing* capital income earned outside the corporation, not in the failure to preserve higher taxes on some forms of capital income by policing an artificial boundary between the meaningless legal form of the corporation, on the one hand, and other forms of business enterprises, on the other.

Given that corporate income tax rates must come down in response to all the larger trends identified earlier, the right move in this case is to: (i) reduce capital income taxes on individuals to the same rate as that imposed on corporations and (ii) lower, not raise, dividend and capital gains taxes on corporate stock to as close to zero as is feasible. In such an environment, returns on marginal investments would compound at the same after-tax rates inside or outside the corporation.

In short, the fundamental insight that flows from understanding the source of the capital stuffing advantage is to align individual and investor-corporate tax burdens on capital income by

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[97] Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010).

lowering, in particular, the tax rate on interest income to the same capital income rate that corporations enjoy on their net profits.

2. Lock-In. The most direct mitigation techniques for the problem of lock-in point in the direction of (i) low capital gains tax rates on sales of corporate stock, (ii) assuring identity in tax rates between dividends and capital gains, and (iii) the elimination of the tax-free step-up at death.

The first point is almost self-evident; in the absence of some mechanism to coordinate shareholder capital gains with corporate taxes, capital gains taxes are the source of lock-in. At the same time, it is important to recognize that the case for low capital gains taxes to mitigate corporate lock-in are much more attenuated when extended to investments not subject to double taxation: in those cases – for example, the sale of a bond at a profit, attributable to a decline in interest rates – a preferential capital gains rate creates a tax-induced distortion *in favor of sales*, in order to capture future streams of ordinary income at lower capital gains rates.

The second point addresses the quasi-lock-in problems attributable to disparities in the tax rates imposed on dividends and capital gains: if such a difference exists, investors and corporations have an incentive to retain earnings in corporate solution and to defer realization events. And the third recommendation of course goes to an additional incentive to defer the realization of gains; unlike the core lock-in phenomenon, this one is readily addressed even within the constraints of a realization system.

3. Labor Stuffing. Labor stuffing today is driven in large measure by some conspicuous anomalies in current law, in particular the S corporation and non-corporate capital gain conversion opportunities described earlier. In the context of corporate employers, and assuming that the "John Edwards" type strategies are separately addressed, the labor stuffing problem is really a subspecies of capital stuffing: the reason an owner-manager would undercompensate herself in the future is not the lower corporate tax rate per se (because that comes with the dividend/capital gain quasi-excise tax, which brings the aggregate rate back to labor tax levels), but rather the opportunity to leave that amount in corporate solution to compound at the superior post-corporate tax rates.

One suggestion is that all closely held corporations mandatorily be taxed as partnerships.[98] That proposal would solve the labor stuffing (and capital stuffing) issue, but without more it would do by raising substantially the tax rate on the capital income of roughly half the U.S. economy. [99] Efficiency concerns and the larger trends in capital income taxation that this paper has summarized all counsel against this approach, without further consideration to the rates imposed on the owners of a private firm.[100] (In effect, the Dual BEIT proposal offered in the last section of this paper does just that, by taxing the capital income of closely held firms at low capital income rates.)

If this paper is correct that the principal advantage of labor stuffing is that it affords the owner-manager the opportunity, not to avoid labor income taxes as such, but rather indirectly to engage in capital stuffing in respect of the retained corporate earnings attributable economically to labor inputs, then the solution proffered earlier for capital stuffing – to reduce the tax rate on capital income earned directly by individuals to the corporate tax rate – would address the problem, at least in the rate environment contemplated by this paper. But tax rates may change, thereby changing the dynamics, and there other reasons (e.g. the payroll tax) to develop a more comprehensive solution. For these reasons, it is worthwhile to consider how a more robust capital-labor income centrifuge might be designed.

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[98] George Yin, Toward Tax Reform chapter.

[99] And in the rate environment imagined here there would be enormous effort applied to becoming a 'barely public' company to take advantage of the superior returns available to corporations described in this paper.

[100] Interestingly, Norway recently has done something vaguely along the lines of what Yin suggests, by taxing the income of private firms at the maximum individual rate. To make this approach consistent with economic theory, however, Norway has also introduced a system to *exempt* normal returns (returns on marginal investments) from tax at all. The Norwegian system thus amounts to a high rate of tax only on economic rents. In the absence of a Norwegian-style special rule for normal returns, raising the tax rate on all capital income not held by public corporations would seem to add significant distortions to U.S. savings and investment.

VI. A COMPREHENSIVE RESPONSE: THE DUAL BEIT.

A. Capital Income Tax Rates and Dual Income Taxes.

1. In General. Putting to one side the more fundamental issue as to whether capital income should be taxed at all, and instead assuming that the United States will continue to tax capital income, the discussion to this point suggests several straightforward conclusions:

• Our current system for taxing capital income is a shambles.

• The hypothetical tax rate ecosystem hypothesized in this paper will place still further stress on that system, by inviting taxpayers to turn the C corporation into a tax shelter. Individuals will engage in widespread capital stuffing, and owner-entrepreneurs will rely on labor stuffing to convert labor income into lower-taxed capital income.

• Proposals to address capital and labor stuffing by increasing the tax rate on dividends and capital gains, or by rejecting the tax rate environment hypothesized here, appear to be inconsistent with international trends, domestic politics, and parity between interest income and other forms of capital income. (Proposals to reduce corporate tax rates and to pay for that reduction by higher taxes on dividend income and capital gains, are discussed briefly below, but in general run afoul of the principle of parity across different forms of capital investment.)

• A more straightforward solution is to *reduce* the tax burden on capital income earned directly by individuals (whether interest, dividends or capital gains) to match the tax burden imposed on corporate income.[101]

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[101] The current Norewegian implementation of its dual income tax aims at this objective, but introduces a novel variant, the "rate of return allowance" (RRA). Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010); *OECD 2012 Norway Survey*. The RRA dual income tax system taxes all capital income, including corporate net income, at one flat rate (28 percent), but deliberately imposes a double tax on corporate dividends and capital gains, *after* taking into account an investor-level deduction for a normal rate of return (the RRA). The net result is that interest and other forms of capital income generally are taxed at 28 percent, corporate net income is taxed at 28 percent, dividends and capital gains from the sale of stock are tax exempt in the hands of investors to the extent of a normal return on their investments, and those dividends or capital gains are fully subject to another 28 percent tax to the extent they exceed that normal return. This brings the tax on such income to a level similar to the highest tax rate on labor income.

The idea is twofold. First, it solves the labor stuffing problem that bedeviled the first iteration of the Norwegian dual income tax, by taxing any extractions from corporate solution at rates closely comparable to labor tax rates. (The problem under the first Norwegian dual income tax system was not technical, but

• This in turn implies a more comprehensive "dual income tax" approach to tax rates.

As previously described, dual income tax systems are income taxes that explicitly reject the ideal of a single rate of tax on all income from whatever source derived, and instead impose different rates on capital income, on the one hand, and all other income (principally, labor income), on the other. Typically, a dual income tax adopts a relatively low flat rate of tax on capital income, and progressive rates on labor income, where the highest labor income rate is materially greater than the flat capital income rate, but other rate structures are possible.

Dual income tax structures offer several fundamental advantages over the drift of current U.S. tax law. First, dual income tax systems take a broad view of capital income and, to the extent reasonably feasible in the quotidian world, they tax that capital income at a consistent rate. Second, by choosing for that rate a relatively low proportional (flat) rate, a dual income tax enhances economic efficiency, by treating the tax rate imposed on losses symmetrically with the tax rates imposed on gains, by mitigating the bias in favor of current consumption attendant on higher rates, and by reducing tax-induced distortions in the allocations of capital investment across different legal forms and different industries. Third, and most directly relevant to the scope of this paper, by taxing capital income earned by individuals at the same rate as capital income earned by corporations, dual income tax systems largely eliminate the tax advantage of capital stuffing and labor stuffing.

2. A Labor-Capital Income Centrifuge. An explicit dual income tax – that is, any regime that taxes capital income at one rate, and labor income at another – requires a labor-capital income centrifuge, to divide business income between labor and capital components in those cases where the suppliers of labor and capital cannot be relied on to specify those returns accurately by themselves. In fact that second issue arises from time to time in the Internal

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rather political – the labor-capital income centrifuge rules by design were easily evaded.) Second, the new system taxes economic rents at close to labor rates. This is its chief policy virtue, as the labor stuffing problems under the original system could easily have been solved by more adroit legislative drafting.

Kleinbard and OECD, supra, both raise objections to the new system, including the introduction of asymmetrical payoffs, and the fact that, if inflation is taken into account, normal returns may be taxed at rates comparable to those imposed on economic rents. OECD in particular emphasizes that a system like the BEIT has very important advantages over the RRA approach, in that it moves the anti-double tax exemption for normal returns to the firm level. In the case of open economies this makes the system's exemption of normal returns available to all investors, including foreign investors, which of course is not true of the "basis bump" offered by the RRA to Norwegian domestic investors.

Revenue Code today, but, as the discussion in Section V demonstrated, our current tools are both internally inconsistent and inadequate to do a remotely plausible job. Given the shoddy work we have made of the issue in the past, a mechanical solution of the sort adopted (at least for a period of time) by the Nordic countries, in which a reasonable return to capital is imputed, and the remaining income treated as labor income, can hardly be faulted as inexcusably imprecise.[102] Moreover, the solution is self-assessable and universally applicable.

The idea of the labor-capital income centrifuge is straightforward. In those cases where markets cannot be expected reliably to separate labor from capital income – that is, in the case of closely held companies – an owner-manager of a firm determines the portion of her total returns that are attributable to her capital invested in the firm by multiplying that capital by a fraction (which typically could be determined by a formula tied to one-year government securities); the result would be the deemed return to capital, and the remainder a deemed return to her labor. Actual Nordic implementations rapidly grew more complex, for example to deal with whether the asset base should be a net or gross asset concept, and how to determine when a company was sufficiently closely held as to invoke the labor-capital income centrifuge, but as these questions have recently been considered in great detail elsewhere, they will not be repeated here.[103]

C. The Business Enterprise Income Tax.

1. Introduction. Dual income tax systems by themselves do not offer any new technologies to measure returns on real assets accurately. This is a fundamental problem if capital income is to be taxed at a constant rate; in the absence of taxing returns to real capital accurately, some investments will be favored over others, and any assumptions underlying implicit integration schemes will fail. For example, if one concludes that gains from the sale of corporate stock should not be taxed, because the underlying capital income has already been taxed to the corporation, that premise will fail when returns to real assets are mismeasured.

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[102] This is a principal theme of Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010).

Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010), also briefly raises the possibility of solutions along these lines.

[103] Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010).

The Business Enterprise Income Tax responds directly to the fundamental problem of measuring returns to real capital invested in business operations, and then coordinating the resulting measurement of real income with the measurement of returns to the financial assets that collectively represent the division of that income among the ultimate providers of capital to the firm. Earlier income tax reform proposals, including the Comprehensive Business Income Tax (CBIT), largely assumed away the problem, and in doing so delivered less than they promised.

The BEIT adopts two novel strategies. First, unlike other comprehensive income tax proposals, the BEIT splits the taxation of returns to capital by taxing time value of money (normal) returns only at the *investor* level, while taxing extraordinary returns at the *business enterprise* level. By doing so, the BEIT sidesteps the problems that plague CBIT and similar comprehensive entity-only income tax proposals, as well as Nordic-style dual income taxes, all of which accurately tax normal returns only if they get economic depreciation precisely right.

Second, the BEIT seeks to reduce the realization principle to its smallest possible component. By taxing normal returns to investors rather than business enterprises, the BEIT takes advantage of the intuition that investment assets turn over more rapidly than do noninventory real assets, so that the *base* for determining normal returns is closer to the economic ideal. For the same reasons, the BEIT repeals numerous exceptions to the recognition of income and requires mandatory income accruals with respect to normal returns. The result is a system where reported taxable income tracks economic income much more closely than under current law.

2. Enterprise Taxation. The BEIT would apply only to *business enterprises*, which for this purpose means only private-sector, for-profit activities, other than traditional investment vehicles. The BEIT imposes income tax on all business enterprises at the entity level. Partnerships and even sole proprietorships are taxed as separate entities.

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. The BEIT can afford to do so because it treats all corporate mergers and similar transactions as "taxable" asset sales, which in turn is feasible because the firm-level tax is a flat consumption tax.

Current law's treatment of consolidated groups is more complex than is commonly understood, which leads to both tremendous compliance costs and tax avoidance strategies designed to game those complex rules. By treating all noninvestment, for-profit endeavors as "business enterprises," and adopting true consolidation rules for related enterprises, the BEIT establishes a comprehensive and consistent base from which to measure returns to capital.

Third, the BEIT repeals all "tax-free" organization and reorganization rules. Instead, all transfers of business assets (or entries of entities into consolidated groups) are treated as taxable asset sales. 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 and reduce lock-in effects that would discourage transfers, the new business asset/business entity transfer rules impose tax rates on sales designed to be "tax neutral," in that the tax the seller pays is set approximately to equal the present value of the new tax depreciation deductions available to the buyer. At the business enterprise level, the aggregate result for buyer and seller is similar to making every purchase of business assets or business enterprises a carryover basis transaction, thereby introducing consistency across different forms of acquisitions. At the investor level, eliminating all "tax-free" reorganization rules introduces more realization events. This in turn reduces the economic distortions that flow from indefinite deferral of economically accrued income.

3. The Cost of Capital Allowance. The Cost of Capital Allowance system replaces current tax law's different treatment of debt capital, equity capital, and various derivatives with a uniform allowance for issuers and a mandatory income inclusion to investors. The COCA regime should largely eliminate tax considerations in the capitalization of business enterprises by providing issuers and investors with uniform tax rules for all capital-raising activities, measured only by the amount of capital raised. Finally, COCA tightly coordinates the two levels of tax.

COCA places the taxation of normal returns on investors for two reasons. First, the intuition here is that financial capital instruments turn over more rapidly than do noninventory real assets. As a result, investors' tax bases in their financial capital instruments should reflect more closely economic measures of income than do business enterprises' bases in their real

assets. Second, investors do not have tax preferences, like accelerated depreciation, that are reflected in investors' bases in their investment assets.

Under COCA, a business enterprise deducts each year an annual allowance for the financial capital invested in it, measured at a rate (equal to a fixed percentage over one-year Treasuries) multiplied by the issuer's total capital. This deduction is available regardless of whether any amount is distributed to investors. No further deductions are available to the issuer even if payments to investors exceed the annual COCA rate. As a result, any extraordinary returns (returns above the COCA rate) are taxed at the business enterprise level.

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

Real assets that today are depreciable (or amortizable) would remain so under the COCA system. Since the effect of depreciation is to reduce asset basis, a business enterprise's COCA deductions would decrease as it depreciates its nonfinancial assets. Thus, the COCA deduction is in addition to, not in place of, asset depreciation. The relationship among depreciation, the BEIT's treatment of asset sales, and the COCA regime is explored below.[104]

In sum, under the COCA system, issuers no longer will face a tax imperative to employ as much debt financing as possible or to issue complex financial instruments designed to give issuers tax-deductible interest expense in respect of contingent returns. Instead, issuers will minimize the *economic* cost of their financial capital, secure in the knowledge that there is no tax component to that calculation.

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

On the other side, the COCA system requires all holders—including (in an ideal world, at least) tax-exempt institutions—to include each year in ordinary income an "Includible Amount," which equals each investor's tax basis in its investments in business enterprises multiplied by the COCA rate for that year. Includible Amounts are taxed currently at ordinary income rates, regardless of the amount received in cash. If those Includible Amounts are not received, the accrued but unpaid amount is added to a taxpayer's basis in its investment and compounded at the COCA/minimum inclusion rate.

Holders of financial capital instruments calculate their Includible Amounts by reference to the tax basis in the instruments they own. As a result, the aggregate of investors' Includible Amounts will *not* equal the sum of issuers' COCA deductions, and generally will exceed those deductions for two reasons. First, the intuition here is that market trading in securities is likely to lead to more realization events at the investor level than will corresponding sales by business enterprises of noninventory real assets. Second, current law effectively permits business enterprises to deduct the cost of developing many intangibles; these immediate deductions reduce an enterprise's aggregate tax basis in its assets but not the actual economic capital invested in the enterprise (which presumptively would be reflected in market prices for the enterprise's securities).

An investor's losses are currently deductible without regard to capital loss limitation principles, up to the amount of prior Includible Amounts. This feature is necessary, or at least desirable, to confirm the constitutional characterization of the BEIT as in fact an income rather than a wealth tax, and accords with economic logic.

Cash distributions are treated simply as reductions in an investor's tax basis in her investments. Cash distributions in excess of basis are not themselves taxed, but if those cash distributions are invested in new investments, the new investments will attract Includible Amounts.

The COCA system applicable to holders requires no special recordkeeping by the issuer or information from prior holders. In particular, calculations are personal to each investor; no Includible Amount accounts carry over from a prior third-party investor from which the current investor purchased that security. The COCA system applicable to holders admittedly requires some recordkeeping by each holder, but that recordkeeping would be mathematically

straightforward and, if reflected on each year's tax return, can be kept up to date even by individual investors.

A simple example is desirable here. Imagine that Investor pays $1,000 on January 1 to acquire an Issuer security (which might be denominated as debt, or stock, or an exotic hybrid—it does not matter which). Assume for simplicity that the COCA rate is 6 percent in every year. Issuer immediately purchases an asset that is depreciated on a five-year straight line basis.

Issuer's COCA deductions each year will equal the sum of the tax bases of all its assets. Assuming for this example a simple rule that looks only to asset basis at the start of the year, Issuer's COCA deduction for this asset will equal $60 in year 1, $48 in year 2, and so on. (Issuer also will obtain a COCA deduction for any asset basis attributable to any net cash the asset generates and Issuer retains.) At the end of five years, Issuer's tax basis in the asset will be zero, and Issuer will no longer obtain any COCA deductions.

Investor, meanwhile, continues to own his Issuer security. Each year, Investor takes into ordinary income a 6 percent yield on his tax basis in his financial capital instrument. If Issuer happens to distribute exactly $60 a year to Investor in respect of that security, Investor will include that $60 a year in income. If Issuer distributes nothing, Investor will include $60 in year 1, $64 in year 2 (6 percent of $1,060 tax basis), and so on. If Issuer makes no current cash distribution and Investor sells the security at the end of year 1 for $1,200, Investor pockets the cash without further tax. New Investor will now recognize $72 of minimum inclusion income in her first year of ownership. Issuer's COCA deductions continue unaffected.

4. Coordination between COCA and Asset Depreciation Rules. The COCA system operates alongside, not in place of, standard asset depreciation rules. An issuer's COCA deductions interact in interesting ways with the issuer's deductions for asset depreciation. These interactions reflect the COCA system's simultaneous roles as a depreciation corrective, an integration device, and a mark-to-market surrogate. This subsection explores some of these interactions.

If tax depreciation perfectly tracked economic depreciation, a business enterprise could simply use that depreciation to measure normal returns at the entity level (for the reasons summarized earlier). An issuer's COCA deductions, and investors' corresponding Includible Amounts would mean that investors, not issuers, pay tax on these normal returns. CBIT would

be a more logically compelling alternative (given the same assumption of tax depreciation perfectly tracking economic depreciation); under that alternative, the issuer would obtain *only* a depreciation deduction in respect of the capital deployed in its business, and investors would receive returns out of tax-paid earnings free of additional tax.

In practice, of course, tax depreciation systems depart in two important respects from economic norms. First, tax depreciation schedules are not tailored to reflect estimates of economic useful lives. Second, the tax expensing of many costs that arguably should be capitalized is permitted, with the result that the intangible assets that those costs create are not reflected in the tax system as assets in the first place.

Because a business enterprise's aggregate asset basis is used to calculate the COCA deduction, the COCA system effectively mitigates distortions attributable to too fast or too slow depreciation. Thus (to take the two extremes), an issuer that deducts rather than capitalizes an expenditure forfeits any COCA deduction with respect to the capital invested, while an issuer that treats that same cost as a nondepreciable capital expenditure receives a COCA deduction in perpetuity. The net result of this self-correcting mechanism is that the present value of the sum of a business enterprise's COCA and depreciation deductions will remain a constant percentage of the enterprise's capital (measured as historic cost), *regardless* of the depreciation and capitalization rules the business employs. By contrast, the tax base for investors' income inclusions reflects the capital they have invested (through market transactions), not the after-depreciation carrying value of the business entity.

In other words, at the business enterprise level, COCA and *any* asset depreciation method will always equal the *exclusion* from income tax of a time value (normal) rate of return on the enterprise's economic capital (albeit measured at historic cost, and assuming that the COCA rate is set at precisely the normal rate of return). This is precisely the appropriate integrated result desired: exemption of a normal rate of return from tax at the business enterprise level, and inclusion of a normal return on investment at the investor level.

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

There are several good reasons not to do so. First, as David Bradford pointed out, a COCA/depreciation system has the advantage over a simple asset expensing rule of mitigating the effects of changes in tax rates.[105] Second, the COCA system has one universal set of tax rules that apply to financial derivatives as well as physical securities (e.g., stocks and bonds). Unlike the latter instruments, where one can draw neat distinctions between issuers and investors, derivatives are employed by both. Moreover, a derivative can change its character from asset to liability and back. At the same time, a derivative can move substantial cash from one party to the other. The COCA system therefore seems to be a necessary (or at least a convenient) part of taxing derivative instruments. Finally, there are important ancillary reasons for retaining COCA/depreciation for issuers rather than adopting a simpler asset expensing solution.[106]

5. COCA and the BEIT's Asset Sales Rules. Imagine a business enterprise ("Seller") that holds a depreciable asset with a tax basis of zero and a value of $100, and which sells that asset to Buyer for $100, incurring $20 of tax on the sale. As noted above, under the BEIT's asset sales tax rates regime, this $20 in tax liability represents the present value of the buyer's future tax savings from depreciating its $100 tax basis for the asset. As a result, Seller and Buyer will be in the same aggregate after-tax position as if the asset were transferred tax-free (and with a zero basis) to Buyer. Unlike tax-free incorporations and reorganizations under current law, however, the BEIT system does not duplicate gain (or loss). Buyer has invested $100 for an asset with a

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[105] (Kleinbard 2005, 102).

[106] First, if the COCA rate diverges from the normal rate of return, the COCA/depreciation system resembles more closely the status quo of relative tax burdens across different industries than does an expensing solution. Second, BEIT/COCA's combination of deductions for depreciation and financial capital can roughly be analogized to the current law's deductions for depreciation and interest expense. I believe that presenting the BEIT as building on well understood tax concepts may enhance its political prospects.

Finally, the administrative difficulties associated with depreciation rules seem overstated, at least when applied to larger companies. The reason that capitalization and depreciation rules are contentious today is that the substantive *consequences* of those rules are momentous. In a world where the capitalization/depreciation decision has no great consequences, much of today's tax dramatics should dissipate.

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

tax basis of $100 (as would be true of any other investment), and Seller does not take a carryover basis in any asset or security Buyer issues.

Seller is in a better *COCA* position after the sale, however, than it was before, because it now has $80 of after-tax sales proceeds (cash), and therefore tax basis, it did not have before. What should be done about this problem?

The proposed answer is to describe this phenomenon as a feature, not a bug. If this paper is correct in assuming that financial capital instruments turn over more rapidly than do noninventory real assets, then, as noted earlier, one can expect investors' Includible Amounts to outstrip issuers' COCA deductions. To the extent that this is true, integration goals are not fully achieved. (By contrast, Includible Amounts that outstrip issuer COCA deductions as a result of issuer-level tax preferences, such as accelerated depreciation, are in fact consistent with an agenda of taxing time value of money returns once and only once.)

The perfect integration answer is probably that a business enterprise's COCA deductions should reflect the sum of the investors' tax bases in the enterprise's financial capital instruments, but such a solution would be impractical. An alternative is the increase in Seller's COCA deduction following the sale of its business asset (in the above example). The reason for this is that investors in Seller already have reflected—or will soon reflect—the $80 in after-tax sales proceeds in their valuation of the company, and therefore (due to the relatively quick turnover of financial capital instruments) in their annual Includible Amounts.

This solution encourages business enterprises to sell rather than hold depreciated but valuable business assets because by doing so an enterprise increases its COCA deductions. On the other hand, that business asset will be fairly priced (because in the aggregate, there are neither immediate tax costs nor depreciation benefits from selling it—in contrast to current law). Moreover, the issue probably is confined to sales of individual assets because sales of entire business enterprises are taxed at the investor as well as at the enterprise level (thereby marking to market both investors' financial capital instruments and the enterprise's assets). On balance, therefore, the BEIT proposal accepts the possibility of some asset-churning as an imperfect but straightforward self-help device to improve the integration of business-enterprise and investor income measures.

The same general analysis applies to corporate mergers and the like, including sales of control of a subsidiary by one firm to another. Under the BEIT, each is treated as a sale of assets at the firm level, and a realization event to non-business enterprise investors.[107] Because the deemed asset sales have no present value tax cost, and because investors have no tax liability beyond their Includible Amounts, the only net effect of these rules is to "reset the clock" on investors' tax bases in their financial interests.

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.

6. Economic Rents. The basic approach of the BEIT to taxing economic rents is to collect that tax at the business enterprise level. The BEIT's treatment of 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 BEIT provisions 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.

A principal conceptual failing of the BEIT as presented to this point is that it taxes rents at the same rates as normal returns. In theory, rents can bear higher rates of tax, precisely because they are unique opportunities. (The Norwegian Rate of Return Allowance system, summarized in an earlier footnote, attempts to address this.) This paper returns to this point below.

7. Consequences. For a tax system that purports to tax capital income and that could in fact be implemented in a large modern economy, the BEIT does a remarkably good job. Most fundamentally, it taxes all capital income once, and only once, without cumbersome (and frequently abused) integration schemes or the like. Economic rents are taxed to the enterprise, and normal returns to investors. The sum of the two is an income tax on capital. The BEIT thus

[107] In other words, like a "forward cash merger" under current law. *West-Shore Fuel, Inc. v. U.S.*, 598 F.2d 1236 (2d Cir. 1979). Once acquired, a corporate subsidiary is treated as simply part of the consolidated assets of the consolidated business enterprise, and its stock is ignored for tax purposes.

can be seen as an improvement on the "Allowance for Corporate Equity" (ACE) implementation of a firm-level consumption tax, combined with a novel complementary income inclusion at the investor level that restores the overall system to a true income tax.[108]

The BEIT further achieves neutrality in other dimensions as well. It taxes all business operations identically (by taxing enterprises, regardless of legal form, consistently). Second, it renders tax objectives irrelevant to the choice of an issuer's capital structure because the capital the issuer employs, not the security issued, determines its cost of capital allowance. Similarly, the tax liabilities of investors are driven by the 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 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.

Finally, the BEIT, although an income tax, offers corporate managers a consumption tax environment in which to conduct business. This should resonate with managers who today express concern about international "competitiveness," and further means that those managers will be able to pursue acquisitions and divestitures without regard to substantial tax consequences.

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[108] The term "Allowance for Corporate Equity" ("ACE") was proposed by the Institute for Fiscal Studies in 1991 and Devereux and Freeman (1992). The BEIT and ACE systems have 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 (applied, however, to "shareholders' funds," not all assets), 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 corrected for errors in company-level depreciation practices. Devereux and Freeman (1992, 5).

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

Moreover, the BEIT is exactly the right move for making the United States an attractive environment for foreign as well as domestic investors to invest. Because foreign investors in U.S. corporations will face a domestic corporate consumption tax, those investors will enjoy the benefits of the reduction in business tax burdens. And at the same time, U.S. resident investors will bear the full burden of capital income tax on the normal returns to all their investments, wherever located. Since the capital of multinational firms is generally held to be much more mobile than the residence of individual citizens of the United States, the result will be a more attractive environment for investment in the United States, and a reduction in the impetus to move capital out of the United States.[109]

D. Integration of Dual Income Tax and BEIT Principles.

The Business Enterprise Income Tax is a robust technology for measuring explicit returns to capital, but is agnostic about tax rates, and does not by itself address the issue of labor income masquerading as capital income. The traditional form of Dual Income Tax outlined here does adopt a view on tax rates (capital income should be taxed at a single flat rate that is lower than the highest marginal labor rates), and does employ a labor-capital income centrifuge to tease apart labor and capital income. By happy coincidence, that centrifuge employs the same technology to separate labor and capital income as does the BEIT to tease apart normal returns and rents.[110] The two almost beg to be married to one another.

A Dual BEIT in general would look like the BEIT outlined above, with the tax rate on Includible Amounts and the business enterprise level tax rate each set at the flat capital income rate (in the hypothetical environment imagined in this paper, 25 percent). As a result, normal returns and economic rents (and, to the extent relevant, net risky returns) would all be taxed at the same rate.

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[109] OECD 2012 Norway Survey at 87 and Altshuler et al [Progressivity and Capital Income Tax] expand on this important point.

For the sake of brevity this paper does not discuss the BEIT's international dimensions, beyond this one observation as to its effects on inbound investment and capital mobility.

[110] The author's personal interest in dual income taxes in fact followed this serendipitous path, in the sense that the COCA predated his stumbling into the rich Nordic tax literature on dual income taxation.

Widely held firms would be presumed to compensate employees fully; as a result, no further emendation to the BEIT principles outlined earlier would be needed. In particular, the labor-capital income centrifuge would not apply.[111] As a result, and as explained in the previous subsection, all of a widely held firm's post-compensation income would be treated as capital income, comprising a mix of normal returns, risky returns and rents. The COCA allowance, in conjunction with depreciation, would be employed simply to separate out the normal return component and tax that component at the firm level at an effective rate of zero.

Closely held firms would be subject to a different regime, but one with the same ultimate objective. For this purpose, a closely held enterprise might be defined, at least as an initial matter, by reference to the ownership tests of current law's personal holding company rules.[112] Admittedly, it is inconsistent with the BEIT's aspirations to introduce a dividing line that in turn will inspire aggressive tax planning, but as developed below it is difficult to avoid drawing this distinction.

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

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[111] This distinction is consistent with Nordic models. The late Steve Jobs might be offered as an exception that proves the rule, in light of his nominal cash compensation. In fact, he received substantial deferred compensation in the form of stock options. To the extent that he in fact was undercompensated for his services, and thereby enriched other shareholders, that income in fact became their capital income, and would be reflected in their Includible Amounts as those shares turned over.

[112] It is true that such rules require a distinction between debt and equity, but only for the limited purpose of determining who is an owner of stock. A more comprehensive test might look to all financial claims holders other than those holding nonvoting interests that do not participate in earnings growth to a significant extent, or to a "vote or value" test. See also section 544(b) (treating convertible debt as stock for personal holding company purposes).

As developed in Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010), one of the chief failings of the original Norwegian dual income tax, whose basic design mirrored that proposed here, was that its definition of a closely-held firm was easily evaded by inserting family members into the ownership structure of a firm. Norway did not adopt constructive ownership rules remotely as comprehensive as those contained in section 544.

The closely held firm's COCA-derived capital income component, as determined above, would remain taxed at capital income rates, and at one level only. The remaining income of the closely held firm, however, would be deemed to constitute labor income. This is the critical difference in treatment between widely held and private firms under the Dual BEIT, because of course widely held firms would treat their post-COCA deduction income as capital income taxed at the flat capital income rate.

The treatment of a closely held firm's taxable income (that is, income after business expenses, including the COCA allowance, depreciation and compensation deductions) as entirely labor income will strike many as controversial. In the case of a widely held firm, the theory is that any residual firm income is largely attributable to economic rents.[113] The proposal made here deprecates the economic rents story, on the theory that most such apparent rents in small firms are deferred returns to labor – for example, the restaurant that apparently earns superior returns, relative to its capital, thanks to its owner-manager, whose hard work and constant presence has built a powerful reputation for the establishment. Since small businesses largely are a reflection of their owner-managers, while widely held ones generally have greater continuity, global reach and diversity of labor inputs, the difference is not unprincipled.

A logical alternative is to argue that economic rents, like labor income, in fact can bear a higher tax rate than normal returns, and that the right move here, rather than to distinguish the tax burdens on closely held firms from those on widely held ones, is to tax the residual income of *both* at labor rates. (In the case of widely held firms, this of course would mean at the maximum labor rate.) This alternative is consistent with economic logic, and in fact was the basis for the most recent (2006) revision of the Norwegian dual income tax system, but raises many difficulties.[114] It inadvertently would expose risky returns to asymmetrical tax rate, as when years of small losses lead to one hugely successful investment, and it would greatly complicate the treatment of sales of business assets and entities, on which the elimination of tax-free reorganization and current law tax consolidation rules are premised.

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[113] Returns to risk obviously also are present but, when viewed from the entirety of the tax system, should in the long run yield normal returns. As noted earlier, the most important design criterion when taxing returns to risk is to do so symmetrically, so that losses in fact offset gains.

[114] See Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41, 67-79 (2010).

This alternative also would put tremendous incremental stress on the COCA rate, because it would determine the breakpoint between capital income taxed at the low normal returns rate and capital income taxed at labor rates. By contrast, under the BEIT as presented here, the COCA rate is important to investors and to firms, for reasons that mirror each other's concerns, but that rate has somewhat less importance to revenue collections as a whole.[115]

Finally, such a move has obvious political economy problems, in light of global trends in headline corporate rates. For these and similar reasons, this paper reluctantly rejects the alternative of taxing a widely held business enterprise's returns beyond its normal return, as captured by the COCA deduction/Includible Amount methodology, at labor income rates.

Of course, introducing a division in tax rates between the net income of closely and widely held firms raises many issues of its own, beyond simply policing the distinction. Mechanically, it would be important that a closely held firm's deemed labor income be taxed at the marginal labor rates of the firm's owners. One straightforward way to do so is to reverse course, relative to the standard BEIT, and treat all closely held firms as partnerships for tax purposes, following existing partnership tax law. The only necessary emendation would be to tax the deemed capital income component of owners' distributive shares at capital income rather than labor rates.[116] The difficulty with this approach is that it creates confusion and complexity, by keeping alive two conceptually very different tax regimes (the BEIT environment and current law partnership taxation), by requiring policing of a boundary (debt and equity, in the partnership context) that has no significance in the BEIT environment.

A better approach would be to follow the general BEIT format, and to tax the residual net earnings of a closely held firm at the maximum labor income rate.[117] This approach relies on self-help: those owner-managers whose income falls into lower tax brackets than the maximum rate will be induced to pay themselves actual compensation, to take advantage of the resulting

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[115] Indeed, its only relevance would be to the extent that the aggregate tax bases of investors in their financial claims exceeds the tax bases of firms in their assets.

[116] This is the difference between a mandatory partnership system here and that contemplated by George Yin, supra n. __.

[117] In the case of closely held firms, this gets to the same place as the Norwegian RRA variant on dual income taxes, but the results of course diverge when applied to widely-held firms. This is a conceptual failing of the BEIT that is counterbalanced by the points made in the preceding paragraphs.

tax savings. Aggregate amounts payable as compensation would be limited to the pre-compensation net income of the firm. To address year-end uncertainty as to the final net income of the firm and to allow for the inevitable forgetfulness of some individuals, firms could designate any of their residual net income as compensation up to 2-1/2 months after the end of a taxable year; the recipients of course would be required to include those designated amounts in income for the preceding year. Amounts so designated and retained in the firm would be treated as deemed further capital investments by the recipients.

Under this approach there is no tax avoidance concern about the overstatement of compensation income. By definition the income in question is labor income, and the only question is whose. Actual allocations of that income among owner-managers through compensation payments presumably will reflect their actual business arrangement, just as partnership allocations do. And of course, just as is true today, there will be cases that require recourse to assignment of income and similar doctrines, to deal with the nitwit nephew scenario.

A closely held firm's capital income would be taxed at the lower capital income tax rate. Again, mechanically the most straightforward way to do so is to follow the standard BEIT model, by taxing financial asset holders on their Includible Amounts, calculated in the same manner as for any other investment. Alternatively, one could imagine moving this income item to the firm level, in which case owner-managers would be taxed in respect of their closely held firms only on their compensation income.[118]

It no doubt would vigorously be argued that a COCA rate that is appropriate to widely held firms is too low for closely held ones. Regardless of the ultimate economic merits of this argument, the Dual BEIT easily accommodates it, because the COCA rate can itself be tiered, with one rate for the first $X of firm capital, another for the next $Y, and so on. The Dual BEIT thus has built into it the flexibility to handle the inevitable political compromises that would be part of any actual legislative process.

[118] The intuition here is that two of the principal motivating factors behind situating the taxation of normal returns at the investor level – the higher turnover of financial claims, compared to underlying real assets, and the higher mobility of firms and firm capital – apply with much less force to closely held firms.

E. Conclusion.

The Dual BEIT system proposed here neatly addresses capital stuffing, because returns to capital enjoy the same tax rate whether situated inside or outside a business enterprise. The system addresses labor stuffing in two steps. First, it employs a simple mechanical rule for teasing apart labor and capital income, so that each can be taxed according to its nature; as a result, labor income cannot masquerade as capital income in the first instance. And in turn, labor income retained by the firm becomes capital, and that capital again is taxed neutrally, whether inside or outside the firm.

More fundamentally, the Dual BEIT replaces the disarray of current law's taxation of capital income with a coherent regime, in which all capital income, regardless of legal label, is taxed at a consistent rate. That moderate rate mitigates the distorting effects of high marginal rates on some capital income, collects significant revenues (especially when compared with the current partiality to bonus depreciation and the like), and moves the most mobile forms of capital income (normal returns) to the least mobile taxpayers (individuals). The Dual BEIT eliminates enormous layers of complexity (the multiplicity of rules for different forms of business organization, the consolidated return rules, the tax-free reorganization rules) and slays the dragon of the debt-equity distinction. It is the right direction in which capital income taxation should head.