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Taxing Capital Income

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Designing an Income Tax on Capital

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The current system for taxing business income and business capital is in complete disarray. The underlying problems are so deeply embedded in the current structure as to require fundamental reforms. The periodic appearance of new and exotic financial capital instruments, and the complex technical tax rules subsequently announced to address these instruments, reflect the corrosive effects of the current system's incoherence. Those instruments' names—"MIPs," "Feline PRIDES," "contingent convertible debt," "income deposit securities," "E-CAPS"[1]—mean nothing outside a small circle of capital markets professionals, their advisors, and their regulators. Yet, for all their exoticism, every one of these instruments reflects a different strategy for making a tax pastry, in which some traditional "equity" feature is stuffed inside a "debt" wrapper (or vice versa).

The reason for these unnatural concoctions stems from two logical discontinuities. First, there is a fundamental division in tax treatment between debt instruments, on the one hand, and equity and most other forms of financial capital, on the other. Second, the government taxes inconsistently instruments with different labels but which offer an investor similar, but uncertain, cash flows (for example, common stock, options, or contingent interest debt).

Thus, today two parallel and incompatible income tax systems exist. In the debt model, the tax code affords issuers current ordinary deductions and requires current ordinary income inclusions of holders. In the "most

everything else" model, the tax code affords issuers no deductions for the capital deployed in their businesses but taxes holders on a realization basis: sometimes at capital gains rates, sometimes at ordinary income rates, and sometimes (as is currently true of corporate dividends) at the same rate as capital gains, but with different secondary characteristics. Moreover, the same contingent cash flows—that is, flows identical in amount and triggered by precisely the same contingency—may be taxed at different rates, depending on the formal characteristics of the instrument (e.g., corporate stock or contingent interest bonds).

This lack of consensus in the tax system was thought for years to be untidy but tolerable, because issuers and investors had diametrically opposed tax interests, with tax anomalies from one party's perspective balanced by equal and offsetting tax costs to the other. But corporate stock *never* has enjoyed this bilateral treatment, because issuers obtain no deduction for the cost of equity capital. Moreover, today's capital markets are supremely efficient at matching taxable issuers and nontaxable investors (such as charities and pension plans), or vice versa, to maximize their collective after-tax returns.[2] In reality, then, tax anomalies that subsidize the cost of issuing one form of security are not balanced by a commensurate incremental cost to holding that security as an investor.[3]

It has been suggested that the current tax system might be salvageable if each complex financial capital instrument were divided into its basic constituent units, in order then to tax that instrument as the sum of the tax liabilities attaching to those units. That premise assumes that tax building blocks exist that cannot be further divided, but that belief is no more accurate than the thought that a proton or neutron is indivisible. The economic equivalent of stock can be expressed as a bond plus two options, and 15 years ago, Randall Kau (1990) demonstrated 13 ways of creating a bond-like return without the inconvenience of using a debt instrument (see also Kleinbard 1989). Because bifurcation—dividing any particular instrument into some exact mix of familiar components—raises such difficult categorization and valuation issues, the tax system has understandably rejected this approach. Accordingly, the system generally still taxes complex or compound financial capital instruments as a unitary whole.

What, then, does the tax system do today when confronted by an exotic new financial capital instrument? Tax practitioners and the IRS analyze that instrument and use arguments based on analogy and correspondence to determine which one idealized type most closely resembles the new

instrument under inspection—like placing instruments into metaphysical cubbyholes (Kleinbard 1991).

Economics plays only a peripheral role in defining these metaphysical cubbyholes. The tax jurisprudence does not, for example, define "debt" by reference to the actual probability of repayment, but rather to certain formal characteristics of the instrument (e.g., stated maturity date, legal remedies on default, seniority in the capital structure). The distinction between deductible interest payments and nondeductible dividends, or the distinction between contingent returns taxed only when paid (and then at capital gains rates) and contingencies that give rise to current ordinary income inclusions, thus turns almost entirely on legal niceties, not on the probabilities of outcomes.

In sum, the primal flaw—our "tax original sin" with respect to financial capital—has been to develop in practice two parallel and incompatible income tax systems (the "debt" and "most everything else" models, with all their subvariants), in which the timing and amount of tax to issuers and holders depend on the purely formal characteristics of an instrument. The result is a system in which the returns on financial instruments are taxed at effective rates that vary widely for no discernable reason.

Why Tax Returns to Capital?

One understandable reaction to the current tax morass is to give up on the idea of taxing current returns to capital and to design our tax base around consumption rather than income. There is a large and sometimes heated literature analyzing which tax system is more appropriate.

A well-designed income tax should be like a wealth tax, which operates by taxing all lifetime accretions to wealth once (and only once) more or less concurrently with the creation of that wealth. A well-designed consumption tax, by contrast, also seeks to tax wealth once, and only once, but defers the timing of that taxation until that wealth is withdrawn from investment activities and consumed. The consumption tax does not directly tax the economic returns to capital but instead taxes those returns as and when they are used to finance consumption. By definition, a consumption tax has a smaller base than a comparable income tax has, and so must impose a higher nominal tax rate to raise the same current revenues (Shaviro 2004).

The arguments supporting income taxes are strongest when policy issues that go beyond economics in its narrowest sense are considered.

For example, income tax proponents point to the corrosive effects on a democracy of great concentrations of wealth and associated power, which suggest the benefits of a system that taxes such wealth as it is accumulated, not simply as it is spent. Moreover, any consumption tax likely will increase the absolute disparity in incomes (and wealth) between the richest and poorest citizens. Income tax supporters also point to the vulnerability of a consumption tax both to evasion (because of its higher nominal rates) and to "one-time" tax holidays couched as incentives to kick-start the economy.[4]

Conversely, consumption tax advocates point out that the current income tax raises little revenue from taxing returns to capital and distorts investment and financing decisions. These criticisms plainly are valid; indeed, the defects of our current system for taxing financial capital instruments are so pervasive, some observers embrace consumption taxes for that reason alone.

This chapter does not purport to resolve the debate between advocates of income and consumption taxes. Instead, it focuses on how we might go about reforming our income tax system to tax more rationally the returns to capital. The hope is that, if we can engineer a more successful income tax, we can then rationally compare the relative costs and benefits of that overhauled income tax to consumption tax alternatives.

Economic Returns to Capital—Capturing the Time Value of Money and Other Returns

The academic literature divides the economic returns to capital into three buckets: a pure *time value of money return* (what economists call the "normal" return), *risky returns* (returns from transactions that on a portfolio basis have an expected risk-adjusted return, but whose individual payoffs may vary substantially from that expected return), and *extraordinary returns* (what the literature describes as "economic rents," or "inframarginal" returns).[5] That literature also demonstrates that a well-designed income tax taxes time value of money returns, but a consumption tax does not. Thus, success in accurately taxing time value of money returns is the primary determinant of whether a tax system is a successful income tax.

By contrast, the literature argues that neither system taxes risky returns—at least in a world where losses are fully deductible—because

taxpayers can "scale up" the size of their bets to put themselves in the same position after tax as with no tax. (For the same reason, the literature reminds us of the distortions that can result from artificial limitations on the deductibility of losses.) Finally, that literature demonstrates that both an ideal consumption tax and an ideal income tax reach extraordinary returns.

We can employ financial theory's division of all investment results into normal returns, risky returns, and extraordinary returns to measure the efficacy of any income tax. First, the primary determinant of whether a tax system is a successful *income* tax will be whether the system taxes the time value of money returns accurately and consistently. Second, it must minimize the distortions that result from artificial limitations on the deductibility of losses (or the double inclusion of income). Finally, it must ensure that extraordinary returns bear the same effective tax rate, whatever legal form those extraordinary returns might take.

Time Value of Money Returns

The current tax system fails to honor the primary income tax imperative of accurately and fairly taxing the time value of money. It simply ignores time-value concepts for many financial capital instruments (e.g., stocks, options). By contrast, rules for taxing most debt instruments (or debt-like derivatives such as interest rate swaps) honor time-value principles, but those rules then excuse enormous portions of collective financial wealth (e.g., pension funds and tax-deferred accounts) from the income tax system.

In a simplified, "Edenic" world of entirely equity-funded sole proprietorships, taxing the time value of money would come down simply to aligning tax depreciation with economic depreciation. That is, if tax depreciation precisely followed economic depreciation, investment in a marginal asset that earns normal (time value of money) returns would result in taxable income each year exactly equal to the cash returns from the asset, less the economic depreciation on that asset (i.e., taxable income = normal return * unrecovered investment). In such a world, the term "financial instrument" would have no meaning, and the recovery of direct investment in real assets (through accurate depreciation schedules) would be the sole mechanism for taxing time value of money returns.

Now imagine that one adds the possibility of borrowing to that ideal world. If the resulting tax system permitted the asset owner to deduct the

interest paid on that borrowing and required the lender to include the interest in income, the tax system would continue to capture time value of money returns to all parties: to the owner through economic depreciation and interest expense, and to the lender through interest income.[6] This is the conceptual origin of the tax deductibility of interest expense.

This primitive model also was the first bite of the apple that led to the "original sin" of treating the cost of some forms of financial capital instrument as deductible and others as not. The fall from income tax grace was complete when this model was employed to explain the capital structure of corporations. As a result, "stockholders" were treated as the indirect owners of *all* of the enterprise, and "bondholders" as temporary renters of money.[7]

This simplistic model collapses under the weight of overwhelming contrary factors in the modern world. Most relevant to this discussion is the simple fact that, in modern capital markets, it is not usually possible to label one financial capital instrument as evidencing "ownership" of a business's underlying real assets, and all other instruments as evidencing the "rental of money" for temporary periods.[8]

Instead, the United States today has debt-like equity (e.g., deeply subordinated debentures and limited-term preferred stock) and equity-like debt (from convertible bonds through all the exotica referred to earlier). The returns paid to investors other than common shareholders do not simply constitute time value of money returns. From the other direction, it is impossible to identify which class of investors should be treated as the functional "owners" of an enterprise (who should recognize normal returns through depreciation of real assets). The only solution is to abandon the premise that holders of claims against a business enterprise can easily be divided into "owners" and "lenders," and instead seek a basis to capture and tax the true time value returns inherent in all such instruments.

Risky and Extraordinary Returns

As described above, modern financial theory implies that attempts to tax "risky" returns in a well-designed tax system are chimerical because taxpayers can scale up their pretax bets to cover the cost of any tax. This last observation is subject, however, to conditions, including that losses be treated symmetrically with gains (so that losses give rise to tax refunds).

The current income tax system completely fails this condition. Because it relies so heavily on the realization principle to tax gains, there is no choice but to adopt mirror antirecognition rules for losses (the capital loss limitation).[9] If policymakers can design a system that permits the deductibility of economic losses without allowing taxpayers to cherry-pick the Treasury to death on their gains, they could substantially advance the cause of designing a good income tax on financial capital instruments and business enterprises.

Modern financial theory also suggests that a well-engineered income tax will reach taxpayers' extraordinary returns (economic rents) by applying internally consistent rules for taxing business income, on the theory that these "super-sized" returns generally arise in the direct conduct of business enterprises. (To this, policymakers should add royalty income from the licensing of intangibles.[10])

Because the United States functions in an open and global economy, many of the best-known recent examples of extraordinary returns to capital achieve their success on a global scale. This observation implies that the most important practical impediment to the proper income taxation of super-sized profits is the perennial problem of intragroup cross-border transfer pricing, particularly with respect to high-value intangibles.[11] The tax problems associated with measuring and taxing extraordinary returns are not, however, problems embedded in the taxation of financial instruments, other than ensuring some coordination between direct and indirect claimants (e.g., a corporation and its security holders) to the same extraordinary income.

Design Criteria for a Good Income Tax

The following sections explain how policymakers could design a good income tax.

Consistently Tax the Different Economic Components of Returns to Capital

First and foremost, a good income tax must consistently identify and tax the different economic components of returns to capital: time value of money (normal) returns, risky returns, and extraordinary returns. In particular, such a system would focus on taxing normal (time value) returns

currently and comprehensively. Different designers might reach different conclusions on whether extraordinary and risky concerns should be taxed at ordinary income or capital gain rates, but all presumably would agree that normal returns should lead to ordinary income on as close to a current basis as possible.

Fundamental tax distinctions should not be drawn between financial capital instruments with similar *economic* but different *formal* characteristics. Accordingly, a comprehensive approach to the income taxation of returns to capital must extend to all instruments that put capital to work in a business enterprise, regardless of their labels, including both traditional "debt" and "equity" securities, financial derivatives (such as forward contracts, options, and swaps), and novel hybrid variations yet to be developed.

Stated more generally, a good income tax system will adopt a *featureless topography*. Every distinguishing feature of a tax landscape—financial versus nonfinancial returns in a consumption tax, or the difference between tradable and nontradable assets in most mark-to-market (or "accrual") income tax proposals—is a fissure that invites abuse and leads to economic inefficiency. The only solutions are to embrace the necessity of such distinguishing features, and with them the concomitant necessity of an endless circle of antiabuse rules and new stratagems, or to design a system that introduces as few distinctive features as possible into the tax landscape.

Minimize the Effects of Realization

Given the fundamental distinctive characteristic of an income tax in taxing accretions to wealth concurrently with their creation, it follows that a well-designed income tax should minimize the distortions that follow from a slavish adherence to realization precepts. The Constitution does not demand the current implementation of the realization principle, and an income tax cannot achieve its objectives without restricting realization's scope in some fashion.[12]

A practical income tax cannot wholly abandon realization precepts. Still, reducing the scope of realization principles could eliminate many concerns about taxpayers' opportunistic "cherry-picking" and loosen current laws' artificial limitations on the deductibility of economic losses. It also would reduce the economic inefficiencies of "locked-in" investments, in which investors hold onto investments that they would sell in a tax-free world solely to avoid the tax cost of that sale.

Embrace Economic Neutrality

A well-designed tax should be neutral—affecting neither "the allocation of investment spending between different assets, nor the method by which this investment is financed" (Devereux and Freeman 1991). In addition to the features described above, a neutral system must tax the returns to capital invested in a business enterprise once and only once, regardless of the legal form of the business enterprise earning that income.

A well-engineered income tax system thus achieves *integration* between issuer and investor tax bases. Integration, properly understood, simply implies coordination between the taxation of business enterprises and holders of financial capital instruments, to capture time value of money returns once (the income principle) and only once (the neutrality principle).

Finally, a neutral system should logically connect the depreciation of a business's real assets and the taxation of the financial capital instruments that represent the indirect claims on those real assets. For both policy and political reasons, however, the tax depreciation (or expensing) deductions actually allowed for a business's real assets (which include not only plant and machinery, but self-developed intangible assets) often deviate significantly from the economic depreciation of those assets. This reality introduces substantial problems for designers of real-world income tax systems.

Comport with International Tax Norms

All income tax systems struggle with the issues posed by international capital flows.[13] These difficulties reflect in part the incompatibilities of different sovereign tax systems, not all of which are equally internally consistent or effective, and which in some cases have completely different design goals.

Given the liquidity of modern global capital markets, a system that does not produce results consistent across different investment scenarios, and consistent with purely domestic investments, will lead to profoundly nonneutral results. Against this backdrop, the best that can be expected of an income tax system for a large open economy is that the system honor its internal principles to the extent consistent with international norms and rely on the tax treaty process to achieve more theoretically satisfactory (and neutral) results.[14]

Address Inflation

Many observers rightly note that most income tax systems do a bad job of addressing inflation; in particular, most systems tax as "gains" amounts that economists would all agree are simply due to inflation. Some analysts have proposed to address this problem through basis indexation systems for investors. In my view, however, inflation should be dealt with squarely as a political and monetary policy issue, not as one of tax policy.[15]

Reduce Administrative Complexity

Most tax reform proposals urge simplifying tax return preparation as a design goal. This criterion makes a sense when applied to the personal income tax, but is not so important in the business tax setting, where some bookkeeping skills can be assumed. Business taxpayers are fully capable of making sophisticated cost-benefit analyses—indeed, positively embracing tax complexity—when they can realize significant tax savings, net of the cost of absorbing that complexity. In the business setting, *certainty* of a tax's application should take precedence over simplification as a design goal.

Income Tax Redemptive Strategies

An income tax engineer can respond in different ways to the observation that holders of many modern financial capital instruments cannot be characterized either as indirect owners of real assets or as simple renters of money. Each response begins, in effect, by acknowledging that *all* investors in a business enterprise collectively own the enterprise in some indeterminate fashion, and then creates rules to identify and tax their collective capital income. This section reviews briefly how these proposals address the problems and design criteria summarized to this point.

Investor-Level Solutions

One possible approach to designing a tax system to reach the time value of money returns on capital would be to return directly to the "Edenic" conditions imagined earlier in this chapter. This approach argues that designing a tax system that focuses on financial capital instruments as if

they were real is a waste of time: why not instead simply apportion business income in some fashion to all stakeholders, in accordance with their relative claims? In this model, enterprise-level real asset depreciation reasserts itself as the means by which time-value returns are taxed because it determines in part the aggregate taxable income to be divided.

Pass-Through Models

Publicly traded partnerships provide experience with this approach. That experience teaches us that full pass-through models are extraordinarily complex to implement, largely because of the difficulties of relating income realization at the entity level (where income from the business first is determined) to realization events at the investor level, through secondary market trading in those partnership interests.[16]

Pass-through taxation also has significant conceptual limitations. Most important, the pass-through model will tax normal returns accurately only if that model properly implements business enterprise income taxation generally—including, in particular, by adopting economically perfect capitalization/depreciation rules. Decades of experience with the political and administrative process have demonstrated the fragility of that assumption.

The pass-through model's taxation of business income also retains all the problems of current law's income mismeasurement attributable to the realization principle; the pass-through model simply distributes that mismeasured income to investors. Finally, the pass-through model does nothing to align the taxation of financial derivatives—which for this purpose can be viewed as side bets on a business enterprise's income—with the allocation of firm income to the holders of direct claims against the business enterprise.

For these reasons, an investor pass-through model cannot serve as a practical platform from which to tax returns to capital. As described below, some of these shortcomings apply with equal force to other, more realistic, proposals as well.

Mark-to-Market

Another approach to a comprehensive solution to tax returns to capital solely at the investor level is to require individuals to value all their financial assets at the end of the year and tax those gains not already realized.[17]

Under this "mark-to-market" approach, business enterprises would not be taxed because the economic income attributable to them would be recognized currently by their owners.

Even the most dewy-eyed academics, however, recognize the practical problems with such a proposal. Fundamentally, nearly every such proposal limits its reach to publicly traded instruments. This would introduce new instabilities into the tax code—new mountains and valleys in the tax topography—at least as troublesome as current law's debt-equity distinction. Taxpayers would opt out of mark-to-market accounting through factual argumentation about valuation and by holding derivatives that track the returns on publicly traded assets. The proposals also leave unanswered what tax system would apply to financial capital instruments that are *not* viewed as publicly traded.

Further, implementing a mark-to-market accounting system requires resolving important (and largely unexamined) conceptual issues.[18] Even the mark-to-market accounting that should be easiest to implement—the application of that accounting method to the country's largest securities dealers—has proven difficult.[19] The alternative—mark-to-market accounting at the *entity* level, and not separately taxing financial capital instrument holders—is even more problematic in that it would require annual valuations of real assets.[20]

Entity-Level Solutions

If policymakers cannot design practical stakeholder-level solutions, then perhaps the right approach is to forgo the direct taxation of stakeholders and instead capture both time value of money returns and economic rents at the business enterprise level. A comprehensive entity-level income tax could do this. Such a tax would treat the business enterprise as a surrogate for its collective financial instrument stakeholders. Implementation of this idea necessarily presupposes that the enterprise's tax capitalization and depreciation schedules would follow *economic* depreciation precepts and that distributions to holders would be exempt from tax.

This effectively was the core theory behind the U.S. Treasury Department's 1992 proposal for the comprehensive business income tax (CBIT). CBIT would have treated all business enterprises as taxable entities, disallowed all interest expense deductions to business enterprises, and collected all tax on time value returns (and most taxes on extraordinary returns) at the entity level.[21] CBIT thus directly addressed the tax original

sin of debt-equity distinctions by treating all debt instruments in a manner similar to current law's treatment of equity, albeit with a zero tax rate on investors.

Certainly, there is much to recommend in CBIT. For example, it would have applied consistent tax rules to all business enterprises, no matter what their legal form. With the recent surge in the popularity of limited liability companies, entities whose attributes carry no commercial liability to individuals but only an income tax liability, this insight has even more power today than it had in 1992. CBIT also aimed to integrate investor and entity-level tax, ensuring that all business income was taxed once, rather than not at all.

Nonetheless, CBIT's designers were forced into a difficult compromise through their fundamental design decision to capture time value of money returns by taxing all business income solely at the business entity level. In particular, this design decision ran afoul of two important problems already discussed in the context of pure pass-through models. First, this approach depended entirely on correctly implementing entity-level income taxation, particularly with respect to capitalization and depreciation rules. Second, the approach almost ensured that income will be mismeasured because of the practical impossibility of finding a substitute for reliance on the realization principle to measure economic appreciation or depreciation of real assets, and the relatively low turnover in noninventory real assets.

The Treasury Department recognized but never fully resolved these problems. It attempted to correct for the inevitable mismeasurement of the returns to capital at the business enterprise level through a compensating tax on entity-level preference income, which would take the form either of an entity-level supplemental tax on distributions or a compensatory tax on holders, in either case to the extent that holders received distributions that had not yet been taxed at the entity level.

The Treasury Department did not develop either compensatory tax in detail. This failing is odd, in light of the compensatory tax's central importance to correcting the systematic undertaxation of income that otherwise would result.[22] The alternative—passing through to holders a mix of taxable and tax-exempt income in respect of each cash distribution, depending on whether the income had previously been taxed to the distributing company—would introduce extraordinary volatility to securities prices as investors react to a changing mix of preference and nonpreference items. Such a system also is surprisingly difficult to draft and implement,

as the George W. Bush administration discovered in 2003, when it proposed a narrower version of the idea.[23]

CBIT also never came to grips with investor-level capital gains. The Treasury Department accordingly did not closely integrate the taxation of capital gain and loss with its new distribution rules, likely leading to substantial tax planning or complex (and as yet unexplored) coordination rules. Finally, CBIT proposed no rules for the taxation of financial derivatives. Today, there are trillions of dollars in notional principal amount of outstanding derivative instruments; even if CBIT's designers could choose in 1992 to ignore derivatives, the income tax engineer today no longer has that luxury.

A Hybrid Alternative: The Business Enterprise Income Tax

This section describes briefly the key features of a new plan to reform the income taxation of business enterprises.[24] That proposal, termed the Business Enterprise Income Tax (BEIT), comprises three sets of reforms designed to redefine the income tax base applicable to business operations, and a fourth set of rules—the Cost of Capital Allowance (COCA) system—intended to replace completely current law's treatment of different financial capital instruments (including derivatives) with a single comprehensive regime.[25]

The overall agenda of the BEIT is to reduce as far as possible the role of tax considerations in business thinking. The BEIT does so by replacing current law's multiple elective tax regimes with a single set of tax rules for each stage of a business enterprise's life cycle: choosing the form of a business enterprise, capitalizing that enterprise, and selling or acquiring business assets or entire business enterprises.

The BEIT builds on current tax principles and on earlier reform proposals, like CBIT, by adopting 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 primarily at the *business enterprise* level. By doing so, the BEIT sidesteps the problems that plague CBIT and similar comprehensive entity-only income tax proposals, 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.

The BEIT would apply only to *business enterprises,* which for this purpose means only private-sector, for-profit activities, other than traditional investment vehicles.[26] The BEIT thus would treat any taxpayer (including an individual) engaged in a trade or business as a "business enterprise."

The Non-COCA Components of the BEIT

The components of the BEIT other than its Cost of Capital Allowance operate as follows. First, the BEIT imposes income tax on all business enterprises at the entity level. Partnerships and even sole proprietorships are taxed as separate entities. In this respect, then, the BEIT is similar to a CBIT.

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. 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.[27] 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, the BEIT treats all transfers of business assets (or the entry of an entity into a consolidated group) 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.

If the above business asset/business entity transfer rules were simply grafted onto the current corporate income tax, the consequence would be to exacerbate tax-induced "lock-in" problems for business transfers: a business enterprise's current tax liability from an actual or deemed asset sale at a gain would exceed the present value of the buyer's enhanced depreciation deductions. This asset-level "lock-in" problem does not exist for the BEIT. The reason is that, while the BEIT *as a whole* is an income tax, viewed solely at the business enterprise level, it is a consumption tax—that is, it exempts normal returns from enterprise-level tax.[28] (Normal returns are taxed under the BEIT, but only at the investor level.) In turn, all consumption taxes are neutral with respect to the tax burden imposed on inter-business sales of assets. As a result, there is no tax disincentive (or incentive) to sales of business assets.

The Cost of Capital Allowance and Time Value of Money Returns

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.[29] 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 through adopting a quasi-integration regime.[30]

The COCA regime places the taxation of normal returns on investors for two reasons. First, 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.

Issuers

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.[31] This deduction is available regardless of whether any amount is distributed to investors. No further deductions are available to the issuer even if its actual cash payments to investors exceed the annual COCA rate.[32] 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 capital of 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.[33]

Real (that is, nonfinancial) 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.

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 what the BEIT terms the "*minimum inclusion*" 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 that a business enterprise owns constitute part of that enterprise's asset base and therefore also enter into the enterprise's COCA expense calculations. Accordingly, a business enterprise would obtain a COCA *deduction* measured by the COCA rate applied to its tax basis in a portfolio investment and would include in income from that investment at least its minimum inclusion equal to the same amount.[34] 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/minimum inclusion rate.

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 calculus.

Investors

The COCA system (in its idealized form) requires all holders—including tax-exempt institutions other than pension plans—to include each year in ordinary income a minimum inclusion, which equals each investor's tax basis in its investments in business enterprises multiplied by the COCA rate for that year. Minimum inclusions are taxed currently at ordinary income rates, regardless of the amount received in cash. If those minimum inclusions are not actually received in cash, 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 minimum inclusions by looking only to their tax basis in the instruments they own. As a result, the aggregate of investors' minimum inclusions will *not* equal the sum of issuers' COCA deductions, and generally will exceed those deductions for two reasons. First, 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).

In addition to minimum inclusions, under the BEIT, an investor must include in taxable income gains on the sale of a financial capital instrument or cash distributions, in either case only to the extent of any excess over prior accrued minimum inclusions. These "*excess distributions*" are taxed at a low rate (e.g., 10 to 15 percent) and are not taxable in the hands of tax-exempt institutions.[35] Gains from dealings in other than business property are taxed at ordinary income rates.

An investor's losses are currently deductible without regard to capital loss limitation principles.[36] The COCA regime treats those losses essentially as reversing prior income inclusions; as a result, the rates at which those losses are deductible vary.

Cash distributions are treated first as tax-free returns of prior accruals of minimum inclusions and then as excess distributions. Just as minimum

inclusions increase a holder's tax basis in a financial capital instrument, cash distributions treated as tax-free returns of prior minimum inclusions decrease an investor's tax basis in that tax instrument.[37]

The COCA system applicable to holders requires no special recordkeeping by the issuer or information from prior holders. In particular, calculations of minimum inclusions and excess distributions are personal to each investor; no minimum inclusion or excess distribution 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 significant 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.

The examples in the appendix and in the notes illustrate these principles in more detail, but 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 rule that simply looks to asset basis at the start of each 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, the first $60 of sales proceeds are tax-free returns of prior minimum inclusions, and the remaining $140 of gain is taxed at excess distribution rates.[38] New Investor will now recognize $72 of minimum inclusion income

in her first year of ownership. Issuer's COCA deductions continue unaffected.

Derivatives

The COCA system taxes derivatives (which in practice can encompass significant capital-raising components) in a manner similar to how physical securities (e.g., stocks and bonds) are taxed. For complex reasons, however, the applicable rules must be modified slightly in the case of losses arising from derivatives.[39] Readers who review the examples in the appendix will see that COCA seeks to tax financial derivatives by dividing the returns from such instruments into returns on invested capital (which is not necessarily a trivial asset, even when speaking of derivatives) and pure returns to risk (i.e., bets). Each component is then separately taxed.

Special Rules

A modified form of the COCA system applies to financial institutions; their financial assets and liabilities are subject to mandatory mark-to-market accounting, and they obtain a COCA deduction for their net investment in financial assets, plus their basis in nonfinancial assets.[40] Other investors can elect mark-to-market accounting for all traded financial capital instruments that they hold, thereby mitigating the effect of any potential minimum inclusions in excess of cash receipts. A special small-business rule mitigates the risk of current minimum inclusion income to, say, a sole proprietor, while her sole proprietorship incurs COCA deductions that yield no current benefits because of start-up losses. Finally, business-enterprise net operating losses are grossed up each year by a time value of money factor.

Results

The COCA system is a time value of money income inclusion system that uses the best possible information—market prices for securities that change hands—to identify the total capital invested in businesses, without introducing the overwhelming administrative and valuation complexities of a pure mark-to-market system. In the absence of current market sales, financial assets are presumed to increase in value annually at the COCA rate, less any cash distributions.

COCA should largely eliminate the role of tax engineering in shaping a business enterprise's capital structure, because the labels attached to

the financial capital instruments that the enterprise issues do not affect its COCA deduction. Capital in turn should be fairly priced, because the system integrates treatment of the providers and users of capital. The COCA system distinguishes, in a logical and consistent manner, ordinary (time value of money) returns (minimum inclusions) and risky or extraordinary returns (excess distributions). Including a current time value return on all financial instruments reduces the opportunities for indefinite deferral, and its concomitant distortive effects of understating income and locking in investments. Finally, replacing today's capital loss limitations with (tax-effected) full utilization of losses eliminates a substantial economic distortion that limits the attractiveness of risky investments.[41]

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 section explores some of these interactions.

COCA and Asset Depreciation

If tax depreciation perfectly tracked economic depreciation, a business enterprise could simply use that depreciation to recognize time value of money income inclusions at the entity level(for the reasons summarized earlier). In that world, the COCA system in practice operates simply to tax investors rather than issuers on time value of money returns. Under these assumptions, CBIT is a more logically compelling alternative, because it is simpler: the issuer obtains *only* a depreciation deduction (in turn corresponding with economic depreciation) 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, the tax system no longer makes even a half-hearted attempt to tailor tax depreciation schedules to reflect estimates of economic useful lives. Second, the tax code permits the tax expensing of many costs that arguably should be capitalized, 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 its 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, the present value of the sum of the enterprise's COCA deduction and *any* asset depreciation schedule will always equal the present value of *excluding* from income tax 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).[42] This is precisely the appropriate integrated result desired: exemption of a normal rate of return from tax at the business enterprise level (as in a consumption tax), and inclusion of a normal return on investment at the investor level.[43]

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 (Bradford 2004).[44] Second, the COCA system is designed to encourage a "featureless topography" by employing 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. The importance of preserving a "featureless topography" in turn requires that no important distinctions be introduced between how a derivative's cash flows are taxed, on the one hand, and how those of a physical security are taxed, on the other.[45]

Finally, there are important ancillary reasons for retaining COCA/depreciation for issuers rather than adopting a simpler asset expensing solution.[46]

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.[47] Under the BEIT's asset sales tax rates regime, this $20 in tax liability also represents the present value of the buyer's future tax savings from depreciating its $100 tax basis for the asset. This follows from the fact that the BEIT, when viewed solely at the business enterprise level, functions as a consumption tax. In a cash flow tax, for example, which is a species of consumption tax, every purchase of a business asset is immediately deductible; the buyer's tax benefit in the above example thus would be $20. The BEIT achieves the same result in present value terms through the combination of its COCA allowance and asset depreciation.

One can alternatively phrase this result by saying that Seller and Buyer will be in the same aggregate after-tax position as if the asset were transferred tax-free (and with a carryover basis) to Buyer.[48] 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 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 appears to be 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 answer is that this phenomenon is an optical illusion. The "extra" basis that seller obtains simply represents the final cash flow in respect of

seller's returns from its investment in the asset that it sold: the present value at the time of investment of the tax-relevant flows (COCA allowance, depreciation, and after-tax sales proceeds) remains constant, even as the quantum of each component varies.

In a similar vein, the fact that investors' aggregate minimum inclusions (normal returns) are expected to outstrip a business enterprise's COCA deduction in respect of its assets is *not* a sign of the system's failure to achieve integration. A business enterprise's value in excess of the tax basis of its assets represents, by definition, the present value of the future rents (super-sized profits) that it will recognize for tax purposes in future years. The BEIT intends to tax those rents at the enterprise level; as a result, the system does not shield them from tax through an artificial COCA deduction that exceeds the actual capital investment that developed the rents. By the same token, once those rents have been identified and valued by the marketplace, a new investor in an enterprise's securities that pays the market price for an interest in that enterprise effectively has capitalized the after-tax value of the enterprise's predicted future rents, just as is true for any other investment. The original investor was the beneficial owner of the enterprise's future rents; to the new investor, the same revenue stream yields simply a normal return.

COCA and Risky Returns

The cost of capital allowance system abolishes the difference between "capital" and "ordinary" returns and instead taxes *all* distributions and gains in excess of an investor's minimum inclusions at a specified low rate. COCA, as currently envisioned, then goes one step further. Relying on the fact that the mandatory minimum inclusion rules mean that investors report substantial ordinary income from their investments every year, COCA permits taxpayers to deduct truly economic losses on a current basis, although those losses are deductible only at tax-effected rates.

As proposed, COCA thus permits taxpayers to cherry-pick their losses while deferring unrealized gains that exceed their minimum inclusion income. The idea, however, is that the minimum inclusion system (which compounds to the extent not paid out currently), together with the abolition of all tax-free organization and reorganization rules, will result in the recognition of a large enough fraction of total economic income

from financial capital instruments that the Treasury Department can absorb the costs associated with residual cherry-picking opportunities.[49]

On a related front, the BEIT also contemplates that a business enterprise's net operating losses 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.[50]

COCA and Extraordinary Returns

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

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.

International Application of the BEIT

Foreign Direct Investment

The special issue of cross-border transfer pricing is a matter of great importance to the proper taxation of extraordinary returns. The current system for taxing foreign direct investment by U.S. business enterprises unfortunately is both schizophrenic and in disarray. The BEIT's response to the current system comprises (1) the full inclusion in the U.S. tax base of foreign subsidiaries' income and loss (via the BEIT's super-consolidation rules) and (2) the repeal of the rules allocating U.S. interest expense (now, COCA deductions) in calculating the foreign tax credit.

The result would be a vastly simpler system. Transfer pricing issues would be less important because artificially low intragroup transfer prices from the United States to a foreign affiliate would not reduce current

U.S. tax liability.[51] This last point should lead to a more accurate inclusion of extraordinary returns (economic rents) in the tax base. The resulting system also would be consistent with international norms that grant priority to the source country in taxing income from foreign direct investments (through the U.S. foreign tax credit mechanism).

Foreign Portfolio Investors

The COCA system is premised on the idea that tax on time value of money returns should be collected only from holders of financial capital instruments. This section considers how the BEIT should define the scope of investors subject to tax on their time value of money returns.

Current U.S. law imposes worldwide taxation on the incomes of U.S. persons (defined differently for individuals and entities). The BEIT preserves this basic jurisdictional scope. At the same time, by segregating the taxation of normal returns (taxed to investors) from the taxation of rents and risky returns (taxed primarily to business enterprises), the BEIT permits fine-tuning the application of the tax to each.

Time value of money returns that U.S. citizens and permanent residents earn are subject to the COCA regime, regardless of whether an investment is made in a U.S. or foreign firm. This result preserves neutrality in investment decisions by U.S. investors, and reflects the basic theme that the normal returns on all capital invested by U.S. nonbusinesses in business ventures should be subject to U.S. tax. At the same time, the BEIT's true consolidation principles mean that U.S. resident entities are taxed on their risky returns and rents, regardless of the source of the capital invested in those entities.

Following this logic, one would adopt the view that foreign investors should be wholly exempt from tax under the BEIT. By carving out foreign investors, the ultimate reach of U.S. tax on time value of money returns would be measured by the aggregate capital invested by U.S. residents in business endeavors. This approach also reflects the reality that, in a world of open economies, investors will be able to earn normal returns from many sources; in this environment, imposing U.S. tax on foreign portfolio investors simply raises the cost of capital to U.S. firms. A U.S. person who invests indirectly in a U.S. business enterprise through a foreign intermediary would still be subject to U.S. tax, because the COCA rules would apply to the indirect investment made by the U.S. investor. For all of these reasons, I find this approach to be persuasive.

Conversely, if one defined the time value of money returns that should fall within the BEIT as those derived from investing in U.S. businesses (rather than investments made by U.S. investors), then foreign portfolio investors in U.S. business enterprises should be taxed currently on their minimum inclusion income. I do not favor this conclusion as a matter of logic because it confuses residence-based taxation of normal returns (determined by the investor's residence) with residence-based taxation of risky returns and rents (determined by the entity's residence). It also creates an unavoidable practical conflict between the COCA system, which taxes income before distributions, and withholding tax collection mechanisms, which impose U.S. income tax on foreign portfolio investors, because those mechanisms require cash distributions to operate. (This is one place where CBIT has a practical advantage over COCA.)

The withholding tax administrative problem can be solved through a combination of "catch-up" withholding tax (with interest charges) on subsequent distributions and more extensive broker reporting, and withholding on sales proceeds. While this solution imposes nontrivial administrative costs on the broker community, such a system technically is feasible.[52]

The BEIT is not relevant for nonbusiness enterprise issuers. As a result, regardless of how one decides to treat foreign portfolio investors in U.S. businesses, the U.S. Treasury Department, in particular, will continue to pay interest on its debt obligations held by foreign investors free of withholding tax, in reliance on current law's portfolio interest rules.

Measuring the Effectiveness of the BEIT

Neutrality of Results

The BEIT largely satisfies the condition of neutrality, except as to the absolute scale of economic activity. First, the BEIT taxes all business operations identically (by taxing enterprises, regardless of legal form, consistently). Second, the BEIT renders tax objectives irrelevant to the choice of an issuer's capital structure, because the issuer's cost of capital allowance is determined only by reference to the capital it employs, not the securities it issues. 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. Fourth, the BEIT is "self-righting" for too fast or too slow tax depreciation (or expensing) of specific assets, through the interaction between a business enterprise's COCA deduction and its unrecovered adjusted tax basis in its assets. CBIT's success in this respect, by contrast, would depend entirely on developing perfect coordination among the tax code's depreciation and capitalization rules for real assets, CBIT's proposed but inchoate compensatory tax, and CBIT's equally ambiguous rules for taxing investor-level capital gains and losses.

The COCA system might prove inferior to CBIT in one important respect: COCA would retain some of current law's "lock-in" effect on investments at the investor level.[53] In the COCA regime, an investor who has achieved extraordinary returns on an investment but who now faces a period of normal returns might prefer to retain that investment rather than face a "step up" in tax basis—and with it, higher minimum inclusions in the future when those sale proceeds are reinvested. If CBIT were implemented without any investor-level capital gains taxes, then an investor subject to the CBIT regime would not face a lock-in effect.

Of course, the original proponents of CBIT were ambiguous as to whether investor-level capital gains taxes had a role in their system. Moreover, COCA ought materially to reduce lock-in effects compared with current law (through the minimum inclusion mechanism). The BEIT proposal therefore accepts some residual lock-in effect as a fair trade for materially improved measurement and taxation of normal returns, compared with current law or a practical implementation of CBIT.

It might also be argued that COCA fails neutrality principles in one other respect, which is that investors' aggregate time value of money inclusions each year (their minimum inclusions) are likely to exceed issuers' aggregate COCA deductions. In fact, the COCA system restores balance to the income tax by effectively measuring time value of money *income* inclusions by reference to enterprise *value*, as reflected in the aggregate bases for investors' interests in that enterprise. That is, the combination of requiring investors to include normal returns in taxable income, regardless of cash receipts, and the faster turnover of financial assets than noninventory real assets can be viewed as producing a rough and ready mark-to-market system. That is, the BEIT looks to market information to

determine the total capital invested in a business as and when investments change hands and, in the absence of market transactions, presumes that investments accrue at normal rates of return.

In contrast to the investor side, the realization principle and the practical bias in favor of over-expensing investments in real assets (whether tangible or intangible) cause the aggregate tax balance sheets of business enterprises to understate the total capital deployed in their businesses. By the same token, however, enterprises have enjoyed the current deduction of expenses that arguably should be capitalized and the deferral of economic gains that economically are reflected in secondary market trading prices for that enterprise's financial capital instruments.

The COCA system admittedly veers from strict neutrality on one other point: the tax it proposes on excess distributions. Logic does not require the tax; instead, the excess distribution tax is conceived as a compensatory tax for any residual tax preferences at the business enterprise level, and a nod to the view that those who are extraordinarily lucky should contribute some of their good fortune back to the community.

Susceptibility to Abuses

COCA will be difficult to game, because the legal form of a business enterprise or an investment in that enterprise has no effect on anyone's tax liability. In addition, COCA (like CBIT) essentially forecloses many traditional tax shelters, because "business" losses from classic tax shelter activities (whether real estate, lithographic plates, almond groves, or high-tech windmills) cannot be passed through to individual investors.

COCA does offer taxpayers the opportunity to "cherry-pick" losses by removing current law's capital loss limitations. This proposal is not, however, strictly necessary: if experience warranted, one could limit the absolute amount of losses deductible in a year. More to the point, COCA will put additional pressure on policing "wash sales"—transactions in which a taxpayer purports to sell an investment to claim a loss, but retains or reacquires an economic interest in the investment that purportedly was sold (for example, through selling an investment at a loss and immediately repurchasing it at its fair market value). Taxpayers under COCA will have two reasons to seek out wash sales: first, to obtain deductible losses, and second, to reduce future minimum inclusion

income (by reducing the tax basis of the investment to its lower fair market value). Although anti–wash sale rules are in place today,[54] in light of the importance they would assume under COCA, they would require significant refurbishing.

Administrative Burdens

COCA unquestionably will add significantly to the administrative burdens the tax system imposes on investors because investors will be required to track their accrued minimum inclusions and to apply distributions correctly against prior accruals. As a practical matter, however, brokers, mutual fund managers, and other market professionals can perform most of these recordkeeping obligations for investors. That does not mean these services will be free: incremental costs presumably will be reflected in increased custodial or management fees. Nonetheless, the cost *per investor* should be reasonably low, because brokers and other professionals will build systems to capture and record the relevant data for their many thousands of customers.[55]

The brokerage industry also would be expected to carry an important responsibility in withholding proceeds (e.g., from sales of securities paid to foreign investors) as the means of collecting tax on such investors' minimum inclusion income. This again will translate into higher custodial and management fees with some resulting loss of liquidity.[56]

Transition Issues

Transition issues are extremely important in any fundamental tax reform proposal. A new tax system will not only create future winners and losers but will also affect current stores of wealth. Income tax reform obviously poses fewer transition issues than a switch to a consumption tax, but that does not mean the issues are trivial. An overnight switch to COCA, for example, could literally bankrupt highly leveraged companies. The BEIT proposal therefore contemplates different transition rules for its non-COCA components (uniform entity-level tax, true consolidation principles, and a revised business asset and acquisition regime), on the one hand, and COCA, on the other.

The BEIT'S non-COCA rules just do not seem to work under a phase-in model and therefore must apply in toto as of a specified date. Since, in

many respects, the rules are simplifications of current law, applying them immediately to operations should not cause irreparable harm to taxpayers.

COCA, in contrast, can be phased in by specifying a multiyear period over which the interest expense deduction scales down and the COCA deduction ramps up. The investor side is more debatable but probably should simply be adopted in toto as of a specified date near the end of the business enterprise phase-in period. To avoid excessive dislocations to entities that today are fiscally transparent, taxpayers should be permitted to elect to move entirely into the COCA regime as early as they wish.

If the BEIT and COCA regime is thought to be attractive, further work on transition issues will be required. Fortunately, because the BEIT and COCA system remains fundamentally an *income* tax system, the difficult transition issues that consumption taxes pose (the taxation of existing wealth) are removed from the table.[57]

Conclusions

A well-designed income tax will reach all time value of money returns once, and only once. That tax also will be neutral, influencing neither the form of business organization nor the mix of financial capital instruments issued to finance that business. To date, most practical comprehensive reform proposals, of which CBIT is the most fully articulated, have placed the taxation of time value of money returns and economic rents at the business enterprise level. The BEIT/COCA system, in contrast, splits the measurement and collection of tax on normal returns, which it places on investors, from the collection of tax on economic rents, which it places on business enterprises.

This chapter has demonstrated why the BEIT/COCA system is the superior practical approach. The non-COCA elements of the BEIT substantially simplify and improve the operation of an income tax imposed on business operations. By treating all business enterprises as taxable entities subject to identical rules and implementing true consolidation principles for affiliated enterprises, the BEIT adopts a uniform and straightforward base on which to impose tax. By repealing all "tax-free" organization and reorganization rules, and instead taxing all transfers of business assets or business enterprises at "tax-neutral" rates, the BEIT attenuates the relevance of the realization principle,

more accurately conforms enterprise taxable income to economic income, greatly simplifies the tax system, and eliminates a wide array of potential abuses.

COCA moves the taxation of capital substantially closer to theoretical income tax norms in five critical respects. First, it treats returns on all financial instruments—including derivative contracts—in the same manner. Second, by requiring an investor to include "minimum inclusions" in income every year, regardless of cash distributions, COCA reduces the importance of the realization requirement in the taxation of financial instruments. Third, by measuring capital at the investor level, COCA is more likely than is any method that taxes normal returns at the business enterprise level to approximate an economic measure of the total capital deployed in U.S. businesses (through the faster turnover of financial assets than non-inventory real assets). These last two points can be rephrased by saying that the COCA system operates as an imperfect, but simple, mark-to-market surrogate by using actual market information—the prices at which securities change hands—to identify the total capital invested in a business, and by presuming in the absence of market sales that financial instruments increase in value annually at no less than the COCA rate.

Fourth, COCA advances good income tax design principles by operating as a corrective to noneconomic tax depreciation schedules and capitalization rules, through adjusting the present values of combined depreciation and COCA deductions always to equal a normal return on a business enterprise's economic capital (albeit measured by historical cost). Finally, relying on its minimum inclusions system to reduce cherry-picking, COCA removes current law's capital loss limitation and replaces it with full deductibility of economic losses (at appropriately tax-effected rates). By introducing this symmetry in the taxation of losses and gains, COCA contributes to the fair pricing of (and willingness to assume) risk.

Summary

This chapter identifies the characteristics of a good system for taxing income from business enterprises and financial instruments, and then proposes a solution that embodies those characteristics: the business enterprise income tax (BEIT). It argues that such a hybrid income tax is

the most robust approach to implementing a comprehensive and coherent income tax on capital. Conclusions include the following:

The current system for taxing income on capital is broken and requires fundamental reform. The United States arbitrarily defines some forms of financial capital as giving rise to deductible expenses, and others as not. The government taxes economically identical contingent cash flows in wildly varying patterns. Recent congressional fixes have only made matters worse. Meanwhile, modern financial engineering leads to ever more complex financial instruments.

Consistent rules must apply for taxing the different components of economic returns. All financial instruments that put capital to work in a business enterprise should be taxed consistently. To do so requires identifying the constituent components of economic returns: time value of money returns, risky returns, and extraordinary returns.

A good income tax system will adopt a featureless topography. Every distinguishing feature of a tax landscape, such as the debt-equity divide, invites abuse and economic inefficiency. A system must be designed that introduces as few distinctive features as possible into the tax landscape.

The U.S. Treasury's 1992 proposal for a comprehensive business income tax (CBIT) remains an important landmark in developing a rational income tax system. It would have applied consistent tax rules to all business enterprises. Still, its fundamental design decision to tax all returns to capital at the business enterprise level, rather than at the investor level, required difficult compromises that were never fully resolved.

The BEIT offers a hybrid alternative plan to reform the income taxation of business enterprises. The BEIT would reduce the role of tax considerations in business thinking by replacing current law's multiple elective tax regimes with a single set of tax rules for each stage of a business enterprise's life cycle.

The BEIT includes a comprehensive cost of capital allowance (COCA) system as a core component. The COCA 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. Moving the taxation of time value of money returns from issuers (as in CBIT) to investors has important theoretical and practical advantages.

If the BEIT/COCA regime is pursued, further work on transition issues will be required. Although it poses fewer transition issues than does a switch to a consumption tax, it would create winners and losers and have direct effects on existing wealth.

NOTES

This chapter continues the exploration of themes first broached in "The Business Enterprise Income Tax: A Prospectus," 106 *Tax Notes* 97 (January 3, 2005). In preparing this chapter for publication, I have benefited tremendously from comments from readers of that earlier article and of previous drafts. I wish to thank, in particular, Jon Ackerman, Rosanne Altshuler, Alan Auerbach, Peter Canellos, Daniel Halperin, Diane Ring, Daniel Shaviro, and C. Eugene Steuerle for their many helpful comments, and for their patience in helping to explain and resolve prior conceptual errors. All remaining errors should, of course, be laid at the feet of the author, and readers should not assume that any of the individuals listed agrees with the proposals made herein.

1. *Investment Dealer's Digest*, August 22, 2005, page 7.

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

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

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

5. Noneconomists may find it more helpful to think of these as "supersized" returns.

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

7. One can see this outmoded view of corporate capital structures at work as recently as the studies supporting the Institute of Fiscal Studies's 1991 "Allowance for Corporate Equity," which was premised on the view that "A company is owned by shareholders, who have a right to its assets and the income stream arising from them after paying all costs. These costs legitimately include the payment of interest to investors who have lent to the company" (Devereux and Freeman 1991, 6).

8. The other, more widely understood, problems are (1) the "classical" (or double-tax) corporate tax model, (2) the pervasive market presence of tax-indifferent and tax-exempt entities, and (3) the realization principle.

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

10. See Simpson, "Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe," *Wall Street Journal*, Nov. 7, 2005, page A-1, column 5.

11. Simpson, "Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe."

12. Some observers turn this point on its head by concluding that realization is the *only* problem with the current income tax and that a direct attack on realization, therefore, can solve all other problems. This chapter, by contrast, begins with the debt-equity distinction as the fundamental source of current tax problems affecting financial capital and argues for minimizing the importance of realization wherever practicable.

13. In particular, the designer of an income tax must bear in mind four forms of international capital flows: foreign direct investment, foreign portfolio investment, inbound direct investment, and inbound portfolio investment.

14. One of the most unfortunate aspects of the global economy today is the success of multilateral tariff agreements (e.g., GATT) and the lack of interest on the part of sovereigns in improving the neutrality and efficiency of capital flows through similar coordination of direct taxes.

15. The reason is not simply dimwittedness, but rather a strongly held (if idiosyncratic) belief that inflation is a great social evil and that indexation is a polite word for partial immunization of the one social class (capital owners) that can resist its spread.

16. In the pass-through model, the entity is not taxable but its income is the measure of what must be allocated among stakeholders. How, though, should one treat an owner's capital gain on selling her stake in the entity when the business enterprise's commensurate gain remains *unrealized*? And how should one treat the subsequent purchaser of that interest (who has paid after-tax dollars for that unrealized gain) when the business enterprise realizes the gain at the entity level?

Not surprisingly, the Internal Revenue Code's partnership rules have an extraordinarily complex set of provisions (sections 734, 743, and 754, among others) to coordinate the two levels of realization events. Partnership tax experts tell me that those rules can work, sometimes, in the simplest cases (although I have never been able to understand them); to my knowledge, no one believes that they can be implemented for a publicly traded partnership.

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

18. For background on the topic, see Kleinbard and Evans (1997); Kleinbard (2001, 2002); and Securities Industry Association, "Submission in Response to Advance Notice Regarding Safe Harbor Under Section 475," July 30, 2003, available through *Tax Notes Today* online at 2003 TNT 177-39.

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

20. Mark-to-market accounting works well for securities dealers precisely because their income is not significantly derived from real as well as financial assets. That accounting method today is flawed in that it applies only to dealers' assets, and not dealers' liabilities. However, because dealers fund themselves overwhelmingly with overnight financing, there is little practical distortion (Kleinbard and Evans 1997, 811–12).

Another approach would be to tax entities on a constructive mark-to-market methodology that treats the sum of the net fair market values of an entity's assets as equal to the market capitalization of the entity's stock. This approach raises substantial practical issues, including the problems described earlier of identifying genuine owners of a modern business enterprise with a complex capital structure. In addition, many business people can be expected to object that public equity prices are too volatile to serve as a fair tax base for an entity, which, unlike a stockholder, cannot simply capture fluctuations in value through a sale of the asset being measured.

21. The CBIT was reprised in a presentation in May 2005 for the President's Advisory Panel on Tax Reform and in 2003, when President George W. Bush's Treasury Department offered its first proposal to lower the tax rate on corporate dividend income, the centerpiece of which was an "Excludable Distributions Account" concept borrowed directly from the original CBIT study.

22. A direct compensatory tax also would radically affect an issuer's cash distribution policies and would exacerbate the coordination issues between stakeholder-level capital gains and the entity-level tax.

A direct entity-level compensatory tax on certain distributions is reminiscent of the United Kingdom's advance corporation tax. That tax clearly distorted U.K. companies' dividend distribution policies and was eventually abandoned.

23. Among the difficult questions is how to allocate items of preference and non-preference income among the different stakeholders, such as charities, individuals, and other corporations.

The President's Advisory Panel on Federal Tax Reform adverted to that experience in its final report, when it explained that it had rejected "more complicated regimes that would more precisely track the amount and timing of dividends and capital gains that should be exempt from shareholder-level tax based on the amount of income on which U.S. tax was paid at the business level" (125).

24. Kleinbard (2005) describes the plan in more detail (the "BEIT Prospectus"); several explanatory paragraphs from that paper have been carried over to this one. The material contained in the paper also was presented to the President's Advisory Panel on Federal Tax Reform in an expanded form in May 2005; that presentation is available online at http://www.taxreformpanel.gov/meetings/meeting-05_11-12_2005.shtml. As a historical footnote, Kleinbard originally proposed a rudimentary COCA in 1989 in an obscure article titled "Beyond Good and Evil Debt and Debt Hedges: A Cost of Capital Allowance."

25. "BEIT" is pronounced as "bite," which seems an appropriate term for a tax.

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

27. In fact, of 31 types of transactions that the Internal Revenue Service has listed as "abusive" in recent years, 13 are the direct result of the manipulation of the carryover basis or consolidated return rules, or inconsistencies in the rules applicable to different types of entities—all of which are directly resolved by the non-COCA components of the BEIT.

28. In this sense, the BEIT can be conceptualized as an enterprise-level progressive consumption tax of the income type, like the late David Bradford's X tax, combined with an investor-level tax on expected normal returns.

Compared with current law's elective tax-free reorganization rules, the mandatory BEIT regime also eliminates "loss duplication" tax avoidance trades and removes many administrative problems of tracking asset or securities basis through former owners. The BEIT also does not provide a seller of assets with any net depreciation benefit from selling and replacing its asset with an equivalent one.

29. Some simple examples of the mechanisms described in the text appear in the appendix.

Technically, the cost of capital allowance system applies only to *financial capital instruments*—financial claims against (or measured by) the earnings, assets, or liabilities of a business enterprise. The COCA system thus would *not* apply to U.S. Treasury securities (those instruments are not financial claims against a business enterprise) and would exclude ordinary trade receivables and payables of a business enterprise. While I appreciate that, in some ultimate sense, claims against the government can be described as indirect claims against other households and businesses, that argument is too diffuse, and the connection too attenuated, to have any practical significance.

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

31. The BEIT Prospectus discusses briefly some preliminary thinking behind how that rate might be determined. Special rules (not discussed in this brief overview) would apply to financial institutions.

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

33. As a consequence, *every* distribution by an issuer in respect of its financial capital would reduce the issuer's tax basis in an asset (here, cash and cash equivalents), and therefore automatically would reduce the issuer's COCA deductions in future periods.

34. This rule would not apply within a consolidated group because the consolidated group is treated as a single business enterprise.

35. The reasons for imposing any tax on excess distributions are summarized in note 30.

36. The straddle rules would, however, continue to apply.

37. One source of a great deal of the complexity in the current law's taxation of financial instruments is the desire to distinguish returns *on* investment from returns *of* investment. Both the "earnings and profits" concept applicable to corporate stock and some tax rules for complex debt instruments address that concern. The COCA system dispenses with the "earnings and profits" concept and instead taxes all returns during the life of an instrument as returns *on* investment (either as nonincludable payments of prior minimum inclusions or as excess distributions). Liquidations and similar transactions are treated as sales so that basis is recovered through the normal mechanism of reducing sales proceeds by adjusted basis. Under a special amortizing debt rule, however, distributions made on any fixed-term instrument that reduce of the holder's claim against the business enterprise during the life of the instrument are respected to that extent as returns

of principal, so long as the ongoing contractual return on the instrument is reasonably related to that contractual reduction of the holder's claim against the issuer.

38. As noted above, losses are treated essentially as reversing prior income inclusions. Thus, imagine that ordinary income rates are set at 45 percent, excess distribution rates at 15 percent, and the relevant COCA rate for the year is 6 percent. A taxpayer invests $1,000 in a business enterprise and receives no distributions. At the end of year 1, the taxpayer includes $60 in income. The taxpayer then sells the investment for $940. The first $60 of loss (in effect, from the adjusted tax basis of $1,060 to $1,000) offsets prior minimum inclusions of $60 and is deductible at a 45 percent rate. The next $60 of loss is treated as the mirror of excess distribution income, and therefore one-third of the loss (15/45) is deductible against ordinary income. The taxpayer thus reduces her tax liability by (45% × $60) + (45% × $20), or $36.

39. See the BEIT Prospectus at 105-06. This introduces an unfortunate tax distinction, under which it is necessary to deviate from a perfectly featureless tax topography by maintaining a limited metaphysical infrastructure to define the difference between a derivative instrument and a physical security. The practical consequences of drawing the line incorrectly, however, are much reduced when compared with current law's debt and equity distinctions. In addition, many taxpayers that make extensive use of derivatives, including all financial institutions, are taxed under COCA on a mark-to-market basis. Finally, if one believes that a derivative ordinarily is a fair bet (once the time value component of its returns has been extracted and dealt with separately), how this perturbation in the tax landscape could spawn a tax shelter industry is difficult to see.

40. The practical problems associated with universal mark-to-market accounting for all taxpayers do not apply to financial institutions because they already employ mark-to-market accounting for purposes of risk measurement, risk hedging, trader compensation, and internal capital allocation decisions, as well as for many of their regulatory and financial accounting requirements. Moreover, Section 475 of the Internal Revenue Code *requires* "dealers" in "securities" (both terms have very broad definitions) to mark to market their assets for tax purposes. As a result, every major financial institution has invested hundreds of millions of dollars in developing mark-to-market valuation models and accounting systems.

Section 475(f) of the Internal Revenue Code permits " traders" in securities to elect into Section 475's mark-to-market regime. Taxpayers with the requisite systems and desire make the election, while others to not. I envision that the same range of outcomes will apply to nonfinancial institution business enterprises in respect of the BEIT's analogous election.

41. COCA has some superficial similarities to the "Allowance for Corporate Equity" ("ACE") that the Institute for Fiscal Studies proposed in 1991 and Devereux and Freeman (1991) summarized, but the two 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 (1991, 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. Also unlike CBIT and COCA, there is at least some real-world experience with ACE. See, for example, Keen and King (2002).

42. In the special case where all capital investments are currently expensed, the result essentially equates to an illustration of the famous "Cary Brown theorem," in which deducting an investment's cost equals exempting a normal rate of return on that investment from tax (Brown 1948).

This combination of depreciation and a COCA-like system was explicitly adopted in the Allowance for Corporate Equity system to design a consumption tax. As noted, the designers of that system did so by exempting the normal return on an amount termed "shareholders' funds" from tax in the hands of stockholders.

43. Recall that CBIT achieved integration only through its poorly articulated excludable distributions account concept.

44. By contrast, a simple expensing solution opens up the prospect of large windfalls (or detriments), depending on the timing of a taxpayer's investments relative to the effective date of new tax rates.

45. As noted earlier, there is one small point of difference between the COCA rules for derivatives and the rules applicable to "physical" securities, but that difference is not germane to this point.

46. 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.

47. In writing this subsection in particular, I benefited from the helpful insights of Daniel Halperin.

48. If asset sales were entirely tax-free, but buyers obtained a carryover tax basis in purchased assets, then Buyer in our example would pay only $80 for the asset (because, by hypothesis, if an asset with $20 in present value tax benefits is worth $100, then an asset with no associated tax benefits is worth $80). Seller would keep the $80 free of any tax and buy a new replacement asset for $80.

In the BEIT/COCA case, Buyer will pay $100 for the same asset to reflect the $20 in tax benefits of ownership. Buyer's total *after-tax* cost for the asset thus remains $80. On

the other side, Seller will recognize $80 in after-tax proceeds. Seller will be required to pay $100 for a replacement asset; as a result, Seller will need to invest an additional $20 out of its own pocket to acquire that replacement asset. The replacement asset in turn will bring with it $20 in present value tax benefits to Seller, so that Seller's after-tax cost for purchasing the replacement asset also will remain $80.

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

50. The same rule was advocated as part of the Allowance for Corporate Equity proposal. See Devereux and Freeman (1991, 7).

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

52. Publicly traded equities, in particular, trade overwhelmingly on exchanges or in organized over-the-counter markets through recognized (and regulated) broker-dealers. (The same is true for corporate debt, except that the debt market is almost entirely an over-the-counter market.) In every such case, there are financial institutions through which sales proceeds flow, and one or more financial institutions on whose books the beneficial owner of a security is recorded. And of course the power and sophistication of technology systems available to financial intermediaries is vastly superior to that available just a few years ago. Both the information and the technology thus exist to impose broker withholding on sales proceeds, if there is political will to do so. If, as a consequence, the United States and other jurisdictions are encouraged to eliminate bearer (i.e., anonymous) bonds—a market with little commercial importance—and to improve exchanges of taxpayer financial information between tax authorities, that result would not be regrettable.

53. I thank Alan Auerbach for pointing out this issue to me.

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

55. The securities industry today has widely divergent practices in assisting investors to track the tax bases of their investments. Some of the practical problems that the industry faces include having no way to validate a customer's starting basis when an account is established, difficulty in sharing information between brokers using different technology platforms when an account is transferred, and difficulty in ascertaining how to treat various financial instruments and transactions when the attendant tax disclosure indicates that the tax analysis under current law is ambiguous. All of these issues are nettlesome; none are insoluble. Mandatory basis reporting rules (as we have today for dividends and interest) and BEIT/COCA's simplified substantive rules for taxing financial capital instruments and business combinations should allow financial institutions to provide investors with the information they need to prepare accurate income tax returns.

56. One other administrative disadvantage to the COCA approach, when compared to CBIT, is that COCA forces one to address directly the role of tax-exempt institutions in the capital markets, while CBIT hides the issue in the tax imposed on business enter-

prises. The practical effect of this observation depends on whether tax-exempt institutions would have understood that CBIT effectively would have taxed their investment returns.

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

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APPENDIX

Examples

Table A.1. Opening of Year 1 Tax Balance Sheet

Assets ($)		Liabilities and equity ($)	
Cash	100	Short-term liabilities	100
Portfolio investment	200	Long-term debt	200
Greasy machinery	500	Funky contingent payment securities	200
Land	200	Preferred stock	100
Total assets	1,000	Common stock	400
		Total assets	1,000

Note: COCA = cost of capital allowance.

Assumptions:

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

Table A.2. Year 1 Results ($)

Income	
Net income from operations	130
Deemed returns on portfolio investment	10
Total gross income	140
Deductions	
COCA deduction	50
Depreciation	50
Total deductions	100
Taxable income	40
Tax at 35%	14
Cash flow	
Net income from operations	130
Less cash coupons on liabilities and equity	(46)
Less taxes	(14)
Net cash flow	70

Table A.3. Opening of Year 2 Tax Balance Sheet

Assets ($)		Liabilities and equity ($)	
Cash	170	Short-term liabilities	100
Portfolio investment	210	Long-term debt	200
Greasy machinery	450	Funky contingent payment securities	200
Land	200	Preferred stock	100
Total assets	1,030	Common stock	430
		Total liabilities	1,030

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

Figure A.1. Holder Example

Assume a constant 5% COCA rate.
Holder invests $1,000 in a security.
For the first three years, there are no cash coupons, but minimum inclusion = $158.
  The basis is therefore = $1,158.
At end of year 3, cash distribution of $500.
  $158 = tax-free return of accrued but unpaid minimum inclusions (basis => $1,000)
  $342 = excess distribution (taxable at reduced rates)
Hold another two years, no cash coupons, but minimum inclusion = $103
  The basis is therefore = $1,103
a) Sell for $1,303: $200 excess distribution.
b) Sell for $1,000: ($103) loss, deductible at excess distribution rates.
c) Sell for $403: ($700) total loss.
    $342 at excess distribution rates
    $261 at minimum inclusion rate
    Remaining $97 at excess distribution rates

Figure A.2. Derivatives

First priority: tax hedge accounting principles.
- Based on current law (e.g., Reg §1.1275-6).
- The presumption is that financial derivatives of a business enterprise that is a nondealer or nonprofessional trader are balance sheet hedges, and as a result a gain or loss is ignored (i.e., subsumed into general COCA regime, where cash coupons on financial capital instruments are ignored).
- Taxpayer may affirmatively elect out.

Second priority: mark-to-market.
- Generally, the regime is mandatory for dealers/professional traders.
- Dealers/traders may elect tax hedge accounting treatment for their liability hedges.

Third priority: asset/liability model.
- Treat all upfront, periodic, and interim payments as (nondeductible) investments in the contract.
- Apply COCA minimum inclusion/deduction rules to resulting net "derivative asset" or to increase in asset basis corresponding to "derivative liability."
- Amount and direction of derivative asset/liability fluctuates from year to year, with no consequence other than minimum inclusions on any net investment (and COCA deductions on assets).
- At maturity or termination, "settle up" by recognizing gain or loss.
- Maturity or termination gain taxed at excess distribution rates.
- Maturity or termination loss taxed identically to general COCA regime for holders (i.e., first deductible at minimum inclusion rates to extent of prior minimum inclusions, then excess distribution rates).
- Result is identical to general COCA rules for gain, or for loss on derivative assets, but different for derivative liabilities (because gain or loss is recognized).
- The consequence is that a bright line test is still required to distinguish derivatives from financial capital investments.

Figure A.3. Derivatives Example

Assume COCA rate = 5%
X pays $50 to Y for a three-year option on S&P 500.
X has minimum inclusions over three-year life = $8 (rounded).
- So X's basis at maturity = $58.
- Y receives COCA deductions on cash proceeds—that is, on assets, not directly on derivative liability.

At maturity, contract pays either:
- $88—X recognizes $30 in excess distribution gain; Y recognizes $38 (not $30) in loss deductible at excess distribution rates.
- $0—X recognizes $8 loss deductible at minimum inclusion rates, $50 loss deductible at excess distribution rates; Y recognizes $50 gain (not $58), taxable at excess distribution rates.