

## ***Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax***

**by Chris Edwards**

### **Executive Summary**

Americans have been inundated with financial scandals at large corporations during the past two years. In many cases, unethical behavior and poor oversight of corporate management are to blame. But a deeper look reveals that the flawed structure of the corporate income tax has been a key driver of corporate waste and inefficiency. The tax code distorts financial and investment decisions and spurs executives to hunt for tax shelters.

Three fundamental flaws in the corporate income tax are behind the distortions and tax shelters. The first flaw is that the corporate income tax rate is very high. Currently, the U.S. statutory corporate rate is the second highest among the 30 major industrial countries. That high rate reduces investment, encourages firms to move profits abroad, and provides incentives to push the legal margins of the tax code.

The second flaw is that the corporate tax base of net income or profits is inherently complex because it relies on concepts such as capital gains and capitalization of long-lived assets that are difficult to consistently account for in a tax system. Costs of capitalized assets are deducted through depreciation, amortization, and other rules. The tax rules for capitalized assets and capital gains are repeatedly exploited in corporate tax shelters. These rules

also cause economic distortions as they interfere with capital investment, business reorganizations, and other decisions. Capital gains taxation and capitalization would be eliminated under a replacement “cash-flow” tax system.

The third flaw is the gratuitous inconsistency of the tax code. Examples include the different tax treatment given to debt and equity and the different rules imposed on corporations and the half dozen other types of businesses. Such inconsistencies played a key role in the tax shelters exploited by Enron and other firms. Worse, they have created large costs to the economy by distorting capital markets and channeling investment into less productive uses. A cash-flow tax would eliminate these distortions and put all businesses and investments on an equal footing.

This study discusses the most serious corporate tax distortions and examines fundamental reforms to fix them. One option examined is a full repeal of the corporate tax. Another option is replacing the corporate income tax with a cash-flow tax. The study concludes that implementing a cash-flow business tax would build on President Bush’s tax cuts, help prevent future Enron-style scandals, and permanently boost the economy.

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## **Introduction**

The corporate income tax will raise about \$150 billion in fiscal 2003, which accounts for about 8 percent of total federal tax revenues.<sup>1</sup> Despite some popular perceptions that large corporations are able to evade much of their tax liability, most large corporations pay a huge amount of tax to the federal government. Consider Wal-Mart. It paid \$3.02 billion in current federal income taxes in 2002 on pretax U.S. profits of \$9.52 billion.<sup>2</sup> That works out to an effective tax rate of 31.7 percent.

Of course, Wal-Mart and other corporations do not actually bear the burden of the corporate tax; they simply act as tax collectors for the government. The actual burden of corporate taxes falls on individuals as workers, consumers, and investors. The extent to which the burden falls on each group is subject to much debate with no clear answers.<sup>3</sup> Suppose that Wal-Mart's \$3 billion tax in 2002 was fully borne by its 1.1 million U.S. workers. The effect would be to reduce each worker's annual wage by \$2,727. But no matter which group actually bears the burden, corporate income taxes create the fiction that \$150 billion of federal spending is "free" because the cost is invisible to the general public.

The corporate income tax is generally considered the most complex and distortionary of all federal taxes. Jane Gravelle concludes that the "one fundamental aspect of the tax law that appears to cause the greatest tax distortions is the double tax on corporate income," which occurs because corporate profits are taxed at both the corporate and individual levels.<sup>4</sup> That distortion has caused concern since the beginning of the income tax, but the costs are rising in today's competitive and globalized economy. The observations that Stanford economists Myron Scholes and Mark Wolfson made in 1991 are still true today:

The United States is out of sync with most of the rest of the world in taxing corporate income so heavily rela-

tive to non-corporate income. In most other countries, corporate income is taxed more favorably by allowing shareholders to take a tax credit for corporate taxes they pay indirectly as shareholders, by imposing low shareholder-level tax rates, or by imposing relatively low corporate-level tax rates.<sup>5</sup>

Scholes and Wolfson concluded that "unless the tax system is changed to make U.S. corporations less tax disfavored relative to partnerships, investment bankers and other organizational designers will continue to search for ways to gut the corporate tax."<sup>6</sup> That comment was prescient, given the subsequent aggressive tax avoidance efforts by Enron and other companies. The U.S. corporate tax is not gutted yet, but policymakers largely have themselves to blame for recent corporate tax avoidance scandals. After all, policymakers have not responded to the reality that nearly every major industrial nation has cut its statutory corporate tax rate to below the U.S. rate.<sup>7</sup>

The recent tax bill passed by Congress included shareholder tax cuts that are a first step toward solving the corporate tax problem. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the top tax rates on dividends and capital gains to 15 percent.<sup>8</sup> However, those tax cuts are set to expire after 2008, and the tax bill did not address many serious distortions in the corporate income tax. For those reasons, Congress needs to pursue a major corporate tax overhaul or a full corporate tax repeal. Former treasury secretary Paul O'Neill's musings about abolishing the corporate income tax were not far-fetched, given the growing strain the tax is under in the competitive global economy.

That growing strain was highlighted in the recent 2,700-page report on Enron Corporation's tax sheltering activities by the congressional Joint Committee on Taxation.<sup>9</sup> Enron is just one company, but it took a team of JCT investigators a year to figure out how all

its tax shelters worked. And the JCT was still unable to determine how much tax Enron should have paid between 1995 and 2001 because the IRS needs to spend many more hours auditing those returns.<sup>10</sup> The efforts of the JCT team were a mirror image of the huge efforts of the experts at Enron, the accounting firms, and investment banks that put Enron's tax shelters into place to begin with.

The brainpower spent on Enron's taxes is a just a fraction of the vast brainpower spent on the 2.2 million corporate income tax returns filed each year.<sup>11</sup> Most of the 54,846 pages of federal tax rules relate to business income taxes.<sup>12</sup> The JCT concluded that Enron "excelled at making complexity an ally."<sup>13</sup> Although it was an ally to Enron, tax complexity is an enemy to productive business management and sound investment decisions. A typical large corporation spends tens of millions of dollars per year on tax planning and paperwork. This paper draws on the numerous Enron tax shelter deals to highlight the serious efficiency and complexity problems of the corporate income tax.

Enron-style tax sheltering has not been the only type of corporate tax scandal in the news. Attention has also focused on the growing number of U.S. companies moving their place of incorporation to low-tax jurisdictions, such as Bermuda. U.S. firms can save taxes on their foreign operations by creating a foreign parent company for their worldwide operations. At the same time, there are growing incentives for foreign companies to acquire U.S. companies because the United States has a bad tax climate for multinational headquarters.<sup>14</sup>

Those developments have prompted knee-jerk denunciations of corporate wrongdoing and a batch of ill-conceived Band-Aids from Congress. But something more fundamental than a sudden decline in ethical standards or patriotism in corporate boardrooms is going on. The more fundamental issues include the high U.S. corporate tax rate, the uncompetitive and complex corporate tax rules, globalization, and tax reforms by foreign governments. In addition, Wall Street "financial innovation is growing rapidly and the tax law

has not kept pace," as the Treasury Department noted in a major study of tax shelters in 1999.<sup>15</sup> For example, the total value of financial derivatives issued is estimated to have jumped from \$3 trillion in 1990 to \$127 trillion today.<sup>16</sup> A recently decided case in the U.S. Tax Court involving Bank One's use of derivatives concluded an eight-year battle and a trial that produced a 3,500-page transcript and 10,000 exhibits.<sup>17</sup> Clearly, the complex modern economy is creating unprecedented pressure on the antiquated income tax system.

In the next section I examine how the corporate tax shelter issue has developed in recent years and contrast legalistic and fundamental economic solutions to the problem. Then I discuss the three fundamental structural problems with the U.S. corporate tax: the high statutory tax rate; the inherent complexity of an income tax that relies on capital gains taxation and capitalization; and the gratuitous inconsistency that Congress has injected into the income tax, such as the different rules for corporations and other types of businesses.

In the final part of the paper I consider two reform options. First, I consider full corporate tax repeal. Second, I examine replacement of the corporate income tax with a low-rate business cash-flow tax. A cash-flow tax would eliminate many current complexities (e.g., depreciation) and distortions (e.g., debt favored over equity) that haunt the current tax code. Cash-flow taxation has been part of numerous reform plans over the years, including a Brookings Institution tax plan from the 1980s and then-house majority leader Dick Arney's flat tax of the 1990s.<sup>18</sup> I conclude that recent scandals and rising tax competition make this an excellent time to repeal the corporate tax or replace it with a business cash-flow tax.

## **Tax Shelters: Legalistic vs. Fundamental Economic Solutions**

Every few years, the income tax generates another cycle of tax avoidance scandals. In the 1970s and 1980s, the main focus was on

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individual tax shelters. Wealthy taxpayers sheltered income in real estate deals, movie projects, and exotic ventures such as jojoba bean farming.<sup>19</sup> The shelters involved strategies such as accelerating deductions, converting ordinary income to capital gains, and use of limited partnerships. A series of tax laws in the 1970s and 1980s mitigated those problems by closing loopholes and substantially cutting tax rates. The top individual income tax rate was cut from 70 percent to 50 percent in 1981, and then to 28 percent in 1986.<sup>20</sup> With that low rate, it made more sense for dentists, doctors, and other high earners to make sound investments rather than dodge the IRS with elaborate schemes.

In recent years, concern has shifted from individual to corporate tax avoidance. By most accounts, corporate tax avoidance has been on the upswing, though there are no firm estimates of the magnitude of those activities. The upswing has been spurred by sophisticated tax planning made possible by advanced computers and software, Wall Street financial innovation, global competitive pressures, and the high U.S. corporate tax rate. The first three factors are realities that will only intensify in the years ahead. But Congress can do something about the high corporate tax rate, as discussed in the next section.

Competitive pressures and financial innovations have also given rise to the manipulations of financial statement earnings that have been much in the news. Many corporate financial manipulations have created the dual benefit of tax reduction and a reported earnings boost at the same time. The rising gap between financial statement income and income reported for tax purposes seems to be caused by both tax avoidance efforts and efforts to inflate book earnings to please financial markets.

The increase in corporate tax avoidance has been costly in time and money for both companies and the government. Accounting and Wall Street firms have developed high levels of expertise at combining disparate parts of the tax code to engineer tax savings. But that expertise costs money: tax shelter promoters have been paid as much as \$25

million for a deal sold to a single company.<sup>21</sup> Enron paid \$88 million for advice on 12 tax shelter deals between 1995 and 2001.<sup>22</sup> These business costs are mirrored by the added costs on government administrators and enforcers. For example, it can cost the government \$2 million just to litigate a single tax shelter case.<sup>23</sup> The IRS, the Treasury, and the courts are kept busy as each new tax shelter is discovered and then squelched through statutes, regulations, enforcement, and litigation. In 1999, the Treasury Department noted that at least 30 new narrow provisions had been added to the tax code in the previous few years in response to particular abuses.<sup>24</sup> Those new rules in turn force taxpayers and their advisers to abide by growing lists of anti-abuse statutes, reporting requirements, and disclosure rules.

**Tax Code Ambiguity Makes Legal Crackdown Ineffective**

One might think that these wasteful efforts could be reduced if corporations simply stopped acting improperly. But there is usually no clear-cut right or wrong in the income tax avoidance cat-and-mouse game. Most corporate tax disputes involve different interpretations of the rules, not straightforward cheating.<sup>25</sup> Indeed, taxpayers often win court cases when the IRS challenges them on their tax law interpretations. Some recent IRS wins against corporate tax shelters in the U.S. Tax Court were reversed by the Federal Court of Appeals.<sup>26</sup> Tax lawyers often come to widely different conclusions when they examine the same facts in particular cases. Many issues are so gray that tax disputes between companies and the IRS can remain unsettled for 10 years or more.<sup>27</sup> The IRS's estimate of the correct tax liability across all corporations can be tens of billions of dollars different from what U.S. corporations believe to be the correct amount owed.<sup>28</sup>

Given this level of legal uncertainty, companies have strong incentives to push the tax code's limits. After all, no taxpayer has an obligation to pay more than what is owed, and the government cannot tell taxpayers for

sure what an illegal tax shelter is. One tax law professor noted that “virtually all tax shelters comply with the literal language of a relevant (and perhaps the most relevant) statute, administrative ruling, or case.”<sup>29</sup> With regard to Enron’s tax shelter activities, the then-JCT chief of staff Lindy Paull testified, “I don’t know if you could call it illegal.”<sup>30</sup> Though they are not clearly illegal, Paull did think that the IRS should challenge many Enron-style tax shelters.

The courts have followed various general principles or doctrines to challenge tax shelters, such as “substance over form,” “business purpose,” and “economic substance.” For example, “substance over form” basically means a taxpayer cannot simply label equity as debt and deduct dividends as if they were interest. That makes sense, but the Treasury Department notes that the “substance over form doctrine is highly subjective and fact dependent, and thus is uncertain.”<sup>31</sup> The economic substance and business purpose doctrines attempt to deny tax benefits for transactions that do not have a nontax business purpose. But ambiguity comes into play because it is not clear how broadly a “transaction” should be defined or how much nontax business purpose is needed for a transaction to pass muster.<sup>32</sup>

In speaking of anti-tax shelter legal approaches, the 1999 Treasury Department report noted that the “application of these doctrines to a particular set of facts is often uncertain.”<sup>33</sup> Indeed, courts often come to different conclusions in seemingly similar cases. Nonetheless, the Treasury Department created its own list of the general characteristics that may identify an unjustified tax shelter. Those include transactions that lack economic substance, create inconsistencies between tax and financial statement income, make use of nontaxable counterparties, are sold confidentially, have high or contingent fees, or involve widespread marketing efforts by the shelter creator.<sup>34</sup>

There is much debate regarding the best way to crack down on tax shelters from a legal point of view. Some experts support

imposing more detailed rules; others support stronger general standards. Some lawyers actually call for vague tax rules and large amounts of IRS discretion to intimidate companies, but that seems to be hostile to the rule of law and may inhibit legitimate business activities.<sup>35</sup> Numerous superficial anti-shelter ideas are currently being implemented. For example, the Treasury Department recently issued regulations that require that taxpayers and promoters of dubious tax avoidance transactions register them with the IRS. In addition, there is a movement to ban accounting firms from doing tax work for their audit clients, especially the marketing of tax reduction ideas. Obviously, such rules would not eliminate the underlying economic incentives to avoid high taxes. Thus, large companies will probably just do more tax planning in-house or purchase shelters from nonaccounting firms. Ultimately, a large and sustained reduction in tax sheltering can be achieved by changing fundamental economic incentives, not by adding endless layers of new rules.

### **Fundamental Economic Solutions Needed**

The development of detailed legal rules is certainly necessary for any tax system. But the tax shelter discussion in the past few years has been far too much a conversation between lawyers, without any focus on economic solutions. The tax shelter discussion has been about which legal doctrines should be used to enforce bad laws, rather than about reforming the bad laws. The 1999 Treasury Department study on tax shelters identified the many “discontinuities” in the income tax as a key cause of shelters.

[Tax] shelters typically rely on some type of discontinuity in the tax law that treats certain types or amounts of economic activity more favorably than comparable types or amounts of activity.

These discontinuities can arise in the basic structure of the Federal income tax system or in specific provi-

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sions of the Code and regulations. The development of sophisticated financial instruments, such as derivatives, has facilitated the exploitation of these tax law discontinuities.<sup>36</sup>

Yet the Treasury study spent only a few paragraphs discussing fundamental reforms that would remove those discontinuities and focused instead on ways to better police them. For example, the tax code favors debt over equity financing by allowing corporations a deduction for interest payments but not for dividend payments.<sup>37</sup> That discontinuity has spurred companies to design complex financial structures that have many features of equity but are treated as debt for tax purposes. If Congress eliminated such inequities, tax authorities could save much time and effort now spent on policing the tax avoidance activities that have arisen in response. The American Bar Association noted that “parties to a tax-driven transaction should have an incentive to make certain that the transaction is within the law.”<sup>38</sup> However, it would be much better to reduce tax-driven transactions altogether by creating a more neutral tax code.

Unless basic economic incentives are changed, narrow limitations on tax-driven activities may simply spawn new tax avoidance techniques.<sup>39</sup> The Treasury Department report notes that a vicious cycle is created as “legislative remedies themselves create the complexity that the next generation of tax shelters exploits, which leads to more complex responses, and so on.”<sup>40</sup> For example, the private sector created new tax shelters in response to the repeal in 1986 of General Utilities doctrine (which had allowed firms to avoid capital gains tax on some transactions), the restrictions on foreign tax credits in 1986, and the more recent implementation of mark-to-market securities rules.<sup>41</sup>

Legalistic approaches to tax shelters usually frame the issue as if Congress should imperiously be able to impose any bad tax policy it wants on Americans without any consideration of the damage it may do. That attitude is

seen in the 1999 Treasury Department report, which states that tax shelters “breed disrespect” for our “voluntary tax system.”<sup>42</sup> But surely it is the compulsory, complex, and ungainly tax system that breeds disrespect and gives rise to tax shelters. If we do not have a transparent and straightforward way of complying with the system, Congress is responsible, not the taxpayers.

One trap that Congress repeatedly falls into is carving out narrow benefits targeted at special interests. Nontargeted taxpayers will often find the new loopholes and exploit them. A classic example was recently reported by the *New York Times*.<sup>43</sup> Decades ago, Congress carved out a tax exemption for small insurance companies—those with less than \$350,000 in premiums—in order to help farmers and others get coverage. The *Times* reports that a host of millionaires and non-insurance companies have seized the opportunity to set up insurance company shells that do little actual insurance business. Those tax avoiders transfer billions of dollars of assets to those shells in order to generate tax-free earnings—all legally.

As long as Congress perpetuates such distortions in the tax code, legalistic solutions to shelters will fail. Another dead end is the belief that more money and more aggressive enforcement by the 100,000-worker IRS will solve the problem. The reality is that the IRS will always be outgunned by highly paid tax experts in the private sector.<sup>44</sup> As Congress makes the rules ever more complex, private-sector tax experts will have an even bigger advantage. The government is already using every kind of legal tool in its arsenal—legislative, regulatory, and judicial—to combat tax shelters.<sup>45</sup> But the distortion-laden income tax is too complex for any bureaucracy to accurately administer.

Instead, it is time that Congress pursued a fundamental economic solution to the problem. That means reducing the corporate tax rate and building the tax code on a neutral and transparent base to make administration and compliance easier for taxpayers and the government. Another advantage to a neu-

tral tax code is that it would reduce tax inequalities between companies. An important cause of aggressive corporate tax sheltering has been the pressure on executives to ensure that their firms' effective tax rate reported on financial statements is no higher than competitors' tax rates.<sup>46</sup> As the Treasury Department notes, effective tax rates are "viewed as a performance measure, separate from after-tax profits. That has put pressure on corporate financial officers to generate tax savings through shelters."<sup>47</sup> Thus, more neutrality in the tax code would equalize tax rates between firms and reduce pressures to pursue tax sheltering.

## **High Rate Exacerbates All Corporate Tax Problems**

After the United States cut its corporate tax rate from 46 percent to 34 percent in 1986, other countries followed suit and tax rates tumbled across the industrial nations of the Organization for Economic Cooperation and Development. Corporate tax rate cutting has continued in recent years, with the average top rate in the OECD countries falling from 37.6 percent in 1996 to just 30.8 percent by 2003.<sup>48</sup> That compares to a 40 percent rate in the United States, including the 35 percent federal rate and an average 5 percent state rate. The United States now has the second highest statutory corporate tax rate in the OECD next to Japan.<sup>49</sup>

More countries are realizing that high corporate tax rates discourage inflows of foreign investment and encourage domestic companies to invest abroad. As world direct investment flows soared from about \$200 billion to \$1.3 trillion during the 1990s, countries sought to attract their share of investments in automobile factories, computer chip plants, and other facilities.<sup>50</sup> Extensive empirical research has concluded that tax rates are important in channeling cross-border investments.<sup>51</sup> As just one current example, the world's third largest memory chipmaker, Infineon Technologies, recently announced

that it may move its headquarters out of Germany partly because of that country's high tax burden.<sup>52</sup>

Indeed, an important conclusion of public finance research is that in an open world economy countries should reduce tax rates on capital income to zero.<sup>53</sup> Higher tax rates raise the required pretax return on investments, which reduces a country's capital stock and wages. In that situation, it would be more efficient for a country, and better for workers, to tax wages directly. It is true that the zero tax rate conclusion depends on certain qualifications, but it is efficient to tax highly elastic items more lightly than other items. Corporate profits are highly elastic or mobile in today's economy and thus should be taxed very lightly in order to maximize U.S. gross domestic product.

The mobility of the corporate tax base is illustrated by the number of U.S. companies that are "inverting," or reincorporating in low-tax foreign jurisdictions such as Bermuda. By doing so, U.S. firms have found that they can reduce taxes paid to the U.S. government on their foreign operations. In a typical corporate inversion transaction, the U.S. firm places itself under a new foreign parent company formed in a lower-tax jurisdiction. Such transactions generally have no real effect on the company's U.S. business operations; the company just pays less tax to the U.S. government.

Many politicians and pundits have found corporate inversions to be scandalous, and a number of bills have been introduced in Congress to stop them. Unfortunately, those efforts offer only a superficial response to the issues raised by inversions and do not tackle the underlying uncompetitiveness of the U.S. corporate tax.<sup>54</sup> It is certainly sad that venerable American businesses such as Stanley Works and Ingersoll-Rand feel that the U.S. tax code is so bad that they must consider incorporating abroad.<sup>55</sup> The decisions to undertake such transactions are not taken lightly by U.S. companies because inversions need complex planning and can involve large up-front tax costs.<sup>56</sup> Thus, U.S. firms would not be pursuing inver-

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sions unless there was something seriously wrong with the U.S. tax system.

This issue highlights the two-sided game that some politicians play with regard to the tax code. First, they attack the tax code's inefficiency and complexity, and then they turn around and attack the taxpayers who logically try to take advantage of the tax mess that the government created. For example, in the mid-1930s President Franklin Roosevelt and Treasury Secretary Henry Morgenthau launched a campaign to energize their constituents by attacking tax loopholes used by the rich.<sup>57</sup> The Treasury Department vilified famous wealthy people as tax cheaters and introduced a string of proposals to increase taxes on the rich and big corporations.<sup>58</sup> Yet in the previous few years, the government had jacked up the top individual tax rate from 25 percent to 79 percent, thus encouraging the rich to aggressively hunt for new tax shelters. Meanwhile, Roosevelt railed against income tax rules "so complex that even Certified Public Accountants cannot interpret them."<sup>59</sup>

Today it is the same with the corporate income tax. The high rate and the distortions work hand in hand to give companies a strong incentive to pursue tax reduction schemes. The high corporate rate exacerbates every distortion in the income tax code, such as the bias in favor of debt. Indeed, high tax rates increase the "deadweight losses" caused by such distortions more than proportionally as tax rates rise.<sup>60</sup> Thus, even modest rate reductions can substantially increase the efficiency of the tax system. As marginal tax rates fall, tax distortions become less important and executives become less interested in taking the risks and paying the high fees involved in tax shelter transactions.

In today's global economy, it is not just the absolute level of the corporate rate that is important but also the U.S. rate compared to rates in other countries. For example, today there is much concern about "earnings stripping," which occurs when parent firms and their affiliates use intercompany borrowing to shift profits from high-tax to low-tax

countries. The benefits of such transactions depend on the tax rates in the two countries. Thus as our trading partners have cut tax rates in recent years, it is not surprising that the U.S. corporate tax is feeling pressure from such tax avoidance techniques.

The United States needs to update its tax policies to keep pace with changes in the rest of the world. Cutting the U.S. corporate rate from 35 percent to, say, 20 percent would increase capital investment, reduce corporate activities aimed at avoiding U.S. taxes, and encourage companies to restructure themselves to move more of their global tax base into the United States.

## **Flaws Intrinsic to the Corporate Income Tax**

The corporate income tax began in 1909 masquerading as an "excise" tax.<sup>61</sup> Ever since the Supreme Court had struck down the income tax in 1895, attempts had been made to work around the Court's decision and somehow apply taxes to an income base.<sup>62</sup> The Corporation Tax Act of 1909 applied a 1 percent tax on corporate net income, on the theory that it was an excise on the "privilege" of organizing in the corporate form.<sup>63</sup> Supporters of the tax took advantage of the populist anti-wealth and anti-big business attitudes that had been gaining steam since the 1890s.<sup>64</sup> Support for the corporate tax also came from opponents of tariffs who wanted to find a substitute revenue source.<sup>65</sup> The corporate income tax was seen as a first step toward broader income taxation that would be adopted a few years later. After the adoption of the Sixteenth Amendment to the U.S. Constitution in 1913, the corporate tax was rolled into the new income tax system.

Even before 1909, there was a history at the state level of taxing corporations more heavily than other types of businesses. State corporate taxes had been supported because corporations were seen as too powerful or as beneficiaries of privileges conferred on them by the government. Politically, special taxes

on corporations made sense because they allowed governments to hide funding for additional spending out of sight of the voters. But taxing corporations differently from noncorporate businesses never had a sound economic justification.

Congress compounded the mistake of imposing a special tax on corporations by applying the tax to the very troublesome base of net income or profits. The tax base of net income created substantial complexity from the beginning. Civil War administrators had trouble measuring income and capital gains under the income tax that lasted from 1861 until 1872.<sup>66</sup> Soon after the corporate income tax was enacted in 1909, the tax base began creating confusion and inefficiency. The congressional Joint Committee on Taxation was created in 1926 to study income tax simplification and the complex tax administration problems that had already arisen. By the 1930s, experts were lamenting all the fundamental income tax problems that cause distortions and complexities today. A major report by the Treasury Department in 1934 noted with regard to the corporate income tax:

The irregularity of income, the taxation of capital gains, the definition of the time of “realization,” the handling of depreciation and appreciation, the cash versus accrual method of accounting, the holding and distributing of corporation earnings in the form of dividends, all raise serious difficulties in the definition of income and administration of a net income tax.<sup>67</sup>

Despite hundreds of statutory and regulatory changes to these provisions during subsequent decades, all these problems persist today. A key problem is that the income tax superstructure has been built ever higher on a very problematic base. The problems begin with the Haig-Simons income concept, which underpins the tax, named after economists Robert Haig and Henry Simons writ-

ing in the 1920s and 1930s.<sup>68</sup> In abstract, Haig-Simons income equals consumption plus the rise in market value of net wealth during a year. In practice, it includes all forms of labor compensation, including fringe benefits, and all sources of capital income, such as interest, dividends, and capital gains.

A Haig-Simons tax would tax income very broadly and would tax it on an accrual basis. Taxing on an accrual basis means taxing income when earned, not when cash is actually received. For example, individuals would be taxed each year on all stock market gains whether or not any stocks were sold. Also, individuals would be taxed on items such as the buildup of wealth in their life insurance policies and the implicit rent received from owning their homes.

It would be completely impractical to tax such a broad accrual income base.<sup>69</sup> For example, many individuals would not have any cash available to pay capital gains tax if they did not sell any stock. As a consequence of the impracticality of full Haig-Simons taxation, the income tax system is a jumble of ad hoc rules based on different theories and various practical realities. David Bradford, a former Treasury official and current Princeton professor, has examined the complexity of income taxation and concluded:

It is simply very difficult to design rules that can be administered by ordinary human beings that will provide an acceptable degree of approximation to the accrual-income ideal. That is why the tax system requires continual patching—one year, tax straddles; another year, self-constructed assets; another year, installment sales; another year, discount bonds; and so on.<sup>70</sup>

Under the current income tax, corporations generally capitalize long-lived assets used for production. That means that such assets may not be deducted when purchased, but their cost is deducted over time under rules for depreciation and amortization. In

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addition, the income tax generally uses accrual accounting, meaning that income is included in the tax base when earned, not when cash is received, and expenses are deducted when incurred, not when cash is paid. Capitalization and accrual accounting involve the creation of many artificial accounting constructs that open the doors to manipulation and distortion of the income tax.<sup>71</sup> (By contrast, under cash-flow accounting businesses deduct all expenses when paid and include income when received.)

Capitalization and accrual accounting are also the building blocks of financial statement income, based on generally accepted accounting principles (GAAP). Recent corporate accounting scandals illustrate that GAAP-based income suffers from large manipulation problems, similar to the problems faced by the current income tax. It is occasionally suggested that income for tax purposes be conformed to GAAP income as a simplification measure. However, recent accounting scandals suggest that that would not produce a less problematic tax base. Also, a tax base of GAAP income would retain the anti-investment bias of the current income tax. For example, it would still require depreciation of capital purchases rather than immediate deduction (“expensing”).<sup>72</sup> Also, conforming tax to GAAP income may cause corporate executives’ tax considerations to distort their financial statements and upset the efficiency of financial markets.<sup>73</sup>

**Net Cash Flow Is an Alternative Tax Base**

An alternative to income taxation based on accrual accounting is consumption taxation based on cash-flow accounting.<sup>74</sup> A cash-flow tax would be imposed on net cash flow of businesses, not net income or profits. The most commonly proposed type of cash-flow tax (an “R-based” tax) would have a tax base of receipts from the sale of goods and services less current and capital expenses. Under an R (real) base, financial items such as interest, dividends, and capital gains would be disregarded—they would not be included in income or allowed as deduc-

tions.<sup>75</sup> (Alternately, an R+F base, real plus financial, would include financial flows.) Under cash-flow accounting, businesses would include receipts when cash is received and deduct the full costs of materials, inventories, equipment, and structures when they are purchased.

Business cash-flow taxes have been discussed in academic and policy circles for years and have formed the basis of numerous legislative proposals since at least the 1970s. (Going back further, Treasury Secretary Andrew Mellon’s chief tax adviser in the 1920s, Thomas Adams, suggested replacing the income tax and its “incurable inconsistencies” with a consumption-based tax.)<sup>76</sup> In 1985, the Brookings Institution’s Henry Aaron and Harvey Galper proposed an R+F-based cash-flow tax on businesses within a comprehensive tax plan.<sup>77</sup> In 1981, the Hoover Institution’s Robert Hall and Alvin Rabushka introduced their “flat tax,” based on an R-based business cash-flow tax.<sup>78</sup> Interestingly, it was former senator Dennis DeConcini of Arizona and former representative Leon Panetta of California, both Democrats, who first introduced the Hall-Rabushka plan in Congress in 1982, illustrating that tax reform was more of a bipartisan concern in the 1980s than now.<sup>79</sup> In the 1990s, Dick Arme and Steve Forbes proposed Hall-Rabushka-style tax reform plans.

Economists from Aaron to Arme agree that many basic income tax distortions would be eliminated under a business cash-flow tax. Those distortions include the different treatment of debt and equity, the different treatment of corporate and noncorporate businesses, the bias against saving, and distortions caused by inflation.<sup>80</sup> As time goes by, the business cash-flow tax becomes more appealing compared with the deepening swamp of complexity and inefficiency under the corporate income tax.<sup>81</sup>

**Income Taxation Is Sensitive to Timing**

Timing is everything under the income tax, which relies on capitalization and accrual accounting. The basic idea is to match

expenses against corresponding income when earned. If cash is spent this year that creates benefits in future years, the expense should not be currently deducted. Instead, the cost must be capitalized and deducted later. Alternatively, rules are needed to deal with cash received this year that relates to economic activity in other years. Thus, in any given year under the income tax there are numerous income and deduction items on corporate tax returns that do not coincide with flows of cash but are based on tax law definitions determining the proper timing of recognition.

Examples of noncash tax return entries are depreciation and amortization. For example, goodwill is created as an artificial asset under some corporate acquisition transactions. The acquiring company in an acquisition amortizes the goodwill asset (takes a noncash deduction) over the subsequent 15 years. Such noncash items may only be rough measures of underlying economic reality. In addition, inflation throws a wrench into the accurate matching of income and expenses since deductions slated for future years lose their value with inflation. As a result, the income tax code is rife with distortions that are roadblocks to efficient investment and offer opportunities for tax avoidance transactions.

The Treasury Department notes that “it is extremely difficult, and perhaps impossible, to design a tax system that measures income perfectly . . . even if rules for the accurate measurement of income could be devised, such rules could result in significant administrative and compliance burdens.”<sup>82</sup> Capital gains is a good example. In theory, broad-based income taxation would tax capital gains on an accrual basis. But since that is not feasible, the income tax falls back on taxing most, but not all, gains when realized. Recent tax shelters have exploited the fact that some gains are taxed on a realization basis and other gains, such as foreign currency contracts, are taxed on a mark-to-market, or accrual, basis. That discontinuity has been exploited by Wall Street experts who have

devised a variety of tax shelters.<sup>83</sup> Apparently, firms subject to mark-to-market tax treatment are able to enter into mutually beneficial transactions with other taxpayers subject to realization treatment to absorb their capital gains.

Many tax avoidance techniques exploit the income tax’s sensitivity to timing. One technique is to take advantage of tax code provisions that accelerate income recognition. Installment sale shelters and lease strips (both of which are now banned) used that approach. Those shelters worked by having a corporation set up a partnership with a nontaxpayer (such as a foreigner). A transaction would be performed through the partnership that generated up-front income; that income would be mainly allocated to the nontaxpayer; then the partnership would be dissolved. Under the lease strip shelter, the partnership would buy an item such as an airplane, lease it out under a prepaid lease, and then allocate the up-front money to the nontaxpayer.<sup>84</sup> The partnership would then be dissolved, leaving the corporation with no income to report but with annual depreciation deductions to take on the airplane or other assets.

A number of Enron deals exploited various timing-sensitive income tax rules. For example, “commodity prepay” transactions were used to reduce taxes. In one deal, Enron sought to generate income in order to use Section 29 tax credits before they expired. Those credits are special interest benefits designed to encourage fuel production from unconventional sources.<sup>85</sup> Enron designed transactions to enable it to receive up-front payments, so that it could use the tax credits, in exchange for later delivery of oil and gas. But no oil and gas were actually delivered, and the transaction was later reversed with a complex flow of money after the tax benefits had been realized.

Most such manipulations with regard to the timing of income and expenses would be eliminated under a cash-flow tax. Income would be included in the tax base when received. Deductions would be taken when

**A number of Enron deals exploited various timing-sensitive income tax rules.**

**Capitalization is probably the greatest weakness of the corporate income tax.**

cash went out the door. That treatment would not only be more economically efficient, it would remove a great many tax avoidance opportunities that exist under the current tax regime.

**Capitalization**

Under the income tax, business costs for assets that generate revenues in future years are typically not deducted at the time of purchase. Instead, such items as buildings, machines, and intangible assets are capitalized and deducted over future years. Under income tax theory, the purchase price of buildings and machines should be deducted, or depreciated, over time to match the loss in economic value of the asset. When intangible assets are purchased, they are amortized over a specified period of time. Materials purchased for inventory and related inventory expenses face special rules to determine when deductions should be taken.

There are two key problems with capitalization: figuring out which assets need to be capitalized and figuring out the period over and method by which to take future deductions. With regard to the first problem, any asset that produces benefits in future years should be capitalized, in income tax theory. But that principle becomes extremely ambiguous in practice. For example, the IRS has battled companies over whether management consultant expenses should be immediately deducted if they relate to long-term improvements in a company's productivity. Taxpayers say yes, but the IRS has held that such expenses must be written off over future years. The tax code contains no consistency on such rules. Advertising and research and development expenses are immediately deducted under current rules, yet they produce benefits in future years. On the other hand, the tax law requires capitalization of numerous expenses that taxpayers think of as current expenses, such as interest costs related to inventory.

Capitalization is probably the greatest weakness of the corporate income tax. University of Chicago law professor David

Weisbach notes that capitalization is "unbelievably complex" and "extremely uncertain" for companies.<sup>86</sup> In recent years, the IRS has been aggressive in forcing companies to capitalize all kinds of expenses that it unilaterally determines yield long-term benefits. One rough estimate was that up to one-quarter of IRS examination resources in some industries are used for capitalization issues alone.<sup>87</sup> Capitalization is a heavily litigated part of the tax code, with taxpayers winning about half the cases against the IRS.<sup>88</sup> Weisbach notes that the outcome of court cases is essentially random because of the ambiguity.<sup>89</sup> The Supreme Court has weighed in on the ambiguity of capitalization: "If one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period . . . in which the expenditure is made, the result will be to force the capitalization of virtually every business expense."<sup>90</sup>

The problems of capitalization are evident in the tax rules for inventory. Businesses may not simply deduct the costs of materials when purchased; rather, costs must be capitalized and deducted later when products are sold. A range of indirect costs related to inventories, such as interest, must also be capitalized. These rules are so complex that a top Treasury Department official thinks that many companies are simply guessing to get the correct inventory deduction on their tax returns.<sup>91</sup> The 1986 tax act was supposed to "reform" the corporate tax by measuring income better, but with inventory accounting and other items the rules became more complex.

The second key problem with capitalization is determining the time period over and method by which each asset should be deducted over future years. In income tax theory, depreciation deductions should match an asset's obsolescence over time. But every asset is different, and new types of assets are being invented all the time. Rough approximations are used to place assets in categories that determine the length of the period for deductions and which formula to use in calculating deductions.<sup>92</sup> For example, cars, farm build-

ings, racehorses, shrubbery, and tugboats may all have different depreciation time periods and other rules. For newer technologies, the asset classification system is long out of date, resulting in incorrect treatment of such items as computers.<sup>93</sup> But even up-to-date depreciation schedules would be wrong because of inflation distortions.

Depreciation plays an important role in many tax shelters, including a number of Enron deals. A basic shelter strategy is to artificially raise the basis of an asset to increase future depreciation deductions. (“Basis” is generally the original cost less accumulated depreciation. For example, a machine that was purchased for \$100 and had \$40 depreciation taken against it would have a basis of \$60.) That strategy was used in 1997 in Enron’s Teresa tax shelter, which involved a synthetic lease, which is a lease treated differently for tax purposes and financial statements.<sup>94</sup> Enron and an investment bank set up a partnership to which Enron contributed its Houston North office building and other assets, as well as preferred shares of an affiliate. In the early years of the deal, Enron paid additional tax from receipt of dividends, but that cost would be outweighed by added depreciation deductions in later years. Tax benefits were gained by shifting \$1 billion in basis from a nondepreciable asset (the preferred shares) to depreciable assets including the office building.

The partnership tax rules combined with the shifting of basis from nondepreciable to depreciable assets was also the key to other Enron tax shelters.<sup>95</sup> Enron shelters Tammy 1 and Tammy 2 involved shifting about \$2 billion in basis to the Enron South office building and other assets. Again, tax benefits were gained by increasing future depreciation deductions.<sup>96</sup> (Ultimately, those deals were not completed as planned because of the subsequent Enron meltdown.)

A business cash-flow tax would eliminate capitalization and all related concepts such as depreciation. Basis could not be shifted from some assets to others as in the Enron deals because asset basis is always zero under

a cash-flow tax. Businesses would include the full price of asset sales in taxable receipts and would deduct the full cost when purchased. All business purchases would be treated the same way and immediately deducted. Partnerships would be taxed the same as other business entities so there would be no advantages in shifting assets to them. Expensing would create tax neutrality across all types of assets. Inflation would not distort marginal tax rates under a cash-flow tax as it does under the income tax. The rules under a cash-flow tax would be simple and durable over the long term.

### **Capital Gains**

Capital gains taxation has caused complexity and distortion throughout the history of the income tax. As early as 1944, a Treasury Department report noted that “the treatment of capital gains has long been a source of controversy in federal taxation.”<sup>97</sup> Under consumption-based taxes, such as a cash-flow tax, capital gains taxation would disappear. But under the income tax, Congress cannot seem to find a stable and efficient treatment for capital gains: it repeatedly changes the rates, exclusion amounts, holding periods, and treatment of losses. Capital gains taxation gets more complex as Congress adds more rules whenever new financial products are developed. For example, complex “constructive sale” rules were added in 1997 to prevent investors from using short selling to lock in gains without paying tax. But the new rules prompted private-sector development of other techniques to allow investors to accomplish the same thing, such as strategies using puts and calls.

While Congress has made capital gains taxation more complex than it needs to be—for example, by imposing multiple tax rates—most of the complexity is intrinsic. For example, practicality dictates that most gains be taxed on a realization basis, yet that treatment “stimulates an almost infinite variety of tax planning.”<sup>98</sup> Since gains are taxed when assets are sold, taxpayers need to optimally plan, matching their gains with losses.

## **Capital gains taxation has caused complexity and distortion throughout the history of the income tax.**

**Germany cut its federal corporate tax rate to 25 percent and eliminated the corporate capital gains tax.**

That planning has prompted the government to create a large apparatus of rules to police realization strategies.

One example of intrinsic capital gains complexity for businesses is the difficulty in drawing distinct lines between assets sold as a part of regular sales, which are taxed as ordinary income, and assets sold by investors for speculation, which are taxed as capital gains.<sup>99</sup> For industries such as real estate, this classification of receipts as ordinary or capital gains is a continuing area of complexity and conflict.

For corporations, net capital gains are taxed at the regular corporate rate, generally 35 percent.<sup>100</sup> Capital losses may be deducted only against capital gains, not ordinary income. Net capital losses may be carried back three years or forward five years. These basic rules necessitate large amounts of tax planning. Companies have an incentive to avoid realizing gains unless they have losses available. Also, they generally prefer income to be characterized as capital gains not ordinary income, and losses to be characterized as ordinary losses not capital losses, because of the limitations on capital losses.<sup>101</sup> In addition, the international tax rules provide incentives to characterize income or gains as foreign-source, but deductions or losses as U.S.-source.

Corporations pay capital gains taxes on sales of capital assets, such as shares of other corporations. But gains on the sale of depreciable assets involve other rules. Sales of personal property, such as machinery, are taxed partly as capital gains and partly as ordinary income. The overall taxable amount is the difference between the sales price and basis, which is generally the original cost less accumulated depreciation. That amount is taxed as ordinary income to the extent of previous depreciation allowances (depreciation is “recaptured”). Sales of real property, such as buildings, are also taxed partly as ordinary income and partly as capital gains, but different rules apply.

In a nutshell, the corporate capital gains rules are complex and compel substantial tax

minimization planning. In addition, they create distortions, such as “locking in” corporate investments in other companies. That occurs because built-in gains face corporate taxation when shares are sold. Thus, companies may avoid selling shares and be stuck holding old investments with low returns or be unable to reallocate their capital when business conditions change.

A key goal of German corporate tax reforms put in place in 2002 was elimination of this lock-in effect. In an effort to improve the economy’s competitiveness, Germany cut its federal corporate tax rate to 25 percent and eliminated the corporate capital gains tax on sales of other firms’ stock.<sup>102</sup> Incestuous cross-holdings between German companies are thought to have sapped the dynamism from the economy. Capital gains taxes stood in the way of needed divestitures and corporate restructuring. The tax reform was designed to allow corporations to unwind their unproductive investments without a tax penalty. The Netherlands has also gained a competitive edge by having no corporate capital gains tax on sales of shareholdings. As a result, the Netherlands is a favored location for holding companies and multinational headquarters.<sup>103</sup>

By contrast, the United States dissuades efficient business reorganizations by taxing corporate capital gains at a high rate. To give one example of the size of the lock-in effect, consider SunTrust and Coca-Cola. SunTrust owns roughly \$2 billion in Coca-Cola company shares, which it has held since 1919. If SunTrust wanted to unload those shares, it would face corporate capital gains taxes of roughly \$700 million at the 35 percent corporate tax rate.<sup>104</sup>

Not surprisingly, the high corporate capital gains tax has caused U.S. corporations to devise elaborate strategies to avoid it. Corporations have developed techniques to effectively divest holdings in other firms while retaining legal ownership and deferring capital gains tax until later years.<sup>105</sup> For example, Times Mirror wanted to unload its holding of Netscape Communications with-

out paying the corporate capital gains tax in 1996.<sup>106</sup> With help from Wall Street, *Times Mirror* designed and issued “PEPS,” which allowed it to put off until later years capital gains taxes on the sale, to get cash up front, to push Netscape risk onto PEPS holders, and to receive an interest deduction for its PEPS payments.<sup>107</sup>

Deals to avoid corporate capital gains taxes come in many flavors. *Tax Notes* columnist Lee Shepard wrote sarcastically a few years ago: “It has finally happened. Wall Street has run out of macho acronyms for securities that purport to be debt. We already have LYONS and TIGRS and CATS and PRIDES and ELKS. We have securities with meaningless names, like MIPS and DECS and PEPS. And now we have PHONES.”<sup>108</sup> PHONES are financial derivatives that give companies the benefit of selling their holdings without actually selling stock and incurring capital gains tax. PHONES were used a few years ago by Comcast when it unloaded its AT&T holdings and by Tribune Company to unload its AOL holdings. Such large stock sales could generate a huge tax at the 35 percent rate; thus companies have big incentives to devise complex strategies, such as PHONES, to avoid the tax.

A number of tax avoidance strategies involve companies buying assets with built-in losses that can be used to offset other income. One strategy popular in the late 1990s involved companies putting profitable activities into their foreign subsidiaries and then acquiring losses from foreigners to offset their profits.<sup>109</sup> For example, a foreign entity might have a built-in loss stemming from owning a financial security worth \$10 million that had been bought for \$50 million. A subsidiary of a U.S. company could devise a strategy to buy the security for, say, \$11 million, and acquire the asset’s high basis and thus built-in loss. Using various provisions of the tax code, the subsidiary could sell the security and take a \$40 million ordinary loss and use it to offset other income.

Enron built a number of tax shelters around the capital gain and loss rules.

Enron’s tax shelter deal Tanya aimed to generate capital losses that it could use to offset gains it had created in other activities.<sup>110</sup> In 1995 Enron had a large gain from the sale of Enron Oil and Gas. Arthur Andersen came up with a transaction that moved assets and liabilities to an Enron subsidiary, Enron Management Inc. Then Enron sold its holding in the subsidiary to create a capital loss of \$188 million for Enron to use to offset gains from other activities. The deal also managed to create duplicate tax deductions in later years. Project Valor was similar, creating a \$235 million capital loss for Enron that it used to offset gains from further sales of holdings in Enron Oil and Gas in 1996.<sup>111</sup>

Steele and Cochise were deals in which Enron acquired built-in losses from another company in order to offset some of its income. The Steele tax scheme involved setting up a new entity, ECT Partners, and then transferring assets with built-in losses from Bankers Trust to the entity. The assets involved were REMIC residual interests, which are particularly suited to such deals.<sup>112</sup> The assets had a basis of \$234 million and a market value of only \$8 million. Since ECT Partners was part of Enron in its consolidated tax return, Enron was able to use the losses to reduce taxable income by \$112 million between 1997 and 2001.<sup>113</sup>

This deal and others generate tax benefits by moving “tax attributes,” such as built-in losses, net operating losses, and credits, from the firms that generate them to other firms that can better use them. Income tax rules try to limit the transfer of tax attributes, and IRS policing is required to challenge deals where there seems to be no nontax purpose to such transfers.<sup>114</sup> But how much nontax purpose is needed to pass IRS inspection is ambiguous. In these Enron deals, the nontax purpose was to increase financial statement income that came about from the reduction in taxes—a clearly circular logic. Nonetheless, in these shelters and others, prestigious law and accounting firms signed off on the deals, usually charging a fat fee for writing opinion letters.<sup>115</sup>

**The high corporate capital gains tax has caused U.S. corporations to devise elaborate strategies to avoid it.**

**The tax law controlling the world of corporate reorganizations is a messy interaction of the income tax rules for capital gains, depreciation, interest deductions, net operating losses, goodwill, and other items.**

Another tax shelter incentive created by capital gains taxation is to increase asset basis before a sale in order to reduce taxable gain. Enron used this strategy with the Tomas deal, which involved increasing the basis of a portfolio of assets it wanted to dispose of, including leased airplanes and rail cars. The deal eliminated \$270 million of taxable gain on the disposition of those assets.<sup>116</sup> Enron set up a partnership with Bankers Trust in 1998, to which it transferred assets that had high market value but low basis (i.e., the assets had been nearly fully depreciated). Once the partnership held the assets, it used various transactions and tax provisions to shift basis from stock it held to these depreciable assets. The deal was able to increase the assets' basis enough to reduce Enron's taxable income by \$270 million. Later Enron liquidated its interest in the partnership. The partnership and Bankers Trust were able to sell the high-basis assets without gain. As in other deals, use of the partnership structure was crucial. Enron paid Bankers Trust \$13 million for the deal.

These tax shelters illustrate the extensive incentives and opportunities that capital gains taxation creates for corporate tax planning and avoidance. Under a business cash-flow tax, capital gains taxation would be eliminated. Businesses would generally not collect "tax attributes," such as built-in losses, that could be traded to other companies in tax avoidance schemes. Asset basis would not be a variable to manipulate up or down to create gain or loss. Businesses would simply include the market price of asset sales in taxable revenue and symmetrically expense assets when purchased. That would create an enormous simplification of business tax planning, close many tax shelters, and reduce the need for government rules and enforcement efforts.

#### **Mergers and Acquisitions**

The tax law controlling the world of corporate reorganizations—mergers, acquisitions, and other transactions—is a messy interaction of the income tax rules for capital

gains, depreciation, interest deductions, net operating losses, goodwill, and other items. Many tax experts echo Cleveland State University professor Deborah Geier's views on this area of tax law:

The current state of the law regarding corporate reorganizations is incomprehensible. The law in this area is not the result of a grand, coherent scheme but rather is the end result of a long accumulation of cases, statutory amendments, and IRS ruling positions, the sum total of which is a system that is staggering in its complexity and unpredictability. Moreover, the system exacts extremely high and inefficient transactions costs, as deals must be structured in ways that make sense only to the tax lawyers.<sup>117</sup>

Tax law stifles economic growth if it stands in the way of flexible business restructuring. Indeed, as noted in a study of the recent German corporate tax reforms, "The freedom to buy, sell, and refocus and reallocate assets in response to changing economic forces is potentially one of the most critical features of competitive market economies."<sup>118</sup> Conglomerates may find that they need to refocus on their core mission and spin off some divisions. Growing firms may want to acquire weaker firms to build greater economies of scale. Industries facing foreign competition may need to restructure to survive. Tax rules should not be a hurdle to those transactions.

Tax rules should also not encourage transactions that make no economic sense. For example, the more favorable treatment of debt than equity may encourage firms to pursue ill-advised debt-heavy acquisitions. There was much concern in the 1980s that the preferential tax treatment of debt was helping fuel the leveraged buyout spree, which was financed by high-yield, or junk, bonds. For example, part of the game plan of the famous 1989 RJR-Nabisco buyout was to

wipe out the company's taxable income for years to come with interest deductions from a huge high-yield bond issue.<sup>119</sup>

Although buyouts are often a big plus for improving corporate management, the tax code should not be setting the parameters in the market for corporate control. But as tax laws change, so do the incentives for mergers and acquisitions (M&As). The 1981 tax act encouraged M&As, but then the 1986 tax act reversed course and discouraged them. One change in 1986 was the repeal of the General Utilities doctrine, which had allowed firms to avoid capital gains tax on certain distributions of assets to shareholders. That change caused firms to innovate and find new ways to avoid capital gains on appreciated property they held.<sup>120</sup>

The complexity of the tax rules on corporate reorganizations spurs companies to create elaborate strategies for tax avoidance. Those strategies provide great fodder for anti-business cynics in the media. The *Washington Post's* Allan Sloan makes it seem as if every business reorganization he reviews is robbing Uncle Sam blind. Some of his column headlines have been "GM Finds a Hole in the Tax Code Big Enough to Drive Billions Through" and "Northrop Grumman Deal Scores a Direct Hit on Taxes."<sup>121</sup> But the critics rarely consider whether there is something fundamentally wrong with a tax system that turns nearly every M&A into a supposed scandal.

The problems that create M&A scandals and complexity are rooted in the basic structure of the income tax. A brief overview of M&A tax rules illustrates the importance of two key income tax problems—capital gains taxation and capitalization.<sup>122</sup> Shareholders of companies being bought (target firms) may be paid either in cash or in shares of the acquiring firm. A tax-free transaction generally occurs when the target's shareholders receive shares. In these deals, target shareholders do not pay capital gains taxes in the transaction. (They will pay capital gains taxes later when they sell their shares.) By contrast, under taxable transactions the target firm

shareholders receive cash and may face current capital gains taxes. Deals are sometimes partially stock and partially cash, in which case target shareholders may pay some taxes.

Different transaction structures (called A, B, C, etc.) provide rules for different amounts of stock and cash, different classes of shares, and other specifics. For example, Allan Sloan criticized General Motors in 2001 for a deal that used multiple classes of shares to get around capital gains taxes on the sale of GM's Hughes Electronics to Echostar.<sup>123</sup> With this deal, GM was apparently able to get around restrictive new rules put in place in 1997. In turn, the 1997 rules had been put in place to prevent transactions of a type with which GM had been able to avoid taxes in a prior deal. What is Sloan's solution to these endless tax avoidance games? He does not have one.

Another key tax issue for M&As is how much depreciation will companies be able to deduct on target assets after reorganization. Under some types of transactions, particularly taxable ones, the basis of the target's assets is stepped up to market value. If a target firm's assets have a market value higher than their current tax basis, the assets will be worth more to another company, which will be able to take larger depreciation deductions than the current owner. That fact creates incentives for acquisitions.

All in all, the tax rules for corporate reorganizations are "immensely complicated," notes tax guide publisher CCH.<sup>124</sup> While Sloan criticizes firms for navigating the tax rules to the best of their ability, consider what one judge said in an M&A tax case. A 1999 Tax Court case involved an energy company acquisition that seemed to be tax driven because the acquiring firm would gain \$84 million of the target firm's losses. The court ended up siding with the taxpayer and concluded, "In the complexity of today's business and tax jungle, a corporate president who does not obtain tax advice before an acquisition or merger or substantial dollar transaction ought to be fired."<sup>125</sup>

Most of the tax rules for business reorga-

**There is something fundamentally wrong with a tax system that turns nearly every M&A into a supposed scandal.**

**The corporate tax will impose a direct cost of about \$150 billion this year, and distortions will cost Americans an additional \$150 billion or so.**

nization would be swept away under a business cash-flow tax. Indeed, a study on tax reform by the American Institute of Certified Public Accountants concluded that “the notoriously complex rules surrounding corporate distributions, liquidations, and reorganizations would become almost entirely obsolete” under a business cash-flow tax such as the Hall-Rabushka flat tax.<sup>126</sup> Generally, business reorganizations that involve an exchange of shares—the purchase of stock of one firm by another—would not be taxable events.<sup>127</sup> However, sales of assets for cash between businesses would be taxable events. The market value of assets would be included in the seller’s tax base, which provides symmetrical treatment to the expensing of asset purchases. The concept of “basis” that is behind capital gains and depreciation under the income tax would disappear under a cash-flow tax.<sup>128</sup> There would be no step up in asset basis during restructuring, no future streams of depreciation or goodwill deductions to consider, and no distinctions between debt and equity for financing. American businesses could merge, split up, spin off, and reorganize any way that was efficient without the tax distortions that plague business restructuring today.

### **Gratuitous Flaws in the Corporate Income Tax**

On top of the intrinsic problems of income taxation, such as capitalization and capital gains taxation, are the gratuitous flaws added by Congress. Corporate and noncorporate businesses are taxed differently. Earnings paid out as dividends face taxation at both the corporate and individual levels, but interest does not. Retained earnings face double taxation insofar as they generate capital gains, but they are favorably treated compared to dividends. The corporate income tax imposes different marginal tax rates on different types of capital investment. All those factors result in investment being misallocated—investment is reduced, too lit-

tle investment flows through corporate businesses, too much debt is used in financial structures, and corporate profits are retained rather than paid out.

How much do such corporate tax distortions cost? Jane Gravelle summarized the extensive research on the issue and concluded that corporate income tax distortions probably cost more than is collected in corporate tax revenue.<sup>129</sup> Thus, the corporate tax will impose a direct cost of about \$150 billion this year in tax liability, and distortions (or deadweight losses) will cost Americans an additional \$150 billion or so.<sup>130</sup> Note that the cost at the margin is greater than implied in this 1-to-1 ratio. In other words, a cut in the corporate rate that reduced revenues by \$20 billion would save the private sector much more than \$20 billion in deadweight losses.<sup>131</sup> In addition, corporate tax distortions are rising over time as a result of the increasing openness in the world economy and greater capital mobility.

These figures summarize the costs that can be measured in formal economic models. In addition, the corporate tax creates other costs that are harder to measure. For example, the bias toward debt probably causes increased bankruptcy, but the destabilizing effects of bankruptcies are difficult to put a dollar value on. Also, complexity and frequent changes in the tax law waste a great deal of executives’ time and energy on tax avoidance and business restructuring. It is hard to estimate how much higher GDP might be if executives focused instead on creating better products.

The following sections summarize some of the major distortions of the corporate income tax that are unwarranted under any tax system.

#### **Multiple Business Structures**

The largest business enterprises in the United States are organized as “subchapter C” corporations and are subject to the corporate income tax. The corporate income tax forms a second layer of tax on investment returns in addition to individual income

taxes. Noncorporate businesses face just a single layer of income taxation. As a result, the overall marginal effective tax rate on corporate income is about twice that on the noncorporate sector.<sup>132</sup> Thus, “despite the critical role played by corporations as a vehicle for economic growth, the United States tax law often perversely penalizes the corporate form of organization,” concluded the Treasury Department’s major 1992 study on tax reform.<sup>133</sup> As a result, fewer businesses take advantage of the benefits of the corporate structure, such as limited liability, ease of ownership transfer, access to public capital markets, and rapid growth potential.

The list of competitors to C corporations includes sole proprietorships, partnerships, subchapter S corporations, limited liability corporations (LLCs), limited liability partnerships (LLPs), real estate investment trusts (REITs), regulated investment companies (RICs), real estate mortgage investment conduits (REMICs), and financial asset securitization investment trusts (FASITs). Each of these structures avoids the double taxation of earnings, but each is subject to an array of special tax code rules. As a result, entrepreneurs and investors must consider the unique limitations of each structure when starting, expanding, or investing in a business.<sup>134</sup> One simple example is that S corporations can only issue a single class of stock and can have no more than 75 shareholders.

The pros and cons of the various business tax rules have resulted in different business structures being popular in different industries. Also, the complex rules have resulted in a multiplicity of business lobbyists in Washington, each looking for narrow changes in the rules for particular businesses. Often, American businesses do not speak with one voice because the tax code has carved them up into multiple constituencies.

As the tax rules affecting each business structure have changed, industry has evolved to fit the incentives created by Washington. For example, changes in the top tax rate for individuals relative to corporations affect the attractiveness of the corporate form. After

the Tax Reform Act of 1986 cut the top individual rate to below the corporate rate, there was strong growth in the number of S corporations, whose owners are taxed at individual rates.<sup>135</sup> Further liberalization in S corporation rules has caused the number of such companies to grow from 0.7 million in 1985 to 1.6 million in 1990 and to more than 2.7 million today.<sup>136</sup> Also, federal and state law changes created rapid growth in LLCs in the 1990s.<sup>137</sup> In general, alternatives to C corporations have grown in popularity during the past decade or two. Indeed, some observers think that C corporations may whither away from “self-help integration” as the rules for other business types are liberalized. That does seem to be the case for small and midsized firms, and it is a positive trend. But it would be much more efficient if Congress took the lead and directly eliminated the double layer of taxation on C corporations.

The existence of different business structures creates tax planning opportunities for businesses since the same activity can be undertaken in different ways with different tax results. Tax shelters used by Enron and others have made extensive use of alternative business structures to conceal debt, change the form of financial flows, and confuse tax authorities and investors. In particular, the interaction of the partnership and corporation rules seems to be a key focus of many tax avoidance efforts. The idea behind partnerships is that income, gains, and losses are not taxed at the partnership level but passed through to individual partners on the basis of the parameters in the partnership agreement. One basic tax sheltering idea is for a corporation to set up a partnership with a tax-exempt entity and to then allocate the tax-exempt partner most of the income, while the corporation is allocated the losses to offset other income it may have.

The “partnership rules often act as chemical plants creating artificial tax losses and distilling them out to U.S. corporations . . . the variations on the idea are infinite.”<sup>138</sup> We saw this with Enron. Partnership rules were used in a number of its tax shelters, including

**The overall marginal effective tax rate on corporate income is about twice that on the noncorporate sector.**

**A business cash-flow tax would treat all business activity equally and eliminate special forms of business organization.**

Tomas and Condor, often with the goal of moving assets between entities to engineer increases in asset basis. If deals can be structured to increase asset basis, taxes can be cut either by reducing capital gains on sales or generating higher depreciation deductions.<sup>139</sup>

The problem is not that the tax code has partnership rules. Rules for partnerships and other structures are in the tax code to relieve the double taxation that faces C corporations. Partnerships allow corporations to enter into deals with other companies without an additional layer of tax acting as a hurdle. The underlying problem is that the government has imposed a double tax on C corporations to begin with, creating an incentive for the nation's biggest businesses to continually hunt for tax relief.

Partnerships were not the only business structure used in Enron tax shelters. The Apache deal used a FASIT, a business structure created by Congress in 1996.<sup>140</sup> FASITs are similar to REMICs, which were created by Congress in 1986. They are both flow-through, or nontaxable, vehicles used in the securitization of debt. REMICs are mainly used to securitize mortgage debt, whereas FASITs hold a broader array of debt, such as automobile loans. One indication of how complex the tax code has become is that one tax guide on the *Federal Income Taxation of Securitization Transactions* covers REMICs, FASITs, and similar investments and spans 1,309 pages!<sup>141</sup> Despite the length, the authors claim it is written in "plain English" and is not just for specialists, which makes one wonder how long the specialist version would be.

In Enron's Apache deal, a FASIT structure was used to get around some punitive parts of the tax code, including the subpart F rules on inclusion of foreign income.<sup>142</sup> Using a foreign subsidiary, Enron created a financial structure that allowed it to deduct both interest and principal payments to a foreign lender. Enron was able to avoid the subpart F rules that would usually require some of the deal's income to be included in taxable income. The deal provided Enron with inter-

est deductions of \$242 million in 1999 and 2000, yet a big circular flow eventually sent the money back to Enron. A FASIT was a crucial middleman in the Apache deal, designed to stand between the Enron foreign subsidiary and U.S. Enron.<sup>143</sup>

Enron used other types of business structures as middlemen in tax shelters. A REMIC was used in Steele and a REMIC and a REIT were used in the Cochise deal.<sup>144</sup> A particular form of REIT, a "liquidating REIT," was exploited by a number of companies as one popular tax shelter in the 1990s.<sup>145</sup> But Congress did not create special interest business structures such as FASITs, REMICs, and REITs for companies such as Enron to exploit. Nonetheless, since Congress created them, financial engineers have swooped in to help every company extract what tax benefits it can from Congress's narrow tax provisions.

The alternative is to establish a single form of business organization across all industries and every type of business big or small. Indeed, that is one of the principles of a business cash-flow tax, such as the Hall-Rabushka flat tax. It would treat all business activity equally and eliminate special forms of business organization. However, the flat tax would not tax income twice because it would tax only labor income to individuals and only capital income to businesses. Thus, it would integrate individual and business taxation so that income from all types of business activity would be taxed only once. Princeton's David Bradford notes that such "uniform treatment of all businesses, whether corporate or in other form, automatically deals with a vast array of complex issues that are intractable under present law."<sup>146</sup> There would be no need for special pass-through entities such as REITs because all income would be taxed only once. Marginal investments would produce the same after-tax return no matter which type of business undertook them.

In addition, a single type of business structure would eliminate the ability of large companies to structure fancy deals that are tough for tax authorities and investors to fig-

ure out. Investors would not have to hunt for suspicious “special purpose entities” on financial statements, which use the rules for partnerships, LLCs, and other entities. Companies would not be able to arbitrage the tax rules on different structures. Tax planning for new investments would be a breeze, and all businesses would compete on a level playing field.

### **Double Taxation of Corporate Equity**

A Treasury Department report said: “Double taxation of corporate profits is the principal problem raised in connection with the corporation income tax. At the present time corporate profits are taxed first to the corporations, then again to the stockholders when they are distributed as dividends.”<sup>147</sup> That assessment was not from the Bush Treasury but from Roy Blough, director of tax research at the Treasury Department in 1944. The double taxation of dividends was a long-festering problem that Congress has just taken the first step to fix in this year’s tax bill with the reduction of dividend and capital gains tax rates.

Corporate earnings distributed as dividends face both the 35 percent corporate income tax and the individual income tax, which had a top rate of 38.6 percent before reductions in this year’s tax law. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the maximum individual rate on dividends to 15 percent through 2008.<sup>148</sup> Earnings retained in the corporation also face double taxation. Retentions generally increase a corporation’s share price, thus imposing a capital gains tax on individuals when the stock is sold. In contrast to dividends and retained earnings, interest is deductible to the corporation and thus only taxable at the individual level. JGTRRA reduced the maximum individual tax rate on capital gains to 15 percent until 2008.

The 1944 Treasury Department report suggested some of the same dividend tax reforms that were considered this year, including a corporate deduction, an individual exclusion, and an individual credit.<sup>149</sup> In

the 1980s, the Reagan Treasury proposed a 50 percent corporate dividend deduction as part of a major tax reform plan.<sup>150</sup> More recently, the Treasury Department’s 1992 report on tax reform discussed various methods of corporate integration to eliminate the double taxation problem.<sup>151</sup> That report’s recommendations were the basis of the current President Bush’s proposal for an individual dividend exclusion. The Bush plan would have allowed individuals to exclude from tax dividends on which corporate taxes had already been paid and provide shareholders capital gains relief on corporate earnings retained.<sup>152</sup>

This year’s dividend tax reduction is not an untried or risky scheme. Indeed, nearly all major industrial countries have partly or fully alleviated the double taxation of dividends. Currently, 28 of 30 countries in the OECD, including the United States with this year’s tax cut, have adopted one or more methods of dividend tax relief.<sup>153</sup> Only Ireland and Switzerland do not relieve double taxation, but Ireland and Switzerland have substantially lower corporate tax rates than does the United States.

The economic distortions created by the current tax bias against corporate equity are briefly reviewed here. These distortions were reduced, but not eliminated, by JGTRRA. As discussed below, a cash-flow business tax would fully eliminate all these distortions. A cash-flow tax would equalize the treatment of debt and equity and remove the bias against dividend payouts. A cash-flow tax would create neutrality in corporate financial and investment decisions.<sup>154</sup>

*Increased Cost of Capital.* High dividend taxes add to the income tax code’s general bias against savings and investment. Dividend taxes raise the cost of capital, which is the minimum pretax rate of return that firms must earn to proceed with a new project. Income taxes on individuals and corporations place a wedge between the after-tax return enjoyed by individual savers and the gross return on corporate investment that their money finances. The tax wedge pushes

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**Heavy dividend taxation certainly hurts new, growing companies that may not have substantial retained earnings to harness for growth.**

up the cost of capital and reduces the number of profitable business investments. Reduced business investment means reduced output and reduced family incomes in the long run.

Nonetheless, there are differences of opinion among economists as to exactly how dividend taxes affect the cost of capital and marginal investment decisions.<sup>155</sup> The traditional view contends that the dividend tax burden falls heavily on marginal investment and thus creates large economic distortions. The new view, which was developed a couple of decades ago, contends that most firms finance marginal investments through retained earnings or debt, and thus dividend taxation does not have a large marginal investment effect (retained earnings face double taxation as well, but less so than dividends). Differences in these two positions affect policy views regarding the effects of dividend taxes on stock market valuation, dividend payout, and other items. Empirical studies lean toward favoring the traditional view.<sup>156</sup> In a recent analysis of the administration's dividend proposal, the Congressional Budget Office assumed an effect midway between those two views.<sup>157</sup> However, there is general agreement that the cost of capital for investment financed by new share issues is increased by dividend taxation. As a result, heavy dividend taxation certainly hurts new, growing companies that may not have substantial retained earnings to harness for growth and need to tap equity markets.

*Excessive Debt.* When corporations borrow money to finance investment they are able to deduct interest payments and reduce their tax liability. By contrast, when new investment is financed by equity, dividend payments cannot be deducted. That means that a corporation needs to earn \$1.54 pretax in order to pay \$1 in dividends but needs to earn just \$1 to pay \$1 in interest. As a result, the tax system favors debt, and U.S. corporate structures have become overleveraged.<sup>158</sup> There are varying empirical estimates of the extent of this distortion. A 1999 study by Roger Gordon and Young Lee found that a

10 percentage point reduction in the corporate tax rate would reduce the share of assets financed with debt by about 4 percentage points.<sup>159</sup> The authors conclude that this is a large distortion, given that the share of assets financed by debt has been about 19 percent historically.

Numerous studies have examined why corporate debt levels are not even higher, given the big tax advantage of debt. The reason appears to be that there are substantial nontax costs to overleveraging. The marginal cost of debt rises with increases in debt load, which curtails debt issuance. This occurs because added debt increases the risk of financial difficulty and bankruptcy and thus affects credit ratings. Excessive debt can also restrict management flexibility, which may be suboptimal. Finally, there are nontax advantages to equity financing that offset equity's tax disadvantage.

Taxation is just one factor that affects corporate financial structure, but it is an important factor. To the extent that taxes distort corporate decisions, the costs can be large, given that corporations are the dominant business organization in the country. If tax rules favor excessive debt, the entire economy may be destabilized as more corporations are pushed into bankruptcy during recessions. As profits turn to losses during recessions, dividends can be suspended, but interest payments must be paid. Since equity provides a cushion against the ups and downs of the business cycle, penalizing it is a poor policy choice.

*Excessive Retained Earnings.* When a corporation earns a profit, it has the choice of retaining earnings or paying them out as dividends. Prior to the 2003 tax cut, dividends faced ordinary tax rates of up to 38.6 percent when paid out to individuals. The 2003 tax law dropped the top dividend rate to 15 percent through 2008. When earnings are retained, they also generate a layer of individual taxation when they push up the share price and create a capital gain. The 2003 law imposed a maximum capital gains tax rate of 15 percent, but gains are taxed only when

realized. The effect of this deferral of tax is to further reduce the effective tax rate. Thus, retained earnings face a lower tax rate than earnings paid out as dividends, thus creating a bias toward earnings retention. However, this bias was reduced by the 2003 tax law.

The precise effects of dividend taxation on earnings payout has been subject to dozens of studies over the years but with few concrete results.<sup>160</sup> The traditional and new views of dividend taxation provide different perspectives on dividend incentives. But it is clear that there has been a downward trend in dividend payments by U.S. corporations. Between 1925 and 2002, the average dividend payout as a share of corporate earnings was 55 percent.<sup>161</sup> Today, the payout ratio hovers around 30 percent. One study found that the share of corporations paying dividends has fallen from about 90 percent in the 1950s to about 20 percent today.<sup>162</sup> Newer firms, in particular, avoid paying dividends. One reason is that corporations are paying out earnings in the form of share repurchases, which avoid the individual dividend tax (but do generate capital gains tax). Repurchases have accelerated since the mid-1980s.<sup>163</sup> Another factor to consider is that a substantial share of dividends is paid to nontaxable entities, such as pension funds.

While dividends are down, they are not out. In 2000, \$142 billion of taxable dividends was reported on tax returns.<sup>164</sup> Economists have asked why corporations pay dividends at all, given the heavy tax penalty. The answer is that there are important non-tax benefits to dividends. Dividends help reduce the “principal-agent” problem caused by the separation of ownership and control in large corporations. Retained earnings allow corporate executives to more easily make imprudent investment decisions and fund wasteful projects. If high dividend taxes cause excessive earnings retention, executives become the default investment managers for shareholders by making decisions that should be made by individual investors. Higher dividends reduce the discretionary cash that executives can pour into pet proj-

ects. Forcing executives to go to the market to raise money provides an added check on their investment strategies. The bias in favor of retentions has also put undue emphasis on stock option compensation, which may lead executives to overemphasize short-term financial results

Dividends signal to shareholders that a corporation is earning solid profits and making good decisions. Dividends help investors accurately judge the financial health of companies because they are paid in hard cash and cannot be fudged or manipulated, as financial statement earnings can be. Financial markets are thought to reward firms that generate rising dividend payouts.<sup>165</sup> As Jeremy Siegel notes, before today’s regulatory agencies were created, dividends were the old-fashioned—but probably superior—way to ensure that earnings were solid.<sup>166</sup> Indeed, nearly all corporate earnings were regularly paid out as dividends during the 19th century.<sup>167</sup>

The upshot is that dividends make good sense from a corporate governance perspective, and high dividend taxes stand in the way of this important investor protection. The problems caused by the tax bias against dividends have been recognized for decades. For example, the issue was discussed in the 1930s when the Revenue Act of 1936 imposed an “undistributed profits tax” on retained earnings to encourage a higher payout. A Treasury Department staff report from 1937 foreshadowed today’s debates about corporate management:

The earnings of a corporation belong to its stockholders; and stockholders are entitled to exercise a choice . . . with respect to the disposition of those earnings. [Tax changes] that encourage corporate managements to obtain the consent of their stockholders for capital expansion, and to give stockholders—the real owners of the corporation—a greater control over the dispositions of their earnings, this effect is altogether desirable. It has often been remarked that cor-

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porate managements are far more prudent in the use of capital funds obtained through formal financing with the aid of investment bankers than in the use of capital funds arising out of reinvested earnings.<sup>168</sup>

The 1930s undistributed profits tax was a bad solution to the problem and was short-lived, but it is interesting that the corporate governance problems of the income tax were noticed right from the beginning. As discussed below, replacement of the corporate income tax with a cash-flow tax would eliminate those problems by creating neutrality in corporate financial and investment decisions.

*Wasteful Financial Engineering.* The tax advantage of debt has spurred corporations to design complex transactions that are treated as debt for tax purposes but as equity for financial statements.<sup>169</sup> In turn, financial innovations have forced Congress and the Treasury Department to add more and more tax rules to police the debt-equity distinction. Disputes between taxpayers and the government on securities that have both debt and equity characteristics have gone on for years.<sup>170</sup>

Corporations have long sought securities that combined the tax advantage of debt and the financial statement advantage of equity.<sup>171</sup> In the 1980s, debt tax preference apparently helped fuel the binge in leveraged buyouts financed by high-yield bonds. In a 1990 study, Lawrence Summers and his coauthors complained about debt securities that were “equity in drag.” These securities helped fuel leveraged buyouts such as the RJR-Nabisco deal and allowed companies to cut or wipe out their taxable income with interest deductions.<sup>172</sup>

In the 1990s, Enron and other companies discovered hybrid securities called monthly income preferred securities (MIPS.), which fit within a broader category of “tiered preferred securities.”<sup>173</sup> Under one deal, Enron set up a subsidiary, Enron Capital LLC, in the Turks and Caicos in 1993.<sup>174</sup> This “special purpose entity,” or SPE, issued \$214 million of preferred shares, then lent the money to Enron to be paid back over 50 years. Enron began

deducting interest payments to the SPE on its tax return. But on its financial statements, Enron counted the transaction as equity called “preferred stock in subsidiary companies.” Therefore, Enron reduced its taxes but was able to avoid increasing its financial statement debt, which might have hurt its credit rating.

MIPS highlight the use of noncorporate business structures in tax shelters. Enron used an LLC in this deal as an SPE to transform the character of the deal’s financial flows. Partnerships and trusts can also play the role of middleman in a tax shelter. For Enron, the SPE was not part of its consolidated tax return; thus it could deduct interest paid to it. But the SPE was part of its consolidated financial statement.<sup>175</sup> During the 1990s, the use of hybrid securities such as MIPS exploded. By 2002, a total of \$180 billion of tiered preferred securities was outstanding, with Enron accounting for about \$800 million of the total.<sup>176</sup>

While many commentators find MIPS and tiered preferred securities very dubious, other tax experts have argued that they are reasonable from a tax and a financial accounting perspective.<sup>177</sup> They argue that Enron’s financial statement disclosures on these hybrids were sufficient and that credit rating agencies should have been able to figure them out.<sup>178</sup> Either way, a legal battle over these hybrids raged between taxpayers and the Treasury Department throughout the 1990s.<sup>179</sup> All in all, such hybrids have surely cost hundreds of millions of dollars in lawyer and accountant fees—pure waste from the perspective of the broader economy. The JCT notes that with MIPS Enron was pursuing self-help corporate integration, or finding a way to get around the double taxation of corporate equity.<sup>180</sup> That cut the cost of capital for Enron, but it would be better to cut out all the game playing and treat all companies the same by real integration under major tax reform.

MIPS are not the only type of tax shelter that preys on the debt-equity distinction. There were also “step-down preferreds,” which, like MIPS used a noncorporate mid-

dleman structure.<sup>181</sup> In this shelter, a U.S. corporation would set up and fund a real REIT in an agreement with a nontaxpayer, such as a foreigner, an American Indian tribe, or a company with losses. The REIT lends the corporation money, which the corporation pays back over time and deducts interest. The REIT is a flow-through entity and uses interest received to generate an income stream to the nontaxpayer. The effect is to allow the corporation to reduce taxes from an interest deduction with no offsetting taxable income reported elsewhere.

The government has typically used narrow Band-Aids to close these sorts of tax shelters. Yet Glenn Hubbard and William Gentry note, “As financial markets become even more sophisticated, the line between debt and equity for tax purposes is likely to be tested more often.”<sup>182</sup> As long as tax distinctions, such as debt versus equity and corporate versus non-corporate, remain, companies will have incentives to keep pushing against the legal definitions. It makes more sense to end the game playing and create a lasting economic solution with fundamental tax reform.

### **Marginal Tax Rate Distortions**

The federal income tax imposes different marginal effective tax rates on different economic activities. (Effective tax rates take into account statutory tax rates plus such items as depreciation deductions and tax credits.) These tax rate differences cause investment to be misallocated across industries and across types of capital equipment. Industries produce too much or too little, and they use the wrong combination of inputs to produce it. Research has found that intersectoral and interasset distortions create large deadweight losses, or inefficiency costs, under the current income tax.

The Tax Reform Act of 1986 narrowed the range of marginal effective tax rates across the economy, but it did so by broadly pushing up tax rates. To provide one example, Gravelle found that before TRA86 the tax rate on a corporate investment in electric transmission equipment was 21 percent, but the rate on communications equipment was

just 4 percent.<sup>183</sup> After TRA86, those tax rates jumped to 36 percent and 22 percent, respectively. Thus after TRA86, corporate investment was subject to higher tax rates, and there are still substantial tax rate differences between assets and industries. Similarly, in a 2002 study Treasury economist James Mackie estimated effective tax rates across industries and types of assets and found fairly substantial differences.<sup>184</sup>

A key factor causing marginal tax rates to diverge across different economic activities is depreciation. Even if broad-based income taxation—which mandates use of depreciation instead of expensing—made economic sense, it is very difficult to design depreciation schedules that accurately track the true depreciation rates of thousands of different assets in the economy. A much better idea is to expense all capital investment, as under a business cash-flow tax. That would eliminate investment distortions as it equalized marginal tax rates across industries and different types of assets.

### **Tax Rules on International Investment**

The tax rules on international investment are perhaps the most complex part of the corporate income tax. Most large U.S. corporations have dozens, sometimes hundreds, of foreign branches and subsidiaries, and they must do a great deal of planning to minimize their global tax burden. A key source of complexity is the application of the corporate tax to the worldwide income of U.S. companies. For example, a U.S. company that owns a winery in France or an oil rig in Iraq must report that foreign income on its U.S. tax return.

An alternative method, used by about half of the major industrial nations, is the “territorial” approach, under which active foreign business income is generally not taxed.<sup>185</sup> Business cash-flow tax proposals, such as the Hall-Rabushka flat tax, generally adopt the territorial approach. Territorial business taxation would allow for a much simplified set of international tax rules.

Simplification is badly needed.<sup>186</sup> For example, profits earned abroad by majority-owned subsidiaries are generally not taxed

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until repatriated—taxation is deferred. But there are overlapping sets of anti-deferral rules that do tax certain types of foreign income as soon as it is earned. On top of those rules, a complex system of foreign tax credits provides relief from taxation when income is taxed in both the United States and a foreign country. But foreign tax credits are subject to complicated limitations. For example, firms may average out income earned in high-tax and low-tax countries in order to maximize their tax credits. But the tax code limits such cross-crediting by dividing up foreign income in nine different categories, or “baskets,” that cannot be blended.

The U.S. international tax rules have been widely criticized for complexity, uncompetitiveness, and “stimulating a host of tax-motivated financial transactions,” as Glenn Hubbard and James Hines put it.<sup>187</sup> Business groups, the American Bar Association, and the American Institute of Certified Public Accountants have repeatedly called for reform.<sup>188</sup> For companies, the international tax rules create a very complex tax-planning climate. For example, a California computer company must perform extensive tax calculations and projections of its U.S. tax situation before deciding where in Europe, if anywhere, to build a new facility.

Enron provides interesting illustrations of the problems with the international tax rules. Enron was particularly concerned with its situation vis-à-vis the foreign tax credit, the rules that allocate interest deductions between domestic and foreign income, and the tax disincentive to repatriating earnings from abroad. The JCT’s Enron report found that “the company faced the possibility of significant double taxation of its foreign source income. This potential for unmitigated double taxation was of paramount concern in Enron’s international tax planning and significantly influenced the structures of Enron’s international operations and transactions.”<sup>189</sup>

Enron’s aggressive global expansion strategy was one source of its tax problems. As the firm expanded abroad by buying power plants and other assets, the U.S. rules threat-

ened it with double taxation. One strategy it used to deal with the problem was to avoid repatriating its foreign earnings. “In Enron’s case, the U.S. international tax rules (particularly the interest expense allocation rules) combined with the relevant financial accounting standards, created a significant incentive for the company not to repatriate foreign earnings to the United States,” the JCT concluded.<sup>190</sup> The tax disincentive to repatriate foreign earnings is a negative for the U.S. economy since it may reduce domestic investment or cause a smaller dividend payout to U.S. shareholders.

Some pundits zeroed in on Enron’s use of hundreds of foreign affiliates as proof of tax evasion activity. But the JCT found instead that “prudent tax planning typically requires a U.S. based multinational enterprise to use a combination of many different entities in many different jurisdictions, even if the enterprise’s tax planning goals are limited to . . . generally unobjectionable ones.”<sup>191</sup> Enron had 1,300 foreign entities in its structure, although only about 250 were used for ongoing business. An important reason for the existence of so many affiliates was Enron’s inability to use foreign tax credits, which gave the company strong incentives to defer tax on foreign earnings through use of complicated affiliate structures.<sup>192</sup> Tax planning for a foreign project often requires creating a complex tier of foreign entities to minimize the risk of excess U.S. taxation.

The JCT also found that media reports far overcounted the number of Enron affiliates in low-tax Caribbean nations. It noted that companies that have affiliates in places that do not have corporate income taxes, such as the Cayman Islands, are not necessarily illegally or unethically avoiding taxes.<sup>193</sup> Overall, Enron’s international tax planning did not particularly push the legal limits. Instead, it simply took part in the usual grossly complex tax planning that most large U.S. corporations deal with under the U.S. worldwide tax system. For investors, the fact that tax rules encourage such complex business structures is an impediment to transparency and accurate assess-

ments of firms' financial health.

The complexity of the international tax rules makes fertile ground for tax shelters, and it makes government enforcement more difficult. Congress makes it worse by greedily squeezing as much tax as it can out of foreign income under the pretense of closing tax shelters. But that greediness can backfire. For example, the 1999 Treasury Department tax shelter report noted: "The 1986 Act included a complex set of restrictions on the use of foreign tax credits. Attempts to avoid these restrictions seem to be at the heart of certain types of tax shelters. . . . Efforts by Congress to rein in specific tax shelters often make the Code more complex, creating a vicious cycle. The legislative remedies themselves create the complexity that the next generation of tax shelters exploits."<sup>194</sup>

The vicious cycle of international tax complexity can be ended by fundamental tax reform. A territorial cash-flow tax would greatly simplify business planning by eliminating most international tax rules.<sup>195</sup> There would be no need for foreign tax credits and numerous other parts of the international tax apparatus. A territorial tax would allow U.S. businesses to compete in foreign markets without the burdens imposed by the U.S. tax code. The United States would become an excellent location for multinational corporate headquarters because foreign affiliates could repatriate their profits free of U.S. tax.<sup>196</sup> The current disincentive for repatriation—a key tax-planning factor for Enron—would be eliminated. Finally, capital expensing under a consumption-based cash-flow tax would create strong incentives for domestic and foreign companies to locate investment in the United States.

### **Employee Compensation—\$1 Million Wage Limit**

Recent corporate scandals have highlighted distortions in the income tax relating to employee compensation and pensions. Some distortions are deeply rooted, such as the general practice of taxing saving more heavily than consumption and then selectively

relieving taxes on pensions and other politically favored types of saving. Other distortions stem from narrow special interest provisions that Congress has placed in the tax code.

One narrow and problematic provision is the arbitrary \$1 million limit on tax deductions for non-performance-based compensation. The tax law denies businesses a deduction for executive wages of more than \$1 million but allows tax deductions for stock option compensation above that limit. This provision was added in 1993 in an attempt to micromanage corporate compensation policy. But the micromanaging has backfired. The limit seems to have caused the rapid growth of stock option compensation in the 1990s, which many observers now complain causes corporate governance problems.

A traditional argument in favor of stock options was that they helped align the interests of shareholders and corporate executives by encouraging executives to earn higher profits. Therefore, stock options appeared to be a solution to the "principal-agent" problem and promote good management. But more recently, analysts have criticized stock options for promoting irresponsible efforts by executives to pump up share prices for personal gain without creating solid long-term growth. Stock options may also discourage executives from paying out dividends because retained earnings help push up stock prices. It appears that the combination of excessive stock option compensation caused by the \$1 million cap and the double taxation of dividends has caused executives to excessively retain earnings and overemphasize short-term financial results.

Another concern has been that, since stock option compensation may be deducted on corporate tax returns, firms such as Enron have reduced their tax liability excessively.<sup>197</sup> It is true that stock options have created large corporate tax deductions, but that tax treatment seems to be correct. When firms take a tax deduction at the point of stock option exercise, individuals take a matching income inclusion taxed at ordinary

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**Congress should not focus on the tax treatment of options. Rather, it should remove artificial incentives that encourage overuse of stock options, particularly the \$1 million cap on wage compensation.**

rates (for nonqualified options). Thus, the treatment is parallel to the treatment of wages, and one estimate found that the individual inclusion may raise more federal revenue than the deduction loses.<sup>198</sup> Therefore, if Congress is concerned about stock options, it should not focus on the tax treatment of options. Rather, it should remove artificial incentives that encourage overuse of stock options, particularly the \$1 million cap on wage compensation.

### **Employee Stock Ownership Plans**

Micromanaging employee compensation through the tax laws has backfired in other areas as well. In the wake of the Enron scandal, it is clear that the tax rules that encourage workers to invest in their own company are misguided. Current tax rules encourage a nondiversified savings strategy, which was evident when many Enron workers lost their savings that had been invested in Enron stock. Similar losses of employee wealth occurred when the finances of Global Crossing and WorldCom collapsed. Enron workers held an average of 62 percent of their 401(k) portfolios in company stock.<sup>199</sup> The average share of company stock in all defined-contribution plans is about 19 to 39 percent. Even that share is higher than prudent.<sup>200</sup>

Jane Gravelle examined compensation issues that have arisen in the wake of the Enron scandal.<sup>201</sup> She finds particular fault with the “juicy” tax benefits given to employee stock ownership plans (ESOPs). ESOPs are defined-contribution plans in which employee accounts are invested primarily in a company’s own stock. Enron’s ESOP was used to provide matches of its stock in workers’ 401(k) plans in a structure called a KSOP. Gravelle’s study drives home the perversity of the current income tax, which simultaneously encourages worker ownership of company stock through ESOPs and KSOPs and discourages it under other rules.

ESOPs represent classic congressional micromanaging gone bad. ESOPs received special tax breaks in 1974 and added further “juicy” benefits in later years, including sub-

stantial new breaks in the 2001 tax law.<sup>202</sup> ESOPs illustrate how special tax breaks create an entrenched interest that pushes Congress for more special benefits. ESOPs have gained support from those wanting to create a kind of worker capitalism with employee-owned companies. Superficially, that might sound like a good idea, but it has backfired. Worker ownership does not seem to work very well. Consider bankrupt United Airlines. It is a prominent employer-owned firm and its “ESOP was a disaster,” according to one industry expert.<sup>203</sup>

Another distortion is the widespread use of the ESOP as a financial tool to ward off hostile takeovers and protect incumbent corporate managers, as occurred with Polaroid.<sup>204</sup> ESOPs interfere with the “market for corporate control,” which is crucial to any economy dominated by large corporations. Corporate executives may not always act in the best interests of shareholders. They may line their own pockets or make bad investment choices. For those reasons, it is important that shareholders have tools to combat these problems and oust bad executives. ESOPs stand in the way of such shareholder empowerment by making it more difficult to launch an outside takeover.

### **Time to Retire Employer-Tied Pensions**

A broader compensation issue raised by the Enron scandal is whether retirement savings should be tied to employers at all. There are nontax reasons for companies to sponsor pension plans, such as encouraging employee loyalty. But employer-tied pensions seem to be mainly an artifact of tax code distortions because saving in employer-tied plans, including defined-benefit (DB) and defined-contribution (DC) plans, is taxed more lightly than regular private savings. Congress needs to rethink employer-tied savings because it has created large risks, complexities, and administrative costs for workers and employers. Individually based saving vehicles are better suited to today’s mobile and diverse workforce because workers usually hold many jobs during a career.

For employers, the administration of both DB and DC plans is complex and costly. Traditional DB plans provide employers an up-front deduction for contributions, with taxes paid later by workers when they receive benefits. DC plans, such as 401(k)s, also receive up-front deductions and individuals are taxed later on their retirement withdrawals. The problem is that “the federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex sets of rules applicable to any area of the tax law,” notes the JCT.<sup>205</sup> For example, “nondiscrimination rules” require that pension plans pass numerous formulaic tests that compare coverage of highly paid workers with coverage of other workers in an attempt to spread pension coverage more broadly.

The rules for employer-based pensions have gotten so complex that many firms have dropped plans altogether. In particular, the share of workers in DB plans has fallen substantially in recent years. The complexity and high cost of employer plans has caused Congress to respond by creating new simplified employee plans, such as SIMPLEs. But the proliferation of new plans itself adds to the complexity of the overall tax system.

One of the costs of DB plans is the high level of government policing that they entail. Workers face the risk that promised benefits may not be there for them if their company goes bankrupt or tries to cheat them. In response, in 1974 the government created the Pension Benefit Guaranty Corporation, a federal bureaucracy designed to regulate pension plans and provide pension insurance by bailing out workers if DB plans are short of money or go bankrupt. But now the PBGC is itself in financial distress; it recently reported an \$11.4 billion loss, the largest in its history.<sup>206</sup> Nationwide, pension plans covered by the PBGC are underfunded by about \$300 billion, a problem for which government experts have not yet found a solution.<sup>207</sup>

Despite the presence of the PBGC, workers are still open to uncertainty and possible losses from DB plans. A recent example was the bankruptcy of US Airways. The airline

has a \$2 billion shortfall in its pension plan, which it is hoping to impose on other Americans through a PBGC bailout.<sup>208</sup> Even with a bailout, some airline workers will get shortchanged because the PBGC places limits on the pension amounts that retired workers can receive. Similar pension reductions occurred a decade ago when a number of airlines went bankrupt.

The bottom line is that workers cannot count on the current employer-government retirement system to deliver future benefits to them with certainty. PBGC’s recent bailouts of steel industry pension plans also illustrate how one industry’s excessive costs can get pushed onto workers elsewhere under the current system. More than \$6 billion in pension costs at Bethlehem Steel and other steel firms have been covered by PBGC in the last year and a half, at the expense of workers in other industries who will face higher premiums.<sup>209</sup>

Individually based savings do not need the complex apparatus of the employer-based system and would give workers more security and control over their finances. In addition, an individually based system would be more equitable because the current system of DB and DC plans covers only about half of all workers. All Americans would have greater saving opportunities if Congress removed the double taxation of savings across the board. One model to aim for is the Hall-Rabushka flat tax, which would end individual taxation of interest, dividends, and capital gains (but would tax capital income at the business level). Note that under the flat tax businesses would still deduct pension plan contributions, and benefits would be taxable to individuals. But employer-based pensions would be de-emphasized because the tax hurdles to all regular savings would be eliminated.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 took a step in this direction by reducing the maximum tax rates on dividends and capital gains to 15 percent (and reducing the rate to 5 percent for lower-income individuals). Next, Congress should consider the Bush administration’s plan for “lifetime savings accounts” (LSAs), which would work like

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expanded and improved Roth IRAs. LSAs would allow all individuals to make after-tax contributions of up to \$7,500 per year, with withdrawals for any purpose not subject to taxes or penalties. Such accounts would greatly simplify saving for most families and encourage Americans to build a stronger financial base free of the many shortcomings of employer-tied savings vehicles.

## **Policy Options**

### **Repeal the Corporate Income Tax**

The corporate income tax has survived for more than 90 years despite having little support in economic theory.<sup>210</sup> Indeed, most economists agree that the cost of the corporate income tax in terms of distortions created is very high.<sup>211</sup> Conservative economists have tended to favor a consumption-based tax system, which has no place for a corporate tax on net income. Liberal economists have tended to favor the Haig-Simons ideal of broad-based income taxation, but that ideal does not require a corporate income tax either. The Haig-Simons approach could be implemented by imposing a broad tax on capital income at the individual level. In his 1977 classic, *Blueprints for Basic Tax Reform*, David Bradford sketched out both a consumption tax and a broad-based income tax model for fundamental reform, and neither included a tax on corporations.<sup>212</sup>

With no compelling economic rationale, then-treasury secretary Paul O’Neill and others have suggested repealing the corporate income tax. But there are some administrative and political hurdles to corporate tax repeal. The politics are easy to understand. Corporations provide a concentrated pool of cash that government can tap to fill its coffers—governments tax corporations “because that is where the money is.” Trillions of dollars of revenue flow through U.S. corporations each year, providing an irresistible target for politicians. Indeed, the country adopted the corporate income tax in 1909, not because of any economic principle, but main-

ly because of the anti-big business political atmosphere at the time.

Corporations are an easy target because they do not vote, and corporate taxes are invisible to individuals. Corporate taxes get passed along to consumers, workers, and investors, but those individuals do not directly observe the burden that falls on them.<sup>213</sup> Tax invisibility is beneficial to politicians, but it creates a basic dishonesty in democratic government. It denies individuals the ability to make informed and efficient choices since government spending appears to be partly “free.” If \$150 billion of corporate taxes is invisible, citizens will likely support a large government.

Of course, the ability to fuel a bigger government by invisible corporate taxation is appealing to some on the political left. Nonetheless, some liberal economists have supported corporate tax repeal as part of an overall tax reform package. One problem they see is that the corporate tax does not allow the fine-tuning of income redistribution that they favor. Recipients of corporate income include both low-income retirees and high-income investors, but they will both be hit by the same 35 percent corporate tax rate.<sup>214</sup> Thus, some advocates of progressive taxation might support corporate tax repeal with the substitution of more individual taxation of capital income (but that is still an inferior option to moving to a consumption-based system).<sup>215</sup>

Aside from politics, there are some administrative hurdles to consider in repealing the corporate tax. The corporate income tax is supported as a backstop to individual taxation of capital income. Corporations are essentially withholding agents for capital income that flows through to individuals. Under the Haig-Simons ideal, businesses would not need to be taxed if all capital income were taxed on an accrual basis at the individual level. But that is extremely impractical (in addition to being bad economic policy). Instead, the current income tax system settled on using corporations as “pre-collectors” of income taxes. That structure prevents individuals from accumulating income

within corporations tax-free, which would violate accrual income tax theory. Also, corporations are used to prevent evasion since they generate information about dividends and interest paid out.

However, there would be no need for a corporate-level tax under some proposals for consumption-based tax reform. “Savings-exempt” or “consumed-income” tax proposals would apply a comprehensive tax at the individual level without need for a business-level tax. One model is the saving-deferred cash-flow tax proposal developed by Norman Ture at the Institute for Research on the Economics of Taxation.<sup>216</sup> This proposal would replace the individual and corporate income taxes with a flat rate individual tax on a base of income less net savings. Individuals would defer tax on savings by deducting savings (and debt repayments) from taxable income but would include withdrawals from savings (and borrowing) in their tax base. The result would be that business earnings would be taxed at the individual level when not reinvested by individuals. A similar proposal is the model cash-flow consumption tax included in Bradford’s 1977 *Blueprints for Basic Tax Reform*. The *Blueprints* model would eliminate the corporate-level tax and allow individuals a choice of two treatments for savings.<sup>217</sup> Savings in qualified accounts would be deducted up front with withdrawals taxed later, like regular IRAs. Alternately, savings could be made from after-tax earnings with the returns received tax-free, like Roth IRAs.

Corporate tax repeal would involve some tricky issues with regard to international investment. As one public finance scholar notes, “One reason most countries tax corporate profits is because most countries tax corporate profits.”<sup>218</sup> Cross-border investments by multinational corporations have caused tax systems to become entangled with one another. For example, corporate tax repeal could result in the federal government ceding tax revenue to foreign governments because, if the United States did not tax the U.S. profits of foreign companies, other

countries would have an incentive to do so. Suppose a Japanese car company earns \$100 million in its U.S. subsidiary and pays \$35 million in U.S. corporate tax. When the company filed its Japanese corporate tax return, it would receive a foreign tax credit, which is designed to prevent taxation of the same income in both countries. But if the United States repealed its corporate tax, Japan’s worldwide system would still tax the U.S. profits, but no tax credit would be provided. The end result might be that the car company paid tax on \$100 million of U.S. profits to the Japanese government but paid no tax to the U.S. government.

However, a number of factors would mitigate that possible problem. The Japanese government might face pressure to reduce taxes on Japanese firms’ U.S. profits so as not to put those firms at a competitive disadvantage in the U.S. market. The firms would be at a disadvantage to firms headquartered in countries that have “territorial” tax systems, which would not tax U.S.-source profits.<sup>219</sup> One step the United States could take with corporate tax repeal would be to place a withholding tax on profits when paid to parent companies of foreign firms. That would generate revenues to the U.S. government and would not necessarily impose higher overall taxes on companies operating here since they would get a credit for the withholding tax on their home-country tax return.

Federal corporate tax repeal may have a precursor at the state level. The share of state tax revenues coming from corporate income taxes has fallen from more than 9 percent to about 6 percent in the past two decades.<sup>220</sup> State-level tax competition has been intense as mobile corporations organize their activities to minimize their state tax payments. States have responded with cuts and various tax base changes.<sup>221</sup> State corporate tax competition has also led to tax complexity and litigation as companies spanning numerous states have had to fight each state tax authority over the proper amount owed. As a result, a growing number of economists are supporting state corporate tax repeal because the tax is highly inefficient and collects little revenue.

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**Recent scandals and the growing uncompetitiveness of the current corporate tax make now an excellent time for Congress to take a fresh look at a cash-flow tax.**

The liberal contributing editor of *State Tax Notes*, David Brunori, came out for state corporate tax repeal last year because the state tax “consumes an inordinate amount of intellectual firepower and economic resources in terms of planning, compliance, and administration.”<sup>222</sup>

Similar pressures and inefficiencies are growing under the federal corporate income tax as international tax competition increases. Revenues from the corporate income tax have fallen from more than 30 percent of federal revenues in the early 1950s to just 8 percent today.<sup>223</sup> As a highly inefficient tax that collects only a small fraction of federal revenue, the corporate income tax is a high priority tax for Congress to repeal.

**Replace the Corporate Income Tax with a Business Cash-Flow Tax**

If a corporate-level tax is retained, reforms should focus on reducing the rate and creating a transparent and uniform base to maximize efficiency and minimize tax sheltering. One idea is to retain an income tax but eliminate some of the inconsistencies. For example, the corporate tax could be “integrated” with the individual tax to reduce the disparities between debt and equity and between corporate and noncorporate businesses. In 1992, the Treasury Department issued a major study on corporate tax reform options that included various integration proposals to eliminate the double taxation of corporate equity.<sup>224</sup> One proposal was to exempt dividends from individual taxation, which also formed the basis of President Bush’s dividend proposal this year.

A more ambitious proposal in the 1992 report was for a comprehensive business income tax (CBIT). The idea behind the CBIT was to tax capital income only once—at the business level. Neither dividends nor interest would be deductible by businesses. But individual taxes on interest, dividends, and capital gains would be repealed. All businesses (corporate and noncorporate) would be taxed under the same rules. The CBIT would equalize taxes on corporate and noncorporate businesses, equalize taxes on interest and

dividends, eliminate the lock-in distortion of capital gains, and remove the bias against dividend payouts.

Although such a tax reform would be far-reaching, key distortions would remain. The CBIT would retain core problems of income-based taxation, particularly capitalization, inflation-caused distortions, and a bias against savings and investment. Those remaining distortions could be eliminated by replacing the corporate tax with a cash-flow tax. That would be like taking the CBIT reforms and adding capital expensing (rather than depreciation) and cash accounting (rather than accrual accounting).

Substituting a cash-flow tax for the corporate income tax has been discussed by economists for years. Fundamental reform along these lines would “dramatically reduce the incentives for tax planning,” concluded Glenn Hubbard and William Gentry.<sup>225</sup> A cash-flow tax would “make it easy to write rules that hold to a minimum tax distortions in financial and business affairs,” concluded David Bradford.<sup>226</sup> Recent scandals and the growing uncompetitiveness of the current corporate tax make now an excellent time for Congress to take a fresh look at a cash-flow tax.

A cash-flow tax would be imposed on net cash flows of businesses, not net income. Net cash flow is calculated as the receipts from the sale of goods and services less current and capital expenses. Financial flows such as interest income and interest expense would be disregarded.<sup>227</sup> Accrual accounting under the income tax would be replaced with simpler cash accounting. Businesses would include receipts when cash is received and deduct materials, inventories, equipment, and structures when purchased. The cost of both a \$1 pencil and \$10 million machine would be deducted immediately.

Various proposals for cash-flow taxes have differed with regard to whether employee compensation would be deductible. If compensation deductions were disallowed, the tax would be a value-added tax (VAT). Such a tax would capture the value added by both labor and capital at the business level. The

broad base of a VAT would need only a low tax rate to raise the same amount of revenue as the current corporate tax. For example, an 11 percent VAT formed part of the “USA” tax proposal of former senators Nunn and Domenici.<sup>228</sup> A recent estimate suggests that a VAT would need a rate of between 5 and 7 percent to replace the revenue generated by the corporate income tax.<sup>229</sup>

However, that raises a key problem with a VAT—it would be a money machine for the government because the tax base is so broad. While the rate might start out low, each rate increase would sound modest yet would raise a huge amount of fresh government revenue. That problem would be exacerbated because VATs, like all business-level taxes, could be hidden from the view of individuals, thus tempting politicians to continue raising the rate over time. Since individuals ultimately bear all tax burdens, taxes should be visible to them so they can best judge how big the government ought to be. As a general rule, tax reforms should keep the bulk of tax collections at the individual level to promote visibility and frugality in government.

The flat tax proposed by Robert Hall and Alvin Rabushka of the Hoover Institution is structured to reap the efficiency benefits of a cash-flow business tax while keeping the bulk of taxes visible and payable by individuals.<sup>230</sup> Versions of the Hall-Rabushka plan were proposed by former house majority leader Dick Armey and by former presidential candidate Steve Forbes. Under the Hall-Rabushka plan, individuals would be taxed on wages and pension benefits at a flat 19 percent, with large basic exemptions provided. Individuals would not be taxed on interest, dividends, or capital gains. Businesses would pay a 19 percent tax on receipts from sales of goods and services less wages and purchases of materials, equipment, buildings, and other expenses.<sup>231</sup> Businesses would disregard interest, dividends, and capital gains. For example, interest would not be deductible, nor would it be taxable. This exclusion of financial flows means that the flat tax has a real, or “R base,” as did the

Treasury’s CBIT.<sup>232</sup> (Alternately, a cash-flow tax could have an R+F base—real plus financial—where firms take into account all flows of cash, other than to their own shareholders, when calculating their tax base).<sup>233</sup>

The flat tax business structure would be similar to the CBIT except businesses would expense capital purchases rather than depreciate them. It is that difference that makes the CBIT an “income tax” and the Hall-Rabushka tax a “consumption-based tax.” Consider the basic economic formulation: income = consumption + investment. Given that, a tax on income with a full deduction for investment is said to be a consumption-based tax. Some observers conclude from this that a cash-flow tax would not tax business profits or capital income at all. That is not correct; the issue is more tricky.

It turns out that business expensing exempts only the “normal” risk-free rate of return (also called the return to waiting) but fully taxes “above-normal” returns (also called “economic rents” or “inframarginal returns”).<sup>234</sup> The normal risk-free rate of return is usually measured by the Treasury bill interest rate. “Above-normal” returns are profits made through monopoly profits, unexpected windfalls, and other unique factors. Because it is thought that above-normal returns account for most of total business profits, a cash-flow tax with expensing would continue to tax most business profits.<sup>235</sup>

However, while a cash-flow tax would continue to tax most business profits, it would do so much more efficiently. That is because marginal investments yielding the normal return would not be taxed. In present value terms, the up-front tax benefit of expensing fully offsets future tax payments on normal returns. As a result, the tax would not distort marginal investment choices, thus spurring greater capital formation.<sup>236</sup> Investment decisions would not be distorted by inflation, depreciation, or other factors that affect marginal effective tax rates under the income tax.

Economists generally agree that a business cash-flow tax would be simpler and more efficient than the corporate income tax. However,

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there are various implementation concerns that would need to be ironed out with the adoption of a cash-flow business tax:

- A cash-flow tax would close a huge array of tax shelters, but it may open a few new ones. One point of trouble for a cash-flow tax with an R-base is the separation of financial from nonfinancial flows, which would create a source of tax avoidance opportunities. For example, businesses would try to characterize normal sales receipts as interest in order to exclude them from taxation. Some tax lawyers have explored more complex financial strategies that might develop to exploit the sharp divide between financial and nonfinancial.<sup>237</sup> One solution would be to adopt an R+F base cash-flow tax, rather than the R-base tax of the Hall-Rabushka model.<sup>238</sup>
- A number of tax avoidance problems under the current tax system would continue to be problems under some cash-flow taxes. An example is transfer pricing by multinational corporations. That refers to the shifting of profits from high-tax to low-tax countries using the prices of goods, services, and intangibles traded between corporations and their subsidiaries. Transfer pricing would continue to be a problem under a Hall-Rabushka cash-flow tax, although it would be eliminated under cash-flow taxes that are “border adjustable.”<sup>239</sup>

Note that tax reform is designed to cut marginal tax rates, which in itself would reduce tax avoidance. For example, the Hall-Rabushka flat tax would have a broad tax base and no tax credits, thus allowing for lower rates than currently. For example, an analysis of all nonfinancial corporations for the period 1998 to 1992 found that the Hall-Rabushka tax at 19 percent would have raised about the same revenue as the current corporate income tax.<sup>240</sup>

With a rate only about half of the current 35 percent corporate rate, the incentive to engage in all forms of tax avoidance, such as transfer pricing, would be greatly reduced.

- Businesses with net operating losses create a challenge for any tax system.<sup>241</sup> In theory, losses should be refundable to create fair and symmetrical treatment between profit and loss firms and between firms with fluctuating and stable profit patterns. The current income tax allows losses to be carried backward 2 years and forward 20 years to offset profits, but without interest. Limitations on losses invite tax avoidance efforts because businesses will try to move losses to profit-making firms. A related issue is whether affiliated entities should file as consolidated units. Consolidation is advantageous since it allows business units to offset profits and losses. To deal with these issues, the Hall-Rabushka plan would allow unlimited carryforward of losses with interest.<sup>242</sup> That favorable treatment would reduce tax avoidance efforts and retain strong incentives for capital investment by companies with losses.
- Financial businesses, such as banks and insurance companies, would require special rules under any tax reform plan, just as they do under the current income tax. Special rules would be needed under an R-based cash-flow tax because it does not include financial flows, such as interest, in the tax base. One solution would be to simply exclude financial businesses under a new consumption-based tax system, as is the case under most state retail sales taxes and foreign VATs.<sup>243</sup> Another option would be to tax financial businesses on an R+F cash-flow tax basis.<sup>244</sup>
- A tax reform challenge will be to create transition rules to move from the old tax system to the new one.<sup>245</sup> A key issue

is treatment of the existing tax basis in assets (that portion of the asset's cost not yet recovered by depreciation deductions). Trillions of dollars of machines and buildings would be only partially written off at the time of switching to a new tax system. Not allowing the remaining deductions on this old capital would impose large losses on owners. On the other hand, allowing full and immediate deduction for basis in old assets would involve a large short-term government revenue loss. Ultimately, creating some middle-ground rules for basis and other transition items is essential to generating support for reform.<sup>246</sup> Transition relief is a hurdle, but given that a new tax system might last even longer than the current one has lasted, it is worth the trouble.

## Conclusion

The flawed structure of the corporate income tax is a key driver of inefficient and wasteful business activities. The income tax distorts corporate investment and financial choices, and its complexity and inconsistency stimulate an aggressive pursuit of elaborate tax shelters.

Three fundamental flaws of the corporate income tax would be addressed by the adoption of a low-rate cash-flow tax. First, a lower corporate tax rate would reduce wasteful tax-sheltering activities, mitigate the economic distortions caused by business taxation, and respond to the rising global competition faced by U.S. businesses.

Second, a business cash-flow tax would eliminate key flaws intrinsic to the income tax, particularly capitalization and capital gains taxation. These features of the income tax create complexities and distortions that seem to get worse over time. Enron and other companies zeroed in on these weaknesses and exploited them with elaborate tax shelters. A business cash-flow tax would eliminate capital gains taxation and would substi-

tute expensing for capitalization to create simple and efficient treatment of business capital investment.

Third, the great number of gratuitous inconsistencies in the corporate income tax would be reduced or eliminated under a cash-flow tax. All businesses would be treated equally, the tax treatment of corporate financing would be neutral between debt and equity, and there would be little incentive or ability of companies to create complex transactions to avoid tax.

Today's combination of corporate management problems and rising global competitive pressures makes this an excellent time to fundamentally rethink U.S. business taxation. A cash-flow tax holds out hope of dramatically reducing the complexity, distortions, and scandals that mark the current corporate tax system.

## Notes

Stephen Entin and Dan Mastromarco provided helpful comments. Of course, all errors are those of the author.

1. Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for FY2004," March 2003, p. 36.

2. Wal-Mart Stores Inc., Form 10-K as filed with the Securities and Exchange Commission. The "current" income tax expense reported on financial statements often differs, sometimes substantially, from actual liability reported on the 1120 tax return filed with the Internal Revenue Service. Wal-Mart's federal tax rate on U.S. income was 28.7 percent in 2001 and 34.7 percent in 2000.

3. Estimates of incidence differ depending on such factors as the length of the time period considered and the international openness of the economy. A good survey is John Whalley, "The Incidence of the Corporate Tax Revisited," Canadian Department of Finance, Technical Committee Working Paper no. 97-7, October 1997.

4. Jane Gravelle, *The Economic Effects of Taxing Capital Income* (Cambridge, Mass.: MIT Press, 1994), p. 245.

5. Myron Scholes and Mark Wolfson, "The Role of Tax Rules in the Recent Restructuring of U.S. Corporations," in *Tax Policy and the Economy* 5

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- (Cambridge, Mass.: National Bureau of Economic Research and MIT Press, 1991), p. 2.
6. *Ibid.*, p. 24.
  7. KPMG, "Corporate Tax Rate Survey," January 2003, [www.us.kpmg.com/microsite/Global\\_Tax/TaxFacts](http://www.us.kpmg.com/microsite/Global_Tax/TaxFacts).
  8. For a description, see Joint Committee on Taxation (JCT), "Summary of Conference Agreement on H.R. 2, the Jobs and Growth Tax Relief Reconciliation Act of 2003," JCS-54-03, May 22, 2003.
  9. JCT, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," vol. 1, "Report," JCS-3-03, February 2003.
  10. *Ibid.*, p. 6.
  11. Internal Revenue Service, *Statistics of Income Bulletin* (Washington: IRS, Summer 2002), Table 13. This is the total number of corporate returns, excluding S corporation returns.
  12. This is the 2003 page count for the CCH "Standard Federal Tax Reporter," which includes the tax code, tax regulations, and various IRS rulings. See [www.cch.com/wbot2003](http://www.cch.com/wbot2003). For the business share of the burden, see Scott Moody, "The Cost of Complying with the U.S. Federal Income Tax," Tax Foundation, November 2000.
  13. JCT, "Report of Investigation of Enron Corporation," p. 16.
  14. For example, the decision to headquarter Daimler-Chrysler in Germany as opposed to the United States was apparently partly motivated by tax considerations. See discussion in Chris Edwards and Veronique de Rugy, "International Tax Competition: A 21st-Century Restraint on Government," Cato Policy Analysis no. 431, April 12, 2002.
  15. U.S. Department of the Treasury (U.S. Treasury), "The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals," July 1999, pp. 17, 27, 30.
  16. John Berry, "Divided on Derivatives," *Washington Post*, March 6, 2003, p. E1.
  17. Glenn R. Simpson, "Derivatives Traders, IRS May Be Near a Truce," *Wall Street Journal*, June 10, 2003, p. C1.
  18. See Henry Aaron and Harvey Galper, *Assessing Tax Reform* (Washington: Brookings Institution, 1985). Aaron and Galper propose an "R+F-based" cash-flow tax.
  19. U.S. Treasury, "The Problem of Corporate Tax Shelters," pp. 19, 55, 58.
  20. The 50 percent rate enacted in 1981 was effective for 1982. The 28 percent rate enacted in 1986 was effective for 1988.
  21. U.S. Treasury, "The Problem of Corporate Tax Shelters," pp. vi, 23.
  22. JCT, "Report of Investigation of Enron Corporation," p. 107.
  23. U.S. Treasury, "The Problem of Corporate Tax Shelters," p. v.
  24. *Ibid.*, p. iv.
  25. For example, in comparing differences in amounts perceived as owed by the IRS and large corporations, the General Accounting Office (GAO) found that "the difference is substantial and, in large part, attributable to ambiguity and complexity in tax law." GAO, "Reducing the Tax Gap," GAO/GGD-95-157, June 1995, p. 4.
  26. See a summary in Steven Toscher and Charles Rettig, "A Once in a Lifetime Opportunity: The Tax Shelter Controversy Continues," 2002, [www.taxlitigator.com](http://www.taxlitigator.com).
  27. GAO, p. 4.
  28. For example, in 1992 the IRS estimated that after audit large corporations owed \$142 billion in taxes, but corporations themselves figured they owed just \$118 billion. See *Ibid.*
  29. Joseph Bankman, "Bankman Examines the New Market in Corporate Tax Shelters," *Tax Notes*, June 21, 1999, p. 1775.
  30. Quoted in Peter Behr, "Enron Skirted Taxes via Executive Pay Plan," *Washington Post*, February 14, 2003, p. E1.
  31. U.S. Treasury, "The Problem of Corporate Tax Shelters," p. 48.
  32. Bankman, pp. 1778, 1787.
  33. U.S. Treasury, "The Problem of Corporate Tax Shelters," p. 46.
  34. *Ibid.*, p. v.
  35. See related comments of Lester Ezrati of the Tax Executives Institute, Statement before the U.S. Senate Committee on Finance hearing on "The Clinton Administration's Proposals relating

to Corporate Tax Shelters,” April 27, 1999.

36. U.S. Treasury, “The Problem of Corporate Tax Shelters,” pp. 6, 9.

37. The recently passed tax law, which reduced individual tax rates on dividend income, will partly solve this problem.

38. Cited in U.S. Treasury, “The Problem of Corporate Tax Shelters,” p. xiv.

39. Ezrati.

40. U.S. Treasury, “The Problem of Corporate Tax Shelters,” p. 30.

41. *Ibid.*, pp. 30, 26, 16.

42. *Ibid.*, p. iv.

43. David Cay Johnston, “Help for Bad Times Now Helps Rich,” *New York Times*, April 1, 2003, p. C1.

44. Bankman notes that many attorneys believe the IRS is currently far outgunned on corporate shelters. Bankman, p. 1786.

45. For a good summary of corporate tax sheltering, see *ibid.*

46. U.S. Treasury, “The Problem of Corporate Tax Shelters,” pp. 7, 14.

47. *Ibid.*, p. 28.

48. KPMG.

49. *Ibid.*

50. For a discussion of cross-border investment, see Edwards and de Rugy.

51. See James Hines, ed., *International Taxation and Multinational Activity* (Chicago: University of Chicago Press, 2001). See also James Hines, “Lessons from Behavioral Responses to International Taxation,” *National Tax Journal*, June 1999, p. 305.

52. Hans Nagl, “Infineon CEO Mulls Moving HQ, Plans Job Cuts,” Reuters, April 29, 2003.

53. For a brief survey of the issue, see Eric Engen and Kevin Hassett, “Does the U.S. Corporate Tax Have a Future?” *Tax Notes*, 30th Anniversary Edition, 2002.

54. For a discussion, see Veronique de Rugy, “Runaway Corporations: Political Band-Aids vs. Long-Term Solutions,” *Cato Tax & Budget Bulletin* no. 9, July 2002.

55. Ingersoll-Rand reincorporated in Bermuda in 2001. Stanley Works ultimately backed down on its plan to reincorporate abroad.

56. U.S. Treasury, “Corporate Inversion Transactions: Tax Policy Implications,” May 2002, p. 21.

57. Joseph Thorndike, “Civilization at a Discount: The Morality of Tax Avoidance,” *Tax Notes*, April 29, 2002. See also W. Elliot Brownlee, *Federal Taxation in America: A Short History* (Cambridge: Cambridge University Press, 1996), pp. 72–82.

58. *Ibid.*

59. Joseph Thorndike, “Historical Perspective: Wartime Tax Legislation and the Politics of Policymaking,” Tax History Project at Tax Analysts, 2002, p. 5, [www.taxhistory.org/Articles/wartaxes.htm](http://www.taxhistory.org/Articles/wartaxes.htm).

60. Michael Boskin, “A Framework for the Tax Reform Debate,” in *Frontiers of Tax Reform*, ed. Michael Boskin (Stanford: Hoover Institution Press, 1996), p. 14. See also Gravelle, *The Economic Effects of Taxing Capital Income*, p. 30.

61. For a summary of the early law, see Roy G. Blakey, “The Federal Income Tax,” U.S. Treasury, September 20, 1934, sec. I, [www.taxhistory.org](http://www.taxhistory.org).

62. The income tax law of 1894 was struck down in *Pollock v. Farmers’ Loan and Trust Company*, 157 US 429 (1895).

63. It is often stated that the corporate business form exists only because of government “privileges.” But that view has been challenged. For example, see Norman Barry, “The Theory of the Corporation,” *Ideas on Liberty* 53, no. 3 (March 2003).

64. Brownlee, pp. 36–46.

65. Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World* (New York: Simon and Schuster, 1986), p. 420.

66. Blakey, sec. I.

67. *Ibid.*, sec. VIII.

68. For further discussion, see Art Hall, “The Concept of Income Revisited: An Investigation into the Double Taxation of Saving,” Tax Foundation, February 1997.

69. For a further discussion, see Chris Edwards, “Simplifying Federal Taxes: The Advantages of Consumption-Based Taxation,” *Cato Institute Policy Analysis* no. 416, October 17, 2001.

70. David Bradford, *Untangling the Income Tax*

- (Cambridge, Mass.: Harvard University Press, 1999), p. 313.
71. For a discussion of the basic problems with income taxation, see *ibid.* See also David Bradford, *Blueprints for Basic Tax Reform*, 2d ed. (Arlington, Va.: Tax Analysts, 1984), p. 22.
72. Note that the measure of net income for tax and GAAP can be quite different. For example, depreciation for tax purposes is generally accelerated compared to GAAP depreciation.
73. Calvin Johnson, "Using GAAP Instead of Tax Accounting Is a Bad Idea," *Tax Notes*, April 19, 1999. Johnson calls GAAP accounting "a pretty sick puppy."
74. For a discussion of cash-flow vs. income taxes, see Jack Mintz and Jesus Seade, "Cash Flow or Income? The Choice of Base for Company Taxation," *World Bank Observer*, July 1991, p. 180.
75. Most cash-flow tax proposals have an "R base" as they consider just real, not financial, transactions. An R+F cash-flow tax base has been considered for the taxation of financial institutions under a consumption-based tax.
76. Brownlee, p. 64.
77. Aaron and Galper. The authors called their plan a "cash flow income tax." The plan would combine a personal consumed-income tax, a business cash-flow tax, and taxation of estates and gifts.
78. Robert Hall and Alvin Rabushka, *The Flat Tax*, 2d ed. (Stanford, Calif.: Hoover Institution Press, 1995).
79. *Ibid.*, p. 47. For another good discussion of cash-flow business taxation from the 1980s, see Mervyn King, "The Cash Flow Corporate Income Tax," National Bureau of Economic Research (NBER) Working Paper no. 1993, August 1986.
80. These distortions are discussed in Aaron and Galper.
81. There has also been substantial interest abroad in cash-flow business taxation. For example, the New Zealand Treasury has produced a number of studies on the issue. A good recent study is Peter Wilson, "An Analysis of a Cash Flow Tax for Small Business," New Zealand Treasury, Working Paper no. 02/27, December 2002.
82. U.S. Treasury, "The Problem of Corporate Tax Shelters," p. 113.
83. *Ibid.*, p. 16.
84. Bankman, p. 1780.
85. JCT, "Report of Investigation of Enron Corporation," p. 346.
86. David Weisbach, Comments at the "Invitational Conference on Tax Law Simplification," sponsored by the American Bar Association, the American Institute of CPAs, and the Tax Executives Institute, Washington, December 4, 2001.
87. *Ibid.*
88. IRS National Taxpayer Advocate, "FY2002 Annual Report to Congress," December 2002, pp. 288, 290. The IRS's aggressive position grew out of the 1992 INDOPCO case. See also Lawrence Lokken, "Capitalization: Complexity in Simplicity," *Tax Notes*, May 28, 2001.
89. Weisbach, Comments
90. Quoted in JCT, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification* (Washington: Government Printing Office, April 2001), JCS-3-01, vol. II, p. 324.
91. Pamela Olson, Comments concerning tax code section 263A at the "Invitational Conference on Tax Law Simplification."
92. Under the Tax Reform Act of 1986, businesses depreciate tangible property under the Modified Accelerated Cost Recovery System (MACRS), sec. 168 of the tax code, which determines recovery periods, placed-in-service rules, and depreciation methods.
93. Tom Neubig and Stephen Rhody, "21st Century Distortions from 1950s Depreciation Class Lives," *Tax Notes*, May 29, 2000. They note that the current classification system is partly based on guidelines from a 1959 Treasury study.
94. JCT, "Report of Investigation of Enron Corporation," pp. 165, 173, 174.
95. *Ibid.*, p. 181.
96. *Ibid.*, pp. 221, 234.
97. Roy Blough, "Postwar Tax Structure—Capital Gains Tax," staff memo, U.S. Treasury, Division of Tax Research, December 5, 1944, [www.taxhistory.org](http://www.taxhistory.org).
98. The New York State Bar Association, cited in U.S. Treasury, "The Problem of Corporate Tax Shelters," p. 10.
99. JCT, *Study of the Overall State of the Federal Tax System*, vol. II, p. 37.
100. For a discussion, see JCT, "Tax Treatment of

- Capital Gains and Losses,” JCS-4-97, March 12, 1997, p. 7. Prior to 1986, the corporate capital gains rate was generally less than the ordinary rate.
101. U.S. Treasury, “The Problem of Corporate Tax Shelters,” p. 36.
102. Mark Lang, Edwards Maydew, and Douglas Shackelford, “Bringing Down the Other Berlin Wall: Germany’s Repeal of the Corporate Capital Gains Tax,” Paper presented at NBER Public Economics Program Meeting, April 6, 2001, p. 11. In the reform, Germany also eliminated its dividend imputation system and went to a 50 percent dividend exclusion for individuals.
103. Sven-Olof Lodin, “The Competitiveness of EU Tax Systems,” International Bureau of Fiscal Documentation, *European Taxation*, May 2001, p. 169.
104. Lang, Maydew, and Shackelford, p. 10. The authors’ example was recalculated at today’s share price.
105. *Ibid.*, p. 6.
106. E. S. Browning, “Hybrid Stock Issue Skirts Tax, Securities Laws,” *Tax Notes*, April 8, 1996, p. 223.
107. “PEPS” stands for premium equity participating securities.
108. Lee Sheppard, “Rethinking DECS, and New Ways to Carve Out Debt,” *Tax Notes*, April 19, 1999, p. 347.
109. Bankman, p. 1777. This is a very brief sketch of Bankman’s “High-Basis Low-Value” example.
110. JCT, “Report of Investigation of Enron Corporation,” pp. 118, 128.
111. *Ibid.*, p. 124.
112. *Ibid.*, p. 146.
113. *Ibid.*, p. 136.
114. *Ibid.*, p. 159.
115. For example, see *ibid.*, p. 142.
116. *Ibid.*, pp. 189, 201.
117. Deborah Geier, “A Proposal for Taxing Corporate Reorganizations,” *Tax Notes*, February 10, 1997, p. 801.
118. Lang, Maydew, and Shackelford, p. 1.
119. Jeremy Bulow, Lawrence Summers, and Victoria Summers, “Distinguishing Debt from Equity in the Junk Bond Era,” in *Debt, Taxes, and Corporate Restructuring* ed. John Shoven and Joel Waldfoegel (Washington: Brookings Institution, 1990), p. 135.
120. U.S. Treasury, “The Problem of Corporate Tax Shelters,” pp. 26, 31.
121. Allan Sloan, “GM Finds a Hole in the Tax Code Big Enough to Drive Billions Through,” *Washington Post*, January 28, 1997, p. C3; and Allan Sloan, “Northrop Grumman Deal Scores a Direct Hit on Taxes,” *Washington Post*, February 27, 1996, p. C3.
122. For an overview, see Patrick Gaughan, *Mergers, Acquisitions, and Corporate Restructurings*, 3d ed. (New York: John Wiley & Sons, 2002). See also Merle Erickson, “The Effect of Taxes on the Structure of Corporate Acquisitions,” *Journal of Accounting Research* 36 (Autumn 1998): 279–98.
123. Allan Sloan, “GM Follows Zero-Percent Financing with a Zero-Tax Sale of DirecTV,” *Washington Post*, November 6, 2001, p. E3. Sloan describes a “reverse Morris Trust” deal.
124. Gary Maydew, *Small Business Taxation*, 2d ed. (Chicago: CCH, 1997).
125. The case was *Plains Petroleum Co. and Subsidiaries v. Commissioner*; T.C. Memo 1999-241 (1999), cited in Vivian Hoard, “Corporate Tax Shelters: Is Every Generation Doomed to Repeat History?” *Tax Practice & Procedure*, June–July 2000, p. 24.
126. Martin Sullivan, “Flat Taxes and Consumption Taxes: A Guide to the Debate,” American Institute of Certified Public Accountants, December 1995, pp. 7, 99. For a discussion of M&A issues under a flat tax, see David Weisbach, “Ironing Out the Flat Tax,” John M. Olin Law & Economics Working Paper no. 79, University of Chicago, August 1999, pp. 36-44.
127. For a further description of rules that might apply under a cash-flow business tax, see Alliance USA, “USA Tax System,” January 24, 1995, pp. 275–84. This tax reform group was chaired by Paul O’Neill and Robert Lutz.
128. However, determining the best treatment of current law asset basis during transition to a new tax system is a difficult problem. For a discussion of transition issues, see *Ibid.*, p. 55.
129. Gravelle, *The Economic Effects of Taxing Capital Income*, p. 90.
130. For a summary of the many estimates of the efficiency costs of the corporate income tax, see John Whalley, “Efficiency Considerations in Business Tax Reform,” Canadian Department of Finance, Technical Committee, October 1997.
131. *Ibid.*, p. 13.

132. Gravelle, *The Economic Effects of Taxing Capital Income*, p. 52. "Effective" tax rates take into account statutory rates and other tax items such as depreciation deductions.
133. U.S. Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington: Government Printing Office, January 1992), p. v.
134. For a discussion, see John Lee, "Choice of Small Business Tax Entity: Facts and Fictions," *Tax Notes*, April 17, 2000, p. 417.
135. Scholes and Wolfson, p. 5.
136. IRS, "SOI Bulletin," Spring 2002, p. 297.
137. The Treasury's "check-the-box" regulations in 1996 simplified the tax classification of LLCs and generally allowed most non-publicly traded entities to avoid the corporate income tax. See JCT, "Report of Investigation of Enron Corporation," p. 368.
138. Calvin Johnson, "Corporate Tax Shelters, 1997 and 1998," *Tax Notes*, September 28, 1998, p. 1603.
139. JCT, "Report of Investigation of Enron Corporation," p. 181.
140. *Ibid.*, p. 244.
141. James M. Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions*, 3d ed. (New Hope, Pa.: Frank J. Fabozzi Associates, 2001), www.securitizationtax.com.
142. JCT, "Report of Investigation of Enron Corporation," p. 255.
143. *Ibid.*, p. 244.
144. *Ibid.*, p. 115.
145. U.S. Treasury, "The Problem of Corporate Tax Shelters," pp. 4, 135.
146. David Bradford, "An Uncluttered Income Tax: The Next Reform Agenda," John M. Olin Program Discussion Paper no. 20, Princeton University, July 1988.
147. Blough.
148. Note that about half of corporate dividends do not face double taxation because they go to tax-exempt entities such as pension funds.
149. Blough.
150. This was the "Treasury I" proposal. See Bradford, *Untangling the Income Tax*, p. 291. The original proposal was contained in U.S. Treasury, *Tax Reform for Fairness, Growth, and Simplicity* (Washington: Government Printing Office, 1984).
151. U.S. Treasury, *Integration of the Individual and Corporate Tax Systems*.
152. U.S. Treasury, "General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals," February 2003.
153. Chris Edwards, "Dividend Taxes: U.S. Has the Second-Highest Rate," *Cato Tax & Budget Bulletin* no. 12, January 2003. Based on data from the Organization for Economic Cooperation and Development.
154. For a discussion, see Mervyn King, "The Cash Flow Corporate Income Tax," NBER Working Paper no. 1993, August 1986, pp. 14-21.
155. See Hans-Werner Sinn, *Taxation and the Cost of Capital: The Old View, the New View, and Another View*, *Tax Policy and the Economy* 5 (Cambridge, Mass.: NBER and MIT Press, 1991), p. 25. See also U.S. Treasury, *Integration of the Individual and Corporate Tax Systems*, p. 116.
156. For a summary of studies, see George Zodrow, "On the Traditional and New Views of Dividend Taxation," *National Tax Journal* 44 (December 1991): 497.
157. Congressional Budget Office, p. 23.
158. For a discussion, see U.S. Treasury, *Integration of the Individual and Corporate Tax Systems*, pp. 3-14, 115.
159. Roger Gordon and Young Lee, "Do Taxes Affect Debt Policy? Evidence from U.S. Corporate Tax Return Data," NBER Working Paper no. 7433, December 1999.
160. For a survey, see Franklin Allen and Roni Michaely, "Payout Policy," Wharton Financial Institutions Center, April 2002, <http://fic.wharton.upenn.edu/fic/papers/01/0121.pdf>.
161. Ken Brown, "Will Stock Dividends Get Back Their Respect?" *Wall Street Journal*, December 10, 2002. Based on Ibbotson Associates' data.
162. Allen and Michaely, Figure 2, pp. 8, 134.
163. *Ibid.*, p. 116.
164. William Gale, "About Half of Dividend Payments Do Not Face Double Taxation," *Tax Notes*, November 11, 2002, p. 839. Gale notes that \$62 bil-

- lion of payments was interest payments from mutual funds that the IRS records as dividends.
165. Allen and Michaely, pp. 10, 117.
166. Jeremy Siegel, "The Dividend Deficit," *Wall Street Journal*, February 2, 2002, p. A20.
167. Brown.
168. George Haas, "Rationale of the Undistributed Profits Tax," staff memo, U.S. Treasury, Division of Tax Research, March 17–18, 1937, [www.taxhistory.org](http://www.taxhistory.org).
169. William Gentry and R. Glenn Hubbard, "Fundamental Tax Reform and Corporate Financial Policy," NBER Working Paper no. 6433, February 1998.
170. JCT, "Report of Investigation of Enron Corporation," p. 327.
171. John Reid, "MIPS Besieged—Solutions in Search of a Problem," *Tax Notes*, December 1, 1997, p. 1057.
172. Jeremy Bulow, Lawrence Summers, and Victoria Summers, "Distinguishing Debt from Equity in the Junk Bond Era," in *Debt, Taxes, and Corporate Restructuring*, ed. John Shoven and Joel Waldfoegel (Washington: Brookings Institution, 1990), p. 135.
173. MIPS were the Goldman Sachs version of this financial structure, while TOPRS were Merrill Lynch's version. See Reid, p. 1057.
174. John McKinnon and Greg Hitt, "Double Play: How Treasury Lost in Battle to Quash a Dubious Security," *Wall Street Journal*, February 24, 2002, p. A1.
175. JCT, "Report of Investigation of Enron Corporation," p. 314.
176. McKinnon and Hitt, p. A1. See also JCT, "Report of Investigation of Enron Corporation," p. 313.
177. For a defense of MIPS, see Edward Kleinbard, "Lee Sheppard's Misguided Attacks on MIPS," *Tax Notes*, June 8, 1998, p. 1365.
178. *Ibid.*
179. McKinnon and Hitt, p. A1.
180. JCT, "Report of Investigation of Enron Corporation," p. 332.
181. See Bankman. See also Lee Sheppard, "Treasury Steps on Step-Down Preferred," *Tax Notes*, March 3, 1997, p. 1102.
182. Gentry and Hubbard, "Fundamental Tax Reform and Corporate Financial Policy," p. 18.
183. Gravelle, *The Economic Effects of Taxing Capital Income*, p. 55.
184. James B. Mackie III, "Unfinished Business of the 1986 Tax Reform Act: An Effective Tax Rate Analysis of Current Issues in the Taxation of Capital Income," *National Tax Journal* 60, no. 2 (June 2002): 293.
185. Carl Dubert and Peter Merrill, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues* (Morristown, N.J.: Financial Executives Research Foundation and PricewaterhouseCoopers, 2001), Table 10-2.
186. For a summary of U.S. rules, see *ibid.* See also National Foreign Trade Council, *The NFTC Foreign Income Project: International Tax Policy for the 21st Century* (Washington: NFTC, 1999), part 1.
187. Glenn Hubbard and James Hines, "Coming Home to America: Dividend Repatriations by U.S. Multinationals," NBER Working Paper no. 2931, April 1989.
188. For example, see American Bar Association, "Tax Simplification Recommendations," February 2001. See also National Foreign Trade Council.
189. JCT, "Report of Investigation of Enron Corporation," p. 370.
190. *Ibid.*, p. 371.
191. *Ibid.*, p. 373.
192. *Ibid.*, p. 377.
193. *Ibid.*, p. 375.
194. U.S. Treasury, "The Problem of Corporate Tax Shelters," p. 30.
195. For a further discussion, see Edwards and de Ruy.
196. For a discussion, see National Foreign Trade Council.
197. Albert Crenshaw, "At Enron, the Compensation Kept Paying," *Washington Post*, February 16, 2003, p. H2.
198. John Graham, Mark Lang, and Douglas Shackelford, "Employee Stock Options, Corporate Taxes, and Debt Policy," NBER Working Paper no. 9289, October 2002, p. 32.

199. Jane Gravelle, "The Enron Debacle: Lessons for Tax Policy," Urban-Brookings Tax Policy Institute, Discussion Paper no. 6, February 2003.
200. *Ibid.*, p. 3.
201. *Ibid.*, p. 2.
202. *Ibid.*, p. 21.
203. Keith Alexander, "Ruling May End Employee Control of United Airlines," *Washington Post*, March 5, 2003, p. E4.
204. Gravelle, "The Enron Debacle," p. 9.
205. JCT, *Study on the Overall State of the Federal Tax System*, vol. II, pp. 149, 150, 197, 198.
206. Albert Crenshaw, "U.S. Pension Agency Goes \$11 Billion in Red," *Washington Post*, January 31, 2003, p. E1.
207. Albert Crenshaw, "Deficit Grows at Agency That Backs Pensions," *Washington Post*, May 1, 2003, p. E2.
208. Kirstin Downey, "Pilot Pensions Off Course," *Washington Post*, March 7, 2003, p. E4.
209. Details of the steel industry bailout are at Pension Benefit Guaranty Corporation, "PBGc to Protect Pensions of 95,000 at Bethlehem Steel," December 16, 2002, [www.pbgc.gov/news/press\\_releases](http://www.pbgc.gov/news/press_releases).
210. A number of economic justifications have been given for a corporate tax, but they do not seem to be crucially important. For example, it may be efficient in theory to correct certain externalities through corporate taxes. For a discussion, see Richard Bird, "Why Tax Corporations?" Canadian Department of Finance, Technical Committee Working Paper no. 96-2, December 1996, p. 4.
211. For example, Bird notes that the high distortions are "sufficiently persuasive to convince most economists that there is little, if anything, to be said for corporation taxes." *Ibid.*, p. 1. However, Bird concludes that there are reasons for retention of the corporate tax, at least within an income tax system in a smaller economy such as Canada's.
212. Bradford, *Blueprints for Basic Tax Reform*, p. 4.
213. Despite endless debate, economists do not agree on which group bears the burden of the corporate income tax. Probably, it changes over time and falls variously on consumers, workers, or investors depending on the openness of the economy and market conditions in various industries.
214. The federal corporate rate is not precisely flat. Indeed, it has rates of 15, 25, 34, and 35 percent, but the large bulk of business activity occurs in the top two brackets that apply to companies with taxable income of more than \$75,000 and \$10 million, respectively.
215. My view is that proportional taxation is both fairer and more efficient than progressive taxation; thus one of the few virtues of the current corporate tax is its essentially flat rate. Also, note again that the actual burdens of capital income taxation may fall on individuals other than the stockholders who mail tax payments to the IRS.
216. See Stephen Entin, "The Inflow-Outflow Tax—A Savings-Deferred Neutral Tax System," Institute for Research on the Economics of Taxation, undated, [www.iret.org](http://www.iret.org). Another version of a savings-exempt tax is the individual portion of the USA tax introduced in 1995 by Senators Nunn and Domenici.
217. Bradford, *Blueprints for Basic Tax Reform*, p. 13.
218. Bird, p. 7.
219. Note that even under worldwide systems, foreign active business profits are usually not taxed until repatriated.
220. David Hoffman, "State Tax Collections and Rates," Tax Foundation, February 2002.
221. Kirk Stark, "The Quiet Revolution in U.S. Subnational Corporate Income Taxation," *State Tax Notes*, March 4, 2002. The author discusses the apportionment formulas that determine the corporate tax base, and he advocates corporate income tax repeal.
222. David Brunori, "Stop Taxing Corporate Income," *Tax Notes*, June 25, 2002.
223. *Budget of the United States Government, Fiscal Year 2004, Historical Tables* (Washington: Government Printing Office, February 2003).
224. U.S. Treasury, *Integration of the Individual and Corporate Tax Systems*. See also discussion in Gentry and Hubbard, "Fundamental Tax Reform and Corporate Financial Policy."
225. *Ibid.*, p. 30.
226. Bradford, *Untangling the Income Tax*, p. 314.
227. Most cash-flow tax proposals have an "R" tax base. Alternatively, a cash-flow tax could have an "R+F" base, which would be calculated using both real and financial income and expense amounts.
228. The proposal included a subtraction-method

VAT, which differs from the credit invoice VATs that are common in Europe. For a discussion of these two types of VATs, see Sullivan.

229. Engen and Hassett, p. 29.

230. Hall and Rabushka.

231. Business expenses that would not be deductible under the Armeij plan include interest, dividends, nonpension fringe benefits, employer's share of payroll taxes, and bad debts.

232. The terminology of cash-flow taxes, R-base (real) or R+F (real + financial), follows from the British government's Meade Commission report on tax reform in 1978.

233. For a discussion, see Bradford, *Untangling the Income Tax*, p. 119.

234. William Gentry and R. Glenn Hubbard, "Distributional Implications of Introducing a Broad-Based Consumption Tax," NBER Working Paper no. 5832, November 1996. Gentry and Hubbard define this issue precisely by breaking down capital income into four parts: (1) the opportunity cost of capital or the return to waiting, (2) the return to risk taking, (3) inframarginal returns or economic profit, and (4) realizations differing from expectation or unexpected windfalls. The income tax taxes all four components. A consumption-based tax taxes only the last three components. See also Gentry and Hubbard, "Fundamental Tax Reform and Corporate Financial Policy," p. 8.

235. See discussion in David Bradford, *Taxation, Wealth, and Saving* (Cambridge, Mass.: MIT Press, 2000), pp. 91-93.

236. Jack Mintz and Jesus Seade, "Cash Flow or Income? The Choice of Base for Company Taxation," *World Bank Observer*, July 1991, p. 180. See also see Mervyn King, "The Cash Flow Corporate Income Tax," NBER Working Paper no. 1993, August 1986, pp. 14-21.

237. For a discussion of some possible administrative problems with the flat tax, see Weisbach, "Ironing Out the Flat Tax." See also Parthasarathi Shome and Christian Schutte, "Cash-Flow Tax," in *Tax Policy Handbook*, ed. Parthasarathi Shome (Washington: International Monetary Fund, 1995), p. 172. See also Gentry and Hubbard, "Fundamental Tax Reform and Corporate Financial Policy," p. 29.

238. Charles McLure and George Zodrow, "A Hybrid

Approach to the Direct Taxation of Consumption," in *Frontiers of Tax Reform*, p. 76. The authors propose a hybrid tax that would tax individuals under the Hall-Rabushka-style individual tax but businesses under an R+F cash-flow basis.

239. A border-adjustable tax would exempt exports from U.S. taxation and symmetrically deny a deduction for imported inputs. The USA tax is a border-adjustable cash-flow tax. By contrast, the Hall-Rabushka tax is "origin based" and would tax income on exported goods but allow a deduction for imported inputs.

240. Price Waterhouse LLP, Economic Policy Consulting Services, "Tax Liability of Nonfinancial Corporations under the USA and Flat Taxes: An Industry Analysis," June 29, 1995. I adjusted the study's 17 percent results up to the 19 percent rate specified under the Hall-Rabushka plan.

241. These issues have been around since the beginning of the income tax. For a discussion from the 1930s, see Blakey, sec. VIII.

242. For a discussion, see Weisbach, "Ironing Out the Flat Tax," p. 36.

243. See Harry Grubert and James Mackie, "An Unnecessary Complication: Must Financial Services Be Taxed under a Consumption Tax?" U.S. Treasury, January 30, 1996. Note that countries with VATs often impose a separate type of tax on financial institutions.

244. See Peter Merrill and Chris Edwards, "Cash-Flow Taxation of Financial Services," *National Tax Journal*, September 1996. See also Peter Merrill and Harold Adrion, "Treatment of Financial Services under Consumption-Based Tax Systems," *Tax Notes*, September 18, 1995. Note that Armeij's flat tax legislation recognized the need for special rules for "financial intermediation services" but did not specify any details.

245. Melbert Schwarz, Peter Merrill, and Chris Edwards, "Transitional Issues in Fundamental Tax Reform: A Financial Accounting Perspective," in *Tax Policy and the Economy* 12 (Cambridge, Mass.: NBER and MIT Press, 1998). Also see David Bradford, "Fundamental Issues in Consumption Taxation," American Enterprise Institute, 1996.

246. The Nunn-Domenici USA cash-flow tax plan did include detailed transition rules. Generally, the plan allowed for the amortization of remaining asset basis over a period of years.

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