THE BUSINESS ENTERPRISE INCOME TAX: A PROSPECTUS

By Edward D. Kleinbard

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In recent months, Kleinbard asserts, many policymakers, practitioners, and politicians have argued the case for fundamental tax reform. Reform advocates, he says, often point to the recent wave of corporate tax shelter controversies as emblematic of the Internal Revenue Code’s complexity and economic inefficiency and conclude that our current income tax is a system gone irredeemably awry.

Most tax reform advocates urge that our income tax system be replaced or supplemented by a consumption tax (most often, a value added tax). This paper, by contrast, urges a genuine reformation of the income tax applicable to business enterprises. Kleinbard’s central thesis is that, in our decades-old quest for a perfect income tax, we have failed to design a very good one.

Kleinbard proposes a new “business enterprise income tax” that would comprise four related revisions to our current system for taxing business income:

• First, a broadening of the business tax base to impose entity-level tax on all business enterprises, whatever their form. Thus, partnerships, for example, would become taxable entities.

• Second, a comprehensive new approach to the taxation of financial capital invested in business enterprises, the cost of capital allowance system, which would eliminate current law distinctions between debt and equity, and subject all investors to current tax on their implicit returns, regardless of whether they receive current cash distributions.

• Third, the repeal of our tax-free incorporation and reorganization rules, and their replacement with a uniform asset-acquisition tax model, coupled with new “tax-neutral” tax rates on the disposition of business assets.

• Fourth, the replacement of our current schizophrenic consolidated return rules with comprehensive true consolidation principles.

Kleinbard argues that the resulting system would be fairer, more efficient, and simpler than current law. Most important, the business enterprise income tax should reduce greatly the role of tax considerations in business thinking.

“The perfect is the enemy of the good”

— Voltaire

I. Introduction

A. Income Tax Reform

This report is a sketch of an outline of a germ of an idea for reforming the income taxation of business enterprises. If there is interest in pursuing these proposals, I will expand the report’s arguments and recommendations into a more comprehensive presentation.

This report proposes a business enterprise income tax, or BEIT (to be pronounced, appropriately for a tax, as “bite”). Many observers may find an income tax reform proposal to be a retrograde starting point: Today, much of the zeal for business tax reform revolves around consumption taxes, including a national sales tax. Canada
has such a system; it takes a vision much bolder than mine to choose the Canadian economy as our guiding light.

More generally, while it might be true that an income tax on capital is a disguised form of wealth tax, I am not convinced that taxing wealth is that terrible an idea, at least compared to the alternatives. Regardless, even proponents of more radical consumption tax solutions need a stalking horse, and I hope they will consider an income tax reformed along the lines suggested here as a better base case than is the sorry statute with which we all live today.

If consumption tax advocates will find this report’s proposals flawed by too modest a premise, practitioners will find these proposals absurdly reductionist, negating decades of highly refined law and lore. The proposals that follow are genuinely radical, in that they abolish the tax distinctions between partnerships and corporations, between debt and equity, and between taxable and tax-free reorganizations. In so doing, the proposed BEIT will be criticized for failing to reach optimal results in a wide array of sympathetic cases. My defense is that, in our 85-year quest for a perfect business income tax system, we have failed to design a particularly good one.

The presentation that follows is a prospectus, not a dissertation; in keeping with that scope, the report contains no footnotes. I recognize that much that follows is not novel. I also remain deeply indebted to a great many academics and practitioners who have published thoughtful articles on the topic of structural tax reform, and who in some cases have patiently explained to me various conceptual errors into which I have fallen over the years. For the moment, however, I believe it appropriate to present the BEIT as an intellectual orphan; I suspect, in fact, that many to whom I would express some intellectual indebtedness no doubt will be relieved not to find themselves listed as potential parents of this proposal.

B. The BEIT in a Nutshell

The principal motivation behind the BEIT is to reduce as much as possible the role of tax considerations in business thinking, including decisionmaking about the legal form a business organization takes, the manner in which that business entity raises financial capital, and acquisitions and dispositions of business enterprises. Because the BEIT is an income tax, rather than a consumption tax, the proposal must address the taxation both to issuers and to investors of financial capital. The presentation that follows is a prospectus, not a dissertation; in keeping with that scope, the report contains no footnotes. I recognize that much that follows is not novel. I also remain deeply indebted to a great many academics and practitioners who have published thoughtful articles on the topic of structural tax reform, and who in some cases have patiently explained to me various conceptual errors into which I have fallen over the years. For the moment, however, I believe it appropriate to present the BEIT as an intellectual orphan; I suspect, in fact, that many to whom I would express some intellectual indebtedness no doubt will be relieved not to find themselves listed as potential parents of this proposal.

(i) A single tax system for all business enterprises, with the bulk of the income tax imposed on business collected at the enterprise level. (Thus, partnerships would become taxable entities.) That system generally would mirror the current corporate system. Current law’s deductions for interest expense (and its income inclusion rules for various forms of financial instruments) would, however, be repealed. The tax-free reorganization rules also would be repealed, and the disposition by a business enterprise of nonfinancial assets (that is, assets other than inventories or interests in other business enterprises) would be taxed at tax-neutral rates, as described below.

(ii) A uniform cost of capital allowance to determine an issuer’s deductions for capital deployed in its business. An issuer would compute its deduction as a simple percentage of the financial capital invested in its business, without regard to the legal form that capital takes (for example, as debt or equity).

(iii) “Minimum inclusion” and “excess distribution” rules to determine the income derived by a holder of a financial claim against a business enterprise. These rules would be designed to work with the cost of capital allowance deduction afforded to issuers to produce a largely integrated tax system for financial capital.

(iv) The repeal of the tax-free reorganization rules, and their replacement with rules under which every acquisition of a business enterprise would be treated as an asset acquisition and also would be taxable to the target’s owners. The tax imposed on a business enterprise on the sale of its business assets would be set at tax-neutral rates, under which gain from the sale of assets with long depreciable lives would be taxed at lower rates than would gain from the sale of short-lived assets.

(v) New “true” consolidation rules, in which business enterprises meeting the affiliation standards for tax consolidation would be treated as a single business enterprise for all tax purposes.

The outlines of these points are developed below. For the sake of simplicity, and in an effort to determine whether the suggestions have any utility at all, I have ignored all international aspects of the proposals. I also generally give short shrift to incentives for particular classes of activities or taxpayers and to special rules for particular industries. Finally, I have ignored for purposes of this article the transition issues raised by this (or any other comprehensive reform) proposal.

C. Policy Objectives

In general, a properly implemented BEIT should dramatically reduce the importance of tax planning to business decisionmaking, which almost by definition should improve the economic efficiency of our tax system. The BEIT largely integrates the taxation of business enterprises with the taxation of investors in those enterprises, thereby eliminating current law’s perverse incentives for overleveraging business operations. The BEIT also reduces the tax burden on most taxable corporate dispositions and harmonizes the tax rules applicable to all
acquisitions and divestitures, which again should encourage business managers to implement decisions about mergers and acquisitions that make sense before taxes are considered.

The BEIT would require a certain amount of recordkeeping — particularly among investors — beyond the recordkeeping that those taxpayers perform today. Records obligations, however, do not have the same profoundly corrosive effect the complexity of the current system does.

Some readers might find complaints that a tax system is too complex redolent of intellectual laziness or political posturing. In fact, while our tax laws never will be easy, our current appetite for complexity has outstripped our ability to digest the consequences. The business tax system as it is administered in the field has become increasingly divorced from the rules on our books, as both taxpayers and IRS agents fall further and further behind in fully absorbing the implications of increasingly arcane rules. With that divorce between practice and statute comes disenchantment with the legitimacy of the system. That disenchantment in turn, fertilized by the unintended consequences that occur from the application of those arcane rules to cases not envisioned by their drafters, spawn corporate tax shelters that would have been dismissed out of hand a generation ago.

The current complexity in the taxation of business enterprises can be explained in part by the necessity of responding to the creative impulses of generations of tax professionals. More fundamentally, however, the complexity reflects two problems: the permissiveness of our income tax rules, which effectively impose no limits on the varieties of business organizations or capital instruments that taxpayers may employ, and the inconsistency of the underlying models adopted for taxing those organizations and instruments, which are derived from historical assumptions about the tax essence of those entities and instruments that no longer are valid.

The result is that every taxing impulse must be adapted to apply to an overwhelming array of different entities (C corporations, S corporations, partnerships, trusts and disregarded entities, to name a few) and financial instruments, including secured debt, unsecured debt, contingent debt, convertible debt, contingent convertible debt, participating debt, and countless other forms of debt, equity, options, prepaid forward contracts, and units. But because the underlying rules for taxing those different entities and instruments are inconsistent, it becomes impossible to channel taxing impulses in the intended directions.

Part II of this report develops the last theme in a little more detail. The presentation of the BEIT begins in earnest in Part III.

II. Ripping Out the Tax Infrastructure

The Internal Revenue Code is a mighty edifice constructed on top of a largely invisible infrastructure. Like pedestrians peering into a Manhattan street that has been ripped open for repairs, nonspecialists (including most tax academics) are astounded by the complex tangle of rules just beneath their feet, and then hurry on, confident that someone somewhere who really cares about that sort of thing knows where the pipes lead. Conversely, tax professionals are so hard at work mastering the intricacies of that infrastructure for their clients that they have neither time nor inclination to reflect on the wisdom of their chosen profession.

Our current business tax system is collapsing because of its own weight. The crisis is palpable; the only effective response will be a radical overhaul of the system.

We need radical and comprehensive business tax reform because of two fundamental and deeply embedded design errors in the tax infrastructure:

- the multiplicity of inconsistent business tax regimes; and
- the radically different taxation of different formal means of supplying financial capital to a business enterprise.

Also, the taxation of corporations — the most important form of business organization — suffers from two debilitating tendencies:

- attribute fetishism; and
- fondness for dime-store metaphysics.

1. Multiplicity of business tax regimes. Our system for taxing business enterprises — indeed, any income tax — depends on many specialized accounting rules to determine when income or expenses are recognized, as well as all of the substantive rules that shape the outlines of that system in the first place. Our system also frequently looks to the context in which income is earned to determine its character (for example, ordinary income or capital gain) or source (for example, domestic or foreign). For example, a U.S. Treasury bond in my hands is a capital asset, but in the hands of a dealer it may be inventory; interest income that I earn on the bond is passive interest income, but the same income when earned by a foreign subsidiary of a U.S. financial institution may be active business income that falls outside the reach of subpart F. All those provisions work properly only if the accounting and substantive results obtained by taxpayers are reasonably consistent across competing firms, and if one can correctly identify the relevant entity whose purpose or activities determine the answer to a contextually based rule.

At every level, our tax system’s application to business enterprises is made infinitely more complex because the system’s business income accounting and substantive rules are layered on top of different regimes for taxing income earned directly by individuals, regular C corporations, S corporations, partnerships, formal branches of any of the foregoing entities, or entities that are awarded judicial significance by a foreign jurisdiction but are disregarded for U.S. tax purposes. Some of those regimes treat an entity as a separate taxpayer for all purposes; others do so only for some purposes; while still others treat an entity as in fact the entity’s owner by another name. Also, the actual tax rules applicable to different forms of business organization are not consistent with one another: A corporation that is a minority investor in another corporation, for example, gets no flow-through of the lower-tier corporation’s losses, but a corporate minority partner in a partnership does. As a result, every substantive, accounting, and contextually based rule for the taxation of business income must be tested and adapted to address every one of those different regimes.
that apply to different forms of business enterprises, or any combination of those regimes that a tax planner can imagine.

2. Business capital. The radically different tax consequences that follow from the election to capitalize a business with different forms of capital — even when that business is wholly owned by a single individual — are so familiar to us that we often forget how much tax mischief ensues. Payments for the use of debt capital are currently deductible to the issuer, while payments for the use of equity capital are not. Holders of debt capital must include an appropriate time value of money return in income regardless of whether they have received any actual payments; equity holders need not. A holder’s returns on debt instruments that contemplate the possibility of contingent interest or principal payments are treated entirely as ordinary income; contingent equity returns create capital gains.

The metaphysical rift is exacerbated by two collateral problems. First, we do not have any consensus in our tax system as to how to tax financial instruments that have contingent cash flows: Both the timing and the character of income attributable to an investment in the stock of Corporation ABC differ from the timing and character of an identical quantum of economic income attributable to a contingent debt instrument linked to that same stock — again, to a total return swap on that stock. Without that consensus, we cannot apply the fundamental tool of tax analysis — the process of analogizing — because we do not know which rule is the norm and which the exception.

Second, we do not believe (in general) in the tax bifurcation of financial instruments into smaller units, in order then to tax that instrument as an agglomeration of those units. As a result, the same promise to pay a fixed or contingent amount can take on completely different tax characteristics, depending on whether it represents the predominant or a minor theme in the overall financial instrument in which it is embedded.

Modern financial engineering and our sophisticated capital markets together effectively exploit those rifts between debt capital and other forms of capital, but the problem predates the growth of our derivatives markets. In particular, the international capital markets are quite efficient at matching the tax profiles of issuers and investors to optimize their collective returns, at the cost of revenues to the fisc.

The strains on the tax fabric introduced by the multiplicity of business tax regimes and the arbitrarily different tax rules applicable to different means of supplying business capital follow a common pattern. In each case, the drafters of the Internal Revenue Code began with the realization that people are free to organize and capitalize their business operation as they choose. Those different forms of business organization and capital of course bring with them different commercial or nontax legal consequences. The holder of a debt instrument, for example, has different rights against a defaulting issuer than does the holder of that issuer’s equity.

The drafters of the code went on, however, to develop differences in tax qualities among those different forms of business organizations and capital based on their intuitions as to those differences in commercial relationships. A partnership, for example, was seen as involving a relationship between owner and entity that was qualitatively different from the same relationship in the corporate context, and that therefore required a (now complex) semitransparent tax system. This report rejects the premise that those differences in commercial relationships necessarily require differences in tax regimes.

3. Corporate attribute fetishism. For financial accountants and casual tax observers, consolidation is a simple concept: The assets, income, and operations of commonly-controlled enterprises are merged into a single undifferentiated whole. In contrast, our corporate consolidated tax return system is predicated on the belief that corporate affiliations are fragile relationships, and that it therefore is vitally important to track the separate tax attributes of every corporate subsidiary on the off chance that it might one day be sold. The complexity that results is impossible to overstate. To take one simple example, the leading tax treatise on consolidated tax returns devotes a chapter that runs nearly 300 pages in length to the simple question of how to treat intercompany transactions (transactions between affiliates). No current tax consequences flow from those transactions, and the concept exists only to keep track of individual tax attributes of different corporate affiliates. That level of complexity would be bad enough, but in my experience, at least, those 300 pages have failed to answer any intercompany transaction question that has arisen in my practice.

4. Corporate dime store metaphysics. Young tax lawyers often are attracted to the field by the lure of the corporate tax-free reorganization rules. Here (unlike the case of the taxation of different forms of business capital, for example) the rules are not grounded in any effort to track observed commercial differences, but rather form a semi-coherent but completely arbitrary world of their own, in which forward triangular mergers permit substantial cash consideration, while reverse triangular mergers permit only a little, and triangular “B” reorganizations none at all, because “‘soley’ leaves no leeway.” Those rules are fun, if one enjoys intellectual games and puzzles, but ultimately they are sterile exercises that serve only to disappoint clients’ rational commercial expectations. More strikingly, after decades of playing that game, the rules are not yet fully developed, and lawyers today argue about tax-free reorganization chestnuts that a lawyer from one or even two generations earlier instantly would recognize. (While our rules for taxing different forms of business capital are a little better grounded in rational economic thinking, in the end our lack of consensus on how to tax contingent cash flows and our distaste for bifurcation lead to very similar metaphysical tax abstractions.)

Fundamentally, the metaphysics of tax-free reorganizations are divorced both from commercial reality and from any discernable tax policy objective. Corporate whales swallow minnows — and minnows, whales — in tax-free transactions that in every commercial sense are buyouts, while corporate equals can, if they choose, merge in a transaction that deliberately fails tax-free reorganization status. In every case, the reason for the result is only that the rules so provide. In that instance, more clearly than in any other part of the Internal...
Revenue Code, the form of a transaction becomes its substance, and differences in form give rise to dramatic and inexplicable differences in result.

III. One Tax System for All Business Enterprises

Under the BEIT, all business enterprises would be taxed under a single system that is based generally on today’s rules for the taxation of ordinary (C) corporations, but with the important modifications described below. As a result, any business enterprise, whether organized as a corporation, a partnership, or an unincorporated activity of an individual, would be taxed as a separate entity. (As applied to individuals, the resulting system thus is loosely analogous to New York City’s Unincorporated Business Tax.)

For these purposes, all income-producing activities would be characterized either as investment or as business activities. Most individuals who today are traders in securities would fall on the investment side of the new definition.

All collective investment funds, however organized, would be taxed under a single system different from the rules for business enterprises. These collective investment vehicle rules of necessity would be more flexible than today’s regulated investment company regime. Entities that “failed” the collective investment fund rules, including true professional traders, like hedge funds (and a small minority of individual traders), would be taxed as business enterprises. (This report does not consider the taxation of collective investment funds further.) Leasing and real estate development activities generally would be treated as per se business activities; a collective investment fund, however, would be permitted to engage in net leasing of real estate.

Current law obviously contains a comprehensive enterprise-level tax (the corporate income tax), but also embodies systems in which tax is levied only on a business entity’s owners, rather than the entity itself (for example, partnership taxation). The decision here to rely entirely on an entity-level tax follows from practical considerations. Particularly as applied to publicly traded entities, any owner-level income tax system quickly becomes exquisitely complex and raises nearly insurmountable issues when cross-border ownership is considered. It also is the case that the largest concentrations of business capital and profits today are in corporations, and conforming the taxation of other enterprises to that model thus should minimize unintended consequences for the economy as a whole.

Under the BEIT, every separate juridical entity (corporation, partnership, trust, LLC, and so forth) that is engaged in business would be separately subject to tax. Every such enterprise would constitute one taxpayer, even if it conducted multiple lines of business. An actual branch of an enterprise would be taxed as part of that enterprise; a “disregarded” entity subsidiary under current law would be handled through the consolidation rules described below. A self-employed individual who was directly engaged in business for her own account would also constitute a single business enterprise, again regardless of how many different businesses she operated. Finally, and as described in more detail below, a consolidated group of business enterprises would comprise a single business enterprise.

By way of an example, if individuals organized a partnership to conduct a business, that partnership would constitute an entity subject to the BEIT. If a corporation that was itself engaged in business also invested in that partnership, the corporation and the partnership would each separately be taxed on its own business income, and the corporation would also be taxed on its returns from its investment in the partnership (as described below).

IV. A Uniform Cost of Capital Allowance

Today’s radically different rules for the taxation to issuers and holders alike of debt, equity and other financial instruments would be replaced by a single tax system for all financial capital invested in a business enterprise: the cost of capital allowance (COCA) system. The COCA system would apply to all holders and issuers of “financial capital instruments,” which would encompass any form of financial claim (debt, equity, options, swaps, and the like) against the earnings or assets of a business enterprise. The idea behind the term “financial” in that context is to distinguish capital-supplying instruments from ordinary accounts payable/receivable and the like.

A. Issuer’s Perspective

Every business enterprise would receive an annual allowance (loosely analogous to a depreciation allowance) for the cost of the capital deployed in its business. That allowance (at a rate fixed by statute, as described below) would be uniform, regardless of the form that the capital took (for example, debt or equity), and regardless of the actual creditworthiness of the issuer. An issuer would not obtain any deduction of any sort for distributions made to holders of its capital in excess of the COCA rate (excess distributions). Issuers also would not recognize gain or loss on the retirement of their financial capital instruments (for example, corporate stock or corporate debt).

The COCA rate would be applied to the issuer’s total capital to determine the issuer’s annual cost of capital allowance. Fortunately, because balance sheets balance, the total capital invested in a business enterprise is easy to determine: It equals the sum of the issuer’s assets. In the tax context, that means that we would apply the statutory rate to the sum of the tax bases of all the issuer’s assets to determine its annual cost of capital allowance. (The COCA system thus would look to an issuer’s tax, rather than financial, balance sheets.) It also means that we do not need to worry very much about when a payment by an issuer is a return of capital: Every distribution by an issuer in respect of its financial capital would reduce the issuer’s tax basis in an asset (here, cash and cash equivalents), and therefore automatically would reduce the issuer’s COCA deductions in future periods.

Nonfinancial assets that today are depreciable (or amortizable) would remain so under the COCA regime. The effect of depreciation is to reduce asset basis, which means in turn (all other factors being equal) that a business enterprise’s COCA deductions would decrease...
as it depreciates its nonfinancial assets. Of course, accelerated tax depreciation produces cash flows in excess of actual economic depreciation; in that case, the COCA deduction would preserve the benefit of that accelerated depreciation, because the COCA deduction would apply to all of an issuer's assets, including the free cash generated by those accelerated deductions.

Financial assets are nondepreciable, but they nonetheless remain assets, and therefore would enter into a business enterprise's COCA base. As a result, a business enterprise would obtain a COCA deduction for its tax basis in a portfolio investment made by it, and (as described below) also would include in income from that investment, at least a "minimum inclusion" equal to the same amount. The net result is that there would be no tax at the business enterprise level on investments, unless the returns on those investments exceeded the COCA/minimum inclusion rate.

A cost of capital allowance can serve different purposes in different tax systems. Prof. David Bradford, for example, employs a COCA in his X tax system. The X tax is a consumption tax, and financial flows generally are excluded from its scope. However, instead of immediately deducting the cost of capital outlays (as generally would be true in a consumption tax model), taxpayers in the X tax system would capitalize and depreciate those costs (as is true under current law, and as also would apply in the COCA income tax system advocated here), and then receive a COCA set at the risk-free rate. Bradford's elegant theory is that taxpayers should be indifferent between (at the two extremes) receiving an immediate deduction for capital expenditures and receiving a perpetuity from the government equal to the risk-free rate multiplied by that expenditure (because the present value of that perpetuity equals the amount expended). Moreover, applying the same rate to unrecouped investments produces the same result, whatever the depreciation schedule. Bradford uses that COCA solely to mitigate the consequences of changes in consumption tax rates; otherwise, taxpayers would receive large windfalls (or detriments) if tax rates fluctuated, depending on when they made their capital investments.

The BEIT is a simplified income tax, not a consumption tax, and the BEIT therefore taxes all financial flows (albeit under the simplified model described here). The BEIT's COCA system is designed to replace current law's deduction for interest expense in a manner that eliminates differences in treatment between debt and equity, and that is radically simpler than today's ersatz rules for taxing financial instruments. As a result, the COCA deduction proposed here is intended to be set at a rate significantly higher than the risk-free rate.

If one were to introduce the COCA system with a goal of revenue neutrality (compared to the current deduction for interest expense), one would set the COCA rate such that, when applied to all capital employed by business enterprises (debt and equity), it would correspond to the aggregate interest deductions claimed by business enterprises today. Within the business community, however, there would be individual winners (equity-financed entities and strong credits) and losers (highly leveraged enterprises and the weakest credits).

The actual COCA rate could be a single fixed rate set by statute, but more logically would vary with, for example, one-year Treasury rates. The actual rate would reflect political and revenue considerations, but (to choose an arbitrary stalking horse) might be something like one-year Treasury rates plus 200 basis points. A slightly more sophisticated variant might offer a significantly higher allowance for the first few million dollars of capital, stepping down under a schedule as a business enterprise's total capital exceeded specified thresholds, to mirror (very approximately) the fact that very large enterprises usually are stronger credits than very small ones.

The yield curve typically is steepest in the very shortest end of the maturity spectrum. It might be argued that a single COCA rate would introduce distortions in the capital markets, by encouraging issuers to rely excessively on financing through very short-dated obligations (for example, commercial paper), on the theory that the issuer's pretax costs thereby would be minimized, while its tax deduction would remain constant. The COCA system could be modified to address that concern, but my current intuition is that it would not be necessary to do so. Issuers today face many practical constraints on their ability to finance solely at the short end of the maturity spectrum: their own liquidity concerns, their desire to lock in favorable long-term financing rates, and rating agency constraints. Moreover, and as described below, the COCA proposal contemplates that investors effectively would measure their investment income by applying the same COCA rate to the amount of those investments; any tax savings to issuers thus should constitute a tax detriment to investors and therefore be reflected in pricing.

One interesting feature of a COCA system along the lines proposed here is that it would offer substantial opportunities for Congress to engage in fiscal fine-tuning (or meddling, depending on one's perspective). Thus, if Congress wished to encourage capital investment, it could bump up the COCA rate for a period of time, while leaving the basic BEIT rate untouched.

In the abstract, the COCA system might seem vulnerable to tax arbitrage. Imagine, for example, that a business enterprise issued a five-year zero coupon contingent payment debt instrument for $100. Over the life of the instrument, the issuer obtains COCA deductions totaling $20 for the $100 of cash received at the outset. Further assume that, at maturity, the contingency has no value, and the issuer therefore retires the bond for $100. The issuer has obtained COCA deductions over the five-year life of the instrument for the asset basis attributable to the instrument's issue price, but in effect has paid nothing for them. Should that trouble us? My answer is no. The COCA system does not tie deductions to returns on specific liabilities. The fisc's protection is the marketplace; the initial investors in that instrument believed the bond to offer attractive positive returns, and over the broad spectrum of business investments those expectations will prove correct. Phrased differently, if it is clear at the outset that the issuer will not pay contingent interest greater than the COCA/minimum inclusion rate, investors will not buy the security in the first place.
A special rule would apply to financial institutions, such as banks, that serve a capital intermediation function. In the case of extremely leveraged institutions, the rough justice of the COCA system would veer too far from an economically correct answer. Another special rule would treat gains and losses from financial derivative contracts as presumptively entered into to modify the issuer’s economic cost of capital, and therefore those gains and losses would be treated as nonincludable and nondeductible.

The COCA rules would apply to a business enterprise that comprised the business operations of a self-employed individual, just as they would apply to any other business enterprise. Similarly, withdrawals of cash by an individual from his own business enterprise generally would be taxed like other distributions, as described below.

Under the COCA system, issuers no longer would face a tax imperative to employ as much debt financing as possible, or to issue complex financial instruments that are designed to give issuers tax deductible interest expense in respect of contingent returns. Instead, issuers would seek to minimize the economic cost of their financial capital, secure in the knowledge that there was no tax component to that calculus.

B. Holders’ Perspective

All holders of a business enterprise’s financial capital instruments, however denominated, would be subject to a uniform set of income inclusion rules. Under those rules, every holder of an investment in a business enterprise would include in taxable income each year an amount equal to the investor’s aggregate tax basis in its financial capital instruments, multiplied by the statutory COCA rate for that year (the minimum inclusion). Minimum inclusions would be taxed currently at ordinary income rates, regardless of whether actually received in cash. If those minimum inclusions were not actually paid, the accrued but unpaid amount would be added to a taxpayer’s basis in its investment (that is, unpaid minimum inclusions would accrue and compound at the COCA/minimum inclusion rate).

The minimum inclusion rules applicable to holders of financial capital instruments would look only to a holder’s tax basis in the instruments it owned to determine the holder’s income inclusions. A holder of a financial capital instrument that itself was a business enterprise would include in income the minimum inclusion on that financial capital instrument (that is, its tax basis in that instrument multiplied by the published COCA rate), and also would claim a COCA deduction for its own cost of capital, which would equal its aggregate tax basis for all of its assets (including financial capital instruments that it owned) multiplied by the COCA rate. As a result, a business enterprise would incur no net tax liability to the extent of the minimum inclusion on financial capital instruments that it held as an investor.

It is proposed that the minimum inclusion rules would apply not only to individuals and other business enterprises but also to tax-exempt institutions such as pension plans. That suggestion might be viewed as inflammatory and probably is not absolutely necessary to the adoption of a successful COCA system. Extending the minimum inclusion rules in this manner would, however, further reduce any possible bias under the COCA system (as discussed earlier) for issuers to fund themselves with very short-term obligations, through claiming tax deductions that were relatively large compared to their actual financing costs (assuming a positively sloped yield curve). If we did have the political will to tax all holders of financial capital instruments on their minimum inclusions, it also would address the systemic distortions that occur under current law, under which tax-exempt institutions cannot directly conduct active businesses in a tax-free manner, but indirectly can earn tax-free returns on the operations of those same businesses in the form of returns on debt capital.

As previously noted, a self-employed individual would treat business activities as a business enterprise separate from personal investments. As a result, it is possible that an individual entrepreneur could operate a business enterprise that lost money, particularly in its start-up years, while incurring minimum inclusion income from his investment in his business. If that result were thought to be politically unacceptable, one could (reluctantly) design around the problem by allowing owners of a very closely held business enterprise to use losses incurred by that enterprise (not exceeding the enterprise’s COCA deduction) against the owners’ minimum inclusion income. With the possible exception of that individual entrepreneur rule, business enterprise losses would not be available to reduce minimum inclusion income, but would carry forward at the business enterprise level.

Distributions received by a holder of financial capital in a business enterprise from that enterprise would be treated first as tax-free returns of prior accruals of minimum inclusions, and then as “excess distributions.” (Excess distributions, unlike minimum inclusions, thus always would represent cash received by an investor.) Just as a holder’s tax basis in a financial capital instrument would increase for any minimum inclusions, it also would decrease by any distributions treated as tax-free returns of prior minimum inclusions.

Excess distributions would be tax-free in the hands of tax-exempt institutions, and would be subject to a single low rate of tax (for example, 10 percent to 15 percent) in the hands of all other holders (including other business enterprises) that satisfy a minimum “at-risk” holding period of, for example, 90 days. Gains on the sale of a financial capital instrument to another investor would be subject to the same low tax rate as excess distributions, provided again that the at-risk holding period was satisfied.

The low rate of tax on excess distributions would not apply to other forms of investment (for example, collectibles, artworks, and so forth); gains on those investments would be taxed at full ordinary income rates. So too would excess distributions received by dealers or professional traders in financial instruments. Even without a special rule, that result ordinarily would follow, because those business enterprises ordinarily would fail the 90-day minimum holding period — particularly after taking into account hedges, which would null the holding period. To simplify administration, however, those classes of taxpayers would be carved out of the low-tax
regime on excess distributions, and would be subject (as
dealers are now) to a mandatory mark-to-market system
(and presumably would be permitted, as dealers are now,
to identify on the date of acquisition instruments that are
held for investment).

As noted, the COCA system would apply uniformly to
all holders of a business enterprise’s financial capital
instruments, including other business enterprises that are
investors in the first enterprise. That rule would not
apply within a consolidated group, because the consoli-
dated group would be treated as a single business
enterprise.

One source of a great deal of the complexity in current
law’s taxation of financial instruments is our desire to
distinguish returns on investment from returns of invest-
ment. Both the “earnings and profits” concept applicable
to corporate stock and some of our tax rules for complex
debt instruments address that concern. The COCA sys-
tem would dispense with the “earnings and profits”
concept and instead tax all returns during the life of an
instrument as returns on investment (either as noninclud-
able payments of prior minimum inclusions or as excess
distributions). Liquidations and similar transactions
would be treated as sales, so that basis would be recov-
ered through the normal mechanism of reducing sales
proceeds by adjusted basis. Under a special amortizing
debt rule, distributions made on any fixed-term instru-
ment that provided for the reduction of the holder’s claim
against the business enterprise during the life of the
instrument would be respected to that extent as returns
of principal, so long as the ongoing contractual return on
the instrument was reasonably related to that contractual
reduction of the holder’s claim against the issuer.

A mark-to-market election would also be available to
holders, which would have the effect of washing out any
overinclusion of distributions that arguably were returns
of capital as excess distributions. (An alternative ap-
proach would be to make mark-to-market mandatory and
to treat all distributions beyond payments of prior mini-
num inclusions as excess distributions; I have tentatively
rejected that approach for reasons of practicality.)

In a perfect COCA world, an investor’s aggregate returns
over the life of an investment in a financial capital
instrument issued by a business enterprise would be
taxed such that amounts equal to an internal rate of
return on the taxpayer’s investment at the COCA/
minimum inclusion rate were taxed as ordinary income,
and only the excess as excess distributions. That perfect
result would require true retrospective taxation. The
COCA system’s rules for losses are designed to approxi-
mate that result in most cases, and to jibe with the
taxation of financial derivatives, as described below.

In practice, it is exceedingly rare for a holder of a
financial capital instrument in a business enterprise to
suffer a midstream loss during the tenure of that invest-
ment — that is, to be required to pay cash to the issuer
before maturity. (The allocation of losses to a partner in
a partnership without a concomitant obligation to fund
those losses on a current basis are simply accounting
entries; those entries are important to partners for deter-
mining their future rights and obligations, but would
have no immediate relevance in the COCA system.)

Accordingly, the proposal is to treat midstream losses
incurred by a holder as an additional investment in the
business enterprise.

On the sale or termination of a financial capital
instrument, a holder’s losses first would be deductible at
excess distribution rates (as described below) to the
extent the holder received prior excess distributions. Any
remaining losses would be deductible at minimum inclu-
sion rates to the extent of all prior minimum inclusions
(regardless of whether those prior minimum inclusions
had been received in cash by the holder). Finally, any
remaining losses (which would represent losses of origi-
nal principal) would be deductible at excess distribution
rates.

For example, imagine that I am an investor in the
COCA world. I invest $1,000 in a security (which might
be debt, or stock, or an exotic hybrid — it does not
matter). During the first three years of my investment, I
receive no cash returns, but I nonetheless accrue $150 in
minimum inclusion income. (These minimum inclusions
would represent a compounded rate over the three
years.) At the end of year three, I receive a $500 cash
distribution; that distribution is treated as a tax-free
return of my $150 in accrued but unpaid minimum
inclusions, and as $350 in excess distributions, taxed at a
preferential rate. I hold the investment for another four
years, receiving no further cash distributions, but accru-
ing $200 in minimum inclusions. (This example obvi-
ously does not represent accurate compounding, assum-
ing a constant minimum inclusion/COCA rate over the
seven-year tenor of my investment, but round numbers
keep the example simpler.) I then sell the instrument.

At the time of sale, my tax basis in the instrument
would be $1,200. If I were to sell the instrument for
$1,500, I would have $300 in additional excess distribu-
tions. If instead I were to sell the instrument for my
original cost of $1,000, I would recognize a $200 loss, all
of which would be tax deductible at excess distribution
(not minimum inclusion) rates, because of my prior
recognition of $350 in excess distribution.

Finally, if I were to sell the instrument for $400 (an
example closer to my actual investment experience), I
would recognize a $800 loss. The first $350 of that loss
would be deductible at excess distribution rates; the next
$350 ($150 + $200) would be deductible at minimum
inclusion rates; and the last $100 (that is, loss of original
principal) would be deductible at excess distribution
rates.

The COCA system applicable to holders would re-
quire no special recordkeeping by the issuer or informa-
tion from prior holders. In particular, every investor’s
calculations of its minimum inclusions and excess distri-
butions would be personal to that investor; no minimum
inclusion or excess distribution accounts would carry
over from a prior third-party investor from which the
current investor purchased that security. The COCA
system applicable to holders admittedly would require
significant recordkeeping by each holder, but that record-
keeping would be mathematically straightforward, and,
if reflected on each year’s tax return, would be kept
up-to-date even by individual investors.

In a world of minimum inclusions, capital loss limita-
tions like those found under current law would become
less important, and probably could be abandoned altogether (although the straddle rules would still be required). Taxpayer electivity would be reduced in most cases to obtaining a deduction for loss of principal (including accrued but unpaid minimum inclusions) on one investment while holding other investments that had appreciated beyond the minimum inclusion rate. If this approach was followed, losses that were deductible at the excess distribution rate would simply be tax-effected, and the resulting smaller amount would be fully deductible against all forms of income. For example, if the ordinary income/minimum inclusion rate were 30 percent, and the excess distribution rate was 15 percent, 50 percent of excess distribution losses would be fully deductible against ordinary income.

A holder’s minimum inclusion accruals (and the issuer’s deductions) would be suspended following the issuer entering into bankruptcy reorganization proceedings. An interesting problem that would remain is how to deal with the sick company that was not yet quite dead. Investments in that issuer would require minimum inclusions, even when the ultimate payment of those amounts was uncertain. Here again a mark-to-market election could be employed to wash out any implicit unfairness.

To prevent cascading tax burdens on excess distributions that pass through several levels of business enterprises, it might be thought desirable to introduce a limited “franking” system, under which excess distributions that are subject to tax in the hands of a business enterprise effectively could be distributed tax-free to another business enterprise. Unfortunately, however, franking systems as employed by other jurisdictions appear to give rise both to great complexity and to tax-driven trading to capture the franking benefit. In the end, it may be more desirable to countenance multiple levels of taxation on excess distributions, on the theory that the system at least would encourage a business enterprise to distribute to its ultimate investors any cash not actually needed for its business.

As previously pointed out, the COCA system has no cascading tax problem associated with minimum inclusions. A business enterprise that is a holder of a financial capital instrument in a lower-tier business enterprise, and that thereby must include in income the minimum inclusion associated with that instrument, also has capital of its own tied up in that investment, and therefore will obtain a COCA deduction to reflect that incremental capital.

C. Financial Derivatives

Financial derivatives will bedevil any tax system, because (i) the same (or at least structurally similar) instruments can be used in completely different contexts—for example, as a hedge of a liability or of an asset; (ii) a single derivative contains both an investment component and a “fair bet” component, in proportions that can vary dramatically from derivative to derivative; and (iii) the same instrument can constitute an economic liability one day and an asset the next.

The COCA system is an imperfect base from which to build a tax model for financial derivatives, but it is vitally important that the taxation of derivatives not depart dramatically from the taxation of the underlying financial capital instruments. Accordingly, the proposal for financial derivatives is as follows:

1. Dealers and professional traders in financial instruments would be subject to mandatory mark-to-market accounting (and full ordinary tax rates) for all financial derivatives held or issued by them (as well as all financial capital instruments held by them, as described earlier); the hedge accounting rules described immediately below would, however, take priority, to address traditional liability hedging.

2. Current law’s tax hedge accounting principles would be preserved (and expanded). The tax hedge accounting rules would take precedence over the general rule below and could be invoked either by taxpayers or the fisc. So, for example, if a business enterprise had issued fixed rate debt and now wanted to swap that fixed coupon into floating, the swap would be treated as relating to the business enterprise’s cost of capital; as a result, the business enterprise would recognize neither income nor expense in respect of that liability hedge. Similarly, hedges of inventory-type property would be taxed at ordinary income rates, and the timing of hedge gains and losses would be matched with the timing of gains/losses from the inventory-type property.

3. Financial derivatives held by taxpayers that were not dealers or professional traders and that were not covered by tax hedge accounting principles would be taxed under an asset/liability model. The calculations described below would be performed on a contract-by-contract basis. The basic theme is to treat a derivative contract each year as an asset or a liability and then to apply the rules developed earlier to the resulting instrument.

Under the asset/liability model, a taxpayer’s net cash outflow on a financial derivative contract in the first year of that contract would be treated as a nondeductible investment in that contract. That investment in turn would attract a minimum inclusion therefrom. Subsequent cash outflows would add to the taxpayer’s investment in the contract. The taxpayer’s investment in the contract would create an asset on the taxpayer’s balance sheet. If one imagines that those cash outflows were funded out of cash on hand, it is easy to see that the taxpayer’s annual COCA deduction would remain unaffected (that is, the taxpayer would simply have substituted an investment in the contract for cash on hand).

Cash inflows received by the taxpayer in a subsequent year would be treated first as returns of prior accrued minimum inclusions, then as returns of capital, and finally as a liability of the taxpayer (a Derivative Liability). Similarly, the counterparty to that hypothetical swap would record a liability in the first year of the swap equal to the net cash inflow on that swap. The excess distribution rules would be triggered only at maturity/termination of the contract.

As explained earlier, the COCA system effectively ignores an issuer’s actual cash flows on its “regular” financial liabilities, like a corporate stock or debt; instead, an issuer obtains an arbitrary cost of capital allowance deductions measured by the sum of the issuer’s bases in all its assets. Cash received by a taxpayer in respect of a Derivative Liability also would increase asset basis, and
therefore a taxpayer’s COCA deduction, but because financial derivatives combine elements of both capital investments and pure bets, the tax rules for handling the termination of Derivative Liabilities would differ slightly from those applicable to traditional capital instruments.

At termination, parties to a financial derivative would recognize gain or loss. Gain would be taxed first at excess distribution rates; loss would be taxed at minimum inclusion rates (to the extent of prior minimum inclusions) and then at excess distribution rates. (In the case of a Derivative Liability, gain or loss would be computed by comparing the amount of that recorded liability to the amount the taxpayer in fact was required to pay.) From the perspective of a taxpayer with a net investment in a financial derivative contract at that time, that result is directly analogous to the rules that would apply to the sale of a traditional capital instrument. For a taxpayer with an outstanding Derivative Liability, however, the result is different. Under the COCA system, taxpayers would not recognize gain or loss on retirement of their traditional capital obligations (for example, debt they have issued), but would recognize gain or loss on the retirement of derivative liabilities. The reasoning here is that it is desirable to preserve symmetry in tax results for traditional financial derivatives, such as an on-market interest rate swap, where the contract is a “fair bet” at the outset. The unfortunate consequence of this rule, however, is that it requires developing a bright line to distinguish derivative liabilities from liabilities from traditional capital instruments.

Imagine, for example, that Taxpayer X paid $50 for a three-year European style option written by Taxpayer Y on the S&P 500. Also imagine that the aggregate minimum inclusions on that $50 investment over the contract’s three-year life were $10, and that at maturity the contract paid (a) $80 or (b) zero. Taxpayer X would recognize $10 of ordinary income over the life of the option, and its adjusted tax basis in the contract would be $60. At maturity, in case (a), Taxpayer X would recognize $20 of excess distributions. In case (b), Taxpayer X would recognize $10 of ordinary loss (the first dollars of loss always reverse prior minimum inclusions) and then $50 of additional loss, deductible at excess distribution rates.

Taxpayer Y would record a $50 liability at the outset. As with other liabilities, no deduction would arise directly from that fact, but Taxpayer Y’s aggregate basis in its assets would increase by $50, which would create a larger COCA deduction.

At maturity, in case (a), Taxpayer Y would recognize $30 in loss, taxable at excess distribution rates. In case (b), Taxpayer Y would recognize $50 of gain; that gain would be taxed at excess distribution rates.

The rules for financial derivatives are disappointingly complex and imprecise. In effect, the reason is that the COCA system assumes that “ordinary” financial capital instruments (like corporate stock and debt) are in fact primarily capital raising instruments, with returns that over time bear some relationship to the time value of money as applied to that capital. Financial derivatives, by contrast, can contain both capital components and pure bets; the simplifying assumptions underlying the COCA-base case fall down in those circumstances. In practice, however, it is to be hoped that the exceptions (hedge accounting and mark-to-market) swallow the rule.

V. Repeal of Tax-Free Reorganization Rules

Under the BEIT, all acquisitions of a business enterprise (regardless of the legal form of that business enterprise) would be taxed as asset acquisitions of the target, with gain (or loss) recognized both by the target and by the owners of the target’s financial capital instruments. The trigger for those acquisition accounting rules would be the same as the threshold for consolidation, described below; that is, the rules would be triggered whenever a business enterprise entered or left tax consolidation. The rules also would be triggered by in-kind excess distributions or liquidations.

Gain to holders of financial capital instruments would be taxed (at low rates) under the excess distribution rules described earlier. The target would pay tax on any previously unrealized gain on any financial capital instrument that it held, in the same manner. The target would pay tax on its inventory-type property (what today is section 1221 property) at ordinary income rates. The target’s gain from the sale of other assets (business assets) would be taxed at tax-neutral rates, by which I mean that those rates would be set such that the present value to a buyer of the tax benefits attributable to the step-up in an asset’s depreciable basis would equal the seller’s tax liability on the sale of that asset. As a result, the tax-neutral rates imposed on a seller would be higher in respect of property for which the statutory depreciation recovery period was shorter, and lower for property with a longer depreciable life. Losses from the sale of business assets would be tax-deductible at the same tax-neutral rates (for example, the amount of those losses would be tax-effected and the resulting smaller loss would be available to offset ordinary income).

A business asset could be defined in general as any asset that is subject to an allowance for depreciation or amortization in the hands of the transferee. Because goodwill and similar intangibles now are understood to constitute amortizable assets, they would be treated like any other business asset in an acquisition. Inventory-type property and financial capital instruments would not constitute business assets.

Tax-neutral rates for the disposition of a business enterprise’s business assets would apply to all transfers of business assets (which would exclude inventory-type property and financial capital instruments), not just the case of business enterprise acquisitions. The idea is to remove tax considerations from the calculus of whether to hold or to sell a business asset, because in every case the present value to the buyer of a step-up in tax basis would equal the tax cost to the seller of recognizing that gain.

Because every acquisition of a business enterprise would be a taxable asset sale, a target’s tax attributes would disappear in an acquisition. That result no doubt economically is indefensible, but it pales in insignificance when weighed against the costs of supporting current law’s legions of tax attribute maintenance specialists. Code sections 382 and 384, for example, would become unnecessary, unless one were to conclude that it was troubling that a group could acquire working control of a
business enterprise with net operating losses and then employ that enterprise as a vehicle for future acquisitions, using its NOLs to shelter the income of those future targets. I am not convinced, however, that something that current owners can do today should be prohibited simply because the business enterprise has new owners tomorrow.

The tax-neutral taxable acquisition model would apply to all transfers of business assets to a different business enterprise, including what today would be treated as tax-free incorporations. That result should not be viewed as unfair or as discouraging new business ventures. By virtue of imposing tax-neutral tax rates on the transferor, the new acquisition model economically should be identical to a carryover basis transaction; that is, the sum of the tax detriment to the transferor and the tax benefit to the transferee of that transfer should be zero, just as in a tax-free incorporation or acquisition. At the same time, the new model would eliminate all of the attribute-tracking rules that underlie so much of the complexity in today’s tax regimes for both corporations and partnerships.

Of course, in practice there will be imperfections. The transferee might not be an immediate taxpayer, or the wrong discount rate might be embedded in the tax rate tables. This report effectively accepts the prospect of those imperfections as a fair price for the clarity and simplicity the new system would offer.

Under the new system, every transfer of a business asset would be taxed in an identical manner. There would, however, be one difference between an incorporation-type transaction and a classic acquisition of one business enterprise by another, which is that in the latter case, but not the former, there would be preexisting holders of target’s financial capital instruments, and they would be taxed on the transaction at excess distribution rates. That double tax moves away from efficiency goals, but so long as the excess distribution tax rate (as previously advocated) is set at a reasonably low figure, no material distortions in behavior should result. In that regard, experience suggests that concerns for the tax burdens of public shareholders rarely have a measurable effect on the structures of corporate acquisitions.

To promote economic efficiency, narrow tax-free spinoff rules would be retained. Under the new rules, spinoffs would avoid holder-level excess distribution tax, but only to the extent that neither transferor nor transferee held appreciated financial capital instruments or other investments (for example, Treasuries), or inventory-type property. Business enterprise-level tax would still apply (and with it, the resetting of tax attributes); that tax should be consistent with efficiency goals, for the reasons stated above.

VI. Tax Consolidation

Under the BEIT, two or more enterprises mandatorily would consolidate when held through a common chain of ownership, defined as either:

(i) the ownership of more than 50 percent of a business enterprise’s total financial capital (which for this purpose would exclude all instruments with a maturity at the time of acquisition or issuance of one year or less);

or

(ii) the ownership of 80 percent or more of the total voting power of all financial capital instruments entitled to vote for the enterprise’s board of directors (or analogous body), and 20 percent or more of the business enterprise’s total financial capital.

It technically would be possible for a single business enterprise to be affiliated with two different parents under the above rules. In those cases, rule (ii) would take priority over rule (i).

The consequences of tax consolidation would be similar to financial accounting consolidation today. The consolidated group would be treated as a single business enterprise, and no significance would be attached to the separate juridical status of any part of the consolidated business enterprise. As a result, the sale of a corporate subsidiary from a consolidated group would always be treated as an asset sale, even if the buyer were the public (for example, in an IPO carveout of the subsidiary).

Minority investors in a consolidated subsidiary would be treated as investors in the entire consolidated group — that is, there would be no difference in tax treatment between minority investors in a consolidated subsidiary and investors in the common parent, except for the timing of excess distributions (which would follow the timing of whenever those excess distributions actually were made).

Corporate acquisitions by a consolidated group would be treated under the acquisition rules described earlier. A consolidated group that acquired less than a consolidating interest in another business enterprise would hold that interest as simply another financial capital instrument, just as would any other holder.