

## **ED KLEINBARD'S BUSINESS ENTERPRISE INCOME TAX: HOW WELL DOES IT SOLVE THE PROBLEM OF HOW TO TAX CAPITAL INCOME?**

Eric Jay Toder

*Ed Kleinbard's Business Enterprise Income Tax (BEIT) would eliminate many of the distortions in current US taxation of investment income, including choices between debt and equity finance and among dividends, stock buybacks, and retained earnings; business choices among alternative assets and between investing in the United States and overseas; decisions on exchanging asset ownership; and choices among how firms are organized. But, similar with other proposed reforms, BEIT is less effective in taxing economic rents earned by the wealthiest individuals. BEIT fits with Kleinbard's overall view that average citizens would benefit from a larger government funded by moderately progressive taxes.*

*Keywords: normal returns, economic rent, capital income, neutrality*

*JEL Codes: H21, H25*

### **I. INTRODUCTION**

It is a great honor for me to be asked to write a paper assessing Ed Kleinbard's proposal for business tax reform, the Business Enterprise Income Tax, or BEIT. After a long career in private practice and a brief stint in government, Ed became an exceptionally productive and prolific scholar. We are all in debt for what he has taught us about corporate taxation, international taxation, tax expenditures, and many other topics.

Policy analysts are often either big thinkers or detail people. Ed was both. He combined both a broad perspective on public finance and the role of government with an exceptional attentiveness to the fine details of policy design and a deep knowledge

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of techniques that multinational corporations use to exploit imperfections in the tax law to minimize their tax liability. His varied experiences as a tax practitioner, public official, and academic gave him unique insights into these realities of corporate tax planning and the effects of interest groups on the legislative process. He used this knowledge to develop practical proposals to achieve broader reform goals.

Ed was far from a detached academic. He combined intellectual rigor and attention to the realities of business practice with a deep passion for social justice. He was a strong and often combative advocate for policies that he believed would serve the general interest by promoting both fairness and economic growth and was especially concerned about how best to use fiscal policy to address the growth in income inequality that we have experienced in the past few decades.

This paper reviews the BEIT, a proposal to tax income from capital at both the individual and firm level that Ed developed in a series of papers between 2005 and 2019 (Kleinbard, 2005, 2007a, 2007b, 2010a, 2017a, 2017b, 2017c). Ed strongly believed that a fair tax system required that people pay tax on their capital income, but he also believed tax rules should be designed to minimize distortions on business decision-making. BEIT represents his efforts to balance these potentially competing considerations. The purpose of the BEIT was to create a neutral tax system that would remove tax distortions that impede economic efficiency, while ensuring that owners of capital would bear an appropriate share of the federal tax burden.

## **II. WHAT IS CAPITAL INCOME AND HOW SHOULD WE TAX IT?**

This paper begins with some preliminary reflections on problems in measuring capital income and alternative criteria for assessing fairness and efficiency in capital and business income taxation. The following sections provide a brief summary of Kleinbard's BEIT proposal; compare the tax burdens under BEIT, current law, and alternative reforms under a variety of assumptions; review how Ed addresses some specific issues in the BEIT proposal; and discuss how the BEIT fits with Ed's broader perspectives on fiscal policy and income inequality.

### **A. How to Define Capital Income?**

Capital income is often defined and measured as returns to business profits, including the sources of individual taxpayer income that come from profits — dividends, interest income, and capital gains. But not all income from business profits fits into the definition of capital that is used in economists' models that assess the efficiency properties of capital income taxation. This paper begins by comparing this traditional economics definition with Ed's broader definition of capital income.

It is helpful to classify income along two dimensions — labor versus capital, and contractual income versus residual income or profit (Table 1). Capital income is the reward for deferring consumption and may also include a risk premium that reflects

**Table 1**  
Classification of Income

	Labor Income and Other	Capital Income
Contractual income	Employee compensation	Interest income
Profits of business owners	Entrepreneurial returns and windfall gains	Normal returns to equity (risk-adjusted)

the year-to-year variability of returns on even a diversified portfolio of equity investments.<sup>1</sup> By this definition, not all business profits are capital income. For example, the discovery of an unusually large deposit of easily recoverable oil that then is translated into a profitable business provides a windfall gain to the owner, not a return to deferring consumption. Similarly, the invention of a new product or production method and its conversion into a profitable business provides a return to the entrepreneur's effort and foresight in addition to a return to deferring consumption.

Contractual income is a regular receipt of income that comes from some form of legal arrangement. It can include either a promised form of payments for the supply of capital, such as interest payments on a bond, or negotiated payments for labor services in the form of wages or fringe benefits. Generally, recipients of contractual income are sacrificing the potential for receiving large gains from successful business activities in exchange for a predictable source of income over a specified period.

Note that the distinction between contractual income and profits is a conceptual one, and economic arrangements often have elements of both. As Ed notes throughout his articles on BEIT, financial instruments are complex and may have elements of both debt instruments (guaranteed payments) or equity instruments (shares in profits), making them difficult to classify when the tax law tries to distinguish between them. Labor compensation arrangements may also be complex, containing elements of guaranteed salary, performance-based compensation, profit sharing, or stock options.

Business owners are entitled to any returns that exceed the payments they must make to suppliers of labor and capital services. This includes returns to their own capital and labor contributions and economic profits — defined as returns in excess of those required to induce them and other contributors (employees, creditors) to supply labor and capital to the business. Ed counts in his definition of capital income all returns to business owners and creditors, including both normal returns and economic profits. But if, instead, capital income is defined as the (risk-adjusted) reward for deferring consumption, the portion of profit that he labels economic rent (the bottom left quadrant of Table 1) may instead be viewed as either a reward to the labor of the entrepreneur or as a windfall.

<sup>1</sup> Kleinbard in his papers distinguishes between risk and uncertainty. Risk reflects the variance of outcomes, as with a coin toss, where the underlying probability distribution is known, but not the outcome of a single or small number of events. Uncertainty is when the underlying probability distribution of outcomes is unknown, as in the case of an entrepreneur introducing a new product or service. See discussion of the concept of risk and uncertainty developed by Frank Knight ([1921] 2002) in Kleinbard (2017a).

## B. What Is the Appropriate Tax Base?

Economists have long debated whether consumption or the Haig-Simons measure of income is the appropriate way to measure ability to pay. But Kleinbard's BEIT proposal appears to endorse a hybrid of consumption and an alternative tax base that I will label permanent income.

*Consumption* excludes income from capital, or the return to delaying consumption. The base of a consumption tax does, however, include economic rent, so it does include the bottom left quadrant of Table 1. By a simple mathematical identity, taxpayers' lifetime consumption equals their initial wealth plus the present discounted value of windfall gains and lifetime earnings. It may or may not include bequests and gifts they give (subject to either an estate tax or an inheritance tax), depending on whether the base is lifetime consumption of an individual or couple or intergenerational consumption of a family.

*Haig-Simons income* equals annual consumption plus the change in net worth. Net worth can increase either through saving or through a revaluation of existing assets. It is the potential amount of annual consumption in any year from the sum of earnings plus income from assets (both normal returns and capital gains/losses) that leaves wealth unchanged.

Advocates of consumption taxation argue that it is neutral on a lifetime basis because it treats people with the same lifetime ability to pay the same without regard to how they choose to allocate their consumption resources over time and without regard to the time pattern of their lifetime earnings. In contrast, a Haig-Simons income tax would impose a relatively larger lifetime tax burden on people who consume later in life or earn earlier in life; in both those cases, an individual would save more and therefore pay more tax on their capital income under an income tax. Advocates of income taxation, in contrast, note that the possession of wealth itself confers utility and economic power and therefore accruals of wealth should be to subject to tax even if not consumed immediately.<sup>2</sup>

*Permanent income* in any year is the potential permanent annual consumption from returns to all assets, both financial wealth and human capital. A permanent income base would include earnings (whether currently saved or consumed) and income from existing assets, but it would exclude asset revaluations. In many respects, as we will discuss below, Kleinbard's BEIT proposal resembles more closely a tax on permanent income instead of tax on Haig-Simons income because it generally excludes capital gains associated with asset revaluations for reasons other than reinvestment of corporate retained earnings.

<sup>2</sup> Ed emphasizes that a consumption base with graduated rates may also violate intertemporal neutrality. If saving, by raising income over time, pushes a taxpayer into a higher marginal rate bracket, the tax system will impose a higher tax rate on future than on present consumption. He further suggests that a flat rate tax on capital income at a moderate tax rate may violate intertemporal neutrality less than a consumption tax with steeply progressive rates.

Consider the example of a bond that pays \$200,000 a year in perpetuity, with no repayment of principal. At a 10 percent interest rate, the value of the bond is \$2 million. If the interest rate subsequently declines to 5 percent, the bond's value increases to \$4 million.

The Haig-Simons definition counts the \$2 million of capital gain in the year the interest rate declines as income because bondholders can spend an additional \$2 million immediately while leaving their wealth unchanged. So, in that sense, the decline in the interest rate makes them better off. But permanent income from the bond is unchanged and, if they want to consume a constant stream of income from the asset in perpetuity, the change in the interest rate has not made them better off. More generally, changes in the relative price of present and future consumption affect people differently depending on their planned pattern of future consumption. A decline in the rate of return (an increase in the relative price of future consumption) makes people better off if they plan to spend down their wealth, makes them worse off if they plan to save and reinvest their income from assets, and has no effect on their well-being if they want to maintain a level consumption stream from their wealth over time (including a bequest that provides the same consumption level to their heirs).

In general, the Haig-Simons measure of income is the standard income measure used by public finance economists. But the National Income and Product Accounts do not count capital gains (other than those associated with corporate retained earnings) as income. And, as we shall see below, Kleinbard's BEIT proposal is much more akin to a tax on permanent income than to a tax on Haig-Simons income because of the way (with some exceptions) that he would tax capital gains.

### C. Can We Measure Haig-Simons Income?

Measuring Haig-Simons income requires measuring changes in the annual net worth of business assets, which depends on the present value of future net revenues they will generate. One can observe expenditures by firms, but it is much harder to determine how much these expenditures increase a firm's value because the time pattern of the revenues many expenditures will generate is very hard to discern.

Depreciation rules intend to capture the pattern of annual changes in the value of investments in physical assets, such as buildings and machinery, and can in some cases do so with reasonable accuracy based on observed prices of used assets that are frequently traded or can be imputed from data on the average service life of different types of assets. But in many cases, measures of economic depreciation are very imprecise. It is even harder to estimate the time pattern of returns from "self-constructed" assets such as spending on research and development and marketing and spending on items not generally classified as capital, such as salaries to employees for improving firm governance, recruiting, and strategic planning.

The current tax law measures imperfectly the income generated by firms, in part not only because of provisions that provide intentional incentives to some forms of investment but also because of this general difficulty of measuring business income

accurately. One possible way around this is to measure income at the individual investor level instead of at the business level. Two general approaches are:

1. Imputing a normal rate of return to the basis of individual holders of business assets, while exempting normal return on the firm's basis in assets. This is the general approach used in Kleinbard's BEIT. It effectively is a tax on the permanent income from assets, while generally exempting asset revaluations.
2. Taxing individual asset holders on a mark-to-market basis, with their asset income equal to dividends plus net changes in accrued capital gains on business assets, whether realized or not (e.g., Toder and Viard, 2016). While mark-to-market plans can accurately capture the income (as perceived by market participants) of owners of publicly traded businesses, it is very difficult to apply it to owners of closely held companies whose shares are not traded in organized markets.<sup>3</sup>

A final approach, of course, is to give up entirely on income taxation as too hard to apply in a comprehensive and uniform way and instead use a consumption tax base. This can be implemented at the business level by allowing firms to expense immediately all outlays, both for current expenses and capital investments, and denying interest deductibility (or, equivalently in present value terms, including loan proceeds in income and allowing deductions for all loan repayments).

#### **D. How to Deal with the Special Case of Start-Up Firms and Entrepreneurial Income?**

New firms present a special example of the conceptual issues in income measurement. Consider a firm whose founder invents a new product or production technique and creates a firm to perform the new activity at scale and market it. All current outlays are for the purpose of building up a firm so that it can start earning net revenues at some future time. As expected future net revenues increase and their starting point comes closer in time, the value of the firm increases. But, in general, the value of the firm (the present discounted value of its future revenues) is unobservable during its start-up phase.<sup>4</sup>

Toder (2020) presents an example of a new firm started by entrepreneurs in year 1, which starts to generate a steady stream of revenues (net of current operating costs and depreciation) in year 8, at which point the entrepreneurs take the firm public and sell their firm to a large company. The entrepreneurs' "labor income" in year 1 is the

<sup>3</sup> As an alternative to mark to market that could apply also to holdings of assets in publicly traded companies, Grubert and Altshuler (2016) suggest replacing a large share of corporate tax revenues with a retrospective tax on realized capital gains (including gains on assets transferred at death) that would include an interest charge to capture the benefits of deferral.

<sup>4</sup> Note that entrepreneurial activities of this type can occur within existing firms as well as new firms (invention of new products, introduction of cost-saving technologies, expansion to new markets, etc.), but these may add to a firm's observable current price/earnings ratio if the firm is publicly traded.

discounted present value of the future stream of revenues beginning in year 8 that is attributable to their efforts in year 1. Their capital income is the return for waiting until year 8 to earn profits — that is, the appreciation in value when the profits become closer to beginning. If we assume an eight-year lag between the entrepreneurial effort and the start of positive net revenues attributable to it, and assume a discount rate of 6 percent, the return to labor is 2/3 of the capital gain from the start-up activity and the capital component is the remaining 1/3 of the gain. The capital share varies positively with the discount rate and the length of time before profits begin.

Under current law, the appreciation in the value of the entrepreneurs' share in the firm (the entrepreneurial component of income) is untaxed until they sell the firm and then taxed at a preferential rate due to both the lower rate on capital gains and the deferral of capital gains tax until realization.<sup>5</sup> It is for this reason that much of the income of many of today's wealthiest Americans has been taxed at a very low rate when accrued or escaped tax entirely.

Kleinbard (2017a) provides a very insightful discussion of the motivation of entrepreneurs, perhaps drawing on his own experience in the private sector. In his words: "The entrepreneur is the person who is willing to absorb the unavoidable residuum—the uncertainty—in return for the possibility of profits. The entrepreneur has unique foresight and managerial skill, along with confidence in her judgment and the 'disposition to back it up in action.'"

He further notes that what makes the entrepreneur different is a completely different attitude toward risk than most investors: "The entrepreneur takes on uncertainty because the entrepreneur is irrationally optimistic. That is plainly true from observation and (together with uncertainty) offers a useful model of what makes the entrepreneur special: the entrepreneur, unlike the risk-averse general population or the risk-neutral homo economicus, accepts uncertainty because the entrepreneur alone is irrationally optimistic."

He adds,

Perhaps intuitions along these lines explain the broadly shared view among policymakers that entrepreneurship is special (in a good way) and has positive externalities. The common view of the positive externalities of entrepreneurship and the heroic nature of the entrepreneur standing firm in the face of the void of unknowns lead to the universal instinct among policymakers (but not economists) that positive entrepreneurial returns should be taxed more lightly than returns from nonentrepreneurial endeavors to create a "neutral" investment horizon for this special class of cockeyed people. . . . If one accepts the policy bias in favor of entrepreneurship, there is a fundamental tension in practice between getting correct the taxation of rents, on the one hand, and entrepreneurial returns, on the other. One points in the direction of high tax rates; the other, in the direction of concessionary low

<sup>5</sup> Of course, entrepreneurs may choose to continue to manage the firm they start, in which case they pay capital gains tax only on the portion of the firm they choose to sell when they take the firm public.

rates. But because returns to uncertainty in turn can beget rents, distinguishing between the two seems impossible in any reasonably implementable capital income tax.

### **E. Do We Want to Tax Capital Income?**

Ed's work includes an extensive discussion of the economic literature that finds that a zero tax on capital income is optimal under certain assumptions, citing in particular the influential work of Atkinson and Stiglitz (1976).<sup>6</sup> To the extent business profits reflect entrepreneurial returns or economic rent, however, this literature does not imply an optimal tax of zero on profits because it uses the classical definition of capital income as the return to deferring consumption. And Ed notes that neither Atkinson nor Stiglitz in their more recent writings have personally favored exempting investment returns from income tax.

Ed further asserts that capital income should be taxable in a world with inheritances, claiming there is no inefficiency from taxing inheritances and significant unfairness from exempting them. But due to the efficiency concerns from the distortion between present and future consumption that is raised in the economic literature, Ed does not favor a comprehensive income tax either. Instead, he would tax capital income at a uniform flat rate that is lower than the top marginal tax on earnings.<sup>7</sup> He cites as examples of this preferred approach to taxation, although not necessarily endorsing all the details of implementation, the dual income tax systems in Scandinavian countries (Sorensen, 1994; Cnossen, 2000).

## **III. SUMMARY OF THE BEIT**

Ed's goals in creating the BEIT are to tax capital income at a uniform flat rate in a way that is neutral among different economic activities and at a rate lower than the top marginal rate on earnings. This promotes economic efficiency by removing tax considerations from business decision-making, eliminating the incentive to engage in transactions that game the system to reduce tax liability, and reducing costs of compliance and administration.

### **A. Goal of Achieving Neutrality**

There are numerous margins of decision-making across which there can be distinctions in tax treatment. Some of the key decision margins Ed's papers address are as follows:

<sup>6</sup> His papers on BEIT include an extensive discussion of the Atkinson-Stiglitz theorem and how it has affected both economists' and lawyers' approaches to tax policy analysis.

<sup>7</sup> Ed argues that a graduated consumption tax does not achieve intertemporal neutrality because, if by saving, an individual increases their future consumption, this may move them into a higher marginal rate bracket. By this mechanism, a graduated consumption tax, like an income tax, may also favor present over future consumption. He further argues that the intertemporal distortion from a flat rate tax on capital income may therefore not be significantly larger than the intertemporal distortion from a graduated consumption tax.

- *Debt versus equity.* Ideally, the tax system should be neutral between decisions by firms to finance their investment with debt or equity. But under current law, corporations may deduct interest payments, but not distributions to shareholders, while dividends and capital gains are taxed at a lower rate than interest income.
- *Different types of enterprises.* Under current law, individuals holding equity in subchapter C corporations face two levels of tax — a tax on the income of the corporation and a second tax on dividends and on capital gains attributed to retained earnings. In contrast, investors in flow-through enterprises (partnerships, limited liability companies, subchapter S corporations) pay a single level of tax at ordinary income rates of their owners or partners and, since the enactment of the Tax Cuts and Jobs Act (TCJA) of 2017, can claim a 20 percent deduction for certain qualified business income (QBI).
- *Labor income versus capital income.* Labor income generally faces ordinary income tax rates, in addition to payroll taxes, of which the portion used to finance Medicare hospital benefits (the hospital insurance, or HI, tax) is not subject to a ceiling. In contrast, capital income is subject to a wide variety of effective rates. Differences in the taxation of earnings and profits within a business taxed as a flow-through results in arrangements that allow income recipients to recharacterize taxable earnings as either capital gains or business profits.
- *Changes in capital ownership.* Changes in asset ownership can occur either through the reorganization of firms or by exchanges of financial assets among investors. Either of these actions could trigger tax consequences, which could discourage certain reorganizations or asset sales.
- *Real investments in assets and industries.* Because of differences in rules for recovering capital costs (depreciation and depletion) across assets and industries and because of selective tax credits for certain activities, the US system of business income taxation imposes different effective tax rates on different real investments.
- *International margins.* US tax rules affect both incentives to invest in foreign countries instead of in the United States and incentives for parent companies of multinational corporations to characterize themselves as foreign-resident companies instead of US residents. In general, tax rules that provide preferential treatment of foreign-source income of US multinationals encourage US companies to invest and report income in low-tax foreign jurisdictions, while they reduce incentives for conducting activities in foreign-resident instead of US-resident companies.

In general, it is impossible to achieve neutrality across all margins because some activities are administratively or politically very difficult to tax — such as labor used in home production, returns to household capital (imputed rent), unrealized appreciation

of assets in privately owned businesses, and foreign-source profits of foreign-resident companies.

Given these non-neutralities, however, efficiency considerations dictate that there should be similar treatment of activities that are very close substitutes. Kleinbard's BEIT proposal focuses in particular on achieving neutrality among activities he regards as close substitutes, such as the choice between characterizing financial transactions as debt or equity; the choice under current law between organizing firms as separate taxpaying corporations or pass-throughs entities; choices among capital investments in different assets, industries, or countries; and choices among different locations for reporting profits of multinational corporations.

Kleinbard's BEIT provides a lower top rate on capital income (which he defines to include all business profits) than on labor income. This creates a problem of how to distinguish between labor income and profits within owner-managed firms, a problem that also exists in current law. The BEIT proposal therefore includes explicit rules on how to distinguish between labor income and profits within owner-managed firms.

Ed was also willing to accept differences in tax rates based on the tax residence of multinational corporations, a concern he regards as less serious than the issues that result from taxing foreign-source income of US multinational corporations at a different rate than domestic-source income. He would address this concern by keeping the corporate tax rate low and modifying the definition of corporate residence to make it based on real activities instead of simply on a firm's place of incorporation.

## **B. Overview of BEIT**

The BEIT has the following major features:

### *1. Flat Rate Tax on Capital Income*

Capital income (including business profits) would be taxed at a flat rate of 25 percent. This would be implemented by taxing "normal returns" to capital at the individual investor level and economic rent at the firm level.

### *2. Individual Income Tax on Normal Returns*

All holders of either debt or equity in firms would report "imputed" income equal to their basis in the firm multiplied by a deemed rate of return. This income would be taxable at a flat rate of 25 percent. Dividends received would reduce an individual's basis in the firm if not reinvested. Capital gains (losses) from the sale of assets would increase (reduce) basis when reinvested.

### *3. No Company-Level Tax Burden on Normal Returns*

Companies would annually deduct a cost of capital allowance (COCA) equal to their basis in assets multiplied by the normal rate of return. Firms could claim depreciation

deductions, as provided for in the tax code, but depreciation deductions they claim, by reducing asset basis, would reduce future COCA deductions. Therefore, depreciation would have no effect on the present value of deductions, discounted at the normal return. The COCA deduction would provide the same present value of deductions as expensing. The result would be a zero effective tax rate on normal returns at the firm level.

The combination of the COCA deduction and the tax on imputed returns of individual investors means that all normal returns would be taxable once at the individual taxpayer level.

#### *4. Equivalence of Debt and Equity*

There would be no difference in the treatment of debt and equity at either the firm or investor level. The COCA would apply to all assets, whether financed by debt or equity. The imputed return tax would apply equally to individual holdings of both business debt and business equity. There would be no deduction of actual interest payments and no tax on the receipt of interest income.

#### *5. Taxation of Economic Rent*

Profits above the normal return would be fully taxable at the company tax rate of 25 percent. Because individual investors would be taxable only on their imputed normal return, there would be no additional tax at the individual level on excess business returns.

#### *6. Taxation of Earnings*

Earnings would be taxable under the graduated individual income tax at rates that exceed the capital income tax rate for upper-income taxpayers. For purposes of exposition, assume that the top marginal rate would be 40 percent, close to the top rate before the TCJA.

#### *7. Taxes for Different Types of Firms*

All firms (except sole proprietorships) would pay a separate corporate income tax of 25 percent on their supernormal profits. Special rules would apply to owner-managed firms to determine their share of their owners' income taxed at the capital income tax rate of 25 percent and the share taxed under the graduated individual income tax rate schedule. This would eliminate the distinction between C corporations and pass-through enterprises, although for all owner-managed firms there would still be a need to split the income between taxable profits (taxed as capital income) and taxable wages.

### 8. *Taxes on Capital Gains*

There would be no tax on realizations of capital gains, thus reducing the lock-in effect under current law, which taxes realized gains but defers (or eliminates if held until death or donated to charitable organizations) tax on unrealized gains. Realized gains that are reinvested, however, would raise investors' basis in assets, thereby triggering higher future taxes on imputed returns.<sup>8</sup>

### 9. *International Provisions*

Multinational corporations that are resident in the United States would pay tax at the 25 percent capital income rate on a current basis on their worldwide income, including income of their controlled foreign companies. This worldwide consolidation would remove incentives for US firms to invest overseas or shift reported income to low-tax jurisdictions.

The definition of corporate residence would be based on the location of the company's headquarters, not simply the place of incorporation. This would make it more costly for a firm to shift their residence to other countries to avoid the tax on foreign-source income, either through inversion transactions or through mergers with foreign-resident corporations.

## IV. COMPARISON OF BEIT WITH CURRENT LAW AND OTHER REFORMS

This section compares the BEIT with current law and two other major proposals to restructure capital income taxation — corporate integration and a mark-to-market tax on income of individual capital owners. To facilitate comparisons between the structural aspects of these options, the computations below assume a common set of tax rates — 25 percent for corporate profits (where taxable), 25 percent for those components of individual income subject to preferential rates on capital income, and graduated rates on ordinary income under the individual income tax up to a maximum rate of 40 percent.

The first group of tables compares the four tax policy options for firms operating in a competitive environment where they earn a normal return (assumed to be 6 percent) on marginal investments in capital assets. They examine four different scenarios: (1) no preferential treatment of either selected business investments or selected investors, (2) preferential treatment for favored business investments, either types of assets or selected industries, (3) preferential treatment for favored investors, such as tax-exempt institutions or individuals saving within qualified retirement plans, and (4) how the different types of tax systems would affect investors in firms that earn supernormal profits or economic rent.

<sup>8</sup> Thus, both imputed returns to current basis and realized capital gains would increase investors' basis in the firm, thereby triggering higher future taxes on imputed returns. But only imputed returns would be taxable when earned, not realized capital gains.

### A. Example: Perfect Competition, No Preferences for Savers or Investors, Savers in Top Tax Bracket

The first examples (Tables 2–5) show the effective tax rates to returns of a marginal investment of \$1,000 for the four policy options under the following assumptions:

- Ordinary income is taxable at graduated rates, up to a maximum tax rate of 40 percent under all four options. Ordinary income includes earnings under BEIT; earnings, interest income, and profits from flow-through businesses under current law; earnings, interest income, and dividends (grossed up for withholding or imputation credits) under corporate integration; and all income under mark to market. Under current law, taxpayers may claim a deduction of 20 percent of some profits from flow-through business income (QBI).
- All personal investment income is taxable at a rate of 25 percent under BEIT. Realized capital gains are taxable at graduated rates up to 25 percent under current law and corporate integration; unrealized capital gains are deferred until realization and exempt if held until death. All capital gains are taxed at rates up to 40 percent under mark to market. Dividends are taxable at ordinary income rates under integration (with a taxable credit for imputed corporate taxes) and mark to market and at graduated rates up to 25 percent under current law. Interest income is taxable at ordinary income rates under all the options except BEIT.
- Corporate profits are taxable at a flat rate of 25 percent under BEIT, current law, and integration and are exempt under mark to market. Under integration,

**Table 2**  
Perfect Competition, Saver in Top Rate Bracket,  
No Business Preferences, 60 Percent Equity Finance

	BEIT	Current Law	Integration	Mark to Market
Net operating revenue	60	60	60	60
COCA deduction	60	0	0	0
Interest deduction	0	12	12	0
Taxable profits	0	48	48	NA
Corporate tax	0	12	12	0
Imputed income (tax)	60 (15)	0 (0)	0 (0)	0 (0)
Interest income (tax)	0 (0)	12 (4.8)	12 (4.8)	12 (4.8)
Dividends (tax)	24 (0)	18 (4.5)	18 (3.6)	24 (9.6)
Realized gains (tax)	6 (0)	4.5 (1.125)	4.5 (1.125)	6 (2.4)
Unrealized gains (tax)	18 (0)	13.5 (0)	13.5 (0)	18 (7.2)
Total tax	15	22.425	21.525	24
Total tax rate (%)	25	37.4	35.9	40

individual taxpayers may claim credit for corporate taxes attributable to dividends they receive.

- The discount rate and the total return on investment assets are 6 percent.
- Firms are on average financed 40 percent with debt and 60 percent with equity. The interest rate is 3 percent, which makes the return on equity investments equal to 8 percent (consistent with a total return on investment assets of 6 percent).
- The return on equity is divided into three parts: 50 percent dividends, 12.5 percent unrealized gains, and 37.5 percent realized gains.

Under these circumstances, if there is perfect competition and the saver is in the 40 percent bracket, BEIT imposes a lower combined corporation-individual tax rate than current law, integration, or mark to market. Under BEIT, there is no corporate-level tax on normal returns because the firm gets to claim a deduction equal to the imputed normal return multiplied by its invested capital (Table 2). This COCA deduction reduces corporate taxable profits and the corporate tax to zero. Individual holders of both equity and debt claims of the firm, however, must claim imputed income equal to the normal return (6 percent) multiplied by their basis in the firm (\$1,000), or \$60 on which, at a 25 percent individual capital income tax rate, they pay a tax of \$15.

In comparison, under current law, corporations deduct interest payments, but not payments to shareholders, and report profits of \$48, paying tax of \$12 at a 25 percent rate. The remaining \$36 of after-tax profits is divided between \$18 of dividends (taxable at a 25 percent rate), \$4.50 of realized capital gains (also taxable at 25 percent), and \$13.50 of unrealized gains (tax free). The \$12 of interest income is taxable at a 40 percent rate. The net tax rate is 37.4 percent.

We represent corporate integration by an imputation credit system that resembles the ones in Australia and New Zealand. Corporations maintain a balance of corporate taxes paid that they spend down when they pay dividends. Shareholders gross up these “franked” dividends for corporate taxes associated with them. At a 25 percent corporate rate, shareholders report \$100 of income for every \$75 of dividends they receive and claim a \$25 tax credit for the corporate taxes associated with the dividend. Tax-exempt and foreign shareholders may not claim the credit.<sup>9</sup>

The net tax rate is slightly lower under integration than under current law. Shareholders pay a 40 percent instead of a 25 percent tax rate on dividends received (the preferential rate on dividends under current law is eliminated), but they receive a

<sup>9</sup> An alternative version of this plan with the same economic effects is the dividend deduction plan developed by former Senate Finance Committee chairman Orrin Hatch in 2016. Under the Hatch plan (at the then 35 percent corporate rate), corporations would have been allowed to deduct dividend payments but instead would be required to pay a dividend withholding tax of 35 percent of gross dividends. Taxable shareholders would be able to claim credit for the dividend withholding tax, but for tax-exempt and foreign shareholders the withholding tax would be a final tax.

credit for the corporate tax associated with the dividend. In the example, the \$18 dividend results in \$24 of taxable income. At a 40 percent rate, the tax on dividend income is \$9.60, but the taxpayer receives a \$6 credit for corporate taxes paid, leaving a net tax burden of \$3.60.

Finally, we represent mark to market as an annual tax at ordinary income rates on interest income, dividends, and net accrued capital gains, whether or not realized. The mark-to-market tax on shareholders replaces the corporate income tax.<sup>10</sup> Under mark to market, taxpayers in the top bracket pay a 40 percent combined tax rate.

Altering the mix of debt and equity finance leaves the ranking of tax burdens under the four options unchanged (Tables 3–5). The method of finance has no effect on tax burdens on either BEIT or mark to market; both systems are neutral with respect to the method of finance. Debt finance is slightly favored relative to equity finance in these examples under both current law and integration. Equity benefits from the preferential taxation of dividends and capital gains compared with interest income at the individual investor level, but debt benefits from the elimination of double taxation of dividends and realized gains under current law and the elimination of double taxation of realized gains under integration.<sup>11</sup> The substantial gap between the top rates on corporate and individual income and the even greater gap between the two rates under current law substantially reduces the net benefit of debt finance compared with what it was prior to the TCJA, when the top corporate rate was only slightly lower than the top individual rate.

Under perfect competition with firms receiving normal returns (capital gains come only from retained earnings, not changes in future expected returns), BEIT and mark to market are also fully neutral between firms organized as taxable C corporations and firms organized as pass-through entities (Table 4) because both tax all normal returns to capital at the same rate (albeit a lower rate for BEIT). In contrast, the 20 percent deduction for QBI income that the TCJA provides through 2025 results in a lower tax rate under current law for pass-throughs than for taxable corporations with the assumed debt equity ratio and dividend payout ratio.

## B. Preferences for Savers

Over time, primarily due to the growth in assets in qualified retirement accounts, the percentage of US corporate shares that face individual income taxation has declined

<sup>10</sup> Toder and Viard (2016) outline a modified version of this plan that retains a 15 percent corporate tax rate but that would allow taxable shareholders to claim a taxable credit for corporate taxes associated with dividends they receive. Under a pure version of mark to market that shifts all liability to the shareholder level, there would be no corporate income tax.

<sup>11</sup> As Ed notes, however, the tax system is much more favorable to debt finance when corporate assets are financed by tax-exempt savers. These savers (tax-exempt organizations and people saving in qualified retirement plans) do not benefit from preferential individual-level taxation of equity income, but they still gain the full benefit of the favorable treatment of debt at the corporate level. This leads to portfolio specialization, with taxable savers preferring to hold corporate equities and tax-exempt savers preferring to hold bonds.

**Table 3**  
 Perfect Competition, Saver in Top Bracket,  
 No Business Preferences, 100 Percent Equity Finance

	BEIT	Current Law	Integration	Mark to Market
Net operating revenue	60	60	60	60
COCA deduction	60	0	0	0
Interest deduction	0	0	0	0
Taxable profits	0	60	60	NA
Corporate tax	0	15	15	0
Imputed income (tax)	60 (15)	0 (0)	0 (0)	0 (0)
Interest income (tax)	0 (0)	0 (0)	0 (0)	0 (0)
Dividends (tax)	30 (0)	22.5 (5.625)	22.5 (4.5)	30 (12)
Realized gains (tax)	6 (0)	5.625 (1.406)	4.5 (1.125)	7.5 (3)
Unrealized gains (tax)	18 (0)	16.875 (0)	13.5 (0)	22.5 (9)
Total tax	15	22.031	20.625	24
Total tax rate (%)	25	36.7	34.4	40

sharply. Rosenthal and Austin (2016) and Rosenthal and Burke (2020) estimate that taxable savers hold only about 25 percent of shares issued by US corporations, with the balance held by tax-exempt institutions, pension funds, individual investors in defined contribution qualified retirement plans, and foreign investors.

**Table 4**  
 Perfect Competition, Saver in Top Bracket,  
 No Business Preferences, 100 Percent Debt Finance

	BEIT	Current Law	Integration	Mark to Market
Net operating revenue	60	60	60	60
COCA deduction	60	0	0	0
Interest deduction	0	30	30	0
Taxable profits	0	60	60	NA
Corporate tax	0	7.5	7.5	0
Imputed income (tax)	60 (15)	0 (0)	0 (0)	0 (0)
Interest income (tax)	30 (0)	30 (12)	30 (12)	30 (12)
Dividends (tax)	15 (0)	11.25 (2.813)	11.25 (2.25)	15 (6)
Realized gains (tax)	3.75 (0)	5.625 (1.406)	5.625 (1.406)	3.75 (1.5)
Unrealized gains (tax)	11.25 (0)	16.875 (0)	16.875 (0)	11.25 (4.5)
Total tax	15	23.719	23.156	24
Total tax rate (%)	25	39.5	38.6	40

**Table 5**  
**Comparing Options under Debt and Equity Finance:**  
**Saver in Top Bracket, No Business Preferences**

	BEIT (%)	Current Law (%)	Integration (%)	Mark to Market (%)
Corporate: equity finance	25	36.7	34.4	40
Corporate: debt finance	25	39.5	38.6	40
Pass-through: equity finance	25	32 <sup>a</sup>	40	40

<sup>a</sup> Assumes pass-through income benefits from 20 percent QBI deduction; otherwise 40 percent.

If the saver is in a zero tax bracket, there is no tax on normal returns to investment income under either BEIT or mark to market because there is no tax on that income at the corporate level either (Table 6).<sup>12</sup> But, assuming 40 percent debt financing and a 3 percent interest rate (compared with a 6 percent total return on assets), the combination of a 25 percent corporate tax and interest deductibility results in a 20 percent total tax on the return on assets under current law, all of it coming from the corporate income tax. The tax rate under integration is the same as current law because tax-exempt savers cannot claim imputation credits to offset the corporate-level tax.

Thus, the pure versions of BEIT and mark to market allow a substantial tax cut for income from corporate assets held by tax-free investors. Some commentators may argue that this fulfills the literal goal of tax-exemption instead of subjecting income that the law intends to be exempt to a less transparent tax at the corporate level. Others may counter that there is no reason to grant a very large tax cut to savers who do not pay much tax to begin with.

### C. Tax Preferences for Investment in Selected Assets and Industries

The story is completely different for tax preferences for selected economic activities than with tax preferences for selected savers (Table 7). Full expensing of assets does not change the effective corporate tax rate because expensing is equivalent in present value terms to the COCA deduction. With both, there is no corporate tax burden on assets that produce normal returns. All taxes are imposed at the individual investor level, and they are unaffected by changing rules for measuring business income. The same is true for mark to market, which explicitly removes the corporate income tax.

The result is that both BEIT and mark to market effectively eliminate corporate tax preferences, whether accidental ones (through the inability to enact depreciation

<sup>12</sup> Toder and Viard (2016) would reduce the benefit their plan would otherwise provide to tax-exempt savers from the elimination of the corporate income tax by imposing a flat rate withholding tax on their interest income.

**Table 6**  
 Perfect Competition, Saver Tax-Exempt,  
 No Business Preferences, 60 Percent Equity Finance

	BEIT	Current Law	Integration	Mark to Market
Net operating revenue	60	60	60	60
COCA deduction	60	0	0	0
Interest deduction	0	12	12	0
Taxable profits	0	48	48	NA
Corporate tax	0	12	12	0
Imputed income (tax)	60 (0)	0 (0)	0 (0)	0 (0)
Interest income (tax)	0 (0)	12 (0)	12 (0)	12 (0)
Dividends (tax)	24 (0)	25.5 (6.375)	18 (0)	24 (0)
Realized gains (tax)	6 (0)	4.5 (0)	4.5 (0)	6 (0)
Unrealized gains (tax)	18 (0)	13.5 (0)	13.5 (0)	18 (0)
Total tax	0	12	12	12
Total tax rate (%)	0	20.0	20.0	0

rules that accurately reflect the annual decline in the economic value of business assets) or intentional ones, through deliberate subsidies of defined activities. Whether this is good or bad depends on one's perspective. If one believes preferences in general reduce economic efficiency by encouraging firms to choose investments based on

**Table 7**  
 Perfect Competition, Saver in Top Bracket,  
 Expensing of Investments, 60 Percent Equity Finance

	BEIT	Current Law	Integration	Mark to Market
Net operating revenue	60	60	60	60
COCA deduction	60	0	0	0
Interest deduction	0	12	12	0
Taxable profits	0	-12	48	NA
Corporate tax	0	-3	-3	0
Imputed income (tax)	60 (15)	0 (0)	0 (0)	0 (0)
Interest income (tax)	0 (0)	12 (4.8)	12 (4.8)	12 (4.8)
Dividends (tax)	24 (0)	25.5 (6.375)	25.5 (12)	24 (9.6)
Realized gains (tax)	6 (0)	6.375 (1.594)	6.375 (1.594)	6 (2.4)
Unrealized gains (tax)	18 (0)	19.125 (0)	19.125 (0)	18 (7.2)
Total tax	15	9.769	15.394	24
Total tax rate (%)	25	16.3	25.7	40

their tax characteristics instead of their social productivity, and that business preferences in the law largely reflect the relative power of selective special interest lobbyists, then making it difficult to enact targeted tax benefits is a positive feature of BEIT.

A counterargument is that under BEIT it would be harder for policy makers to use the tax code to encourage activities, such as research and experimentation or investment in renewable energy, that may generate social benefits that exceed private gains to investors. Ed would probably respond that, if these activities are worth subsidizing, they should be supported by direct spending instead of “backdoor” spending in the form of tax subsidies (see Kleinbard, 2010b).

In contrast to BEIT and mark to market, current law claws back some of the benefits of business preferences through taxes on the increased individual investment income that people who finance these activities receive. Still, in this example, expensing reduces the combined corporate-individual tax rate under current law by almost half and makes tax rates for expensed investments lower under the current law than BEIT. Integration, in contrast, claws back more of the firm-level preference than current law because imputation credits are available only for corporate taxes paid and dividends are assumed to face the ordinary income tax rate of 40 percent.<sup>13</sup>

To sum up, the different tax systems have varying effects on the benefits of exemptions for selected savers and preferences for selected industries (Table 8). BEIT and mark to market eliminate any individual or corporate tax liability for tax-exempt savers, while under current law and mark to market, tax-exemption reduces, but does not entirely eliminate, their tax burden on corporate investments. In contrast, BEIT and mark to market provide no benefit for expensed investments, while both current law and, to a lesser extent, integration reduce the overall tax burden on these investments.

The story is a little different for investments in firms that are currently taxed as pass-throughs (Table 9). Expensing reduces the effective tax rate on pass-through income to zero under all the tax structure options except for BEIT. This is because BEIT imposes separate entity-level investor taxes on all firms, including those currently taxed as pass-throughs.<sup>14</sup> All the options impose no tax of returns to tax-exempt savers.

## D. Economic Rent or Windfalls

### 1. *What Return Is Being Taxed?*

In contrast to normal returns, Ed would impose a 25 percent tax on economic rent at the firm level under BEIT but no tax at the individual level. As discussed above, economic rent occurs because value has been created in excess of the investor's

<sup>13</sup> In the example in Table 7, the corporate rate on the favored asset is negative due to the combination of expensing and interest deductibility for the debt-financed portion of the asset. The computations assume that this negative rate reduces corporate taxes that may be credited against dividend taxes on returns from other assets held by the firm.

<sup>14</sup> Following Toder and Viard (2016), we assume that mark to market does not apply to non-publicly traded firms because of the difficulty in measuring their change in value, so that these firms are currently taxed the same way that current law taxes flow-through firms.

**Table 8**  
Effects of Preferences on Effective Tax Rates  
with 60 Percent Equity Finance

	BEIT (%)	Current Law (%)	Integration (%)	Mark to Market (%)
No preferences	25	37.4	35.9	40
Tax-exempt saver	0	20.0	20.0	0
Expensed investment	25	16.3	25.7	40

basis in the asset. This could occur because the original investor is an entrepreneur who creates value through sweat equity, which is effectively expensed because the opportunity cost is labor services as an employee of another firm that would be taxable. Or, alternatively, the investor may experience a windfall gain due to unanticipated changes in market conditions or for another reason. This gain is also untaxed as accrued, so is effectively the equivalent of an expensed investment. Once value has been created (or received through luck) by the entrepreneur, new investors will pay the market price for shares in the business. Therefore, the prior examples might accurately describe a new investor in a firm receiving economic rents earning a normal return because the price of existing shares reflects the value of those rents, but it would not reflect the experience of the original investors.

The existing firm pays tax on its profits in excess of deductions for existing real assets, reflecting its return from intangible assets (Table 10). There is no COCA deduction because the firm's basis is zero. But if the investor's basis is also zero, there also is no tax on the imputed return of the investor. So, in this example, under BEIT, the entire tax is paid at the corporate level. Other than that, nothing changes because the corporate rate is the same as the individual tax rate on capital income. The combined corporate-individual tax rate under BEIT continues to be 25 percent.

So, it appears that a firm with economic rents is also facing a combined tax rate of 25 percent, just like the firm with normal returns. But is this the right way to look at it?

What if, for example, the original contribution of value and appreciation was never taxed? In that case, the effective rate on the capital income of the original owner (not the new investor, who pays an imputed return on basis) is zero. The original owner is

**Table 9**  
Effects of Preferences on Taxation of Equity-Financed Pass-Throughs

	BEIT (%)	Current Law (%)	Integration (%)	Mark to Market (%)
No preferences	25	32	32	40
Tax-exempt saver	0	0	0	0
Expensed investment	25	0	0	0

in the same position (abstracting from any corporate-level tax) as a saver who deposits money in a qualified retirement plan. Contributions to the plan (analogous to the entrepreneur's labor services) and investment earnings within the firm (analogous to the return for waiting for income to start) are tax free. Distributions from the plan (analogous to operating profits from the firm) are taxable. The tax is not a tax on the capital income of the original investor/entrepreneur; it is instead a deferred tax on the previously untaxed labor income and windfalls. If so, why tax it at the capital income rate instead of under the graduated rate schedule generally applied to earnings?

## 2. Taxation of Capital Gains

The discussion of taxing the returns to economic rent highlights the critical importance of how the tax law treats capital gains. Capital gains of individual investors may be thought of as coming from three sources: (1) retained earnings of normal returns of corporations, (2) windfalls resulting from revaluation of assets, and (3) returns to entrepreneurs.

Under current law, gains arising from corporate retained earnings are subject to the corporate income tax (Table 11). Individual shareholders pay a second level of tax, at a preferred capital gains rate, when they realize gains attributable to these retained earnings, but they escape this tax if they hold onto shares with gains until death or donation to a qualified charitable organization. Other gains, including gains that result from revaluations of corporate assets (not generated by retained earnings) or revaluations of

**Table 10**  
Taxation of Equity Returns of New Investor in Asset Worth \$1,000 Created from Tax-Free Income (i.e., asset basis is zero)

	BEIT	Current Law	Integration	Mark to Market
Net operating revenue	60	60	60	60
COCA deduction	0	0	0	0
Interest deduction	0	0	0	0
Taxable profits	60	60	60	NA
Corporate tax	15	15	15	0
Imputed income (tax)	0 (0)	0 (0)	0 (0)	0 (0)
Interest income (tax)	0 (0)	0 (0)	0 (0)	0 (0)
Dividends (tax)	22.5 (0)	22.5 (5.625)	22.5 (4.5)	30 (12)
Realized gains (tax)	5.625 (0)	5.625 (1.406)	5.625 (1.406)	7.5 (3)
Unrealized gains (tax)	16.875 (0)	16.875 (0)	16.875 (0)	22.5 (9)
Total tax	15	22.031	20.906	24
Total tax rate (%)	25	36.7	34.8	40

**Table 11****Taxation of Capital Gains under Alternative Tax Regimes**

Source of Gain	BEIT	Current Law	Mark to Market
Corporate retained earnings	Imputed return taxable at capital income rate	Subject to corporate income tax. At individual level, deferred or exempt if retained; taxable at capital gains rate if realized; limits on losses	Taxable at ordinary income rates with full loss offset
Windfalls from asset realization	Generally exempt; increase in basis raises taxes on future imputed income	Deferred or exempt if retained; taxable at capital gains rate if realized; limits on losses	For publicly traded assets, taxable at ordinary income rates with full loss offset; other assets treated as under current law for flow-through enterprises
Returns to entrepreneurs	Special rules for taxing when new firms go public	Deferred or exempt if retained; taxable at capital gains rate if realized; limits on losses	Special rules for taxing when new firms go public

other assets, are taxed at preferential rates only when realized and are also exempt if held until death or charitable donation.

BEIT has a more complex set of rules for taxing capital gains. Gains resulting from corporate retained earnings of firms earning a normal rate of return are taxed as accrued at the general rate of taxing capital income, but gains resulting from pure revaluations are exempt from tax. Those gains, if reinvested, do increase basis in assets, raising imputed capital income and future tax liability. But unlike saving from wages, which is subject to ordinary income tax before being reinvested, the reinvestment of these gains comes from pretax dollars.

In contrast, a mark-to-market regime would tax capital gains from both retained earnings and revaluations of corporate assets at ordinary income rates. But because of the difficulty in valuing assets of companies that are not publicly traded, the mark-to-market regime proposed by Toder and Viard (2016) would treat revaluations of assets in those firms the same way as current law — taxable, but only when realized, and at a preferential rate to reduce the lock-in of investors to existing assets. An alternative proposal by Grubert and Altshuler (2016) would tax all gains when realized at ordinary income rates, but it would impose a retroactive tax upon realization to capture the benefit of deferral.

Both BEIT and a mark-to-market regime need to address the problem of how to tax the gains of entrepreneurs who take their new companies public. Kleinbard (2017c) and Toder and Viard (2016) discuss methods of taxing those gains at preferential rates to prevent their full exemption, while reducing the disincentive to take new firms public.

## V. OTHER ISSUES

### A. Owner-Managed Firms

Ed's papers discuss extensively the problem of how to treat owner-managed firms under the BEIT. The issue is that the separate rates applied to capital income and labor income under BEIT require some way to separate out the two types of income for owner-managers of closely held companies — a problem Ed refers to as the “capital-labor” centrifuge. This problem is not unique to the BEIT; it is also a problem under current law for determining how much of the income of small firm owners is subject to the HI payroll tax. And, in designing the TCJA, congressional tax writers had to write complex rules to determine which income of owners of pass-through businesses was eligible for the 20 percent QBI deduction, instead of being taxable as ordinary income.

If one uses the definition of capital income at the beginning of this paper, there is a simple method to separate labor and capital income. Capital income would be computed as a normal return to basis (the same way the BEIT imputes income to investors in corporate equity), and the remainder would be labor income. This method would provide preferential taxation only for income that reflects the risk-adjusted return from deferring consumption.

Ed, however, wishes to include economic rent in the definition of tax-preferred capital income so that only employee compensation, not profits from any source, would face the regular income tax rate schedule. As a result, his approach is necessarily somewhat ad hoc. He would tax three times the normal return on basis as capital income (at a 25 percent rate). Current income in excess of that amount would be taxable as ordinary income, up to the maximum rate (40 percent in the examples in this paper). And any realized gains on sales of the business asset in excess of adjusted basis would be taxable as capital income. The best that can be said for this is that one needs some objective rule to determine how much income falls in which category and perhaps this approximates the level of business taxation that Ed intends.

Finally, an alternative way to implement a split-rate tax that deals with the problem of owner-occupied business is to replace a portion of the income tax with a value-added tax (VAT), as proposed by Michael Graetz (2010). Because a VAT allows expensing and therefore exempts the normal return to capital, while effectively including labor income in the tax base (by reducing real wages), the combination of a VAT and an income tax automatically leads to a tax system in which labor income is taxed at a higher rate than capital income.

## **B. Financial Institutions**

All tax systems that do not tax financial flows directly require special rules to deal with taxation of income from financial institutions. These institutions earn profits by engaging in risk arbitrage, earning profits from the spread between the return they earn on investments and the returns they pay to depositors seeking to hold assets with less risk and more liquidity. A tax system that only includes in the base real income, while excluding financial flows such as interest earnings, interest paid, dividends, and realized capital gains, does not address these types of firms. In addition to Kleinbard's BEIT, examples of tax instruments or rules that only address real but not financial flows are value-added taxes, the X tax developed by David Bradford (1986) and advocated by Carroll and Viard (2012) and others, and the destination-based cash flow tax (Auerbach, 2010).

In recognition of this issue, the BEIT would tax financial firms on their net interest income. Issues would still arise, however, with companies that combine real and financial activities, such as an automobile company that provide loans to its customers. Presumably, Ed would want to in some way separate out the financial activities of these companies from the remainder of their activities.

## **C. International Capital Flows**

Kleinbard's BEIT would tax worldwide normal returns to capital at the individual investor level only. This exploits that fact that capital assets are much more mobile internationally than individual residents. BEIT's exemption of normal returns at the

corporate level gives firms no incentive to shift marginal investments in real assets to low-tax jurisdictions or to change the residence of their parent company.

BEIT would, however, tax excess returns on real assets at the company level. As Ed has documented in many papers (Kleinbard, 2011a, 2011b, 2013), multinational corporations use complex techniques to shift their ownership and reported income from intangible assets to low-tax jurisdictions. Because these intangible profits are easy to shift, Ed rightly rejects a source-based or territorial approach to taxing multinational corporations.

Instead, Ed favors taxing the worldwide income of US multinationals on a current basis. Requiring firms to file a consolidated return and pay tax on a current basis on their worldwide profits would render ineffective the income-shifting schemes that Ed documents. But because the US could only apply such a tax to US-resident corporations, it would provide substantial incentives for existing US firms to change their residence through mergers with foreign-resident companies and for new US firms to incorporate overseas and could place firms continuing to be US resident at a competitive disadvantage compared with foreign-resident multinational corporations. (Ed believed the competitiveness issue was nonexistent or at least exaggerated; see Kleinbard, 2014.)

Ed addresses this problem in part by taxing economic rent as capital income, at the preferential 25 percent rate (a reduction from the 35 percent corporate tax rate in effect when Ed was writing these papers). He would also change the US definition of corporate residence from one based solely on place of incorporation to one based on the locale of central management activities. This latter change would increase the cost of residence shifts and therefore make them less likely, but it would also raise the economic costs (in terms of reduced domestic activity, including possibly research and development) of those residence shifts that do occur.

The recent OECD efforts to gain international agreement through Pillar 2 of a global minimum tax on corporate income makes Ed's support for worldwide taxation seem more feasible now than several years ago. It remains to be seen, however, whether that agreement will be broadly implemented, including by the United States itself.

#### **D. Constructive Realization at Death**

Ed would include as part of BEIT a provision to tax unrealized capital gains that are transferred at death. This provision is necessary as a backup to correct for the exemption under the BEIT proposal of most capital gains that individuals accrue in their lifetime.

But the issue of how to treat gains transferred at death needs to be addressed in all the structural options compared in this paper. Exemption of these gains is a major loophole in current law. The Biden administration in its fiscal year 2022 proposed including gains transferred at death in excess of \$1 million in taxable income on the decedent's final income tax return (US Department of the Treasury, 2021). Toder and Viard (2016), in their proposal for a mark-to-market tax on income from publicly

traded assets, would also tax unrealized gains at death on assets that are not subject to mark-to-market taxation, as would Grubert and Altshuler (2016) on unrealized capital gains in their proposal.

The bottom line is that any income tax system needs to address the problem of how to eventually tax unrealized gains. Taxing gains at death is an important component of Kleinbard's BEIT proposal, but it could be added to the tax law without his other structural reforms. And it would confront the same political constraints that the Biden administration's fiscal year 2022 proposal and previous attempts to eliminate step-up in basis have faced in the current system.

## VI. A BROADER ISSUE: HOW TO ADDRESS INCOME INEQUALITY

Ed's entire body of work reflects his strong concern about the adverse consequences of the increase in income inequality in the United States since the 1970s. This rise in inequality has two separate, though related, aspects — the sharp rise in the share of income received by the very highest-income individuals (originally documented in Piketty and Saez, 2003) and stagnation of earnings of low- and middle-income individuals. Kleinbard (2017a) is much more concerned about the latter problem than the former, not only because it affects the living standards of millions of people whose interests should be served by government in a democratic society but also because accompanying shortfalls in education and health services seriously retard human capital development and reduce economic growth. He cites recent research by International Monetary Fund economists (Ostry, Berg, and Tsangarides, 2014) that finds that, contrary to the traditional view that there is a trade-off between distributional equity and economic growth (Okun, [1974] 2015), increased inequality may reduce growth.

But Ed in his BEIT proposal does not suggest much higher taxes on wealthy individuals as the solution to the problem of inequality. In part, this reflects the general difficulty of taxing high-income people uniformly at higher rates. As discussed, sharply progressive taxation of capital income is very difficult to implement because it is hard to measure capital income accurately at the firm level, it is very hard to measure the wealth of individuals from holdings in privately run (that is, not publicly traded) companies, and it is difficult to prevent individuals and corporations from avoiding tax through international transactions. All structural reforms must confront these problems.

Kleinbard's BEIT therefore fits well with his overall worldview. It would impose a moderate, low rate of taxation of most capital income, combined with a graduated tax at a higher tax rate on earnings. And, as he has proposed in other writings (Kleinbard, 2016), combining higher and moderately progressive taxation with more spending on public goods is a more efficient and effective way to construct a progressive overall fiscal system than is a sharply progressive income tax that raises less revenue and therefore funds a small public sector.

## VII. CONCLUSION

Ed Kleinbard's BEIT proposal is a major contribution to the literature on capital income taxation, which has received less attention than it deserves. BEIT eliminates many of the important distortions in the US federal income tax. These include provisions that distort corporate choices between debt and equity finance and among dividends, stock buybacks, and retained earnings; business choices among alternative investments in assets and between investing in the United States or overseas; choices about how firms are organized; and decisions about exchanging asset ownership, whether in the form of corporate reorganizations or individuals' sales of real and financial assets. It also reduces the distortion between present and future consumption inherent in an income tax by providing for a lower tax rate on income from capital than on earnings.

Kleinbard's papers on BEIT also provide thoughtful ways of reducing some of the remaining distortions that BEIT does not fix and some of the new ones it creates, including problems in taxing financial institutions, differentiating between labor and capital income in owner-managed firms, and placing US-resident corporations at a potential disadvantage compared with foreign-resident corporations.

BEIT works especially well in creating a uniform and economically neutral tax system under conditions of perfect competition in which firms earn the marginal return and there is no tax on economic rent. But BEIT works less well in circumstances in which firms or investors earn economic rents, either due to their entrepreneurial efforts or due to windfall gains. It does not, as a result, solve the problem of preventing the wealthiest in our economy from paying very low effective tax rates due to exemption or deferral of capital gains from tax.

Ed may, of course, have disagreed with these last points. I would have very much been interested in his rejoinders.

I would add, however, that there is no other reform proposal that fully addresses in a practical way the main concerns this paper has raised about BEIT. Taxing unrealized gains at death, as Ed and others have recommended, would limit the extent of permanent tax avoidance from the inability to tax capital gains as they accrue. Constructive realization at death is a reform that could be included in BEIT, current law, or any of the other major capital income taxation reforms that have been proposed, but it is also a provision that has been outside the realm of political feasibility within our lifetimes and probably a long time before that.

## DISCLOSURES

I have no financial arrangements that give rise to conflicts of interest with respect to the research reported in this paper.

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