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Ideas on U.S. Tax Reform

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In order to pursue meaningful tax reform, it is necessary to define income using either the consumption or the accretion to net worth (income) standard. Advocates of the consumption standard assert that by taxing consumption, the government achieves tax equity and removes a bias against saving the tax code would otherwise create.

Dallas Headquarters:
14180 Dallas Parkway, Suite 350
Dallas, TX 75254
972.386.6272

www.ncpa.org

Washington Office:
202.830.0177
governmentrelations@ncpa.org

Executive Summary

Arguably, saving is taxed only once under the consumption standard but twice under the accretion standard. However, advocates of the accretion standard say that the consumption tax is biased against low-income households because they consume a larger share of their income than do high-income households.

Corporate taxes present a separate problem in that they tax income twice — first, the corporate level and again at the individual level. Depending upon which standard is used, the government has a choice of three categories of reform to reduce the corporate tax with the intention of creating a more rational tax code:

- Proposals that would retain, but reform, the corporate tax;
- Proposals that would automatically eliminate the corporate tax; and
- Proposals that eliminate any distinction between incorporated and unincorporated enterprises.

President Obama's FY 2016 Budget proposal. The president's budget proposal, unveiled in February 2015, included more tax incentives for lower income families, increased taxes on high-income taxpayers, and a reduction in the corporate tax rate — but only if some tax breaks for the oil, gas and coal industries were eliminated. The president's budget also favors renewing the 100 percent capital gains exclusion for noncorporate taxpayers, making the research tax credit permanent and less complex, and expanding the credit for health insurance provided by small employers to their employees.

The Tax Reform Act of 2014. House Ways and Means Committee Chairman Dave Camp (R-Mich.) proposed the comprehensive Tax Reform Act of 2014. Under this act, the top corporate tax rate would be reduced to 25 percent, phased in over time, and carried interest would be taxed as ordinary income instead of as capital gains. Many corporate and business income tax breaks would be eliminated in order to broaden the tax base. For multinational corporations, Camp proposed a 95 percent exemption for dividends received by U.S. corporations from foreign subsidiaries. Subpart F rules would be changed to tax the intangible income (income arising from

the sale of intangible property such as patents, trademarks and copyrights, or capital gains and dividends) of foreign subsidiaries when earned and to tax foreign intangible income at a 15 percent rate.

The most popular proposals are the following:

Proposals for Tax Integration. Since corporate dividends to shareholders are subject to double taxation, options for integrating tax laws include a deduction for dividends and other distributions paid to shareholders up to the amount of the corporation's "earnings and profits."

The FairTax. This proposal would eliminate the corporate income tax and replace almost all federal taxes with a national 23 percent retail sales tax and provide a "prebate" cash payment for each household.

Value Added Tax (VAT). The VAT tax base is similar to the FairTax base, except that there is no explicit cash payment or mandate to eliminate all other taxes as a condition for its implementation.

The Flat Tax. A flat tax is a (roughly) proportional, revenue-neutral tax on income that would require eliminating many deductions and credits, and repealing the estate and gift taxes. According to one proposal, all businesses and individuals would pay a standard 19 percent (declining to 17 percent later) on wages, retirement distributions and unemployment benefits. The flat tax is by definition a tax on consumption.

The key to meaningful corporate tax reform lies in choosing which of these standards to adopt and in deciding which standard — accretion or consumption — is to be followed. The answer lies in educating the public to the fact that (1) corporate taxes, like all taxes on capital, reduce capital formation and, in the process, impose a burden on labor, and (2) the difficulty of achieving reform and of reducing compliance costs derives from an unwillingness to decide just what it is — "income," as conventionally defined, or consumption — we want to tax.

David G. Tuerck is a professor of economics at Suffolk University in Boston and is the executive director of the Beacon Hill Institute for Public Policy, which he helped found in 1991. He has published widely on economic policy issues and brings over four decades of experience as a working economist. Dr. Tuerck holds a doctorate in economics from the University of Virginia.

James P. Angelini is an associate professor of accounting and taxation, and director of the Master of Science in Taxation Program, at the Sawyer School of Business at Suffolk University in Boston. Dr. Angelini teaches both undergraduate and graduate courses in taxation. A Certified Public Accountant in Massachusetts, Dr. Angelini has over 40 years of public accounting experience and has published numerous articles on various topics in federal and state taxation.

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Introduction

Corporate tax reform begins with the need to decide which standard for reform should be used. Using the consumption standard, only income that is spent, not saved, would be taxed. The accretion standard, however, includes taxing all income, whether it is spent or not. Thus, returns to savings and investments via dividends and capital gains (that is, accretions to net worth) would be taxed. We will give consideration to the broad conceptual issues that arise in any discussion of tax reform, to the end of showing the choices available to a government that sees reduction of the corporate tax as a step toward a more rational tax code. But, first, a little history.

Haig-Simons versus the Consumption Tax

In 1651, the philosopher Thomas Hobbes, reflecting on what is now called tax equity, argued that government should tax consumption, rather than income (as conventionally defined). Writing in *Leviathan*, he said that it is only fair that tax impositions fall on consumption: "When the impositions, are laid upon those things which men consume, every man payeth equally for what he useth."[1] Centuries later, in the 1920s and 1930s, Robert M. Haig and Henry C. Simons provided what became the textbook defense for taxing income (conventionally defined) rather than consumption.[2] Thus was joined a still-unresolved debate between two fundamentally different visions of tax equity and efficiency.

Debate over this issue is made more difficult by terminological confusion. Part of the confusion is over just what we mean by "income." The popular definition is the amount of cash (after any business expenses) a taxable entity (or individual) receives in a year's time. That is the definition we have been using here.[3]

The Haig-Simons definition follows the "accretion" standard. There are only three things an individual can do with the cash he acquires in a year's time: He can spend it, save it or pay taxes out of it. Ignoring taxes, that leaves just two: spend or save. What he spends goes to consumption. What he saves goes to the acquisition of some asset: cash, a bank CD, stock in some corporation and so forth. However he saves, the acquisition of that asset brings about a change to net worth. Consumption tax advocates argue, however, that income should only include cash that contributes to our current well-being. Because it is our consumption, not saving, that contributes to our well-being, we should define the tax base as consumption.

Permanent Income Hypothesis. Underlying this idea is a strand of modern macroeconomics called *the permanent income hypothesis*, which makes a distinction between transitory and permanent income. If someone hits the lottery for a million dollars, his transitory income rises by a million dollars, but his permanent income rises by only a fraction of that amount. Why? Because people try to even out their consumption over their lifetime, borrowing when they are young, saving when they are middle-aged and dissaving when they are old. So today's lucky winner (especially if young) would want to put most of his winnings into saving, consuming only a small fraction of his winnings now. Suppose saving can earn interest at 5 percent. Thus, while his transitory income rises by a million dollars his current consumption might rise by only, say, 5 percent of that, or $50,000. That rise in his current consumption equals the rise in his permanent income, because $1 million could earn about $50,000 a year, allowing $50,000 in consumption annually for the remainder of the lottery winner's life. Thus permanent income equals consumption, and it is permanent income that should matter for tax purposes.

Contrary to this point of view, advocates of the accretion concept would say that this is nonsense. The lottery winner's ability to pay rises by a million dollars, not $50,000, and his taxable income should be the one million.

Two Households' Taxes. Let us consider another, more complicated example: Suppose that there are two households that earn the same amount in wages, say, $50,000 in each of two years. [See Table I.] In year 1, Household X spends it all, but Household Y saves $10,000 of this amount and puts its saving in the bank at 5 percent interest. Under Haig-Simons, Household X's year-1 tax base B is calculated as:

$$(1) \quad B = C + \Delta NW = \$50,000 + 0 = \$50,000.$$

Where B = tax base

C = consumption

ΔNW = change in net worth

Household Y's tax base is the same:

$$(21) \quad B = C + \Delta NW = \$40,000 + 10,000 = \$50,000$$

If the income tax is 20 percent, they both pay $10,000 in taxes. This, according to proponents of the accretion concept, is only fair, since they both have the same ability to pay taxes in year 1.

Consumption-tax advocates complain that the fairness here is a mirage: Consider what happens in year 2. [See Table II.] In that year, Household X again pays $10,000 in taxes, but Household Y now has to pay taxes both on its wages and on the interest earned on the money saved in year 1. (That interest is an accretion to its net worth, so Household Y must pay taxes on that as well.) It pays $10,100 (= 0.2 x $50,500) in taxes. Thus, although the two households start out in exactly same circumstances, the household that saves pays more in taxes.

Table I

Taxes Paid by Two Households - Accretion Concept

	Year 1		Year 2	
	Household X	**Household Y**	**Household X**	**Household Y**
Income	**$50,000**	**$50,000**	**$50,000**	**$50,000**
Consumption	$50,000	$40,000		
Δ Net Worth	0	$10,000	0	$10,500
Tax Base	$50,000	$50,000	$50,000	$50,500
Tax Rate	x 20%	x 20%	x 20%	x 20%
Income Tax	$10,000	$10,000	$10,000	$10,100

Source: Authors' calculations.

If we assume a discount rate of 5 percent, the present value of Household X's taxes under the accretion standard is $19,524 (= $10,000 + $10,000/1.05).[4] [See Table II.] The present value of Household Y's taxes is $19,619 (= $10,000 + $10,100/1.05). Household Y, which innocently (and perhaps commendably) decided to be the more thrifty of the two, ends up with a tax liability whose present value exceeds that for Household X.

Now suppose both households are taxed only on their consumption. [See Table III.] The government permits households to deduct their saving in computing their taxable income (and, by the same token, requires them to pay taxes on any dissaving, which is to say, consumption spending from previously saved income and interest). For Household X, nothing changes. It still has a tax liability whose present value is $19,524. [See Table IV.]

Table II

Present Value of Taxes – Accretion Concept

	Household X	**Household Y**
Year 1	$10,000	$10,000
Year 2	$10,000/1.05	$10,100/1.05
Present Value	$19,524	$19,619

Source: Authors' calculations.

Household Y pays $8,000 (= 0.2 X $40,000) in taxes in year 1. To complete the example, let Household Y consume both its $50,000 in wages in year 2 and the $10,500 that it has in the bank, so that it dissaves $10,500. Thus its taxable income in year 2 is $60,500 (= $50,000 + $10,500), and it pays $12,100 in taxes. Now the present-value of its tax liability is exactly the same as X's: $19,524 (= $8,000 + $12,100/1.05).

Advocates of the consumption standard make two arguments regarding this example.

- First, by taxing consumption, the government taxes both households equally.
- Second, by taxing consumption it removes a bias against saving that the tax code would otherwise create.

Arguably, saving is taxed twice under the accretion standard but only once under the consumption standard. Thus the accretion standard is biased against saving.

Contrarily, advocates of the accretion standard say that the consumption tax is biased against low-income households. Because low-income households allocate a larger share of their income to consumption than do high-income households, low-income households pay more in taxes relative to their income under the consumption standard. (The issue of tax equity is further explored in the discussion of the "FairTax" proposal below.)

Some Corporate Tax Reform Proposals

As we will show, the preceding discussion provides a framework for corporate tax reform. Let us next consider a few specific proposals for tax reform, all of which would affect corporate taxes.

Table III				
Taxes Paid by Two Households - Consumption Concept				
	Year 1		Year 2	
	Household X	Household Y	Household X	Household Y
Income	**$50,000**	**$50,000**	**$50,000**	**$50,000**
Consumption	$50,000	$40,000	$50,000	$50,000
Δ Net Worth	0	$10,000	0	($10,500)
Tax Base	$50,000	$40,000	$50,000	$60,500
Tax Rate	x 20%	x 20%	x 20%	x 20%
Income Tax	$10,000	$ 8,000	$10,000	$12,100

Source: Authors' calculations.

The Obama Administration's FY 2016 Budget. On February 2, 2015, President Obama released his almost $4 trillion FY 2016 budget proposal. As with his prior proposals, the president calls for more tax incentives for lower income families, a consolidation of the myriad education tax breaks and creation of new retirement saving incentives (of which there are already many). He also wants to increases taxes for high-income taxpayers. On the business side, he reiterated his call to reduce the corporate tax rate, but only if the base is broadened by eliminating "loopholes" that permit C-corporations to reduce their effective tax rate, especially in the international tax area. Specifically, the president would lower the C-corporate tax rate to 28 percent (25 percent for domestic manufacturing) and "pay" for this by eliminating some tax breaks for the oil, gas and coal industries (a step toward a carbon tax).

For the past few years, small businesses have been able to utilize section 179 of the U.S. code to expense, rather than capitalize and depreciate, up to $500,000 of non-realty assets if they purchase less than $2 million in one year.[5] In addition, there has been a 50 percent bonus depreciation deduction for all businesses, not just small ones, for the purchase of new, non-realty assets. These provisions expired at the end of 2014, when the section 179 deduction fell to only $25,000 and the 50 percent bonus depreciation expired altogether. Although there has been some discussion about restoring these deductions, their fate is uncertain. The president would permanently restore the section 179 deduction to $500,000, increase it to $1 million in 2016 and index it thereafter. Since the president does not support an extension of bonus depreciation and congressional Republicans agree with extending and increasing section 179, the prospects of an extension for the 2015 tax year are promising.

Table IV		
Present Value of Taxes – Consumption Concept		
	Household X	Household Y
Year 1	$10,000	$10,000
Year 2	$10,000/1.05	$12,100/1.05
Present Value	$19,524	$19,524

Source: Authors' calculations.

Internal Revenue Code section 1202 allows a 50 percent, 75 percent or 100 percent exclusion of the gain on the sale of certain C-corporation small business stock, if held at least five years. The 75 percent exclusion expired September 28, 2010, and the 100 percent exclusions expired December 31, 2013, for stock acquired before those dates. The president is in favor of renewing the 100 percent capital gain exclusion for noncorporate taxpayers.

The Tax Increase Prevention Act of 2014 extended the research tax credit through 2014, but Congress has not extended it to 2015. The president proposes to make it permanent and less complex.

Regarding health care, the president wants to expand the credit for health insurance provided by small employers to apply to up to 50 employees, rather than 25, phasing out between 20 and 50 employees.

The president's budget also attempts to curtail tax avoidance via international transactions. Instead of eliminating the tax on worldwide income, the president would create a hybrid system. He would tax the

previously untaxed earnings of Controlled Foreign Corporations (CFC's) at 14 percent (paid over five years), after which the accumulated earnings could be repatriated without tax. U.S. corporations would pay taxes on foreign income (with no deferral) at the rate of 19 percent, reduced by 85 percent of the foreign tax rate paid on the same income.

Other international tax reforms proposed by the president include:

- Removing tax deductions for jobs outsourced to foreign countries;
- Curbing inversions whereby corporations change their country of residency to a lower tax country to avoid tax on their worldwide income;
- Limiting the shifting of income via intangible property transfers;
- Taxing carried interest profits of some partnerships as ordinary income instead of as capital gains;
- Increasing the deduction for start-up expenses under section 195;[6]
- Permitting corporations to issue Qualified Public Infrastructure Bonds;[7]

Table V

FairTax Concept

	Tom	Ed
Income	**$50,000**	**$500,000**
Consumption	$50,000	$300,000
Δ Net Worth	0	$200,000
Tax Base	$50,000	$300,000
Tax Rate	x 23%	x 23%
Income Tax	$11,500	$ 69,000
Prebate	($ 2,201)	($ 2,201)
Net Tax	$ 9,299	$ 66,799
Tax Rate	18.60%	13.36%
FairTax – Measured as Consumption		
Net Tax	$ 9,299	$ 66,799
Consumption	$ 50,000	$300,000
Tax Rate	18.60%	22.27%

Source: Authors' calculations.

Regarding the personal income tax, in the past the president has called for tax relief for the middle class (those making less than $250,000) and continues to call for higher taxes on the "rich" and on corporations that do not pay their "fair share."

The Tax Reform Act of 2014. House Ways and Means Committee Chairman Dave Camp (R-Mich.) proposed the comprehensive Tax Reform Act of 2014. Corporate tax rates would be reduced to 25 percent, phased in over time. These rate reductions would be paid for by base broadening. He would also tax carried interest as ordinary income, instead of as capital gains, for certain partnerships. The bill aims to be revenue neutral over 10 years.

Pass-through income from S-corporations and partnerships, and sole proprietorships, would be taxable for individuals, as they are now. Many corporate and business income tax credits, deductions and other provisions would be eliminated or reduced. Depreciation of business assets would be much slower, thus reducing the deduction and raising the cost of capital.

For multinational corporations, Camp proposes a 95 percent exemption for dividends received by U.S. corporations from foreign subsidiaries. Subpart F rules would be changed to tax the intangible income of foreign subsidiaries when earned and to tax foreign intangible income at 15 percent. The proposal also includes "thin capitalization" rules that restrict domestic interest deductions. To capture some of the $2 trillion in unrepatriated income, Camp calls for a one-time tax on U.S. corporations of 8.75 percent tax on previously untaxed earnings and profits of foreign subsidiaries.

The FairTax. The "FairTax" is a proposal to replace almost all federal taxes with a national retail sales tax.[8] The Fair Tax Act of 2013 (H.R. 25/S. 122) would tax personal consumption and government purchases at 23 percent, measured on a tax-inclusive basis.[9] The goal is to encourage savings by taxing consumption only. To offset its regressivity, the Fair Tax Act would provide a rebate payment (or "prebate") for each household equal to the tax that household would pay if its income was just equal to the poverty level for a household of similar size and composition. The FairTax would eliminate the corporate income tax, along with all other taxes on investment.

The FairTax is controversial. There is, first of all, the fact that it would be considered regressive even with the prebate since tax incidence is usually measured by dividing the tax paid by income defined in Haig-Simons terms. For example [see Table V]:

- Suppose Tom makes $50,000 per year. He spends it all and pays the 23 percent tax, which comes to $11,500.
- He receives a prebate of $183.43 per month or $2,201.16 per year. His net tax is $9,299, which equals 18.60 percent of his income ($9,298.84/$50,000).
- Ed makes $500,000 per year, but spends only $300,000. His tax is $69,000 (= $300,000 x 0.23).
- He receives a prebate of $2,201. His net tax is $66,799. His tax rate, as a percentage of his income (measured by the accretion standard) is $66,799/$500,000 or 13.36 percent, much less than Tom's rate.

The fact that low-earner Tom pays a much larger share of his income in taxes than Ed does is what makes the tax unfair in the view of advocates of the Haig-Simons standard. FairTax tax advocates would argue that the tax appears unfair only because the example (wrongly) defines income as an accretion. We get just the opposite result if we define income as consumption.[10] Taking the same example as above:

- Tom's net tax ($9,299) divided by his income, measured as consumption ($50,000), is 18.60 percent.
- Ed's net tax ($66,799) divided by his income, measured by the same standard ($300,000), is 22.27 percent. Ed pays a higher tax rate than Tom.

To be sure, compliance is an issue (as it is with any tax). Because the retail price of goods would include not only the FairTax, but also any state sales tax, measured on a tax-exclusive basis the rate would approach 40 percent in some states. It is hard to predict how large a black market in retail goods and services this would create, but one would certainly emerge.

There are also transition issues. In the short term, the price of homes would probably fall with the elimination of deductions for home mortgage interest and property taxes. The accumulated saving of retired people would fall in value as retail prices rose. Charities are concerned that donations would decline because there would be no more income tax deduction for charitable contributions.[11]

Finally, there are the quite-valid concerns that the FairTax, as conceived by its sponsors, would be subject to the same corrupting influences that bedevil the existing tax system. The FairTax would tax medical services, groceries and babysitting. How long would it take for those activities to become exempt, in the face of political pressures and the realities affecting compliance? Nations with a value added tax (VAT) have struggled for years with defining taxable consumption, and there are over 9,600 different sales tax rates in the United States, with different definitions of what is taxable.

Valued Added Tax (VAT). A VAT is a consumption tax that is assessed at every stage of production. Frequently used in other countries that are members of the Organization for Economic Cooperation and Development (OECD), the idea of a VAT is gaining bipartisan support in the United States.[12]

The VAT tax base is similar to the FairTax base, except that there is no explicit prebate or mandate to eliminate all other taxes as a condition for its implementation. The benefits and drawbacks of a VAT are much the same as those of the FairTax. Like the FairTax it obviates any consideration of business organization inasmuch as it is imposed on sales, not income. A major concern is the same as with the FairTax — that the underlying standard would be vulnerable to erosion in the face of political realities. VAT taxes have increased for many countries since their inception.[13] And, currently, VAT taxes are rising worldwide.[14] An important difference between the VAT and the FairTax is that the VAT is imposed at every stage of production rather than at the point of final sale, with the result that the burden of the VAT is less visible to the final consumer, and thus the taxpayer, than the FairTax.

The Flat Tax Act (H.R. 1040).[15] A flat tax is a (roughly) proportional tax. For example, if John makes 10 times more than Judy, John pays about 10 times more tax. In a progressive rate structure John pays more than 10 times what Judy pays. Because we currently have a very progressive income tax rate structure, moving to a revenue-neutral flat tax would require broadening the base by eliminating many deductions and credits — a politically difficult endeavor. Broadening the base also means taxing the 47 percent of taxpayers who do not

currently pay income taxes. Warren Buffet's tax rate, and most likely the amount of taxes he pays, would necessarily decrease.

The Flat Tax Act is modeled after a much-heralded (and debated) proposal by economists Robert E. Hall and Alvin Rabushka.[16] It allows businesses and individuals to pay taxes under the current tax code or to elect irrevocably and to be subject to a 19 percent rate (initially, falling to a 17 percent rate after two years). The estate and gift taxes would also be repealed. The flat rate would apply to wages, retirement distributions and unemployment benefits. A dependent child's taxable income would be taxable to the parent if the child is under the age of 14.

The flat tax would have "standard deductions" depending upon filing status:

- $32,496 for a married couple filing jointly or a surviving spouse;
- $20,739 for a single head of household;
- $16,248 for a single person or a married person filing a separate return;

An "additional standard deduction" of $6,998 would be allowed for each dependent. All deductions would be indexed for inflation using the consumer price index (CPI).

"Broadening the tax base means taxing the 47 percent of taxpayers who do not currently pay income taxes."

For all businesses, including sole proprietors, C-corporations, S-corporation shareholders and partners in partnerships, the initial tax rate would be 19 percent (declining to 17 percent) on the difference between the gross revenue of the business and the sum of its wage payments, purchases from other firms and pension contributions.

Even though the flat tax is an income tax, insofar as it is collected on business and personal income, so redefined, it is a tax on consumption. Although the legislation makes the noted distinction between incorporated and unincorporated business, all businesses would calculate their taxable income as gross sales minus expenses. There would be no incentive to choose one form of business organization over another based on tax considerations and there would be no double taxation of income.

One of the selling points is that, by virtue of its simplicity, the flat tax would eliminate almost all taxpayer compliance costs. Both businesses and individuals could file their taxes on a post-card-size return.[17]

Again, there are pitfalls: The standard under which all income would be taxed at the same rate would be at the mercy of the same pressures, now in play, to make taxes more progressive. There is nothing to prevent Congress from creating new and higher tax brackets for high wage earners. The proposed law would make it difficult to raise the tax rate or reduce the standard deduction, by requiring a three-fifths majority vote, but whether Congress would so constrain itself is another question.

Limiting Corporate Inversions. A corporate tax avoidance technique that is receiving renewed scrutiny is a tax inversion. In a tax inversion a U.S. corporation reorganizes so that the parent corporation is domiciled in a foreign, zero or low tax country that did not tax foreign source income. By making the low tax country the resident country the corporation is taxed only on its earnings within the United States rather than being taxed on worldwide income.

This technique is not new and was first employed in the late 1990s. The first attempt at stopping corporate inversions was the American Jobs Creation Act of 2004, which denied the tax benefits of an inversion if the original U.S. stockholders owned 80 percent or more of the new firm and there was no real business activity taking place in the foreign country.[18] But there were some loopholes that have subsequently been exploited with great success. Inversions were allowed if there were substantial business operations in the new country. For a time, the threshold for establishing a "substantial" business interest was only 10 percent of the business in the new country. This threshold was subsequently increased to 25 percent. The other loophole permits American shareholders to own up to 79.9 percent of the new foreign parent corporation and be subject to taxation only on their U.S. income.

Several recent inversions have received significant interest from President Obama and Congress.[19] Thus, unsurprisingly, on September 22, 2014, the U.S. Treasury issued new regulations to stop further erosion of the U.S. tax base, but those regulations have only slowed down the activity. It cannot be stopped without new law. Proposals

to curb inversions include H.R. 4679, S. 2360 and the President's FY2016 budget. The proposals would treat all merged firms as U.S. firms if the U.S. shareholders simply maintain control (controlled more than 50 percent, rather than 80 percent) of the merged company. H.R. 694 and S. 250 would also eliminate the deferral that is now allowed on unrepatriated earnings. H.R. 5278 and S. 2704 would bar inverted firms from receiving federal contracts.

Two policy options have been discussed in response: a general reform of the U.S. corporate tax and specific provisions to deal with tax-motivated international mergers. Some have suggested that lowering the corporate tax rate as part of broader tax reform would slow the rate of inversions. Although a lower rate would reduce the incentives to invert, it would be difficult to reduce the rate to the level needed to stop inversions.

Eliminating Double Taxation. There are two ways to eliminate the double taxation of C-corporation dividends. The first is to allow C-corporations a deduction for dividends paid to shareholders. This would save the corporation taxes at its marginal tax rate. Alternatively, double taxation could be eliminated by making dividend distributions to shareholders nontaxable. Both methods eliminate double taxation, and both are equivalent, but only if the C-corporation tax rate is equal to the individual tax rate. To avoid the problem of differing marginal rates of tax between the corporation and the shareholder, the individual could be allowed a tax credit equal to the corporate tax paid. However, not all distributions to shareholders are dividends; some could be distributions of the capital of the corporation. Under current law, distributions that exceed the earnings and profits of the corporation are not taxable up the shareholder's cost basis in the stock, but distributions in excess of the cost basis are capital gains to the shareholder.[20] Since corporate dividends to shareholders are subject to double taxation, dividends and other distributions paid to shareholders should be deductible up to the amount of the corporation's "earnings and profits."[21]

"Corporate income is taxed twice — at the corporate level profits are taxed and at the individual level dividends are taxed."

There is also potential double taxation of appreciated property if a C-corporation is liquidated. There is one tax to the corporation on the gain, or deemed gain, on corporate appreciated assets and a second tax to the shareholders upon receiving the liquidating dividend.[22] This double tax can also be eliminated by either method, but rules would have to be enacted that allow the deduction to the corporation only when there is net gain on assets or the shareholder's stock is appreciated.

Two Competing Standards

As we can see, there are three categories of existing reform proposals:

- Proposals that would retain, but reform, the corporate tax (the President's FY 2016 Budget proposal, the Tax Reform Act of 2014, proposals that limit corporate inversions, and proposals for tax integration);
- Proposals that would automatically eliminate the corporate tax (the FairTax and the VAT); and
- Proposals under which corporations would still file a tax return but there would be no distinction, for tax purposes, between incorporated and unincorporated enterprises (the flat tax).

We have shown that there are two opposing standards of tax equity — one based on the accretion standard for measuring income, the other based on the consumption standard. In large measure, the key to getting meaningful reform lies in choosing which standard to adopt.

Consider the ever-fashionable idea that accelerated depreciation of corporate assets is a tax "loophole."[23] Indeed, it is a loophole under the accretion standard. Under that standard, net investment is part of the tax base, and businesses may deduct only depreciation defined as δK, that is, only economic depreciation. Under the consumption standard, however, all investment is untaxed. Thus, under the flat tax, it is permissible (indeed, mandatory) to expense investment. Under the FairTax, investment is untaxed because the tax base consists only of personal consumption and government consumption.

In reality, the entire tax code is a mishmash of compromises between the two standards. The tax on bank interest reflects the accretion standard. The deductibility of contributions to IRAs and 401Ks and the favorable tax treatment of dividends and capital gains reflects the consumption standard. In order to get meaningful tax reform, it is therefore necessary to decide which standard, the accretion or the consumption standard, is to be followed.

Conclusion

Which path shall we take, the taxation of income defined as an accretion or the taxation of income defined as consumption? We have considered three proposals (the FairTax, the VAT and the flat tax) that would move us down the second path and that would, in the process, effectively eliminate corporate taxation.

If the choice is to move down the first path, then it becomes necessary to eliminate the double taxation of corporate income and to tax all income of U.S. residents equally. We accomplish that and, in one stroke, eliminate the problem with inversions, by taxing only individual income and not business income. Under the accretion standard, Americans would be taxed on dividends received from corporations located in the United States and from their foreign subsidiaries, but the parent companies would not be taxed on their profits. Hence, reform based on the accretion concept, like reform based on the consumption concept, eliminates corporate taxation.

Any principled change in tax policy is subject to erosion in the face of political realities. The Tax Reform Act of 1986 was supposed to be a model for the standard that good tax policy combines a low tax rate with a broad base.[24] That law fixed the top personal income tax rate at 28 percent and eliminated many deductions. The top rate now is 39.6 percent. And the tax base is a concoction of exclusions all aimed at making the effective top rate even higher. How could any principled change in corporate tax policy withstand such erosive forces, considering that a majority of voters appear to believe that only faceless corporations bear the burden of corporation taxes?

The answer lies in educating the public to the fact that (1) corporate taxes, like all taxes on capital, reduce capital formation and, in the process, impose a burden on labor and (2) the difficulty of achieving reform and of reducing compliance costs derives from an unwillingness to decide just what it is — "income," as conventionally defined, or consumption — we want to tax. We hope that this essay will provide a step toward a meaningful discussion of that issue.

Notes

1. Thomas Hobbes, *Leviathan [electronic resource] / Thomas Hobbes; edited with an introduction and notes by J.C.A. Gaskin,* J. C. A. Gaskin & I. NetLibrary, Trans. J. C. A. Gaskin & I. NetLibrary eds. (New York: Oxford University Press, 1998).

2. For a review of this episode in the history of economic thought, see Boris Bittker, "A 'Comprehensive Tax Base' as a Goal of Income Tax Reform," *Harvard Law Review,* 1967, Vol. 80, No. 5, pages 925-985. doi: 10.2307/1339337 and and David Wildasin, "R. M. Haig: Pioneer Advocate of Expenditure Taxation?" *Journal of Economic Literature,* 1990, Vol. 28, No. 2, pages 649-654. doi: 10.2307/2727267. It seems that, that of the two, Simons was the far more enthusiastic proponent of the accretion approach.

3. Businesses that use the accrual, rather than the cash, method pay taxes on receivables and deduct payables.

4. The discount rate is the interest rate used to determine the present value of future cash flows. The greater the risk of uncertainty of future cash flows, the higher the discount rate.

5. See Title 26 of the U.S. Code, Section 179 [hereafter, §179], "Election to expense certain depreciable assets." Available at https://www.law.cornell.edu/uscode/text/26/179.

6. See §195, "Start-up expenditures."

7. These are tax-exempt bonds that corporations contracted to build public infrastructure could offer.

8. Disclosure: Co-author Tuerck directed research that was conducted by the Beacon Hill Institute under contract with sponsors of the FairTax for a period of several years. He testified in favor of it before the House Ways and Means Committee in 2011. See http://www.beaconhill.org/FairTax2011/Kotlikoff-Tuerck-Testimony-to-Ways-Means2011-0726Rev.pdf. See also http://www.beaconhill.org/FairTaxPapers.htm for a list of works on the FairTax performed by the Beacon Hill Institute.

9. This differs from the usual, tax-exclusive measure of a sales tax rate. If a product sells for $1.00 without any sales tax, it would sell for $1.30 under the FairTax, with the government collecting the 30 cents added to the price. Because 0.3/1.3 equals 0.23, the rate becomes 23 percent on a tax-inclusive basis. Most people would think of the rate on a tax-exclusive basis however, which puts it at 30 percent (= 0.3/1). One criticism of the proposal, sponsored by Representative Rob Woodall (R-Ga.), is that it deliberately understates the tax rate as most people think about it. Defenders argue that, because personal income taxes are considered on a tax-inclusive basis, a sales tax should be considered in the same way.

10. The Beacon Hill Institute found that, under the consumption definition, the FairTax would be progressive, not regressive. David G. Tuerck et al., "The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model," Beacon Hill Institute at Suffolk University, February 2007. Available at http://www.beaconhill.org/FairTax2007/EconomicEffectsFTBHICGEModel4-30-07.pdf.

11. The Beacon Hill Institute found that this worry is unwarranted. Charitable contributions would rise because the FairTax would expand household income and, in that way, induce people to contribute more rather than less. See David G. Tuerck et al., "The FairTax and Charitable Giving," Beacon Hill Institute, February 2007. Available at http://www.beaconhill.org/FairTax2007/FTaxCharitableGivingBHI4-24-07.pdf.

12. John D. McKinnon, "Tax Proposals Would Move U.S. Closer to Global Norm. Proposals for a consumption tax gain traction in both parties," *Wall Street Journal*, March 30, 2015.

13. Editors, "The Global VAT Craze," Review & Outlook, *Wall Street Journal*, March 20, 2015.

14. Ibid.

15. The "Simplified, Manageable, And Responsible Tax (SMART) Act" (S. 173) is very similar to the flat tax.

16. Robert E. Hall, Alvin Rabushka and Jan Krepelka, *The Flat Tax* (Stanford, Calif.: Hoover Institution Press, 1995).

17. To be sure, this is merely what the designers of the flat tax claim. In reality, there would be a myriad of complexities, especially for business filers, which make the postcard return more fantasy than reality.

18. U.S. Government Printing Office, "American Jobs Creation Act of 2004," Public Law 108-357. Available online at http://www.gpo.gov/fdsys/pkg/PLAW-108publ357/html/PLAW-108publ357.htm.

19. For example, Pfizer, Chiquita, AbbVie and Burger King.

20. §§301, 312 and 316.

21. "Earnings and Profits" is a tax term of art and it measures the corporation's dividend paying ability. See §§312 and 316. Distributions that exceed earnings and profits are tax free to the shareholder up the shareholder's basis in the stock (§301(c)(2)). Therefore, the corporation should not get a deduction for these amounts because there is no double taxation for this portion of the distribution. §301 distributions that exceed both the E&P and the shareholder's basis are capital gain income to the shareholder. Presumably, this part would be deductible also. The double and triple tax on distributions to shareholders that are C-corps is lessened through a Dividend Received Deduction. We assume no deduction would be allowed to the paying corporation for dividends to C-corp shareholders.

22. §§331 and 336. This assumes the corporation has an overall gain on its assets and the shareholder has a gain on the stock.

23. Sarah Stodola, "10 Giant Loopholes That Businesses Use to Dodge Taxes," *Business Insider,* February 10, 2011. Available at http://www.businessinsider.com/corporate-tax-breaks-2011-2?op=1.

24. See "General Explanation of the Tax Reform Act of 1986," Joint Committee on Taxation. Available at http://www.jct.gov/jcs-10-87.pdf.