TOWARD TAX REFORM

Recommendations for President Obama's Task Force

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TOWARD TAX REFORM:
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Foreword: The Volcker Task Force on Tax Reform

By Robert Goulder

On March 25 President Obama announced the creation of a special task force to review the shortcomings of the U.S. tax system. The group is part of the President's Economic Recovery Advisory Board and has come to be known as the Volcker task force because of the appointment of Paul Volcker as the board's chair.

Volcker is being assisted by Austan Goolsbee, the president's senior economic adviser, who serves as the board's staff director. Members of the task force include Martin Feldstein, Laura D'Andrea Tyson, Roger Ferguson Jr., and William Donaldson. They have been charged with presenting Treasury Secretary Timothy Geithner with a report and recommendations by December 4.

Mindful that it faces considerable challenges, we at Tax Analysts wish the task force success on this critical project. Its mission, like ours, is to foster a tax system that is fairer, simpler, and more economically efficient. Every American stands to benefit from a tax system that better serves these shared interests.

We are proud to present the task force, and the taxpaying public, with this collection of original essays to aid in that endeavor. We have assembled a roster of the most experienced and knowledgeable experts in the tax community to offer specific proposals on how to improve our tax system. We sought contributing authors with diverse backgrounds, drawing from a pool of internationally respected lawyers, economists, academics, and — knowing that taxation will inevitably be viewed through a political prism — liberals and conservatives.

Each essayist was presented with a hypothetical scenario: Imagine having five minutes alone with task force members to advise them on what features of the tax system most need fixed and how you would change them. The writers were limited to roughly 1,000 words, a restriction that necessitates concise analysis and clarity of thought. Countless volumes, if not entire libraries, have been devoted to tax reform. We do not seek to replicate those

exercises here. We anticipate that readers will appreciate that these essays waste little time in getting to the point.

We are grateful to the authors who undertook this project. For each of them, as for us, the pursuit of optimal tax policy is a labor of love.

Reflections on the Mission

Like many other Americans, we welcome any rethinking of our country's tax system. Our enthusiasm must be tempered by the need to be realists. Previous groups have conducted similar reviews of our tax regime but generated little in the way of concrete results. The most recent report was less than four years ago (November 2005), courtesy of President George W. Bush's Advisory Panel on Federal Tax Reform.

But things are different now. There is reason to hope that the task force may produce lasting benefits. Not only do we have an administration that professes to embrace change, but our country's economic situation is more precarious than at any other time in recent history. The same budget projections that suggest a dismal future might serve as a necessary catalyst for genuine reform. History teaches that it often takes a crisis of great magnitude to force Congress's hand, especially on such politically sensitive matters as taxes.

The influence of that sensitivity cannot be overstated. The perceived failing of Bush's advisory panel was that it dared to question the prevailing incentives for homeownership, the treatment of employer-provided healthcare coverage, and the deductibility of state and local tax payments. In other words, generous tax expenditures were labeled as such. One hopes that this time, everything will be on the table, even the sacred cows of the Internal Revenue Code.

At one level, the scope of the task force has been narrowly defined. Office of Management and Budget Director Peter Orszag initially told reporters the group's mandate was to: (1) reduce the tax gap, (2) simplify compliance burdens, and (3) close loopholes that enable ''corporate welfare.''

Those are worthy goals. But many Americans will be disappointed if the task force limits itself to those problems. Larger issues are at play, and our fiscal circumstances beg for a broader

review of U.S. tax policies. This is especially true in light of changes in the global economy in which U.S. businesses must operate. Decades of piecemeal legislative tinkering have resulted in a fragmented statutory scheme that can be characterized as disjointed and dysfunctional.

We know that America can do better. This project represents an opportunity to wipe the slate clean and provide our nation with the tax system it deserves.

Comments? E-mail Tax Analysts at TowardTaxReform@tax.org. ■

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Closing the International Tax Gap Via Cooperation, Not Competition

By Reuven S. Avi-Yonah

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law and director of the International Tax LLM program at the University of Michigan.

All three major goals of the Volcker task force — reducing tax evasion and loopholes, simplifying the code, and reducing corporate welfare — can be advanced by focusing on the international aspects of the tax gap. These aspects include both enforcement of existing U.S. law on U.S. residents earning income overseas (the evasion issue) and reforming deferral for U.S.-based multinational enterprises (the avoidance issue). To best advance the task force's three goals, I would propose a change in each of these two major international areas.

The Evasion Issue

The recent revelations involving Swiss bank UBS reveal a fundamental problem in enforcing U.S. tax law on U.S. residents earning income overseas. Beginning with the enactment of the portfolio interest exemption in 1984, the United States has engaged in a race to the bottom designed to encourage residents of other countries to invest their funds in the United States without having to report the income to their home jurisdiction.

Thus, we permit those foreign residents to earn investment income from U.S. sources without meaningful withholding (capital gains, interest, and royalties are exempt, and dividends can be replaced with dividend substitutes) and without the U.S. payer having any information about the real identity of the payee. (Interest can be paid directly to tax haven corporations, while royalties and dividends can be paid to qualified intermediaries, and in both cases the U.S. withholding agent will not know who the real payee is.)

The problem, as the IRS's recent pursuit of UBS for noncompliance revealed, is that these rules enable U.S. residents to also

earn U.S.-source investment income without paying any tax on it. The provisions that are designed to prevent this, such as legends on bearer certificates and audits of qualified intermediaries by foreign auditors, do not work.

The currently fashionable solution is exchange of information. If all tax havens automatically gave all their data on U.S. residents to the IRS, the problem would be solved. But that will never happen, because we cannot make all the havens cooperate.

There is a better solution. The key observation here is that funds cannot remain in tax havens and be productive; they must be reinvested into the prosperous and stable economies of the world (which is why some laundered funds that do remain in the tax havens earn a negative interest rate). If the rich countries could agree, they could eliminate the tax havens' harmful activities overnight by, for example, imposing a refundable withholding tax (for example, at 35 percent) on payments to noncooperating tax havens, or more broadly, to all nontreaty countries, and by insisting on effective automatic exchange of information with treaty countries. The withholding tax would be refunded after a showing that the income was reported to the country of residence.

The financial services industry would no doubt lobby hard against such a step, on the grounds that it would induce investors to shift funds to other OECD member countries. However, the European Union and Japan both have committed themselves to taxing their residents on foreign-source interest income. The EU savings directive, in particular, requires all EU members to cooperate in the exchange of information or impose a withholding tax on interest paid to EU residents.

Both the EU and Japan would like to extend this treatment to income from the United States. This would seem an appropriate moment for the United States to cooperate with other OECD member countries in imposing a withholding tax on payments to tax havens that cannot be induced to cooperate in exchanging information, without triggering a flow of capital out of the OECD.

The Avoidance Issue

The debate on subpart F has been going on for almost 50 years. From its enactment in 1962 to 1994, a series of steps were taken to curtail deferral, without significantly altering the original

compromise that permitted deferral of most active income. From 1994 to 2006, another series of steps significantly expanded the scope of deferral, and there is now a push to go further and exempt dividends from active income.

Exempting dividends makes sense from an economic efficiency perspective, because the current tax on dividends raises little revenue while inducing significant behavioral changes. But there is an obvious alternative: eliminating deferral altogether. That would result in significant simplification because dividends, interest, and royalties from controlled foreign corporations would not be taxed, and formulas could be used to allocate deductions, just as they now are for interest. Also, outbound transfer pricing would be eliminated, and the foreign tax credit would be greatly simplified (for example, the tricks designed to obtain credits for foreign taxes on deferred income would disappear).

The problem, however, as always, is competitiveness: Like they did in 1961, the U.S.-based MNEs would argue that eliminating deferral would make them noncompetitive, and they would threaten to migrate.

But this problem, too, has a cooperative solution, namely for all OECD members to adopt or strengthen their CFC rules. Because 90 percent or more of MNEs are headquartered in OECD countries, if all OECD jurisdictions abolished deferral, the competitiveness issue would disappear. Inversion transactions could be combated with strict residency definitions based on a properly interpreted managed and controlled standard, because few MNEs would truly want to set up headquarters in tax havens. There may be some growth in MNEs based in developing countries, but economically most MNEs will need to be based in OECD countries for a long time to come.

In my opinion, the solution to both the evasion and the avoidance problem is the same: cooperation with other OECD members, not competition. In a multilateral world, that is the way to preserve the income tax, which cannot be maintained for either individuals or corporations if cross-border income is exempt from taxation. ■

Tax Policy Should Encourage U.S. Investment and Growth

By William C. Barrett

William C. Barrett is the vice president of tax and trade with Applied Materials.

Businesses are compelled (and duty-bound in their obligation to shareholders) to reduce costs and maximize profits. A U.S. multinational competing globally is exposed to lower costs and more efficient offshore operating models. When a company evaluates potential offshore sites for its operations, maximizing return on operating costs such as manufacturing, research, and logistics is a key consideration.

Another consideration when selecting an investment location is the possibility of a lower corporate income tax burden. At a minimum, corporate tax is on an equal footing with other costs of doing business when operational investment location is under review. A low tax rate alone, however, will not compensate for the absence of other favorable business investment conditions.

As part of a global analysis of operational cost and efficiency opportunities, corporate tax is a critical piece of the investment location analysis. If the analysis shows that the United States and country X are equally competitive at the operating cost level, but the country X effective tax rate is 10 percent and the U.S. effective tax rate is 35 percent, the 25 percentage point tax rate difference (representing reduced shareholder return on investment) cannot be ignored if the multinational is to remain competitive.

Tax, as a cost variable in deciding investment location, has a direct impact on locating manufacturing and research and a corresponding direct impact on economic growth and employment. A higher tax rate negatively affects share values, which in turn negatively affects retirement accounts and pensions and the ability to fund healthcare reform.

Recent federal tax proposals are designed to increase the tax rate on income earned (and already taxed) in foreign markets. If

tax policy takes the path of increasing the U.S. multinational cost structure, multinationals will explore cost reduction alternatives to make up for lost profits as a result of the corporate tax increase — one dollar of after-tax operating cost is no different than one dollar of tax cost.

The result of increasing multinational tax rates is predictable: U.S. companies (or their foreign subsidiaries) will become targets of foreign acquirers; more research and manufacturing will be forced to migrate offshore; management and control will migrate offshore; or companies will become marginalized relative to foreign competitors, which may force them out of business. Those potential outcomes illustrate why the corporate tax is really a tax on employees. An employee who loses a job because of the corporate tax suffers a 100 percent tax burden.

Policymakers — both Democrats and Republicans — find themselves at a very important crossroads. The fiscal policy decisions they make now will either move the country in the direction of increasing indigence or create a favorable investment climate by reducing the corporate tax burden, which will encourage retention and growth of U.S. investment and jobs. The more desirable approach would be to design a tax policy that encourages U.S. investment and does not punish multinationals for being successful in foreign markets.

The global effective tax rate on U.S.-based companies must be reduced if the United States is to become competitive again as a preferred investment location. This can be achieved either through a significant reduction in the existing corporate income tax or through a fundamental change of the way U.S. multinationals are taxed. The following are three alternative approaches to the U.S. corporate tax system:

- A 20 percent or lower U.S. corporate tax rate will produce a global effective tax rate in line with the rest of the world. This can be achieved with either worldwide taxation of income earned offshore or a territorial tax (operating income earned offshore is not taxed in the United States) that replaces the current tax system.
- A variation of the territorial tax approach that would truly distinguish the United States as an attractive investment location would be to ''border adjust'' exports and imports. Under a border-adjusted tax system, income earned on

exports from the United States would not be taxed, but imported products would be taxed — either through taxation at import or allowing no deduction for imported goods.

- A further evolution of a border-adjusted approach would be to repeal the existing corporate income tax and adopt a business transaction tax or business activity tax (BTT/BAT). Key features of a BTT/BAT would include border adjustment of exports and imports; territorial taxation of foreign income; a deduction for capital and inventory purchases; no deduction for salaries and wages; a 15 percent or lower statutory tax rate; and a credit for employment taxes.

A BTT/BAT would greatly simplify corporate tax administration, increase transparency, and, most importantly, promote a fiscal policy approach that encourages U.S. investment, employment, and growth. A BTT/BAT can be designed to minimize winners-and-losers transition issues through the employment tax credit and a cap on the BTT/BAT (equal to a percentage of financial statement income). The effective tax rate on U.S. earned income would be higher than the BTT/BAT 12 percent to 15 percent statutory tax rate because of the compensation addback and elimination of most tax credits (other than a credit for employment tax). Therefore, a BTT/BAT system can be designed to be tax revenue neutral for the U.S. government.

A BTT/BAT corporate tax system would send the clearest message to multinational companies that the United States is again a viable investment and job creation location. A BTT/BAT is a better (and simpler) corporate tax model in a global economy, and because of the territorial and border-adjustment elements of the model, it would not override other sovereign countries' tax policies.

Fiscal policy should encourage, not discourage, U.S. investment and employment. Investment, productivity, and real wage growth in the United States increase the asset side of the U.S. balance sheet to absorb increasing levels of federal debt. Corporate tax policy that raises the U.S. global tax rate of multinationals will impede growth and innovation — clean energy, high tech, or otherwise. If the United States does not chart a fiscal policy course of action that encourages U.S. investment and productivity, it will run the risk of systemic unemployment and lag behind the rest of the world in resurgent growth. ■

Repeal the Debt-Financed Rule as Applied to Exempt Investors in Funds

By Kimberly S. Blanchard

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Congress could accomplish significant structural tax reform simply by repealing section 514 as applied to investments by pension funds and other exempt investors in investment funds that employ leverage at the fund level. Thoughtful commentators have been calling for the simplification, if not outright repeal, of section 514 for years.[1] This reform was proposed in 2007 but went nowhere.[2] As this article went to press, House Ways and Means Committee member Sander M. Levin, D-Mich., introduced a similar reform bill, H.R. 3497.

Section 514 was enacted in 1969 to combat a specific tax abuse made famous by the *Clay Brown* case.[3] It is designed to prevent tax-exempt organizations from leveraging off their exemption by making leveraged, ''bootstrap'' acquisitions of property from taxable sellers. Because an exempt owner does not pay tax on many types of income generated by property, it can earn a tax-free yield while passing on a portion of its benefits to the taxable seller. Section 514 attempted to address at least part of that tactic by imposing tax on a tax-exempt organization's income attributable to debt-financed property.

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[1]*See* New York State Bar Association Tax Section, ''Report on Notice 90-41 and Certain Other Issues Arising Under Section 514(c)(9) of the Internal Revenue Code Relating to Debt Financed Real Estate Investment by Tax Exempt Organizations,'' *Tax Notes*, May 27, 1991, p. 1057; Arthur A. Feder and Joel Scharfstein, ''Leveraged Investment in Real Property Through Partnerships by Tax Exempt Organizations After the Revenue Act of 1987 — A Lesson in How the Legislative Process Should Not Work,'' 42 *Tax Lawyer* 55 (1988).

[2]This provision was in section 612 of H.R. 3996, the Temporary Tax Relief Act of 2007. H.R. 3996 was ultimately enacted as the Tax Increase Prevention Act of 2007, but the provision did not make it into the final legislation.

[3]*Commissioner v. Clay B. Brown*, 380 U.S. 563 (1965).

An example in the regulations under section 514 posits that a tax-exempt organization that is a partner of a partnership will be treated as if it incurred its share of any acquisition indebtedness incurred at the partnership level.[4] While that interpretation makes sense as an antiabuse rule — for example, when an exempt organization forms a partnership to avoid section 514 — the policy of section 514 is not implicated when an exempt organization invests in a widely held fund formed as a partnership.

Most investment funds (including hedge funds, venture capital funds, buyout funds, and private equity funds) borrow to make acquisitions of investment assets, and most have a significant number of tax-exempt partners, including pension funds, university endowments, and other exempt organizations. Most of those investors do not expect to pay tax on unrelated debt-financed income; some of them would lose their exemption entirely if any of that income were earned. Accordingly, the principal effect of section 514 in the investment industry is to force investment funds to use foreign feeders and blockers, set up in tax-neutral jurisdictions such as the Cayman Islands, to avoid section 514.

Given that no policy is served by applying section 514 in those cases, and given Congress's distaste for offshore fund vehicles, repeal of section 514 as applied to leveraged investment funds would simplify the law without forgoing revenue (none is raised anyway) and would permit this important class of U.S. investors to invest directly without resorting to offshore secrecy jurisdictions. Repeal of section 514 in this context would increase transparency and be entirely revenue neutral. It would promote efficiency by freeing up fund managers and their advisers to concentrate on more important matters than setting up complex alternative investment vehicle and blocker structures. In short, it would be a win-win for all interests involved.

Some in Congress may believe that pension funds should pay some tax on their investment income. However, section 514 raises no tax revenue because it can be planned around. If one believes

[4]Reg. section 1.514(c)-1(a)(2), Example (4).

that the nation's pension savings should contribute to the tax system, a simpler and fairer way to raise revenue from pension fund investors might be to use a provision already in the code, namely the excise tax imposed on private foundations by section 4940. That tax could be applied at a low rate to the investment income and gains of pension funds. Not only would the tax raise significant revenue in recovering markets, it would be easy to collect and administer and hard to evade, and it would have no competitive or geographic cost of living externalities. It would be borne by all individuals who have savings in proportion to those savings. The proceeds of the tax could be earmarked to pay for healthcare or retirement benefits for the uninsured. ■

10 Recommendations for Business Tax Reform

By Herman B. Bouma

Herman B. Bouma is an attorney in the Washington office of Buchanan Ingersoll & Rooney PC.

The following are my recommendations for business tax reform for President Obama:

1. *Tax all businesses in the same way.* Although individuals engage in business in many different forms for business law purposes, in general all businesses should be taxed in the same way for income tax purposes because they have the same basic ontological nature (that is, they are various ownership arrangements for assets and liabilities). There is no conceptual reason for taxing them differently. Advantage: Distinctions between corporations, S corporations, partnerships, and sole proprietorships would be eliminated for income tax purposes.

2. *Apply mandatory amalgamation to determine a business tax unit.* A business tax unit for income tax purposes would consist of: (a) a business entity (generally as defined by reg. section 301.7701-1(a) and -2(a) but also including a sole proprietorship) and all business entities wholly owned by that business entity; together with (b) all business entities that have the same owners as the first-described business entity. Advantages: The proposal would (1) eliminate the possibility of different U.S. tax results depending on how many wholly owned business entities a business sets up; (2) reduce the need to determine arm's-length pricing for transactions between related persons; (3) reduce the number of returns required to be filed and make enforcement easier for the IRS; and (4) eliminate the need for complicated consolidated return regulations.

3. *Tax all business tax units at the unit level.* Advantage: The proposal would greatly simplify compliance because owner-level taxation (aka ''partnership'' taxation) can be very complicated when just a few owners are involved, let alone hundreds.

4. *Eliminate the distinction between U.S. and foreign business tax units.* There is no logical reason for taxing business tax units differently depending on the law under which they were formed; tax them all in the same way. Advantage: U.S. business tax units and foreign business tax units would be placed on a level playing field.

5. *Use U.S. generally accepted accounting principles (or international financial reporting standards) to determine the worldwide earnings of a business tax unit.* Advantages: A business tax unit would need to keep only one set of books (subject to adjustments, such as adding back foreign income taxes) and not at least three additional sets of books (for determining taxable income, alternative minimum taxable income, and earnings and profits); and book/tax differences would be minimized.

6. *Use formulary apportionment to determine the taxable base to which U.S. tax rates apply.* The taxable base to which U.S. tax rates apply would be determined by applying an apportionment formula (for example, using property, payroll, and sales) to a business tax unit's worldwide earnings, as determined under U.S. GAAP (or IFRS). The United States would adopt this approach unilaterally but would also work with the OECD to develop a model apportionment formula to reduce the incidence of double taxation. Advantage: The extremely murky topics of whether a U.S. trade or business (or permanent establishment) exists and the amount of profits attributable thereto would be avoided.

7. *Apply a flow-through rule to income of a passive foreign investment company.* In the case of income whose derivation does not require much in the way of people and tangible property, a special flow-through rule would be needed (otherwise, an allocation of the income to a low-tax jurisdiction would be fairly easy to accomplish). The income of a business tax unit that constituted a PFIC (generally as defined under current law, but with the term ''passive income'' adjusted to exclude income that would generally be tax exempt (such as dividends; see next recommendation)) would flow through to the owners. (Publicly traded PFICs would be marked to market.) Advantage: The law would retain

an antiabuse rule, but the complicated controlled foreign corporation rules (which also attack some active business income) would be eliminated.

8. *Eliminate double taxation of income earned at the unit level.* All distributions from a business tax unit and all gain on the sale of an interest in a business tax unit would be free of tax. Advantage: Double taxation of earnings would be avoided with maximum simplicity. (Ideally, to equalize their taxation, both dividends and interest should be tax exempt and nondeductible.) Alternatively, an owner's basis would be adjusted for the owner's pro rata share of earnings derived by the business tax unit during the shareholder's holding period, and distributions would reduce basis first. A return in excess of basis, and gain on the sale of an interest in a business tax unit, would be subject to a reduced rate of tax in order to reduce the burden of double taxation of earnings.

9. *Eliminate the general concept of capital gain.* Favorable treatment of capital gain (other than gain on the sale of an interest in a business tax unit) makes no conceptual sense and would be eliminated. Advantage: The entire code would be vastly simplified.

10. *Eliminate withholding taxes on fixed or determinable annual or periodic (FDAP) payments to foreign persons.* Withholding taxes on certain payments (FDAP payments) to foreign persons would be eliminated because: (a) income realized by business tax units would be taxed under formulary apportionment, and withholding on payments to them would thus be inappropriate; (b) individuals should normally be taxed on a residence basis; and (c) income tax should not be imposed on a gross basis. (Under current law, most FDAP interest paid to foreign persons is already exempt from tax; dividends should be exempt for everyone to reduce the incidence of double taxation of earnings.) Advantage: Under current law, a payer must try to apply sourcing rules that are often arcane, try to determine the true status of the payee, determine the possible application of an income tax treaty, and then comply with complicated reporting requirements; elimination of the withholding tax regime would result in significant simplification (including for qualified intermediaries). ■

Promote Dividend Repatriation

By Joseph M. Calianno and Fred F. Murray

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To stimulate the U.S. economy, enhance the competitiveness of U.S. companies, and increase federal tax revenues, we propose that a provision similar to section 965 that would promote the repatriation of dividends from foreign entities be adopted and made permanent.[1] Such a provision could be made even more effective than section 965 (and make the United States more attractive to multinationals) by not incorporating some elements of the existing statute, such as the base period limitation of section 965(b)(2).

Congress enacted section 965 as part of the American Jobs Creation Act of 2004 to encourage the repatriation of foreign earnings of controlled foreign corporations to their U.S. corporate shareholders. Subject to certain requirements, special rules, and limitations, section 965 permitted domestic corporations that were U.S. shareholders[2] of CFCs to elect, for one tax year, an 85

[1]Other bills have been proposed that have made some modifications to the original version of section 965. In the 111th Congress, Sen. Barbara Boxer, D-Calif., and Senate Finance Committee member John Ensign, R-Nev., offered a version as a secondary amendment to H.R. 1, and House Ways and Means Committee members Kevin Brady, R-Texas, Wally Herger, R-Calif., and Sam Johnson, R-Texas, introduced a version as H.R. 507. In the 110th Congress, Ensign offered a version as an amendment to the Economic Stimulus Act of 2008 during the Finance Committee markup of that bill; then-Ways and Means member Phil English introduced a version as stand-alone legislation in H.R. 7044 and as a provision in a broader stimulus bill, H.R. 6152; and Rep. Steve King, R-Iowa, included a version as a provision in a stimulus bill introduced as H.R. 7264.

[2]For the general definition of U.S. shareholder, see section 951(b). For a special rule, see section 965(c)(5).

percent dividends received deduction (DRD) on certain cash dividends received during the relevant tax year from their CFCs. The DRD effectively amounted to a 5.25 percent federal tax rate on qualifying dividends — before any applicable credit that may have been permitted by section 965.[3]

According to IRS statistics, section 965 resulted in vast sums of foreign earnings of CFCs being repatriated back to the United States. Specifically, 843 U.S. corporations took advantage of the provision, and those corporations repatriated $312 billion in qualified dividends for a total combined deduction of $265 billion. Manufacturers were responsible for 81 percent of the qualifying dividends.[4] The amount of money repatriated matched the most ambitious estimates and appears to have exceeded the expectations of Congress's official scorekeeper, the Joint Committee on Taxation, which originally predicted that the provision would raise about $2.8 billion in new revenue in 2005. Thus, despite the 85 percent DRD, the provision resulted in an increase in federal tax revenue.[5]

A provision similar to section 965 that would promote the repatriation of dividends from foreign subsidiaries would have several demonstrably positive effects. By providing a lower effective tax rate on qualifying dividends, the proposal would help alleviate some of the implications of a complex corporate income tax system that has one of the highest corporate tax rates.[6] It also would help alleviate the financial crisis in the

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[3]*See* Notice 2005-64, 2005-2 C.B. 471.

[4]*See* the IRS's Spring 2008 *Statistics of Income Bulletin*.

[5]*See, e.g.*, Robert Shapiro and Aparna Mathur, "Using What We Have to Stimulate the U.S. Economy: The Benefits of Temporary Tax Relief for U.S. Corporations to Repatriate Profits Earned by Foreign Subsidiaries," (Sonecon: Jan. 2008); and Joann M. Weiner, "Bring Back the Repatriation Tax Holiday," *Tax Notes*, Feb. 2, 2009, p. 573.

[6]The United States has one of the highest corporate income tax rates of all industrialized nations. *See* Figure 1 of Weiner, *supra* note 5. The 27 countries of the European Union have an average tax rate under 24 percent, with eight taxing at 20 percent or lower. The U.S. system for the taxation of the foreign business of its companies, including the repatriation of foreign profits, is more complex and burdensome than that of any of our trading partners, and perhaps more complex than that of any other country. *See generally* Fred Murray, ed., *The NFTC Foreign Income Project: International Tax Policy for the 21st Century*, National Foreign Trade Council, Washington, 2001. For an analysis of other measures of the high U.S. relative tax rates, including effective tax rates, on business income, see Peter R. Merrill, "Competitive Tax Rates for U.S. Companies: How Low to Go?" *Tax Notes*, Feb. 23, 2009, p. 1009; and Kevin Markle

United States and liquidity problems faced by U.S. companies by providing not only a short-term economic stimulus, but also an efficient way for U.S. companies to fund their U.S. operations over the long term. That funding could replace costly external domestic borrowing and reduce the cost of capital. That, in turn, would make U.S. companies more competitive in the global marketplace.

Another possible collateral benefit of the proposal would be a reduction in the number of companies that may consider relocating their headquarters outside the United States (possibly reversing a trend in which the United States has been losing headquarters[7]), along with decreasing the pressures on the U.S. tax system that have resulted in the enactment of anti-inversion provisions such as section 7874. The proposal would also be consistent with measures other nations are taking to change their international tax systems to promote the repatriation of foreign earnings and, in general, to try to be more attractive locations for multinationals (see, for example, the recent adoption of a foreign dividend exemption system by Japan and the United Kingdom).[8] Moreover, despite the lower effective tax rate on qualifying

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and Douglas Shackelford, ''Corporate Income Tax Burdens at Home and Abroad,'' University of North Carolina, Jan. 30, 2009.

[7]Ominously, studies have shown for many years that the United States and Japan are tied as the least competitive G-8 countries for a multinational company to locate its headquarters, taking into account taxation at both the individual and corporate levels. *See generally* OECD, *Taxing Profits in a Global Economy: Domestic and International Issues* (1991). In fact, of the world's 20 largest companies (ranked by sales) in 1960, 18 were headquartered in the United States. By 2000 that number had dropped to 8. (Data provided by the International Tax Policy Forum based on an analysis of the *Forbes* International 500 list.) The location of companies' headquarters has important consequences for future domestic growth and employment trends. *See* Laura D'Andrea Tyson, ''They Are Not Us: Why American Ownership Still Matters,'' *The American Prospect* (Winter 1991), pp. 37-49. (Tyson is the former chair of the Council of Economic Advisers and former chair of the National Economic Council in the Clinton administration White House.) These issues also are discussed in the NFTC report, *supra* note 6, at note 36, Volume 1, Part One, Chapter 6.

[8]Jim Carr, Jason Hoerner, and Adrian Martinez, ''New Dividend Exemption Systems in Japan and the U.K.: Tax Considerations for Distributions From U.S. Subsidiaries,'' *Tax Management International Journal*, Bureau of National Affairs, Vol. 38, No. 6, June 12, 2009. Pursuing analogous objectives to section 965, Mexico issued a presidential decree, published in the official gazette on March 26, 2009, to encourage repatriation of funds by Mexican entities and individuals to Mexico. Under the decree, qualifying funds that are remitted to Mexico through December 31 will benefit from a 7 percent tax rate for legal entities and a 4 percent tax rate for individuals.

dividends, the proposal likely would increase U.S. tax revenue as a result of the increase in the amount of foreign earnings that would be repatriated. Finally, the proposal could require that a certain amount of the repatriated earnings be designated for national priorities (such as job creation) and could include other requirements to further promote the effectiveness of the provision and the growth of the U.S. economy.[9]

A 2009 study conducted by George Schink and Laura Tyson shows some of the benefits of a repatriation provision. The Schink-Tyson study evaluated the potential impact of a temporary repatriation proposal modeled after section 965 for purposes of stimulating the U.S. economy. The proposal would permit U.S. companies to repatriate incremental foreign earnings and pay a 5.25 percent maximum tax on the incremental repatriated earnings during 2009 and 2010.[10] It also included a requirement that the funds be used for a list of permitted uses and required that a certain amount of those funds be used for national priorities.

The Schink-Tyson study concluded that: (1) the proposal would attract an estimated $565 billion of additional repatriated earnings to the United States that would otherwise remain overseas (and contrasted that with the stimulus bill the House passed in January that calls for government spending of $545 billion); (2) those incremental earnings would be available to support the domestic activities of U.S. companies and would have a substantial effect in 2009 and 2010, years of great vulnerability for the U.S. economy; (3) the additional funds would mean 425,000 more jobs during the 2009-2012 period, resulting from the creation of new jobs and the retention of existing jobs that would have been lost if those additional funds

[9]Some recent bills have addressed the criticism from opponents of section 965 as enacted by proposing modifications to section 965.

[10]George Schink and Laura Tyson, ''A Temporary Reduction in Taxes on Repatriated Profits for the Purpose of Economic Stimulus and Investment in National Priorities: An Economic Assessment,'' LECG LLC, Jan. 30, 2009. The rate reduction in the proposal was accomplished by excluding 85 percent of the incremental repatriated earnings from taxation. The remaining 15 percent would be taxed at the 35 percent tax rate adjusted downward to reflect foreign taxes already paid on those earnings. The ''incremental'' repatriation would be defined as repatriations in excess of ''normal'' repatriations over the last six years. The proposal elaborates on this definition.

were not available[11]; and (4) the proposal would increase rather than reduce federal government revenue.[12]

The proposal included a requirement that at least 5 percent of the incremental repatriated earnings be committed to investment in national priority areas, including renewable energy projects, energy efficiency projects, healthcare initiatives, and broadband development. The Schink-Tyson study concluded that if, as expected, the temporary tax relief were to attract $565 billion of incremental repatriated earnings, the commitment would generate an additional $28 billion of investment in those areas.[13] ■

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[11]*See* Allen Sinai, "Macroeconomic Effects of Reducing the Effective Tax Rate on Repatriated Foreign Subsidiary Earnings in a Credit- and Liquidity-Constrained Environment," Decision Economics Inc., New York, Jan. 30, 2009.

[12]For a discussion of the increased revenue, see p. 14 of Schink and Tyson, *supra* note 10.

[13]*See* pp. 3-4 of Sinai, *supra* note 11.

Creation of National Appellate Tax Court Will Improve Tax Law

By Jasper L. Cummings, Jr.

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In consideration of President Obama's tax reform task force, Tax Analysts has asked for suggestions on ways to reduce the budget gap not just by raising rates, but by reducing tax evasion and loopholes, simplifying the code, and reducing corporate welfare.

I will not join the many others who properly will call for broadening the base and lowering rates, eliminating the alternative minimum tax, increasing IRS funding, and the multitude of other good and obvious proposals; the panel is already aware of those and won't care what I think. Rather, I will offer less obvious suggestions.

Tax Controversy Proposals

Two of the most astute observers of the federal tax system, Robert H. Jackson and Randolph Paul, said over half a century ago that the federal tax controversy system had too much litigation and too many sources of authority (Jackson counted 13). Those characteristics produce maximum flexibility in all directions for taxpayers. Taxpayer pressure for such flexibility explains why Congress overruled the Dobson[1] rule in 1948 and why the many proposals to create a court of tax appeals have gone nowhere: Taxpayers don't want their flexibility constrained. If the Tax Court is unlikely to rule in a taxpayer's favor, an individual can consider his local district court and its related court of appeals. If that venue is not conducive to victory, he can consider the claims court and its related court of appeals.

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[1]*Dobson v. Commissioner*, 312 U.S. 231 (1944).

Perhaps the time has come when we can no longer afford so much taxpayer flexibility.

I propose reinstating the Dobson rule by statute (which is where it started), meaning that a high threshold would have to be surmounted to reverse fact-findings by the Tax Court. I also join others who have proposed creating a national court of tax appeals to which all federal tax decisions of the Tax Court, the district courts, and the claims courts would be appealed. Further appeal to the Supreme Court would remain the same.

The national court of tax appeals would unify the interpretation of the tax laws in all parts of the country. Research has shown that such a specialty court may be expected to interpret the code so as to try to enforce the purposes of Congress, in contrast with the current tendency of the courts of appeal to read the code literally. (See David F. Shores, ''Textualism and Intentionalism in Tax Litigation,'' 61 *Tax Law.* 53 (Fall 2007).)

Shores isolated 10 Tax Court cases decided between 2000 and 2006 in which the law was clear but its application produced results contrary to congressional purpose. In all 10 cases, the Tax Court ruled contrary to the literal meaning of the code, and in all 10 cases the appeals court reversed based on the plain language of the statute. I believe the Tax Court's approach is more desirable from the viewpoint of the fisc and would be shared by the court of tax appeals.

Antiabuse Proposals

The code's principal antiabuse rules are sections 269, 482, and various rules targeting specific related-party transactions such as section 267. Sections 269 and 482 have fallen into disuse (except in the international area). Rather than create new and untried antiabuse rules, Congress should beef up those sections and direct Treasury to issue additional regulations, particularly under section 269.

If Congress wants to create another statutory antiabuse rule, it should focus on allowance of losses and deductions, which are by far the main components of tax shelters. The courts already strictly construe deductions, and section 165(a) requires that losses be sustained, a term that has never been fully defined. Congress should expand on those concepts.

Regulatory Authority

There is a fair amount of confusion about Treasury's authority to issue regulations and their effect on litigation, under the *Chevron* doctrine. For example, Treasury capitulated to an ill-considered appellate court decision in *Rite Aid*, which invalidated a consolidated return regulation (which Treasury now has spent over 20 years on), leading to legislation Congress used to address the problem created by that case by gingerly amending section 1502 in 2004.

Congress can cut through that confusion by enhancing Treasury's authority in section 7805(a) to issue binding regulations, including upgrading the status of existing interpretive regulations.

Conclusion

These proposals are not taxpayer friendly, but that was not the goal. Their unifying theme is that better tax law is made not in the courts, but by Treasury and Congress. Dean Griswold observed long ago that tax law is principally a matter of administration, not litigation. Although he was a great tax litigator, presumably he was speaking from the viewpoint of what was best for the system. ■

Obama's Treasure Hunt

By Chris Edwards

Chris Edwards is director of tax policy studies at the Cato Institute and a former economist at the Joint Economic Committee.

One news headline announcing the Obama administration's tax reform task force got it exactly right: ''Obama Tax Panel on Treasure Hunt.''[1] The task force, which is to report its findings by December, does not appear to be a serious effort at tax reform. Instead it seems to be another administration initiative to hold Americans upside down by the ankles and shake them.

A presidential ''tax reform'' effort reminds one of the bipartisan Tax Reform Act of 1986, which eliminated loopholes and dramatically cut tax rates. Could the Obama task force lead to similar major reforms? Very doubtful. While the task force has some talented members, the Democrats have moved so far to the left that there are few centrists around these days to broker a compromise deal with the Republicans, as occurred in 1986.

Consider that President Obama has been actively working against all four major themes of 1986: marginal rate cuts, tax base reform to increase neutrality and horizontal equity, distributional neutrality, and revenue neutrality.

Rather than cutting marginal tax rates, Obama plans to increase effective marginal rates at the top end in a variety of ways. Rather than reforming the tax base, Obama has proposed creating numerous special breaks, such as a new tax credit for college expenses.

Regarding the distribution of tax payments, Obama is raising taxes on households at the top while providing refundable giveaways to households at the bottom, such as the Making Work Pay tax credit and expansions in the child and earned

[1]Jeanne Sahadi, ''Obama Tax Panel on Treasure Hunt,'' CNNMoney.com, Mar. 27, 2009.

income tax credits. But the top fifth of households already pay an effective federal tax rate of 26 percent, while the bottom fifth pay just 4 percent, on average.[2] The tax code is already far too graduated, and Obama is exacerbating this inequity.

The fourth theme of 1986, revenue neutrality, is of no interest to the Obama administration. When announcing the new task force, the administration reiterated its promise not to raise taxes on families with incomes of less than $250,000. But the president already broke that promise with a cigarette tax increase in February, and his cap-and-trade energy plan is effectively a large tax increase on all families. Healthcare reform might also include a significant tax increase on average families. Thus, it wouldn't be surprising if the Obama tax task force also morphed into a drive to raise taxes on the middle class.

Another issue is that the three stated goals of the task force — simplifying the tax code, closing loopholes, and reducing tax evasion — are in direct conflict with current Obama policies. Many of Obama's tax plans would further complicate the tax code, including his proposed tax credits and tax increases on multinational corporations. As for tax loopholes, Obama favors adding more special tax breaks in numerous areas such as alternative energy.

What about the task force's goal of reducing evasion? Obama's efforts to raise tax rates on individual income, dividends, and capital gains will increase incentives for evasion. And his plan to increase corporate taxes will likely erode the U.S. tax base as business activity moves offshore. Microsoft Corp., for example, has already said it will move jobs abroad if the Obama plan goes through.

All that said, the task force's goal of cutting ''corporate welfare'' is a good one.[3] It could, for example, propose eliminating the low-income housing tax credit (LIHTC), which is a

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[2]Congressional Budget Office, ''Data on the Distribution of Federal Taxes and Household Income,'' Apr. 2009. These data include income taxes, payroll taxes, and excise taxes.

[3]Jeff Mason, ''Volcker Panel to Study Tax Reform, Report to Obama,'' Reuters, Mar. 25, 2009.

$5-billion-a-year giveaway to real estate developers.[4] Even better, it could propose cutting the $90 billion of corporate welfare on the spending side of the federal budget.[5]

However, eliminating codified giveaways such as the LIHTC is a different matter than the general issue of growing business tax avoidance in the global economy. The Obama effort to impose even more tax rules and regulations on corporations is a dead end. We've been going down that road for more than two decades, and the only result is a highly complex and uncompetitive corporate tax code.

A much better way to deal with corporate tax avoidance and evasion is to cut statutory tax rates, as just about every other major nation has figured out.[6] Recent reforms in Canada's industrial heartland of Ontario, for example, cut the combined federal-provincial corporate tax rate to just 25 percent — 15 points lower than the average U.S. federal-state rate. Ontario's marginal effective tax rate on business investment is being cut in half.[7] Why did Ontario make those changes? To improve tax competitiveness, to generate economic growth, and to increase productivity, according to the government.[8]

While Canada is making fundamental reforms, Obama's task force is on a wild-goose chase to ''aggressively'' close the $290 billion federal tax gap.[9] That won't do anything for American competitiveness, and it seems like a total waste of time given that U.S. tax compliance is already at a high level of about 86 percent.[10] That rate is higher than the U.S. compliance rate with seat belt laws, and it appears to be a higher tax compliance rate than in most other countries.[11]

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[4]Edward L. Glaeser and Joseph Gyourko, *Rethinking Federal Housing Policy* (Washington: American Enterprise Institute, 2008), pp. 112-114.

[5]*See* http://www.downsizinggovernment.org/special-interest-spending.

[6]For a discussion, see Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).

[7]*See* http://www.rev.gov.on.ca/english/notices/str/01.html.

[8]*Id.*

[9]Sahadi, *supra* note 1.

[10]Government Accountability Office, ''Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap,'' GAO-07-391T, Jan. 23, 2007.

[11]The U.S. seat belt law compliance rate is 81 percent. *See* National Highway Traffic Safety Administration, ''Seat Belt Use in 2006: Overall Results,'' Nov. 2006. For

The tax gap is not a primary problem — it is a side effect of our grossly complex tax law and high tax rates. The Government Accountability Office has noted that the proliferation of special tax breaks increases the tax gap by providing return filers more chances to claim unjustified benefits.[12] For example, about one-third of EITC payments are fraudulent or erroneous.[13] Politicians complain about the tax gap, but they are the ones responsible for more than doubling the number of federal tax expenditures since 1974.[14]

In sum, the Obama administration needs a more consistent and constructive tax policy approach. If it believes in a simplified tax code with fewer loopholes, then it should stop pushing to add new tax credits. If it favors reduced corporate tax avoidance, it should propose a reduction in the statutory tax rate.

Most importantly, the Obama administration should rethink its devotion to tax increases as the solution to seemingly every policy issue. Tax increases make no sense in the competitive global economy, and they imply that there are no savings left to be made on the spending side of the federal budget. But after years of studying federal spending programs, I am confident that that is not the case.[15] ■

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international comparisons of black markets, see Friedrich Schneider and Dominik Enste, "Shadow Economies Around the World: Size, Causes, and Consequences," IMF, Working Paper 00/26, Feb. 2000; and Friedrich Schneider, "Shadow Economies of 145 Countries All Over the World: What Do We Really Know?" Aug. 2006.

[12]GAO, *supra* note 10.

[13]GAO, "Federal Budget: Opportunities for Oversight and Improved Use of Taxpayer Funds," GAO-03-922T, June 18, 2003.

[14]GAO, *supra* note 10.

[15]I have begun to outline possible budget savings at http://www.downsizinggovernment.org.

Consider International Trends and Norms in Reforming the System

By Rocco V. Femia

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On May 4 President Obama proposed sweeping changes to the U.S. rules for taxing the foreign business activities of U.S. multinationals. Those changes, the cost of which would be borne largely by a few hundred U.S. multinationals, were projected to increase overall corporate tax collections by upwards of 10 percent. Several of the proposed changes were derived from proposals put forward in 2007 by House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., in the context of more fundamental, and revenue-neutral, corporate tax reform. There has been surprisingly little consideration of international trends and norms in assessing the merits of the proposed changes.

U.S. international tax rules need reform. They are needlessly complex. They create incentives to engage in inefficient, tax-driven practices, most notably the accumulation rather than repatriation of foreign earnings. The rules are difficult for the IRS to administer, and they raise little revenue. In most cases, taxpayers that can opt out of them do; thus, companies have inverted their corporate structures and removed their foreign business operations from the U.S. tax net altogether, and entrepreneurs are advised to structure start-ups as foreign-based companies from the outset.

The proposals under consideration appear to be a good-faith attempt to address some of those deficiencies. Overall, however, they represent a missed opportunity. They would exacerbate the complexity of the current system. In some cases, they would increase the perverse incentive to accumulate earnings offshore. In others, they would reduce U.S. taxpayers' ability to manage

their foreign tax liabilities, thereby increasing foreign creditable taxes and potentially reducing U.S. tax collections. They would increase the incentive to remove foreign business operations from the U.S. tax net, perhaps prompting another round of legislation to further restrict this phenomenon.

Even when a proposal seems sensible in isolation (and it is difficult to defend any aspect of our international tax system in isolation), enactment of it would upset balances that have been struck in our system. Yes, under the current system taxpayers may optimize their foreign tax credit position by selectively repatriating earnings from some foreign subsidiaries and not others — but that is appropriate under any system that attempts to match taxes with associated earnings (the laudable objective of one of the proposals). And yes, the check-the-box rules do allow taxpayers to redeploy active business earnings among their foreign business operations without incurring U.S. tax under the antideferral rules. But that result has been allowed since 2005 by statute as a necessary patch on our increasingly outdated anti-deferral rules, and the administration has proposed extending this statutory treatment until 2011. In our system, two wrongs sometimes make an uneasy right, and addressing one without the other can lead to undesirable results.

A better starting point could be to ask what we want out of our international tax rules (and more generally, our corporate tax system). If we want a system for taxing the foreign business activities of U.S. multinationals in light of global economic forces, we could examine the policies our major trading partners have adopted in response to the same forces. In recent years our trading partners have abandoned efforts to tax the foreign business activities of their resident multinationals, reduced the rate of corporate tax on domestic business activities, and increased indirect taxes. Those policy trends should matter to U.S. policymakers for two reasons.

First, it is instructive to observe the reactions of our trading partners to the same economic forces facing the United States. Sometimes we can benefit from considering global trends that we did not initiate.

Second, the policies adopted by our trading partners have placed further downward pressures on the tax rates applicable to

foreign business activities. That has had the effect of setting a tax cost or ''price'' of operating in a given market for most (non-U.S.) businesses equal to the local tax burden. Businesses that face a higher tax under home country tax rules have a reduced ability to compete in that market. Perhaps in light of that, home countries have abandoned their taxation of foreign active business income, leaving host countries to benefit from any additional domestic corporate rate reductions. That cycle has repeated itself across the globe and has led countries to rely increasingly on taxes other than the corporate income tax.

Many policy responses could be considered in light of these developments. The most promising may be to consider either forgoing U.S. tax on active foreign business operations, as our major trading partners have done, or imposing current U.S. tax on active foreign business operations at a rate more in line with international norms. Either approach could be implemented in a manner that would simplify the rules, reduce or eliminate barriers to repatriation, and even raise revenue if coupled with true loophole closers.

Policymakers may instead prefer to focus on the preservation of our domestic tax base by discouraging U.S. multinationals from engaging in foreign operations. From that perspective, exempting active foreign business income from U.S. tax, or taxing it at a lower rate, would leave intact or even exacerbate the incentive to shift income (and, at times, related business activities) abroad.

In other words, adopting international norms for the taxation of foreign income without doing so for domestic income would throw into relief the relatively high tax cost of conducting U.S. business activities in taxable corporations. Perhaps, in the context of broader corporate tax reform, we should consider whether it is in the interest of the U.S. economy and its participants to maintain a tax rate on incorporated U.S. business activities that is higher than that of virtually all of our major trading partners. This is less a tax policy question than a political and economic policy question.

In the meantime, the least we can do is give due consideration to international norms and trends in developing international tax policy proposals. ■

Remove the Return

By William G. Gale

William G. Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy at the Brookings Institution and codirector of the Urban-Brookings Tax Policy Center.

The Volcker task force on tax reform, part of the President's Economic Recovery Advisory Board, faces a daunting task that is made materially more difficult by *ex ante* constraints placed on its purview and recommendations. Broad-based reform proposals seem to be out of the question, and distributional constraints appear to eliminate many serious ideas. Nevertheless, I believe that significant tax simplification is feasible despite the task force's constraints, and I will take it as a given that simplification is desirable.

Simplification efforts are never easy, of course. Although almost everyone agrees that the overall tax system is too complex, every year taxes become even more complicated. Why is that? We all know the reasons. Simplicity often conflicts with other tax policy goals, like equity and enforcement. People often don't mind complexity that reduces their taxes; indeed, many groups lobby for specific provisions that provide targeted benefits. There is a vicious cycle in which targeted subsidies for one group create demand for additional targeted subsidies by other groups. Complexity is hard to measure and so is often ignored in the political process. Simplification, in short, tends to get sacrificed for other policy goals; it is always a bridesmaid, never a bride. That fact, however, could turn the task force's limited focus into an advantage for simplification efforts because more ambitious reforms are off the table. Here are five thoughts on simplifying the tax system.

First, the goal should not be to just simplify the tax system; it should be to simplify citizens' interactions with government. Converting all deductions, credits, etc., to government spending programs would simplify ''taxes'' greatly, but would greatly

complicate people's lives if it meant they had to apply separately for each benefit. That the income tax form serves as the application for literally dozens of government programs makes the income tax more complex, but it can reduce citizens' overall cost of dealing with government.

Second, simplification is not just an issue of filling out forms; it also involves how individuals pursue activities that minimize or avoid taxes. Thus, the overall structure of the tax system — for example, lower marginal rates — can have a first-order effect on complexity, even if the forms don't change.

Third, complexity is now affecting taxpayers in all income groups; it is not just a problem for high-income taxpayers.

Fourth, several existing compendiums contain good, specific simplification proposals.[1] Those studies highlight several areas of low-hanging fruit for simplification efforts:

- consolidate family, work, and dependent provisions;
- consolidate education incentives;
- consolidate saving incentives;
- tax capital gains like ordinary income;
- repeal the alternative minimum tax;
- reduce the number and variety of phaseouts;
- eliminate hidden taxes and ''take-back'' taxes, including the personal exemption phaseout and the Pease itemized deduction limitation; and
- increase the use of withholding taxes.

Fifth, and most important, the task force should recommend gradually moving an increasing number of people to a ''return-free'' tax system. This could be either a fully return-free system, which would feature exact withholding, or, more likely, a tax agency reconciliation system, in which the IRS sends households a provisional tax return for confirmation or changes. These systems are feasible; they already exist in several developed countries. And a recent California experiment with a tax agency reconciliation system was successful and popular.[2]

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[1]*See* Joint Committee on Taxation (2001), IRS national taxpayer advocate annual reports to Congress, President's Advisory Panel on Federal Tax Reform (2005), and Treasury (2003).

[2]*See* Goolsbee (2006).

A return-free filing system would have several advantages. First, it would simplify taxes for many people. Second, it would create an objective, measurable benchmark. Most simplification gains are hard to document; a return-free system would resolve that problem by providing a clear, objective criterion: Is the system simple enough to operate in a return-free manner? If not, which provisions of the system are getting in the way? Third, it would help prevent further complexity. With a return-free system in place, any new provision that could not be accommodated into that system would face a natural hurdle for enactment.

There are two major objections to a return-free system. One is that the current system is too complex to accommodate a return-free system. While it is correct that return-free systems would require some structural simplification, I view that as a strength of the proposal, not a weakness. A return-free system could even create a ''virtuous cycle'': The availability of return-free filing for some taxpayers, and the likely resulting popularity of the system, would create pressure to simplify the tax system further so that more people could use the return-free system.

The second objection is that the IRS lacks the capacity to administer a system like this. However, the system could probably be applied to up to 50 million returns with relatively small structural changes.[3] IRS capacity can be addressed fairly straightforwardly. A similar problem existed a few years ago with electronic returns. In response, Congress set a goal for the IRS to have 80 percent of returns filed electronically by 2007. A similar phase-in approach would work well for a return-free filing system. And increasing the number of taxpayers in a return-free system would probably prove to be a more politically palatable way to justify additional IRS funding than giving the IRS more resources to monitor and enforce an ever-more-opaque set of tax rules.

So let's start small and grow. Let's aim to get 10 million people into a return-free system by 2013 — that's less than one-fifth of all people who file forms 1040a and 1040EZ — and then aim to get all 60 million filers of those forms on the no-return system by

[3]*See* Gale and Holtzblatt (1997) and Treasury (2003).

2016. At that point, voters can decide how far they would like to see the system extended to the rest of the population.

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Be Careful in Designing International Tax Reform Measures

By Alan W. Granwell

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Industrialized countries have heightened their scrutiny of offshore financial centers (a multitrillion-dollar industry) and the use of offshore accounts in efforts to recoup much-needed revenue from taxpayers improperly using those centers to evade tax.

G-20 countries have been working together to prevent abuses of the global financial system in several areas, including taxation. The G-20 countries have focused on international cooperation of tax authorities and on establishing effective exchange of information arrangements whereby countries can obtain stricter compliance with their national tax laws. In the past few months, a fundamental transformation has taken place in international tax cooperation practices. Numerous well-known offshore financial centers that previously had bank secrecy have endorsed the OECD exchange of information standards, and several of those centers have taken steps to implement those standards.

In ''The Global Plan for Recovery and Reform,'' the G-20 leaders agreed to ''take action against uncooperative jurisdictions, including tax havens'' and to use sanctions to protect their public finances and financial systems. The leaders after their London meeting in April said that ''the era of bank secrecy is over.''

Current IRS Enforcement Initiatives

The IRS uses many methods to find noncompliant taxpayers using offshore accounts or tax haven entities. They include: (1) international collaboration through the exchange of information

provisions of bilateral tax agreements and cooperative information agreements that the United States has entered into with more than 70 countries; (2) the qualified intermediary program that the IRS has with foreign financial institutions that agree to become QIs; (3) criminal investigations with the Justice Department; (4) the whistle-blower program through which the IRS receives many tips; and (5) the John Doe summons authority, which the IRS uses when it suspects U.S. taxpayers are using offshore bank accounts to avoid paying taxes but does not know their identities.

The IRS commissioner has said that international tax issues are a major priority and that the IRS needs more resources, information from both foreign countries and financial institutions, and regulatory and legislative changes.

Legislative Proposals

The Obama administration and various lawmakers have proposed legislation that would enhance international tax enforcement. In general, the proposals are designed to combat offshore tax evasion, specifically by strengthening and expanding the QI program. The overall objective is to facilitate compliance by U.S. taxpayers and require that foreign financial intermediaries provide the IRS with additional information on U.S. account holders. The proposals are also intended to create disincentives for those U.S. taxpayers who choose to do business with a financial institution that is not a QI.

The QI-related proposals would require foreign financial institutions — apparently wherever situated and not necessarily in an offshore financial center — to enter into a QI agreement with the IRS. Under that agreement, the foreign financial institution would be required to undertake significant new obligations regarding U.S. account holders. QIs would be required to: (1) identify all account holders that are U.S. persons; and (2) report all payments (both U.S.- and foreign-source) received on behalf of U.S. account holders and to backup-withhold on those payments if documentation was not received from the U.S. account holders (similar to the obligations imposed on U.S. financial institutions). Also, the IRS would be authorized to publish a list

of QIs, and Treasury would be authorized to promulgate regulations designed to control abuses of the existing program — for example, regulations that would require QIs to collect information on the beneficial owner of a foreign account holder, such as a shareholder of a foreign corporate account holder, and to report that information to the IRS. The regulations also could provide that all commonly controlled financial institutions must either register as QIs or implement similar reporting procedures as the affiliated QI.

The proposals would encourage non-QIs to become QIs to avoid such disadvantages as the potential imposition of full U.S. withholding tax on all payments to non-QIs (including those for the benefit of foreign account holders who have bona fide treaty claims to reduced rates) and the application of negative legal presumptions that would be created against U.S. users of non-QIs, such as (1) a presumption that any foreign financial account owned by someone otherwise subject to the requirement to file a foreign bank account report (FBAR) contains sufficient funds to trigger the FBAR filing obligation and (2) a presumption of willfulness that would apply if a U.S. person fails to file an FBAR for an account with a non-QI containing more than $200,000, which could support significant civil penalties.

The proposals' other provisions would implement stricter withholding rules, broader information reporting, strengthened penalties, and a longer statute of limitations that would enhance the IRS's ability to obtain information and enforce U.S. tax laws. The IRS would also be allowed to hire many more revenue agents.

Comments

With the globalization of financial markets and the financial crisis, initiatives to achieve greater fiscal transparency, exchange of information, and international cooperation in tax matters have become increasingly important. Those initiatives, however, should be carefully tailored in the least burdensome manner to achieve their intended objectives.

The Obama proposals would place significant new and expansive obligations and financial burdens on foreign financial institutions that want to function as intermediaries regarding

investments in U.S. stock and securities. A foreign financial institution that did not agree to those obligations would find itself at a competitive disadvantage compared with a financial institution that agreed to undertake the new obligations as a QI.

The QI/non-QI proposals raise several issues. For example, in terms of providing incentives for financial institutions to become QIs, how would they affect financial institutions resident in important developing countries that may not have become QIs? Also, consideration should be given as to whether foreign countries would retaliate by seeking to impose similar types of obligations on U.S. financial institutions.

In summary, proposals to enhance international tax enforcement are important but should be drafted to achieve their intended and necessary purposes and should also be considered in the context of how our major foreign trading partners may react. ■

Protectionist Pitfalls in U.S. Tax Reform

By James R. Hines Jr.

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The magnitude of current and projected U.S. budget deficits makes it appropriate for the government to cast its net wide in seeking new revenue sources. In doing so, however, there is the danger of misconstruing the role of domestic taxation in a global economy, and thereby designing a tax reform proposal with significant protectionist elements.

Movements to impose heavier taxes on Americans earning active income abroad would undermine the vitality of the U.S. economy and its ability to generate tax revenue. A much sounder and more sustainable tax reform course would be to increase the country's reliance on expenditure-based taxes, which is the direction most of the world has taken in response to the competitive pressures faced by all economies.

Active foreign income earned by American businesses is taxed by foreign governments and, to a lesser extent, by the U.S. government. U.S. taxes typically apply to that income only when it is returned to the United States and after taxpayers have been allowed to claim credits for foreign tax payments. The resulting low ratio of U.S. tax collections to annual foreign income gives the system the appearance of treating foreign income more generously than domestic income and thus makes it an attractive target of reform efforts designed to raise tax revenue.

In fact, the United States taxes foreign income far more heavily than any other major capital-exporting country. Efforts to increase the U.S. tax burden by limiting deferral or reducing foreign tax credits would only increase the obstacles facing American firms attempting to compete in global markets and thrive at home.

The question for reformers is whether current U.S. taxation of foreign income is excessive, or alternatively whether the absence of full U.S. taxation of foreign profits is tantamount to an unwarranted subsidy. The burdens are easily identified: American firms are at a significant disadvantage in low-tax foreign markets compared with all of their foreign counterparts. Competition with investors from countries that exempt foreign income from taxation raises acquisition prices and other costs of operating abroad, thereby effectively pricing Americans out of foreign markets despite the benefits of low tax rates.

Far from being unconscionable loopholes, the limited ability to claim credits for foreign taxes and the deferral of active foreign income do not permit American businesses to compete effectively against investors from any other country in the world. As a result, American firms lose the productivity benefits that would otherwise contribute to their worldwide profitability.

Efforts to increase the U.S. tax burden on foreign income are motivated by the understandable concern that foreign investment by American firms comes at the expense of domestic investment and employment. While there are examples of American employers substituting foreign production for domestic production, there are also hundreds of American companies whose domestic profitability depends in part on their foreign operations. The net effect of foreign investment on domestic economic activity by American firms therefore depends on the relative magnitudes of the substitution and productivity considerations — and the evidence suggests that the productivity effects dominate.

American firms expanding foreign operations generally expand domestic operations at the same time. The most recent statistical evidence indicates that a 10 percent growth in a firm's foreign employment is accompanied by a 3.7 percent growth in domestic employment. Recent evidence for British, Canadian, German, and other firms displays similar patterns.

The more general point is that the desirability of greater domestic economic activity does not imply that greater foreign activity is undesirable. On the contrary, every nation can benefit — and the United States certainly does benefit — from expanded international trade and investment. When Americans invest abroad, they not only undertake greater domestic investment

themselves, but also encourage foreign investment in the United States. As a result of international exchange, business assets are held by the most productive owners, regardless of nationality, to the benefit of all economies.

It does not follow from this logic that the U.S. tax system should subsidize foreign investment; rather, the United States should follow the policies of virtually every other nation in exempting active foreign income from taxation. Doing so promotes efficient ownership of business assets and generates more total tax revenue than a policy that discourages cross-border ownership. The alternative viewpoint — that a failure to tax active foreign income is equivalent to a subsidy — is itself little more than a protectionist fallacy. The reality is that foreign governments tax that income, and competition from foreigners whose home governments exempt foreign income from taxation removes the need for the United States to tax the income directly.

Expenditure taxes such as excise taxes and VATs are attractive alternatives to corporate and personal income taxes in a globally competitive world. Expenditures have clear geographic associations, reducing the potential for international tax avoidance and greatly reducing the mobility of the tax base compared with income tax options. There is ample opportunity to deepen our reliance on expenditure taxes.

The United States is one of the few countries with no VAT, and the U.S. ratio of excise tax collections to total tax revenue is the lowest in the OECD. Historically, small countries with the most open economies have relied most on expenditure taxes, because the personal income tax — and in particular the business income tax — alternatives have been much more costly. But economic developments are rapidly turning all countries, including the United States, into small countries.

Fair and efficient tax policies do not tax all income that governments can identify. Instead they are selective, reflecting the potential mobility of the tax base and the circumstances in which income is earned. Americans earn foreign income in environments that are made highly competitive by the actions of investors that are not taxed by their home countries. In seeking new revenue sources, it would be a serious mistake to increase U.S. taxation of active foreign income, particularly compared with expenditure tax alternatives. ■

Adopt Formulary Apportionment And Combined Reporting

By Joe Huddleston

Joe Huddleston is executive director of the Multistate Tax Commission. The views expressed in this article are his own and do not necessarily represent the views of the Multistate Tax Commission or its member states.

I urge Chair Volcker and members of the task force to seriously consider formulary apportionment, along with combined reporting, as a new method for multinational firms to determine the share of their net income subject to tax in the United States. As the world economy becomes increasingly integrated, the federal sourcing method that attempts to separately identify a geographic source of particular items of ncome becomes increasingly impractical. The federal system requires a resident multinational firm to separately account for income and expenses attributable to specific activities in the United States using geographic accounting and extremely complex transfer pricing rules. The formulary apportionment system is simpler and more practical because it treats the production of world income as more of a multinational endeavor with contributions from all taxing jurisdictions. Under formulary apportionment, there is no need for detailed separate geographic accounting or transfer pricing agreements. The complex rules for deferrals and U.S. taxation of foreign-source income could be eliminated, or at least greatly simplified.

Combined formulary apportionment would allocate a portion of a multinational firm's worldwide net income based on a formula that roughly reflects the relative amount of economic activity located in the United States (that is, based on property, payroll, and sales in the United States) as a percentage of those activities in all jurisdictions. Of course, there is no one true answer to the question of how much income a multinational firm earns from its activities in the United States. Both separate

accounting and formulary apportionment produce reasonable estimates, but formulary apportionment makes that estimate with less complexity and less opportunity for tax avoidance.[1] Thus, combined formulary apportionment provides a more accurate reflection of the tax base that would permit a combination of increasing tax revenues and a reduction in marginal tax rates. Reducing marginal tax rates enhances economic efficiency while also reducing the incentive to improperly shift income to lower-tax countries.

Under the current system, some firms engaged in international trade can improperly shift income from the United States to lower-tax jurisdictions through the use of transfer pricing and by assigning their valuable patents and trademarks to affiliates in tax havens and deferring their tax liabilities. Combined reporting, by requiring the components of a single multinational enterprise (corporate parents and subsidiaries) to add their income together, prevents a variety of tax avoidance schemes that many multinational corporations have devised to artificially move net income out of the jurisdictions where they are earned and into jurisdictions where they will be taxed at lower rates — or not at all.

A federal formulary apportionment system is also a practical approach to taxation of world income that would allow for increased efficiencies in tax administration through greater coordination of federal and state corporate tax systems. Most states base their corporate income tax base on the federal definition of net income, with adjustments. Nearly half of those states also use combined reporting, and many of the combined reporting states allow combination on a worldwide basis.[2]

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[1]*See, e.g.*, Michael J. McIntyre, ''The Use of Combined Reporting by Nation States,'' *Tax Notes Int'l*, Sept. 6, 2004, p. 917; Charles E. McLure Jr. and Joann M. Weiner, ''Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income,'' in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford Univ. Press (2000)); Reuven S. Avi-Yonah and Kimberly A. Clausing, ''Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment,'' Discussion Paper 2007-06 (Washington: The Hamilton Project, June 2007).

[2]*See, e.g.*, Cal. Rev. & Tax Code section 25110; Ma GL ch 63, section 32B(c)(3); W. Va. Code section 11-24-13f. *See also Barclay's Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1993) (worldwide combined reporting not unduly burdensome).

Of course, the U.S. federal tax system is interwoven and balanced to some extent with the tax systems of other nations. A change to the U.S. system could prompt changes in other nations' systems. There is an opportunity to consider this specific change now, as the European Union is also considering formulary apportionment.[3] Together, these two large segments of the world economy could provide international leadership in creating a more practical system of sourcing income. ■

[3]*See* Ana Agúndez-García, "The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-Jurisdictional Corporate Income Taxation: A Review of Issues and Options," European Commission, Taxation and Customs Union, Working Paper 9 (2006).

The Terrible State of the Tax Base

By Calvin H. Johnson

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Taxable income has become a rotten measure of the nation's economic resources. Years of tax planning, myopic doctrine, and constituent pressure have left the tax base looking like a sponge with large holes and little fiber. The system needs repair. Improving the description of either consumption or income will expand the tax base.

Taxable income figures do not describe the standard of living of our richest taxpayers. A *Forbes* survey estimated that in 2000, the nation's richest 400 taxpayers paid total taxes of "barely" 1 percent of their wealth.[1] Some pay less. Leona Helmsley famously told her maid that "only little people pay tax," which was merely a description of the world as she knew it. Helmsley was married to one of the richest holders of real estate in the country, and the excess depreciation deductions kicked off by their hotels must have meant permanent shelter.[2] Realization rules also meant that much of the Helmsleys' wealth was never reached by the income tax. According to the taxable income data, the Helmsleys were destitute.

Economic tax rates on capital have decayed to almost nothing. The real tax rates on investment across the economy can be measured by how much interest an investor must give up to get legal tax exemption on long-term municipal bonds.[3] By that

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[1]William P. Barrett, "Unrealized Riches," 172 *Forbes* 60 (Oct. 6, 2003).

[2]Calvin H. Johnson, "Depreciation Policy During Carnival: The New 50 Percent Bonus Depreciation," *Tax Notes*, Aug. 4, 2003, p. 713; Calvin H. Johnson, "Pretty Cruddy Investments Brought to You by Stimulus Depreciation," *Tax Notes*, Feb. 11, 2008, p. 731.

[3]Calvin H. Johnson, "A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax," 56 *S.M.U. L. Rev.* 13 (2003).

measure, our tax system imposes only trivial taxes on investment. Taxpayers have too many opportunities to avoid tax, and they are willing to, and must, accept only trivial reductions in interest for municipal bonds.

Given the state of the system, tax incentive deductions are wasteful. The federal cost of tax incentives is no longer being passed on to the supposed beneficiaries. Many of the best 500 ideas for base expansion would just repeal existing tax expenditures.

Our tax system also imposes widely divergent tax rates on different kinds of investments. You can measure how tax reduces pretax return by looking at the ratio of adjusted basis to the pretax fair market value of the investment. By that measure, businesses like Macy's that are subject to serious capitalization inventory rules pay tax in excess of the statutory tax rate. Some of the least meritorious companies bear the lowest rates of tax, including, for example, Lorillard Tobacco Co. and the makers of the video games Guitar Hero, Doom III, and Grand Theft Auto IV.[4]

Expand the Tax Base

The best tax base is broad and unavoidable. Avoided tax does no one any good. Taxpayers rationally do themselves damage by planning around tax, and the government collects no revenue from a tax that has been avoided. Both real work and real savings are inelastic in response to tax, but for the federal government to get access to the advantage of the underlying inelasticities, the system needs to cut off easy alternatives to paying tax. Taxpaying cannot be voluntary. The broadest tax base also allows the lowest tax rates for any given level of revenue.

The task force proposals should protect and expand the tax base in 500 good ways. The Shelf Project, which I help lead, is a collaborative effort to offer proposals for raising revenue without raising rates.[5] Its ideas should help.

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[4]Calvin H. Johnson, "The Effective Tax Ratio and the Undertaxation of Intangibles," *Tax Notes*, Dec. 15, 2008, p. 1289.

[5]Calvin H. Johnson, "The Shelf Project: Revenue-Raising Projects That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077.

We need to use mark-to-market accounting whenever there is a public market for the assets. Accountants have done that for years, although with exceptions about subjective intent that are unnecessary for tax. The realization limitation, which is too indulgently interpreted, creates a kind of quasi-cash method under which a taxpayer can easily avoid tax by avoiding cash. We need to reach noncash resources more broadly by, for instance, repealing the exemption for like-kind exchanges and reorganizations.[6] We should tax the value of the use of personal-use property, even when the economic value of the use has not been reduced to cash.[7]

Tax accounting also captures the interestlike income from property only if the adjusted basis for the investment is equal to fair market value. The prime directive that adjusted basis must equal investment value implies repeal of last-in, first-out inventory accounting and an end to taxpayer identification of which block of stock has been sold.[8] Loss deductions should not be allowed when the taxpayer has basis that has not been lost.[9] Cash received should be treated as a realization of the taxpayer's built-in gain before it is treated as recovery of basis not yet lost.[10]

The task force can help the government meet its revenue goals from taxpayers with real economic consumption of more than $250,000, but it must want to do it. For example, section 1014 gives a taxpayer a basis for inherited property that includes imaginary cost. Wastrel heirs can consume the founder's capital

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[6]*See, e.g.*, Calvin H. Johnson, "Impose Capital Gains Tax on Like-Kind Exchanges," *Tax Notes*, Oct. 27, 2008, p. 475 (proposing to tax like-kind exchanges because they are always cash sales except that the cash is kept offstage); Calvin H. Johnson, Andrew Pike, and Eric A. Lustig, "Tax on Insurance Buildup," *Tax Notes*, Feb. 2, 2009, p. 665 (proposing to tax the earnings on a life insurance contract, just as bank account earnings are taxed).

[7]Calvin H. Johnson, "Taxation of the Really Big House," *Tax Notes*, Feb. 16, 2009, p. 915.

[8]Calvin H. Johnson, "End Identification of Stock Certificates," *Tax Notes*, June 16, 2008, p. 1171.

[9]Calvin H. Johnson, "Casualty and Business Losses When Basis Hasn't Been Lost," *Tax Notes*, July 28, 2008, p. 357.

[10]Calvin H. Johnson, "End Tax-Free Monetization of Wealth," *Tax Notes*, June 30, 2008, p. 1361; Calvin H. Johnson, "Deferred Payment Sales: Change the Basis and Character Rules," *Tax Notes*, July 14, 2008, p. 157.

without either founder or wastrel paying tax.[11] Basis should include only real and provable investment costs. The estate tax should raise significant revenue. When capital gains are consumed, as often happens, the regular set of tax brackets should apply. Capital gains, combined with ordinary deduction of inputs, routinely create negative taxes or shelters.[12]

It may well be that tax accounting under current law is irremediable. The distortions caused by accounting-based income taxes are so severe that we may need to reduce our reliance on accountant-defined income. We should impose a higher tax on carbon put into the air, and we should similarly impose a tax on shareholder and partner access to public markets measured by market capitalization.[13] Taxes that taxpayers are willing to pay for benefits they need have no deadweight losses. ■

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[11]Calvin H. Johnson, "The Elephant in the Parlor: Repeal of Step-Up in Basis at Death," *Tax Notes*, Dec. 8, 2008, p. 1181.

[12]*See, e.g.,* Calvin H. Johnson, "Sale of Goodwill and Other Intangibles as Ordinary Income," *Tax Notes*, Jan. 14, 2008, p. 321.

[13]Calvin H. Johnson, "Replace the Corporate Tax With a Market Capitalization Tax," *Tax Notes*, Dec. 10, 2007, p. 1082.

Where Can We Stand to Gain Perspective?

By Edward D. Kleinbard

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The difficulty in tax reform lies not in finding good ideas, but in articulating principles and processes for choosing among them. Traditional concepts like equity (horizontal and vertical), simplicity, or efficiency often are reduced in practice to truisms or implicit value-laden decisions. Before debating which substantive proposals it prefers, the Volcker task force would do well to think about the tools and metrics of its decision-making process.

If one accepts as a postulate that the task force's goal is to revisit the income tax, then some important but underappreciated consequences necessarily follow that can inform the task force's thinking. Most fundamentally, income comes in only two flavors: returns to labor and returns to capital.

Tax policies typically do not break down labor income into smaller groupings. For example, we do not distinguish manual labor income from returns to the application of intellect, at least in our tax rate structures.[1] Moreover, we actually know a good deal about how to tax labor income, given the constraints of a

[1]The literature addressing the taxation of human capital has pointed out that the tax system advantages education-intensive labor in at least two respects. First, under realization principles, the enhanced earnings potential attributable to a degree is not taxed when the degree is awarded, but only in the future as income is earned. Second, students pay for higher posteducation incomes in part through forgoing current taxable income (to attend school), thereby providing a tax subsidy to the cost of education. Those sorts of arguments leave most nonspecialists baffled. The analyses arguably also understate the tremendous variety of individual career paths — high-skill crafts can require years of apprenticeship, and many students work full time while attending school. The literature might be said also to ignore the fragility of life itself, both regarding its span and an individual's ability to capitalize on her acquired skills. In practical terms, those arguments probably will have little impact, except perhaps to point toward increasing the ability of students from lower-income households to pay tuition costs with pretax dollars, to minimize differences in outcomes attributable to differences in starting wealth.

practical tax system. Of course, there are profound questions as to the degree of progressivity that the tax rate schedule should reflect, but those are issues probably best left to the political process rather than expert advice — that is, the very purpose of the political process in this context is to serve as the mechanism through which we discover our appetite for progressivity.

Practical tax policy debates about labor income usually turn on when we should construct exceptions to the general rule, typically to serve social objectives. We can improve those decisions by turning to tax expenditure analysis. In the broadest terms, tax expenditure analysis provides a practical tool for observing when specific tax rules work to give certain taxpayers an effective government subsidy (or, in the rarer case of negative expenditures, impose a double tax on a taxpayer). The social and economic objectives and consequences of the subsidy can then be explicitly analyzed, relative to its cost. Further, policymakers can consider whether the tax system is the appropriate vehicle for that subsidy.[2]

Given that there is little theoretical disagreement about how to measure labor income in a practical income tax system, tax expenditure analysis is a particularly useful tool in this context. By using it, the Volcker task force can address those cases that are susceptible to straightforward cost-benefit analysis (where, for example, a subsidy is mistargeted in practice because of poor design), and it can more explicitly present to the political process the choices that lie buried in those cases that involve the weighing of intangible social values.

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[2]Tax expenditure analysis fell on hard times for many years, because it was widely perceived as resting on a false premise. To use this analysis, one compares current tax rules with some more comprehensive alternative measure of income. If (as was widely suspected in the past) the alternative income base itself could not be derived from universally accepted first principles, tax expenditure analysis could fairly be criticized as simply promoting the alternative base as a reform agenda, rather than communicating anything objectively helpful about current law. The Joint Committee on Taxation's staff addressed those concerns in a series of pamphlets in 2008 that proposed a comprehensive new tax expenditure taxonomy. *See* "A Reconsideration of Tax Expenditure Analysis," JCX-37-08 (May 12, 2008). That work is briefly summarized in my 2009 Woodworth Lecture, at *Tax Notes*, May 18, 2009, p. 925.

Most of the difficulties in designing a practical income tax relate to how to tax capital income, and in turn how to distinguish labor from capital income. Here the Volcker task force can make real conceptual progress. The fundamental insight that can guide the work is that one must take a holistic view of capital income.[3] The corporate income tax, capital gains tax, taxes on dividends and interest income, and even the estate tax are all taxes on capital income, not separate taxes. The goal should be to tax capital income consistently, but that cannot be achieved until these separate categories are revealed as simply empty legal artifacts of 19th-century trust law, company law, and financial accounting, not anything based on economics.

As one simple example, consider interest income. If an individual owns a Treasury bond, and interest rates decline, the future interest income is taxed as ordinary income, just as would have been the case had rates remained stable. But if the individual sells that Treasury bond in the new lower-rate environment at a gain, that gain is taxed at advantageous capital gains rates, even though it represents just the discounted present value of the same stream of future ordinary interest income. The artificial label of ''capital gain'' has obscured the identity in economic returns.

On the other side, if the corporate income tax in fact fairly measures and collects tax on capital income where that capital is held in corporate form, what justification is there for any CGT on the sale of corporate stock? And if the answer is that the corporate tax base is defective, is there not another more straightforward response than the rough justice of CGT on corporate stock, with all its mismeasurements and lock-in problems?

Modern finance theory teaches us that returns to capital can be divided into three species: normal returns (the basic time value of money returns that compensate an investor for deferring consumption), risky returns (the individually uncertain returns attributable to taking on uncertainty), and rents (the supersized returns attributable to a unique asset or position, such as a

[3]Edward D. Kleinbard, ''A Holistic Approach to Business Tax Reform,'' *Tax Notes*, Jan. 8, 2007, p. 90.

valuable patent). One can debate whether all three should bear the same tax rate or whether that rate should be the same as the rate imposed on labor income, but what is important is that we move beyond the empty formalities of our inherited legal labels and begin to think in these terms.

It is possible to do so in an implementable tax system. One admittedly ambitious approach is the business enterprise income tax, which basically divides up the taxation of capital income into two responsibilities: Individual owners of capital are charged with paying current tax on normal returns (the basic time value of money returns) on their investment capital, and firms of all legal sorts (including sole proprietorships) are charged with paying tax on risky returns and rents.[4] The sum of the two represents a single comprehensive accounting for capital income. Another approach is the Nordic ''dual income tax'' structure, in which all capital income (including imputed rents on owner-occupied housing!) is taxed at a single low rate, relative to the rate imposed on labor income.

Finally, if it proposes a holistic approach to the taxation of capital income, the Volcker task force must also address how to distinguish labor from capital income. The carried interest debate of 2007 was one example of the problem. Here again good work has already been done — for example, in the Nordic structures referred to above. ■

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[4]Edward D. Kleinbard, ''Rehabilitating the Business Income Tax'' (Hamilton Project, 2007).

Should the Internal Revenue Code Include a GAAR?

By Jerome B. Libin

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Part of the impetus for major corporate tax reform is the perceived existence of certain ''loopholes'' that inappropriately allow corporations to reduce their federal income tax burden. Many of those so-called loopholes have been expressly created by Congress (for example, deferral). They will need specific legislative correction if they are to be closed. Some of the other targeted loopholes presumably include provisions that were enacted for one purpose but that have been applied by corporations and their tax advisers for another purpose that produces a meaningful but unintended tax benefit.

The code contains few specific antiavoidance provisions that might effectively preclude taxpayers from claiming unintended tax benefits. As a result, the courts have developed extrastatutory doctrines and concepts to test whether a taxpayer engaging in a transaction or pattern of activity should be allowed to receive the benefits claimed.

The business purpose and economic substance doctrines are, of course, the classic judicially created doctrines designed for this purpose. They were developed because the courts concluded that Congress could not have intended to bestow tax benefits in certain situations simply because there had been formal adherence to the letter of the law. Those doctrines reflect a recognition by the judiciary that in drafting precise statutory language describing transactions intended to produce certain tax consequences, Congress cannot always anticipate the circumstances under which taxpayers might attempt to take advantage of that language in a way neither contemplated nor intended.

There are several valid objections to having a court apply a judicially created doctrine, rather than principles of statutory

construction, to test the validity of a transaction implemented on the basis of language in the code. Not least among them is that we have many different courts, at both the trial level and on appeal, that hear tax cases. As a result, there are many different formulations of the same doctrine. For example, some courts view economic substance as having two separate requirements — business purpose and profit potential — that must be satisfied before a transaction will be accorded the tax benefits claimed. Other courts believe satisfying either requirement should be sufficient for the transaction to be respected. Still others favor a blend of subjective and objective analysis. The disinclination of the Supreme Court to provide any new guidance, despite what is now a morass of lower court opinions in the area, has compounded the problem. (The Supreme Court's last foray into the area was over 30 years ago, when it decided *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).)

Because of the confusion as to the proper standards to be applied in any given situation, Congress on several occasions has come close to codifying the meaning of economic substance. While codification has not yet occurred, it is an item scheduled for action in the Obama administration budget proposals.

A legislative definition of economic substance would presumably allow the court reviewing a transaction to determine first whether the doctrine is relevant to its analysis. If the court concludes that economic substance is relevant, the legislative definition would take over. One element of that definition would likely be a requirement that the transaction must have a substantial nontax business purpose. Other elements would likely include a requirement that the taxpayer's economic position must change in a meaningful way as a result of the transaction, and that if an expectation of profit is part of the taxpayer's argument, the expectation must be reasonable and the present value of the expected profit must be measured against the present value of the expected tax benefits.

To some, this is an excessively detailed set of requirements that could cause the denial of tax benefits to legitimate business transactions that might fall short on one or another element. Moreover, a legislative definition along the lines described would inevitably place new questions with the courts: What is a

substantial nontax business purpose? What constitutes a meaningful change in economic position? What discount rate should be used to measure present value?

There is also a sense that codification of the economic substance doctrine could be counterproductive. A specific statutory definition would make more precise a flexible concept that has given the courts considerable latitude in evaluating particular transactions. Skilled tax planners might continue to plan aggressively, seeking to come within the new statutory definition with the expectation that their transactions would be immunized from challenge on other grounds.

Perhaps it is time to approach the situation from a different direction. Perhaps what the United States needs is something similar to what Canadian taxpayers have been living with for some 20 years — a statutory general antiavoidance rule.

The GAAR would replace judicial doctrines to test the validity of corporate transactions. It would be a single statutory rule that could be made applicable to all corporate transactions for which tax benefits are claimed under the code. It could provide, for example, that despite what might appear to be the favorable tax consequences of a transaction, those consequences would be realized only if the taxpayer could establish that either the primary purpose for the transaction was not tax avoidance, or the taxpayer was at risk regarding a material change in its economic position apart from the anticipated tax benefits.

Other formulations could be considered. The Canadian GAAR tests whether a transaction was undertaken primarily for bona fide purposes other than securing tax benefits. Our own code section 269, which denies some tax benefits in some types of acquisition transactions if the principal purpose for the acquisition was tax avoidance, is a mini-GAAR that could serve as a starting point.

A broad, statutory GAAR would of course present interpretive questions of its own. What is meant by primary purpose? What is meant by ''at risk'' in this context? Yet a case can be made that the overarching breadth of a statutory GAAR, as contrasted with a more precise statutory definition of economic substance, would help curtail aggressive tax planning.

For the vast number of business transactions undertaken — say, 95 percent — the GAAR would have no potential application because it would be obvious that the transaction was undertaken in the normal course of business operations for a legitimate business reason and not primarily for tax avoidance. Regulatory guidance from the IRS addressing normal business transactions could make that clear.

For the remaining 5 percent of transactions — the ones tax administrators sometimes refer to as ''aggressive tax minimization arrangements'' — the existence of a GAAR should cause corporations and their tax advisers to pause and reflect on whether a contemplated transaction would pass muster under the new rule. That would be good for the tax system.

One might ask whether corporate tax advisers are not already sufficiently reflecting on transactions that fall into the 5 percent category. Why are the business purpose and economic substance doctrines insufficient to do the job? While corporations and their tax advisers undoubtedly take those doctrines into account, perhaps because they are judicially created the doctrines do not seem to prompt as much reflection as they should — or as much as a statutory GAAR likely would.

Tax minimization is part of our corporate culture. During the period when IRS enforcement took a back seat to customer service, aggressive tax planning went into overdrive. The resulting transactions are now working their way through the system. What might make sense are some additional steps to curtail the corporate appetite for the extremely aggressive tax planning seen in the recent past. A new GAAR in the heart of the code could be one of those steps.

In short, despite the interpretive issues it would raise, a code-based GAAR would likely engender more respect than the current set of purely judge-made rules that vary from court to court. Also, a code-based rule has a reasonably good chance of producing sharper Supreme Court guidance as to its meaning.

For all of these reasons, and despite some obvious problems, the enactment of a well-designed GAAR, in lieu of a more precise statutory definition of economic substance, is worthy of serious consideration as part of an effort to achieve comprehensive corporate tax reform. ■

Simplifying the Tax System Will Help Our Economy

By Martin Lobel

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Everyone agrees that our tax system is broken. It is too complex. It interferes with the free market too much, and, worst of all, it doesn't equitably raise the revenue we need to fund programs enacted by Congress. Most of the proposed tax system fixes are the equivalent of putting a Band-Aid on a spurting artery. It is time to stop the auction system of tax legislation and go back to basics: raising the revenue we need with as few special interest subsidies as possible. Now is the time to do it, because this is one of the few times that the public's attention is focused on the issue, which will make it much harder to hide special interest deals behind a cloud of complexity.

Corporate tax laws are so complex that even with the best intentions, it is almost impossible to comply with them. And the temptations to cheat are overwhelming, particularly for the multinational corporations that can use transfer pricing and tax havens to avoid taxation. Every IRS commissioner who has testified on transfer pricing has admitted that the Service cannot police it. This gives those multinational corporations a real competitive advantage over domestic corporations paying much higher taxes.

Abolishing corporate income taxes would make sense if it were possible to impute the income to shareholders and collect taxes from them. But far too many shareholders are tax exempt or foreign, so that's not possible.

Abolishing corporate tax provisions and imposing a tax on the income corporations declare under oath to shareholders and the SEC should be considered. That way, corporations would avoid tax accounting costs and corporate tax rates could be substantially lowered, thereby minimizing the economic distortions

caused by tax planning while raising the same amount of revenue. Such an arrangement would also take some of the pressure off the demand for special subsidies in the tax code by sophisticated corporations. Actually, that could be this proposal's fatal flaw, because it could impair congressional fundraising. This rationale, however, does not apply to taxes intended to discourage harmful behavior, such as smoking or polluting.

There is another problem on the horizon. If we give in to the multinationals' push to adopt international financial reporting standards rather than U.S. generally accepted accounting principles, there will be far too much temptation to use the much looser IFRS to manipulate income and avoid taxes. Finally, in light of increasing worldwide trade, we should work with other countries — particularly those in the OECD — on an international mechanism to ensure that profits don't get ''lost'' in tax havens.

Individual taxes are too complicated and shift too much of the burden from upper-income to middle-income taxpayers. Even though the IRS is a terrible social welfare agency, Congress continues to impose new welfare programs for upper- and lower-income individuals on it. We need to eliminate all those special welfare provisions and make tax rates truly progressive once again. If a welfare program is worth funding, it is worth reviewing each year in the appropriations process to determine whether it is worth continuing, and if so, at what level. For far too long Congress has financed social programs through the tax system and continued them whether they work or not. At the very least, we need to sunset every tax subsidy at least once every five years.

In short, we shouldn't be satisfied with simply tweaking the system. We need to go back to basics and use the tax system to raise money, not subsidize every special interest that is sophisticated enough or deserving enough of government help. By simplifying and lowering our business and personal taxes, we will make them more equitable and allow our economy to function more efficiently. ■

Strive for a Sound and Respected Tax System

By Annette Nellen

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Our federal income tax can be modified to better reflect good tax policy and reduce the tax gap. Lasting improvement will require a commitment to stop enacting changes that violate principles of good tax policy or that use the tax law to solve problems that would be better addressed another way. A strong commitment to a sound and respected tax system by Congress, Treasury, and the public, along with modernization of rules, can yield a workable system appropriate for 21st-century ways of living and doing business.

Five proposals are offered for consideration by President Obama's task force on tax reform.

1. Require tax proposals to pass a "tax system soundness" analysis. For too long, our federal tax system has been viewed not only as a revenue source, but as a method for solving almost any problem. This has led to an immensely complicated system, the need for high tax rates and an alternative minimum tax, and growing disrespect for the system. Complexity and disrespect also contribute to the tax gap.

Many of today's deductions and credits were not created to reach an appropriate measure of taxable income, but to encourage certain behavior or to provide relief that may not be appropriate or even needed. Those provisions come with costs and problems:

- Complexity, which increases the tax gap and compliance costs.

- Reduced revenue that must, in effect, be made up by other taxpayers.
- Distortions that can adversely affect the economy and people's lives. For example, homeowners may deduct interest on home equity loans, but not on other personal debt. That rule does more to encourage debt on a residence than to appropriately measure taxable income. Incentives that are too narrowly focused can create economic distortions, such as with the ethanol fuel incentives that have increased corn prices.[1]
- Unnecessary rules that are often complex and inequitable. Not everything needs to be encouraged via the tax code or the government. For example, federal tax law encourages homeownership. However, the rules go far beyond that goal by allowing mortgage interest deductions on a vacation home and on debt that exceeds the median U.S. home price.
- Violation of design features. For decades, individuals have either claimed the standard deduction or itemized deductions. In recent years, the integrity of that system has been violated by allowing nonitemizers to claim deductions such as real property taxes. If there is concern that the standard deduction is too small to reflect ability to pay, the deduction should be increased rather than adding selected deductions for some nonitemizers.

A system is needed to require any proposal for a new or expanded deduction or credit to satisfy criteria to help ensure that provisions serve a legitimate and appropriate purpose; do not run counter to existing design features; and meet principles of good tax policy, including equity and simplicity.[2] An approach similar to the tax complexity analysis created by section 4022 of the Internal Revenue Service Restructuring and Reform Act of 1998 — but with more authority — should be required of tax proposals.

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[1]*See* Congressional Budget Office, "The Impact of Ethanol Use on Food Prices and Greenhouse-Gas Emissions" (Apr. 2009).

[2]Various formulations of those principles can be found at Annette Nellen, "Policy Approach to Analyzing Tax Systems" (Apr. 2003).

2. Modernize the tax system by considering trends. Much of our tax system was designed for the industrial era, employees who worked for a single employer, U.S. dominance in world markets, and shorter life spans. An analysis of economic, societal, technological, and environmental trends will help in modernizing our tax system so that it is better aligned with today's ways of living and doing business. For example, rapid technological advancement and greater use of outsourcing and just-in-time practices means that some depreciation lives are too long and that uniform capitalization and other inventory rules may no longer be serving a legitimate purpose.

Changed work patterns and longer lives call for reconsideration of tax rules on retirement and savings plans. An analysis of trends as they relate to existing tax rules should be performed to identify where our tax system needs modernization to support, rather than work against, business and personal welfare and the U.S. economy.

3. Simplify. There are numerous proposals for simplification, such as from the 2001 Joint Committee on Taxation study[3] and from the American Institute of Certified Public Accountants and the American Bar Association. Those proposals should be acted on. Also, the number of special provisions should be reduced, replacing them with lower tax rates. That should also reduce the tax gap. The tax system soundness analysis suggested above would help identify existing provisions that should be repealed.

4. Address the tax gap with an appropriate overall plan. Recent efforts to address the tax gap, such as requiring basis reporting by securities dealers, are good steps, but they avoid the larger aspects of the tax gap such as the 20 percent that is attributable to sole proprietors.[4] There are many proposals from the Government Accountability Office and others on how to reduce the tax gap. Action must be taken through a comprehensive plan that

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[3]*See* Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification," JCS-3-01 (Apr. 2001).

[4]*See* Government Accountability Office, "Using Data From the Internal Revenue Service's National Research Program to Identify Potential Opportunities to Reduce the Tax Gap," GAO-07-423R (Mar. 15, 2007), estimating a nonfarm sole proprietor gap of $68 billion and a total gap of $345 billion.

addresses the key causes of the tax gap rather than through a piecemeal approach that results in the enactment of proposals designed to hit a revenue target.

5. Stop studying and act. Our tax system has been the subject of many studies by government agencies, academics, think tanks, and federal tax reform commissions. Many of those reports describe weaknesses of the federal tax system and offer proposals for improvement. The reports address complexity, the tax gap, depreciation, penalties, global competitiveness, corporate integration, worker classification, and more. The most comprehensive and objective of them should be reviewed and used by the task force. Rather than continually studying the tax system, it is time to improve it. ■

Political Will Can Shore Up Tax Administration, Enact Reform

By H. David Rosenbloom

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There are two major problems with the state of the U.S. tax system: the law on its face and the law as applied. Much attention has been paid over the years to the first problem, generally without much to show for it in the way of improvement (although the Tax Reform Act of 1986 could be viewed as a change for the better). Too little attention has been paid to the second problem. As a result, the applied law is a tax system unto itself, bearing only passing resemblance to the rules Congress believes it has enacted.

If there is a shared desire to raise more tax revenue, and if amelioration of the tax system is really a goal of policymakers, the first step should be to shore up tax administration. That means restoring that function to its rightful place at the heart of our country's affairs. Specifically, the Obama administration should be seeking to improve morale and performance at the IRS, an agency that politicians of all stripes have found convenient to vilify for more than 30 years. That is tantamount to national suicide. The agency needs more support in every form — funds for operations; training for specialists; technical supervision at the management level; and encouragement from the political class, up to and including President Obama. It would not be a bad idea, in fact, for the president to make an appearance at the IRS to acknowledge clearly and forcefully that its employees are performing a valuable public service and to tell them their efforts are appreciated.

It also would make sense to recruit more skilled and experienced personnel in every corner of the agency, not only in Washington; to ensure that employees receive regular training and encouragement to improve their capabilities; and to give them enough time to perform their duties. Rushing through examinations of large-business taxpayers is senseless, as is thinking of taxpayers as customers and neglecting the basic law enforcement function inherent in tax administration. Doubtless many other steps could be taken to improve tax administration, and it would be worthwhile to survey IRS employees and others with detailed knowledge of the agency for the purpose of collecting and developing more ideas.

The preceding recommendations assume no change in substantive tax law.

The substantive tax law, however, is a major part of the tax administration problem. The rules are too complex to be understood by most people, including those charged with administering them; too concerned with policies peripheral to raising revenue, the true function of the tax system; too redundant in their penalty and other compliance-securing provisions; and too generous to high-income taxpayers and business interests. Beneficial changes in the rules are not hard to either imagine or develop. What is and has been lacking is not ideas, but political will.

It would be an excellent idea to remove millions of taxpayers from the tax rolls by adopting a VAT and limiting application of the individual income tax to incomes above a specified level. That idea has been proposed by Yale Law School Prof. Michael Graetz, and it is a good starting point for a policy of depending less on the income tax as the source of our tax revenue. If we depend less on the income tax, the inherent flaws in that tax will have less importance.

In the area of cross-border taxation, it is time to rethink the inbound rules. The ones in place were developed in 1966 and have changed little in the 43 years since. Does anyone think the United States stands in the same position today as it did in 1966? There should be more effective limits on stripping the U.S. tax base, clear rules — better meshing with the U.S. tax treaty network — on the taxation of foreign persons doing business in

the United States, and more attention paid to the foreign taxpayer generally. Foreign taxpayers are now happily eating the U.S. lunch.

Insofar as outbound taxation is concerned, the rules of the foreign tax credit should be streamlined and a partial exemption system installed. The credit system costs more than total exemption and lends itself to abuse. A direct challenge to deferral is less important, despite the notoriety of that issue. Exemption should be used for income from true business activity in countries with normal and serious tax systems, the countries where most U.S. foreign investment is situated.

Finally, the rules for low- and no-tax jurisdictions (tax havens) should be different from those applicable generally, insofar as transfer pricing, deferral, and the credit and exemption rules are concerned. The United States ties its hands when it relies on rules that equate France with the Cayman Islands, as the rules in place now do. Adoption of a partial exemption system should be accompanied by rules requiring full current taxation of income earned in the tax havens. The United States should discard the belief that there is no harm to U.S. interests in a lower foreign tax paid by affiliates of U.S. multinational companies. That is not true, because low foreign taxes suck investment from the United States. ■

Count Capital Gains in AMT, Unify Higher Education Credits

By Deborah H. Schenk

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Two assignments of the Volcker task force are to identify specific measures to close loopholes that help create the $300 billion tax gap and to simplify the code. I'll offer one of each.

Closing the tax gap may mean reducing tax evasion and loopholes, but it also may mean raising revenue, because one of the Obama administration's goals is to cut the budget deficit in half. Closing the tax gap through enforcement alone will not do the trick; hence, raising rates or widening the base may be necessary. Neither is politically palatable, and doing both simultaneously might be political suicide.

But there is a way to accomplish the goal that is not so transparent and might fly under the political radar: Include capital gains in the alternative minimum tax base.

That suggestion rests on the assumption that Congress will not repeal the AMT. Even though the AMT is everyone's favorite whipping boy, it raises a lot of revenue. Indeed, the revenue from it is far greater than the tax gap, and AMT repeal would be a huge tax cut for the wealthy. So even if lawmakers are looking for ways to raise revenue to reduce the deficit, repealing the AMT will not be on the table.

So instead let's return the AMT to its original function of closing loopholes and reducing tax preferences. The first AMT, adopted in 1969, increased the effective tax rate on capital gains. The Tax Reform Act of 1986 eliminated the capital gains preference, and as a result, capital gains disappeared from the AMT base. When the preferential rate made a quick reappearance, Congress failed to reinsert it into the AMT. Now would be a good time to do that.

If simplification is the goal, raising the rates on capital gains directly is simplest. But a second-best approach would be to effectively raise the rates by subjecting capital gains to the AMT. The AMT is already a contributor to progressivity, and effectively raising the rates on capital gains would also promote progressivity because most capital gains are lodged in the upper-income cohorts.

And as long as we are simplifying, we could use the opportunity to rid the AMT base of those items that do not belong there so as to return the base to its original purpose of scaling back tax preferences. In exchange for capital gains inclusion, remove miscellaneous itemized deductions, the standard deduction, exemptions, and the medical deduction from the AMT base. That should make it easier to avoid ending up with tax increases on those with income of less than $250,000 (a constraint imposed on the task force).

My simplification suggestion is to streamline the various provisions intended to provide benefits for higher education. As I have shown elsewhere, the current welter of provisions is unlikely to accomplish the goal of increasing college attendance because, at the margin, the provisions are not sufficient to change behavior. The tax incentives do not affect those who are not price-sensitive, and they do not decrease the cost sufficiently to enable someone who otherwise could not afford college to do so. Instead they are best viewed as a subsidy, a government transfer that reduces the after-tax cost of college.

It's a mystery why the government would want to do that in such a complex way. Taxpayers must try to figure out whether it is more beneficial to use the HOPE or lifetime learning credits or the tuition deduction or the deduction for interest on education loans or a section 529 plan or perhaps a Coverdell plan. The tax incentives have inconsistent definitions of college costs and different eligibility rules. They have inconsistent phaseouts, with rapid phaseouts of the credits and a cliff-effect phaseout for the deduction, and they even use different definitions of income for the phaseouts. This makes it extremely difficult for taxpayers to determine which incentive provides the most benefit.

Part of President Obama's education initiative is to raise the amount of a Pell grant — which is a good idea, as low-income

taxpayers cannot benefit from the various tax incentives because the incentives are nonrefundable. High-income taxpayers stand to benefit significantly from section 529 plans (the tax savings are too low in lower tax brackets to provide a significant subsidy). So that leaves the "middle class" to use the other tax provisions. Much simplification could be achieved with a single targeted credit so that the value is the same for all users. (A deduction for interest on education loans is the least useful incentive, because it provides a future benefit long after tuition has been paid.)

The credit should have one simple set of rules defining eligibility. College costs should be expanded to include room and board, in part to provide parity with section 529 plans and in part to subsidize the true cost of college. A gradual phaseout should be adopted. Finally, the credit should be based on the previous year's income so that a family could determine the amount of the subsidy when tuition must be paid. Better yet, deliver the subsidy at that time.

And, to tie the two ideas together, eliminate the education credit from the AMT base. Sweeping an education incentive into the AMT reduces its effectiveness. Instead, pull in capital gains. ■

Moving to a Territorial System and Reforming the Corporate Tax

By Daniel N. Shaviro

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As the Volcker task force evaluates base-broadening ideas, some important and meritorious reforms are unfortunately off the table. One example would be (after the housing market workout has eased) replacing the home mortgage interest deduction with a smaller, capped subsidy for homeownership that is unrelated to homeowner debt and takes the form of a refundable credit. Surely we've learned from the financial crisis that encouraging excessive homeownership (giving people undiversified asset portfolios), financed by excessive leverage, is undesirable.

On the business side, it's unfortunate that the Obama administration led off with international tax proposals whose long-term feasibility is undermined by the difficulty of sustaining residence-based taxation of corporate entities. Investors can all too easily avoid those taxes by investing through non-U.S. entities, suggesting that in the long run, the United States may need to follow the worldwide trend toward territorial taxation of active business income.

Tax reformers should keep in mind, however, that under the current international tax rules, U.S. multinationals have invested more than $10 trillion abroad, perhaps including as much as $1 trillion of what they designate for accounting purposes as permanently reinvested earnings. There is no reason those investments should reap a windfall transition gain from a shift to exemption. The most straightforward way to avoid the windfall would be to impose a one-time tax (the payment of which might be deferrable with interest) on the accumulated earnings and

profits of U.S. companies' foreign subsidiaries.[1] If that is politically or administratively unfeasible, a more complicated fallback, based on William Andrews's similarly motivated effort to limit windfalls from the adoption of corporate integration, might involve limiting dividend exemption to a normal return on post-effective-date new equity.[2]

Shifting to a territorial system should also be accompanied by improving the source rules so that companies cannot as easily shift income outside the United States. Several important studies have recently explored how that might be done.[3] Key details should include relying on objective factors such as worldwide sales ratios[4] — whether or not the method used is called formulary apportionment[5] — and applying the system as uniformly as possible to multinational groups headed by U.S. companies on the one hand and foreign companies on the other.[6] That would make corporate residence as irrelevant for tax

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[1]The tax on repatriation of those earnings under present law would have been partly offset by the allowance of foreign tax credits. One rough-justice simplification approach, in lieu of allowing the credits, would be to simply lower the tax rate to reflect average foreign tax credit levels. Thus, if the average foreign tax rate on foreign earnings is about 20 percent, the one-time transition tax on accumulated earnings and profits might deny credits but apply at a 15 percent rate.

[2]*See* American Law Institute, Federal Income Tax Project, ''Reporter's Study Draft — Subchapter C (Supplemental Study)'' (1989). Obviously, such a proposal would raise major design and feasibility issues that cannot be explored here.

[3]*See, e.g.*, Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption Versus the Current System* (Washington, D.C.: AEI Press, 2001) (proposing a shift to dividend exemption and raising revenue due to changes to source rules for interest and royalties); Reuven Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, ''Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split,'' *Fla. Tax Rev.* (2009).

[4]*See* Avi-Yonah, Clausing, and Durst, *supra* note 3, proposing that the United States unilaterally adopt formulary apportionment in determining the source of income, but that sales be the only weighting factor used (as distinct from the common practice of also using assets and payroll) on the grounds that it is less manipulable.

[5]*See* James M. Wetzler, ''Should the U.S. Adopt Formulary Apportionment?'' 48 *Nat'l Tax J.* 357, 361 (1995) (suggesting that ''the competing models of formula apportionment and arm's-length pricing are destined to converge'' because transfer pricing relies on quantitative data, while under apportionment, ''there would be pressure to develop specially tailored formulas for particular industries, to preserve existing tax incentives for exports and research, and to refrain from applying a formula across affiliates that were not highly integrated or had very different profit margins'').

[6]*See* Avi-Yonah, Clausing, and Durst, *supra* note 3, thus applying formulary apportionment, and noting that under present law and practices, corporate groups headed by foreign companies often must share worldwide group information with the IRS regarding the resolution of transfer pricing controversies.

purposes as it is economically. However, because this proposal would amount to raising the tax burden on business investment in the United States, rather than simply preventing the use of tax planning to recharacterize income generated here as foreign source, it should be accompanied by lowering the U.S. corporate tax rate.

A further tax reform issue worth addressing, given the contribution that excessive debt levels made to the worldwide financial crisis, concerns the existing corporate income tax bias that generally favors debt over equity. Lowering the U.S. corporate tax rate would immediately reduce the tax bias in favor of debt, and indeed would create tax clienteles that would prefer investing via equity rather than debt, as long as they were confident that they could avoid the shareholder-level tax.[7] That in turn would raise concerns about the use of corporate entities as tax shelters to avoid application of the top individual marginal rates. One response might be to enact a corporate cost of capital allowance for equity as well as debt (further addressing debt bias), accompanied by an automatic inclusion for the holders of both types of financial instrument.[8] A second response might be to enforce reasonable compensation rules for owner-employees on the low end as well as the high end — so that, for example, the next Bill Gates could not cause the profits from his labor to be taxed only at the reduced corporate rate, rather than at the top individual rate, via self-payment of salary below arm's-length levels.[9] ■

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[7]This insight was first thoroughly developed in Merton H. Miller, "Debt and Taxes," 32 *J. Finance* 261 (1977). I discuss it at length in Daniel N. Shaviro, *Decoding the U.S. Corporate Tax* (Urban Institute Press, 2009).

[8]*See* Edward D. Kleinbard, *Rehabilitating the Business Income Tax* (Hamilton Project, 2007).

[9]Guidance on the possible design of those rules might be obtained from the study of Nordic dual income tax systems, which may treat corporate profits in excess of a normal return as indicating the presence of undercompensated labor income. *See, e.g.,* Peter Birch Sorensen, "The Nordic Dual Income Tax: Principles, Practices, and Relevance for Canada," 55 *Canadian Tax J.* 557 (2007). I am grateful to Edward D. Kleinbard for bringing this literature to my attention.

Close the 'Growth Gap,' Not the Tax Gap

By Amity Shlaes

Amity Shlaes is a syndicated columnist for Bloomberg and a senior fellow at the Council on Foreign Relations.

Closing the tax gap, simplifying the tax code, and rationalizing taxation of corporations are three of the initial goals stated for the task force. Those goals are valuable, however, only insofar as they permit enduring economic growth. The panelists should evaluate any tax reform proposal in the context of growth. It's hard to imagine any panelist saying he or she would not take growth into account. Still, taxwriting is a mesmerizing art that tends to distract both practitioners and audience from measures that might sustain growth. If the U.S. economy can grow faster, income tax and corporate tax revenues will flow in.

Consider, first of all, the tax gap. To be sure, the federal government needs more revenue to offset expanding federal debt. If capturing more of the revenue already owed to the government will reduce the debt, well and good. If capturing more revenue makes it possible to avoid statutory rate increases, that can also be good. Tax increases restrict growth. Stronger enforcement of regulations already on the books seems like the lesser evil and the process least unfriendly to economic growth.

Still, a tax gap project can be a trap. That's because efforts to haul in revenue due but unpaid rarely succeed to the extent expected. In the hunt for revenue, prosecution of tax evasion soon extends to prosecution of tax avoidance or even a hunt for abuses in formerly accepted practices. What's more, the culture of tax enforcement is a culture that says, ''We want to get the slippery rich guy.''

The same culture tends to want to increase tax rates. Voters who endorse aggressive tax collection campaigns often also tolerate rate increases on higher earners. Rare is the politician who won't exploit that coincidence to raise rates, even if a rate

increase was not his initial intention. Tax enforcement and tax rate increases end up going together.

The result is a perverse cycle. As Steven J. Davis of the University of Chicago and Magnus Henrekson of the Stockholm School of Economics have shown, high tax rates correlate to large tax gaps: the higher the rates, the larger the shadow economy.[1] To ignore that global pattern is tax provincialism.

What then should the panel do when it comes to the tax gap? The main task is to prevent the topic from taking too much air out of the room. The temptation will be to pursue revenue abroad by recommending increased cooperation with foreign governments or international institutions. Instead of building up policing, the panel might want to focus on increasing the relative competitiveness of the United States. That is, its work should be about making the United States a cash magnet rather than trying to limit the force of cash magnets elsewhere. Draw revenue instead of chasing it.

As for tax simplification, it can be good civics because people trust something they understand. A simpler tax code is one likely to result in better tax compliance. If authorities are going to ''dissemble'' with tax complexities, goes the logic, the taxpayer may dissemble as well. What's more, simplification is a virtue in that it reduces uncertainty. Simplification this year adds value because it suggests there will be no big tax reform the following year.

The problem with simplification is that it becomes as much an aesthetic goal as a pro-growth one. Preoccupied with the architecture of their revision, tax policymakers tend to forget about the average investor on the ground. Simplification doesn't have to come at a cost to that investor, but it often does. For example, a tax simplification that curtails the home mortgage interest deduction makes sense to tax theorists because it broadens the tax base, and base broadening is one of the tenets of tax theology. But in terms of the individual, the shift represents a negative — a

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[1]Friedrich Schneider, *Shadow Economies of 145 Countries All Over the World: What Do We Really Know?* Center for Economics, Management and the Arts, Basel, 2004. *Also see*, Steven J. Davis and Magnus Henrekson, *Tax Effects on Work Activity*, National Bureau of Economic Research Working Paper 10509, May 2004.

retroactive change on the deal from government that the buyer thought he was getting. That homeowner will refrain from buying or investing in all areas, not just homes, because his confidence has been shaken. This is true even if other effective tax rates do not change or drop.

On the corporate side, one concern is that reform will have the quality of the recent spending stimulus package. Changes will favor one industry or form of corporation over another. The justification for this will be that some industries are currently disadvantaged, or that breaks for all are too costly in revenue terms. In the short term such unevenness looks all right, but in the longer term instabilities result. The ideal tax reform here would be one that opened the same opportunities to all individuals and industries, domestic or international.

To foster growth, federal taxwriters will also want to consider factors less frequently mentioned. One is state and municipal taxes. A federal tax increase that seems ''affordable'' is no longer affordable when you consider the increases in state and local levies currently in train. Presumably a ''Europeanization'' of the U.S. growth rate (that is, a slowing down) is something the panel wants to avoid, but increases in state taxes mean that Europeanization is happening automatically, even without statutory increases in federal taxes.

If the erosion of property rights continues in the United States, foreign investors will stay away. Some forms of property (dollar-denominated investments held by the Chinese) are truly not in the purview of this panel. But many others are; capital gains taxes erode property prospectively. The main thing is to take the role of foreign investors in U.S. prosperity seriously because their absence will cause shortfalls that make the current tax gap look minor.

It sounds odd to suggest that a tax panel address issues that belong to a growth panel. Yet the best tax panel is a growth panel as well. ■

Individual Nonfilers and The International Tax Gap

By Paula N. Singer

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On April 15 the IRS announced its new approach to international tax law with the goal of improving voluntary compliance with international tax provisions, thereby reducing the international tax gap. A historic problem the IRS has faced is how to identify international nonfilers and bring them into compliance. Those international nonfilers include inbound foreign national employees transferred to work in the United States who continue to be paid on their home-country payrolls and U.S. citizens and immigrants (popularly called green card holders) who live and work outside the United States.

Announced strategies such as ''leverag[ing] partnerships with other government organizations to gather and share information'' will go a long way toward solving the problem of foreign national nonfilers. For example, U.S. Citizenship and Immigration Services has records of all sponsored foreign workers as well as who sponsored them. That information would allow the IRS to establish compliance initiatives for payroll withholding and reporting by business sponsors, resulting in increased payroll tax revenue. Form W-2 reporting will identify individuals obligated to file U.S. tax returns. Compliance with U.S. worldwide taxation provisions by foreign national filers (and U.S. citizen filers) could be enhanced by adding a certification to Form 1040 that their taxable worldwide income has been included in the return.

Payroll education and audit initiatives that include information about benefits in kind, including items provided overseas, that must be included in wages will increase revenue. However, those initiatives must include educating business personnel who have the information, personnel who initiate the immigration

process, and those who cross-charge salaries from abroad without regard to the payroll and individual tax return implications of those transactions. Payroll practitioners can comply only with withholding and reporting obligations on employment income that they know about.

Payroll education and audit initiatives will also improve compliance by U.S. citizens and green card holders sent abroad (U.S. expatriates) by U.S. employers to work temporarily — particularly employers such as small and medium-size firms involved in the international economy that lack tax advisers who have experience with the special payroll and tax return rules that apply to U.S. expatriates. Those education and audit initiatives would result in increased tax compliance by the U.S. expatriates because of more accurate Form W-2 income reporting.

The historically intractable problem of nonfiling U.S. citizens who live and work or retire abroad might not be resolved soon, if at all, by the new IRS strategies. The total number of overseas Americans is estimated to be between 4 million and 7 million. That now includes a huge number of ''accidental citizens'' — the sons and daughters of foreign workers, students, and scholars who were born in the United States and moved home with their parents when they were still children. It also includes the U.S.-born children of illegal aliens who left the country with their parents when they returned home voluntarily or through deportation. According to a survey of expatriate voters conducted after the 2008 election, 72 percent of overseas Americans have lived abroad for a long-term or indefinite period.

While efforts with other U.S. agencies such as the State Department could help identify many nonfilers (a 1984 law mandates that U.S. citizens provide their foreign address to the IRS when renewing a U.S. passport), convincing them to come into compliance voluntarily will be difficult because of the associated administrative and tax costs. Most overseas Americans are subject to worldwide taxation by their country of residence as well as by the United States. The two tax regimes designed to help avoid worldwide double taxation — section 911 foreign earned income exclusions and foreign tax credits — are complicated. Congress made section 911 more complex with the 2005 revisions designed to generate revenue. The foreign tax

credit regime, simplified somewhat in recent years, mitigates, but does not necessarily allow for avoiding completely, worldwide double taxation.

Voluntary compliance by overseas Americans can be accomplished more readily in the short term by recognizing the administrative and cost burdens imposed on those Americans compared with resident Americans and by simplifying U.S. tax rules and administrative procedures accordingly. Eliminating the cap on section 911 exclusions for income from labor (including deferred retirement income) is one obvious solution. Considering the administrative impact on individuals (and the IRS) when tightening the foreign tax credit regime is another. While those changes would be helpful for the future, overseas Americans coming into voluntary compliance would still have to deal with the more complicated and costly rules in effect for prior calendar years.

The long-term solution is for Congress to recognize that the United States is part of a global economy and to adopt residence-based U.S. taxation for individuals, the norm in the industrialized world. That can be accomplished by adopting the U.S. residence-based tax regime, which now applies only to foreign nationals, for nonresident U.S. citizens and green card holders as well. U.S. tax residency status for all individuals could be based on substantial presence enforced through an entry and exit system. The tax rules and procedures that now apply to nonresident alien taxpayers could apply to all nonresidents. The new exit tax could apply to taxpayers who leave the United States and become U.S. tax nonresidents. The uncapped section 911 exclusions could be maintained for a temporary period for U.S. citizens and green card holders moving abroad (for example, for three calendar years following relocating abroad). U.S. citizens and green card holders with a substantial nexus to the United States (for example, employees with a U.S. employer and retirees with U.S. family members) could be allowed to elect to stay in the U.S. tax system. In lieu of requiring years of tax returns to come into voluntary compliance, Congress could provide an amnesty with a one-time payment for overseas Americans who have lived abroad for six or more years (with an exemption for accidental citizens) who become nonresidents under this new tax regime. ■

Real Tax Reform Is Always Hard: Some Advice for the Task Force

By C. Eugene Steuerle

C. Eugene Steuerle is vice president of the Peter G. Peterson Foundation and previously was a senior fellow at the Urban Institute and former Treasury deputy assistant secretary for tax analysis.

Political theater? Such is the label many have attached to the tax reform task force headed by Paul Volcker. But I heard the same claim made about President Reagan's State of the Union request for a tax reform study from the Treasury Department to be made only after the 1984 election was over. Congress literally burst out laughing.

Forget the laughter. That 1984 study led to the Tax Reform Act of 1986, the most sweeping tax reform in the nation's history — and one that was bipartisan. Opportunity must be seen to be embraced.

I served as the economic coordinator and original organizer of that study. We knew from the start that if we wanted to have any impact, we had to square circles, offend many constituents, and contradict past claims of the administration itself. We lowered rates but at the same time reversed some of the base-narrowing efforts that the administration supported in 1981. We had fights with extreme supply-siders inside and outside the administration who wanted to keep negative tax rates on many investments, even with the proliferation of tax shelters and the resulting contribution to economic stagnation. And we were constantly opposed by political types everywhere, including in the White House and some departments, who either represented narrow constituencies or made the obvious but largely unhelpful objection that real reform might offend someone. And despite fears about transition costs, we moved to one of the highest real growth rates in the nation's history at that stage of an economic expansion.

Why should you or anyone else expect fewer complications this time? The success of your task force will depend on your determination as task force members. The more constraints you accept on doing what you believe to be beneficial to the public, the more you tie your study up in incomplete and contradictory recommendations. As just one example, if you want to move higher education tax benefits into a simplified structure, either as a direct spending item or as a single tax expenditure item, you either will have to accept creating losers with income under $250,000 or forgo simplification. Either decision could be interpreted as a violation of your mandate. You can't get around it. The only way to avoid creating losers (especially if we honestly recognize deficits as creating losers) is to maintain the status quo in all its "glory."

Therefore, the most important decisions the task force will make concern process. Here are my suggestions to you, the task force members, on how to proceed yet remain faithful to President Obama's mandate — just as the 1984 Treasury study was faithful to Reagan's mandate, leading to great success.

- Make sure you get complete buy-in from Treasury to provide suggestions and estimates without political interference as to what you can cover or can't cover. This will take an upfront commitment, probably from the Treasury secretary and Obama.
- Do not — I repeat, do not — start with a list of items you do and don't like. Go to trusted experts — including Treasury tax staff — for a long and detailed list of possibilities.
- Gather almost every legitimate base-broadening proposal and simplification that can be found, ignoring for now what income classes those affect. For instance, removing all home mortgage interest deductions will discriminate against borrowers and in favor of older equity owners, for reasons I will not delve into here. But that may mean preferring limitations or partial conversion to repeal. That's only one set of complicated nuances on hundreds of items that you should be addressing. This step will be extremely difficult, so don't delay.
- Recognize that some reforms cannot mutually advance all goals. For instance, some reforms to promote fairness are not

simple. Also, simplification refers as much to simplifying tax planning as to the number of lines on tax forms.

- Add a discussion of how much revenue a VAT would raise. Again, you don't have to favor it.
- Add a discussion of how government could raise Social Security revenues, including base broadening, tax rate changes, and more years of work. Higher labor force participation is one of the most important revenue options that doesn't require lifetime benefit reductions or tax rate increases.
- In light of the financial crisis, include a separate discussion of how to remove some of the tax favoritism of debt financing over other forms of intermediation.
- Go back over the options you developed in the previous step and reject those you consider bad policy, but at this stage make your decision based only on economic, social, and administrative grounds.
- Ask Treasury to come as close as possible to providing draft language on each of the remaining options. That was one of our crucial steps in the 1984 Treasury study. Unlike with past reform studies, we had a volume 2, which included a how-to manual.
- Develop several rate reduction packages that return to the public various portions of the net revenue raised through other reform. Since the president asked for it, include among your packages one that will leave neutral those income classes (but not everyone in those classes) with income under $250,000.

After this 10-step procedure, make your recommendations to the president. Everything before this is designed to get you the best answers possible before considering the politics. It's also designed to protect you from the early attacks of the lobbyists, who don't want you to think in any expansive way and will object to some of the steps for just that reason. Save the politics for last — considering the political aspects is not your primary job.

My guess is that in 2010 or 2011, fiscal and deficit issues will dominate Congress. Be sure that your report contains information relevant to that debate. You owe it not only to the public, but to your personal reputation, to be relevant.

Remember, you've got one great thing going for you: The complaints you'll receive will be nothing compared with what your chair, Paul Volcker, took on when he led the Federal Reserve in getting inflation under control in another period with severe economic problems. ■

What Does a 21st-Century Tax System Look Like?

By Clinton Stretch

Clinton Stretch is the managing principal for tax policy at Deloitte Tax LLP and served as counsel to the Joint Committee on Taxation from 1979 to 1985.

Chair Volcker:

You and your task force have been burdened with a difficult but imperative task: to shape much-needed federal tax reform in a period of unprecedented fiscal and economic turmoil. The very charge that the president has given you — to reduce tax evasion and loopholes, to simplify the code, and to ''reduce corporate welfare'' — bespeaks the central challenge that you face. Our income tax systems, both corporate and individual, which are the product of mid-20th-century policy thinking, are ill-suited to 21st-century domestic and global economies.

Although there is no single correct approach to fundamental tax reform, we believe the path to a competitive future for U.S. workers and businesses lies before us, not behind us in the policy and rhetoric of the past. Your principal challenge will be to find new solutions, rather than recycle old ideas that no longer fit the realities in which individuals and businesses conduct their affairs. In particular, we offer three recommendations.

First, the task force should recognize the limitations of the current system, which are many. The spending triggered by the economic downturn, as well as long-term structural deficits, will require a comprehensive review of both spending priorities and taxes. The tax gap issue aside, the current income and wage tax systems cannot and should not raise sufficient revenue to fund additional programs or reduce long-term deficits.

President Obama, during his campaign, suggested aggregate cuts in individual income tax collections. This was a realistic

recognition of the system's limitations. The president also proposed to substantially shift the tax burden toward higher-income taxpayers by restoring the rates that existed during the last Democratic administration.

Although restoration of those rates appears to be a foregone conclusion, more tax increases on higher-income taxpayers would seem unwise. Any set of proposals that would impose a combined effective marginal federal, state, and local tax rate even approaching 50 percent would likely be broadly perceived as unfair. Unfair tax systems are unsustainable over time and are bad short-term policy.

The corporate income tax presents an even less promising source of revenue to address our long-term fiscal needs. Our corporate income tax has become a global oddity. Its rates are substantially higher than those of our major trading partners and competitors. If anything, corporate taxes, which burden domestic and multinational firms as they seek to grow in the United States, should be reduced by any meaningful reform.

While we do not suggest abandoning the tax system, recognizing its limitations will necessarily lead the task force to ask the harder and more compelling question: If not a 20th-century tax system, then what?

Second, the task force's tax reform recommendations must seek to level the playing field between U.S. multinationals and their foreign competitors. To do this, the task force must engage the business community in an open dialogue that seeks to understand the competitive pressures faced by U.S. firms without prejudging the tax policy outcome. To compare the U.S. tax burden on multinationals with the burden on purely domestic enterprises harkens back to the 1960s when more than 90 percent of cross-border investment was outbound from the United States.

Today most major U.S. businesses face competition more from foreign-based companies than from other U.S. firms. To blame the tax system for the loss of U.S. jobs is to pretend that the U.S. tax system somehow created globalization and international competition. Besides imposing rates far in excess of those in other major economies, the United States attempts to impose worldwide taxation in a rapidly expanding global economy. This

persistently disadvantages U.S. multinationals as they compete with firms headquartered in countries with largely territorial tax systems. Any corporate tax reforms must:

- result in a substantial reduction in rates;
- prevent double taxation of foreign earnings by reducing extraterritoriality or by providing foreign tax credits free of artificial limitations;
- avoid creating barriers to outbound investment by U.S. firms; and
- encourage repatriation of earnings.

The free flow of capital across borders and a competitive tax system are essential to a strong global and domestic economy.

Third, the task force must engage in an honest examination of the tax gap. Attacking ''corporate welfare'' is not a new idea and does not change the discussion to move it in a constructive direction. Those attacks often distract from the deeper compliance challenges in the tax system. The corporate income tax and compliance with it are not perfect, but our professional experience is that large companies with the sophisticated accounting systems required by their investors have a substantially higher compliance rate than any other taxpayer group.

According to IRS studies, some 80 percent of the tax gap is attributable to underreporting of income by individuals and small businesses. Indeed, some sectors of the small-business community report less than half of their income. To date, the response to this challenge has been greatly tempered. The costs, both in dollars and in taxpayer goodwill, seemingly have discouraged aggressive enforcement of the tax laws in the farm, small-retail, and other small-business sectors. Some highly creative approaches will be necessary to address this problem.

The task force should ask whether it is realistic to expect small businesses to comply fully with present law. A couple running a small business with net earnings from self-employment as low as $87,000 will face a combined tax burden on the next dollar of reported income of 38 percent (25 percent income tax plus self-employment taxes, half of which are deductible against the income tax).

This high marginal rate does not encourage voluntary compliance. Perhaps the task force should explore replacements for the current wage tax system that remove compliance burdens from small businesses as well as from individuals hiring household help. ■

Focus on the Tax 'Avoidance' Gap

By Eric Toder

Eric Toder is a fellow at the Urban Institute and the Tax Policy Center and former Treasury assistant secretary for tax analysis.

President Obama's tax reform task force has been asked to propose ways to close the $300 billion per-year tax gap by simplifying the tax code, reducing evasion, closing loopholes, and reducing corporate tax breaks. That $300 billion figure is an IRS estimate of the ''net tax gap'' for tax year 2001. The IRS defines the net tax gap as the difference between the amount taxpayers owe for a given tax year and the amount they pay on time, less what the IRS expects to recover in the future from voluntary late payments and enforcement activities.

The apparent focus on the IRS-defined tax gap is the wrong agenda for a tax reform panel. The United States faces two tax gaps: the IRS measure of tax evasion and a second gap that may be called the legal avoidance gap. This second gap — the difference between taxes under an income tax without special preferences and taxes under current law — is much larger than the evasion gap, and there are ways to reduce it substantially, if the political will exists.

Comparing the Two Tax Gaps

Government agencies estimate both the ''evasion'' and ''avoidance'' gaps. There are major technical and conceptual problems in measuring both gaps, but the evasion gap is much harder to estimate. Reducing the evasion gap requires better monitoring of the behavior of individual and corporate taxpayers, but the perpetrators of the avoidance gap are legislators, not taxpayers.

Both evasion and avoidance impose costs on the rest of us (higher tax rates to raise the same revenue, larger deficits, and less funding of public services). But measures to reduce them also have economic costs. Reducing evasion requires measures that increase the IRS budget and impose costs on audited

taxpayers and third parties required to supply more data to the IRS. Closing tax preferences reduces whatever social and economic benefits some tax incentives provide. And the most costly of those preferences — provisions such as the mortgage interest deduction, exemption of employer-provided health benefits, and exemption of income accrued in section 401(k) plans — are widely used and have strong political backing.

The IRS periodically updates its estimates of the tax gap, most recently in 2006 for tax year 2001. That evasion gap consists of three components: nonfiling, underreporting (by filers who underreport liability), and underpayment (failure to pay the full amount of tax reported). Underreporting is by far the largest component, and its biggest source is the individual income tax — especially for income sources not subject to withholding or document matching.

Information about the size of the avoidance gap comes from annual lists of tax expenditures published by the Office of Management and Budget and the Joint Committee on Taxation. Tax expenditures are defined as ''revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability'' (OMB). Whether labeled as disguised expenditures or structural defects in the tax system (Kleinbard, 2008; Shaviro, 2004), those provisions represent departures from a normative concept of a broad-based income tax.

There are serious problems in measuring both gaps. But the avoidance gap is easier to measure than the evasion gap because it derives from visible transactions that would generate different revenue under alternative tax rules, while the evasion gap comes mostly from transactions people fail to report accurately and is therefore less visible. (For a discussion of issues in measuring the evasion tax gap, see Toder, 2007[a]. The OMB discusses some of the issues in measuring tax expenditures.)

The IRS is responsible for enforcing the tax laws and thereby limiting the size of the evasion gap. Treasury's Office of Tax Policy has traditionally assumed responsibility for resisting proposals that would erode the tax base. But the combination of strong political and institutional forces pushing for special tax

breaks and a weakening of the Office of Tax Policy's influence since the 1980s suggests continued problems in controlling the avoidance gap.

How Big Are the Tax Gaps?

The IRS estimates a gross tax gap of $350 billion for tax year 2001, of which it expects to recover $50 billion eventually. If it maintained the same fraction of fiscal year receipts over time, the gross tax gap would increase to about $410 billion by 2010. In contrast, the OMB's 2010 budget lists tax expenditures totaling $934 billion for fiscal 2010. Adding the separate estimates introduces errors by ignoring interactions, but Burman, Toder, and Geissler, 2008, find that the cost of most individual tax expenditures estimated simultaneously exceeds the sum of the separate provisions. However one measures it, the avoidance gap is at least twice the size of the evasion gap.

The evasion gap is much harder to close than the avoidance gap. Expanded information reporting and more IRS examination resources could improve compliance, but the additional amount that those measures could raise is fairly modest (Toder, 2007[b]). Some recently advanced proposals (broker reporting of cost basis, third-party reporting of credit card sales) have already been enacted, and additional compliance proposals in the Obama administration's budget proposal would raise just $10 billion in the next decade. Reducing or closing preferences in the individual and corporate income taxes could raise much more money (for examples, see Congressional Budget Office, 2007).

Conclusions

The tax reform panel's apparent mandate to focus on tax evasion is misplaced. The avoidance gap — the additional revenue that could come from broadening the income tax base — is much larger than the evasion gap and much easier to close, with sufficient political will. Congress should certainly give the IRS the appropriate tools to catch tax evaders, but the real erosion of revenue comes from legislation that lets favored taxpayers who engage in favored activities pay less than others with the same income. The panel's main focus should be on finding appropriate ways to close that second tax gap.

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25 Ways to Make the Tax Code Simpler, Fairer, and More Efficient

By Alan D. Viard

Alan D. Viard is a resident scholar at the American Enterprise Institute and a former economist with the Joint Committee on Taxation. *He thanks Alex Brill, Amy Roden, Jason Saving, and Victor Brian Viard for helpful suggestions. The views expressed are solely his own.*

I propose 25 changes intended to improve the simplicity, efficiency, and fairness of the income tax system. The proposals would have various revenue and distributional effects, which could be offset, if desired, through changes in tax brackets. Many of these ideas are taken from the national taxpayer advocate's annual reports and the Joint Committee on Taxation's March 2001 and January 2005 reports. The task force should also draw heavily from the many other valuable proposals in those reports.

I have excluded larger reforms that could be considered as part of a sweeping overhaul. Those might include reducing tax preferences for employer-provided health insurance and owner-occupied housing, changing the state and local tax deduction, repealing the alternative minimum tax, moving to a dividend-exemption corporate tax system, repealing the corporate tax, and replacing the income tax with a consumption tax.

Changes to Personal Income Taxation

1. Simplify section 1(h) by excluding a uniform percentage of long-term capital gains and qualified dividends from taxable income in all brackets and eliminating the special treatment of gains on collectibles and depreciable property.

2. Repeal the section 22 credit for the elderly and disabled and the section 63(c)(3) additional standard deduction for elderly (nonblind) taxpayers. These provisions are unnecessary in view of the size and growth of transfer payments to the elderly.

3. Simplify section 23 by changing the child-care credit to an above-the-line deduction, which is an appropriate treatment for a work-related expense.

4. Amend sections 24, 32, 36A, 63, and 151 to consolidate the child tax credit, the earned income tax credit, the Making Work Pay credit (if permanently extended), the standard deduction, and the personal exemption into a few simplified and coordinated provisions, such as the family and work credits proposed in 2005 by the President's Advisory Panel on Federal Tax Reform.

5. Reduce complexity and inefficiency by eliminating income-based phaseouts, including the section 68 itemized deduction limitation and the section 151(d)(3) personal exemption phaseout. The only remaining phaseouts should be in the family and work credits described above. Any other tax preferences, such as those for saving and education, should be available at all income levels or at none.

6. Repeal personal energy credits, such as those provided by sections 25C, 25D, 30B, 30C, and 30D, which are inefficient substitutes for direct taxes on energy and pollution.

7. Simplify tax calculation for nonitemizers by repealing the section 63(c)(7) above-the-line deduction for a limited amount of real property taxes.

8. Simplify section 86 by making a uniform percentage of Social Security benefits taxable at all income levels. If desired, the taxable percentage could be set to rise over time. In view of the size and growth of transfer payments to the elderly, it would be appropriate for that percentage to reach a relatively high level relatively soon.

9. Amend section 162 or reg. section 1.162-5 to resolve the uncertainty, manifested in recent Tax Court decisions, about whether and when MBA tuition is a deductible employee business expense. Also, consolidate current education incentives into two or three simplified provisions.

10. Amend section 165(d) to make all gambling losses nondeductible and amend the code to exclude gambling winnings from taxable income. The taxation of winnings and losses gives rise to complexity and noncompliance and is unnecessary because income tax already applies to workers and capital providers in the gambling industry.

11. Amend section 170(e) to reduce or eliminate the preferential treatment of taxpayers who donate property to charitable organizations relative to the treatment of taxpayers who sell property and donate the sale proceeds.

12. Consolidate current tax-preferred savings accounts and plans into a few simple and coordinated provisions, along the lines suggested by the presidential panel in 2005.

13. Dramatically expand the availability of section 904(k), allowing more mutual fund and other investors to avoid the complex computation of the foreign tax credit limitation.

14. Repeal the complex and distortionary section 1202 exclusion for capital gains on small-company stock.

15. Amend section 1211(b) to increase the $3,000 capital loss deduction limit, which has been unchanged since 1978, index it for inflation, and authorize the Treasury secretary to increase it during stock market downturns. This change would reduce the tax penalty on risky portfolio investments.

16. Add provisions to more effectively prevent and prosecute the evasion of tax on offshore interest income, along the lines proposed in President Obama's fiscal 2010 budget proposal.

Changes to Business Income Taxation

17. Amend section 41 to provide a single flat research tax credit, avoiding the complexity and inefficiency of the current incremental and alternative credits.

18. Repeal business energy tax credits, such as those provided by sections 43, 45, 45H through 45M, 48, 48A, and 48B, which have the same defects as the personal energy credits described above.

19. Amend sections 167(h), 291(b), and 613A to provide neutral tax rules for all oil producers, ending the current discrimination against large producers.

20. Amend section 172 to authorize the Treasury secretary to extend the net operating loss carryback period during recessions. This change would reduce the tax penalty on risky business investments.

21. Repeal section 179 expensing, which provides little marginal incentive and discriminates against large firms. For simplicity, allow all firms to expense a small specified volume of investment.

22. Repeal the section 199 domestic production deduction, which provides a complex and inefficient incentive to produce goods rather than services.

23. Amend section 243 to eliminate the tax on intercorporate dividends, a third tax layered on top of the double tax on corporate income.

24. Repeal the section 472(c) last-in, first-out conformity rule. Given that book conformity is not required for accelerated depreciation on equipment and structures, it should not be required for LIFO, which levels the playing field by providing comparable tax treatment for inventories. This change would be essential if the SEC adopts international financial reporting standards, which do not allow the use of LIFO.

25. Terminate the inefficient export subsidies provided by the domestic international sales corporation provisions in sections 991 through 997. ■

It's Time to Adopt Formulary Apportionment

By Joann M. Weiner

Joann M. Weiner is an adjunct professor at George Washington University.

International tax reform cannot wait.

In 1996 the Treasury Department rejected the formulary apportionment (FA) method for taxing multinational corporations. That was the right decision at the time; economic integration and multinational activity was not sufficiently advanced to justify abandoning the arm's-length method. But developments since then reveal that it is time to reconsider that decision.

The arm's-length method reflects an era when companies delivered tangible goods, provided services in person, and conducted business through simple corporate structures. That era is long gone. Companies now deliver goods and services electronically, conduct cross-border operations via an intangible economic presence, and operate through complex, often hybrid corporate structures.

Unfortunately, the arm's-length method ignores those realities. It requires that multinational enterprises have a permanent establishment to be subject to tax in a country. It requires them to calculate their profits as if their integrated operations were separate and distinct from each other and to price every internal transfer of goods and services under the fiction that those transfers occurred with unrelated parties at market prices. It allows them to shift income to low-tax countries and expenses to high-tax countries with a keystroke. The United States can no longer afford to ignore those realities.

The arm's-length method may have been the best way to tax multinational corporations in the 20th century, but there is a better way to tax them in the 21st century.

The Formulary Apportionment Alternative

FA is the way. Under FA, a corporation's tax liability depends on its business activity in a country, not on the income it reports to that country. If a corporation has employees, sales, and factories in a country, it not only has income in that country, but it also has a tax liability, regardless of what its internal transfer prices indicate.

The vast majority of corporations do not abuse the arm's-length method. But with tens of thousands of cross-border transactions occurring daily, it is anachronistic to price each internal transaction — especially because equivalent results can occur by distributing profits across countries using a simple formula.

Simplicity, flexibility, stability, and competitiveness are the keywords that describe FA.

FA is simple. A multistate company finds out how much it earned in each state by multiplying its total profits by the share of its business activity in each state. FA has one measure of profits and one formula.

FA is flexible. It treats a complex multinational corporation as a single economic unit for tax purposes. Under FA, economic substance triumphs over legal form.

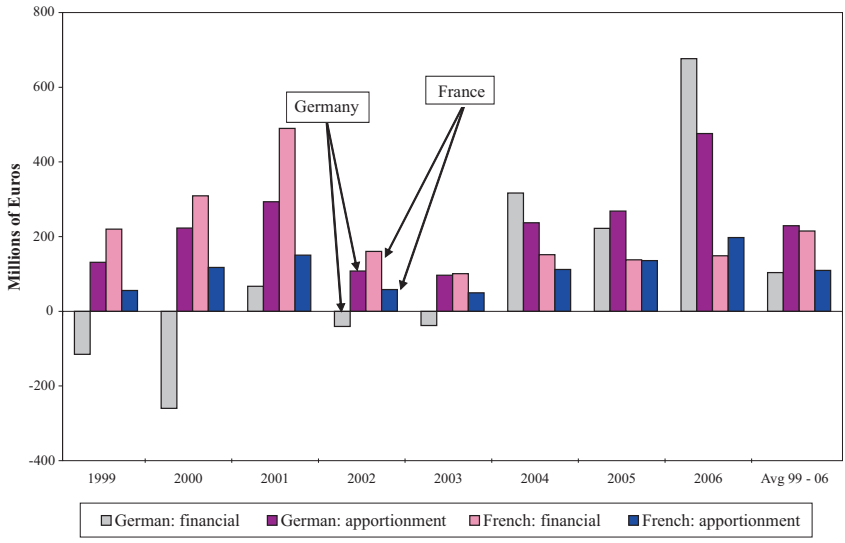
FA creates tax base stability. As the chart on p. 105 shows, as long as a company is profitable overall, FA guarantees each country a positive tax base. By contrast, the tax base measured under financial accounts can swing widely from profit to loss, creating uncertainty for tax authorities and taxpayers alike.

FA promotes competitiveness. Under FA, countries design competitive tax policies, because each country must build a system that encourages companies to locate their factories and employees, not just their income, in the country.

Given those advantages, it is no surprise that senior economists in the Obama administration support FA. National Economic Council Director Lawrence Summers has favored FA for decades. He was Treasury deputy secretary when Treasury held a conference to evaluate FA, where he noted that the U.S. states provide useful experience in thinking of ''ways to address the technical problems created by world economic integration.'' Other senior administration economists, including Jason Furman

Merck Group Consolidated Financial Earnings Before Interest and Taxes and Estimated Apportionment Income

(using an assets, number of employees, and external sales apportionment formula)



Notes: The figure uses Merck's financial accounts to indicate the geographic distribution of the company's group activity. It compares Merck's earnings before interest and taxes from its financial accounts with its income determined under formulary apportionment in Germany and France. The formula is a weighted average of the share of external sales, net operating assets, and number of employees in the country relative to Merck's EU totals.

To illustrate how the income attributed to a country using apportionment can differ from the amount reported in the financial statements, consider Merck's 2002 results. During that year, Merck's German operations lost €41 million according to the company's consolidated financial statements. If Merck had calculated its German income using formulary apportionment for its European profits, its German income would be measured by the share of total European earnings before interest and taxes located in Germany as measured by its share of European operations located in Germany. For example, in 2002 Merck had an average of 40 percent of its assets, sales, and employees in Germany. Merck earned €272 million in profits from its European operations. Thus, under formulary apportionment, Merck would report €108 million in profits in Germany in contrast to the €41 million financial statement loss reported in Germany.

Source: Jack Mintz and Joann M. Weiner, "Some Open Negotiation Issues Involving a Common Consolidated Corporate Tax Base in the European Union," 62 *Tax Law Review* 81 (2009).

at the National Economic Council and Austan Goolsbee at the Council of Economic Advisers, have written in favor of FA.

Guidance From the EU

Fortunately, the Obama administration does not have to start from scratch to design an FA system; the European Commission has already done the work. Along with the European Union member states, it drafted an FA system for the EU. The formula would be calculated as ⅓ * property share + ⅓ * sales share + ⅙ * number of employees share + ⅙ * employee compensation share. The tax base would be consolidated at 75 percent ownership. Active foreign earnings would be exempt, subject to a switchover mechanism to a foreign tax credit for low-taxed foreign earnings. Multinational enterprises would work with a single tax authority under a ''one-stop shop'' idea.

FA Is Not Perfect

Because it restricts income shifting, FA will help close the $300 billion tax gap, but it will not create a tax windfall, and it is not problem free. Just like under the current system, intangible property creates difficulties, as does determining the members of the consolidated group. State tax experts are all too aware of how corporations shift income through the strategic use of passive investment companies, real estate investment trusts, and captive insurance companies.

But perfection is not the goal. On balance, FA is superior to the arm's-length method. FA is a simple, flexible, and stable tax method that encourages beneficial tax competition. Rather than rehashing the tired old arguments about capital import and export neutrality, the Obama administration should profit from the expertise of its most senior economists and work with its international trading partners to refine the EU's FA outline and develop an international FA system for the United States and its major trading partners.

There is no time to wait.

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10 International Tax Questions for The Volcker Tax Reform Panel

By Philip R. West

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The Volcker task force is charged with making recommendations for closing loopholes, simplifying the code, and generating revenue. Recent international tax proposals have been described as closing loopholes and generating revenue, and the international tax rules are certainly complex. It stands to reason, then, that the task force will be considering those proposals and rules. And whether or not the task force focuses on the international tax rules, in the coming months those rules almost certainly will be a hot topic of debate in one form or another. It is therefore appropriate to comment on them here.

The Volcker task force, however, is well advised already. So rather than offer one more opinion on what the outcome of its work should be, I thought it would be more useful to pose some fundamental questions that it may want to consider as it proceeds. Hopefully, these questions will also be useful, or at least interesting, to a broader audience.

1. The international tax debate can be framed in terms of both revenue and policy. To what extent should the debate be about allocation of the spending burden, and to what extent should it be about other policy considerations such as economic efficiency and the effect of the international tax rules on the economy?

2. To what extent should competitiveness be a relevant factor, compared with other policy considerations? How should competitiveness be defined? (By comparing specific international tax rules? By comparing the tax burden on foreign income more broadly? By comparing the total corporate tax burden? By comparing the overall business

environment? By comparing other factors?) And once competitiveness is defined, how should it be measured?

3. Should the business community and the administration (and Congress) attempt to reach an agreed understanding of the international tax rules adopted by our major trading partners and how they operate in practice? Should the OECD attempt to publish such a description and analysis? How important is this comparison? In other words, do foreign rules create international norms to which we should be moving or a race to the bottom that we should be resisting, ignoring, or at most just factoring into our own policy deliberations?

4. What is the connection between our international tax rules and job growth or loss? What is the significance of these two facts: (a) large amounts of income can be earned abroad without a large number of foreign jobs, and (b) neither Congress nor the administration thinks it is a good idea (or at least a good enough idea to propose) to alter the basic rule that foreign manufacturing income is deferred (that is, that the movement of manufacturing jobs abroad would generally increase deferral)?

5. Related to 4(a) above, can and should anything be done about the fact that earnings are often driven by intangible assets such as intellectual property and contract rights, which can be both mobile (and therefore easily located in low-tax jurisdictions) and valuable without regard to physical assets or jobs?

6. Is it politically impossible to recommend significant international tax simplification through either a full inclusion system with foreign income taxed at a lower rate than domestic income or a territorial system with appropriate treatment of U.S. expenses? Would significant transition relief make either of these (or other) proposals more attractive?

7. What should be done about the decreasing relevance of corporate residence, both because it is very manipulable and because its justification as a basis for taxation is tenuous? And what does this say about the wisdom, from a policy

perspective, of our deferral rules and the arm's-length standard, when weighed against the alternative of formulary apportionment?

8. Assuming the presumptions of S. 506, the Stop Tax Haven Abuse Act, introduced by Sen. Carl Levin, D-Mich., could easily be altered to depend on something other than a so-called blacklist, what objections to the bill moved the administration to include much narrower provisions in its recent budget proposals?

9. How aggressive is the administration willing to be to more effectively obtain tax information from other countries? To the extent those countries are less developed countries, how would (a) the relatively small amounts of revenue derived from providing financial secrecy, (b) developments in distance learning and the remote provision of services, and (c) our experience with the wage credit in Puerto Rico suggest a policy that includes a significant increase in foreign aid?

10. What role should a VAT play in the debate? ■

Allow Expensing of All Investment Outlays and Dividend Payments

By Arthur W. Wright

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President Obama's tax reform task force should consider two proposals related to the corporate income tax: allowing firms to expense all investment outlays, including research and development, and allowing firms to expense dividend payments.

Both of those proposals would promote at least one of the three goals in the mandate of the task force. Both would improve economic efficiency, thereby increasing national output and the associated incomes that make up the base of the federal income tax. Expensing investment outlays would also permit simplification of the code, make enforcement easier, reduce firms' incentives to pursue loopholes, and end the breaks on depreciation deductions that I take to be the meaning of corporate welfare.

Politically, under the ''Nixon goes to China'' theory, a Democratic government (executive and legislative branches) could more readily enact the proposed measures than a Republican one. The GOP would likely come under partisan attack for cronyism were it to attempt such changes to the nation's tax laws. On a good day, one can even imagine either change attracting bipartisan support in Congress.

Expensing of All Investment Outlays

A standard result in financial theory, encountered early in all undergraduate finance textbooks, is that profit-maximizing business firms subject to an income tax are able to attain the greatest possible economic efficiency if they are allowed to expense *all* outlays during the tax period (for example, a year) in which they are made. Thus, the existing mare's nest of deductions and incentives for depreciation is economically less efficient than a

policy of allowing firms to expense their investment outlays, just as they may expense outlays on labor and material inputs. (I ignore the question whether alternatives to a federal tax on corporate income might be more efficient.)

The current U.S. tax treatment of investment expenditures raises firms' costs of capital, compared with allowing firms to expense them. That same treatment gives firms an incentive to try to lower their costs of capital by lobbying for more generous depreciation deductions. But that adds insult to injury: Put through the legislative sausage grinder, the outcome is a tax law that is not only inefficient, but also expensive both to enforce and to comply with.

The efficiency-enhancing effects of reducing the drag from current depreciation provisions can be seen from the substantial empirical evidence that accelerated depreciation and investment tax credits boost corporate investment.

Note that interpreting our current anti-capital-depreciation policy as pro-labor is false, to the (considerable) extent that workers' productivity is increased by having more and better capital to work with. Reducing firms' costs of capital by allowing the expensing of investment outlays would actually benefit their employees.

Expensing of Dividend Payments

Taxing corporate income before dividends are paid, and then taxing it again on the individual returns of dividend recipients, is taxing dividends twice. (I refer here to what are called ''ordinary dividends'' and ignore ''qualified dividends,'' which are taxed at capital gains rates.) As with the requirement to depreciate investment outlays over time, the effect of the double taxation of dividends is to raise the cost of capital to corporations, thereby reducing investment and both the quantity and quality of business firms' capital stocks.

Why do companies pay dividends? One suggested reason is as a signal to financial investors about their financial situations. In that sense, dividends are no different a form of business expense than, for example, the costs of debt financing. But even if a firm

pays dividends for want of profitable internal investment opportunities, taxing the dividends twice impedes the reallocation of capital from less productive to more productive uses in the broader economy.

Supposing we were to agree to end the double taxation of corporate dividends, how should it be done? Allowing firms to deduct dividends from their taxable incomes would parallel the tax treatment of wages and salaries paid to employees. The alternative — to exclude dividends from individuals' taxable incomes — would tax dividend income at corporate rates but wages and salaries at individual rates. My own preference would be for the former, pending a thorough reexamination of the relative rate structures applied to the two types of income. ■

Corporate Tax Reform, Finally, After 100 Years

By George K. Yin

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Individual income tax rates will soon rise, with the rates for top-bracket individuals perhaps increasing significantly to finance the cost of healthcare reform, climate change mitigation, or other government initiatives, or to reduce the national deficit and debt. Many policy analysts have also recommended a reduction in the corporate tax rate, principally as a means to encourage cross-border investment and reduce revenue losses from transfer pricing manipulation.

These two changes to the income tax landscape are incompatible with one another because they invite the widespread use of C corporations as tax shelter vehicles. Top-bracket individuals will have a strong incentive to incorporate their affairs and subject their income to the lower corporate tax rate. Even if the graduated corporate tax brackets are eliminated (already the rule for personal service corporations and a justifiable change apart from any other reforms) and the tax on corporate distributions and gains from stock sales is increased, the changes would not offset the advantage of accumulating income year after year at the more favorable corporate rate. The problem may be even more severe once the effects of employment taxes and state and local income taxes are taken into account.

Although the problem is not new, it has never been addressed successfully. If policymakers are not careful, their changes may resurrect the need for the collapsible-corporation provision (section 341), which is now repealed only through 2010. That

provision was ''characterized by a pathological degree of complexity, vagueness and uncertainty''[1] and famously contained a single sentence (section 341(e)) that was twice the length of the Gettysburg Address.

A straightforward way to avoid the tax shelter problem is to restrict the corporate tax to public corporations and their subsidiaries. All nonpublic firms, including corporations, would have to be taxed as passthrough entities.[2] If the firm is ineligible for, or fails to elect, subchapter S, it would be taxed as a partnership under subchapter K (or be treated as a disregarded entity). Top-bracket individuals would therefore not have the option of sheltering their income under the corporate tax. The corporate tax rate could be reduced, if appropriate, with the tax on corporate distributions and stock sales adjusted to help meet revenue needs.

This change would continue trends that have occurred over the last two decades. Between 1985 and 2005, there was an over fivefold increase in the number of S corporations, from 725,000 to almost 3.7 million. Between 1993 and 2005, the number of limited liability companies taxed like partnerships grew from 17,000 to almost 1.5 million. Thus, increasing numbers of closely held firms are now taxed under a form of passthrough taxation. Passthrough taxation allows income to be taxed just once when it arises, at the tax bracket applicable to the person allocated the income. And unlike shareholders of C corporations, owners of passthrough entities may offset their income with entity-level losses, subject to limitations imposed by the passthrough system. The proposed change would improve equity and efficiency by taxing all owners of closely held firms alike.

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[1]American Law Institute, Federal Income Tax Project: Subchapter C 111 (1982).

[2]*See* American Law Institute Reporters' Study, Taxation of Private Business Enterprises 67 (1999) (proposal 3-1). David Shakow and I served as reporters. Prof. Daniel Halperin has recently offered a different proposal to address the same problem. His proposal would limit the type of corporate income eligible for a lower corporate tax rate and strengthen the corporate distributions tax by reducing both the step-up in basis of stock at death and the charitable deduction for contributions of appreciated stock. *See* Daniel Halperin, ''Mitigating the Potential Inequity of Reducing Corporate Rates,'' Tax Policy Center, July 29, 2009, *available at* http://www.taxpolicycenter.org/Uploaded PDF/411931_mitigating_corporate_rates.pdf.

The proposal would also eliminate a key structural difficulty with the corporate tax — its need to adapt to two completely different groups of taxpayers. According to IRS data, more than 90 percent of the roughly 2 million C corporations reported income of $50,000 or less in 2006, which allowed that income potentially to be taxed at no more than the lowest (15 percent) corporate tax rate.[3] Meanwhile, a mere 3,801 C corporations, representing just 0.2 percent of all such corporations, reported income of more than $18.33 million — taxed at a flat 35 percent rate — and paid almost 90 percent of the corporate income tax.

Although many closely held firms have few assets and little or no income, their organization as C corporations has necessitated many corporate tax rules generally designed to prevent avoidance of individual income taxes by the shareholders of the firms. By removing those firms from the corporate tax, the rules could be simplified and tailored to public firms, with little loss of corporate tax revenue and potential increases in overall tax revenue.[4]

Transitioning to the new system would be the most challenging task. Although closely held C corporations may not pay much corporate tax, some of them own appreciated property that is potentially subject to two levels of future tax. A tax-free transition of a C corporation into a passthrough entity

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[3]The data, from a special tabulation compiled by the IRS Statistics of Income Division, is based on ''income subject to tax,'' which is generally corporate net income after taking into account the net operating loss deduction for prior-year losses and the dividends received deduction. About 65 percent of the corporations reported zero income or less, and another 25 percent (about 500,000 corporations) reported positive income of $50,000 or less. Personal service corporations, which are not separately identified in the data, are ineligible for the lower corporate tax rates. Section 11(b)(2). Under current law, the tax shelter advantage of using a C corporation is modest and is fully realized once the corporation has $100,000 of income. Taxpayers in the 35 percent bracket save $12,750 in income taxes if they shelter that amount of income in a C corporation.

[4]In addition to permitting repeal of the collapsible-corporation provision and the taxes on accumulated earnings (section 531 et seq.) and personal holding companies (section 541 et seq.), many other rules, such as section 302 regarding the taxation of stock redemptions, could be greatly simplified or eliminated. The corporate tax also could be tailored to public corporations by, for example, having the base of the tax conformed more closely to income reported for financial purposes or measured by changes in the market capitalization value of the firm. *See* Joe Bankman, ''A Market-Value Based Corporate Income Tax,'' *Tax Notes*, Sept. 11, 1995, p. 1347; Michael Knoll, ''An Accretion Corporate Income Tax,'' 49 *Stan. L. Rev.* 1 (1996).

would allow at least one of those levels to escape taxation. On the other hand, a taxable transition may be inappropriate from a policy standpoint and, in any event, would not be politically feasible.

The transition should be carried out through some combination of carrots and sticks. The principal stick would be elimination of all of the graduated corporate tax brackets and an increase in the corporate tax rate for nonpublic firms equal to the top tax rate for individuals. This stick would be accompanied, however, by rules permitting a tax-free transition of the firm into subchapter K (or disregarded entity status) along the same lines as current-law transition of a C corporation into an S corporation. A subchapter K firm or disregarded entity with a prior C history might, for example, be subject to a section 1374-type tax for a period of years.

Alternatively, the usual owner-level basis adjustment might be denied when a passthrough entity recognizes and passes through built-in C gain to its owners. Another possibility would be to preserve in the surviving firm the lower of the inside and outside bases of the former subchapter C firm.[5]

The proposed change would reverse a policy decision made exactly 100 years ago. The first federal income taxes in the United States, enacted during the Civil War and in 1894, taxed corporations in two different ways. Some corporations were treated as passthrough entities. Others were taxed directly but primarily as a way to collect an income tax from the investors in those companies.

It was not until 1909, during the period before ratification of the 16th Amendment when income taxation of the owners of corporations was impermissible, that Congress passed the first truly separate income tax on corporations. Although the tax was termed an excise tax, it was measured by the net income of the corporation. When the individual income tax was enacted in 1913, Congress carefully integrated the existing corporate tax

[5]The rules may need to prohibit public firms from going private and then converting into passthrough entity status under the liberal transition rules.

with the new tax on individuals to avoid double taxation, but changes in both taxes over the years gradually eroded that arrangement.

It is time to modernize the tax system to better serve the fiscal needs of the nation. Although Congress may soon be forced to adopt income tax rates reminiscent of years before 1986, it need not and should not bring with that change the same impenetrable problems and failed solutions of that bygone era. The income of all closely held firms should be taxed just once, under a passthrough system. The corporate tax should be limited and tailored to public firms. ■

Use a Multilateral Approach in International Tax Enforcement

By Bruce Zagaris

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In the last few months, several congressional hearings and legislative proposals have focused on closing the international tax enforcement gap regarding individuals. Several of the proposals could have positive effects. Many look at the problem from the narrow perspective of obtaining revenue, but reform must also consider the U.S. macroeconomic situation, especially the important role of foreign direct investment in the U.S. economy. If the United States acts primarily through multilateral and bilateral initiatives rather than unilateral ones, the initiatives will be more sustainable because they will engage the regulatory and enforcement resources of other governments and be more diplomatically acceptable.

A. Multilateral

Although the United States participates in the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters, it should drop its reservations to, and participate in, the provisions on service and collection. It should also encourage other countries to join the convention.

It should also join the Council of Europe Convention on Laundering, Search, Seizure and Forfeiture of Assets. This is the most important convention on money laundering, and governments are increasingly using anti-money-laundering laws and tax law enforcement against scofflaws.

If the United States wants to impose international tax enforcement standards, such as the harmful tax practices initiative, the standards will be more sustainable if it and its allies use international organizations with universal membership, such as the IMF, rather than the OECD.

The United States should consider using Western Hemisphere organizations for strengthening tax law enforcement. The Organization of American States (OAS) Mutual Assistance in Criminal Matters Convention already has a protocol on tax matters. If the United States and its allies cannot persuade the countries in the Americas to join the Convention on Mutual Administrative Assistance in Tax Matters, it should use the OAS protocol or a regional tax information exchange agreement. It should also consider using the Inter-American Center of Tax Administration for more tax enforcement initiatives.

In the long term, the United States should promote the establishment of an international organization for taxation with universal membership and sufficient funding and authority. International tax policy is now made through the United Nations, the OECD, and the IMF, or the G-8 and G-20. Disputes are too often litigated in the WTO, which lacks the expertise to effectively adjudicate them.

B. Bilateral

The United States' bilateral tax treaties and its model treaty need strengthened collection provisions like those in the U.S. treaties with Canada and the Netherlands.

The U.S. effort to secure more TIEAs has fallen short of the promises that former Treasury Secretary Paul O'Neill made to Congress. For the agreements to be sustainable, Congress must provide more carrots and fewer sticks. In 1983 President Reagan recommended investment credits when he designed the Caribbean Basin Initiative. Congress decided instead to offer only eligibility for North American Convention deductions — an incentive that is meaningful only to the one jurisdiction (the Bahamas) that has significant convention facilities. The others have neither the convention facilities nor the air traffic capacity to take advantage of the initiative.

The United States has not replaced its former incentives: eligibility for section 936 financing and eligibility to host foreign sales corporations. It could negotiate tax treaties with countries that have an income tax system and could negotiate minitreaties

— like the Bermuda-U.S., Isle of Man-Netherlands, and other recent double tax treaties — with countries that lack an income tax.

The United States could also enact legislation to allow reciprocal deductions for charitable contributions, similar to the provisions in the Mexico-U.S. double tax treaty. From the George H. Bush administration on, the United States has prioritized mobilizing the Caribbean diaspora to engage in the development of their countries. The U.S. government has also prioritized debt for environmental and development swap programs and urged the U.S. private sector to make charitable contributions to those initiatives. However, the absence of statutory or tax treaty provisions to encourage contributions has limited the initiatives. Congress could also find other, similar investment or economic cooperative measures (for example, in tourism, education, healthcare, and electronic commerce).

The United States should issue regulations that give taxpayers who are affected by requests for information from other countries the right to be notified of, and to object to, the request. Treasury promised to issue those regulations when it sought the U.S. business community's support for U.S. ratification of the Convention on Mutual Administrative Assistance in Tax Matters.

Treasury often tries, when its treaty partners request information, to obtain assistance informally by writing to people and requesting the information rather than issuing a summons. That deprives the tax information exchange process of fairness and erodes its integrity.

The United States could follow the European Union savings directive and share some of its statutory withholding tax with countries agreeing to conclude TIEAs.

C. Unilateral

The United States should also consider ways to strengthen its ability to make jeopardy assessments for individuals and entities that exit the country. It should consider using a ''know your client'' anti-money-laundering regime for tax enforcement, like under the proposed EU savings tax directive.

The Obama administration proposals for strengthening the qualified intermediary regime and providing incentives for

transactions that use QIs and disincentives for those not using them are sensible, provided the United States persuades more countries, such as Brazil and China, to participate.

The United States should abandon the concept of an offshore secrecy jurisdiction and the effort to unilaterally sanction those countries. International law does not support the concept, and Treasury lacks the ability to develop and maintain lists of the jurisdictions. Even if it had that ability, the lists would cause dislocations in direct investment and adverse diplomatic repercussions, especially with countries whose standards in corporate transparency are superior to those of many U.S. states.

Those provisions are likely to trigger similar protectionist elements around the world and litigation in the WTO against the United States for discriminating against trade in financial services in violation of the General Agreement on Trade in Services. Financial institutions are already overburdened with anti-money-laundering and counterterrorism financial enforcement and will soon face Internet gambling regulations. The last thing they need is another compliance person to vet which transactions originate from countries on an ever-changing list of offshore secrecy jurisdictions.

The United States should broaden its program to automatically exchange with key countries information on interest paid to depositors that are residents in those countries. The proposed regulations of the Clinton administration should be made final, and consideration should be given to include other countries, such as Mexico, that have already requested those exchanges. ■

Reform the Taxation of Business Income

By Eric M. Zolt

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Choice is good. We choose political candidates, spouses, and different types of consumer products. But freedom to choose, especially within our tax system, brings costs as well as benefits. With apologies to Yogi Berra, whenever taxpayers get to a fork in the road, they take the fork.

The tax code (especially the tax rules that apply to business income) is chock-full of implicit and explicit elections that contribute to the complexity and inefficiencies of the tax system. By eliminating many elections, we could simplify the tax law, make it more efficient, and likely raise substantially the same revenue at lower tax rates.

I offer three proposals to reform the taxation of business income. None are particularly original, and all have been proposed in different forms before. Here are the three proposals:

- apply the same tax regime to all business income regardless of organizational form;
- delink the taxation of income from labor and capital and apply a single flat tax rate to capital income; and
- treat debt and equity the same for tax purposes.

Single Tax Regime for Business Income

Our legal system provides for several forms of business organization, each with different state law consequences, such as ownership and governance structures and liability rules. Similarly, our tax system allows taxpayers to apply different tax regimes to their business operations — such as sole proprietorships, partnerships (general and limited), cooperatives, S corporations, and C corporations.

Individuals balance the nontax costs and benefits of adopting a particular business form against the costs and benefits of the tax regimes tied to that form. But as Bill Klein and I noted in a 1995 article in the *University of Colorado Law Review*, there is no good reason to link business form and tax regime. Why should taxpayers have to choose a suboptimal organizational form to achieve a favorable tax result? This was the logic behind Treasury's check-the-box rules, adopted in 1996. It also led state legislatures to adopt the limited liability company regimes that paired limited liability status with single-level, passthrough taxation.

But why allow taxpayers to choose their tax regime? Why not just adopt a single set of tax rules that apply to all business income? If we want a tax system that is neutral as to business form, then one size fits all.

Several proposals to reform business income taxation would apply without regard to business form (perhaps with exclusions for small businesses operating as sole proprietorships). Some tax the full return on equity capital, some tax the full return of both debt and equity capital, and others seek to tax only economic rents. These include proposals by President George W. Bush's Advisory Panel on Federal Tax Reform, the comprehensive business income tax from Treasury's 1992 integration study, and the business enterprise income tax. They are all steps in the right direction.

Flat Taxation of Capital Income

The conventional wisdom is that good tax systems are based on a comprehensive income tax model, whereby capital and labor income are treated equally and the combined income is taxed at progressive rates. In reality, income tax systems often turn out to be neither very comprehensive nor very progressive. Different types and forms of capital bear different tax burdens. Taxpayers structure their investments to minimize tax liability.

One response is to continue the slog toward the ideal comprehensive income tax model. This has not been particularly effective. Another approach delinks the taxation of income from labor and income from capital, retaining progressive tax rates for labor income and taxing capital income at a flat rate. With increasing

globalization and tax competition, this so-called dual income tax approach may have greater appeal because countries can reduce tax rates on more mobile capital income while retaining higher and more progressive tax rates on less mobile labor income.

A flat tax regime for capital income has several advantages over the current regime. First, it will simplify the tax rules that apply to income from capital, especially if reforms also eliminate or reduce existing tax preferences and exemptions. Second, it will make the taxation of capital income more uniform and less distortive. Third, a single tax regime can lead to substantial enforcement and administrative gains through provisional and final withholding regimes.

Debt and Equity Treatment

The so-called classic corporate income tax distorts decisions on organizational form, decisions to retain or distribute corporate earnings, and decisions to use debt or equity in the firm's capital structure. Of those three distortions, the preferential tax treatment of debt over equity is the most troubling.

Why allow taxpayers to choose the tax treatment applicable to their investment in a firm? Debt and equity are just different financial claims on the same enterprise. And thanks to the efforts of lawyers, accountants, and investment bankers, it is increasingly difficult to distinguish between them.

Treating debt and equity the same way requires either extending the deductibility of interest to dividends or denying the deductions for interest. Both approaches have merit. In 1992 Treasury put forward a proposal to tax business income once by providing for no corporate-level deduction for dividends and interest paid and no inclusion into income at the investor level for any dividends or interest received. This comprehensive business income tax proposal is simply a form of dual income taxation, a schedular tax on dividends and interest with final withholding at the entity level.

It will not be easy to make fundamental changes to the taxation of debt and equity. There would have to be a period of transition. And it would require coordination with other developed countries to have source-based taxation of interest and dividends. But it would improve how we tax business income.

Choice is not always good. These three proposals share a common theme: Choices made by taxpayers will not change the tax treatment of business income. Eliminating tax electivity will make the tax system simpler and more efficient. ■

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