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A Common Sense Corporate Tax: The Case for a Destination-Based, Cash Flow Tax on Corporations

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A Common Sense Corporate Tax: The Case for a Destination-Based, Cash Flow Tax on Corporations

Cover Page Footnote

Professor of Law, The Dickinson School of Law of the Pennsylvania State University.

A COMMON SENSE CORPORATE TAX: THE CASE FOR A DESTINATION-BASED, CASH FLOW TAX ON CORPORATIONS

William B. Barker⁺

I. THE DEFICIENCIES OF A CORPORATE INCOME TAX	958
A. <i>Debt v. Equity in the Corporate Setting</i>	964
B. <i>International Taxation and the Corporate Income Tax Base</i>	966
II. THE ELEMENTS OF A CASH FLOW TAX ON CORPORATIONS.....	971
A. <i>The Basics of Cash Flow Taxes</i>	972
B. <i>Origin v. Destination-Based Cash Flow Taxes</i>	976
C. <i>Two Methods for Measuring Cash Flow: The R-Type and the R&F-Type Cash Flow Tax</i>	978
D. <i>A Comparison of Income and Destination-Based Cash Flow Taxes</i>	983
III. CASH FLOW TAXATION AND THE TAXATION OF CAPITAL INCOME	987
IV. THE POLITICS AND POLICY OF CORPORATE TAXATION.....	996
A. <i>Benefits of Corporate Status</i>	1001
B. <i>Cash Flow Tax as a Tax on the Unique Profits of Corporations</i>	1003
V. CONCLUSION.....	1010

For over thirty years, there has been an ongoing debate over the continued viability of the personal and corporate income tax systems and the need for change.¹ Several governments—including the United States, the United Kingdom, Australia, and Sweden—have conducted studies considering the merits of changing their current income tax systems to systems based on a cash flow, consumption-style tax.² To date, not one country has replaced its income

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1. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1113–22 (1974) (providing one of the earliest accounts of the possible advantages of a consumption-style tax).

2. THE INST. FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION 33–45 (1978) (comparing ways to reform the tax system of the United Kingdom including a discussion of measuring one’s tax base through consumption) [hereinafter THE MEADE REPORT]; SVEN-OLOF LODIN, PROGRESSIVE EXPENDITURE TAX—AN ALTERNATIVE? A REPORT OF THE

tax with a direct consumption tax.³

Several concrete proposals have been proffered for replacing the income tax with cash flow or consumption taxes.⁴ In the United States, Robert Hall and Alvin Rabushka—the pioneers of this field—proposed a uniform flat rate tax on all businesses, which would allow for an immediate deduction for all costs, including wages, and a uniform flat tax rate on wages received by individuals.⁵ Other popular consumption tax proposals include the Unlimited Savings Allowance (USA) tax system⁶ and the Business Activities Tax (BAT).⁷ The

1972 GOVERNMENT COMMISSION ON TAXATION 21–29 (1978) (providing a discussion of the arguments for and against implementing an expenditure tax in the Swedish tax system); REPORT OF COMMITTEE OF INQUIRY INTO INFLATION AND TAXATION 464–68 (1975) (discussing a proposal for a cash flow concept tax system in Australia) [hereinafter MATHEWS COMM. REPORT]; U.S. DEP'T OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 9–15 (1977) (discussing potential reforms to the United States' federal income tax by presenting, among other ideas, a model for a cash flow consumption tax) [hereinafter BASIC TAX REFORM].

3. CHARLES E. MCLURE, JR. & GEORGE E. ZODROW, CONSUMPTION-BASED DIRECT TAXES: A GUIDED TOUR OF THE AMUSEMENT PARK 3 (2007) (reporting on several countries that considered cash flow direct taxes but did not adopt them).

4. See, e.g., DAVID E. BRADFORD, FUNDAMENTAL ISSUES IN CONSUMPTION TAXATION 5–18 (1996) (proposing a consumption tax in the form of a value-added tax and discussing its relationship to income tax); Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377, 392–403 (1992) (discussing whether a consumption tax is risky and potentially unfair); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1575–77, 1584–97 (1979) (describing a consumption tax as more economically efficient and outlining its general structure); Alvin C. Warren, Jr., *How Much Capital Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1, 2–15 (1996) (comparing four methods for exempting capital income within a cash flow tax system) [hereinafter *How Much Capital Taxed*]; Alvin Warren, *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081, 1093–1121 (1980) (discussing several factors that make a consumption tax fairer than an income tax, including utility, discrimination towards savers, and the defectiveness of measuring income).

5. ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed., Hoover Institutional Press 1995).

6. The USA system suggests a flat-rate business tax on domestic gross profits and a graduated individual tax, which permits savings deductions. Alliance USA, *Unlimited Savings Allowance (USA) Tax System*, 66 TAX NOTES 1482, 1487–90 (1995).

7. The BAT replaces the corporate income tax with a consumption-style tax while retaining the individual income tax. OFFICE OF TAX POL'Y, U.S. DEP'T OF TREASURY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY 19–37 (2007) [hereinafter THE 2007 TREASURY STUDY]. The BAT is essentially a value-added tax (VAT) that differs from the European-style VAT—which uses a tax credit method—by taxing added value using the subtraction method. *Id.* at 20–21, 37. The BAT was originally supported by Senators John Danforth and David Boren and was re-proposed by the Bush Administration in a 2007 Treasury Study. See George R. Zodrow & Peter Mieszkowski, *Introduction: The Fundamental Question in Fundamental Tax Reform*, in UNITED STATES TAX REFORM IN THE 21ST CENTURY 2 (George R. Zodrow & Peter Mieszkowski eds., 2002) [hereinafter TAX REFORM IN THE 21ST CENTURY]. Although this Article focuses on direct consumption taxes like sales taxes or VATs, the BAT is mentioned here because the Treasury recommendation was that the BAT would replace the income tax on businesses. THE 2007 TREASURY STUDY, *supra*, at 19.

primary argument in favor of replacing income taxes with consumption taxes is that there would be a dramatic increase in national productivity,⁸ but many scholars vigorously contest the estimated level of economic growth that would result.⁹

Economic models have shed considerable light on the relative merits of income versus consumption taxation; nevertheless, these models do have limitations.¹⁰ Most models assume a closed economy, which ignores the tremendous impact world trade and capital flows have on the merits, design, and implementation of income and consumption taxes.¹¹ Even those models that try to simulate an open economy employ an over-simplified view of the tax treatment of foreign source income and thus do not adequately address the complexities of taxes in an economically open, highly competitive world.¹² Finally, these comparative models—simulating both an open and closed economy—assume an ideal income tax, which is quite different from our present system.¹³ Consequently, analytical completeness demands a different perspective on the subject.

This different point of view is a global perspective and it serves as the central focus of this Article. A global perspective analyzes tax regimes that must deal with worldwide economic forces of free trade, competitive capital markets, and the increasing mobility of many factors of production.¹⁴ A global perspective starts with the reality of an open economy, not one that is closed.¹⁵ Instead of taking a purely theoretical economic perspective, a global perspective takes account of the actual, imprecise laws of nations regarding the ever-changing flows of international transactions.¹⁶ Analysis must also confront the reality that nations compete for mobile economic activity through the use of tax incentives.¹⁷ Not surprisingly, viewing the relative merits of

8. THE 2007 TREASURY STUDY, *supra* note 7, at 19; Zodrow & Mieszkowski, *supra* note 7, at 2–3.

9. See Zodrow & Mieszkowski, *supra* note 7, at 2–6.

10. See, e.g., Jane G. Gravelle, *Behavioral Responses to a Consumption Tax*, in TAX REFORM IN THE 21ST CENTURY, *supra* note 7, at 25–28.

11. See Charles L. Ballard, *International Aspects of Fundamental Tax Reform*, in TAX REFORM IN THE 21ST CENTURY, *supra* note 7, at 109–10, 132–38 (comparing outcomes from “Closed-Economy Simulation Models,” which are frequently used, and “Open-Economy Simulation Models,” which are used less frequently).

12. See *id.* at 134–38; see also Gravelle, *supra* note 10, at 42.

13. See Ballard, *supra* note 11, at 132–38.

14. See William B. Barker, *International Tax Reform Should Begin at Home: Replace the Corporate Income Tax with a Territorial Expenditure Tax*, 30 NW. J. INT’L L. & BUS. 647, 647 (2010).

15. See Ballard, *supra* note 11, at 132–38.

16. See *infra* Part II.B.

17. See William B. Barker, *Optimal International Taxation and Tax Competition: Overcoming the Contradictions*, 22 NW. J. INT’L L. & BUS. 161, 172 (2002) (providing an account of the effect of tax competition on nations’ tax systems).

income and consumption taxes from a global perspective yields different insights and conclusions.

This different perspective indicates that serious consideration should be given to adopting a cash flow, consumption-style, or expenditure-type tax on corporations and other large businesses. Limiting a cash flow tax to corporations and other large businesses distinguishes this Article from other popular proposals because it leaves intact the personal income tax on wages, earnings, and capital income of individuals.¹⁸ For instance, the proposed cash flow tax differs from a value added tax, such as the BAT, in that it allows the deduction of labor costs.¹⁹ In addition, this new global perspective prompts the adoption of a destination-based, cash flow tax contrary to other popular consumption-type, origin-based taxes.²⁰

This Article is divided into four parts. Part I deals with the practical problems of income taxation of corporations and what makes reform of the corporate income tax system formidable. Part II sets out the elements of a cash flow tax and illustrates how a cash flow tax remedies the inadequacies of an income tax. This Part also discusses the virtues of a destination-based cash flow tax as compared to other tax proposals. Part III explores the economic differences between income and cash flow taxes and demonstrates how these systems approach the taxation of capital income on a practical level. Part IV explains why a cash flow tax on only corporations is justified considering efficiency, justice, and politics as well as how a cash flow tax works in concert with an income tax on individuals.

I. THE DEFICIENCIES OF A CORPORATE INCOME TAX

The corporate income tax has been in continuous operation in the United States for over 100 years.²¹ Recently, however, the executive branch has made corporate tax reform a priority.²² President Obama's corporate tax proposal provides for broadening the corporate tax base by eliminating various tax deductions and credits attributable to loopholes while concurrently lowering the statutory corporate tax rate.²³ There are two main goals of this reform.

18. See *infra* Part II.A–B.

19. See THE 2007 TREASURY STUDY, *supra* note 7, at 19.

20. See, e.g., HALL & RABUSHKA, *supra* note 5, at 53–64; THE MEADE REPORT, *supra* note 2, at 33–37 (proposing origin-based cash flow taxes); see also *infra* Part II.B (discussing the similarities and differences between an origin-based and a destination-based cash flow tax).

21. Tariff Act of Aug. 5 1909, ch. 6, § 38, 36 Stat. 11, 112–13. The 1909 Act imposed a special tax of 1% of net income above \$5,000 for all corporations, joint stock companies, or associations, including foreign entities engaged in business in the United States. *Id.*

22. See Eric Kroh, *Obama Asks Business Leaders to Aid Corporate Tax Reform Efforts*, 130 TAX NOTES 745, 745 (2011) (reporting President Obama's recent efforts to engage the business community on tax reform).

23. See THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM, A JOINT REPORT BY THE WHITE HOUSE AND THE DEPARTMENT OF THE TREASURY 9–10 (2012) [hereinafter 2012 JOINT REPORT] (outlining these proposals).

The first goal is to simplify the system and substantially reduce the burden of tax compliance, which currently costs corporations approximately 40 billion dollars per year or 12% of revenues collected.²⁴ The second goal is to increase the competitive posture of American companies at home and abroad by lowering tax rates and decreasing the costs of accessing new capital.²⁵ President Obama's underlying objective is to accomplish these goals in a revenue-neutral fashion, thus requiring the effects of lower rates to be offset by a broader tax base, achieved primarily through the elimination of tax preferences.²⁶

Businesses voicing an opinion on the suggested reforms have reacted in a predictable way,²⁷ wishing to preserve current tax incentives while approving rate reduction.²⁷ The reason is obvious: tax preferences affect various enterprises differently and reforms would produce substantial winners and losers. A recent study indicates that if all major tax expenditures other than accelerated depreciation were eliminated, Congress would be able to lower the corporate tax rate from 35% to 28%.²⁸ One study found, however, that this reduction could provide as much as a 12.3% decrease in taxes to some industries and as great as a 69.7% increase to others.²⁹

Substantial base broadening with a lower rate would be a significant achievement, simplifying the corporate tax code and eliminating some reasons for tax planning, which would produce savings in compliance costs for corporations.³⁰ The case for enhancing the competitiveness of U.S. enterprises is obscure, however, because as long as the reform is revenue neutral, the amount of taxes paid by corporations will, in itself, have little effect on overall

24. *Id.* at 3–4, 65.

25. *Id.* at 69–72.

26. *See id.*; *see also* Kroh, *supra* note 22, at 745 (“In a speech at the U.S. Chamber of Commerce, . . . [President] Obama argued that the federal government’s interests are aligned with those of business owners and that revenue-neutral corporate tax reform would be of mutual benefit.”).

27. *See* Kroh, *supra* note 22, at 745 (noting that in private meetings with administration officials, some business leaders have requested that overall corporate tax rate cuts not be offset by the elimination of tax subsidies).

28. *See* 2012 JOINT REPORT, *supra* note 23, at 9–10 (noting the top federal tax rate of 35%); *see also* Martin A. Sullivan, *Winners and Losers in Corporate Tax Reform*, 130 TAX NOTES 731, 731 (2011) (citing THE 2007 TREASURY STUDY, *supra* note 7, at 48–49); *infra* text accompanying note 39 (describing accelerated depreciation).

29. Sullivan, *supra* note 28, at 733 tbl.2A. The five greatest winners would be securities, insurance, credit intermediation, retail trade, and bank holding companies. *Id.* The five biggest losers would be electrical products, transport equipment, computers and electronics, technical services, and agriculture. *Id.*

30. *See* 2012 JOINT REPORT, *supra* note 23, at 9–10.

competitiveness.³¹ Further, many tax incentives are aimed at enhancing the competitiveness of U.S. businesses internationally.³²

A different goal of corporate tax reform should be to restructure the tax in a way that would provide a source of sustainable revenue to the government, especially in times of large public deficits, such as the current situation. Although the United States has one of the highest statutory corporate tax rates, the current corporate tax system does not result in comparatively high corporate tax revenues.³³ Between 2000 and 2005, the United States' corporate tax revenue was only 2.2% of Gross Domestic Product (GDP), whereas OECD countries averaged 3.5%.³⁴ The United States' corporate tax revenue has decreased as a share of U.S. GDP from a high of 4.5% in the mid-1960s,³⁵ despite the fact that overall tax revenues have increased from nearly 25% of GDP to approximately 28% of GDP between 1965 and 1998.³⁶ These low figures for corporate tax revenues are surprising when related to the level of control that corporations exercise over the national economy. In 2008, receipts from all businesses in the United States exceeded thirty-four trillion dollars.³⁷ Of these receipts, over twenty-eight trillion dollars were attributable to corporations alone, resulting in corporations representing 84% of all receipts.³⁸

31. See *infra* notes 48–59 and accompanying text.

32. See, e.g., I.R.C. §§ 199, 861, 863 (2006 & Supp. IV 2011) (providing tax deductions for domestic production and manufacturing activities and special rules regarding the reporting of inventory property sales); Treas. Reg. § 1.863-3 (outlining the inventory property sales source rules); see also 2012 JOINT REPORT, *supra* note 23, at 13–14.

33. See THE 2007 TREASURY STUDY, *supra* note 7, at 6–10.

34. *Id.* at 10.

35. OECD, TAX POLICY STUDIES NO. 6, TAX AND THE ECONOMY, A COMPARATIVE ASSESSMENT OF OECD COUNTRIES 13 fig.2 (2001).

36. *Id.*

37. INTERNAL REVENUE SERV., TABLE 1. NUMBER OF RETURNS, TOTAL RECEIPTS, BUSINESS RECEIPTS, NET INCOME (LESS DEFICIT), NET INCOME, AND DEFICIT BY FORM OF BUSINESS, TAX YEARS 1980–2008 [hereinafter IRS TABLE 1].

38. The exact figures for 2008 were \$34,608,202,747,000 in total receipts for all businesses, with \$28,589,771,221,000 attributable to just corporations. *Id.* The Bureau of Economic Analysis reached similar results.

	2005	2006	2007	2008	2009
Domestic Business	8,687.5*	9,336.8	9,511.4	9,490.4	8,958.2
Corporate Business	6,435.0	6,897.4	6,992.2	6,907.5	6,655.7
Percentage	74.1%	73.9%	73.5%	73.4%	74.3%

* All numbers billions.

U.S. DEP'T OF COMMERCE, BUREAU OF ECON. ANALYSIS, NATIONAL ECONOMIC ACCOUNTS, TABLE 1.13, NATIONAL INCOME BY SECTOR, LEGAL FORM OF ORGANIZATIONS AND TYPE OF INCOME (2011).

A 2007 U.S. Department of the Treasury study attributed the low yield, in part, to the narrowness of the corporate tax base created by certain tax preferences, such as deductions for domestic production and manufacturing activities, research and experimentation credits, allowing immediate expensing deductions for some capital costs, and accelerated depreciation.³⁹ The study estimated that the total corporate revenue offset by tax preferences alone was \$932 billion over ten years.⁴⁰ This reduction in corporate net income represents 8.6% of net taxable corporate income for 2007.⁴¹ If the government's goal was to increase revenue from corporations instead of maintaining revenue neutrality, eliminating tax preferences would be a step in the right direction. Although tax preferences account for a part of low corporate tax yield, the decline in corporate tax revenues is also the result of four other critically important factors.

The first important factor is the availability of pass-through tax alternatives to the traditional C corporate form.⁴² These alternatives include subchapter S corporations, limited liability entities, and partnerships.⁴³ The use of these alternatives has increased dramatically over the years. In 1980, approximately 87% of U.S. business measured by receipts was in C corporations, with approximately 3% in S corporations and 4% in partnerships (including limited liability companies).⁴⁴ By 2008, C corporations' share of receipts was substantially reduced in favor of pass-through entities; C corporations accounted for only 63%, whereas S corporations (17.7%) and partnerships (13.6%) greatly increased their shares.⁴⁵ Extending the corporate tax to large non-corporate business enterprises could substantially reverse this trend.

39. THE 2007 TREASURY STUDY, *supra* note 7, at 47–48.

40. *Id.* at 48 tbl.3.1.

41. This is found by dividing \$93.2 billion by the C corporation 2008 net of \$1.078770 trillion. See IRS TABLE 1, *supra* note 37, at 44.

42. *Corporations, INTERNAL REVENUE SERV.*, <http://www.irs.gov/businesses/small/article/0,,id=98240,00.html> (last visited Jul. 13, 2012) (describing a C corporation, which “is recognized as a separate taxpaying entity”); see also 2012 JOINT REPORT *supra* note 23, at 7 (discussing the differing tax structures for a traditional C corporation and other businesses, such as sole proprietorships, partnerships, and S corporations).

43. *S Corporations, INTERNAL REVENUE SERV.*, <http://www.irs.gov/businesses/small/article/0,,id=98263,00.html> (last visited Jul. 13, 2012) (“S corporations are corporations that elect to pass corporate income, losses, deductions, and credit[s] through to their shareholders for federal tax purposes.”); see also 2012 JOINT REPORT, *supra* note 23, at 7.

44. The figures for 1980 are C corporations: 6,133,036,929,000 in total receipts out of 7,064,487,840,000 total receipts for all businesses; S corporations: 210,322,424,000 in total receipts out of 7,064,487,840,000 for all businesses; and Partnerships: 291,998,115,000 in total receipts out of 7,064,487,840,000 for all businesses. IRS TABLE 1, *supra* note 37.

45. The figures for 2008 are C corporations: 21,914,035,420,00 in total receipts out of 34,608,202,747,000 for all businesses; S corporations: 6,126,386,899 in total receipts out of 34,608,202,747,000 for all businesses; and Partnerships: 4,700,988,521,000 out of 34,608,202,747,000 for all businesses. *Id.*

The other three important factors do not involve loopholes, but involve critical systemic problems of the corporate income tax. The second important factor, the deductibility of interest on debt, plays a large role in reducing the corporate tax base.⁴⁶ Although the United States has one of the highest statutory corporate tax rates in the world, the impact of the statutory rate is misleading in large part due to the deduction of interest.⁴⁷ The true measure of taxation is the Effective Marginal Tax Rate (EMTR).⁴⁸ A 2007 international study showed the United States' EMTR in comparison with other countries was as follows:

TABLE I

Country	Statutory Corporate Income Tax Rate*	Present Discounted Value of Depreciation Allowance-Equipment (Equity)	Effective Marginal Tax Rate – Equipment (Equity)	Effective Marginal Tax Rate – Equipment (Debt)
United States	39	79	24	-46
OECD Average	31	75	20	-32
G-7 Average	36	76	24	-39

* Includes local corporate taxes.⁴⁹

According to the original data in 2005, U.S. corporations were actually taxed less than their G-7 competitors.⁵⁰ Table I shows that the U.S. average tax on

46. See 2012 JOINT REPORT, *supra* note 23, at 5 (“[I]nterest paid by businesses (both corporate and non-corporate) is deductible The current system therefore results in high effective tax rates on equity-financed investments and low effective rates on debt-financed investment. This provides incentives for businesses to finance new investments with debt, and to maintain a higher level of debt in their capital structure, increasing the likelihood of financial distress and bankruptcy.”); see also *infra* Part I.A.

47. See 2012 JOINT REPORT, *supra* note 23, at 19–20 (noting the United States’ top statutory federal corporate tax rate of 35%, which, combined with the state corporate tax rates, creates a 39% overall top statutory corporate tax rate). At the time of the 2007 Treasury Study, the United States was second only to Japan for OECD countries, which had a 40% corporate tax rate. See THE 2007 TREASURY STUDY, *supra* note 7, at 6.

48. See THE 2007 TREASURY STUDY, *supra* note 7, at 8 (noting the inaccuracies of the statutory corporate tax rate as compared to the EMTR, which “combines corporate tax rates, depreciation allowances, and other features of the tax system into a single measure of the share of an investment’s economic income needed to cover taxes over its lifetime”).

49. *Id.* at 7 tbl.1.1 (citing *Corporate Tax Database*, INST. FOR FISCAL STUDIES (2005), <http://www.ifs.org.uk>).

50. *Id.* (showing the U.S. EMTR (24%) to be less than Canada (25%), Germany (29%), and Japan (28%)); see also *id.* at 12 tbl.1.3 (listing G-7 countries as Canada, France, Germany, Italy,

new equity investment was the same as the G-7 average (24%), whereas the U.S. average tax on debt-financed investments was lower than the G-7 average (negative 46% and 39% respectively).⁵¹ Table I also shows that in 2005, U.S. corporations—in comparison to all OECD countries—were taxed similarly, paying effectively 24% as compared with 20% for equity investments and negative 46% as compared with negative 32% for debt-financed investment.⁵² Furthermore, in comparison with other OECD countries, the United States provides a relatively generous structure for certain tax incentives, particularly accelerated depreciation, as evidenced by row one of Table I.⁵³ The conclusion from all of this data is that U.S. corporations do not face a substantially different tax burden than other nations' corporations even though U.S. corporations face one of the highest statutory rates.

The third important factor—the drain on the corporate income tax resulting from the tax rules that apply to corporations internationally—is substantial. Nations today face grave challenges to their tax systems as the result of other nations using their tax systems to compete for business activity.⁵⁴ For over a century, the United States has vigorously pursued the taxation of residents' economic activity outside the United States and the domestic activity of foreign persons.⁵⁵ However, these rules do not yield significant revenue from foreign operations.⁵⁶

The fourth important factor is the reduction of the tax base by the deduction of imports. Increased imports directly cause a reduction of the corporate tax base even where the production is by U.S.-owned foreign corporations.⁵⁷ In

Japan, the United Kingdom, and the United States (citing Int'l Bureau of Fiscal Documentation (2007a)).

51. *Supra* TABLE I.

52. *Supra* TABLE I.

53. *Supra* TABLE I; *see also* THE 2007 TREASURY STUDY, *supra* note 7, at 9. Tax incentives, particularly accelerated depreciation, first account for the drop from the U.S. statutory rate of 39% to the EMTR of 24% for equity capital, with an additional drop from 24% to negative 46% EMTR for debt capital. *Supra* TABLE I.

54. *See* Barker, *supra* note 17, at 171–80 (providing general treatment of international tax competition).

55. *See id.* at 182–84 (detailing the history of the United States' comprehensive taxation, both foreign and domestic).

56. *See infra* Part I.B. The present U.S. tax system, which includes residence taxation with deferral for foreign incorporated entities and foreign tax credits for U.S. corporations, produces little revenue. *See* Rosanne Altshuler & Harry Grubert, *Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 NAT'L TAX J. 787, 798 (2001) (finding that tax on repatriated earnings of multinational corporations can be approximately 3%).

57. *See* Alan J. Auerbach et al., *Taxing Corporate Income*, in DIMENSIONS OF TAX DESIGN 837, 853–55 (Stuart Adams et al. eds., 2010) (discussing the impact of taxation on multinational corporate decisions).

2007, net imports (the excess of imports over exports) represented 5% of U.S. GDP.⁵⁸

Although base broadening and a lower statutory rate should make the corporate tax system simpler and reduce compliance costs, these reforms do not address four of the most fundamental problems of the corporate tax system. Two of these features, the disparity in treatment of debt and equity and the problems of international taxation and tax competition, warrant further consideration.⁵⁹

A. Debt v. Equity in the Corporate Setting

The growth of new types of financial products has made it difficult for tax authorities to distinguish between debt and equity.⁶⁰ Financial derivatives and other hybrid instruments have narrowed the distinction to such an extent that the distinction is meaningless in many cases.⁶¹ Yet, the disparate treatment of debt and equity remains one of the most important features of corporate taxation.⁶²

The United States applies a system of economic double taxation on corporate profits attributable to equity capital.⁶³ In general, the return on equity investments is taxed both at the corporate level and at the shareholder level as dividends or capital gains.⁶⁴

Despite the two-level tax structure, the U.S. system does have some complex trade-offs. Prior to the Jobs and Growth Tax Relief Reconciliation Act of 2003,⁶⁵ corporate dividends were simply taxed as ordinary income at regular

58. See Alan J. Auerbach, *A Modern Corporation Tax*, THE HAMILTON PROJECT Dec. 2010, at 13, available at http://www.brookings.edu/~media/research/files/papers/2010/12/corporate%20tax%20auerbach/12_corporate_tax_auerbach.pdf.

59. The remaining two features—the problematic use of pass-through entities and the impact of imports—are examined further in the discussion of cash flow taxes. See *infra* Part II.B. In particular, the use of pass-through entities for large businesses could be addressed by reforming income taxation or cash flow taxation. Both systems could address this problem by applying corporate tax to large non-corporate business. In addition, a destination-based cash flow tax directly addresses the problem of imports. See *infra* Part II.

60. See BORIS I. BITTKER & JAMES S. EUSTICE, 1 FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ch. 4 (7th ed. 2006) (discussing the issue of debt versus equity, including classification issues as well as the use of hybrid debt and hybrid-equity vehicles, which further challenge classification schemes); Robert E. Culbertson & Jamie E. King, *U.S. Rules on Earnings Stripping: Background Structure and Treaty Interaction*, 29 TAX NOTES INT'L 1161, 1161 (2003).

61. See Auerbach et al., *supra* note 57, at 859.

62. See *id.* at 857–58.

63. See THE 2007 TREASURY STUDY, *supra* note 7, at 43.

64. *Id.* at 51. To the extent that profits are not distributed to shareholders, these after-tax profits may be taxed to shareholders upon sales of shares to the extent these profits are reflected in the sale price of the shares. *Id.*

65. Jobs and Growth Tax Relief and Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in scattered sections of 26 U.S.C.).

rates.⁶⁶ Today, qualified corporate dividends are taxed at the taxpayer's top marginal rate or 15%—whichever is lower.⁶⁷ Double taxation is also mitigated somewhat by the treatment of retained earnings, which are only subject to the corporate tax and not the individual income tax.⁶⁸ To the extent that a shareholder indirectly realizes these profits through a sale of shares, they would be subject to an individual income tax at the maximum rate for capital gains of 15%.⁶⁹ This indirect second tax on retained corporate earnings is deferred until the shareholder disposes of his or her investment.⁷⁰ The effect of deferral results in a substantial reduction of taxpayers' income from capital invested in shares.⁷¹ One study estimated that the effective rate on capital gains from shares was between one-quarter and one-third of the statutory rate due to deferral.⁷² It has also been estimated that approximately one-half of corporate capital gains escape taxation altogether when held by taxpayers at death.⁷³

The tax treatment of corporate debt is quite different from equity. Interest accrued on corporate debt is deductible from corporate profits.⁷⁴ As shown in Table I, the treatment of debt financing results in a U.S. EMTR of negative 46% for debt-financed capital used in corporate activity,⁷⁵ while the U.S. EMTR for equity financing is positive 24%.⁷⁶ The result is that the combination of tax incentives and debt financing produces a substantial

66. See Auerbach et al., *supra* note 57, at 857.

67. I.R.C. § 1(h)(1), (h)(11) (2006) (treating qualified corporate dividends as capital gains with a 15% maximum tax rate). The 15% maximum rate mitigates the effect of double taxation for those in the higher income tax brackets that exceed 15%. See Auerbach et al., *supra* note 57, at 13.

68. See THE TAXATION OF INCOME FROM CAPITAL 221 (Mervyn A. King & Don Fullerton eds., 1984) (noting that retaining earnings creates a deferral advantage on later potential personal income tax).

69. I.R.C. § 1(h)(1) (providing a 15% maximum rate for long-term capital gains from the sale of corporate securities).

70. See Jane G. Gravelle, *The Corporate Income Tax: Economic Issues and Policy Options*, 48 NAT'L TAX J. 267, 270–71 (1995).

71. See THE 2007 TREASURY STUDY, *supra* note 7, at 51.

72. See THE CAPITAL GAINS CONTROVERSY: A TAX ANALYSTS READER 1 (J. Andrew Hoerner ed., rev. ed. 1992).

73. See THE TAXATION OF INCOME FROM CAPITAL, *supra* note 68, at 221 (“[N]o capital gains taxes are paid out of the estate, but the basis for calculating capital gains of the new owner is set equal to market value at the time of inheritance.”). The transfer of property at death is not a taxable event. See I.R.C. § 1001. Those who receive property through inheritance are entitled to a fair market value basis in the property. *Id.* § 1014.

74. See I.R.C. § 163. Therefore, to the extent of interest payments, the profit earned through the use of debt is not subject to corporate tax. See Auerbach et al., *supra* note 57, at 4. Interest payments are included in the income of creditors and taxed at the creditor's applicable rates.

75. See *supra* TABLE I.

76. See *supra* TABLE I.

government subsidy to corporations.⁷⁷ In contrast, the return on new equity capital is subject to corporate level tax and results in a positive rate of tax.⁷⁸

In an ideal corporate income tax system, the rate of tax on the return to debt-financed investment should be zero.⁷⁹ Currently, the negative rate of tax is created largely by the special tax preferences in the corporate system that cause the real system to deviate substantially from that ideal.⁸⁰ Because both forms of capital currently enjoy these preferences, the gap between debt and equity would remain unchanged if preferences were eliminated.⁸¹ For example, reducing the maximum tax rate from 35% to 31% would lessen the corporate tax incidence on equity and would *slightly* reduce the tax benefit of debt financing.⁸² However, closer is not the same; the difference in treatment should be exactly the bite of the actual corporate tax rate.

One proposal made by President Obama's Economic Recovery Advisory Board was to limit the deductibility of net interest.⁸³ For example, one plan could be to limit the deductibility of interest expense to 90% for payments of more than \$5 million per year.⁸⁴ The estimate is that this plan would allow the corporate tax rate to be lowered by roughly .7%.⁸⁵ Although such a provision might have some effect on the amount of corporate debt, it does very little to change the fundamental difference between debt and equity.⁸⁶

B. *International Taxation and the Corporate Income Tax Base*

Effective international taxation begins with the determination of the tax base—or what and who to tax.⁸⁷ The concerns are the fair and efficient taxation of both resident taxpayers with foreign income generated by transactions and operations abroad, and foreign persons with domestic income

77. See *supra* notes 39–41 and accompanying text.

78. See *supra* TABLE I.

79. See Auerbach et al., *supra* note 57, at 3 (proposing a tax system whereby the treatment of debt would mirror the treatment of equity—“taxable when borrowed but deductible when repaid”).

80. See 2012 JOINT REPORT, *supra* note 23, at 5–6.

81. An important tax advantage of deducting the return on debt-financed investment is that the interest deducted by corporations is nominal interest, which includes an inflationary component. To cure this defect, the tax system should index the interest deduction for inflation. See James Mackie, *Unfinished Business of the 1986 Tax Reform Act: An Effective Tax Rate Analysis Of Current Issues In The Taxation Of Capital Income*, 55 NAT'L TAX J. 293, 294 (2002). Though the income tax over-taxes interest income because it includes the inflationary component, it under-taxes income financed by debt. See *infra* Part III (providing a further discussion of interest).

82. See *supra* note 28 and accompanying text.

83. 2012 JOINT REPORT, *supra* note 23, at 9–10.

84. *Id.* at 73.

85. *Id.*

86. See *id.* at 74.

87. See Barker, *supra* note 14, at 651.

generating transactions and operations in the United States.⁸⁸ Although these objects appear to justify two different, but analogous tax bases—(1) the U.S. domestic source tax base for foreign corporations and (2) the foreign source tax base for U.S. resident corporations⁸⁹—there are two other critical base considerations. These bases are the net income earned by U.S.-owned foreign corporations, which are tax-exempt, and the domestic source base for U.S. corporations.⁹⁰

Generally, there are two primary international taxation regimes: territorial taxation and residence taxation.⁹¹ For U.S. corporations, the United States has adopted a residence taxation regime, which taxes the worldwide income generated by domestic and foreign operations transactions.⁹² However, this regime is elective in many instances due to the ability of U.S. corporations to conduct foreign activities through foreign-incorporated subsidiaries.⁹³ For foreign corporations, the United States has adopted a territorial taxation regime that only taxes income generated in connection with the United States.⁹⁴ Although worldwide taxation and territorial taxation are conceptually quite distinct, both systems share many problems that are inherent with a global tax regime.⁹⁵ Therefore, effective international taxation must begin with establishing and isolating these tax bases.

The concept of territory is critical to all of these tax bases. National borders, however, lose their traditional economic meaning when viewed from the perspective of multinational enterprises and their global activities.⁹⁶ International tax reform's "primary focus should be protecting the domestic tax base [of both resident and non-resident corporations] from erosion that is caused by mischaracterizing and misvaluing foreign and domestic income."⁹⁷ International income tax laws have proved largely ineffective at preventing this erosion. Actual international tax reform has lacked both theoretical and political consensus on what should be done.⁹⁸

88. *Id.* at 652.

89. *Id.* at 651–52.

90. *See id.*

91. *Id.* at 650. Territorial, or source taxation, "is based on the proposition that a country has the right to tax income that has 'arisen' in that country." *Id.* Residence, or domiciliary taxation, "is a personal jurisdiction approach; a nation seeks to tax its residents on income irrespective of source." *Id.*

92. *Id.* at 650–51.

93. *Id.* at 651 (noting that, "[i]n general, income earned by U.S. owned foreign corporations is deferred until repatriation").

94. *Id.*

95. *Id.* at 650–52.

96. *Id.* at 650.

97. *Id.* at 651–52.

98. For example, in April 2010, Northwestern Law School held a symposium that brought together government officials from both Democratic and Republican administrations, academics, business representatives, and tax practitioners to address the problems and needs of international

Although territorial taxation of foreign-owned corporations in the United States does not typically receive the political and scholarly attention that worldwide taxation does, its importance should not be underestimated.⁹⁹ In regard to all corporations doing business in the United States, foreign-owned corporations account for about 10% of the U.S. economy.¹⁰⁰ Without U.S. taxation of foreign enterprises doing business in the United States comparable to U.S. taxation of domestic corporations, U.S. corporations could experience a substantial competitive tax disadvantage.¹⁰¹

To see this, examine the three basic components of U.S. territorial taxation of foreign-owned corporations. The first, the source of income within a territory, is a process of linking the production of income to a taxing jurisdiction.¹⁰² The second is the threshold for taxation of corporate business. In general, business income under the Internal Revenue Code is not taxed unless it is effectively connected with a *trade or business within the United States*¹⁰³ or, as modified by treaty, is not taxed unless it is connected with a permanent establishment located within the United States.¹⁰⁴ The third component is the type of tax. Territorial tax is a tax on net income applied in the same fashion as applied to domestic taxpayers.¹⁰⁵ Where U.S.-sourced income is not subject to business tax rules, it can be taxed on a gross basis.¹⁰⁶

Theoretically, worldwide taxation of U.S. corporations is not concerned with these limitations. U.S. corporations are taxed on their worldwide income no matter where it is sourced.¹⁰⁷ However, the scope of worldwide corporate taxation is dramatically affected by two major factors. The first is that the

tax reform. Hilary Hurd Anyaso, *Northwestern Law Hosts International Tax Reform Symposium*, NORTHWESTERN UNIV. (Apr. 6, 2010), <http://www.northwestern.edu/newscenter/stories/2010/04/taxadvisory.html>. Though many different approaches were examined, agreement on reform of the international tax income system lacks any hope of consensus. The reason is simple; no plan yet advanced does much to improve the situation. See David L. Cameron and Philip F. Postlewaite, *Symposium on International Tax Reform in a Reset Economy: Introduction*, 30 NW. J. INT'L L. & BUS. 505, 514 (2010).

99. See, e.g., MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION ch.6, at 266 (2003) (devoting only one chapter to inbound business transactions).

100. See Cletus C. Coughlin, *Foreign Owned Companies in the United States: Malign or Benign?* 74 FED. RES. BANK ST. LOUIS REV. 17, 19 (1992), available at http://research.stlouisfed.org/publications/review/92/05/Foreign_May_Jun1992.pdf.

101. *Id.* at 24–25.

102. See I.R.C. § 861 (2006) (providing the source rules relating to foreign income from sources within the United States).

103. *Id.* § 882. Foreign corporations are taxed on income “effectively connected with a trade or business within the United States.” *Id.* § 882(a)(1).

104. See United States Model Income Tax Convention of November 15, 2006, art. 5, 7(1) (raising the threshold for business taxation to income derived from a permanent establishment located within the United States).

105. I.R.C. § 882(a)(1).

106. *Id.* § 881(a).

107. See Barker, *supra* note 14, at 650.

taxing jurisdiction must give relief to the U.S. taxpayer for foreign tax paid.¹⁰⁸ The U.S. does this by allowing a tax credit against U.S. corporate taxes for foreign income taxes.¹⁰⁹ The amount of this credit is limited by the U.S. tax that is paid on foreign income.¹¹⁰ Hence, the location or territory where the income is earned or sourced is a critical factor in determining the tax actually paid to the U.S.¹¹¹

The second aspect of worldwide U.S. taxation of U.S. corporations is the definition of a U.S. corporation. Only corporations incorporated in the United States are U.S. corporations.¹¹² U.S.-owned foreign corporations are not taxed directly on their income; any tax is deferred until the profits are repatriated to the U.S. corporation.¹¹³ The U.S. corporation is entitled to an indirect credit for foreign dividends with regard to the foreign tax on the foreign earnings of the U.S.-owned affiliate.¹¹⁴ Thus, the combination of the direct taxation of worldwide income of U.S. corporations and deferred, indirect taxation of foreign corporate income creates a powerful incentive for new enterprises to incorporate their parent corporations outside the United States in low-taxed foreign jurisdictions.

The present system of worldwide taxation—with deferral for active business income earned by foreign corporations coupled with the application of the foreign tax credit for repatriated earnings—requires the proper determination of the source of income and the proper allocation of deductions between domestic and foreign sources.¹¹⁵ Territorial taxation of foreign enterprises by the United States must also confront the similar challenge of locating the site of income and deductions for allocation to the U.S. tax base.¹¹⁶ The lack of an economic basis or any consensus on appropriate rules of sourcing and allocation is well known¹¹⁷ and results in distortions in income and expense classification, which are magnified by the shifting of income and deductions through pricing and debt planning.¹¹⁸ Consequently, legislators have been

108. I.R.C. § 901(a).

109. *Id.* § 904 (foreign tax credit limitation).

110. *Id.*

111. *See* Barker, *supra* note 14, at 650–51.

112. *See* I.R.C. § 7701(a)(3)–(5) (defining a domestic and foreign corporation).

113. *See* Barker, *supra* note 14, at 651 & n.23.

114. I.R.C. § 902.

115. *See supra* text accompanying notes 108–14.

116. *See supra* text accompanying notes 102–06.

117. *See, e.g.,* Barker, *supra* note 17, at 202–12 (analyzing a variety of international source rules and their respective flaws); Fred B. Brown, *An Equity-Based, Multilateral Approach for Sourcing Income Among Nations*, 11 FLA. TAX. REV. 565, 629 (2011) (stressing the necessity for international agreement); Stephen E. Shay et al., *The David R. Tillinghast Lecture “What’s Source Got to Do With It?” Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 137–38 (2002) (examining the inherent difficulties of allocating individual gains based on the underlying net income concept of U.S. federal income tax laws).

118. *See* Barker, *supra* note 14, at 674; *see also supra* Part I.A.

active in enacting complex anti-avoidance rules to mitigate the abuses.¹¹⁹ However, as shown in Table I, the combination of debt financing and tax incentives results in a negative corporate income tax on the debt-financed activities of U.S. corporations.¹²⁰

Due to the prevalence of debt financing of foreign-owned corporations doing business in the United States, the U.S. corporate income tax is quite ineffectual.¹²¹ As demonstrated in Part I.A, corporations can easily replace equity capital with debt capital, thereby removing would-be profits from the tax base.¹²² The problem of debt financing is further exacerbated in the case where the creditor of the foreign-owned U.S. enterprise is a related party, which may result in excessive deductible interest payments.¹²³ This practice—the overuse of debt and charging interest that represent a rate greater than a market return on debt capital—is called “earnings stripping.”¹²⁴ In the United States, which provides for transfer pricing rules and regulations on debt characterization, Congress has tried to curb the abuse through legislation.¹²⁵ Generally, however, only a fundamental change in the way the United States taxes foreign-owned enterprises would cure this problem.¹²⁶

Although the United States has taken aggressive measures toward foreign operations of U.S. corporations, it hardly seems worth the effort. The United States collects little revenue from the foreign business of U.S. corporations.¹²⁷ The nation stands alone today as the only country in the world that attempts to tax the worldwide business income of its resident corporations.¹²⁸ Among the proposals for international tax reform,¹²⁹ many governments have moved to

119. I.R.C. § 482 (2006) (permitting the adjustment of income calculations to prevent tax evasion); *id.* § 951(a) (taxing U.S. shareholders on certain income from their controlled foreign corporations in order to prevent erosion of the U.S. tax base); Barker, *supra* note 14, at 674 (noting the substantial compliance cost of anti-avoidance rules).

120. *Supra* TABLE I (U.S. corporations pay negative 46% on debt-financed investment).

121. See Culbertson & King, *supra* note 60, at 1161–62.

122. See *id.* at 1161–66; see also *supra* Part I.A.

123. See Culbertson & King, *supra* note 60, at 1162; see also *supra* note 46 and accompanying text (explaining that interest on corporate debt is deductible).

124. See Culbertson & King, *supra* note 60, at 1161–66 (describing the practice known as earnings stripping in detail).

125. I.R.C. § 163(j) (2006) (limiting interest deductions if a corporation has excess interest and a debt-to-equity ratio that exceeds 1.5 to 1); *id.* § 267(b) (defining related entities for purposes of § 163(j)); see also Culbertson & King, *supra* note 60, at 1166–69 (describing the interplay between these and other relevant statutes).

126. See generally William B. Barker, *An International Tax System for Emerging Economies, Tax Sparing and Development: It Is All About Source!*, 29 U. PA. J. INT'L. L. 349 (2007) (providing such a proposal).

127. See *supra* note 56.

128. See Barker, *supra* note 14, at 647, 650–51, 682 (explaining that the United States is unique in its approach to taxing a corporation based on its worldwide income).

129. See *id.* at 647–87 (discussing the various reform proposals and their drawbacks).

comprehensive corporate income taxation with the exemption of active foreign business income.¹³⁰

To date, lawmakers in the United States do not appear interested in such a change, nor should it be recommended. Studies have shown that this “new” regime of territorial income taxation, known as exemption systems, is subject to the same compliance costs, difficulties, and abuses as the present U.S. system.¹³¹ Exemption of foreign business income also raises the same sourcing, allocation, and characterization problems that deferral does.¹³²

II. THE ELEMENTS OF A CASH FLOW TAX ON CORPORATIONS

The suggestion of a cash flow tax as the solution to tax reform is not novel.¹³³ Previous proposals have primarily focused, however, on the desire to replace the income tax with a consumption tax for all taxpayers.¹³⁴ This article’s contribution is quite different; it suggests only a reform of the corporate income tax, which is accomplished by implementing a cash flow tax solely for corporations and other large businesses.¹³⁵ It also rejects the longstanding view that countries should adopt an origin-based cash flow tax¹³⁶ and instead proposes a destination-based cash flow tax. This dramatically different conclusion results from approaching the problems of effective taxation of corporate income from an international perspective. It unifies corporate tax under one principle: all corporations, whether foreign or domestic, without thresholds or exceptions, are subject to a destination-based cash flow tax.¹³⁷

130. *Id.* at 682.

131. *Id.* at 682–86.

132. *Id.*

133. *See supra* notes 1–8 and accompanying text.

134. *See supra* notes 4–8 and accompanying text.

135. This proposal was first illuminated in a prior work by this author and was meant to respond to an article by Professor Reuven Avi-Yonah in which Prof. Avi-Yonah suggested the merits of a territorial cash flow tax on corporations. *See* William B. Barker, *Tax Reform in the (Inter)National Interest: Why Wait?*, 124 TAX NOTES 828, 828 (2009). In April 2010, this same author delivered a paper on this same topic at Northwestern University School of Law’s Symposium on International Tax Reform in a Reset Economy, which was published in the 2010 summer issue of the *Northwestern Journal of International Law and Business*. *See* Barker, *supra* note 14. In that paper, the author further refined his recommendations by proposing the adoption of a destination-based, territorial consumption tax for all corporations. *Id.* at 687–97. In December 2010, Professor Alan J. Auerbach, in a paper released jointly by the Center for American Progress and The Hamilton Project, also proposed the adoption of a destination-based cash flow tax for corporations. *See* Auerbach, *supra* note 58, at 10.

136. This was the proposal of both THE MEADE REPORT, *supra* note 2, at 229–30, and HALL & RABUSHKA, *supra* note 5, at 60–61.

137. Unlike many of the previous works on comprehensive consumption taxes, the proposal that the United States should adopt a destination-based cash flow tax for all corporations is the outgrowth of considerations of international taxation reform. Early research demonstrated that the principle problem with international taxation was its lack of an economic basis for the source

A. *The Basics of Cash Flow Taxes*

Taxation under a cash flow tax does exactly what its name suggests; it taxes the net positive cash flow of a business.¹³⁸ The basic form includes the value of all receipts in income and allows a deduction for all payments.¹³⁹ The essential difference between a cash flow tax and an income tax is the treatment of capital expenditures.¹⁴⁰ Whereas a cash flow tax provides for the immediate deduction of all capital expenditures, an ideal income tax denies the immediate deduction of capital expenditures, requiring instead that the taxpayer deduct those expenditures over the useful life of the asset through depreciation.¹⁴¹ However, the practical consequences are more complex.

The general rule under the American income tax system is that expenditures for tangible assets with a useful life of more than one year are capitalized.¹⁴² It

rules for foreign and domestic income. The application of cash flow tax concepts results in a practical, fair, and economically sound allocation of income and expenses between resident countries taxing on a worldwide basis and host countries taxing on a territorial basis. The basic premise is that a cash flow tax captures the value that is attributable to the location in which the business is conducted. It provides a fair allocation of non-capital business income among nations, while capital income is fairly allocated exclusively to the nation where that capital was produced or derived, which is the state of the taxpayer's residence. *See* Barker, *supra* note 126, at 374–75 (advocating that the revenue produced by multinational corporations should be taxed by the countries in which they operate).

These insights led to the conclusion that an effective and fair base for source taxation of business profits is domestic economic rents. This left the tax on the normal return from capital from foreign activities to the nation of the taxpayer's residence. The most practical method to implement such a system was to use a cash flow expenditure tax. *See id.* at 380 (arguing for rent taxation systems in developing nations).

Later research expanded upon this analysis and concluded that a cash flow tax system should be applied to all corporations in the United States, both foreign and domestic. This recommendation proceeded from two interdependent factors.

The first was the understanding that resident states face many of the same practical problems of effective corporate taxation that source states do. *See* Barker, *supra* note 14, at 682–86. Second, the free movement of many of the factors of production, specifically capital and technology, has led to increasing tax competition. *See* Barker, *supra* note 17, at 721–22. Even developed nations' resident tax systems are strained by transfer pricing issues, debt equity issues, and foreign income deferral. Both the economic and the tax bases of many nations are at risk. This leads to the practical solution to abandon the corporate tax on capital income, while leaving intact taxation of an individual's capital income and progressive income tax principles. In general, a tax on business income without a tax on capital income can be implemented best by a cash flow tax. *See* Barker, *supra* note 126, at 381–82.

138. *See* BASIC TAX REFORM, *supra* note 2, at 2, 9.

139. *See* *How Much Capital Taxed*, *supra* note 4, at 1. A cash flow tax would continue the income tax rule that individual gifts are not deductible. *See* I.R.C. § 274(b) (2006). There is no technical reason for why the deduction for charitable contributions could not be continued. *See id.* § 170.

140. *See* *How Much Capital Taxed*, *supra* note 4, at 1.

141. *Id.*; *see also* BASIC TAX REFORM, *supra* note 2, at 44 (discussing the inherent difficulties in determining the depreciation of an asset in an income tax system).

142. I.R.C. § 263A(a).

is this cost or basis that is recovered, ideally, through depreciation over the economic useful life of an asset.¹⁴³ The U.S. tax system provides several mechanisms to accelerate these deductions, permitting the taxpayer to recover costs more quickly.¹⁴⁴ Similarly, in the case of intangible assets, the basic structure of capitalization and depreciation is applied by statute and regulation.¹⁴⁵ American tax law, however, is riddled with exceptions.¹⁴⁶ Many intangibles, like going concern value or goodwill, are a byproduct of otherwise deductible expenditures like wages, and therefore are not capitalized and depreciated.¹⁴⁷ The statutory scheme of capitalization and amortization is primarily a factor only when intangibles are acquired through direct purchase.¹⁴⁸ Finally, the cost of some assets, like land, cannot be depreciated either because they are not consumed in creating income or because they lack a fixed, determinable useful life required for depreciation under an income tax system.¹⁴⁹ Their costs can only be recovered upon sale or other disposition of the asset.¹⁵⁰

Most studies performed by economists compare an ideal income tax that permits only economic depreciation with a consumption tax that permits the deduction of all profit-making expenditures, including wages.¹⁵¹ The present U.S. income tax system permits first-year deductions or credits for many expenditures that create value beyond the end of the taxable year, including advertising and research and development, and allows deductions or greatly accelerated depreciation for other capital expenditures—thus making the present system a hybrid income/consumption tax system.¹⁵² Therefore, comparing idealized forms overstates the advantage to taxpayers and the loss

143. See BASIC TAX REFORM, *supra* note 2, at 44 (stating that, conversely, the tax base is eroded when depreciation rules are inconsistent with the actual depreciation of an asset).

144. I.R.C. § 168 (2006 & Supp. IV 2011) (permitting an accelerated cost recovery system).

145. See I.R.C. § 197 (allowing for straight line depreciation, or amortization, of intangible assets); see also Treas. Reg. § 1.263(a)-4(f) (2004) (providing the general rule for capitalization).

146. Research and development activities that can produce considerable future value are generally deductible by statute. See I.R.C. § 174(a) (granting the taxpayer an election to deduct research and experimental expenditures). Advertising, which creates value over more than one year, is deductible. See Don Fullerton & Andrew B. Lyon, *Tax Neutrality and Intangible Capital*, in 2 TAX POLICY & THE ECONOMY 63, 66 (Lawrence H. Summers ed., 1988).

147. The test for capitalization is very broad. Expenditures that create significant future benefits must be capitalized. See *Indopco, Inc. v. C.I.R.*, 503 U.S. 79, 88–89 (1992).

148. See I.R.C. § 197(d) (providing examples of intangible assets subject to amortization); see also Amy J. Bokinsky, Note, *Section 197: Taxpayer Relief and Questions of Asymmetry*, 14 VA. TAX REV. 211, 236 (1994) (“To amortize an intangible asset, it must have been purchased in a taxable transaction.”).

149. I.R.C. § 167.

150. *Id.* § 1001.

151. See, e.g., BASIC TAX REFORM, *supra* note 2, at 44 (comparing depreciation in an income tax model with depreciation in a cash flow tax model).

152. Roger Gordon et al., *Do We Now Collect Any Revenue from Taxing Capital Income?*, 88 J. PUB. ECON. 981, 1000–01 (2004).

of revenue to the government of consumption taxes.¹⁵³ It should not be surprising that one recent study concluded that overall revenue would not significantly decrease were the corporate tax system changed from income to cash flow.¹⁵⁴ Thus, our present hybrid income/consumption tax system attempts to reach certain consumption tax results without the practical benefit of a consistent consumption tax approach.¹⁵⁵

In comparison, a cash flow tax measures what is available for consumption after accounting for all expenditures.¹⁵⁶ Consequently, all expenditures for assets that are normally capitalized under an income tax system are simply deducted.¹⁵⁷ The treatment of financial assets under a cash flow tax depends on the type of cash flow system adopted.¹⁵⁸

The value of a cash flow tax to the taxpayer is that the immediate deduction of all expenditures does not tax the normal return on capital, whether in the form of debt or equity.¹⁵⁹ However, a cash flow tax does tax the supernormal returns to capital, which are referred to as economic rents.¹⁶⁰ A corporate income tax, in an asymmetrical fashion, taxes the normal return on equity, but does not tax the normal return on debt.¹⁶¹ It does this by allowing a deduction for interest but not for dividends.¹⁶²

If an individual earns all returns on debt or equity capital directly, there would be no distinction between debt and equity under a comprehensive income tax system.¹⁶³ Basic investment of either debt or equity would be tax neutral, as would capital recovery of any sort.¹⁶⁴ The return on capital, whether the profits on capital take the form of a return on equity or interest on debt, would be included.¹⁶⁵

153. See, e.g., Fullerton & Lyon, *supra* note 146, at 63–64 (finding that untaxed intangible capital reduces overall efficiency in the current tax structure).

154. See Gordon et al., *supra* note 152, at 987–89.

155. *Id.* at 1000–01 (explaining that the U.S. system “has long been recognized as a hybrid of an income and consumption tax, with elements that do not fit naturally into either pure system”).

156. See THE MEADE REPORT, *supra* note 2, at 9.

157. See *id.*; see also *supra* notes 147–50 and accompanying text.

158. See *infra* Part II.C (discussing the differences between R and R&F-type cash flows).

159. See Barker, *supra* note 14, at 689; see also *infra* Part III.

160. See Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 23–24 (1996); David Elkins & Christopher Hanna, *Taxation of Supernormal Returns*, 62 TAX LAW. 93, 100 (2009).

161. See Barker, *supra* note 14, 689.

162. *Id.*

163. See Cunningham, *supra* note 160, at 23–24; see also Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1058–65 (2000) (describing the current U.S. debt-equity distinction in tax treatment).

164. See Pratt, *supra* note 163, at 1058–65.

165. *Id.*

The incidence of corporate tax, however, adds a new perspective on the tax treatment of different forms of investment capital.¹⁶⁶ Debt is subject to one layer of tax, whereas equity is subject to two.¹⁶⁷ Thus, in the context of individual taxpayers, the distinction between debt and equity is mostly about assigning priorities among the business owners and creditors.¹⁶⁸

Corporate form changes everything because the true owner of equity capital is not the corporation. Where investment is made in corporate form, the incidence of a separate corporate tax within an income tax system treats such investment in dramatically different ways depending on its classification as debt or equity.¹⁶⁹ Classic taxation imposes tax at the investor level equally on interest or dividends.¹⁷⁰ Interest expense is deductible by the corporation; however, dividend payments are not deductible by the corporation.¹⁷¹ This results in one level of tax being imposed solely on the creditor for the return on debt capital.¹⁷² The return on equity capital is taxed twice.¹⁷³

The following table illustrates this distinction. Compare an equal investment of debt and equity under both the classical system and the present modified system.¹⁷⁴ Assume a 34% corporate tax rate, a 35% individual tax rate, and a special rate of 15% on corporate dividends.

166. See *supra* Part I.A (discussing debt and equity in the corporate setting).

167. See Pratt, *supra* note 163, at 1064; see also *supra* Part I.A.

168. See *supra* Part I.A. Whether we consider the principle amount of a loan or the commitment of equity capital, the flow to and from a business is tax neutral. As to the return on capital, interest is deductible by the business, thus ensuring that the portion of the profits paid as interest is taxed once to the owner of that stream of income. The return on equity capital is not deductible to ensure that the owner of that capital is assessed tax on the return from that capital.

169. See *infra* TABLE II.

170. Under present law, dividends are taxed at a maximum rate of 15%, which is the standard tax rate on long-term capital gains. See I.R.C. § 1(h) (2006); see also *supra* text accompanying note 69.

171. See Pratt, *supra* note 163, at 1058–65.

172. See *infra* TABLE II.

173. It is first taxed to the corporation, and—when profits are distributed out of the corporation's after-tax income—the returns are taxed a second time to the shareholders.

174. See *infra* TABLE II.

TABLE II

	Debt	Equity (at 35%)	Equity (Div 15%)
Invest	1000	1000	1000
Profit	100	100	100
Corp. Tax 34%	0	34	34
Distribution	100	66	66
Tax at 35%	35	23.10	
Tax at 15%			9.9
After Tax Return	65	42.90	56.1

In order for the taxpayer to receive the same after-tax return on equity as on debt, the corporate profit on equity financing in the case of the present split rate (15%) system would have to be \$115.86 instead of \$100.00.¹⁷⁵ In the classical system, with the full taxation of dividend income and the taxpayer being in the highest tax bracket (34%), the before-tax corporate income would have to be \$129.97.¹⁷⁶

B. *Origin v. Destination-Based Cash Flow Taxes*

There are two different systems for defining the tax base of a cash flow tax: the destination principle and the origin principle.¹⁷⁷ Both are territorial tax systems and, like all cash flow taxes, both do not tax the normal return from capital—they only tax the economic rents earned by a corporation.¹⁷⁸

Origin and destination-based cash flow taxes differ in how they determine inclusions and exclusions from the tax base. The tax base under an origin principle identifies the value created by a nation after subtracting the normal cost of capital.¹⁷⁹ The first component is the total income from the sale of goods and services sold in a country, whether produced domestically or imported.¹⁸⁰ The second component is the deduction of the total cost associated with those goods and services, whether produced domestically or imported.¹⁸¹ The result is that an origin-based cash flow tax reaches only domestic *production*.¹⁸²

The tax base under a destination principle identifies the value consumed by a nation after excluding the normal cost of capital.¹⁸³ The first component is the

175. The formula is $65 = X - .34X - 15(X - .34X)$.

176. The formula is $65 = X - .34X - .35(X - .34X)$.

177. See Barker, *supra* note 14, at 690.

178. *Id.* at 690–96; see also *infra* Part III.

179. See Barker, *supra* note 90, at 690.

180. *Id.*

181. *Id.*

182. *Id.*

183. *Id.* at 692–93.

total income from the sale of all goods and services destined for the home market, which excludes all sales of exported goods and services.¹⁸⁴ The second component is the deduction of the cost of all goods and services *produced* in the country, which does not allow for a deduction of imports.¹⁸⁵ The destination principle's opposite treatment of exports and imports results in a tax on production consumed in the home market irrespective of where it was produced.¹⁸⁶ Whereas the origin principle taxes domestic *production*, the destination principle taxes domestic *consumption*.¹⁸⁷

Thus, when seeking to establish a cash flow tax base, the choice is between a tax on domestic production or on domestic consumption. The origin-based approach taxes on the basis of what a nation *adds* to the store of consumables.¹⁸⁸ Its territorial form relinquishes the right to foreign-produced economic rents consumed within the United States, while gaining the right to U.S.-produced economic rents consumed outside the United States.¹⁸⁹

The destination-based approach taxes on the basis of what a nation *removes* from the store of consumables.¹⁹⁰ In contrast to the origin principle, its territorial form relinquishes the right to domestic-produced economic rents consumed outside the United States while gaining the right to foreign-produced economic rents consumed inside the United States.¹⁹¹

Both an origin-based and destination-based cash flow tax offer a nation a legitimate tax base well within the general sovereignty of each nation. From a philosophical perspective, both systems reach consumption. The only issue, however, is whose consumption is taxed: that of Americans only or that of all persons consuming American goods and services.¹⁹² Purely practical considerations dictate that in a globalized world where many of the factors of production are mobile and where, consequently, other nations will compete for business with tax incentives, only a destination-based cash flow tax will yield a largely unavoidable corporate tax.¹⁹³

184. *Id.* at 692–94.

185. *Id.* at 693.

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.* at 690–91; *see also supra* note 160 and accompanying text (describing economic rents).

190. Barker, *supra* note 14, at 692–93. Taxation under the destination principle is more consistent with general consumption tax philosophy. *See* THOMAS HOBBS, *LEVIATHAN* 158 (George Rutledge & Sons, 3d ed. 1887) (setting forth the classical justification for consumption taxes: taxing on what one removes from society rather than taxing on what one produces or contributes to society). Although this justification makes sense for individuals, it is not persuasive when applied to corporations as they do not directly consume.

191. *See* Barker, *supra* note 14, at 693.

192. *See id.*

193. *See id.* at 694–95.

Because an origin-based approach taxes exports and allows deductions for imports, it provides a tax incentive for locating production outside the home country and provides a strong incentive for transfer pricing abuse.¹⁹⁴ Thus, an origin-based tax distorts economic decision-making in an open economy where many of the factors of production are mobile and corporations are free to locate their activities outside the United States.¹⁹⁵ A destination principle eliminates exports and imports from the tax base, thus its subject matter—domestic sales and domestic production—is much more easily monitored by the taxing jurisdiction.¹⁹⁶ Therefore, a destination-based cash flow tax does not distort economic decision-making and renders the tax largely unavoidable, even in the real world of open economies.¹⁹⁷ Consequently, the destination principle eliminates much of the benefit of non-arm's-length transfer pricing, which remains an important loophole in both income taxes and origin-based cash flow taxes.¹⁹⁸ Although similar to a destination-based value added tax (VAT) imposed only on corporations, the destination-based cash flow tax diverges from the VAT in that it allows a deduction for wages paid for services performed in the United States.¹⁹⁹ Thus, unlike a VAT, a destination-based cash flow tax is not a tax on labor; it is a tax on economic rents closely associated with a particular nation through its peoples' consumption.²⁰⁰

C. Two Methods for Measuring Cash Flow: The R-Type and the R&F-Type Cash Flow Tax

There are two general models that can be used for measuring cash flow. Each starts with a comprehensive income tax base and allows an immediate deduction for materials, labor, and fixed assets.²⁰¹ The basic model, the R-type, ignores all financial transactions, with dividends and interest neither

194. See *id.* at 691 (describing transfer pricing abuse when multinational businesses artificially inflate the cost of imports or deflate the cost of exports to respectively increase deductions or decrease taxable income).

195. See Auerbach et al., *supra* note 57, at 839, 883–84 (noting that an origin-based cash flow tax is nondistortionary only in a closed economy); see also Barker, *supra* note 126, at 351–52.

196. See Barker, *supra* note 14, at 695 (noting that “problems of avoidance under a destination expenditure tax are substantially eliminated,” while incentives to mischaracterize domestic sales as exports and imports as domestic production will remain).

197. See Auerbach et al., *supra* note 57, at 839, 883–84; see also Barker, *supra* note 14, at 695.

198. See *supra* notes 121–26, 194–97.

199. See Auerbach et al., *supra* note 57, at 839, 883–84.

200. *Id.* at 884–85.

201. See THE MEADE REPORT, *supra* note 2, at 230–33; see also Barker, *supra* note 14, at 689.

taxed when received nor deductible when paid.²⁰² Both payments and repayments of equity capital and debt principal are tax-neutral.²⁰³

A second design, the R&F-type, changes the treatment of all financial instruments. On the one hand, all amounts received as interest, dividends, the principal amount of the debt, and the initial equity investment are included in the tax base.²⁰⁴ On the other hand, payments of interest, dividends, and the principal amount of debt and equity investments are deducted.²⁰⁵ The R&F-type takes into account all cash flows, both real and financial.²⁰⁶ The R-type takes into account only real cash flows from business operations.²⁰⁷

Because the sole difference between the models is the treatment of financial transactions, the R-type is often recommended for active business enterprises on account of its perceived simplicity.²⁰⁸ The R-type is not recommended for financial service enterprises because its application would exempt most profit, as the R-type exempts net interest income.²⁰⁹ An R&F-type, however, includes all capital flows, which includes net interest. Where a corporation's primary business is providing credit and other financial services, the R-type method would fail to capture the true profit of the firm.²¹⁰

Financial service businesses are similar to other businesses because they also provide services and products.²¹¹ Their product, so to speak, is credit. Their services include various items that facilitate the flow of money and capital. Much of a financial service business's gross income is in the form of interest and not payments for specific services, even where a substantial portion of the charge is for services.²¹² Were banks to charge fairly and separately for all services, the exemption of interest income and interest expense under an R-type system would make less difference. Interest paid to bank depositors

202. See THE MEADE REPORT, *supra* note 2, at 230–33; see also Barker, *supra* note 14, at 689.

203. See Barker, *supra* note 14, at 689.

204. See *id.*

205. See *id.*

206. See THE MEADE REPORT, *supra* note 2, at 233.

207. See *id.* at 230.

208. See *id.* at 239. Because neither profits nor losses are part of the system, a yield exempt or R system is thought to be the economic equivalent of an R&F or pure cash flow system because both exempt the normal return from capital but not the risk premium. A yield exempt does differ from the pure cash flow in exempting economic rents whereas cash flow does not. See *How Much Capital Taxed*, *supra* note 4, at 14. Because financial transactions under the R-type are ignored, no accounting for them need be made. See THE MEADE REPORT, *supra* note 2, at 240. In contrast, every part of financial transactions is included under an R&F system. See Barker, *supra* note 14, at 689.

209. See THE MEADE REPORT, *supra* note 2, at 236, 240; see also Barker, *supra* note 14, at 695.

210. See THE MEADE REPORT, *supra* note 2, at 236, 240; see also Barker, *supra* note 14, at 695.

211. See THE MEADE REPORT, *supra* note 2, at 236.

212. See *id.*

would be higher where all services provided to depositors were separately charged, and interest charged to borrowers would be lower because some of the value provided to borrowers would be re-characterized as service income.²¹³ As a result, financial service providers would start to resemble business enterprises that tend to be net debtors with financial costs exceeding financial gains.²¹⁴ As long as this is the case, an R-type system captures the true profits or economic rents of the corporate enterprise.²¹⁵ However, where any corporation earns net financial profits, the *only* way to capture these true profits or economic rents is by including interest and all other capital flows in the tax base under an R&F-type cash flow tax.²¹⁶

Application of the R&F-type method to corporations should not be lightly abandoned because of its perceived complexity. Applied to relatively sophisticated corporations, the R&F-type is straightforward; some suggest the R&F-type system is only slightly more technically difficult than an R-type and is conceptually simpler because it treats all receipts and expenditures the same.²¹⁷ There would be no reason to characterize different receipts or expenditures as real or financial because they would all be fully included in the tax base.²¹⁸ Corporations are sufficiently sophisticated to apply the R&F-type, which merely requires accounting for all capital flows.²¹⁹ Indeed, taxation should be much simpler when compared to the current corporate income tax.

The perception that the R&F-type is more complex can be the result of viewing it from the income tax perspective. An R&F-type radically changes the way capital is treated in that the principal amount of loans and equity capital are added to income when received.²²⁰ Similarly, deducting the repayment of loans, equity capital, dividends, and interest is equally strange from an income tax perspective.²²¹ The R-type, however, also contains elements foreign to an income tax, such as the exclusion of interest and dividends from income and the inability to deduct interest.²²² This has led to the suggestion that an R&F-type should be adopted for non-financial

213. See *Bank of Am. v. United States*, 680 F.2d 142, 143–45 (Ct. Cl. 1982) (providing an example of the difficulty in distinguishing between interest and other financial service income in the international context); see also THE MEADE REPORT, *supra* note 2, at 231–32.

214. See THE MEADE REPORT, *supra* note 2, at 230–32. It is more likely in the case of non-financial business enterprises that the returns from financial capital would take the form of business profits, which are fully included in income in an R-type tax. See *id.* at 230.

215. See *id.*

216. See Barker, *supra* note 14, at 689.

217. See *id.*; see also *supra* note 208 and accompanying text.

218. See Barker, *supra* note 14, at 689. A cash flow tax would undoubtedly continue the income tax's prohibition of deducting gifts over \$25. See I.R.C. § 274(b) (2006). However, it may also continue the deductibility of charitable contributions. *Id.* § 170.

219. See Barker, *supra* note 14, at 689.

220. Compare Barker, *supra* note 14, at 689, with Pratt, *supra* note 163, at 1054–64.

221. See Barker, *supra* note 14, at 689.

222. See *id.*

enterprises only for debt,²²³ solely on the basis that it would aid the transition from an income tax that allows the deduction of interest to an R-type that does not.²²⁴

The adoption of such a hybrid R/R&F-type would be a mistake. The hybrid R/R&F-type perpetuates the distinctions between debt and equity, whereas the R-type ignores them and the R&F-type eliminates them.²²⁵ Only applying cash flow principles to debt but not to equity capital would make the system dependent on the problems of debt-equity characterization that plague the income tax.²²⁶ The history of the income tax demonstrates the ambiguity inherent in such classifications; courts and administrators have always struggled with classification regimes and their application.²²⁷ Because debt and equity are both forms of capital investment, the exaggerated difference in tax regimes provides large incentives for manipulation.²²⁸ A hybrid R/R&F-type would put a premium on careful planning to take advantage of cash flow principles for debt and exemption principles for equity.²²⁹

The adoption of the basic R-type would similarly be a mistake, as it also creates opportunities for tax avoidance. The R-type creates critical distinctions in classifications by excluding financial transactions from cash flow.²³⁰ These distinctions are not between debt and equity but between operating income and expense, and financial income and expense.²³¹ The R-type advantages financial income, which is exempt, and operating expenses, which are deductible.²³² This allows the opportunity to take advantage of these asymmetries when tax planning.²³³

Thus, a hybrid R/R&F-type perpetuates the income distinctions between debt and equity²³⁴ and the R-type creates a new distinction between financial and non-financial transactions.²³⁵ Both types would perpetuate important

223. See Altshuler & Grubert, *supra* note 56, at 795.

224. See THE MEADE REPORT, *supra* note 2, at 233; see also Altshuler & Grubert, *supra* note 56, at 795.

225. See Barker, *supra* note 14, at 689.

226. See BITTKER & EUSTICE, *supra* note 60, ch. 4 (providing detail on these existing problems); see generally Pratt, *supra* note 163.

227. See BITTKER & EUSTICE, *supra* note 60, ch. 1.01; see also Pratt, *supra* note 163, at 1065–72 (detailing the history of corporate income tax and the debt-equity distinction).

228. See Culbertson & King, *supra* note 60, at 1161–62.

229. See *supra* Part I.A. For example, where interest expenditures exceed interest income, the ideal plan would be the utilization of debt, which would yield a net deduction. Where interest income exceeds interest expense, the ideal form would be equity since the net equity income would be exempt.

230. See David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599, 624 (2000).

231. See THE MEADE REPORT, *supra* note 2, at 230–32.

232. See *id.*

233. See *id.*

234. See *supra* notes 220–29 and accompanying text.

235. See *supra* notes 230–33 and accompanying text.

defects in the present corporate income tax system. These problems evaporate with the R&F-type cash flow tax, which does not differentiate between debt and equity nor between financial and non-financial transactions.²³⁶ Consequently, characterization of receipts or expenditures is irrelevant, removing the central element of most tax arbitrage schemes. The adoption of the R&F-type furthers the objective of creating a largely unavoidable corporate tax.²³⁷

Applying this concept internationally, U.S. corporations could continue to conduct their foreign operations under separate corporations.²³⁸ Conversely, foreign-owned corporations could continue to conduct their U.S. activities in separate corporations subject to a destination-based cash flow tax.²³⁹ Incoming loans, capital from shareholders, dividends, and interest would be included in the tax base whether the source was domestic or foreign.²⁴⁰ Similarly, outgoing loans, equity payments to shareholders, dividends, and interest would be deducted from the tax base whether the source was domestic or foreign.²⁴¹

Further, foreign borrowing should not be excluded from the tax base despite suggestions to the contrary.²⁴² First, the system would be simpler if no distinction were made between U.S. and foreign loans. If a corporation desired to keep its foreign financial activities separate, it could place these activities in a foreign corporation.²⁴³ Second, for U.S. operations, the change with foreign borrowing does little substantively because full inclusion or full exclusion are essentially economic equivalents for loans.²⁴⁴ But were the tax law to distinguish between both the source and the destination of funds as relevant to inclusion or exclusion, complex tracing and accounting would be required.²⁴⁵ Finally, fully including loans regardless of their source or destination does not result in any benefit to the taxpayer because the loans would be fully subject to the cash flow principle.²⁴⁶ As demonstrated in the tables below, only the

236. See THE MEADE REPORT, *supra* note 2, at 233; see also Barker, *supra* note 14, at 689.

237. See *supra* Part I.A (discussing avoidance measures under the current corporate tax regime).

238. See Barker, *supra* note 14, at 692–95 (discussing the merits of a destination-based R&F-type tax).

239. See *id.*

240. See *id.*

241. See *id.*

242. See Auerbach et al., *supra* note 57, at 887–88 (suggesting that foreign borrowing under a destination-based R&F-type tax would not generate taxable income).

243. See Barker, *supra* note 14, at 693 (“The destination principle exempts the economic rents that are consumed elsewhere.”).

244. This holds true where the interest rate is a market rate because, by definition, a market rate represents the normal return on capital, which is tax-exempt under a yield exempt tax and a cash flow tax. See discussion *infra* Part III.

245. The loan would be taxed when received and deducted when paid. See Barker, *supra* note 14, at 689; see also *infra* TABLE III.

246. See *infra* TABLE III.

destination of the expenditures is relevant to a destination-based cash flow tax because intragroup cash flows are ignored and only domestic expenditures are deducted.

TABLE III

Inclusion of Foreign Financial Transactions	
Source of Loan	Destination of Proceeds
<i>U.S. Lender:</i> Receipt principal and interest included Repayment with interest deducted Same as <i>Foreign Lender:</i> Receipt included Repayment with interest deducted	<i>U.S. Production:</i> Expenditures deducted Disposition of asset included Or <i>Foreign Production:</i> Expenditure not deducted Disposition not included

Exclusion of Foreign Loans	
Source	Destination
<i>U.S. Loans:</i> Receipt principal and interest included Repayment with interest deducted Different from <i>Foreign Loans:</i> Exclude receipts No deduction for payments	<i>U.S. Production:</i> Receipt principal and interest included Repayment with interest deducted Different from <i>Foreign Production:</i> Exclude receipts No deduction for payments

D. A Comparison of Income and Destination-Based Cash Flow Taxes

The United States should replace the corporate income tax with an R&F-type, destination-based cash flow tax. To illustrate the effects of this proposal, the following tables illustrate the results of comparing an income tax system and a destination-based cash flow corporate tax system. First, Table IV

considers a U.S. or foreign corporation that imports goods and services for sale in the United States. It is assumed that the foreign corporation meets the threshold for U.S. taxation by meeting either the statutory test or the treaty test.²⁴⁷

TABLE IV²⁴⁸

Comparison of Present U.S. Corporate Income Tax with R-Type Destination-Based Cash Flow Tax			
Inflow (Income)	Amount	Income Tax	Cash Flow
Gross income from sales, rents, royalties, sales of business assets (U.S. source)	10,000	10,000	10,000
<i>Total Income</i>	10,000	10,000	10,000
Outflow (N-Current Exp.)	Amount	Income Tax	Cash Flow
Labor (U.S. only)	<1,000>	<1,000>	<1,000>
Imports (IMU purchase)	<4,000>	<4,000>	--
Capital Expenditures ²⁴⁹	--	--	--
<i>Total Expenses</i>	<5,000>		<9,000>
<i>Total Base</i>		5,000	9,000

Table V represents a more complex example by showing a corporation doing business in the United States and producing for domestic and foreign markets. The table also assumes that most foreign activities are conducted through corporations incorporated outside the United States.

247. I.R.C. § 882 (2006) (income effectively connected with a U.S. trade or business); United States Model Income Tax Convention of November 15, 2006, arts. 5, 7(1) (income derived from a permanent establishment in the United States). If the foreign corporation failed to meet this threshold, it would not be subject to the territorial income tax regime of the United States with respect to its business income. *See supra* text accompanying notes 91–93. The U.S. corporation would be taxed nevertheless because it would be subject to worldwide taxation. *See supra* text accompanying notes 91–93. The foreign corporation, however, would still be subject to a destination-based cash flow tax even if it were not “doing business in the United States” as long as it made sales within the United States. *See Barker, supra* note 14, at 692–93. Where a foreign corporation imports products into the United States and sells them directly to retail outlets, under a destination-based cash flow tax, one of two possibilities exist. Either the retail establishments would not be entitled to a deduction for the cost of these goods, where the foreign corporation was not taxable, or the foreign corporation would pay tax on these goods without deduction. For the latter, the U.S. retailer would be entitled to a deduction. In either case, the full value (or cost) of the imports would be taxed. *See id.* at 695–96.

248. To make the illustration simpler, TABLE IV adopts the R-type cash flow system, which exempts or eliminates consideration of all capital flows, both debt and equity.

249. The assumption is that all capital expenditures are foreign and their cost is reflected in the value of the imports.

TABLE V

Comparison of Present U.S. Corporate Income Tax System with Simple R-Type Destination-Based Cash Flow Tax on Corporations			
Inflow (Income)	Amount	Income Tax	R-Type Cash Flow
Gross income from sales, rents, royalties, sales of business assets			
U.S. consumption	20,000	20,000	20,000
Exported	4,000	4,000	0
Interest	100	100	0
TOTAL INCOME	24,100	24,100	20,000
Outflow (Expenses)	Amount	Income Tax	Cash Flow
Labor:			
U.S.	<5,000>	<5,000>	<5,000>
Foreign	<2,000>	<2,000>	--
Cost of Goods and Services	<4,000>	<4,000>	<4,000>
Interest (Domestic)	<500>	<500>	--
Dividends	<500>	--	--
Depreciation (U.S. & Foreign)	<750>	<750>	--
CURRENT EXPENSES		<12,250>	<9,000>
OUTFLOW		5,000	9,000
Capital Expenditures			
Domestic source	<2,000>	--	<2,000>
Foreign source	<400>	--	--
TOTAL DEDUCTIONS		<12,250>	<11,000>
TOTAL BASE		11,850	9,000
	Tax at 35%	4,147.50	3,150
	Foreign Tax Credit	630.00	--
	(35% net inc.)		
	TOTAL TAX	3,517.50	3,150

Table IV presents a simple case of an importer of goods that has very little activity in the United States.²⁵⁰ Table V presents the more complex case of a corporation that has both imports and exports.²⁵¹ Interest expense has been

250. See *supra* TABLE IV.

251. See *supra* TABLE V.

downplayed in these tables to focus attention on the role of imports, exports, and capital expenditures. Under both systems, all costs of *production* within the United States are deductible.²⁵²

The R&F-type adds the consequences of financial transactions to the calculation of the tax base.²⁵³ Table VI illustrates the modifications that would be made to Table V where the R&F-type cash flow tax is applied.²⁵⁴

TABLE VI

Modification of Table V Using R&F-Type Destination-Based Cash Flow Tax		
Add to Inflows	Amount	Cash Flow (R&F)
Interest and Dividends	100	100
Debt Capital (Loans)	750	750
Equity Capital	100	100
<i>Total Additions</i>		950
<i>New Subtotal</i>		20,950
<i>Current Deductions (No Change)</i>		<9,000>
Add to Outflows		
Loan Repayment Principal	<50>	<50>
Interest	<500>	<500>
Capital distributed	0	0
Dividends distributed	<100>	<100>
<i>Additional Deductions</i>		<650>
<i>Total Tax Base (R&F)</i>		11,300
TAX (35%)		3,955

These tables illustrate the difference in scope of a destination-based cash flow tax. Because the tax base is domestic consumption, the tax base includes only sales in the U.S., ignores foreign investment sales and expenditures, and permits deductions for all U.S. produced goods and services, but not for imports.²⁵⁵ It allows deductions even where the products or services produced are exported because exports do not represent domestic consumption and includes capital flows as they relate to domestic consumption.²⁵⁶ It taxes the income from business operations.²⁵⁷ The consequence is that the R&F-type

252. See *supra* TABLE V.

253. See *supra* notes 230–36 and accompanying text.

254. See *supra* TABLE V; see also *infra* TABLE VI.

255. See *supra* TABLES V–VI.

256. See *supra* TABLES V–VI.

257. See *supra* TABLES V–VI.

cash flow tax excludes the normal returns from capital and captures the supernormal returns from capital consumed in the United States no matter what the original source.²⁵⁸

III. CASH FLOW TAXATION AND THE TAXATION OF CAPITAL INCOME

The essential difference in outcome between cash flow or consumption-style taxes and income taxes is that cash flow taxes reduce the tax burden on capital.²⁵⁹ The way cash flow taxes relieve the tax on capital depends on the actual method chosen for measuring the tax base.²⁶⁰ When analyzing the income generated by capital, it is helpful to start with the possibility that a taxpayer may choose an investment with a practically certain return. This return is known as the risk-free return on capital.²⁶¹

The actual risk-free interest rate is known as the nominal rate.²⁶² This can be viewed as including both a real rate of return and an inflationary component.²⁶³ Where inflation exists, an investor must reduce the nominal rate by the rate of inflation to determine the true profit.²⁶⁴ Historically, the real risk-free rate of return has been less than 1%.²⁶⁵ The U.S. income tax system taxes nominal interest.²⁶⁶ This includes a tax on the inflationary component of the return, which is not a tax on real income.²⁶⁷ Taxing the inflationary component can tax capital, which is not the purpose of an *income* tax.²⁶⁸

To illustrate, where a taxpayer loans \$100.00 at a 4% nominal rate, after one year the taxpayer has \$100.00 of principal and \$4.00 of interest pre-tax. The after-tax result at a 35% tax rate is \$102.60 (\$100.00 principal and \$4.00 interest minus tax of \$1.40 (35% of \$4.00)). Were the rate of inflation 3%, the real, inflation-adjusted value of \$100.00 at the end of one year is \$103.00 and the real rate of return would be .97%.²⁶⁹ Therefore, after taxes of \$1.40, the taxpayer has \$102.60, which is a real loss in the value of his or her capital.

258. See *supra* TABLES V–VI.

259. See *How Much Capital Taxed*, *supra* note 4, at 1.

260. See *generally id.* (providing a comprehensive examination of the effect of cash flow taxes on the taxation of capital and applying different economic assumptions).

261. See Cunningham, *supra* note 160, at 20–21. An investment in U.S. Treasury bills is the paradigm for a risk-free return. See *id.* at 21 & n.23.

262. LAURENCE M. BALL, MONEY, BANKING, AND FINANCIAL MARKETS 77 (2d ed. 2012).

263. See *id.* (“The real interest rate is the nominal rate minus the inflation rate.”).

264. See *id.*

265. See BRADFORD, *supra* note 4, at 12; see also Bankman & Griffith, *supra* note 4, at 387–88.

266. See Bankman & Griffith, *supra* note 4, at 391–92.

267. *Id.*

268. *Id.*

269. This is calculated by dividing the interest of 1 by the inflation adjusted principal of 103. The formula can be set out as follows: $\text{Nominal} = ((1 + \text{Real}) / (1 + \text{Inflation})) - 1$. See IBBOTSON SBBI 2009 CLASSIC YEARBOOK: MARKET RESULTS FOR STOCKS, BONDS, BILLS, AND INFLATION 1926-2008, at 81 (2009).

Not only has the income tax taken the taxpayer's entire real return, it has actually reduced the taxpayer's capital. In terms of general income tax principles, this makes no sense.²⁷⁰

Both R- and R&F-type cash flow taxes eliminate the tax on inflationary gains from capital.²⁷¹ With regard to financial instruments, an R-type cash flow tax is a yield-exempt system for purposes of financial transactions.²⁷² In the example above, the \$4.00 of interest would simply not be taxed with the result that the taxpayer would have \$104.00 after tax.²⁷³

The R&F-type cash flow tax also eliminates the tax on inflationary gains.²⁷⁴ In the example above, the taxpayer who has \$100 to invest after taxes would actually invest \$153.85 before taxes.²⁷⁵ Because \$153.85 would be deductible, assuming a 35% tax rate, the taxpayer would receive a refund of \$53.85, making the out-of-pocket investment only \$100.00. \$153.85 at 4% would yield \$6.15 in one year. Assuming the taxpayer relinquished her investment at the end of one year, he or she would be taxed on \$160.00, which would include the original investment of \$153.85 plus interest of \$6.15. A tax of 35% on \$160.00 would be \$56.00, leaving \$104.00 after taxes.

In the example above, regardless of the method utilized, the taxpayer would be in the same post-tax position.²⁷⁶ The two methods exempt the entire risk-free return on capital including the inflationary component of income.²⁷⁷ This distinguishes consumption-type taxes from income taxes that, in contrast, do tax the risk-free return from capital.²⁷⁸

The different cash flow methods, however, do not always reach the same result because their different methodologies can profoundly affect the actual taxation of capital income.²⁷⁹ The R- and R&F-type are only economically equivalent under certain assumptions: the *ex ante perspective* of the *present value* of the *expected return* on the investment.²⁸⁰ One way to illustrate the

270. See Daniel Halperin & Eugene Steuerle, *Indexing the Tax System for Inflation*, in *UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME CONSUMPTION TAX* 347, 348–53 (Henry J. Aaron et al. eds., 1988) (arguing that inflation should not be taxed under an ideal income tax).

271. See *supra* Part II.C.

272. See *supra* Part II.C.

273. See *supra* Part II.C.

274. See *supra* Part II.C.

275. The idea is to determine the amount a taxpayer would invest in order to have a net cost after taxes of \$100.00. The formula for determining this amount is $(100) / (1 - \text{tax rate}) = \text{investment before taxes}$.

276. Assuming risk-free rate of return at 4%.

277. See Barker, *supra* note 17, at 213 (stating that interest and dividends are not taxed in either an R- or R&F-type cash flow system).

278. See *supra* text accompanying notes 262–68.

279. See Barker, *supra* note 126, at 383 n.115 (citing THE MEADE REPORT, *supra* note 2, at 230–33).

280. See Graetz, *supra* note 4, at 1602.

difference between a pure cash flow (R&F-type) and a hybrid cash flow (R-type) is to compare the treatment of a traditional Individual Retirement Account (IRA) and a Roth Individual Retirement Account (Roth IRA).²⁸¹ A traditional IRA is a pure cash flow consumption tax under which all investments are deductible and all withdrawals are income.²⁸² A Roth IRA, on the other hand, is a yield-exempt consumption tax, under which investments are not deductible and withdrawals are not income.²⁸³ Traditional IRAs are established with pre-tax contributions; Roth IRAs are established with post-tax contributions.²⁸⁴ For instance, assume a taxpayer that has \$100.00 to invest pre-tax in an investment that is expected to return 10% in one year. Table VII compares the results where the return is positive.²⁸⁵

TABLE VII

Comparison of Income Tax, Roth IRA, Traditional IRA			
	<i>Income Tax</i>	<i>Roth IRA</i>	<i>Traditional IRA</i>
Investment	70 (after 30% tax)	70 (after 30% tax)	100 (no tax)
Interest (10% per annum)	7	7	10
Total Before Tax	77	77	110
Tax	2.1	0	33
Total After Tax	74.9	77	77

Both IRAs are the economic equivalent even if the investments realized a loss.²⁸⁶ Table VIII compares the results where the return on this investment is negative.²⁸⁷

TABLE VIII

	<i>Income Tax</i>	<i>Roth IRA</i>	<i>Traditional IRA</i>
Investment	70 (after 30% tax)	70 (after 30% tax)	100 (no tax)
Interest/Loss	<35>	<35>	50
Total Before Tax	35	35	50
Tax	10.5 (refund)	--	<15>
Total After Tax	45.5	35	35

281. See I.R.C. § 408 (2006) (general provisions of IRAs); see also *id.* § 408A (general provisions for Roth IRAs); *id.* § 219 (deductibility of contributions to traditional IRAs).

282. See Karen C. Burke & Grayson M.P. McCouch, *Lipstick, Light Beer, and Back-Loaded Savings Accounts*, 25 VA. TAX REV. 1101, 1110 (2006).

283. See *id.*

284. See *id.* at 1112.

285. See *infra* TABLE VII (showing a positive return from the initial investment regardless of whether a Roth IRA or a traditional IRA is used).

286. See *infra* TABLE VIII.

287. See *infra* TABLE VIII.

Tables VII and VIII illustrate a situation where the results under both Roth and traditional IRAs are identical even where the actual results vary from the expected results.²⁸⁸ This only holds true under certain assumptions and may not be true in many cases.²⁸⁹ Both an income tax and a cash flow tax, like a traditional IRA, tax actual results, not projected results because they are post-paid taxes.²⁹⁰ In contrast, a yield-exempt consumption tax, like a Roth IRA, taxes anticipated results because it is a pre-paid tax.²⁹¹ In some cases, there can be a considerable difference between expected results and actual results. For example, were the tax rates to change from the time of the investment to the time of withdrawal one year later, the effect on total return would be quite different. Table IX illustrates this result.

TABLE IX

	<i>Income Tax</i>	<i>Roth IRA</i>	<i>Traditional IRA</i>
Investment	70 (after 30% tax)	70 (after 30% tax)	100 (no tax)
Interest (10% per annum)	7	7	10
Total Before Tax	77	77	110
Tax (at 40%)	2.8	0	44
Total After Tax	74.2	77	66

Pre-paying the tax in contrast to post-paying the tax adds another dimension of risk and return to the cash flow versus yield-exempt comparison when there is a difference in the tax rate from the start of the investment to the end.²⁹²

The different timing of the methods can also dramatically change outcomes depending on what the taxpayer does with the tax savings. Assume once again that the taxpayer has \$100.00 pre-tax to invest. Under a yield-exempt approach, the taxpayer has only \$70.00 to invest because the taxpayer pays \$30.00 in tax to the government.²⁹³ Under a cash flow tax approach, the \$100.00 available for investment is composed of \$70.00 plus \$30.00 in tax savings, which are attributed to the deduction of the investment.²⁹⁴ As demonstrated in Tables VIII and IX, cash flow and yield-exempt are equivalent only where the tax savings available are invested at the same time and in an

288. See *supra* TABLES VII–VIII.

289. See Linda Sugin, *Sustaining Progressivity in the Budget Process: Commentary on Gale & Orszag's An Economic Assessment of Tax Policy in the Bush Administration, 2001–2004*, 45 B.C. L. REV. 1259, 1268 (2004).

290. Burke & McCouch, *supra* note 282, at 1112.

291. *Id.*

292. See *supra* TABLE IX.

293. See Burke & McCouch, *supra* note 282, at 1110, 1112; see also *supra* TABLES VII–VIII.

294. See *supra* TABLES VII–VIII.

investment with the same return, whether positive or negative.²⁹⁵ Assuming the taxpayer was to invest the \$30 in tax savings differently, the tax on capital income would also be different.²⁹⁶

Because these tax savings are, in a sense, on temporary loan from the government and must eventually be repaid, the taxpayer may choose a different investment of the \$30 in tax savings for several reasons. First, taxpayers might be more risk adverse with what is owed in future taxes and consciously choose a less risky investment with a smaller return. A second possibility is that the savings might not be immediately available for taxpayers to invest in the same investment because they will only receive those savings from the government in the future as a tax refund. Borrowing the additional \$30 during the delay and incurring additional risk may not be financially wise or acceptable to the taxpayer. A third possibility is that taxpayers might not have sufficient income immediately available to provide a full tax offset from the deduction, which could delay the tax refund.²⁹⁷ Under any of these scenarios, the tax savings will likely be placed in a different investment at a different time, where the risk and the rate of return may differ and the taxpayer will have lost some of the time use of his or her money.

Table X illustrates simultaneous investments with two different positive rates of return.²⁹⁸ Table XI illustrates what would occur in Table X if the investment of the tax savings were delayed six months.²⁹⁹ Table XII assumes a loss in the first investment and a positive return from the tax savings.³⁰⁰ In each case, when the investment of the tax refund is delayed, the return for the investment of the tax savings is reduced.³⁰¹

TABLE X

	Cash Flow		Exempt
Investment	70	30	70
Interest	7 (10%)	1.50 (5%)	7
Total Before Taxes	77	31.50	77
Subtotal	108.50		77
Tax	32.55		0
Total After Tax	75.95		77

295. See Burke & McCouch, *supra* note 282, at 1110; see also *supra* TABLES VII–VIII.

296. See *infra* TABLES X, XII (showing how the taxes vary when the taxpayer invests \$30 of tax savings differently than the initial \$70).

297. See E. Cary Brown, *Business Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN* 300, 301–06 (Lloyd A. Metzler et al. eds., 1948) (recognizing the importance of full-loss offsets).

298. See *infra* TABLE X.

299. See *infra* TABLE XI.

300. See *infra* TABLE XII.

301. See *infra* TABLES X–XII.

TABLE XI

	Cash Flow		Exempt
Investment	70	30	70
Interest	7 (10%)	.75 (5%, ½ year)	7
Total Before Taxes	77	30.75	77
Subtotal	107.75		77
Tax	32.32		0
Total After Tax	75.43		77

TABLE XII

	Cash Flow		Exempt
Investment	70	30	70
Interest	<35>	1.50 (5% Int.)	<35>
Total Before Taxes	35	31.50	35
Subtotal	66.50		35
Tax	19.95		0
Total After Tax	46.55		35

The key to these results is whether or not the tax is pre-paid or post-paid. A tax can be said to be pre-paid because the taxpayer's investment is out of earnings available for present consumption. Because the investment is not initially deducted, the consumption, even though it is postponed to the future, is fully taxed. This is why, in Table VII, where the taxpayer earned \$100.00, he or she only had \$70.00 (after a \$30.00 tax) to invest.³⁰² Although the taxpayer has not yet consumed, the present value of the future consumption is \$100.00.³⁰³ The yield-exempt model operates prospectively by taxing future consumption today at its present value.³⁰⁴ Because the government has fully received its tax today on future consumption, it has no stake in the actual outcome.³⁰⁵

302. See *supra* TABLE VII.

303. See James R. Repetti, *Democracy and Opportunity: A New Paradigm in Tax Equity*, 61 VAND. L. REV. 1129, 1165 (2008) (noting that, under a pre-paid tax, return on investment is not affected).

304. See *id.*

305. Cf. Cunningham, *supra* note 160, at 24. Under the pre-paid tax the government bears no interest in the outcome, unlike under a post-paid tax where the government has a stake in the return on a capital investment.

The cash flow model, in contrast, operates retrospectively, waiting to tax consumption when it occurs.³⁰⁶ Thus, the \$100.00 invested is treated as investment, not consumption, with its quality as future consumption ignored.³⁰⁷ Consequently, the \$100.00 is excluded from the tax base under the cash flow model.³⁰⁸ All receipts are included in the tax base, but will be offset by deductions as long as they are invested and not consumed.³⁰⁹ Thus, a cash flow tax is post-paid; it is paid when the taxpayer recovers capital and profits.³¹⁰ By deducting the investment when made, the cash flow tax anticipates the entire loss of the taxpayer's capital.³¹¹ If neither income nor capital is returned, there will be no tax.³¹²

In a cash flow tax, the government must wait for its tax.³¹³ Because the tax base in a cash flow tax excludes the original \$100.00, one way of looking at it is that the government refunds its tax of \$30.00, thus making the government, in a sense, a silent partner with the taxpayer.³¹⁴ The government puts its deferred tax revenue at the taxpayer's disposal.³¹⁵ The tax savings are only temporarily on loan from the government, which shares in the profits and losses of the taxpayer's investment.³¹⁶ The government, unlike the case of a yield-exempt pre-paid approach, is a stakeholder.³¹⁷

The analogy to a partnership between the taxpayer and government is not perfect. The government is not an active partner because the taxpayer controls the investment of the government's tax money without the government's input.³¹⁸ Where the taxpayer puts the government's tax money (\$30.00) in the same investment as the taxpayer's money (\$70.00), then the government bears all of the risks and benefits of its investment of \$30.00 in the original investment, and the taxpayer bears all of the risks and benefits of her investment of \$70.00. That is why yield-exempt and cash flow methods produce the same results in Tables VII and VIII.³¹⁹ However, under a cash flow tax where the taxpayer invests the tax savings in a different investment,

306. See Andrews, *supra* note 1, at 1116; see also David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1, 21 (2004).

307. See Andrews, *supra* note 1, at 1116; see also Weisbach, *supra* note 306, at 21–22.

308. See Andrews, *supra* note 1, at 1116.

309. See *id.* at 1116, 1179. TABLE VII demonstrates this outcome: the taxpayer reports the full amount of the returned investment of \$100.00 plus the \$10.00 of income earned. See *supra* TABLE VII.

310. See Burke & McCouch, *supra* note 282, at 1112.

311. See Cunningham, *supra* note 160, at 25.

312. See *id.*

313. See *id.* at 24.

314. See *id.* at 25.

315. See *id.*

316. See *id.*

317. See *id.*

318. See *supra* note 314 and accompanying text.

319. See *supra* TABLES VII–VIII.

the government's investment is a percentage of the total return of each investment.³²⁰

Traditional IRAs and Roth IRAs serve as good comparisons to the cash flow and yield-exempt models because they are close economic equivalents for taxpayers due to similar funding practicalities. Where the IRAs are funded through regular payroll savings plans, the investment, whether pre- or post-tax, flows into the same investment, creating present value equivalents.³²¹ Because the future investments of earnings will be channeled into the same investments tax-free, their actual future post-tax results would also be the same assuming the same effective rate of tax.³²²

Corporations, however, do not fit this pattern. Corporations are continuously making new investments with new debt capital and retained earnings, including tax savings.³²³ Returns can vary considerably and tax savings may be delayed due to the inability to currently utilize net losses.³²⁴ Additionally, corporations do not fit precise molds. Even many non-financial businesses have large holdings of cash and other financial assets.³²⁵ Thus, the differences between real world outcomes and expected outcomes can dramatically affect the nature of corporate consumption taxes. In the corporate setting, one must consider what consumption taxes do and do not do with respect to the taxation of capital income.

Consideration of these different methods demonstrates the inherent difficulties in understanding the full implications of taxing capital income in the consumption context. To see this, economists view capital income as having three components: the riskless rate of return, the risk premium, and the supernormal return or economic rents.³²⁶

The riskless rate of return is the guaranteed rate on receipts without chance of default.³²⁷ The riskless rate of return is exempt from cash flow and yield-exempt taxes, but is fully taxed by income taxes.³²⁸ The risk premium is the additional return expected by investors to compensate them for risk-taking.³²⁹ It is generally believed that the risk premium is not subject to

320. See *supra* TABLE X.

321. See Burke & McCouch, *supra* note 282, at 1110.

322. See *id.* (noting that the "theoretical equivalence" between the pre-tax and post-tax treatments is destroyed without a "uniform, invariable rate of tax").

323. See Steven A. Bank, *Dividends and Tax Policy in the Long Run*, 2007 U. ILL. L. REV. 533, 556 (2007) (discussing the sources of a firm's capital).

324. Cf. Cunningham, *supra* note 160, at 39 n.78.

325. See Ben Casselman & Justin Lahart, *Companies Shun Investment, Hoard Cash*, WALL ST. J., Sept. 17, 2011, at A2.

326. Cunningham, *supra* note 160, at 23. Professor Cunningham also notes the need to eventually address an inflation premium. *Id.* at 23 n.32.

327. See Bankman & Griffith, *supra* note 4, at 387 & n.27 (likening a risk-free rate of return to the guaranteed interest derived from short-term treasury bills).

328. See Elkins & Hanna, *supra* note 160, at 103-04.

329. See Bankman & Griffith, *supra* note 4, at 387-88 & n.30.

either cash flow or yield-exempt consumption taxes.³³⁰ Often it is argued that under certain assumptions, sophisticated investors can avoid the income tax on the risk premium by changing one's portfolio in favor of riskier investments.³³¹

Economic rents, or inframarginal returns, are those yields above the risk-free and risk premium components.³³² Economic rents are subject to both income taxation and cash flow taxation,³³³ but are not subject to taxation under the yield-exempt model, because the tax is pre-paid on the basis of expected, not actual, returns.³³⁴ Because economic rents are unexpected and cannot be anticipated by the investor, they are not caught by a yield-exempt tax on expected returns, but are subject to tax under cash flow principles.³³⁵ Economic rents would only be exempt if the investor could invest her tax savings in a way that would earn economic rents of the same magnitude as the original investment.³³⁶

Although the comparison of cash flow and yield-exempt consumption systems with traditional and Roth IRAs aids in demonstrating how consumption taxes work, conclusions must be reached carefully.³³⁷ Roth or traditional IRAs are contrasting devices that will usually reach the exact same result with the exception of changing tax rates.³³⁸ The analysis applies well to non-entrepreneurial investors because any economic rent is in the nature of a windfall to capital.³³⁹ Taxing businesses, however, is not so straightforward. Corporations, unlike other investors, are in the business of earning economic rents.³⁴⁰

Economic rents are included in the tax base of an R&F-type tax because it is a pure cash flow tax that incorporates actual returns.³⁴¹ The result under an R-type tax is less predictable because the R-type is a hybrid cash flow tax;³⁴² it is a cash flow tax for most types of business income and operating

330. See Cunningham, *supra* note 160, at 26; see also Elkins & Hanna, *supra* note 160, at 103; *How Much Capital Taxed*, *supra* note 4, at 2–4.

331. This is based on a somewhat impractical pair of assumptions that a taxpayer can and will increase his or her debt and can and will increase his or her exposure to risky investments in order to undo the effects of the income tax. See Cunningham, *supra* note 160, at 29–30.

332. *Id.* at 23.

333. *Id.* at 24.

334. See *How Much Capital Taxed*, *supra* note 4, at 6.

335. See *id.* at 5.

336. When considering non-entrepreneurial investors, it may be reasonable to conclude that economic rents are so unusual that these investors would normally never see them. For this reason, the relevance of economic rents to the comparison of cash flow taxes is minimal for non-entrepreneurial investors. See Cunningham, *supra* note 160, at 23–24.

337. See Burke & McCouch, *supra* note 282, at 1116.

338. *Id.* at 1113.

339. See Elkins & Hanna, *supra* note 160, at 100 & n.36 (quoting Warren, *supra* note 4, at 5).

340. See discussion *infra* Part IV.B.

341. See Barker, *supra* note 17, at 214.

342. See *id.* at 213; see also *supra* note 141 and accompanying text.

expenditures but a yield-exempt tax for financial flows.³⁴³ An R-type does not include the economic rents generated by financial flows.³⁴⁴ The R- and R&F-type would reach identical outcomes when a business does not have rents from financial operations.³⁴⁵ Because the actual tax outcome would depend on the unique mix of financial and non-financial activities of each business under an R-type, the R&F-type presents a superior solution for all corporations.³⁴⁶

IV. THE POLITICS AND POLICY OF CORPORATE TAXATION

Any proposed corporate tax system must deal with the question: “Why tax corporations on income?” Both income and cash flow taxes tax income in some way. An ideal income tax taxes the entire return on capital only from equity in the corporate setting.³⁴⁷ Cash flow taxes tax economic rents, or true profits, while excluding the normal return on equity as well as debt.³⁴⁸ Whether the tax base is the normal return from capital, economic rents, or both, these income components can also be in the tax base of shareholders.³⁴⁹

The justification for corporate taxation of income should reflect the underlying nature of a corporation. There are several schools of thought. One approach views the corporation as merely the aggregate of its owners.³⁵⁰ This view leads to the widespread belief that taxing corporations offers a convenient and practical way of indirectly taxing corporate shareholders.³⁵¹ Because there are fewer corporations than shareholders, corporate tax presents an easier method of tax collection.³⁵² In addition, corporate taxes provide an effective way of taxing foreign shareholders.³⁵³ In sum, the aggregate view supports corporate taxation as a substitute, or surrogate, for shareholder taxation. If there were an effective way to directly tax shareholders, there would be no need for corporate taxation.

The aggregate theory of corporations is not without deficiencies, thus leading some scholars to a different theory of corporate taxation known as the agency theory.³⁵⁴ This theory analyzes how the pass-through tax consequences

343. See *supra* notes 230–33 and accompanying text.

344. See Cunningham, *supra* note 160, at 23–24.

345. See *supra* notes 215–16 and accompanying text.

346. See Barker, *supra* note 17, at 213–14.

347. See *supra* Part I.A; see also *supra* notes 159–62.

348. See *supra* notes 159–62.

349. See *supra* Part I.A.

350. See Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax 2* (John M. Olin Center for Law and Economics, Research Paper No. 04-006, 2004), available at <http://ssrn.com/abstract=516202>.

351. See *id.* at 3.

352. See *id.* at 7.

353. See Auerbach et al., *supra* note 57, at 867; see also Avi-Yonah, *supra* note 350, at 7.

354. See Avi-Yonah, *supra* note 350, at 12; see also Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, but to Save It*, 56 TAX L. REV. 329, 347–49 (2003) (describing the

of different corporate investments would impact management and some shareholders differently.³⁵⁵ Consequently, management and shareholders may not agree on an investment strategy.³⁵⁶ The corporate tax places all equity holders in the same position in regard to different corporate investments.³⁵⁷ There is no need for the shareholders to agree. The tax on the shareholder's agent—the corporation—is incurred by the shareholder in exchange for the corporation bearing the direct tax consequences of corporate activities, thus avoiding those direct tax consequences that might not be in the shareholders' interests.³⁵⁸

Another approach to the nature of corporations is the artificial entity theory, which views the corporation as a creature of the state.³⁵⁹ Therefore, it is reasonable for the state to impose a charge or a tax for the privilege of doing business in corporate form.³⁶⁰ Though this rationale supports an independent basis for taxing corporations, it neither demonstrates any relationship between the benefit received and the payment due nor accounts for the fact that many of the same benefits are provided to unincorporated entities.³⁶¹ Although this view recognizes corporate uniqueness, it does not provide a convincing argument for how corporations should be taxed.

The most modern approach is the real entity view, which views the corporation as an entity distinct from its owners.³⁶² This represents a modern view of finance and economics: owners are separated from the thing they own and managers are really in control of the enterprise.³⁶³ Owners are no longer “classical merchant adventurers” who combine their capital and talents, but instead are true stockholders investing capital with professional

agency cost when management and shareholders are taxed at different rates than other shareholders under pass-through taxation).

355. See Avi-Yonah, *supra* note 350, at 12; see also Schlunk, *supra* note 354, at 347–49.

356. See Avi-Yonah, *supra* note 350, at 12; see also Schlunk, *supra* note 354, at 347–49.

357. See Avi-Yonah, *supra* note 350, at 12; see also Schlunk, *supra* note 354, at 347–49. *But see* Avi-Yonah, *supra* note 350, at 12–13 (finding the agency cost justification “unpersuasive” and noting that inequities in personal income taxation still exist even though the corporation itself is taxed at one rate).

358. See Avi-Yonah, *supra* note 350, at 12; see also Schlunk, *supra* note 354, at 347–49.

359. RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 272–73 (1973); see also Avi-Yonah, *supra* note 350, at 10.

360. See MUSGRAVE & MUSGRAVE, *supra* note 359, at 272; see also Avi-Yonah, *supra* note 350, at 10. The corporate income tax was initially characterized as an excise tax assessed on the privilege of doing business in a corporate capacity. It was on this basis that the Tariff Act of 1909 was sustained on constitutional grounds. See *Flint v. Stone Tracy Co.*, 220 U.S. 107, 115–16 (1911).

361. See MUSGRAVE & MUSGRAVE, *supra* note 359, at 272; see also Avi-Yonah, *supra* note 350, at 10.

362. See Avi-Yonah, *supra* note 350, at 11–12.

363. Adolf A. Berle, *The Impact of the Corporation on Classical Economic Theory*, 79 Q.J. ECON. 25, 30 (1965).

administrators.³⁶⁴ In general, “[s]tockholders act like an unorganized, usually inert, political constituency.”³⁶⁵ Management wields the real power of corporations. The thought is that taxation of corporations is the result of the recognition of corporate independence and power.

This view leads to two justifications for corporate taxation. First, independent corporations have a separate ability to pay, and such control of resources is a sufficient basis for taxation without regard to the tax’s incidence on shareholders or others.³⁶⁶ Second, taxation is required to control and regulate the power of management.³⁶⁷ In a world where corporations have become the most significant global economic force, taxation provides a mechanism for popular control.

Though these rival theories of corporate essence are expressed in terms of their superior insights and truth value, each approaches the question of corporate tax from a different viewpoint. The aggregate theory relies upon the contractual and legal relations between corporations and their shareholders.³⁶⁸ This perspective justifies corporate tax only as a substitute for shareholder taxation—a second best solution at most.³⁶⁹

The artificial entity theory is predicated on the legal relations between corporations and the government.³⁷⁰ Entity taxation, though justified by this approach, stands on rather flimsy grounds.³⁷¹ A license fee makes more sense under this justification.³⁷²

The real entity theory takes the perspective of modern corporate economic reality.³⁷³ This theory dismisses shareholders as irrelevant and leaves the corporation as a free entity possessing the capacity to pay taxes.³⁷⁴ However, the most recent version of this theory shies away from the conclusion that this provides a significant justification for corporate tax.³⁷⁵ Instead, the real entity theory introduces public interest as a justification for taxing corporations, that is, to regulate the enormous power of these entities in the public interest.³⁷⁶

364. *Id.* at 25, 37–39.

365. *Id.* at 31.

366. 2 ADRIAN A. KRAGEN & JOHN K. MCNULTY, FEDERAL INCOME TAXATION 960 (3d ed. 1981).

367. *See* Avi-Yonah, *supra* note 350, at 12–13.

368. *See id.* at 7.

369. *See id.*

370. *See id.* at 10.

371. *See id.* (discussing the objections to the entity theory).

372. *See* 9 MCQUILLIN MUNICIPAL CORPORATIONS § 26:16 (3d ed. 2012) (discussing licensing fees as tools to regulate or raise revenue).

373. *See* Avi-Yonah, *supra* note 350, at 30.

374. *See id.* at 30–31.

375. *See id.* at 13.

376. *See id.* at 13, 34–35.

Thus, corporate taxation is not economically justified, but politically required. Taxation, once again, becomes a second-best solution.

It would be a mistake to dwell on the exclusivity of the approaches and fail to appreciate the contribution they each make to our understanding of the nature of corporations. The various perspectives of law, contracts, and economics are valid in terms of the different ways corporations interact with society and governments.³⁷⁷ These perspectives help explain why nations uniformly apply income tax to corporations; yet none of the approaches explains why any particular type of tax is appropriate for corporate taxation.³⁷⁸

None of these theories properly tackle the unique problems of corporate taxation, which encompasses not only the taxation of corporations, but also the taxation of shareholders.³⁷⁹ Practically all countries tax corporations and their shareholders in a way that results in economic double taxation of the same income.³⁸⁰ Many countries have sought ways to reduce the burden of economic double taxation, but none have eliminated it completely.³⁸¹ However, none of the theories highlighted above—from pre-payment on behalf of shareholders to taxation as a means to regulate corporate management—adequately justify double taxation.³⁸²

The late Professor Richard Musgrave and Peggy Musgrave provided the classic argument against corporate double taxation in their work on public finance.³⁸³ In dismissing taxation based on the notion “that a corporation has an ability to pay of its own and should be subject to a distinct tax,” they said,

Obviously, all taxes must in the end fall on somebody, i.e., natural persons. Corporate profits are part of the income of the shareholders and, in the spirit of the accretion approach to the income tax, should be taxed as part of their income. There is no reason why they should either bear an extra tax or be given preferred treatment.³⁸⁴

Although the case for corporate double taxation has been problematic, the case for general corporate taxation is very strong. Though there may be disagreement over the reasons behind such a tax, most, including the Musgraves, recognize its merit.³⁸⁵ Corporate tax in practice is based on a strong political consensus. The public requires corporations to pay taxes

377. *See id.* at 2–3.

378. *See id.* Only the aggregate approach need not answer the question because the corporation is paying the tax solely as the agent of shareholders. *See id.* at 7.

379. *See id.* at 13; *see also supra* Part I.A.

380. *See* Barker, *supra* note 14, at 650–51.

381. *See* Avi-Yonah, *supra* note 350, at 7–8; *see also* Barker, *supra* note 14, at 650–51.

382. *See* Avi-Yonah, *supra* note 350, at 13–14.

383. *See* MUSGRAVE & MUSGRAVE, *supra* note 359, at 271–72.

384. *Id.* at 272.

385. *Id.* at 272–74.

because corporations present a good source of revenue and it is perceived to be just to tax bodies with control over large resources.³⁸⁶

Does a consumption tax imposed on corporations in lieu of an income tax more adequately satisfy fundamental notions of fairness? In general, it is thought to be fair to tax individuals on what he or she takes out of society under a consumption tax.³⁸⁷ Also, nations tax individuals on income because it is thought to be fair to tax people based on their ability to pay taxes, with income considered the most practical base for measuring economic capacity.³⁸⁸ In this way, people are fairly taxed in accordance with their use of total societal resources. This is based on the idea that people are members of societies, and with that right (and the benefits that flow from it), come certain unique obligations.³⁸⁹ Therefore, all individuals making use of society's benefits—both citizens and non-citizen residents alike—must pay their equal share of taxes.³⁹⁰

In contrast, corporations do not consume in the same way as individuals. Corporations have control over resources, but, as artificial persons, their relation to the state and society cannot be described in the same way as individuals.³⁹¹ Despite these differences, income tax treats corporations like individual residents or citizens.³⁹² This status has been defined in various ways. Corporations have been taxed on their income on the basis of formal criteria such as legal status, place of incorporation, location of the principal officers or board of directors, or on the basis of a more practical economic link like principal place of business, or seat (location of principal officers).³⁹³ These approaches to corporate residency begin with a common viewpoint: a corporation owes allegiance to a state in the same manner as an individual does.

Corporations, as artificial persons, have many options regarding place of incorporation or residence.³⁹⁴ Corporate residency can often be manipulated for tax reasons and many corporations will avoid tax if they can.³⁹⁵ In a world

386. See Avi-Yonah, *supra* note 350, at 14 (“Ordinary Americans have a viscerally negative reaction to the notion that large, profitable corporations should pay no tax while they bear the income tax burden.”).

387. See Bankman & Griffith, *supra* note 4, at 386.

388. See Graetz, *supra* note 4, at 1634–35.

389. See MUSGRAVE & MUSGRAVE, *supra* note 359, at 193 & n.8.

390. See *Taxation of Resident Aliens*, INTERNAL REVENUE SERV. (Dec. 2, 2011), <http://www.irs.gov/businesses/small/international/article/0,,id=96493,00.html> (“A resident alien’s income is generally subject to tax in the same manner as a U.S. citizen.”).

391. See Barker, *supra* note 14, at 665.

392. See *id.*

393. HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 434–36 (3d ed. 2010).

394. See Barker, *supra* note 14, at 664–65.

395. See *id.* at 664–66.

where many of the factors of production are highly mobile, governments will encourage migration with their laws and tax incentives.³⁹⁶

Corporations are different from individuals and standards of fairness should encompass those differences. The essence of the individual's relationship is totality; individuals are social, political, and economic actors. The essence of a corporation's relationship is primarily economic.³⁹⁷ Consequently, effective corporate taxation should consider first—and perhaps only—economic justifications for tax.

In other contexts, double taxation in various forms is endemic. Nations first tax individuals on income and later tax those same individuals on funds left over after tax used for consumption.³⁹⁸ The difference between this pattern and corporate tax is that the latter two taxes are both income taxes.

It is one thing to justify a tax on corporations for the reasons set out above, where, in reality, the tax paid is “on account” of the ultimate obligation of its shareholders.³⁹⁹ It is quite another to impose a tax on corporations that results in economic double taxation of the same income.⁴⁰⁰ It is not enough to rest the case for double taxation “on a nagging feeling that corporations, especially large publicly-held corporations, are aggregates of capital, legal entities and groups of managers . . . that have a capacity to pay.”⁴⁰¹ A separate and *distinct* tax on corporations should be justified on the basis of the unique benefits that corporations derive from the state and from a country in general.

Three questions must be considered. First, do corporations receive unique benefits that justify the imposition of a separate and distinct tax? Second, does the tax imposed fairly relate to or assess those benefits? Third, is it fair to impose a distinct tax that the shareholders ultimately must pay, which results in a second charge for the *same* benefit?

A. Benefits of Corporate Status

There are many features that make a corporation special, but limited liability is the historic key to the success of the corporation as a pivotal institution in society today.⁴⁰² Limited liability has two interrelated functions. It ensures that shareholders are not liable for the debts of their firm beyond their capital contributions.⁴⁰³ Consequently, it allows the firm to engage in risk-taking

396. *See id.* at 647; *see also* Barker, *supra* note 17, at 171–80 (describing tax competition); *supra* Part I.B.

397. *See* Barker, *supra* note 14, at 665–66.

398. *See* 67B AM. JUR. *Sales and Use Taxes* §§ 5 & 6C (2012) (describing a sales tax on consumer purchases and distinguishing sales tax from other taxes).

399. *See supra* text accompanying note 384.

400. *See supra* notes 379–84 and accompanying text.

401. KRAGAN & MCNULTY, *supra* note 366, at 960.

402. *See* Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1047 (1988–1989).

403. *See id.* at 1057–58.

while limiting consequences to the shareholders.⁴⁰⁴ This gives shareholders the potential opportunity to realize greater returns by investing in riskier enterprises.⁴⁰⁵ The opportunity to employ limited liability can also be considered a government subsidy or benefit.⁴⁰⁶ The Musgraves argue that, although limited liability is of tremendous value to a corporation, it is practically costless to society.⁴⁰⁷ Society, which includes the victims of corporate disasters, might not agree.

An important consequence of limited liability is that it leads directly to the efficient provision of capital: “[E]conomists would view the availability of limited liability as an efficient way to organize the raising of large amounts of capital and allocating risks.”⁴⁰⁸ Limited liability has given corporations, especially those that are publicly traded, ready access to capital markets.⁴⁰⁹ This liquidity provides firms with a lower cost of capital.⁴¹⁰

Corporate capital needs are, however, provided in different ways. Studies indicate that there is very little market-raised equity, with one study finding that firms derive only 2 to 3% of their new capital from shareholders.⁴¹¹ Most corporate capital needs are derived from retained earnings, which are subject to a single layer of corporate tax, and debt, which is only subject to one layer of non-corporate tax.⁴¹²

Ultimately, what makes a corporate investment truly unique is its liquidity, which is made possible in part by the limited liability of shareholders and by the public market for securities, both stocks and bonds.⁴¹³ Shares of stocks and corporate bonds can be turned into cash quickly through markets with high volume, and consequently there is great certainty in the price at the moment of sale because fluctuations in the price are low.⁴¹⁴ Liquidity gives stockholders—and to a large extent bondholders—the ability to enjoy higher risk-adjusted returns from their investments than they would be able to from illiquid investments.⁴¹⁵ Marketability of these types of investments gives investors the capacity to enjoy the benefits of long-term corporate investments without the long-term commitment. Investors can choose the pattern of their

404. *See id.* at 1058.

405. *See id.*

406. *See id.*

407. MUSGRAVE & MUSGRAVE, *supra* note 359, at 292.

408. Gravelle, *supra* note 70, at 267.

409. *See* Rudnick, *supra* note 402, at 1113–14.

410. *See id.* at 1103.

411. Berle, *supra* note 363, at 38–39.

412. *See supra* notes 68–73 (covering taxation of retained earnings); *see also supra* notes 74–79 (summarizing taxation of corporate debt).

413. *See* Rudnick, *supra* note 402, at 1113–14, 1127–28.

414. *See id.* at 1128.

415. *See* Schlunk, *supra* note 354, at 343. The more liquid a security, the less risk ownership of that security entails. Thus, the market demands a lower risk premium for more liquid securities. *See* IBBOTSON, *supra* note 269, at 108.

consumption by investing and divesting at any time.⁴¹⁶ The state facilitates such benefits through the maintenance and regulation of the financial markets, which is essential for these opportunities to exist.⁴¹⁷

Liquidity has also resulted in the separation of control from stockholder ownership and vesting it in corporate management, granting management control over the affairs of the corporation with little serious interference.⁴¹⁸ Limited liability and liquidity have enabled investors to immunize their investments from those of the corporation.⁴¹⁹ The combination of these factors has led to gargantuan business enterprises⁴²⁰ whose size alone gives corporations a “social significance”⁴²¹ that cannot be attributed to smaller business enterprises.⁴²²

Nevertheless, does the burden of the corporate tax fairly relate to the benefits derived by, and the nature of, the corporate enterprise? Both an income tax and a cash flow tax reach the profits derived by corporate uniqueness,⁴²³ but income taxation is over-inclusive.⁴²⁴ As this Article will demonstrate, only a cash flow tax is limited to a tax on the unique profits earned by a corporation.

B. Cash Flow Tax as a Tax on the Unique Profits of Corporations

An important normative goal of taxation is that taxes are to be fairly allocated among taxpayers.⁴²⁵ The general approach to fairness has

416. See Berle, *supra* note 363, at 39.

417. See *id.* at 32. These factors have led to the tremendous growth of corporate enterprises, which are identified by their huge concentrations of economic power. The fact that corporations can exist indefinitely helps foster long-term relations with both labor and other businesses, adding tremendous intangible value to firms. See *id.* at 34–35. The corporate firm is fundamentally different from the traditional market because its size and hierarchical structure make it possible to avoid transactional costs by producing goods and services internally or through smaller captive corporations. *Id.* at 27; Ronald Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 388 (1937).

418. See Berle, *supra* note 363, at 30.

419. See Rudnick, *supra* note 402, at 1098–99.

420. See *supra* Part IV. For example, the capitalized share value of Apple and Exxon Mobil as of February 2012 was \$506 and \$411 billion, respectively. See Peter Stevenson, *Apple Market Capitalization Tops \$500 Billion*, THE HUFFINGTON POST (Feb. 29, 2012, 6:11 PM), http://www.huffingtonpost.com/2012/02/29/apple-market-capitalization-500-billion_n_1310408.html.

421. See Rudnick, *supra* note 402, at 1094 (quoting ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (1933)).

422. See Barker, *supra* note 17, at 165 (providing an account of the dominance of publicly traded corporations in the world economy). Such factors can lead to unique profits, which some have argued yield excessive profits to corporate producers. Rudnick, *supra* note 402, at 1074. Some of these profits can be characterized as monopoly profits produced by market control and an achieved equilibrium with competitors. Berle, *supra* note 363, at 32.

423. Compare *supra* Part II.D, with *infra* Part IV.B.

424. See Gordon et al., *supra* note 152, at 982 (discussing frequent modifications from comprehensive income tax to prevent over-inclusiveness).

425. Barker, *supra* note 14, at 665.

emphasized two distinct concepts of fairness: a taxpayer should be taxed in accordance with his or her ability to pay or a taxpayer should be taxed in accordance with the benefits he or she receives from society.⁴²⁶ Corporate tax cannot be merely a surrogate for the fair taxation of shareholders because it is a uniform tax on those who are otherwise in incomparable situations. Justice requires that a tax on corporations stand on its own.⁴²⁷ This requires taxation on the basis of benefits received.⁴²⁸

The present state of knowledge supports the assumption that corporations have the *opportunity* to make unique profits. Though these unique profits are not certain, where they arise, unique profits would be a proper base for a separate and distinct tax on corporations. These unique profits are called economic rents.⁴²⁹ In economic jargon, a tax on economic rents is a true net profits tax, allowing a deduction for the cost of all capital whether equity or debt.⁴³⁰ As outlined in Part II, a cash flow tax targets the return over and above the normal return from capital—the supernormal return or economic rents.⁴³¹ Depending on one’s assumptions of taxpayer behavior, the income tax taxes part or all of the normal return from capital.⁴³² The income tax also overtaxes the risk-free return due to its inclusion of non-real inflationary gains in the tax base.⁴³³

To many investors, economic rents can be a windfall to financial investment.⁴³⁴ To those lucky few that can uncover investments with economic rents, those gains are the product of the special talents or ingenuity of the investor and are only tangentially related to a return on capital.⁴³⁵ Corporations, in contrast, are engaged in entrepreneurial and business activity, which is essentially the business of earning rents.⁴³⁶ Corporations earn economic rents in the global world “by cost leadership, by product differentiation, and by focus[ing] on . . . particular market niche[s].”⁴³⁷ Economic rents are also often associated with monopoly power.⁴³⁸ There are

426. See William B. Barker, *The Concept of Tax: A Normative Approach*, in THE CONCEPT OF TAX 21, 24–26 (Bruno Peters et al. eds., 2005) (discussing the various theories of just taxation).

427. Barker, *supra* note 14, at 688 (arguing that international tax law should set aside current systems and begin taxing corporations on their received benefit).

428. See *id.*

429. See Barker, *supra* note 17, at 211, 213.

430. RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE, 280–81 (8th ed. 2006).

431. See *supra* notes 159–62 and accompanying text.

432. See *supra* notes 159–62 and accompanying text.

433. See *supra* notes 159–62 and accompanying text.

434. See Cunningham, *supra* note 160, at 23–24.

435. See *id.* at 23 & n.34.

436. See BREALEY ET AL., *supra* note 430, at 281.

437. *Id.*

438. See *id.*

five aspects of corporate structure that determine which firms are able to earn economic rents over the long haul. These factors are a “rivalry among existing competitors, the likelihood of new competition, the threat of substitutes, and the bargaining power both of suppliers and customers.”⁴³⁹

Firms evaluate new projects in terms of economic rents, which can be calculated by determining the Net Present Value (NPV) of a project.⁴⁴⁰ A positive NPV is a return greater than the cost of capital.⁴⁴¹ Economic value is added to the firm where income earned from a project exceeds the cost of capital multiplied by the investment.⁴⁴² In the case of debt financing, NPV is the present value of the expected stream of income minus depreciation less the present value of interest and principle payments.⁴⁴³ In this way, the investment adds value to the firm if there is residual income, also known as Economic Value Added.⁴⁴⁴

The expected return is the normal return, which includes a risk-free return plus a risk premium.⁴⁴⁵ This is the opportunity cost of capital that represents the expected return for an equally risky investment.⁴⁴⁶ Put another way, it is the return investors expect for waiting and taking risks.⁴⁴⁷ This presents a conundrum. Shareholders are not interested in just any return but in an investment producing economic rents, that is an NPV investment, which is greater than a normal return.⁴⁴⁸ Yet shareholders only expect a normal return that includes a premium for the level of risk they assume.⁴⁴⁹ But this normal return is *speculative* because of the potential deviations in actual results that are caused by “the varying but statistically unpredictable fortunes of the firm.”⁴⁵⁰ Ownership of shares does not guarantee any return or even that a shareholder will recoup his or her capital.⁴⁵¹

439. *Id.*

440. *See id.* at 17, 281 (defining Net Present Value as the value of an asset today subtracted by the investment required to obtain that asset).

441. *See id.*

442. *Id.* at 310–11.

443. *Id.* at 332.

444. *Id.* at 310–11 (Economic Value Added (EVA) equals residual income, which equals income earned minus income required; income required equals income earned minus the cost of capital times the investment).

445. *See supra* notes 326–29 and accompanying text (describing the three components of capital income, including the riskless rate of return and the risk premium).

446. *See* BRADFORD, *supra* note 4, at 10.

447. *See id.*

448. *See* BREALEY ET AL., *supra* note 430, at 310 (asserting that corporate shareholders seek positive NPV investments only).

449. *See* BRADFORD, *supra* note 4, at 12.

450. *See id.*

451. *See* BREALEY ET AL., *supra* note 430, at 145 (noting that Amazon’s stock prices rose 6,000% in one year, only to decrease by 90% in the next year).

The consequence of corporate taxation is that shareholders get less. Is this result acceptable double taxation? Because economic rents are extraordinary, the opportunity to earn rents is not a serious factor in stock purchase and the possibility has little effect on shareholder behavior.⁴⁵² Corporate rents are a windfall; their creation has nothing to do with the talents and skills of the stockholder.⁴⁵³ Human capital and monopoly power explain rents; supernormal returns are usually associated with the return from ideas, labor, and management skills, or market power.⁴⁵⁴ Stockholders are capital owners, not capital users.⁴⁵⁵ To the extent stockholders earn a normal return, they are compensated for the risks they bear.⁴⁵⁶ Though stockholders own the residual rights to rents, capital has not produced these rents—people have.⁴⁵⁷ Because rents are a windfall to shareholder capital, taxation is fair.⁴⁵⁸

Those who purchase shares from others *may* be paying for previously earned economic rents, which would naturally be reflected in the value of the shares.⁴⁵⁹ The purchase price may also reflect the capital value of expected rents including the future tax cost at the corporate level.⁴⁶⁰ These same principles apply today to the income tax.⁴⁶¹ Though these rents would not be a windfall to capital, having been expected and paid for, not taxing them would result in a tax windfall to the purchaser.⁴⁶²

Logic dictates that shareholders realize rents through dividends or capital appreciation. It is, however, unlikely that stockholders receive rents knowingly. Many corporations do not pay any dividends, while other corporations pay them regularly.⁴⁶³ Dividends do not represent economic rents, but instead merely represent a portion of the expected normal return on

452. See *supra* notes 448–49 and accompanying text.

453. See Elkins & Hanna, *supra* note 160, at 101 (quoting William M. Gentry & R. Glenn Hubbard, *Distributory Implications of Introducing a Broad-Based Consumption Tax*, 11 TAX POL'Y & ECON. 1, 6 (1997)).

454. See *id.*

455. See BREALEY ET AL., *supra* note 430, at 6 (explaining how stockholders own the corporation but do not manage it).

456. See *supra* note 449 and accompanying text.

457. See *supra* notes 453–54 and accompanying text.

458. See Elkins & Hanna, *supra* note 160, at 102.

459. Cf. BREALEY ET AL., *supra* note 430, at 420 (explaining how a higher dividend often results in a higher stock price).

460. Cf. *id.* at 429–30 (explaining how a stock's price will reflect expected future dividend payments, including future taxes on those dividends).

461. See *supra* Part III (discussing how economic rents are subject to income taxation and are taxed on the basis of expected return).

462. See Elkins & Hanna, *supra* note 160, at 102.

463. See BREALEY ET AL., *supra* note 430, at 418.

capital.⁴⁶⁴ Under a cash flow tax, the amount of profits representing dividends would not be subject to tax.⁴⁶⁵

Indeed, in our system of stockholding, dividends are the only instance when the reality of corporate earnings intrudes into the daily life of shareholders.⁴⁶⁶ Common sense suggests that a record of dividend paying will have an impact on stock valuation,⁴⁶⁷ yet economists have three contradictory views. On the right, it is asserted that the payment of dividends increases the value of the firm (even though assets leave the corporate solution).⁴⁶⁸ On the left, it is asserted that the payment of dividends decreases the value of shares.⁴⁶⁹ In the middle, it is asserted that the payment of dividends has no effect.⁴⁷⁰ This lack of theoretical consensus and supporting meaningful data suggest that there is disconnect between corporate share value and distributed corporate profits.

The effect of economic rents on share value is even more problematic than that of dividends. Rents are elusive, ephemeral, and are not a factor when the only relevant concerns when investing in shares are price and dividends.⁴⁷¹ It was the late Adolf Berle who suggested that there was, at best, an indirect correlation between share value and the value of a corporation as an operating entity.⁴⁷² Berle concluded that “the stock market[] . . . [is a] more or less closed, system of property-holding . . . that . . . is essentially independent from the actual productive processes.”⁴⁷³

464. Expected returns on shares of stock based on historical data include both an income element (paid as a dividend) and a much larger element for capital appreciation. See IBBOTSON, *supra* note 269, at 23. It is this return composed of a risk-free rate plus a risk premium that is exempt from taxation at the corporate level under a cash flow tax. These “profits” would only be subject to one level of tax at the shareholder level.

465. See *supra* notes 178, 464 and accompanying text.

466. See Berle, *supra* note 363, at 39.

467. See BREALEY ET AL., *supra* note 430, at 420.

468. See *id.* at 428 (arguing that, because investors seek stocks with established dividends, those stocks command higher prices).

469. See *id.* at 429–30 (arguing that, because investors prefer the tax advantages of capital gains, stocks with dividend policies have depressed prices).

470. See *id.* at 433.

471. See Berle, *supra* note 363, at 39.

472. *Id.* at 37–38.

473. *Id.* at 38–39. In some cases, there exists indirect correlation between the risks and benefits of stock ownership and the risks and benefits of corporate assets. John H. Davies, *Public Stock, Private Stock: A Model for the Corporate Income Tax*, 124 U. PA. L. REV. 299, 309 (1975). This indirect correlation results from the specific risks borne by shareholders due to specific industry risks or the unique properties of particular corporations. See BREALEY ET AL., *supra* note 430, at 162. This is known as unique risk. See *id.* Though unique risk is accounted for in the risk premium, it is not particularly important risk because it can be minimized by diversification. See BRADFORD, *supra* note 4, at 10 (explaining the normal return as accounting for the particular risks of the firm); see also BREALEY ET AL., *supra* note 430, at 162. The most significant risk for most shareholders is market risk, which is also known as systemic risk. *Id.* at 162 & n.27. Systemic risk generally springs from external macroeconomic factors that affect all companies in a particular fashion, albeit with different magnitudes. See IBBOTSON, *supra* note

The publicly traded corporation is a unique form of ownership in that “[i]t has destroyed the unity that we commonly call property—has divided ownership into nominal ownership and the power formerly joined to it.”⁴⁷⁴ Many stockholders own shares indirectly through mutual funds and pension plans run by corporate management with little idea of the companies they own, let alone the risks and benefits of the individual companies contained in their portfolios.⁴⁷⁵

The substantial disconnect between the underlying assets and business activity of a corporation, which can be called inside value, and market value is well illustrated by the insufficiency of meaningful corporate data.⁴⁷⁶ For example, corporate accounting reflects the net book value of assets and residual earnings for a corporation, “which is original cost less depreciation computed according to some arbitrary schedule.”⁴⁷⁷ This is only an approximation of the true value of some of the assets. For example, it was reported that Heinz’s stated book value for its outstanding shares of stock was \$1.99 billion or \$3.42 per share in April of 2003.⁴⁷⁸ Concurrently, Heinz’s common shares were selling at \$30 per share for a capitalized market value of \$10.5 billion.⁴⁷⁹

Valuation of intangibles is part of the reason for the huge discrepancy between inside value and market value. Book value does not include most intangible capital, which is comprised of visual assets, like patents and trademarks, and also almost invisible assets like trade secrets, goodwill, customer service, headquarters efficiencies, profits lost in order to establish new markets, and all of the training and skills acquired by an established work force.⁴⁸⁰ It has been estimated that the value of intangible capital may be as high as one-third of all business assets.⁴⁸¹ Despite its importance, the value of intangible capital is merely conjecture.⁴⁸²

Due to the immeasurability of intangible capital, one cannot determine true value, one can only observe the value of corporate assets or the corporate enterprise by viewing the market value of the corporation’s outstanding shares.⁴⁸³ It is the stock market price that has real consequences to the

269, at 45. Market risk takes into consideration the fluctuation in prices due to the economy as a whole as opposed to individual corporate concerns. *See* BREALEY ET AL., *supra* note 430, at 162. Unlike unique risk, market risk is not diversifiable. *Id.* at 162 & n.27.

474. BERLE & MEANS, *supra* note 421, at 6–7.

475. Berle, *supra* note 363, at 28.

476. *See* BREALEY ET AL., *supra* note 430, at 419.

477. *See id.* at 317.

478. *Id.* at 366.

479. *Id.*

480. *See* Fullerton & Lyon, *supra* note 146, at 64, 67–68.

481. *See id.* at 74.

482. *See id.* at 68, 72, 74.

483. BREALEY ET AL., *supra* note 430, at 316–17.

shareholder.⁴⁸⁴ Standard finance texts tell us to trust market value, claiming that the market reveals the true value of shares.⁴⁸⁵ In other words, the current price is neither under- nor overvalued. An investor, therefore, is concerned only with relative value, which is the value of shares today as opposed to their value yesterday.⁴⁸⁶ The relationship between economic rents and share value is only a matter of speculation.⁴⁸⁷ Consequently, it can be concluded that shareholders are neither particularly interested in economic rents nor significantly affected by them.⁴⁸⁸

Shareholders look for a normal return on their investment, calculated as the sum of a risk-free return and a risk premium.⁴⁸⁹ This normal return would be exempt from taxation under a corporate cash flow tax, resulting in only one layer of taxation at the shareholder level.⁴⁹⁰ To the extent that economic rents trickle down to shareholders, they are unexpected windfalls.⁴⁹¹ In many cases, rents may not accrue to shareholders at all.⁴⁹² This is because there are several constituents that vie for economic rents, including equity capital (dividends), debt (contingent interest),⁴⁹³ and labor (greater wages and benefits).⁴⁹⁴ Management is in a unique position to capture rents through compensation in the form of disproportionate salaries, non-taxed benefits, and stock options, translating their efforts into capital return.⁴⁹⁵ Thus, economic rents present the one fair base for taxing the profits of a corporation, even if those rents are taxed twice.⁴⁹⁶

484. *Id.* at 75 (describing investors' expectations for stock growth when observing stock prices during the present day).

485. *See, e.g., id.* at 350 (stating that stock prices can be trusted in an "efficient market . . . for they impound all available information about the value of each security"); *id.* at 348.

486. *Id.* at 348.

487. *Id.* at 281 (discussing the factors that influence the sustainability of economic rents).

488. *See* Elkins & Hanna, *supra* note 160, at 101–02 (describing the nature of supernormal returns); *see also supra* notes 434–35 and accompanying text.

489. *See supra* notes 324–29 and accompanying text.

490. *See supra* notes 159–62 and accompanying text.

491. *See supra* notes 434–35 and accompanying text.

492. *See supra* notes 452–58 and accompanying text.

493. Theoretically a loan of debt capital tax has a zero NPV because the rate is exactly equivalent to the opportunity cost of capital. *See* BREALEY ET AL., *supra* note 430, at 332–33. Certain creditors, however, may be in the position to bargain for a share of economic rents in addition to a normal return on capital.

494. Even customers might vie for a portion of the rents, but to the extent customers get better prices, we would hesitate to classify these as rents. *See, e.g.,* Elkins & Hanna, *supra* note 160, at 101 (arguing that supernormal returns should be defined as "returns on labor or as windfalls").

495. Consequently, there may be a case for limiting deductions for management compensation in a cash flow system because excessive compensation represents economic rents. On the other hand, since debt and equity receive identical treatment under a cash flow tax, it is irrelevant whether rents are paid to shareholders or creditors. *See supra* note 159 and accompanying text.

496. *See supra* notes 429–31 and accompanying text.

V. CONCLUSION

This Article has argued that the case for taxing economic rents to corporations satisfies the important goals of corporate taxation: providing revenue and regulating corporations in a way that can control management. A separate cash flow tax on corporations taxes them in a way that directly reflects the benefits they derive from society, which are fairly reflected in the tax base.⁴⁹⁷ In general, cash flow taxes work in a way that is non-distortive and economically efficient.⁴⁹⁸ Although all comprehensive cash flow taxes are taxes on economic rents, a destination-based cash flow tax includes only those rents that are clearly accessible by a nation because they are inextricably bound to a nation's domestic consumption.⁴⁹⁹

Recent data shows that corporate taxes as a percentage of GDP have substantially declined since the 1960s.⁵⁰⁰ This decline is despite the fact that corporations still account for over 80% of business activity in America.⁵⁰¹ President Barack Obama's tax-reform plan is to broaden the corporate tax base by reducing or eliminating tax preferences while lowering corporate tax rates to accomplish overall neutrality.⁵⁰² Revenue neutrality will not reverse this decline. Even loophole-closing with the existing tax rates would not significantly reverse the trend because tax preferences only account for approximately 8.6% of corporate taxable income.⁵⁰³

Other factors account for the decline in revenue more directly. First, many large businesses have escaped the corporate tax by using pass-through nontaxable entities.⁵⁰⁴ Second, an increasing number of corporations use a higher percentage of debt-financing rather than equity financing, resulting in a negative corporate tax on business profits.⁵⁰⁵ Third, national borders are dissolving when seen from the perspective of multinational corporations and global economics.⁵⁰⁶ Consequently, nation-states' international tax regimes are disintegrating in the face of the challenges of international tax competition.⁵⁰⁷ The taxation of the foreign earnings of U.S. multinationals and foreign corporations doing business in the United States is the result of a flawed international system that exacerbates transfer pricing gambits and debt

497. See *supra* text accompanying notes 425–28.

498. See *supra* note 197 and accompanying text.

499. See *supra* Part II.B (arguing that “only a destination-based cash flow tax will yield a largely unavoidable corporate tax”).

500. See *supra* notes 34–35 and accompanying text.

501. See *supra* note 38 and accompanying text.

502. See *supra* notes 22–23 and accompanying text.

503. See *supra* notes 40–41 and accompanying text.

504. See *supra* notes 42–43 and accompanying text.

505. See *supra* notes 46–47 and accompanying text.

506. See Barker, *supra* note 17, at 171–80.

507. See *id.*

financing.⁵⁰⁸ Imports substantially reduce tax revenue.⁵⁰⁹ Proposed international tax solutions include source-based territorial taxation,⁵¹⁰ but neither loophole-closing nor the adoption of a territorial income tax can cure the basic problems of corporate tax.

This Article has outlined the need for a paradigm shift from a corporate income tax to a corporate cash flow tax. Unlike other cash flow proposals that suggest an origin-based cash flow tax for all,⁵¹¹ cumulative research indicates that the adoption of a destination-based cash flow tax solely for corporations and other large businesses is the optimal corporate tax scheme.⁵¹² A destination-based cash flow tax for corporations and other large businesses would practically eliminate the problems of the corporate income tax, including tax preferences to international tax issues. It accomplishes this by taxing all gains from U.S. consumption, both real and financial, leaving the taxation of labor income to workers and the normal returns from capital to investors under the income tax system.⁵¹³ A destination-based cash flow tax reverses the income tax bias for foreign production by taxing all sales for domestic consumption while excluding export sales.⁵¹⁴ A destination-based cash flow tax allows a deduction for all costs other than those for imported goods and services.⁵¹⁵ It protects the domestic tax base by completely removing the foreign element from the equation.⁵¹⁶ Cash flow taxes present a fair and economically sound base for taxing corporations.

A cash flow tax on corporations would also benefit shareholders. Cash flow taxes remove the normal return from capital from the corporate tax base by equalizing the tax treatment of debt and equity.⁵¹⁷ Economic double taxation of corporate income would be of no practical importance. Shareholders would have the added bonus of effective information on corporate profitability derived directly from corporate income tax returns, which would measure the true profit from shareholder's capital and would be a direct measure of management performance.⁵¹⁸

508. See *supra* notes 194–95 and accompanying text.

509. See Auerbach et al., *supra* note 57, at 853–55.

510. See *supra* Part II.B (discussing origin-based and destination-based territorial tax systems).

511. See Barker, *supra* note 14, at 690–93.

512. See *supra* notes 194–200 and accompanying text.

513. See *supra* notes 194–200 and accompanying text.

514. See *supra* notes 194, 196–97 and accompanying text.

515. See Barker, *supra* note 14, at 695.

516. See *id.*

517. See *id.* at 689.

518. See *supra* text accompanying notes 425–28.

