Between Scylla and Charybdis: Taxing Corporations or Shareholders (or Both)

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1 Dean Emeritus and Harvey R. Miller Professor of Law and Economics, Columbia Law School. Copyright David M. Schizer 2016. All rights reserved. This Essay will be published in the Columbia Law Review. I appreciate the helpful comments of Dan Amiram, Alan Auerbach, Jay Blumenstein, Tom Brennan, Arthur Feder, Dan Halperin, Robert Scarborough, Michael Schler, Willard Taylor, Al Warren, and participants at workshops at Hebrew University, Harvard Law School, the Tax Club, the Tax Forum, and the National Tax Association.
Abstract

The US taxes both corporations and shareholders on corporate profits. In principle, the U.S. could rely on only one of these taxes, as many commentators have suggested. Although choosing to tax the corporation or its owners may seem like taking money from one pocket or the other, this Essay emphasizes a key difference: corporate and shareholder taxes prompt different tax planning. Relying on one or the other mitigates some distortions and leaks, while exacerbating others. As a result, choosing which tax to impose is like navigating between Scylla and Charybdis.

In response to these dualing distortions, this Essay recommends using both taxes. Some tax should be collected from corporations, and some from investors. The two rates should be coordinated, so they aggregate to the combined rate Congress wants, which ideally would be the rate for pass-through businesses. The main goal of this Essay is to defend the use of both taxes, and to analyze what the balance should be between them. Using both taxes has three advantages. First, if one of these partially overlapping instruments is avoided, the other still raises some revenue. Second, if the goal is to deter a planning strategy, cutting the rate to zero is an overreaction. If the rate is low enough, paying a tax is cheaper than avoiding it, since tax planning is not free. Third, if one tax is cut instead of repealed, the other can be correspondingly lower, and thus induces less planning.

Even so, using two taxes poses challenges as well. First, although the taxes are supposed to backstop each other, they cannot do so when a planning strategy avoids both. Second, using two taxes is likely to increase administrative costs. Third, coordinating the two taxes to produce the right combined rate – ideally the rate for noncorporate businesses – is not easy.

Once Congress chooses the combined rate on corporate profits, how should this burden be allocated between corporate and shareholder taxes? Since the corporate tax probably is more distortive, it should be cut significantly. The shareholder tax should be increased to make up the difference (or at least some of it).

This Essay also cavasses reforms to shore up corporate and shareholder taxes, so the combined rate that actually is collected comes closer to the one on the books. While the focus is on incremental reform, this Essay’s central recommendation extends to more ambitious reforms as well. They also benefit from using two taxes, instead of one.
“So we sailed on through the narrow straits, crying aloud for fear of Scylla on the one hand while divine Charybdis sucked the sea in terribly on the other.” – Odyssey Book 12.

The US taxes corporate profits twice. Corporations pay one tax, and shareholders pay another when they receive dividends or sell stock. Many commentators have criticized this “double tax,” proposing instead to use only one of these taxes. For instance, some want to replace the corporate tax with a mark-to-market tax on shareholders;2 while other proposals to repeal the corporate tax emerged in the 2016 presidential campaign.3 The mirror image is to keep the corporate tax and repeal the shareholder tax. For example, the “comprehensive business income tax” (“CBIT”),4 considered in an influential 1992 U.S. Treasury report, would eliminate the dividend tax, and possibly also the capital gains tax.5

2 See Eric Toder & Alan D. Viard, Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax, 2014 [hereinafter “Major Surgery Needed”] (replacing corporate tax with mark-to-market shareholder tax); Eric Toder & Alan D. Viard, A Proposal to Reform the Taxation of Corporate Income, 2016 [hereinafter “A Proposal”] (revising proposal so corporate tax is retained, but at only a 15% rate); see also Victor Thurnoyi, The Taxation of Corporate Income-A Proposal for Reform, 2 Am. J. Tax Pol'y 109 (1983) (“The basic thrust of the proposal is to repeal the corporate income tax on publicly held corporations and to tax their shareholders on the annual increase in value of their shares.”); David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111, 1134-37 (1986) (proposing mark to market taxation for publicly traded stock and repeal of corporate tax); Deborah Schenk, Complete Integration in a Partial Integration World, 47 Tax L. Rev. 697 (1992) (“I propose that an expanded subchapter S applicable to most nonpublicly held corporations be combined with an accrual tax on publicly held corporations to produce a workable complete integration system.”); Joseph M. Dodge, A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal, 50 Tax L. Rev. 265 (1995) (proposing to repeal the corporate tax and to replace it with a mark to market tax on shareholders of public corporations, and a pass-through regime for privately held corporations). Michael Knoll would also tax corporate income based on changes in the value of corporate securities, but he would collect this tax from corporations. Michael S. Knoll, An Accretion Corporate Income Tax, 49 Stanford Law Review 1(1996). Knoll assumes there will be a separate entity tax, in addition to the personal income tax, but does not defend the use of a second tax. Id. at 5 n.18 (“Of course, this article presumes that there is an entity-level corporate tax. I defend neither the double tax on corporate income nor the income tax. . . .”). Joseph Bankman has also proposed to tax corporations on annual changes in their market value. Joseph Bankman, A Market Value Based Corporate Income Tax, 68 Tax Notes 1347 (September 11, 1995). Like Knoll, Bankman assumes there will be a separate entity level tax, but observes that it “could be easily adapted to an integrated tax system. In that event, the MVT would replace both the current entity-level corporate tax and the shareholder-level tax on corporate distributions.” Id. at 1348.


5 In analyzing CBIT, Treasury did not take a firm position about whether to tax capital gain, noting that “the fundamental problem of capital gains taxation in CBIT is similar to that encountered in other integration prototypes and either resolution (to tax or to exempt capital gains) will be controversial.” Id. at 56. Treasury observed that
Although choosing to tax the corporation or its investors may seem like taking money from one pocket or the other, this Essay emphasizes a key difference: corporate and shareholder taxes prompt different tax planning. Relying on one or the other mitigates some distortions and leaks, while exacerbating others. As a result, choosing which tax to impose is like navigating between Scylla and Charybdis. For example, if we rely only on a (high) shareholder tax, firms would retain more earnings, shareholders would defer selling stock, and tax exempt and foreign shareholders would no longer pay tax (indirectly) through the corporate tax. To solve these problems, we could move to the other end of the spectrum, relying solely on the corporate tax. But then corporations would shift income abroad, change their tax residence, and delay selling appreciated assets.

In response to these dualing distortions, this Essay recommends using both taxes. Some tax should be collected from corporations, and some from investors. The two rates should be coordinated, so they aggregate to the combined rate Congress wants, which ideally would be the rate on pass-through businesses. The main goal of this Essay, then, is to defend the use of both taxes – in essence, to show “how I learned to love the double tax”\(^6\) – and to calibrate the balance between them.

Using both taxes has three advantages. First, if one of these partially overlapping instruments is avoided, the other still raises some revenue. Second, if the goal is to deter a planning strategy, cutting the rate to zero is an overreaction. When the rate is low enough, paying a tax is cheaper than avoiding it, since tax planning is not free. For example, a firm’s incentive to shift income abroad can be eliminated not only by repealing the corporate tax, but also by cutting the rate to 10% or 15%. Third, if one tax is cut instead of repealed, the other can be correspondingly lower, and thus induces less planning. Proposals to use only one tax on business profits typically neglect these advantages of two.\(^7\)

Even so, using two taxes poses challenges as well. First, although the taxes are supposed to backstop each other, they cannot do so when a planning strategy avoids both. Second, using two taxes can increase administrative costs. Third, ensuring that two taxes aggregate to a particular rate is not easy. This coordination is fairly blunt unless we shore up both taxes to they

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6 This phrase is borrowed from Herwig Schlunk, who offers a very different justification for using two taxes: one (the corporate tax) can fund services to businesses, and the other (the shareholder tax) can fund services to individuals. See Herwig Schlunk, How I Learned To Stop Worrying and Love Double Taxation, 79 Notre Dame L. Rev. 127 (2003).

7 David Gamage has also emphasized the advantages of using multiple taxes, instead of a single instrument. But he does not focus on corporate tax reform. As this Essay shows, this is a setting where this argument has particular resonance. Instead, Professor Gamage’s goal is to recommend separate taxes on labor income, consumption, capital income and wealth. See generally David Gamage, The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth, 68 Tax L. Rev. 355 (2014).
are hard to avoid, and also use a sophisticated mechanism like an imputation system, which gives shareholders a credit for tax already paid by the corporation.

Once Congress chooses the combined rate on corporate profits, how should it allocate this burden between corporate and shareholder taxes? Since lower rates discourage planning, the more distorting tax should be lower. The corporate tax probably is more distorting, so it should be cut significantly. The shareholder tax should be increased to make up the difference (or at least some of it).

This Essay also cavasses a number of reforms to shore up the corporate and shareholder taxes, so the combined rate that actually is collected comes closer to the one on the books. For instance, share appreciation should be taxed even if shareholders die with appreciated shares or contribute them to charity. Likewise, the corporate tax’s treatment of debt and equity should be conformed. But instead of accomplishing this goal with one tax – by extending the current treatment of debt to equity, so interest and dividends are both deductible\(^8\) – two taxes should be used. In other words, the current treatment of equity should be extended to debt: firms would not deduct either dividends or interest, and investors would face the same rate on corporate dividends, interest, and capital gains.

While this Essay focuses on incremental reform, more ambitious reforms also benefit from using two taxes, instead of one. For instance, income shifting can be eased by repealing the corporate tax and relying only on a mark-to-market tax on shareholders. But this reform fails to tax nonprofit and foreign shareholders, and also induces planning at the boundary between mark-to-market and realization. To mitigate these distortions, we can cut the shareholder tax and supplement it with a low corporate tax. In contrast, another ambitious reform – imputation – already offers the advantages of two taxes: it collects tax from both corporations and shareholders, offering shareholders a credit for tax paid by the corporation.

Before proceeding to the analysis, six clarifications are in order. First, this Essay focuses on publicly-traded businesses, since private firms usually do not pay corporate tax under current law, and use other planning strategies that are mostly beyond this Essay’s scope.\(^9\) Second, this Essay generally assumes that income is the tax base, although some consumption tax alternatives are discussed briefly as well.\(^10\) Third, the goal is to maximize national welfare, instead of global welfare. Fourth, this Essay does not focus on distribution, since the alternatives it compares –

\(^8\) Edward D. Kleinbard, The New Political Economy of Capital Income Taxation, at 94.

\(^9\) For example, high corporate rates can induce controlling shareholders to spend more on corporate expenses with a consumption element, such as expensive health plans, business travel, or company cars. In addition, as discussed below, differences between the corporate and personal rates can influence how much cash controlling shareholders leave in the firm, as well as whether their preference for salary or dividends.

\(^10\) This assumption does not flow from a conviction that income is a better base, since there are reasons to prefer consumption. See generally Joseph Bankman & David A. Weisbach, The Superiority of an Ideal Consumption Tax over an Ideal Income Tax, 58 STAN. L. REV. 1413 (2006). Rather, this Essay focuses on income on the assumption that corporate tax reform is likely to proceed incrementally.
corporate and shareholder taxes – both tax capital income, and thus reach high-income taxpayers. Even so, distributional effects can still vary if the incidence of these taxes is different. Fifth, this Essay focuses on where rates and rules should end up. How the transition should be managed – including whether changes apply only to new firms or equity (e.g., to avoid windfalls), as well as whether they should be phased in gradually – is beyond this Essay’s scope. Finally, the focus here is on policy instead of politics, although political constraints are discussed briefly.

Part I explains why nominally equivalent corporate and shareholder taxes induce different planning. Part II surveys planning strategies for a high corporate tax, and Part III canvasses strategies for a high shareholder tax. To deal with these dualing distortions, Part IV develops an incremental reform strategy, which allocates tax between corporations and shareholders and strengthens each tax with targeted reforms. Part V extends the analysis to more comprehensive reforms.

I. Taxing the Corporation or the Shareholder: Why It Matters

If the corporate tax’s function is to backstop the shareholder tax, as this Essay assumes, these two taxes initially seem interchangeable. Yet because these taxes have different gaps, taxpayers use different planning strategies to avoid them. As a result, the choice to tax corporations or shareholders affects taxpayer behavior, as well as how much revenue is collected.

A. Nominal Equivalence of Corporate and Shareholder Taxes

At first blush, the same percentage of a firm’s profits (seemingly) can be collected with different combinations of corporate and shareholder taxes.

1. Conforming the Tax on C-Corporations and LLCs

For instance, the integration literature recommends using the same rate for pass-through businesses and corporations,11 but pass-throughs are taxed at 39.6% and corporations are taxed 50.5% under current law.12 As a recurring example, this Essay assumes that Congress conforms them at 40%. (To be clear, this round number is merely illustrative, and is not intended as a recommendation.)13 A 40% combined rate can be implemented with a 40% corporate rate and no shareholder tax;14 a 40% shareholder tax and no corporate tax;15 a 22.5% rate for both;16 or any of the following:17

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12 This assumes all are in the top bracket. To see the effect of a 35% corporate rate and 23.8% shareholder rate, assume a corporation earns $100, pays $35 in corporate tax, and distributes $65. The shareholder pays a 20% capital gains tax of $13 and a 3.8% Obamacare tax of $2.47, leaving $49.53.
13 For a discussion of factors relevant to the choice of the combined rate, see Part IV.A.1, infra.
14 Again, a total of $40 of tax is imposed on $100 of earnings, leaving the investor with $60 after taxes.
15 If the corporation earns $100, it pays no entity-level tax. The shareholder pays a $40 tax, leaving $60 after taxes.
Nominally Equivalent Pairs of Corporate and Investor Tax Rates: Combined Tax of 40%

<table>
<thead>
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<th>Corporate Rate</th>
<th>Shareholder Rate</th>
<th>$100 Taxed at Corporate Rate</th>
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<td>40</td>
<td>7.8</td>
<td>35</td>
<td>92.2</td>
<td>60</td>
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</tbody>
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2. Conforming the Tax on Debt and Equity

In addition to aligning the tax on corporate and noncorporate businesses, these rate pairs also conform the tax on corporate debt and equity. Since firms deduct interest, only the creditor is taxed under current law (at the personal rate). The same rate is used for pass-through equity, so the rates for corporate debt and pass-through equity are already the same. Therefore, extending this rate to corporate equity aligns the rates for corporate debt and equity.

B. Why Nominally Equivalent Taxes Can Be Different: Rules and Frictions

Yet although these rate pairs conform the rates for corporate and noncorporate businesses, as well as for corporate debt and equity, rates alone do not determine the tax burden. Corporate and shareholder taxes define income differently. One measures a firm’s earnings, while the other reaches dividends and capital gains.

Even if these metrics yield the same answer in the long run—since the stock price is supposed to be the present value of future earnings—they diverge in the short term for three familiar reasons. First, the timing is different, since some steps trigger one tax but not the other. For example, assume a shareholder buys stock in a corporation, which rises in value because the firm buys an asset that appreciates. Sale of the asset triggers corporate tax, while sale of the stock triggers shareholder tax. Taking only one of these steps triggers one tax, but not the other. Second, the source rules are different. In general, corporate tax depends on the source

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16 If $100 of corporate earnings are taxed at 22.5%, and the remaining $77.50 is distributed, the shareholder has $60 after paying a 22.5% tax of $17.50.
17 More generally, the pass-thru tax (P) equals the combined corporate (C) and shareholder tax (S) when: (1 – P) = (1 – C)(1 – S).
18 See Knoll, supra, at 2-3 (“In an efficient market, . . . . the change in the aggregate market value of the corporation’s shares will equal the change in the corporation’s expected future returns, or its periodic income”).
19 David Weisbach has described this as the “dual ownership” problem, and has argued that it is a source of “irreducible complexity” in corporate tax doctrine. David A. Weisbach, The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax, 60 Tax L. Rev. 214 (2005).
of the profit, while shareholder tax depends on the *residence* of the taxpayer. For instance, if a foreign corporation earns money abroad, the (source-based) corporate tax exempts this income. But if U.S. shareholders sell stock in this foreign firm, the (residence-based) shareholder tax *does* reach them. Third, these two regimes offer different tax expenditures as well. For example, a corporation’s tax bill is reduced by favorable depreciation rules, but shareholders still pay tax on any share appreciation deriving from this generous depreciation.  

In addition to defining income differently, corporate and shareholder taxes also involve different *nontax* planning costs (or “frictions”). On one hand, public firms usually have better access to sophisticated expertise than shareholders. On the other hand, shareholders are not audited as regularly. They also can make their own planning decisions, instead of relying on managers, who have somewhat different interests.

**C. Component Rate Strategies versus Combined Rate Strategies**

Since corporate and shareholders taxes have different gaps, the planning is different. This Essay uses the term “component rate” strategies to describe strategies to reduce only one of these taxes, since these strategies affect only a component of the overall tax on corporate profits. For instance, holding onto appreciated stock defers only the shareholder tax. In contrast, “combined rate” strategies avoid both corporate and shareholder taxes. For example, organizing a venture as a nonprofit or as a pass-through entity avoids both of these taxes.

**D. Allocation of Tax Between Corporations and Shareholders**

If we collect tax from both corporations and shareholders, we have to decide how much to collect from each. This allocation has a dramatic effect on *component* rate strategies, but not on *combined* rate strategies.

1. **Component Rate Strategies**

   For component rate strategies, this allocation affects how much revenue is lost, as well as how cost-effective these strategies are for taxpayers. For instance, holding stock until death avoids shareholder tax, but not corporate tax. Therefore, revenue falls to zero if the shareholder tax is 40% (and the corporate tax is 0%), but is unaffected if the shareholder rate is 0% (and the corporate rate is 40%).

   In addition, costs that are justified when the relevant tax rate is 40% are no longer justified when the rate is 0% (or even 15%). After all, paying advisors and modifying behavior is worthwhile only when these nontax costs (or “frictions”) are less than the tax savings. Some strategies are costlier than others. When a component rate is very low, even the cheapest

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20 Capital gains can diverge from corporate income also because they derive – not just from a firm’s profitability – but from an investor’s ability to predict price changes. Daniel N. Shaviro, Decoding the Corporate Tax 18 (2009).
21 Section 1014.
planning is no longer worthwhile. As the rate rises, more strategies become cost-effective. For instance, hedging appreciated stock with derivatives is more plausible to avoid a 30% tax than a 10% tax. The break-even point varies among taxpayers, since a strategy can be easier for some than others. Once the rate reaches a certain point, most strategies are already in use, so further increases induce less additional planning.\textsuperscript{22}

2. Combined Rate Strategies

Although quite important for \textit{component} rate strategies, the allocation between corporate and shareholder taxes is less important for \textit{combined} rate strategies, which avoid \textit{both} taxes. For instance, in deciding whether to use a pass-through entity instead of a corporation, taxpayers focus on the aggregate of the corporate and shareholder rates, not the allocation between them. When the personal rate is 40\%, a pass-through entity offers no tax advantage if the corporate rate is 40\% and the shareholder rate is 0\%. The same is true if the corporate rate is 0\%, and the shareholder rate is 40\%. The key is that the corporate and shareholder rates aggregate to 40\%, but the balance between them is less important.

Even so, this balance can have second order effects when one component is easier to avoid than the other. If Congress allocates more of the combined burden to the easily-avoided tax, less \textit{combined} tax is collected. For instance, assume the corporate tax is easy to avoid, but the shareholder and personal taxes are not. If the (easy-to-avoid) corporate tax is 40\% and the (hard-to-avoid) shareholder tax is 0\%, the true burden is less than 40\%, giving corporations an advantage over pass-through entities. But the true burden is 40\% – eliminating this advantage – if the (easy-to-avoid) corporate rate is 0\% and the (hard-to-avoid) shareholder rate is 40\%.\textsuperscript{23}

E. Dualing Distortions

Therefore, the allocation of tax between corporations and shareholders influences the cost-effectiveness of various planning strategies. Changing the mix of rates can deter some strategies, while encouraging others. For example, suppose a corporation has appreciated assets, while the firm’s shareholders have appreciated stock. Both the corporation and its shareholders

\textsuperscript{22} I am grateful to Tom Brennan for this observation.

\textsuperscript{23} In principle, the allocation between corporate and shareholder taxes also matters if these taxes pursue different goals. For instance, Reuven Avi-Yonah has argued that the corporate tax limits corporate power by reducing the resources under corporate control. \textit{See} Reuven S. Avi-Yonah, \textit{Corporations, Society, and the State: A Defense of the Corporate Tax}, 90 Va. L. Rev. 1193 (2004). Although shareholder taxes do not drain corporate resources in the same way, this Essay does not focus on this difference, since the corporate tax is a blunt way to limit corporate power; unlike antitrust, it is not limited to firms with market power. Another potential difference is that these taxes might fund different government services. According to Herwig Schlunk, the corporate tax should fund services to businesses, while the shareholder tax should fund services to individuals. \textit{See} Herwig Schlunk, \textit{How I Learned To Stop Worrying and Love Double Taxation}, 79 Notre Dame L. Rev. 127 (December 2003). Yet this distinction is not easy to draw. Is thwarting a terrorist attack on an Apple store a service to the business or the people who work and shop there? In any event, distinguishing services provided to businesses and individuals – especially in the cross-border context, which Professor Schlunk analyzes – can be accomplished in other ways (e.g., different source rules for active and passive income, instead of two taxes).
have a tax incentive not to sell, known as “lock in.” Cutting the corporate rate mitigates the corporation’s lock-in. But if this cut is funded by increasing the shareholder rate, shareholder lock-in is exacerbated. As the next two Parts show, this sort of tradeoff is pervasive.

**II. High Corporate Taxes: Planning Strategies and Other Challenges**

This Part canvases planning strategies to avoid corporate tax, as well as other challenges in relying on this tax. These problems become easier when the corporate rate is cut. But if this cut is funded by increasing shareholder taxes, taxpayers will respond with other planning strategies to avoid shareholder taxes, which are surveyed in Part III.

**A. Shifting Income Abroad**

Perhaps the most important problem is that a high U.S. corporate rate motivates firms to shift income to other jurisdictions. Shareholder taxes, by contrast, do not create the same incentive. Since shareholders are taxed based on where they live – regardless where they earn money – shifting income does not change their tax treatment. In contrast, corporations are taxed based on source. Foreign corporations generally pay U.S. corporate tax only on U.S. earnings. Likewise, U.S. firms generally pay current tax only on U.S. earnings, and can defer tax on foreign earnings (while claiming a credit for foreign taxes it pays). Therefore, corporations can change their tax treatment by sourcing income abroad. They have a particular incentive to do so because the U.S. corporate rate (35%) is the highest in the OECD. The OECD median is 24.5%, while Ireland (12.5%) and the UK (20% now, and 18% in 2020) are much lower.

Shifting income induces two types of distortions. First, firms move assets and jobs abroad, even if they would rather operate in the U.S. As the gap in rates widens, more investment flows to low-tax jurisdictions, shifting assets to owners with less expertise or fewer synergies with other assets. Since real activity is harder to shift in some sectors than others, tax distorts capital allocation across sectors. Second, income can be shifted not only with changes in real activity, but also with familiar planning strategies. For example, even if profitable

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25 Commentators describe this tax distortion as a violation of capital export neutrality.


28 See Erik Cederwall, *Reconciling the Profit-Shifting Debate*, 150 Tax Notes 712, 714 (Feb. 8, 2016) (“There is clear evidence that significant heterogeneity exists among MNEs regarding their capacity and desire to shift profits, and the costs and benefits of profit shifting vary dramatically.”).
innovations are developed in Silicon Valley, a subsidiary in a low-tax jurisdiction (a “low-tax sub”) can hold the patents, shifting income when a U.S. affiliate pays (deductible) royalties to the low-tax sub.29 With the right planning, the U.S. does not tax this income until it is paid as a dividend to the U.S. parent.

A great deal of income is shifted abroad,30 costing the U.S. approximately $100 billion of annual revenue31 and distorting behavior in a variety of ways. Managers and advisors invest significant time in shifting income.32 In addition, U.S. multinationals keep approximately two trillion dollars of foreign earnings offshore. To invest it in the U.S., they have to pay a 35% repatriation tax or use costly planning to bring it back another way.33

Two decades ago, the Treasury and ALI did not focus on this vulnerability of corporate taxes, or the immunity of shareholder taxes to it. When the Treasury and ALI published integration studies, the economy was less global, foreign rates were higher, and some tax rules used in income shifting, such as the “check the box” rules, where not on the books. Perhaps for

29See generally Michael Graetz & Rachel Doud, Technological Innovation, International Competition, and the Challenges of International Income Taxation, 113 Colum. L. Rev. 347, 394 (2013) (“Income from IP is much more mobile than the highly skilled workers and entrepreneurs who create it.”). For example, increasing the tax differential between affiliates by 1% is thought to increase the low-tax affiliate’s patent applications by 3.5%. Tom Karlinsky & Nadine Riedel, Corporate Taxation and the Choice of Patent Location Within Multinational Firms, 88 J. Int’l Econ. 176 (2012). Likewise, a 1% reduction in this differential is estimated to increase the high-tax affiliate’s intellectual property holdings by 2.2%. Matthias Dischinger & Nadine Riedel, Corporate Taxes and the Location of Intangible Assets Within Multinational Firms, 95 J. Pub. Econ. 69 (2011).

30See, e.g., Harry Grubert, Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized, 65 Nat. Tax. J. 247 (2012) (many profitable U.S. multinationals have a high percentage of sales in the U.S., but a much lower percentage of their taxable income is earned there); Jane G. Gravelle, Tax Havens: International Tax Avoidance and Evasion, CRS Report for Congress, 2015 (profits reported by U.S. affiliates in Bermuda and the Caymans represent 1,614% and 2,06% of the GDP of these nations; some of this income is shifted from the U.S., while some presumably is shifted from high-tax foreign jurisdictions).

Kimberly A. Clausing, The Revenue Effects of Multinational Firm Income Shifting, Tax Notes, Mar. 28, 2011, at 1580 (documenting the gap between where U.S. multinationals report income (e.g., Netherlands, Luxembourg, Ireland, Bermuda, etc.) and where they have employees (e.g., U.K., Canada, Mexico, China)). Compared with shifting income from the U.S., foreign to foreign shifting has somewhat different normative implications, since it arguably increases the (residual) tax collected by the U.S. See also Dhammika Dharmapala, What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature, 35 Fiscal Stud. 421 (2014) (10% differential in tax rates between affiliates induces an 8% increase in the low-tax affiliate’s reported income).


32Dhammika Dharmapala, The Economics of Corporate and Business Tax Reform 7 (2016) (noting deadweight loss from commitment of talent and effort to tax planning, instead of a more socially valuable occupation).

33See Stephen Shay, The Truthiness of “Lockout”: A Review of What We Know, 146 Tax Notes 1393 (Mar. 16, 2015) (noting that firms repatriate earnings by borrowing against their overseas cash, and that this planning can weaken a firm’s credit); Harry Grubert and Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals For the Reform of International Tax, 66 Nat. Tax J. 671, 685 (2013) (estimate these planning costs to be seven percent; as evidence, citing unexpectedly large response from multinationals when Congress temporarily reduced the repatriation tax to 3.6% in 2005); Melissa Redmiles, The One-Time Received Dividend Deduction, Internal Revenue Service Statistics of Income Bulletin, Spring, 102-114 (stated rate was 5.25%, but a partial foreign tax credit was allowed, so estimated average effective rate was 3.6%).
this reason, the Treasury proposed to rely on the corporate tax, and to repeal the shareholder tax on dividends (and, in one version, the capital gains tax as well).\(^{34}\) Although more plausible in 1992, this proposal is untenable today, as one of its principal architects has emphasized.\(^{35}\)

**B. Shifting Residence Abroad**

Another challenge in taxing corporations is that they can change residence more easily than shareholders. This matters because tax burdens are generally higher for U.S. residents. U.S. citizens are taxed on *worldwide* income, while nonresidents usually pay tax only on *U.S.* income. Likewise, U.S. corporations are taxed on worldwide income (although tax on active foreign earnings can be deferred). In contrast, foreign firms are taxed only on *U.S.* income.

In principle, high taxes can motivate *both* shareholders and corporations to change tax residence, but this step is harder for shareholders. They have to renounce U.S. citizenship and leave the U.S., forgoing the right to come back.\(^{36}\) They also may owe an “exit tax.”\(^{37}\) In contrast, corporations can change tax residence by incorporating abroad, which has only modest impact on them. Their headquarters can remain in the U.S., along with factories, researchers, and customers. They still can be listed on a U.S. exchange. Admittedly, incorporating abroad can have *some* consequences. Firms pay an exit tax,\(^{38}\) and also may alienate some customers and investors.\(^{39}\) Since different corporate law rules apply, the cost of capital may increase if investor protections are weakened. But self-interested managers may not mind, especially since they can blame the tax law for any erosion of shareholder rights.\(^{40}\) These (state) corporate law changes should not be overstated, moreover, since investor protections also are provided in a firm’s charter, as well as in federal securities law (which governs foreign firms listed in the U.S.).\(^{41}\)

Since a corporation faces only modest nontax costs in changing tax residence, Congress enacted Section 7874 in 2004 to deter reincorporation abroad. But this statute does not stop a firm from *initially* incorporating abroad, or from combining with foreign firms that are

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\(^{34}\) The main proposal preserved the tax on capital gains, but one version would have scaled it back by allowing shareholders to use retained earnings to increase their basis with a “DRIP.”

\(^{35}\) Statement of Michael J. Graetz, Professor of Law, Columbia Law School at a Hearing of the Senate Finance Committee on Tax Reform March 8, 2011, at 7, [https://www.charitableplanning.com/cpc_1816409-1.pdf](https://www.charitableplanning.com/cpc_1816409-1.pdf).

\(^{36}\) In theory, former citizens can even be barred from short visits, since Congress has authorized the Justice Department to deny reentry to those who expatriate for tax reasons.

\(^{37}\) The tax applies to built-in gains above $600,000 for taxpayers with $2 million in assets or average income of at least $155,000 over the past five years.

\(^{38}\) Section 367.

\(^{39}\) For instance, in abandoning its plans to invert, Walgreens responded in part to consumer pressure.

\(^{40}\) See David M. Schizer, *Tax and Corporate Governance: The Influence of Tax on Managerial Agency Costs*, Oxford Handbook of Corporate Law and Governance (Gordon & Ringe eds. 2015).

sufficiently large.\textsuperscript{42} In response to a wave of these combinations, the U.S. Treasury has issued a series of notices and regulations, but blocking combinations has proved difficult.\textsuperscript{43}

\textbf{C. Debt}

Another familiar way to avoid corporate tax is debt. Since interest is deductible, corporations pay no tax on revenue that funds interest payments. Lenders pay the only tax, which is avoided if they are tax exempt or foreign. When debt finances favorably-taxed assets (e.g., that are eligible for accelerated depreciation), the effective tax rate can be negative. Intercompany debt also is a familiar way to shift income: when high-tax affiliates borrow from low-tax affiliates, interest payments can shift income to the low-tax jurisdiction.\textsuperscript{44}

In addition to reducing revenue, the tax preference for debt has other familiar effects. It reduces agency costs by forcing managers to distribute cash. Although managers have discretion not to pay dividends, they are obligated to pay interest. Self-interested managers may respond by taking on too little debt, so the tax preference counters this agency cost. Yet in other circumstances, debt can exacerbate agency costs. To head off insolvency, managers might “swing for the fences.” Even if a risky initiative has negative expected value, managers personally share in the gains (by avoiding the reputational cost of bankruptcy), while shifting losses to creditors (who recover less in bankruptcy).\textsuperscript{45} More generally, debt exposes firms to insolvency risk. The tax preference encourages firms to assume more of this risk\textsuperscript{46} or to use (costlier) hybrid securities, which are taxed as debt but have economic features of equity.

\textbf{D. Corporate Lock-in}

Another problem, mentioned above, is that a high corporate tax discourages managers from selling appreciated assets. In some cases, managers attain economic benefits of a sale tax-free with spinoffs or derivative transactions. But these strategies involve advisory fees and transaction costs, and are not always feasible.

\textsuperscript{42} U.S. shareholders should own less than 80\% (or, for some purposes, 60\%) of the combined firm. Section 7874.
\textsuperscript{43} In announcing new regulations in April of 2016, Treasury Secretary Jacob Lew said that “we know companies will continue to seek new and creative ways to relocate their tax residence to avoid paying taxes here at home,” and called for new legislation. \textit{Treasury Announces Additional Action to Curb Inversions, Address Earnings Stripping}, Apr. 4, 2016, https://www.treasury.gov/press-center/press-releases/Pages/jl0405.aspx.
\textsuperscript{44} See\textit{, e.g.,} Stephen E. Shay, J. Clifton Fleming, Jr., & Robert J. Peroni, \textit{Treasury’s Unfinished Work on Corporate Expatriations}, Tax Notes, Feb. 22, 2016 (discussing regulatory responses to impede earnings stripping by inverted companies).
\textsuperscript{46} The consensus estimate is that cutting the corporate rate by 10\% would reduce the debt to asset ratio by 2.8\%. See Ruud A. De Mooji, \textit{Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions}, 33 Fiscal Studies 489 (2012). The bankruptcy costs associated with tax-induced leverage are estimated to be approximately 1\% of corporate tax revenue. See Roger H. Gordon, Taxation and the Corporate Use of Debt: Implications for Tax Policy, 61 Nat Tax J. 151 (2010).
E. Comparative Advantage of Corporations Over Shareholders in Tax Planning

Another challenge in taxing corporations is that they enjoy greater economies of scale in tax planning than shareholders. When firms incur advisory fees and other structuring costs, all shareholders share in these costs. In contrast, individual shareholders cannot pool costs in the same way. While their advisors may be able to do so, spreading costs among clients is more plausible in developing planning strategies than in implementing them.

Even though corporations have this comparative advantage, agency costs sometimes keep them from using it. Managers can be wary of tax planning because they (alone) bear reputational costs when strategies fail, but share tax savings with shareholders when strategies succeed. Even so, there are familiar ways to mitigate these agency costs, including legal opinions to protect managers’ reputations, as well as bonuses for lowering the firm’s effective tax rate.

When managers are willing to engage in tax planning, they are more likely to focus on corporate taxes than shareholder taxes. Shareholder taxes often turn on shareholder choices (e.g., about when to sell) and vary with each shareholder’s tax bracket. As a result, managers do not always have the necessary information or influence to minimize these taxes. Managers also are less motivated to do so, since standard metrics of managerial performance, such as reported earnings, are affected more by corporate than shareholder taxes.

F. Tailoring the Tax Burden to the Owner’s Individual Circumstances

Another familiar limitation of corporate taxes is that, unlike shareholder taxes, they do not vary with a shareholder’s income. As a result, corporate taxes do not track current law’s treatment of labor income or of the noncorporate sector – discontinuities that induce planning – and also are less effective at pursuing distributional goals.

G. Incidence

47 Even so, when deciding whether to pay dividends or repurchase shares, managers do have influence on shareholder taxes, and there is some evidence that they consider them. See, e.g., Jennifer Blouin, Jana Raedy & Douglas Shackelford, Dividends, Share Repurchases, and Tax Clienteles: Evidence from the 2003 Reductions in Shareholder Taxes, NBER Working Paper 16129 (2010) (firms repurchased fewer shares after the rates for dividends and capital gains were aligned in 2003).

48 See, e.g., Edward D. Kleinbard, Rehabilitating the Business Income Tax, Brookings Institution Hamilton Project Discussion Paper 2007-09, at 56 (June 18, 2007) (posing that for agency cost reasons “investor tax consequences will not materially affect managers’ business decision making”). Of course, if accounting for shareholder taxes reduces a firm’s cost of capital, this savings could influence metrics that matter to managers.

49 This advantage featured prominently in the ALI’s recommendation to use an imputation system, which applies the shareholder’s individual rate to dividend income. See generally ALI Report, supra. The same goal can be accomplished by eliminating the corporate tax and relying solely on a shareholder tax.

50 Although individual tailoring is not feasible if we rely solely on the corporate tax, it is feasible if we rely only partially on it. We can impose a flat tax at the corporate level, while also collecting a shareholder tax, which varies with the shareholder’s income. George Yin proposed this approach, describing the shareholder tax as a “surtax.” See George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 431 (1992). For instance, the corporate tax can be a flat 22.5% tax, while the shareholder tax can vary between 0% and 22.5%, depending on the shareholder’s income.
A further challenge with corporate taxes is that their incidence is famously ambiguous, so it is hard to know whether the incidence of shareholder taxes is different. One reason why corporate taxes may burden workers – instead of wealthy investors, as voters often assume – is income shifting. If firms respond by shifting real activity overseas, there is less capital in the U.S., reducing the productivity and wages of U.S. workers. Yet this effect will not necessarily arise if firms shift income with planning, instead of moving real activity. Shifting income also is not a viable strategy – so incidence is not likely to be on workers – when U.S. firms earn rents, are not capital intensive, or cannot easily rely on foreign production.

Compared with corporate taxes, are shareholder taxes more or less likely to be shifted to workers? Shifting the burden requires bargaining power, so a key question is whether shareholders have less clout than corporations. Although generalizations are hard, shareholders have less bargaining power in one respect: shifting income does not reduce their tax bill, so their threats to redeploy capital are less credible. As a result, the incidence of corporate and shareholder taxes could be different, but it is hard to know whether this actually is the case.

III. High Shareholder Taxes: Planning Strategies and Other Challenges

The last Part showed that a high corporate tax motivates a range of planning strategies. Cutting (or repealing) the corporate tax eases these distortions. But if this cut is funded with increases in dividend and capital gains taxes, taxpayers can respond with other planning strategies, described in this Part, to avoid those taxes.

A. Shareholders May Never Sell

Although corporate income is taxed every year, share appreciation is taxed only when stock is sold. By discouraging sales, shareholder taxes can distort portfolio choices and encourage costly hedging transactions. These taxes are never collected, moreover, if shareholders contribute appreciated stock to charity or hold it until they die. The appeal of these planning strategies increases with the shareholder rate.

B. Firms May Not Pay Dividends

51 Since high corporate rates are more likely to trigger shifting than low rates, a low corporate tax presumably is more likely to burden investors than a high tax.
52 Clausing, supra.
54 Instead of using the decedent’s basis, heirs can “step up” the basis to fair market value. Section 1014. Likewise, contributions of stock to charity are not taxed as a sale. Taxpayers can deduct the stock’s fair market value, instead of their basis, if they hold it for more than a year. See Section 170. Although encouraging charity has positive externalities, there are other ways to do so, such as a credit with a higher rate.
55 Empirical estimates suggest that taxpayers are quite sensitive to tax rates in deciding how much gain to realize. See, e.g., Timothy Dowd, Robert McClelland & Atiphat Muthitachareon, New Evidence on the Tax Elasticity of Capital Gains, 68 N.T.J. 511 (2015) (estimating elasticity of persistent tax changes to be about -- .80, with transitory elasticity above 1).
Another planning strategy is to delay dividends. At first blush, we might think the goal is to defer the dividend tax. Yet in fact, delaying this tax does not reduce its present value (unless the rate is going to decline). Instead, this planning exploits gaps between corporate and personal taxes. When the corporate rate is lower – so profits inside the firm are taxed at a lower rate than profits outside the firm – money can grow faster inside the corporation. In effect, a corporation functions as a tax-advantaged account. This strategy used to be common when corporate rates were significantly lower than personal rates. Although it receded when this gap narrowed in 1981, this planning would revive if the gap widens.

A tax preference for retained earnings is especially problematic because of agency costs. Managers already have an “empire building” reason to horde cash: avoiding the discipline of raising new money from investors. A low corporate rate also exacerbates agency costs another way. Along with discouraging dividends, it lets corporations keep more cash, since less is needed to pay corporate tax. Put another way, relying on shareholder taxes, instead of corporate taxes, leaves more cash under managers’ control.

Shareholder taxes also can affect corporate cash flow in another way. Taxing dividends creates a timing mismatch for shareholders whose stock has not appreciated: current income from the dividend is offset by future capital loss when they sell stock. One way to avoid this mismatch, emphasized by David Weisbach, is to accelerate dividends, paying them before stock

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56 Daniel N. Shaviro, Decoding the Corporate Tax 37-38 (2009) (“Ordinarily in income tax planning, deferral is a good thing . . . . In the corporate distributions setting, however . . . . things are more complicated because the amount that ultimately will have to be distributed . . . . is growing by reason of the positive return to the funds the company is keeping on hand in the interim.”).

57 See Daniel I. Halperin, Mitigating the Potential Inequity of Reducing Corporate Rates, 126 Tax Notes 641 (2010) (“[I]f distributions are taxed and the combined rate is equal to the individual rate, there is no advantage from the deferral of the tax on the initial corporate earnings. The advantage is the higher return on reinvested earnings.”).

58 For instance, assume a firm can either distribute $100 of profit to shareholders, or retain it for three years and distribute it. Assume the annual pretax return during those three years is 10% either way, and that the personal rate is 40%, the corporate rate is 0%, the shareholder rate is 40%. If the firm keeps these earnings for three years, it can earn a 10% after-tax return (since the 0% corporate rate applies). But if the firm distributes the earnings immediately, the shareholder can earn only a 6% return (since the 40% personal rate applies). At the end of three years, the shareholder has $79.26 if the corporation retains these earnings, compared with $71.46 if the corporation had distributed them immediately.

59 Another problem with a low corporate tax, considered by Grubert and Altshuler, is that foreign jurisdictions may respond by taxing revenue that the U.S. would otherwise tax. Grubert & Altshuler, Shifting the Burden, supra, at 8.

60 Halperin, supra. Indeed, if Congress wants to use the same rate for noncorporate and corporate businesses – so the corporate and shareholder rates aggregate to the personal rate – the corporate rate has to be lower than the personal rate, as long as at least some tax is collected from shareholders (and the timing of these taxes varies). Specifically, if (1-p) = (1-c) (1-s), and s>0, c has to be less than p.

61 Conversely, when corporate rates are higher than personal rates, there is a tax incentive to distribute earnings, which could keep firms from pursuing valuable projects (e.g., if outside investors won’t fund them because of asymmetric information).

62 For example, assume a shareholder buys stock for $100 and immediately receives a $5 dividend, which reduces the stock price to $95. The shareholder has five dollars of taxable dividend income, but no economic profit. As a result, this current income is offset by five dollars of future capital loss, which is not deductible until the stock is sold.
is sold to a new owner with shares that have not appreciated. Conversely, another solution is to delay dividends until shares appreciate. Still another (partial) fix is to cut dividends, so the magnitude of this mismatch is reduced.

**C. Salary Shifting**

Another planning strategy becomes appealing when personal rates are higher than corporate rates: owners who also are employees claim below market salaries, converting (high-taxed) salary to (low-taxed) corporate earnings. This “salary shifting” loses its appeal if the corporate rate is increased to match the personal rate. But raising the corporate rate exacerbates income and residence shifting, as well as the other problems in Part II. To avoid all these distortions, the U.S. corporate rate has to equal both the U.S. personal rate (to deter salary shifting) and foreign corporate rates (to deter income and residence shifting). This is mathematically impossible under current law because the U.S. personal rate is significantly higher than foreign corporate rates. Once again, we have to pick our poison.

**D. Tax-Exempt Shareholders**

Another familiar problem with shareholder taxes is that, unlike corporate taxes, they do not reach tax-exempt shareholders. For instance, assume that tax-exempt shareholders own a for-profit corporation, which earns $100 million. If the corporate tax is 40%, and the shareholder tax is zero, $40 million of tax is collected. But if these rates are flipped – so the corporate rate is 0% and the shareholder rate is 40% – no tax is collected.

This gap in investor-level taxes already is an issue for debt. Under current law, tax exempt lenders pay no tax on interest, but corporations can still deduct it. As a result, the U.S. collects no tax on revenue servicing this debt. This hole in the tax base would grow if equity is also taxed only (or primarily) at the investor level. Significant revenue is at stake, since less than half of U.S. equities are held by taxable U.S. shareholders; tax exempt and foreign shareholders own the rest. This gap in shareholder taxes complicates any effort to fund a corporate tax cut with them.

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64 The scope of the mismatch increases when dividends are large, and also when shareholder taxes are high; either one increases the size of the initial income inclusion, which is offset by a deferred capital loss.
65 Dhammika Dharmapala, *The Economics of Corporate and Business Tax Reform*, available on SSRN (“[T]he corporate tax is a single instrument that affects two very different kinds of behavior – the incorporation decisions of (typically small) business entities or individuals, and the location and investment decisions of large MNCs”).
Obviously, the treatment of tax exempts does not have to be binary. Instead of paying a full tax or no tax at all, they can pay an intermediate amount, as with the (indirect) corporate tax under current law. How much they pay should depend, at least in part, on the reasons for exempting them. Since the rationales vary with the type of tax exempt, the tax could vary too. For example, IRAs encourage savings, especially for low-income people. So do pension funds, although distribution features less prominently (since there are no income limits).

In contrast, exempting investment income of universities, religious organizations, and cultural institutions is supposed to promote their charitable missions. But another tax preference – the charitable deduction – also advances this goal, and arguably is more effective. The deduction rewards charities for attracting support from donors; government money flows only if donors have “skin in the game.” In contrast, exempting investment income rewards charities for running a surplus and investing it successfully, which is a less reliable signal of social value. In fact, nonprofits with investment income are under less pressure to raise new money. They have less need to demonstrate continuing value to donors, especially when investment income is tax-free, and thus covers more of their budget. As a result, the deduction arguably promotes positive externalities more effectively than the exemption. Yet even if these rules are equally effective, charity can still be subsidized without the exemption, as long as the deduction is available. A cut in one can be offset with enhancements to the other.

E. Foreigner Shareholders

Like tax exempts, foreigners are taxed indirectly by the corporate tax, but (largely) escape shareholder taxes. They pay no tax on capital gains. Although their dividends are subject to withholding, treaties often reduce the rate (e.g., from 30% to 15%). Foreigners used to avoid even this reduced withholding by investing in derivatives. Although a reform was supposed to plug this gap, questions remain about its effectiveness. So if foreigners own a U.S. corporation earning $100 million, $40 million of tax is collected with a 40% corporate tax and a 0% shareholder tax. But no tax is collected if these rates are reversed, as long as shareholders earn capital gain instead of dividends. Like tax exempts, foreigners already avoid both corporate and investor taxes in lending to corporations. This gap would grow if equity is also taxed only (or primarily) at the investor level.

A key question, then, is how much tax foreigners should pay. Taxing them enhances national welfare in three ways. First, it keeps resources in the U.S. economy. Second, revenue

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67 See generally David Schizer, Subsidizing Charity: Donations or Endowment Income? (unpublished manuscript).
68 The assumption here is that these foreigners do not live in the U.S.; if they do, they are taxed like U.S. citizens.
69 Section 871(m).
71 Likewise, if the firm pays a $100 million dividend, and a treaty reduces the foreign shareholders’ tax to 15%, only $15 million is collected.
72 For instance, if foreign owners would otherwise receive $100 of corporate profits, a 40% tax keeps $40 in the U.S.
targets can be met with a lower (and less distortive) tax on U.S. firms and shareholders. Third, taxing foreign owners of corporate businesses matches the treatment of noncorporate businesses, whose foreign owners already pay tax on U.S. profits. (The politics are tempting as well, since foreign investors do not vote in the U.S.)

Even so, taxing foreign investors has two offsetting costs. First, the U.S. might attract less foreign investment. Yet a zero rate seems like an overreaction, even though the U.S. exempts interest for this reason. After all, investing in the U.S. is appealing, so foreigners presumably will pay some tax to do so. Second, if the U.S. raises taxes on foreigners, other jurisdictions might reciprocate with higher taxes on U.S. investors. If Americans claim more foreign tax credits, the U.S. might not raise (net) revenue.

So far, the focus has been on revenue losses when a corporate tax cut is funded with higher shareholder taxes: less revenue is collected from foreign and tax-exempt shareholders of U.S. corporations. However, these rate changes offer offsetting revenue gains as well: more is collected when U.S. shareholders invest in foreign firms that earn money abroad. The corporate tax does not reach foreign profits of foreign firms, but the shareholder tax does. Therefore, cutting the corporate rate and raising the shareholder rate collects more tax on these profits.

F. Administrative Costs

In addition to the revenue losses from exempt and foreign shareholders, another challenge in taxing shareholders instead of corporations is the loss of economies of scale in compliance and collection. Corporations can spread the cost of advice, record keeping, and other infrastructure across all shareholders. For the government, monitoring the firm is more cost effective than policing (and suing) owners of small blocks of stock. Even so, these administrative advantages have become less compelling over time. Superior expertise has enabled corporations not only to comply with rules, but also to avoid them, as emphasized above. At the same time, third party reporting of dividends and basis has helped the government monitor shareholder compliance more effectively.

G. Tax Expenditures

Finally, another difference between corporate and shareholder taxes is that shareholder taxes have less influence on managers. In theory, since shareholder taxes affect a shareholder’s return, a manager should try to minimize them. But tax exempt and foreign investors do not want them to devote resources to these efforts – since they would not benefit – and shareholder

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73 See Harry Grubert & Rosanne Altshuler, Shifting the Burden of Taxation From the Corporate to the Personal Level and Getting the Corporate Tax Rate Down to 15 Percent [hereinafter “Shifting the Burden”] (“for proposals that include an increased tax on capital gains and dividends it would also be necessary to add U.S. resident holdings of foreign shares. This would seem to add at least 6 to 10 percentage points to the 26 percent”).
taxes also have less immediate impact on reported earnings.\textsuperscript{74} Since managers do not focus on shareholder taxes, tax expenditures have less influence on corporate behavior when included in shareholder taxes, instead of corporate taxes. Of course, this is a disadvantage only if the relevant tax expenditures are good policy. If they are not, reducing their impact actually is an advantage.\textsuperscript{75}

IV. Balancing Component Rate Distortions: Advantages of Using Two Taxes

The last two Parts surveyed key challenges in taxing corporations and shareholders. Cutting one rate and raising the other fixes some problems, while complicating others. At one end of the spectrum, if the corporate tax is repealed and tax is collected only from shareholders, firms no longer have tax reasons to shift income abroad, invert, or keep appreciated assets. But these advantages come at a cost. A low corporate rate induces firms to retain earnings and entrepreneurs to take below-market salaries. Likewise, high shareholder taxes encourage shareholders to donate stock to charity or hold it until they die. Tax exempts and foreigners are no longer taxed indirectly.

To solve these problems, we can move to the other end of the spectrum, eliminating shareholder taxes and collecting tax solely from corporations. This mix of rates solves the problems of trapped earnings and shareholder lock in, and treats tax exempts and foreigners the same as other shareholders. But this progress is not free. A high corporate rate induces income-shifting, residence-shifting, and corporate lock-in. Given these dueling distortions, what is the right mix of rates? Instead of relying solely on one tax or the other, this Essay’s central recommendation is to use both.

A. Value of Keeping Both Taxes

1. Built-in Redundancy

There are three reasons to collect tax from both corporations and shareholders. First, the government gets two bites at the apple. If one tax is not collected, the other still is. For instance, even if corporations avoid the corporate tax by shifting income abroad, shareholders are still taxed on dividends and capital gains. To make a system more reliable, engineers often add a backup. This built-in redundancy is useful not only for planning strategies already in use, but also for ones that have not been developed yet. Just as the Treasury’s integration study twenty years ago did not worry about income shifting and inversions, we cannot predict what leaks and distortions will arise two decades from now.

\textsuperscript{74} Halperin, \textit{supra}, at 3 (“[S]ince only the corporate tax affects reported corporate earnings and earnings per share, the shareholder’s tax burden on distributions may not affect corporate decision making, except to the extent it raises the cost of capital.”).

\textsuperscript{75} Even then, a further issue in relying less on the corporate tax – so the gap between it and the personal rate widens – is that the same tax expenditure becomes more valuable for pass-through businesses (in avoiding the higher personal rate) than for corporate businesses (in avoiding the lower corporate rate). Viard & Toder, \textit{A Proposal}, \textit{supra}. A solution is to use credits, instead of deductions, so their generosity does not depend on the tax rate.
Admittedly, built-in redundancy is effective only when two systems have different vulnerabilities. For one to work when the other does not, their limitations have to be somewhat uncorrelated. Corporate and shareholder taxes satisfy this condition, since they are avoided with different planning.

2. Repeal is an Overreaction

Second, to cure distortions from a tax, repeal is too drastic a remedy in some cases. Instead, cutting the rate often is sufficient. As long as the rate is low enough, paying a tax is cheaper than avoiding it. After all, tax planning is not free. Taxpayers have to hire advisors, incur transaction costs, and change business decisions in ways that otherwise are unappealing. These costs are justified only if they are less than the tax.

Obviously, the magnitude of these costs varies for different strategies. For instance, moving factories abroad might be cost-effective when the U.S. corporate rate is 10% higher than in other jurisdictions, but not when it is only 7% higher. Likewise, the threshold for moving patents offshore could be a 7% gap, while the threshold for intercompany debt could be 5%. If this differential narrows to 3%, shifting income may no longer be worth the trouble.

When tax planning has this sort of cost curve, cutting the rate winnows out costlier strategies. As the rate is reduced, fewer strategies remain cost-effective. If even the cheapest strategies involve significant costs, rate cuts can meaningfully ease distortions – indeed, almost as effectively as repealing the tax – while still collecting some revenue.

3. Repeal of one Tax Puts More Pressure on the Other

Third, this revenue is another advantage of using both shareholder and corporate taxes. If one of these taxes is eliminated – instead of merely cut – the surviving tax has to be even higher (assuming the two taxes, in combination, have to meet a revenue target). For example, if the combined rate is supposed to be 40%, and the shareholder tax is repealed, the corporate tax has to be 40%. But if the shareholder rate is 15% (instead of 0%), the corporate rate can be reduced to 29.5%. While a 29.5% rate will motivate some efforts to avoid the corporate tax, a 40% rate presumably will prompt even more, since tax planning becomes more appealing as rates increase.\(^76\)

For instance, assume the goal is to mitigate distortions from both corporate and shareholder lock-in. The severity of corporate lock-in depends on the corporate rate (C), while the magnitude of shareholder lock-in depends on the shareholder rate (S). If tax must be collected either from corporations or shareholders, there is a tradeoff: to ease shareholder lock-in (by cutting S), we have to exacerbate corporate lock-in (by raising C), and vice versa. Cutting one tax more than necessary puts more pressure on the other. If a 0% rate is used for one, when

\(^76\) This acceleration continues only up to a certain point. When the rate is high enough, all plausible strategies are already in use. Once planning “maxes out” in this way, increasing the rate does not induce more planning.
a 10% rate is just as effective at eliminating the relevant distortion, the other rate has to be correspondingly higher, and thus more distortive.  

B. Challenges in Keeping Both Taxes

1. Combined-Rate Decisions: Irrelevance of Allocation of Rates

To be clear, although using two taxes can ease distortions from component rate planning (such as corporate and shareholder lock-in), it cannot do so for combined rate planning. For instance, only the combined rate matters when taxpayers decide to use a corporation instead of a partnership or, for that matter, to save money instead of spending it. For these combined rate choices, whether tax is collected from corporations or shareholders usually is irrelevant; it matters only in changing the combined rate (e.g., by altering the present value of what actually is collected) or in shifting the incidence of the tax, as noted above.

2. Imperfect or Unstable Coordination

Even for component rate planning, moreover, using two taxes is not a panacea. Although relying on both taxes has distinct advantages, there are two key challenges as well. First, it is not easy to coordinate corporate and shareholder rates so they always aggregate to a particular combined rate. After all, an important rationale for using two taxes is that, if one is avoided, the other is still collected. When this happens, only a portion of the combined tax is collected, rather than the entire amount. This means the combined rate does not apply uniformly to all economic activity. Of course, these disparities are likely to be even greater if we rely on only one tax, which sometimes can be avoided entirely. But even so, using two taxes is not a complete remedy. It still is necessary to shore up both taxes, so they actually are collected. In addition, the challenge is not just to coordinate rates now, but also over time. This is particularly difficult, since Congress constantly tinkers with tax rates.

Ideally, rates would be coordinated so one adjusts automatically when the other is avoided or changed. Current law does not supply this sort of coordination, but there are various ways to do so. For example, a reduced shareholder rate for dividends can be available only if the firm has paid tax on the distributed profits. Likewise, dividends can be deductible only if the firm withholds shareholder tax on the distribution. Coordination is even more nuanced in an imputation system: shareholders claim a credit for tax already paid by the firm. As a result, shareholders backstop any tax the corporation was supposed to pay. By cutting its tax bill, a corporation reduces the shareholder’s credit, and thus increases the shareholder’s tax liability.

77 Henrik Kleven & Joel Slemrod, A Characteristics Approach to Optimal Taxation and Tax-Driven Product Innovation, Sept. 2009, at 25, http://webuser.bus.umich.edu/jslemrod/pdf/KS%20Characteristics%20090809.pdf (“[I]n general, it is not optimal to eliminate distortions completely; it is better to have small distortions ‘everywhere’ than large distortions somewhere and none elsewhere.”).


79 See generally Michael J. Graetz & Alvin C. Warren, Jr., Integration of Corporate and Shareholder Taxes.
Instead of an automatic adjustment when a taxpayer avoids one of the taxes, a less ambitious approach is an adjustment when Congress changes the rate schedule. For instance, Congress can impose a statutory relationship between corporate, shareholder, and personal rates, so a change in one automatically triggers adjustments in the others. Obviously, Congress would be free to repeal this formula (or to override it explicitly) when changing rates. Yet if it does not do so, the desired balance is maintained as rates change.\footnote{I am grateful to Tom Brennan for this suggestion.}

3. Administrative Costs

A second challenge with using two taxes is that administrative costs are higher. The government has to administer both taxes, and taxpayers have to comply with them. With one regime, administrative costs are likely to be lower. This is not a trivial advantage, since these regimes are complex. The corporate tax, in particular, is extraordinarily intricate.

Even so, the administrative savings from repeal may not fully materialize for two reasons. First, if only one tax is used, it will have to be shored up, and these enhancements are likely to increase compliance and enforcement costs. Second, if taxpayers believe the repealed regime may someday be reinstated, their compliance costs will not go down as much. For instance, if the corporate tax is repealed, would corporations be confident enough in the permanence of this reform to stop tracking their tax basis in assets? In any event, even if a second tax adds administrative costs, this is the price of built-in redundancy and the other advantages of two taxes.

IV. Implications for Incremental Reforms

This analysis of the costs and benefits of using two taxes has important implications for reforming corporate and shareholder taxes. This Part considers incremental reforms, which preserve the broad contours of current law, while the next Part considers more fundamental reforms.

A. Three-Part Strategy for Incremental Reform

Incremental reform should proceed in three steps. First, Congress should determine the combined rate for corporate profits. Second, Congress should allocate this burden between corporate and shareholder taxes, relying more on the one that is harder to avoid. Third, each tax should be shored up with incremental reforms.

1. Determine the Combined Rate on Corporate Profits

In choosing the combined rate for corporate profits, Congress should consider a range of familiar issues, including empirical estimates of elasticity, incidence, and distributional impact, as well as the nation’s revenue needs and social welfare function. Since these issues are beyond
this Essay’s scope, this Essay does not recommend a rate, offering 40% only as an illustrative example.

Even so, in focusing on planning, this Essay’s analysis has four implications for rates. First, the rate on corporate and noncorporate businesses should be comparable, since disparities breed familiar distortions. Second, corporate and shareholder taxes are inefficient revenue sources. To ease the pressure on these porous regimes, rates should be low. The revenue cost of low rates is less than it may seem, since effective rates are much lower than stated rates under current law. Therefore, lower stated rates can generate the same revenue, as long as they actually are collected. Third, high rates advance distributional goals only if the incidence of these taxes is on high income investors, instead of on low- and middle-income employees. Even then, these inefficient taxes may not pursue distributional goals as effectively as other policy instruments, such as progressive wage taxes. Fourth, Congress should be wary of taxing private businesses at a (much) lower rate than salaries. Otherwise, employee owners will convert salary to business profits, treat personal consumption as business expenses, and the like.

2. Striking the Balance Between Corporate and Shareholder Rates

Once Congress picks the combined rate for corporate profits, the second step is to allocate this burden between corporate and shareholder taxes. For each one, a lower rate would induce fewer distortions. But since these taxes have to aggregate to the combined rate target (e.g., of 40%), cutting one means increasing the other. If the goal is for both rates to be as low as possible, each should be 22.5%, which is the minimum rate for both taxes that aggregates to 40%. If one is lower than 22.5%, the other has to be higher.

Yet these rates should not necessarily be the same; rather, if one tax is more distortive than the other, its rate should be lower in order to mitigate its (more severe) distortions. If the corporate tax induces more planning – as seems likely, although this empirical question cannot be resolved here – its rate should be lower. Obviously, this is the opposite of current law (35% for corporations and 23.8% for shareholders). In any event, instead of 22.5% for both rates, a better split would be 20% for corporations and 25% for shareholders or, for that matter, 15% for corporations and 29.5% for shareholders.

3. Adjust for Targeted Reforms

81 These distortions are well documented in the literature on corporate integration. While a premium can be charged for access to public markets, the prevalence of private equity financing suggests that this premium should be modest.
82 For example, the General Accounting Office recently estimated that the average effective tax rate on corporations is only 12.5%, which is approximately 1/3 of the stated rate.
83 If the corporation earns $100, shareholders will have $60 after the corporation pays $22.50, and distributes the remaining $77.50, which is subject to another 22.5% tax of $17.50.
84 Michael J. Graetz & Alvin C. Warren, Jr., Integration of Corporate and Shareholder Taxes (“Given the ability of multinational corporations to create new entities in low-tax jurisdictions, to shift items of income and deductions among countries to obtain tax advantages, and even to change the residence of the parent company, it is the corporate, not the shareholder, rate that needs to be reduced today.”).
Raising the shareholder rate obviously increases the pressure on this tax. In response, targeted reforms should shore up some of its familiar vulnerabilities. With these changes, the shareholder rate could be increased even more. Likewise, the corporate tax could be cut a bit less if targeted reforms plug some of its leaks. More generally, the appropriate balance of rates can shift if targeted reforms address some of the distortions discussed above. These reforms are needed, moreover, to enable the combined rate that actually is collected to come closer to the combined rate on the books.

**B. Political Constraints**

While this Essay focuses on policy instead of politics, tax reform is always subject to political constraints. Fortunately, both sides of the aisle recognize the need to reduce the corporate rate and reform the rules for multinationals. Nevertheless, support for reform in the abstract does not translate into a consensus for specific proposals, which are vigorously debated.

Reaching a consensus is difficult for four reasons, which should be mentioned briefly. First, the business community is divided. To fund a corporate rate cut, firms want to repeal tax breaks for others, instead of tax breaks for themselves. For instance, limits on income shifting are more appealing to sectors that cannot shift income anyway, such as retail and real estate. Similarly, cutting the corporate rate does not benefit pass-through businesses, so they do not want it funded with increases in their taxes, such as repeal of accelerated depreciation. Self-interest also colors the perspective of managers. For instance, since they benefit from retaining earnings, they resist reforms that encourage distributions.

Second, statutory rates for corporations and shareholders are politically salient. As a result, some Democrats are reluctant to support tax cuts for “rich corporations,” even though the tax burdens workers, as well as investors. Meanwhile, Republicans face a parallel political constraint. Although they want to cut the corporate rate, they are reluctant to pay for it with higher shareholder rates.

Third, although rates are politically salient, gaps and planning strategies are not. The average voter does not have the esoteric knowledge to understand these gaps, or to monitor efforts to plug them. Therefore, organized interest groups wield disproportionate influence, which they use to block or water down these reforms. The result is stated rates that are much higher than effective rates, a combination that has familiar political advantages and policy disadvantages.

Finally, a political downside of cutting the corporate rate is that this tax is invisible to many who bear it.\(^85\) Shareholders are more likely to focus on taxes they pay than on taxes corporations pay for them. Unsophisticated investors ignore the corporate tax because they do

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\(^85\) Daniel N. Shaviro, Decoding the U.S. Corporate Tax 13 (2009) (“And even insofar as voters understand that a corporate tax necessarily hits some set of people, the ambiguity of exactly whom it is taxing may be politically advantageous.”).
not write the check, while sophisticated investors know that some of this burden is shifted to workers. Meanwhile, workers are even less aware of the corporate tax’s impact on them. As a result, many beneficiaries of this tax cut would not realize they are benefitting, and thus would show less gratitude to politicians for supporting it.

Even so, the political payoff would still be substantial if reforms improve the anemic U.S. growth rate. Rising wages, lower unemployment, and booming real estate and stock markets generate good will (and greater job security) for elected officials. To reap these policy and political benefits, the next president may seek a “grand bargain,” funding a corporate tax cut with base-broadening reforms and higher shareholder rates. But admittedly, the political case for this package is weaker than the policy case, so its prospects are uncertain.

C. Illustrative Examples of Incremental Reforms to Shore Up the Shareholder Tax

Using a higher shareholder tax to fund a lower corporate tax is more plausible if Congress plugs familiar leaks in the shareholder tax. The more Congress shores up the shareholder tax, the lower the corporate rate can be. This Section offers a few illustrative examples of incremental reforms. The goal is to highlight this connection between reforms and rates, not to offer a proposal or comprehensive analysis. This Section focuses on reforms that largely preserve current law. 86 Obviously, some are more plausible politically than others.

1. Tax-Free Appreciation: Charitable Contributions and Stepped-Up Basis

Under current law, shareholders avoid the shareholder tax in two familiar ways: they can contribute appreciated stock to charity or hold it until they die. The ways to plug these holes are just as familiar. One is to treat these steps as a sale, so donors and decedents are taxed on the appreciation. Another is to limit the charitable deduction to the taxpayer’s basis, 87 and to require heirs to use donors’ “carryover” basis. 88 If we have the political will to revoke these tax benefits – and, frankly, it is not clear that we do – new rules would not be difficult to draft or administer.

2. Salary Shifting and Trapped Earnings in Private Firms

Two other familiar planning strategies arise when corporate rates are lower than personal rates. First, entrepreneurs take below-market salaries, transforming high-taxed salary into low-taxed corporate income. Second, earnings are retained, compounding at a higher after-tax rate

86 This analysis uses the same methodology as the Treasury’s December 1992 integration report, which favored reforms that “retain current law” and “rely on established principles and rules.” Department of the Treasury, A Recommendation for Integration of The Individual and Corporate Tax Systems 6 (Dec. 1992) (“The desire to retain current law was a major reason for choosing a dividend exclusion system. Retaining current law significantly simplifies the transition to integration by relying on established principles and rules.”).

87 While this reform reduces the subsidy for contributions of stock, it aligns their treatment with contributions of cash. There is no reason for them to be different. If the government wishes to provide a more generous subsidy, there are other ways to do so more uniformly, such as increasing the subsidy rate.

88 A more modest approach is to disallow the basis step up only for retained earnings. See ALI, supra; Halperin, supra.
than if they were distributed. Although low corporate rates create these problems, they obviously ease other distortions, reducing the incentive to shift income or reincorporate abroad.

Fortunately, this tradeoff in using a low corporate rate is not hard to manage, since these planning strategies appeal to different types of firms. Income and residence shifting are plausible for multinationals, but not for small family businesses. In contrast, salary shifting makes sense for family businesses, but not for multinationals. After all, for salary shifting to be a viable strategy, the employee has to own the business. Otherwise, she is sharing her salary with other owners, something the CEO of a multinational obviously would not do. Likewise, using a corporation as a tax-advantaged savings vehicle also is especially plausible for a family business, since the corporation can function like a family investment account.

Since a low corporate rate deters planning by multinationals, but encourages planning by family businesses, the solution is to offer the low rate only to multinationals. There are three ways to do this. Since multinationals are almost always public companies, one option is for the C-corporation form – and, therefore, the reduced rate – to be available only to public firms. Private businesses would have to be LLC’s, partnerships, or S-corporations, and thus would not have access to the reduced corporate rate.

Second, if the C-corporation form is still available to private firms, the rate structure should be adjusted so a higher marginal rate applies to family businesses (to deter salary shifting) than to multinationals (to deter income shifting). To accomplish this, top personal rate (39.6%) should apply to the first $30 million of income – or another threshold approximating the earnings of successful family businesses – and a lower rate (e.g., 15% or 20%) should apply above that level.

Third, a special tax can be imposed when employees own more than a minimum percentage of a firm. The profits of these firms could be divided into the return on capital (taxed at the lower corporate rate) and disguised labor income (taxed at the higher personal rate). As Professor Kleinbard has proposed, these returns can be distinguished by applying an assumed

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89 The fixed costs of this activity arguably are not justified for businesses with modest income, and special tax rules, such as the controlled foreign corporation rules, are more likely to apply to family-owned businesses.

90 Dharmapala, supra, at 14. Admittedly, this income would be overtaxed, if the regular shareholder rate applies to dividends and capital gains, but taxpayers could avoid this issue by using pass-through entities instead.

91 Another approach, proposed by Daniel Halperin, is to apply the lower rate to active business income, while applying the higher rate to passive income. See Halperin, supra.

92 This threshold could be defined as a share of both vote and value, and would use attribution rules (e.g., for family members, controlled corporations, options, etc.).
rate of return (e.g., AFR plus 4%) to capital invested in the firm (e.g., measured by tax basis).  

An extra tax could apply to profits above this level.

3. **Trapped Earnings in Public Firms**

A low corporate rate traps earnings not only in private firms, but also in public firms, where managers already have familiar agency cost reasons to horde cash. In theory, the accumulated earnings tax is supposed to stop retained earnings “beyond the reasonable needs of the business.” But this test sets a low bar, since the IRS and courts lack the expertise to apply it effectively. Reinvesting in the business is sufficient, even if this is not the best use of capital. Firms also can keep a significant amount of cash on hand.

In contrast, a “split rate” system avoids the challenge of targeting excess retained earnings by taxing all retained earnings at a higher rate. For instance, if the corporate rate is 30% and firms can deduct one-half of each dividend, the effective rate for dividends (15%) is half the rate for retained earnings (30%). This differential is desirable, since dividends enhance corporate governance in familiar ways, but are undersupplied for agency cost reasons. As a result, the tax cut is conditioned on a step we want managers to take, instead of ones we don’t want to encourage, such as shifting real activity abroad for tax reasons.

4. **Tax Exempt Shareholders**

Under current law, the shareholder tax does not reach tax exempt shareholders, but the corporate tax does so indirectly. Therefore, a higher shareholder tax can fund a corporate rate cut more effectively if tax exempts also pay it. To accomplish this, dividends and capital gains can be treated more like income from a pass-through business, so they are taxed (in whole or in part) as unrelated business taxable income (“UBTI”). Tax exempts should also be taxed on

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93 Capital invested could be measured with either the firm’s basis in assets or the investors’ basis in their investments in the firm. A choice is needed about whether to focus on the firm’s net or gross assets at the firm level, and how to treat debt at the investor level.

94 This sort of rule has been used in Nordic countries, which have imposed this tax at the entity level. A downside, though, is that it passive investors bear a portion of it. Edward Kleinbard proposes an alternative approach, which would apply at the shareholder level. For other reasons, he favors taxing investors on the normal rate of return every year, and would add an additional amount for employee owners in some circumstances. Edward D. Kleinbard, The New Political Economy of Capital Income Taxation, at 94.

95 Section 531. See generally Homer L. Elliott, The Accumulated Earnings Tax and the Reasonable Needs of the Business: A Proposal, 12 Wm. & Mary L. Rev. 34 (1970) (“In practice, widely held public corporations have been exempted from the accumulated earnings tax.”).

96 See Bardahl Manufacturing Corp v. Commissioner, 24 TCM 1030 (1965), (permitting one full operating cycle, accounting for turnover in inventory, accounts receivable and accounts payable).

97 Peter Harris, Corporate Tax Law: Structure, Policy, and Practice (2013); ALI, supra, at 642 (noting that split rate system is indistinguishable from partial deduction for dividends).

98 More fundamental reforms also can counter the incentive to retain earnings. For instance, If shareholders are required to mark their stock to market, retained earnings are taxed currently, to the extent they increase the stock’s value. Imposing an interest charge on dividends, as a way to compensate for deferral, would have a similar effect.

99 If the rationale for not taxing tax exempts on corporate stock is that the corporation is paying tax, this rationale becomes less compelling as the corporate rate is cut.
equity derivatives, which are close substitutes for corporate stock. Arguably, interest income should be taxed as well, so there is no preferential treatment for debt, and a familiar hole in the tax base is plugged.\textsuperscript{100}

In setting the rate for this new tax, one possibility is to offset the corporate rate cut.\textsuperscript{101} For instance, if the corporate rate falls from 35% to 20%, this 15% of corporate tax can be replaced with an 18.75% shareholder tax.\textsuperscript{102} Politically, the easiest way to justify this new tax is that it replaces a tax they were already paying indirectly.

Yet in principle, the rate should not turn on what tax exempts already pay, but on a policy judgment about the right level. This assessment should account for social benefits of tax exempts, which vary for different types. A further question is whether exempting investment returns is the most effective way to support their missions. As noted above, the tax exemption arguably is less effective than the charitable deduction, which rewards nonprofits that attract donations instead of ones that invest a surplus successfully.

5. Foreigner Shareholders

Like tax exempts, foreign investors are taxed indirectly by the corporate tax, but (mostly) avoid the shareholder tax under current law. Any effort to rely more heavily on shareholder taxes must either forgo this revenue or change the treatment of foreign shareholders.

Changing the rules for foreigners is harder than for tax exempts for two reasons. First, a vast network of tax treaties would have to be renegotiated.\textsuperscript{103} In principle, the U.S. could override these treaties with legislation, as long as the intent to do so is clear.\textsuperscript{104} But the U.S. rarely overrides treaties,\textsuperscript{105} and has done so only to target abuses.\textsuperscript{106} Second, to collect this tax,

\textsuperscript{100} As noted above, corporate revenue funding interest payments to a tax exempt are never taxed under current law, since the corporate can deduct these payments. A further question is whether this tax should apply only to corporate debt, or to other types of debt as well (to avoid creating a tax preference for the debt of pass-through businesses, governments, etc.). Graetz & Warren, Integration, supra, at 29.

\textsuperscript{101} See Treasury Report, supra, at 79 (“This Report recommends, in general, retaining the current level of taxation of corporate equity income allocable to tax-exempt shareholders.”).

\textsuperscript{102} Assume a nonprofit owns a share of stock, which earns $100 per share. With a 35% rate, there would be $65 left over to distribute (tax-free) to the nonprofit. If the corporate tax is cut to 20%, so that $80 is distributed, an 18.75% tax on the nonprofit shareholder would bring the after-tax amount back to $60, since .1875*(80) = 15. The assumption here is that a 15% decline in the tax would lead to a 15% cut in corporate tax collections. But if the rate cut leads to less avoidance, a more modest tax on nonprofits would cover the difference. The rate also could be lower if it applies to interest income as well, since the base for this tax would be broader.

\textsuperscript{103} See U.S. Model Treaty, Art. 10 (interest); Art. 13 (gains).


\textsuperscript{105} For instance, when the U.S. enacted the branch profits tax in 1986, Section 163(j), which arguably was inconsistent with existing treaties, it deferred implementing the tax until treaties were renegotiated. Reuven Avi-Yonah, Tax Treaties and Overrides: A Qualified Defense of U.S. Practice, in Tax Treaties and U.S. Law 75-76 (Guglielmo Maisto ed.).
the U.S. would need information about the holdings of foreigner shareholders, as well as infrastructure to withhold the tax. Although this infrastructure is already in place for dividends, one would have to be created for capital gains, which is not straightforward.

Assuming a tax on foreign shareholders can be collected, would it enhance national welfare? This revenue would add to the U.S. GDP, while allowing a lower rate to govern U.S. taxpayers. But there are two reasons to tread carefully, as noted above. First, the U.S. benefits from attracting foreign investors, although a low tax is unlikely to deter them, given the unique appeal of the U.S. market. Second, if foreign governments respond by raising their taxes on U.S. investors, U.S. revenue would fall as U.S. taxpayers claim foreign tax credits. Therefore, taxing foreign shareholders enhances U.S. welfare only if the U.S. can still attract enough foreign investment and raise revenue on a net basis.

**D. Illustrative Examples of Incremental Reforms to Strengthen the Corporate Tax**

The last Section considered how to strengthen the shareholder tax, so it can fund a steeper corporate rate cut. Shoring up the corporate tax offers parallel advantages; if it can collect more revenue at a lower rate, the shareholder rate does not have to increase as much. There is an extensive literature on shoring up the corporate tax, so only a few illustrative examples are offered here, which preserve the broad contours of current law. Again, the goal is not to recommend any specific reform, but to highlight this interaction between reforms and rates.

1. **Interest**

While this Essay recommends using two taxes, debt is taxed only once under current law. Because firms can deduct interest, investors pay the only tax on debt-financed revenue. Using only one tax creates three problems. First, there is no built-in redundancy, so no tax is collected when lenders are foreign or tax exempt. Second, if the goal is to discourage tax planning, **cutting this tax can be as effective as eliminating it**. Indeed, the interest deduction is a counterproductive way to target planning, since a lot of corporate tax planning **depends on** this deduction. Third, since no revenue is collected at the corporate level, the investor tax on interest has to be correspondingly higher, and thus more distortive.

In response, some of this tax burden should be shifted to corporations. One way is to offer only a partial deduction for interest. Like travel and entertainment expenses, a portion of interest would be deductible (e.g., 50%). At the same time, Congress could offer an offsetting reduction in the lender’s tax. For instance, the same fraction of interest income could be excluded (e.g., 50%). If the same deduction and exclusion are also applied to dividends, the tax preference for debt would be eliminated, along with the familiar distortions it causes.

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106 Examples include earnings stripping, Section 7701(l), multi-party financing, Section 894(c), and reverse hybrids. In a sense, shifting the tax to shareholders is a reaction to abuse – in particular, the gaming of source and other rules by multinationals – but the solution is at some remove from the abuse.
Another alternative is to eliminate the interest deduction entirely, while cutting the corporate tax substantially. Broadening the base in this way can help fund the rate cut. At the same time, the treatment of interest and dividends could be conformed at the investor level. For example, if the target combined rate is 40%, the corporate rate could be 15% or 20% (with no interest deduction), while the rate for dividends and interest could be 29.5% or 25%.

Admittedly, a full interest deduction is needed for financial firms. Their business model is to make loans with borrowed money, earning a profit on the spread. To tax only this spread, an interest deduction is needed. Therefore, banks would have their own tax regime, like securities dealers and insurance companies under current law. The scope and details of this regime are beyond this Essay’s scope.

2. Income Shifting

In addition to the debt-equity distinction, another reform priority is to block income shifting. But this problem is excruciatingly difficult, as long as the U.S. continues to have a much higher corporate rate than other countries. In fact, the two leading options for international reform would exacerbate this problem, instead of solving it, by offering favorable treatment to foreign earnings: a territorial system exempts these earnings, while a minimum tax taxes them currently at a reduced rate. In theory, income shifting can be blocked with better source rules, which treat income as really earned in the U.S., even if taxpayers say otherwise. A virtue of reforming source rules is that they govern both U.S. and foreign firms, so tougher rules do not put U.S. firms at a disadvantage. But source rules are hard to improve for a familiar reason: conceptually, the source of income is often unclear. For instance, profit from a cell phone could be characterized as originating not only where its technology was invented, but also where it was manufactured or sold. Since source rules resolve this sort of issue in arbitrary ways, they are easy to manipulate. Likewise, when value is added in different jurisdictions, the allocation of profit among them is malleable. Multinationals include low-tax affiliates in the production of

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107 For example, if a firm borrows $100 million at 2%, and lends it at 3%, they will have $3 million of revenue and $1 million of profit. If the $3 million of revenue is taxed at 20%, the $600,000 tax is equivalent to a 60% tax on the $1 million profit.

108 If such a regime is developed, there are good reasons to conform the treatment of debt and equity. As Mark Roe and Michael Tröge have observed, eliminating the tax preference for debt – for instance, by offering a cost of capital allowance for equity – reduces the need for burdensome (and potentially ineffective) financial regulation. See Mark Roe & Michael Tröge, Taxing Banks Properly: The Next Regulatory Frontier

109 Rosanne Altshuler and Harry Grubert have proposed a minimum tax on all foreign income or just above market returns earned abroad. See Altshuler & Grubert, supra. The Obama Administration has also proposed a minimum tax. See General Explanations of the Administration’s Fiscal Year 2016 Revenue Proposals, Feb. 2015, https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

110 Michael Devereux, Issues in the Design of Taxes on Corporate Profits, Nat Tax J., at 725 (“There is simply no answer to the question: in which country is profit generated? All . . . elements of the company’s activities play a part in generating worldwide profit.”); Shaviro, Decoding the Corporate Tax, supra, at 107 (“source’ is an idea that verges on having ‘no there there’”).
process, and allocate disproportionate profits to them. This internal accounting has little significance – aside from cutting the U.S. tax bill – since the same shareholders own all these affiliates.

In response, a familiar alternative is to ignore this internal accounting. Instead, income can be allocated with a formula based on the location of the firm’s employees, property, and sales. Yet formulary apportionment also can be manipulated in familiar ways, for instance, by moving employees and capital to low-tax jurisdictions. At first blush, sales may seem harder to manipulate, since firms want to sell their products in the U.S. But firms can still access the U.S. market without (technically) having any U.S. sales: they can sell to an independent distributor in a low-tax jurisdiction, which then sells in the U.S. Even if these avoidance strategies are blocked, the formula still has to be coordinated with other jurisdictions to prevent double taxation. This is a tall order, since the OECD opposes formulary apportionment.

Instead of general changes in source rules, narrower reforms can target especially mobile deductions and income, such as interest expense and intellectual property income. For instance, firms should not be allowed to source interest deductions in the U.S. – where they offset high-tax income – if the loan generates income in low-tax jurisdictions. A formula can block this strategy, at least to an extent, by allocating interest based on each affiliate’s earnings, assets, and equity. Likewise, a tech firm’s profits derive largely from intellectual property. Instead of allowing firms to choose where to source these profits, a formula (or other rule) can allocate them based on the location of research or sales. While this sort of narrow reform can offer some relief, income shifting will continue to be a serious problem as long as the corporate rate in

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111 Current law accounts for each corporation separately, even if they are commonly owned. Although affiliates are supposed to pay the same “arm’s length” price as an unrelated party, this standard is famously malleable, especially if there are no comparable transactions with third parties.
114 OECD, Action Plan for Base Erosion and Profit Shifting 14 (2013) (“[T]here is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioural changes companies might adopt in response to the use of a formula would lead to investment decisions that are more efficient and tax-neutral than under a separate entity approach.”).
115 After all, if multinationals borrow in the U.S. to invest in low-tax jurisdictions, this matching of high-tax deductions with low-tax income subsidizes overseas investment. In response, a multinational’s total interest deductions could be capped at the total interest paid to external creditors (and not increased by interest paid to affiliates). Michael J. Graetz, A Multilateral Solution for the Income Tax Treatment of Interest Expenses, 62 Bulletin for International Taxation 486 (Nov. 2008); Mihir A. Desai & Dhammika Dharmapala, Interest Deductions in a Multijurisdictional World, Coase-Sandor Institute for Law & Econ. Working Paper No. 725 (Apr. 2015). In this spirit, the OECD recently released a discussion draft to explore various options. OECD, BEPS Action 4: Interest Deductions and Other Financial Payments (Dec. 2014), http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf.
116 Graetz & Doud, supra, at 426 (proposing to source intellectual property income based on the location of research or sales). In contrast, current law leaves multinationals considerable discretion to source IP income where they want. For instance, although the sale of IP for a fixed price is sourced in the seller’s resident country, the sale for a contingent price is generally sourced where the IP is used.
the U.S. remains uniquely high. Thus, income shifting is a compelling reason to cut the corporate rate, since other reforms are unlikely to solve this problem on their own.\textsuperscript{117}

3. Residence Shifting

In contrast, cutting the corporate rate is not the only effective way to eliminate the appeal of inversions. A territorial system accomplishes this goal by exempting a U.S. firm’s foreign earnings from U.S. tax. Like foreign firms, they pay only foreign tax on foreign operations, and can repatriate earnings tax free. In taking this step, Congress might not lose much revenue, since the effective rate on foreign earnings already is low.\textsuperscript{118} Yet an important downside, noted above, is that the incentive to shift income persists, and could even grow stronger.

However, if the U.S. continues to tax worldwide income, inversions will remain a challenge, unless Congress cuts the corporate rate substantially. Section 7874 blocks some inversions, while allowing others. Although the Treasury has introduced a series of regulations to tighten up the rules, a truly comprehensive ban on inversions would be overbroad. For instance, if the rule is “once a U.S. firm, always a U.S. firm,” it could deter mergers with foreign firms that are not tax-motivated, while also not stopping new businesses from organizing as foreign corporations.\textsuperscript{119} Given these difficulties, current law does not seek to stop all inversions, but to make them incrementally more costly so the trickle does not become a flood.\textsuperscript{120} This task is more daunting when the corporate rate is 35%, instead of 15% or 20%.

V. Implications for Fundamental Tax Reform

So far, this Essay has focused on incremental reform, but its core argument also applies to more ambitious reforms: Even when fundamental reforms seem economically comparable,

\textsuperscript{117} Toder and Viard estimate that a reduction in income shifting offsets a meaningful portion of the revenue loss from cutting the corporate rate: if the rate is cut to 15%, corporate tax revenue declines by $212 billion without any change in income shifting, but by only $167 billion once this change is taken into account. Toder & Viard, A Proposal, supra, at 42.
\textsuperscript{118} The Treasury department estimates a loss of $130 billion over ten years from switching to a territorial system, while the Joint Committee has estimated a loss of $76 billion in that window. The President’s Economic Recovery Advisory Board, Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation (August 2010); Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (March 2011). Other commentators estimate that the shift will involve no revenue losses, on the theory that firms are already using deferral and foreign tax credits to shelter earnings. See, e.g., Eric Drabkin, Kennith Serwin & Laura D’Andrea Tyson, Implications of a Switch to a Territorial Tax System in the United States: A Critical Comparison to the Current System, Berkeley Research Group Working Paper (Nov. 2013), http://www.thinkbrg.com/media/publication/391_BRG_Implications%20of%20Territorial%20Tax_Nov2013.pdf; see also Altshuler & Grubert, supra, at 31 (“If dividends are removed from taxable foreign income total US tax revenue increases by about one billion. The dividends taxable on the margin after credits are more than offset by the credits originating with dividends that currently spill over to other income.”).
\textsuperscript{119} Another strategy is to use the location of the headquarters, instead of the site of incorporation to define residence, on the theory that managers might be reluctant to move. Yet if they do move, this avoidance strategy becomes even more distortive, especially if there are positive externalities in having the headquarters (and highly skilled workers) in the U.S.
\textsuperscript{120} Daniel N. Shaviro, Fixing U.S. International Taxation (2014).
they can induce different planning strategies, which usually are easier to block with two taxes than one. This Part assesses the vulnerability of five fundamental reforms to the various planning strategies discussed above: first, the comprehensive business income tax; second, the “dual BEIT”; third, mark-to-market accounting or interest charges for shareholders; fourth, imputation; and fifth, corporate cash flow taxation. While a comprehensive analysis of these proposals would fill several volumes, the modest goal here is to show the relevance of this Essay’s analysis to fundamental reforms.

A. Comprehensive Business Income Tax

One option, which the Treasury called the “comprehensive business income tax” in its 1992 integration report, is to replace current corporate and shareholder taxes with a single entity-level tax. This proposal repeals the shareholder tax on distributions, and possibly also on capital gains.121 Similarly, businesses no longer deduct interest, and creditors do not include it.

This proposal offers four advantages. First, aligning the treatment of debt and equity eases an important distortion under current law. Second, since debt features prominently in many tax planning strategies, CBIT defangs these strategies. Third, a high entity-level tax eliminates the incentive to retain earnings or recharacterize salary as corporate income. Fourth, if capital gains are not taxed, shareholder lock-in ceases to be an issue.

Although these advantages are significant, they come at a steep cost. A high entity level tax breeds familiar distortions, including income and residence shifting and corporate lock-in.122 CBIT forgoes the advantages of built-in redundancy by collecting tax only once. Moreover, eliminating the shareholder tax, instead of merely cutting it, goes farther than necessary to ease shareholder level distortions.

B. Dual BEIT

The main advantage of CBIT – taxing debt and equity the same way – can be accomplished not only by disallowing the deduction for debt, as CBIT does, but also by extending this deduction to equity. For instance, Edward Kleinbard proposes a reform, known as the “DUAL BEIT,” which taxes stock with a regime modeled on the original issue discount rules. Every year, firms deduct (and investors include) an amount based on their cost of capital, regardless of how much cash is paid out or whether firms issue debt or equity.123

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121 Treasury discusses different ways to treat capital gains, without specifying a particular approach. For instance, to avoid taxing capital gains from retained earnings, Treasury considers using a dividend reinvestment plan or relying on a purchaser’s built-in capital loss to offset a seller’s capital gain. Treasury Report, supra, at 83-84.
122 See supra Part II (describing planning strategies if the shareholder rate is zero and all tax is collected from the corporation).
123 For example, if a firm issues $5 billion of stock and $5 billion of debt, pays no current interest or dividends, and has a cost of capital of 6%, it deducts (and investors include) $600 million each year.
Like current law’s treatment of interest, this approach has an important disadvantage: since the assumed yield is taxed only at the shareholder level, not at the corporate level, there is no built-in redundancy. As a result, when investors are foreign or tax exempt, no tax is collected.  

In addition to the investor-level tax, the Dual BEIT also has an entity level tax, but its use of two taxes is not consistent with the approach recommended in this Essay. The difference is that Professor Kleinbard divides a business’s return into two components – normal returns and above-normal returns – and uses a separate tax for each: investors pay the only tax on normal returns, while the entity pays the only tax on above-normal returns. Therefore, the Dual BEIT taxes each component of the return once, and only once. In contrast, this Essay recommends collecting some tax at both levels for both types of returns: normal returns should be taxed at both the entity and investor level, as would above-normal returns. In a sense, Professor Kleinbard is slicing a business’s returns vertically (so each type of return is taxed by different taxes), while this Essay recommends slicing returns horizontally (so each type of returns is taxed by both taxes). So even though the Dual BEIT deploys two taxes, the division of labor between them is quite different.

Instead of relying on built-in redundancy and low rates to constrain planning, Professor Kleinbard uses more sophisticated rules to address various distortions. For example, he shows that taxing shareholders based on an assumed yield can mitigate lock-in, and also can reduce an employee-owner’s incentive to recharacterize salary as investment return. While these reforms are promising, they could still be used in a system that taxes the entire return at both levels, and thus offers built-in redundancy.

C. Mark-to-Market Accounting or Interest Charges

Another option is to use mark to market accounting to strengthen the shareholder tax, as Eric Toder, Alan Viard, and others have proposed. Taxing gains annually – even when shareholders do not sell – offers two important advantages. First, it mitigates shareholder lock-in. Delaying a sale no longer defers capital gains tax, or allows shareholders to avoid this tax entirely by contributing shares to charity or leaving them as a bequest.

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124 Professor Kleinbard regrets this result in the case of tax exempts (and would prefer to tax them on assumed returns, if Congress has the political will to do so), see Kleinbard, supra at 89, but is untroubled by this result for foreigners – indeed, he invokes this as an advantage, see Kleinbard, supra, at 39, arguing that the U.S. will be well positioned to attract foreign capital.

125 For example, investors could be taxed initially on the assumed yield, but a subsequent adjustment could be added at realization, as in the contingent debt regime under current law. See Treas. Reg. 1.1275-4. To ensure that an entity level tax is also collected, firms could be allowed to deduct only a portion of their cost of capital. For instance, the firm could deduct half of its assumed yield, as well as half of any additional amounts it pays in the subsequent adjustment. Shareholders would include both of these amounts, and the corporate and shareholder rates would be coordinated to yield the appropriate combined tax rate.

126 Toder & Viard, Major Surgery, supra; Toder & Viard, A Proposal, supra; Dodge, supra; Bankman, supra; Knoll, supra.
A second advantage, which is less familiar, is that a mark to market tax on shareholders counters a firm’s tax incentive to retain earnings. Without this reform, if the corporate rate is lower than the personal rate, firms are more tax efficient investors than shareholders, since profits inside the firm are taxed at the (lower) corporate tax, while profits outside the firm are taxed at the (higher) personal tax. Eventually, profits inside the firm also are taxed at the shareholder rate, but this tax is deferred under current law. In contrast, this deferral is eliminated under mark to market accounting, so investments inside the firm are taxed at both the corporate and shareholder rate. As a result, these investments lose their tax advantage over investments outside the corporation.127

Yet notwithstanding these benefits, a mark to market tax poses familiar valuation and liquidity challenges, which are manageable only for publicly-traded assets.128 Since this reform cannot be used for private businesses, collectibles, or real estate, it creates a tax preference for these investments. Investors may shy away from publicly-traded assets, and owners of private firms may hesitate to go public.129

To avoid this sort of distortion, the same timing rule has to apply to all investments. Since a mark-to-market rule cannot do so, a different remedy is needed for shareholder lock-in and trapped earnings. As an alternative, Harry Grubert and Rosanne Altshuler propose to delay the shareholder tax until stock is sold, as under current law, but to add an interest charge to compensate the government for this delay.130 Yet their proposal is less accurate than a mark to market rule. Instead of measuring the return each year, it uses (imperfect) assumptions to allocate gains across the relevant years, creating planning opportunities when these assumptions are inaccurate.131 This is all the more true when a taxpayer’s bracket changes during these years.132

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127 For example, assume the corporate rate is 0%, shareholder and personal rates are 40%, and a 10% pretax return is available both inside and outside the firm. Under realization accounting, a $1 million investment grows faster if earnings are retained for three years than if they are distributed and invested in a bond: the profit is $198,600, instead of $191,016. But if the stock is marked to market, the after-tax profit shrinks to $191,016 – the same as with the immediate distribution – as long as retained earnings cause a dollar-for-dollar increase in the stock price, and shareholders sell a portion of their stock each year to fund the mark-to-market tax.
128 If annual payments are too onerous, even for publicly traded shares, the tax can apply to only a portion of gains each year. See, e.g., Toder & Viard, A Proposal, supra (proposing a smoothing mechanism that taxes 20% of gains each year).
129 In response, Toder & Viard propose to tax pre-IPO gains at a reduced rate, and to allow this tax to be paid over ten years. Toder & Viard, A Proposal, supra, at 20.
130 Grubert & Altshuler, Shifting the Burden, supra [hereinafter “Shifting the Burden”].
131 For example, if the asset immediately appreciates, taxpayers have the incentive to keep the stock – a form of lock-in – so some of this gain is allocated to later years.
132 See, e.g., Toder & Viard, A Proposal, at 64 (“If the tax rate that prevails in the year of realization is assumed to apply throughout the holding period, the incentive to realize in low tax years may actually be stronger with the deferral charge than under a conventional realization-based tax. On the other hand, recomputing tax liabilities for each year of the holding period to obtain the correct tax rates is clearly impractical.”).
In addition to creating new distortions, mark to market accounting and interest charges share two other limitations as well. First, unlike corporate taxes, they do not reach tax exempts and (mostly) miss foreign shareholders as well. Second, both proposals are likely to encounter political opposition. Rules that impose interest charges under current law are unpopular, as is taxing gains that could prove temporary. 133 While these proposals may be easier to sell if applied only to high-net worth shareholders, as David Miller has proposed, 134 this limit would introduce another boundary for taxpayers to game.

Therefore, in shoring up the shareholder tax with a mark to market rule or interest charges, the goal should not be to eliminate the corporate tax – even though this is what many commentators have suggested – but to cut it. 135 There are two reasons for this. First, if the corporate tax is repealed, tax exempts would escape tax entirely, and foreigners would (mostly) do so as well, unless the treatment of these taxpayers changes. 136 Second, collecting some tax from corporations relieves pressure on the shareholder tax. The shareholder rate does not have to increase as much, so shareholder distortions are not as severe (e.g., at the boundary between mark to market and realization). 137 Therefore, even when fundamental reforms strengthen the shareholder tax, two taxes still have advantages over one.

D. Imputation

Still another reform option, an imputation system, adheres to this Essay’s core recommendation by collecting tax from both corporations and shareholders. The corporation pays the first tax, and shareholders pay a second tax at their individual marginal rate. Since shareholders can claim a credit for tax already paid by the corporation, the corporate tax functions as a withholding tax. For instance, if the corporate tax is 35%, a shareholder whose

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133 For instance, taxpayers shy away from investing in PFICs.
134 We can also consider imposing mark to market accounting only on taxpayers with sufficiently high incomes, as David Miller has proposed, on the theory that they have the sophistication and liquidity to be taxed in this way. See David S. Miller, A Progressive System of Mark-to-Market Taxation, 121 Tax Notes 213 (Oct. 13, 2008).
135 For example, Toder and Viard proposed in 2014 to use mark to market accounting to eliminate the corporate tax, Toder & Viard, Major Surgery Needed, supra. In so doing, they followed Victor Thuronyi and David Shakow. See Thuronyi, supra; Shakow, supra. In contrast, Grubert & Alshuler proposed to keep the corporate tax, but at a 15% rate. Grubert & Alshuler, supra. Notably, in a revised version of the proposal in 2016, Toder and Viard opted to keep a 15% corporate tax. See Toder & Viard, A Proposal, supra.
136 One way to avoid these gaps is to collect this mark-to-market tax from the corporation, instead of shareholders. Dan Halperin has suggested imposing a tax on publicly-traded corporation, which would be based on changes in their market value in the relevant tax year. Professor Halperin considers pairing this tax with an imputation system, so shareholders can claim a credit for tax paid by the corporation. As long as this credit is not available to tax exempts and foreigners, tax is still collected (indirectly) from them. See Daniel I. Halperin, Saving the Income Tax: An Agenda for Research, 24 Ohio N.U.L. Rev. 493 (1998).
137 In proposing a mark to market shareholder tax to replace the corporate tax, Joseph Dodge offers a different reason to retain a second tax: “offer[ing] a vehicle to deliver modest tax preferences.” Dodge, supra, at 308.
marginal rate is 40% pays an additional 5% of tax, while a shareholder whose marginal rate is 20% receives a 15% refund.\(^\text{138}\)

The combined effect is to tax business profits at a shareholder’s individual marginal rate. Since a shareholder’s bracket depends on her other income, using this rate advances distributional goals. Another advantage is that this rate also is used for pass-through entities, as well as for corporate debt. Therefore, as Alvin Warren has emphasized, imputation systems conform the rates for corporations and pass-through businesses, as well as for corporate debt and equity.\(^\text{139}\)

How vulnerable are imputation systems to other planning strategies considered in this Essay? Overall, this reform holds up fairly well. A key reason is that it relies on two points of collection, instead of one. As a result, the corporate tax backstops the shareholder tax. For example, the corporate tax can still reach foreign and tax exempt shareholders indirectly, as long as they cannot claim a credit for this corporate tax.\(^\text{140}\) Likewise, the shareholder tax can still backstop the corporate tax. For instance, income that is shifted abroad can still be taxed (eventually) at the shareholder level (when shareholders receive a dividend or sell stock); if no corporate tax was paid, shareholders cannot claim a credit.

Arguably, corporate and shareholder taxes backstop each other more effectively in imputation systems than under current law, since these taxes are better coordinated. When a corporation cuts its tax bill, it reduces the credit available to shareholders. As a result, income shifting and other corporate planning becomes less attractive, since it (potentially) increases the shareholder tax.\(^\text{141}\) Some studies suggest that corporations engage in less planning under an imputation system (e.g., in Australia), and ramp up planning when imputation is repealed (e.g., in Europe).\(^\text{142}\)

\(^{138}\) For instance, if a corporation with earnings of $10 per share pays $3.50 of corporate tax and a dividend of $6.50 per share, its shareholders pay tax on the full $10 of earnings per share – instead of on the $6.50 of cash they receive – while also claiming a $3.50 credit for the corporate tax already paid. Under this approach, shareholders in the 40% bracket owe a total of $4.00 per share so – in addition to the $3.50 credit – they pay $.50 per share. In contrast, shareholders in the 20% bracket owe only $2.00, and thus receive a $1.50 per share refund.

\(^{139}\) See ALI, supra.

\(^{140}\) Notably, European systems used to rely on imputation, but stopped using them when the European Court of Justice ruled that these credits had to be equally available to foreign investors from other European jurisdictions.

\(^{141}\) See Richard Vann, Corporate Tax Reform in Australia: Lucky Escape for Lucky Country? 1 British Tax Review 59 (2013); Graetz & Warren, Integration of Corporate and Shareholder Taxes, supra (“Limiting shareholder credits to the amount of U.S. corporate taxes paid on income distributed as dividends has the advantage of reducing incentives of dividend-paying U.S. corporations to shift their income from the U.S. to lower tax foreign jurisdiction.”); Dan Amiram, Andrew M. Bauer & Margaret Frank, Tax Avoidance at Public Corporations Driven by Shareholder Demand: Evidence from Changes in Shareholder Dividend Tax Policy (July 29, 2014) (“Corporate tax avoidance in an imputation system simply shifts tax payments from the corporation to its shareholders and as a result corporate tax avoidance does not increase the shareholders’ after-tax cash flows.”).

\(^{142}\) See, e.g., Catherine Ikin & Alfred Tran, Corporate Tax Strategy in the Australian Dividend Imputation System, 28 Australian Tax Forum 523 (2014) (finding that Australian managers whose firms pay “franked” dividends are
Yet this effect should not be overstated, since corporations still have three reasons to cut their tax bills under imputation systems. First, these efforts still help shareholders who cannot claim a credit for corporate tax, and thus do not face higher shareholder taxes when the corporation cuts its tax bill. Since tax exempt and foreign shareholders are likely to be in this position, they will prefer firms with low effective tax rates. Indeed, activist pension funds and large foreign shareholders will lobby firms to ramp up corporate tax planning.

Second, taxable shareholders also have reason to join this chorus. Even though cutting the corporate tax bill reduces imputation credits, these credits are not always needed. Shareholders have other ways to avoid shareholder tax, such as deferring sales or contributing appreciated stock to charity. When these strategies are available, shareholders do not need imputation credits, and are happy for the firm to cut its corporate tax bill. After all, even if taxable shareholders do not benefit when the corporation’s effective rate is lower than their (effective) shareholder rate, they do not want the corporation to have a higher effective rate. The corporate tax functions as a withholding tax, and shareholders do not want the firm to withhold tax that they may never owe. For instance, shareholders are taxed currently on dividends, but not on retained earnings (as long as they do not sell shares). So shareholders need imputation credits only for dividends, and want the firm to minimize the corporate tax on retained earnings. More generally, an imputation system preserves familiar gaps in corporate and shareholder taxes. Although it weakens incentives to exploit these gaps in some cases, it maintains them in others.

Third, even when shareholders do not benefit from corporate tax planning, managers still have agency cost reasons to invest in it: reporting higher (after-tax) earnings could inflate their equity compensation or bonuses. This incentive is especially pronounced in the U.S., where equity compensation is pervasive. So even though evidence suggests that imputation systems have discouraged corporate tax planning in Europe and Australia, these jurisdictions use much less equity compensation, so the U.S. experience could turn out to be different.

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less likely to defer corporate income in advance of an announced reduction in the corporate rate); Amiram, Bauer & Frank, supra (“Using a sample of 70,518 firm-year observations from 23 countries during 1994 to 2008, we estimate that the elimination of an imputation system increases corporate tax avoidance by as much as 10% of pre-tax corporate income.”). Somewhat unexpectedly, this effect is larger for firms with domestic income than for multinationals. Notably, this is not true of versions of imputation systems that provide a shareholder credit even when the corporation pays no tax. In these “partial imputation” systems, planning does not reduce the credit, and thus continues to be appealing. Amiram, Bauer & Frank, supra.

143 Even a modest corporate tax bill should be sufficient to provide imputation credits for dividends. Firms that fall short can respond not only by paying more corporate tax, but also by cutting dividends. Grubert & Altshuler, Shifting the Burden, supra.

144 A response to this limitation is to pair imputation with other reforms. See, e.g., Toder & Viard, A Proposal, supra (suggesting both mark to market accounting paired with an imputation system).

145 See Ikin & Tran, supra (Australia); Amiram, Bauer & Frank, supra, at Table 1 (countries in there sample that eliminated imputation were all in Europe: France, Germany, Finland, Italy, Norway, and Spain).
Therefore, it is too optimistic to expect imputation, on its own, to shut down the various planning strategies in this Essay. But imputation still is a valuable step, especially if paired with a lower corporate rate, as well as other reforms to shore up the corporate and shareholder tax. A key advantage of imputation is that – like current law, and unlike some other proposals – it relies on two taxes, instead of one. Imputation also has the further advantage of coordinating these taxes more effectively than current law.

**E. Cash Flow Corporate Taxation**

A final alternative, a “cash flow corporate tax,” is a type of consumption tax. Its defining feature is that capital investments are deducted currently, instead of capitalized. Therefore, this reform avoids the challenge of calibrating depreciation to reflect economic reality (or encourage investment). As in a 401(k) plan, the deduction of investments spares the “normal” (or market-wide) return on capital from tax. Since this return is not taxed anyway, tax planning is not needed to shield it from tax.

But this reform is still supposed to tax above-market returns (for instance, when intellectual property creates market power), as well as disguised labor income (when owners are paid a below-market salary). Therefore, taxpayers still have an incentive to shelter these returns from tax. Although their interest in tax planning is muted, it does not disappear.

Even so, the available planning opportunities depend on how the tax is structured.\(^{146}\) A key variable is whether the tax covers economic value *produced* or *consumed* in the U.S. If the tax applies only when value is *produced* here (an “origin-based” tax), firms have an incentive to shift income overseas. Admittedly, there is no need to shift normal returns, which are exempt anyway, but shifting above-market returns is advantageous. This is a significant limitation of the “X-Tax,”\(^{147}\) an origin-based tax endorsed by David Bradford, Robert Carroll and Alan Viard. Although they acknowledge this problem,\(^{148}\) they rely on current law’s (porous) responses, such

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\(^{146}\) For example, David Weisbach has described planning opportunities that arise when consumption taxes are “open,” which means one counterparty can claim a deduction even if the other counterparty does not have an inclusion. This is especially true for taxes that are “R-based,” which means they disregard financial transactions. As an example, Professor Weisbach shows that taxpayers can enter into derivative contracts and then settle them by either delivering the underlying property or paying cash. An R-based system would account for the delivery of property, but not the cash. As a result, taxpayers can deliver property if they have a loss, and settle in cash if they have a gain. See, e.g., David Weisbach, *Ironing Out the Flat Tax*, 52 Stan. L. Rev. 599 (2000).

\(^{147}\) The X-tax is an origin-based cash flow corporate tax, which uses a flat rate and offers a deduction for wages. A separate tax on wages, using progressive rates, is collected from workers.

\(^{148}\) Robert Carroll & Alan D. Viard, *Progressive Consumption Tax: The X-Tax Revisited* (2012) 113 (“In cases in which the correct market value cannot be objectively determined, as will often be true in cases involving abnormal returns, the origin-based tax offers an incentive to relocate investment abroad and to misstate prices to prevent the proper amount of tax from being collected in the United States.”).
as transfer pricing and a tax on repatriated earnings.\textsuperscript{149} Another prominent origin-based proposal, Hall and Rabushka’s flat tax, shares this limitation.\textsuperscript{150}

In contrast, there is no incentive to shift income when a tax applies to goods and services consumed here, regardless of where they are produced (destination-based taxes). Even if the product is developed abroad, this tax still reaches above-market returns from U.S. sales.\textsuperscript{151} This advantage motivates Alan Auerbach to recommend a destination-based cash-flow corporate tax,\textsuperscript{152} and Michael Graetz to favor a destination-based value added tax (“VAT”).

While immunity from income shifting is a notable advantage – and some commentators argue that destination-based consumption taxes solve all problems with the corporate tax under current law\textsuperscript{153} – these taxes still have familiar limitations. For example, international trade rules may block variations that tax wages separately with progressive rates (such as cash flow corporate taxes, but not VATs).\textsuperscript{154} Another limitation is that (by design) destination-based taxes do not reach exports. As a result, they collect less revenue from debtor nations like the U.S., which have to run trade surpluses in the future to compensate for past trade deficits, and thus will have more (untaxed) exports than (taxed) imports.\textsuperscript{155} A further concern is that destination-based taxes can trigger a one-time transfer from the U.S. to its trading partners, which could be quite large.\textsuperscript{156}

Given these distortions and leaks, relying solely on one of these new taxes – without a second tax as a backstop – can be problematic. For instance, an origin-based corporate cash flow tax would not reach above-normal returns that are shifted abroad, but a second tax (e.g., on a shareholder’s capital gains and dividends) would reach them. Likewise, a destination-based cash

\textsuperscript{149}Carroll & Viard, supra, at 114 (“The Bradford proposal calls for U.S. firms and households dealing with foreign related parties to include all inflows both real and financial, from the related party, and to deduct all outflows, both real and financial. . . . [I]f the American gets a $7000,000 price on the $1 million idea and therefore avoids tax on $300,000 of export receipt, he will be taxed on an additional $300,000 (in expected present discounted value) of dividend inflows from his wholly owned firm.”)
\textsuperscript{150}Weisbach, Ironing Out the Flat Tax, supra.
\textsuperscript{151}Carroll & Viard, supra, at 112 (“[B]order adjustment eliminates transfer pricing problems among firms.”)
\textsuperscript{152}Alan J. Auerbach, A Modern Corporate Tax, Hamilton Project (2010).
\textsuperscript{153}Dhammika Dharmapala, The Economics of Corporate and Business Tax Reform 25 (2016) (“The DBCFT [Destination-Based Cash Flow Tax] would solve virtually all distortions from the corporate tax.”).
\textsuperscript{154}The problem arises because the rebate that firms collect on exports would be based on the corporate rate, but some of the tax being rebated would have been paid by workers at a lower rate. If the rebate exceeds the tax that was paid, it could be characterized as an export subsidy. Stephen E. Shay & Victoria P. Summers, Selected International Aspects of Fundamental Tax Reform Proposals 51 U. Miami L. Rev. 1029 (1997).
\textsuperscript{155}Carroll & Viard, supra, at 110 (because “today’s trade deficits must eventually be followed by trade surpluses,” a border-adjusted tax would raise less revenue; estimating the difference to be $.97 trillion).
\textsuperscript{156}According to Carroll and Viard, his transition effect arises because the tax applies to Americans who fund imports by liquidating foreign assets, but not to foreigners who finance exports by liquidating U.S. assets. This imbalance should reduce the real value of Americans’ foreign holdings and increase the real value of foreigners’ U.S. holdings, causing a one-time transfer from Americans to foreigners, which Carroll and Viard call “a gift to the world, rather than a gain for the United States.” Carroll & Viard, supra, at 110-11 (estimate that this increases the tax burden on Americans by $7.88 trillion and reduces tax burden on foreigners by 8.85 trillion in present value terms).
flow tax would not reach exports, but a second (e.g., shareholder) tax would do so. In this spirit, Professor Auerbach pairs his destination-based corporate tax with the current personal income tax, while Professor Graetz proposes to use three taxes: a destination-based VAT; a corporate income tax (at a much lower rate); and a personal income tax (for high earners only).

Admittedly, coordinating two taxes can be a challenge. If some activity is subject to only one of them, the combined rate varies for different activity. For instance, if an origin-based cash-flow tax of 20% is paired with a shareholder tax of 25%, only the shareholder tax reaches above-normal returns that are shifted abroad. As a result, the combined rate for this foreign income (25%) is lower than for U.S. source income (40%). This sort of inconsistency can be conceptually unsatisfying, and also is likely to induce distortions. Yet these problems are even worse if the origin-based cash flow tax stands alone, without a shareholder tax as a backstop. Since foreign income is not taxed at all, the disparity is 40%, instead of 15%. So even though the second tax is not a complete solution, it is still helpful.

VI. Conclusion

To sum up, then, a central challenge in taxing corporate profits is that corporate and shareholder taxes prompt different planning strategies. By cutting one tax, and funding it with an offsetting increase in the other, we mitigate some distortions and leaks, while exacerbating others. To deal with these dualing distortions, this Essay recommends keeping both a corporate tax and a shareholder tax. If taxpayers are able to avoid one, the other can still collect some tax. Moreover, to deter planning that targets only one of these taxes, repealing this tax is farther than we have to go. Cutting the rate can also accomplish this goal, while generating at least some revenue.

We should coordinate the two taxes so that, in combination, they equal (or approximate) the rate on noncorporate businesses. We also should shift the balance of rates under current law, so the corporate rate is lower than the shareholder rate. In addition, we should consider targeted reforms to shore up both taxes, so the combined rate that actually is collected comes closer to the one on the books.

Although this incremental reform strategy would improve current law significantly, it still leaves some problems unsolved. For instance, shareholder lock-in remains a concern, unless we charge interest on tax deferral or adopt mark-to-market accounting for publicly-traded stock (and derivatives based on it). Likewise, since the coordination between corporate and shareholder rates is likely to be rough, an imputation system can improve it. These more ambitious reforms are appealing, if we can muster the will to enact them. But even with more fundamental reforms, there are significant advantages in relying on two taxes, instead of on one alone.