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CBIT 2.0
Executive Summary

David Hasen*

Introduction

This Executive Summary summarizes a proposal (the “Proposal”) described in a Special Report, titled “CBIT 2.0,” that is scheduled to appear on Aug. 26, 2013, in the trade publication Tax Notes (the “Special Report”). The Proposal advocates adoption of an updated version of the comprehensive business income tax, or CBIT, in place of current taxes on business income.

The Treasury Department first proposed the CBIT in 1992.¹ In Treasury’s version, which it developed as part of its report on the integration of the corporate and individual tax bases (the “Treasury Report”), the CBIT would be levied at a flat, 31 percent rate, which equaled the then-maximum rate on individual income. Taxes on distributions would be eliminated, including on interest payments from CBIT-covered entities. Correlatively, interest paid by CBIT entities would generally be non-deductible. The CBIT would apply not only to corporations, but also to partnerships and sole proprietorships.

When the Treasury Report was published, the maximum rate on corporate income was 34 percent. By pegging the CBIT rate to the then-maximum individual rate and eliminating taxes on distributions, tax-motivated decisions to retain or distribute entity-level earnings would be eliminated. By treating debt and equity equally, the tax bias in favor of debt financing would be eliminated. And by subjecting all business income to the same, single level of tax, the tax bias against conducting business in the corporate form would be eliminated. In Treasury’s calculations, these benefits, together with the repeal of most business tax expenditures, would result in a tax that was approximately revenue-neutral when compared with existing law, despite the loss of tax revenue from dividend distributions and from the sale or exchange of interests in CBIT entities, and despite the reduction in the top corporate rate from 34 to 31 percent.

Since 1992, a number of changes to the business environment have made the CBIT as originally proposed unworkable. In particular, there is substantial pressure for the U.S. to make its business tax rate more competitive with the rates in effect in other OECD countries. Therefore, it is not feasible to peg the CBIT rate at the maximum individual rate. Additionally, known fiscal commitments would make it difficult to forgo all taxes on distributions even if entity-level rates did not drop. Finally, top individual rates have moved substantially above top corporate rates, meaning that even in the absence of a drop in rates at the entity level, a substantial tax incentive for earnings retention has arisen.

The Proposal represents an effort to address these developments while preserving the principal and quite substantial benefits the CBIT would confer. The main

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¹ “Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Once,” Jan. 1992. The Report is available at <http://www.treasury.gov/resource-center/tax-policy/Pages/integration-paper.aspx#summary>.

modification is the addition of a tax on distributions and capital gains for high earners. However, unlike the business income tax itself, which would remain a tax on income, the distribution tax would operate as a cash-flow consumption tax on distributees. It would be implemented by means of a tax on distributions to high earners, offset by a corresponding deduction for distributions timely reinvested.

Such a dual-track system would address many of the problems that have long beset the taxation of business income, yet it would have comparatively minor structural effects on other areas of the tax law, including in particular the taxation of cross-border investment, whether of U.S. persons abroad or of non-U.S. persons in U.S.-based activities. In addition to the efficiencies described above, it would result in substantial simplification, permitting the repeal of much of Subchapter C and virtually all of Subchapters K and S. Its principal detriment (from the point of view, at least, of a normative income tax) would be the conversion of part of the income tax on high earners to a consumption tax. As explained below and argued in greater detail in the Special Report, the objections to a shift to explicit consumption taxation solely for such distributions do not appear to be persuasive.

Part I of this Executive Summary lays out the Proposal, Part II discusses incentive effects, Part III touches briefly on international aspects, Part IV examines revenue effects, and Part V replies to anticipated objections.

I. The Proposal

The principal reform recommendations are as follows:

1. Replace the tax on corporate income with a flat tax on net business income, imposed without regard to the form in which the business is conducted. Sole proprietorships would be included. Thirty percent is almost certainly at least revenue-neutral and likely revenue-positive when compared against 2011 law (the most recent year for which revenue figures are available).
2. Eliminate the deduction for interest paid by businesses subject to CBIT.
3. Eliminate targeted business tax incentives and preferences such as accelerated depreciation, deductions for start-up costs and other business tax expenditures.
4. Replace the tax on interest and dividends received from CBIT entities with a grossed-up tax on distributions (dividends or interest) to individuals, but only to the extent their marginal tax bracket exceeds the CBIT rate. Distributions to distributees in lower brackets would be tax-free. The gross-up would ensure that entity-level income is taxed at the full marginal rate applicable to individuals in marginal brackets above the CBIT rate (disregarding the time-value benefit of delays in personal spending). Gross-up rates of 7.1 and 13.7 percent correspond to overall rates of 35 and 39.6 percent.
5. Apply the same grossed-up taxes on high earners on gains from the sale or exchange of CBIT equity interests or debt instruments issued by CBIT entities.
6. Provide an above-the-line deduction to individuals to the extent amounts received subject to the tax on distributions or gains from sale or exchange are reinvested within one year of distribution (or within some other specified period).
7. Repeal the withholding taxes on interest and dividends paid to non-U.S. persons.

8. Adopt, in some cases in modified form, the other recommendations made in the Treasury Report necessary to implement the CBIT, including in particular the transition rules.²

If adopted as proposed, the overall effect would be to tax business income at a rate that is roughly comparable to that imposed by many OECD countries. (As of 2012, nominal national corporate tax rates in OECD countries ranged from 8.5 percent (Switzerland) to 35 percent (U.S.).³) The denial of the deduction for interest expense would make the tax law neutral between debt and equity as a choice for business finance. Persons in marginal tax brackets not above the entity bracket would not be subject to direct tax on business earnings: Because creditors and equity holders are taxed on interest and dividends, respectively, only to the extent their marginal rate exceeds the entity rate, the CBIT operates as a withholding tax and not in addition to the regular individual income tax. Similarly, reporting allocable interest expense to non-U.S. creditors provides an easy mechanism by which foreign jurisdictions that tax on a residence basis can treat the denial of the interest deduction as a creditable withholding tax. The imposition of a surtax on distributions is designed to preserve much of the progressivity of the income tax and to provide for adequate revenue while maintaining international competitiveness. Permitting a deduction for distributions otherwise subject to the surtax on amounts timely reinvested converts the tax on distributions (but not the entity-level tax) to a consumption tax for amounts received to the extent the distributee's marginal rate exceeds the CBIT rate. The purpose of this reform is to discourage tax-motivated entity-level retention of earnings.

II. Incentive Effects

The principal advantages of the CBIT as originally proposed were that it eliminated the tax biases against the corporate form and in favor of debt finance, and that it provided for dramatic simplification by permitting the repeal of subchapters S and K and of the rules on distributions from C corporations. In addition, if Congress were to follow Treasury's companion recommendation that business tax expenditures be dramatically curtailed, efficiencies in business activity and further simplification would be realized.

The Proposal preserves these benefits (except for the full simplification of distribution taxes) and, in addition, addresses the problem of tax-motivated earnings retention. This problem has resurfaced as top marginal rates have recently moved substantially above top corporate rates and is likely to become worse in the absence of explicit relief, because of the pressure to lower entity-level rates. By providing for consumption tax treatment on taxes that would apply to distributions, the tax incentive to retain earnings is largely eliminated. In contrast to the original CBIT, the rules for distributions cannot be eliminated under the Proposal, because of the need to retain a tax on distributions to higher-bracket individuals.

III. International Aspects

The Proposal generally follows Treasury's recommendation to separate business tax reform from other areas of tax reform, to the extent possible. Accordingly, no

² See generally Treasury Report, 43-60.

³ OECD, "2012 Taxation of Corporate and Capital Income," col. 1.: "Central government corporate income tax rate."

recommendations are offered regarding whether or how the U.S. international tax rules should be amended, except to the extent necessary to ensure that the basic objectives of the Proposal are realized. However, because one of the Proposal's objectives is to enable Congress to maintain a competitive tax rate on foreign-source business income of U.S. persons, the Proposal departs from Treasury's recommendation to leave intact the double-tax treatment of foreign-source income of U.S. persons (albeit with an ordering rule, under the original CBIT, on distributions that would have ameliorated the double tax to some extent⁴). Instead, foreign income taxes paid would be treated as creditable for all CBIT purposes, assuming the existing rules on foreign-source income remain largely unchanged (or become more residence-based than they currently are). Alternatively, if the U.S. system becomes more territorial in nature, the Proposal advocates treating foreign taxes paid as a full substitute for the CBIT, assuming the amount of foreign taxes paid otherwise satisfies the requirements for exemption from U.S. tax at the entity level.

Other changes to the international tax rules that Treasury recommended are carried over. These include the repeal of the withholding tax on dividend and non-portfolio interest payments to non-U.S. persons and the extension of the availability of the indirect, or deemed, foreign tax credit to all CBIT entities otherwise meeting the ownership requirements for the credit.

IV. Revenue Effects

The Special Report does not provide a revenue estimate. It does, however, attempt to show that under conservative assumptions, a CBIT rate of 30 percent on a clean business tax base with distribution taxes of 7.1 and 13.7 percent on taxpayers currently in, respectively, the 35 and 39.6 percent brackets (subject to deduction if timely reinvested) is almost certainly revenue-neutral when compared against a baseline of 2011 law and likely revenue-positive against that baseline. The conservative assumptions include:

- that Congress provides relief to lower-bracket distributees of dividends and interest through a credit for the CBIT paid;
- that the elimination of both interest inclusions and interest deductions is revenue-neutral rather than revenue-positive, despite the substantial tax incentive for borrowing; and
- that Congress takes no steps to ameliorate base erosion and profit-shifting activities of U.S. multinationals.

If these assumptions were relaxed, a revenue-neutral rate in the mid-20 percent range may be attainable.⁵

V. Reply to Objections

This section briefly addresses two anticipated objections to the Proposal: first, that the adoption of consumption-tax treatment on distributions to high earners is inconsistent with the U.S. income tax, and second, that the Proposal will be regressive with respect to income because it will tax all business income at a flat rate of

⁴ See Treasury Report, at 55.

⁵ Revenue neutrality is assumed solely for purposes of determining the feasibility of the Proposal, not for purposes of determining the proper CBIT and distribution rates. In light of known and expected future spending commitments, revenue increases will almost certainly be necessary.

approximately 30 percent, even if that income would be taxed at a lower rate under current law. Both objections are addressed in greater detail in the Special Report.

A. Partial Consumption Taxation

In the following discussion, it is important to bear in mind that the consumption tax treatment advocated in the Proposal applies only to the tax that will apply on distributions (whether of interest or dividends) to high-bracket distributees. The CBIT itself remains a tax on income. By offering a deduction against the distribution tax for distributions that are timely reinvested, the Proposal defers tax on distributions (to the extent otherwise taxable) until they are drawn down for consumption. The overall effect is to apply consumption taxation to what amounts to a surtax on distributions for high-bracket taxpayers. Such an arrangement may seem incongruous in the context of what otherwise appears to be a system of income, not consumption, taxation.

However, as noted in the Special Report, the current tax system already contains a number of consumption tax features and is more properly characterized as a hybrid income-consumption tax than an income tax. These features include the realization rule, or the principle that capital gains and losses generally are not subject to tax until they are disposed of; the availability of retirement and other deferred compensation vehicles that operate under explicit consumption tax treatment; and the taxation of owner-occupied housing. The addition of another consumption tax element (to the limited extent it replaces an element that operates as an income tax) merely moves the system further in the direction of consumption taxation; it does not transform an otherwise “pure” income tax system into a hybrid system.

Secondly, because of the elasticity under current law of earnings distributions in closely-held entities to distribution taxes and because of clientele effects in the case of the ownership of large, publicly-traded corporations, consumption taxation already is in effect for most entity-level earnings to the extent a distribution tax applies to them. In particular, closely-held “C” corporations can defer distributions until such time as their owners wish to use the distributions for consumption, while investors in publicly-held corporations can choose to invest in “growth” stock rather than dividend-paying stock if they are tax-sensitive to distributions; for these investors, the cash-out occurs in the form of a sale of stock rather than a tax-timed distribution, again when it is time to consume. To the extent this description of investor and firm behavior applies to existing distribution decisions and ownership choices, consumption taxation already is in effect, and the shift to explicit consumption taxation of distributions amounts to a shift in the conditions under which consumption tax applies rather than a shift in the tax base: In place of consumption taxation of distributions at the price of inefficient earnings retention, the same consumption taxation applies, but without inefficient trapping of earnings in the entity in which they arise.

Finally, it is not clear that there is anything amiss with consumption taxation, or at least partial consumption taxation, especially when adopted in the form recommended here. The usual objections to consumption taxation are that it is regressive and that it is incapable of generating adequate revenue. In light of the fact that consumption taxation effectively applies already to most otherwise taxable distributions, the revenue concern should be minimal. Further, the distribution tax applies only to high-income individuals.

B. Potential Regressivity

The Proposal assumes a flat rate of 30 percent on business income. Thirty percent would represent an increase for taxable units currently in lower brackets that earn business income either directly or through a pass-through entity. However, Congress could ameliorate the effect by providing a credit for lower-bracket owners against their personal taxes, and, indeed, the Special Report assumes Congress does provide such a credit for purposes of analyzing revenue effects. Even with such a credit, a 30 percent CBIT rate seems easily within reach without loss of revenue (when compared against a 2011 baseline), and a lower rate may well be within reach even on these assumptions. Further study would be required to make a proper revenue estimate.

Even if Congress chooses not to provide relief through a credit, the progressivity effects of a 30 percent CBIT would be unclear. They depend not only on average effective tax rates but also on the use of tax revenues and on the allocative effects of adopting the Proposal. As regards the former, if outlays are adjusted so that increased revenue is returned to lower-bracket individuals through spending programs (whether direct or indirect), the overall effect would not be to reduce progressivity. As regards allocative effects, if adoption of the Proposal increases opportunities for persons currently in lower brackets to generate income, the nominal reduction in progressivity may be ameliorated or overcome by real, after-tax income growth for low-bracket businesses.

Conclusion

Three considerations will be of particular concern to Congress as it considers major business tax reform: 1. maintaining or enhancing the competitiveness of U.S. businesses and of the U.S. as a favorable investment environment; 2. simplification; and 3. meeting revenue commitments. The Proposal is designed to address all three. By keeping business-level rates low, it improves the position of both U.S. business and the U.S. itself as a market for foreign investors. By eliminating much of the complexity in existing law, the Proposal dramatically reduces compliance and administrative costs; and by providing for a tax on distributions to higher-income taxpayers, the Proposal preserves the ability of the system to raise adequate revenue.

In addition, the Proposal dramatically enhances efficiency in that it removes the three main tax-motivated biases that infect the current system of business taxation: the bias against the corporate form, the bias in favor of debt finance, and the bias in favor of earnings retention. Further efficiencies and simplification would be realized to the extent Congress repeals base-narrowing business tax incentives.