

**Transcription of 2014 *Chapman Law Review*  
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Issues in the Taxation of U.S. Entities”**

**Keynote Address: “Corporate Tax Reform,  
Business Tax Reform, or Capital Income Tax  
Reform?”**

*Edward D. Kleinbard*

The following is a lightly-edited transcription of Professor Edward D. Kleinbard’s oral remarks at the 2014 *Chapman Law Review* Symposium.\*

INTRODUCTION OF PROFESSOR EDWARD D. KLEINBARD BY  
MICHAEL LANG, PROFESSOR OF LAW, CHAPMAN UNIVERSITY DALE  
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It is my distinct pleasure to introduce to you Edward D. Kleinbard from USC Law School. Ed has an interesting background. He got his BA in Medieval and Renaissance Studies, and he also has an MA in History, both from Brown University. Those of you who think there is a good preparation for tax in taking something like Economics, no. Tax is obscure and arcane. Medieval and Renaissance studies is where you get the background. He has his JD from Yale Law School, and he was a partner with Cleary Gottlieb in New York for two decades. When he left Cleary Gottlieb, he became Chief of Staff for the U.S. Congress Joint Committee on Taxation, and he has been at the University of Southern California Gould School of Law and a fellow at the Century Foundation since 2009. He is a prolific scholar of a wide range of tax policy issues, including: stateless income, tax expenditures in a tax base, proposals from presidential candidates and Capitol Hill, and a dual income tax with different rates for capital income and labor income. Join me in extending a warm welcome to Ed Kleinbard.

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\* His keynote address was accompanied by a presentation available at <http://www.chapman.edu/law/publications/chapman-law-review/annual-symposium/2014-symposium/>.

KEYNOTE ADDRESS OF EDWARD D. KLEINBARD, PROFESSOR OF  
LAW, UNIVERSITY OF SOUTHERN CALIFORNIA GOULD SCHOOL OF  
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Michael, thank you very much and thank you all for being here. Since this is a business tax symposium, it seemed to me worthwhile, before we figure out how to do business tax reform, to think about what it is we want to reform and why. In particular, I wish to ask the question, "Are we reforming the corporate income tax, the business income tax, or capital income taxation?" Calls for business tax reform are all around us, but we have to remember that in the United States, businesses and corporations are not synonymous. Meanwhile, there is a deeper level to the question of what it is we might want to think about, and that is the idea of capital income.

There are only two meaningful kinds of income: labor income and capital income. Those of you who have taken Tax I might have the impression that tax practice is all about discovering a stash of cash in a second hand piano. Cases involving this, record-setting home run baseballs, or treasure trove turn out to be a very small part of the typical practice. For our purposes of approximation, income is either from labor, or as a return on capital.

Capital income means all returns to savings and investment, not just capital gains. For example, capital income would include interest income, rents, or dividends. It would also include net business profits, because the labor inputs to business, in an ideal world, have already been accounted for through the deduction for wages. In a public corporation in particular, where if you want to get the returns to your labor paid out to you, you take them in the form of wages, what is left is some kind of return to capital.

Why is it that we want reform? One obvious answer is that the corporate headline rate, the 35% statutory rate, is uncompetitive. That is true in the sense that the U.S. headline rate is now substantially higher than the statutory rate in many other jurisdictions. Alternatively, do we want to engage in business tax reform to capture incremental economic efficiency gains? Again, it is certainly true that economically similar kinds of returns to capital are taxed at wildly different rates. That, in turn, leads to misallocation of investments. The most conspicuous example, of course, is homes, where by virtue of the heavy subsidization of home ownership, U.S. households have disproportionately invested in housing rather than in productive business capital.

Or do we want to pursue reform to advance distributional goals? One of the differences between rich people and other people is that rich people have more money. They have more capital, and as a result, they have more capital income. How you tax capital income therefore has a huge distributional implication. It is much more heavily top-weighted than our distributions of labor income.

Finally, what about revenue? Are we trying to reform business taxation in order to collect more revenue because we are short of our revenue needs?

Let's try and disentangle all these. Here I am going to keep peeling back layers of the onion. Is the corporate rate really uncompetitive? Yes, of course the statutory rate is, but we know for a fact that the effective real-life tax rate—the real-life burden—on foreign income of U.S. multinationals is in the single digits. Domestic effective tax rates are very different. Corporate effective tax rates in the United States, which you would think would be our first priority, get amazingly little attention in public discourse. If you look at the effective tax rate on a firm's next investment, its marginal investment—unincorporated businesses are a little bit lower-taxed than corporates; maybe 25% for corporations and 21 or 22% for unincorporated entities.

If we truly want a more economically efficient environment, the resulting tax system will require radical overhaul, as we will see in a minute. That is going to require thinking much more comprehensively about the different instances of capital income and how we can link them in some useful way.

Remember also that if economic efficiency is your goal, there is a classic problem: the usual base-broadening and rate-lowering intuition is said to reward old capital. That is, old investments would simultaneously enjoy the benefits of old accelerated depreciation methods and new lower rates. Why should we reward old investment through classic base broadening and rate lowering? I personally think that this issue is somewhat overstated, since old capital and new capital tend to go hand-and-glove. Firms that have old capital tend to continue and make new investments. But nonetheless, the efficiency is not easy to capture. Distributional goals are generally thought to conflict with efficiency goals because, from a distributional point of view, you might want to have a significant tax on capital incomes since they are so top-weighted. From an efficiency point of view, we want to encourage investment because ultimately that leads to greater productivity, greater GDP in the United States.

Revenue goals are the most fraught of all as a political matter. The reason tax reform in a broad sense cannot happen is that there is no agreement—or in my view, possibility—of agreement on the fundamental question of how large government should be and therefore how much we should finance. Those of us who think about tax tend to ask the questions in the wrong order. We start by asking, “How should we reform taxation?” But the government of the United States is not in business for the purpose of collecting taxes. The government of the United States, like all governments, is in business to *spend money*. The first question, the ultimate question, and the question dealt with at length in my new book *We Are Better Than This: How Government Should Spend Our Money*, is: What should we be spending our money on, and only then, how should we finance that spending? Frankly, tax policy is much, much easier than spending policy, but we have muddled the two, and so we indirectly argue about how much we should be spending under the guise of arguing about how much tax revenue we should be collecting. This is a backwards way of phrasing the question. Instead, we need to ask, “What should we be spending on, and then, can we afford to finance that?” It is really a fundamentally different perspective. That is one of the reasons why public debates on tax reform are so unproductive, because we are really arguing about government spending, and we are doing so through the guise of arguing about the tax system.

Let’s peel off another layer: Do we wish to reform corporate income, or business income? The United States is really unique among large economies in having half of its domestic business income in the unincorporated sector. You cannot treat partnerships, LLCs, and the like as some kind of a rounding error. Now, that number is somewhat overstated, as there are incentives to muddle labor and capital income for firms with the classic owner-entrepreneur; in other words, the closely held firm with an owner-entrepreneur. The result is that there is, in fact, a lot of implicit labor income in the United States that is being presented as net business profits of closely held firms. If you look at capital intensiveness, the number is probably closer to 70/30. That is, corporations probably have 70% of the capital investment, and that is just a rough-and-ready rule of thumb.

But remember that when you start down the path, whichever path you take, there are weird overlap issues. If you want to do corporate tax reform and pay for it through closing business tax expenditures, like accelerated depreciation, you are asking the unincorporated sector to pay for lower corporate rates. And conversely if, like Dave Camp, you propose a large-scale

reform where individual rates are lowered, businesses are asked to pay more, as we will see. In fact, the tax burdens on unincorporated entities in a proposal like Dave Camp's involve two things moving in opposite directions: after reform, they would face higher business taxable income tax, and they have lower rates on that business income. Thus, when thinking about the Camp proposal, we in fact have to think not just about how much business will be paying through base broadening, but also how much unincorporated entities are receiving through lower rates.

If we really want to have serious reform, we have to think much more radically, and we would want a system in which capital income is taxed at consistent rates, regardless of the form of financial investment. First, why do we care so much whether something is called debt or equity? Why should the effective tax rate vary so much? Second, it turns out that depreciation is not just for accountants. It turns out that depreciation *is* in fact the way that you measure returns to real financial investment. (When economists say "real," they mean investment in greasy machinery and the like, as opposed to financial investments.) Depreciation and amortization of intangibles are essential to whether you are accurately measuring capital income from real investments. Third, you would have rules that would get the same results without regard to the form of business organization.

I recognize that it is fun to have clients come in to your law office, and to recommend an S Corporation for one client, and an LLC for another. But if reform is your goal you want to take a big step back and think about a system that treats capital income consistently; you would not have different rules for different forms of business organization. If you really want to pick up these efficiency gains from taxing capital income more coherently, you need to tax all business enterprises identically. You need to rethink "debt versus equity" kinds of distinctions. And you would need to tease apart labor and capital income in a closely held firm through what I call a "labor-capital income centrifuge" so that you are applying the right rules to the right kind of income.

Very quickly, we can say with certainty that we are doing an okay job with labor income, we really are. If labor income were all that we cared about, and we are not that far off the mark. However, we do a horrific job at taxing capital income.

CBO did a great study a few years ago which found that the effective tax rates, the marginal investment by a corporation, could swing from 36% to -6%, depending on how it is financed, the depreciation rules, and so on. That is a 42 percentage point

swing in effective tax rate. When you look at investments that are debt-financed and have accelerated depreciation, and someone says, "That has a negative effective marginal tax rate," what they are saying is that all of us are paying money to that company to make that investment, which is a very odd thing to ask of us in a world that is supposed to be market-driven.

If you want to think these sorts of radical thoughts about capital income, what rate should we apply? There are all kinds of capital income: there is the dull, plodding returns, from return to waiting; there is the so-called normal returns; there is the returns from taking on risk; and there are economic rents, which are the super-sized returns, because you have a special angle, you have a patent, and you have a unique position that you can exploit. There is no reason to believe that those three kinds of income should be taxed the same, and there is certainly no reason to think that, as a logical matter, they ought to be taxed the same as labor income. It would be true only by coincidence.

What I am suggesting is that capital income reform is a great aspirational goal. It turns out to be technically possible, but it requires very radical rethinking: treating all business enterprises alike, treating all kinds of financial investments alike, separating labor from capital income, and having a coherent theory about which kinds of capital income are taxed at which rate. Capital income reform is too large a topic to tackle today, however I have an idea for a solution called the "dual business enterprise income tax," and it is the subject of my book *We Are Better Than This*.

Let us return our focus to more traditional corporate reform and business reform. When you start thinking about business reform today, you cannot avoid the central importance of how international income is taxed. This is a corporate issue. Unincorporateds have very little international incomes. We can all agree that it is critically important both to the firms themselves—multinational firms themselves—and to any tax reform initiative.

I think we can all agree as well that the current law is just immensely flawed. Corporations are quick to say that they face an uncompetitive business environment. Their idea of "competitiveness" requires what I call a "toothless territorial tax system." These complaints are largely fact free. In fact, if you look at the effective tax rates on major U.S. multinationals today, they are under foreign income. Whether you look at a Microsoft, an Apple, a Google, or a General Electric, their effective tax rates on their foreign income is in the single digits. There is no country in the world in which they actually do business that has tax rates

as low as their worldwide effective rate on their non-U.S. income. General Electric just reported \$13 billion of income for the last year, on which they had a *worldwide* effective tax rate—including the United States—of 4.2%.

Very quickly, the U.S. international tax system today really becomes an ersatz kind of territorial system. If you look at cash taxes that are actually paid, yes, some money comes back. The money that comes back, comes back with full foreign tax credit. I talked about this at length in the article *Stateless Income*. So the actual taxes paid on repatriated earnings today is close to nil. We do have the cost of the so-called “lock-out phenomenon” in which income must be held nominally in the ownership of the foreign subsidiary.

Competitiveness is therefore not the issue. Current law, however, does have extraordinary behavioral distortions. For example, the famous “lock-out effect” allows firms to have trillions of dollars of earnings that are owned by their foreign affiliates in order to take advantage of gaming current law. And because of arbitrage opportunities, in particular the opportunity to leave all of your interest expense in the United States and let your foreign income accumulate at very low rates, the U.S. domestic corporate tax base is at risk. It is at risk to an extent that is not fully appreciated.

My stateless income papers in effect try to develop the following: it always understood that U.S. tax system had incentives for firms to distort their results, i.e., to book as foreign income—income that arguably was really earned in the United States, and possibly to make foreign investments in low tax countries. However, it turns out that if you look a layer deeper at how international taxation actually works, we are incentivizing U.S. firms to invest in high-tax foreign countries because it is then extremely easy for them to move the income from a starting point in Germany, via Freedonia, to Bermuda, where it finally comes to rest. The result is a perverse incentive to invest outside the United States, not necessarily just on some island that is barely above high tide, but to invest in real foreign countries and then to shift those profits to those tax-haven atolls. And that is exactly how U.S. firms actually operate.

The consequences of and the explanation for the urgency that U.S. firms bring to the debate today about their competitiveness is not that they in fact face a high foreign effective tax rate; it is that they are hoist by their own petard. They have earned so much low tax income that they now have \$2 trillion of earnings outside the United States in a nominal sense, owned by their foreign subsidiaries. They would sincerely

like to use that money to prop up the share price of their companies. That is their goal, but they cannot. That is the only thing they cannot do. The money instead is invested in U.S. Treasuries, it is in U.S. bank deposits, it is in the United States, but it is not propping up share price, and that is troublesome for companies. That is what is really going on today. There is no material tax or GAAP-drag from current law. The result is this very distortive environment in which U.S. firms have an incentive to invest outside the United States. There is an efficiency cost in all the resources, they have to be devoted. Lost opportunities for Americans are a social cost. And the "lock-out phenomenon" does lead to sub-optimal investment decisions. Finally, there is the base erosion point domestically.

There are only three problems in doing better on the international side. First, what exactly is a U.S. company? What do we mean when we say, "This is a U.S. company subject to certain rules?" Second, figuring out the source of income—where is it really earned—is even more difficult, and I would argue in fact, rises to the level of impossibility. Third, the politics are made much more difficult by what I called "tax mercantilism," which is when countries have gone out of the business of explicit export subsidies, but try to achieve analogous goals through the tax system. We no longer engage in explicit trade wars—that is one of the things GATT, the General Agreement of Trades and Tariffs, and the World Trade Organization has done for us. Instead, countries have switched their subsidy programs to the tax arena. The United Kingdom, for example, has gone into the business of trying to attract European multinationals to re-headquarter in London and provide them a lower tax rate on their non-UK income than would be true if they stayed in their home countries. When you have countries competing on that basis, the international environment becomes very difficult.

Let us talk about where tax reform is today. The President has said that he wants a lower corporate tax rate, perhaps 28%. He has not quite explained how that is going to happen. He has said that he wants to tax existing offshore permanently reinvested earnings. The President wants to tax that to collect about \$150 billion to invest in the United States infrastructure. And he wants to raise another \$250 billion by making the international tax regimes tougher.

Dave Camp, by contrast, has a really big comprehensive bill, and there are a lot of good aspects to the bill. It is designed to be revenue-neutral over the ten-year budget window, the official window of time that Congress looks at, and to do so by having, in the aggregate, lower tax revenues on personal income. He

proposes a corporate rate of 25%. The individual rate—the highest bracket—would go down to 35%, but on a broader base than current law, so many high income individuals actually might pay more. On the international side he would move to a territorial system funded in part by a \$170 billion transition tax on those same permanently reinvested offshore earnings. If you were to look closely at the Joint Committee's revenue estimates for what this bill would mean, it shows \$590 billion more of business taxes in the next ten years, and \$590 billion less in personal income taxes, but as I'll explain in a minute, for unincorporated business owners, this accounting is misleading, as it is only the net of the two moves that is relevant.

Can we get to a deal? The Camp bill, unlike the President's observations, is comprehensive, it is detailed, and you can actually talk about it. There are a lot of points in common. Everyone agrees that the headline rate on corporate income has to come down. Everyone agrees that the international system is unstable and that the lock-out effect—the idea that foreign subsidiaries must retain their low tax foreign earnings to get lower effective tax rates and have a tax penalty if they repatriate too much to United States—is unwise.

There seems to be some confusion about the idea that business tax reform should be revenue-neutral because Camp imposes more tax on the business sector. I would have thought there would have been consensus. But we will dissect that in a minute. It remains the case that there is no chance whatsoever of consensus on this larger issue of how much overall revenue should be collected, because that is really the stalking horse for how big government should be. That means that if we are going to see business tax reform anytime in the next several years, we must look at it as a separate piece of legislation.

The current Camp Bill has to crash and burn and then, phoenix-like, a business-only legislation has to emerge. That is the only scenario that I can ever see working. That in turn has its own complexities. A number of people, including the President, are very unenthusiastic about breaking out business tax reform. There are a number of technical issues in doing so, and very different views about what to do about international income.

The Camp bill is a piece of serious legislative drafting, fully scored by the JCT. We should talk about how it is that a Republican Chairman of the Ways and Means Committee would produce legislation that would impose \$590 billion more tax on businesses, notwithstanding the lower rate. That seems very odd. The answer is in part that this overlooks the netting that goes on

within the unincorporated sector. That is, the Camp bill broadens the business income base, but individual rates are going down. The JCT staff scored the former as “more business taxes” and the latter as “lower individual taxes,” even though the two are netted against each other on the tax return of an unincorporated firm. If you make a few sensible assumptions, that really what is going on is \$250 billion or so is being used from the corporate sector to finance the personal sector, once you net all the unincorporated business stuff.

The JCT, a wonderful group, presents things to some extent in ways that they were told. Nonetheless, it is a fair criticism of the long and detailed revenue estimates that were prepared that you cannot answer the question how much the corporate sector’s tax burdens are rising compared to personal income tax returns. That is a normal question to ask; that is a question we ought to be able to answer. But because of the way they present all of business in one lump and then all of the consequences of personal rate reduction over on different tables, you cannot answer these very straightforward questions. I find that to be very frustrating. I would also hypothesize that there is a piece of paper with that answer. This is what Chairmen of Ways and Means Committees do, so that when an important constituent who has an unincorporated business comes into see you, you say, “Here, let me show you the picture,” and there is a piece of paper somewhere that says, “This is how much net corporates are bearing, this is how much net the personal side is bearing.”

The numbers themselves—even once you get past this question of how much is really being shifted from business to personal side—are quite fuzzy, as often is the case. It turns out that doing what everyone wants, reducing the corporate tax rate to 25%, is very expensive: \$680 billion over ten years. In fact the real number is greater, because Camp phases in the lower rate over five years. We don’t even have a full ten-year cost for a 25% tax rate. Then we have these other two personal income items that basically wash out against each other. If these were fully phased in, you would be looking at \$800 billion more in revenue, lost through reducing personal tax rates. That is a big hole to fill.

There also is a lot of frontloading and backloading that goes on in the bill. The phase-in of the lower rate for corporation is an example of backloading the cost of the legislation. Slower depreciation and amortization rules tend to effectively frontload the revenue pick up from those changes. The international provisions of the Camp bill would raise about \$70 billion over ten years, but that turns out to be entirely fictitious. It is because of a one-time \$170 billion tax on the existing stock pile of of

permanently reinvested earnings. If you take that out, the Camp bill would reduce burdens on international income by another \$100 billion. You take income that today is taxed at a single-digit effective rate and say, "You know what, let's all throw another hundred billion dollars your way." It is not the call I would have made.

Finally, some of the revenue pick ups are unrealistic even to me, like rules requiring you to capitalize and amortize advertising expenses and rules that would require you to capitalize and amortize research and development rather than expense it, as we do currently. These are very, very large numbers, which is why I mentioned them, and not very likely ones.

What to do, what to do? Well of course, what you want to do right now is stand up and shout, "But surely dynamic analysis will fill the gap." This requires a visit from the growth fairy, and it also turns out that this dynamic estimating stuff is very difficult. When the JCT does a revenue estimate, the revenue estimate is dynamic in the sense that it does take behavior into account. It does not however, assume that GNP (Gross National Product) will be affected—it has a fixed GNP constraint. So-called "dynamic analysis" or macroeconomic analysis says, "What will this tax legislation do for the economy as a whole?"

The JCT macro analysis of the Camp bill suggests under some circumstances that there could be some growth in GDP over the next ten years. But every point needs to be asterisked. Macro analyses do not predict compounded growth in perpetuity. In fact, if you think about it, revenue-neutral legislation should not have huge macro effects because what one person is getting, another person is losing. Thus, the extent of growth effects would be limited to some modest efficiency gains.

We therefore should be very suspicious of a revenue-neutral legislation that is said to have huge macroeconomic consequences. Most interestingly, the real lesson to take from the JCT macro study of the Camp bill is that the effective tax rate on capital income appears to be going up, because they are predicting lower capital investment in the future or break-even capital investment in the future. All of the GDP pick up from the Camp bill comes from more consumption. It comes from the fact that individuals whose income is primarily labor income have lower taxes. Therefore, they will spend more, and that leads to a larger economy. But it does not do so forever. You do not in fact grow simply by spending more; you have to invest more to grow more. The real irony of the Camp bill is that it is at best

lukewarm, and arguably hostile, to investment through all of the changes it proposes.

Finally, it is worth taking a minute to talk about the JCT conclusion because it is so important. The JCT's macro conclusions have been widely misunderstood in the press. In fact, Dave Camp did misspeak a couple of times in public media that were to the advantage of the point he wanted to make. So I think I should, on his behalf, correct the record. The JCT macro study of the Camp tax bill found, in the best possible case they could conceive of, that GDP would grow by 1.6% in the aggregate over the next ten years. That is not the same as saying that the *growth rate* of the economy would increase by 1.6 percentage points a year for the next ten years. The economy is predicted to grow about 2.5% a year for the next ten years; this misreading would mean that the economy will grow at 4.1% a year instead. That would be nice but it is not what he said. What JCT said was, "Instead of having \$233 trillion of aggregate GDP over the next ten years, we will have \$237 trillion—maybe—in the best possible case that we could conceive of." That is not the same thing. If you do the arithmetic, it implies that instead of a 2.5% growth rate, we would have maybe a 2.8% growth rate in the best possible scenario.

Even a small increase in GDP growth would be nice if it were true, but it is not sustainable in perpetuity if in fact investment is not keeping pace, which I think is consistent with the JCT staff's conclusions. And it requires some heroic assumptions in the model about human nature, among other things, because it assumes that individuals basically, in effect, live forever and have perfect foresight as to the future. That is effectively what the model assumes about human beings. It makes the *modeling* easier; it just makes the results inherently spurious. The results have nothing to do with life as it is lived in the world that we actually know.

Even on its own terms, the Camp bill is revenue challenged. It is not a sustainable revenue-neutral legislation. I think actually a point of order might lie against it in the Senate for that reason. Even without regard to the Byrd Rule, there is a newer point of order that I think would lie against it for this reason. What are we going to do about that? What is the case for \$100 billion of lower tax on international income? What is the case for shifting \$250 or more billion net to the personal side and having a significant tax hike on corporations at least for the next ten years? It is not at all clear what the business case is for those fundamental directions that the Camp bill is going in, notwithstanding all of the good ideas that are in it.

Finally, let us remember what we are really talking about. If you really want to fill the revenue hole, this entire conversation is nonsensical, because the Fiscal Cliff tax deal of January 2013 destroyed our budget. In 2012, the official CBO baseline basically showed us growing out of deficit problems. It showed us raising about 21% of GDP in tax revenues, and it showed deficits going down to 1% or so of GDP, which means we would actually be paying down our national debt, because if the economy is growing significantly faster than that, the result is that national debt as a percentage of GDP would be declining. We were in a very good place from a budget point of view in January 2012.

In January 2013, we reversed course and made permanent all of the Bush tax cuts except for those individuals earning over \$450,000 which is the reverse of the assumption that CBO made in 2012, because it followed the law which contemplated that all of those would expire. Thus, the result is that \$4.6 trillion of new deficits appeared, plus additional interest. Those numbers now show a total deficit prediction of \$8 trillion over the next ten years. Eight trillion dollars? That is half of 2014 GDP. That should focus the attention of young people in the room, who will not doubt be affected by this, and who should think seriously about these issues.

Slashing spending is in fact an exercise in magical thinking. Even if you want to seriously limit entitlement spending, the fact is that doing so must be phased in slowly. The last time we adjusted Social Security, for example, we did it over a thirty-year horizon. In the meantime, the deficits have to be financed. You cannot run the economy of the United States on revenues of 18.5% of GDP. The United States in 2012, and it is predicted again in 2014, is in fact the lowest taxed country in the OECD as a percentage of GDP. We are not a high-taxed country. You are not unfairly put upon. This is a low-taxed paradise. The bankers of Zurich wish only that they could only endure the tax rates that we think are so punitive.

So in sum, the Camp bill is too soft on international, clearly, too hard on capital investment, too soft on labor income, and where is the money going to come from to fund the trillion dollar deficit?

Let us close by coming back to the international side, since that is where the big bid-ask spread difference is on corporate reform. Territorial solutions would say that international income should be taxed only where the income is earned abroad once. This works if you can have perfect confidence that the income around the world is, from a tax point of view, being attributed to the jurisdiction with the closest economic nexus to that income. If

we could do that, a territorial system makes perfect sense. The trouble is, it is impossible. It is completely impossible to pin down income to say that this is the jurisdiction with the strongest nexus case.

Why do we have multinationals? We have multinational enterprises because there are global synergies and lower internal transactions costs to doing business in this form, because they can conduct their business seamlessly across borders. All of that, in effect, should signal that it will be impossible to imagine a world in which we can predict with confidence the economic nexus of income. And because we cannot get very close at all to determining the geographic nexus of income, a territorial system in effect starts to fall apart. Everything else is like trying to hold back the sea with a broom—for example the current so-called “BEPS project”—because it begins with unsustainable premises.

There is one success story in this nexus world. Section 954(h) was designed by the Treasury to allow financial services firms to earn banking-type income—financial income—outside the United States, and it is ferocious. And it works. It is one of the great myths of some writing in this area that banking income is easy to move around. It is exactly the opposite. Actually, banks are the only ones who in fact have to prove nexus in every case. No one is volunteering for more 954(h).

The other direction is some kind of minimum tax as a safety net on international taxation or Baucus Option Z, which I think is sort of the worldwide true tax consolidation that I propose, combined with a split rate, a somewhat lower rate on international income than on domestic income.

I prefer a true residence-based worldwide tax consolidation regime. This in effect would address the issue of nexus by saying, “It is impossible,” and instead give a great deal of weight to residence of the company. In effect, my preferred approach would say, “If a company is a U.S. firm, that has meaning, and we’re going to tax it at a rate that is within the norm of developed country rates—which would mean mid-twenties—and we are going to treat that worldwide income as logically within the scope of the U.S. tax net.”

Why? What would be the policy justification for that? I think it comes out to a two-step analysis. The first step is: Why do we have a corporate tax at all? I think that the best answer is that a corporate tax is simply a non-refundable withholding tax on the income of owners. It is too hard to measure the income at the owner level. So the corporate tax really is a tax on owners in which the firm is just a proxy for owners. If you then assume that

the vast bulk of U.S. firms are ultimately owned by U.S. persons, then the idea of taxing U.S. firms on their worldwide income is not perfect—but it is good enough.

The standard Treasury data say 85 to 90% of U.S. firms are U.S. owned. A recent article suggested that that overstates things. The answer is yes, it is not perfect, but the number is not 45% either; if the number is 80 instead of 85, the basic claim that a U.S. firm is a pretty good proxy for U.S. investors still holds up. Given the impossibility of a territorial system, given the impossibility of the nexus of income, you need some other form of solution, and whether you call it a minimum tax, or a split rate on a worldwide income, in all of those cases, you have to recognize that what you are doing is in fact affirmatively embracing a residence-based tax system. I have tried to offer you a theory as to why doing so has some coherence. With that, I will stop, and I am delighted to take any questions.

#### QUESTION AND ANSWER

**Audience Member:** You indicate that there is not a competitive problem in the current system for internationals. Yet, in order to achieve that low rate of tax, they have to jump through hoops in a way that is entirely from the moon in terms of the transactions that they do, and if the IRS had more resources in terms of economists and auditors, much of that would be shut down. My thesis would be that that is why we have a low tax rate effectively on international income.

**Kleinbard:** I do not actually agree with that. We have a low rate on international income because the United States has aided and abetted it through the CFC look-through rules, through the check-the-box rules. We are a pariah among sensible countries in that respect. Yes, there are a lot of arm's-length pricing questions where people simply misprice relationships within the multinational group, but an awful lot of the income shifting that goes on is straight down the middle of the transfer pricing fairway.

The result is driven by the nonsensical idea of treating foreign subsidiaries as independent actors with their own capital structure. So even if we had perfect transfer pricing, we would still have low effective foreign tax rates. The problem is deeper and more structural than can be solved through litigation. Nonetheless, you are absolutely right that there is a lot of fertile ground for litigation. Frankly, the IRS should reach out to the private sector more and bring in more private help on these big ticket litigation items.

**Audience Member:** Thanks, very simple question. I am very sympathetic to your presentation. On your last point though, my question is, how does a worldwide tax system with a lot of pressure on residence of the corporation solve the problem, whereas the obvious response is, "Okay, well, we will incorporate in Cayman or we will incorporate in Bermuda." Are you going to have some kind of attribution regime?

**Kleinbard:** Yes. A residence-based system requires more sophisticated residence rules than we have today. It requires, in effect, an either/or test. It is like Lloyd Doggett's bill that he introduces every year in which basically either you are incorporated in the United States or mind and management is in the United States. So if Mark Zuckerberg thought, "Geez, I am going to make a billion dollars or more, I should start life as a Cayman Islands company," the mind and management of Facebook would still be in the United States; it would still be a U.S. company. There would be an occasional case that slips through. But government has to move on, and the advantage of this is that it is much simpler; it does not have the transfer pricing consequences that we just discussed because in the end, the money could be taxed somewhere at 25%. And if all the executives of Mark Zuckerberg's firm actually decamp for the Cayman Islands, then I will take the risk of losing an occasional company.

**Audience Member:** Thanks, you mentioned the ten-year budget window that Congress looks at, and in particular, denying deductions for IRAs and all kinds of other pension changes that would shift cost out into the future.

**Kleinbard:** I do not know if everyone really understands what the questioner is saying. He is saying that another really good example of the backloading gimmicks going on is changing the way the IRAs work in ways that ultimately cost the government more money on present value terms if the IRAs do well, but which have the apparent effect of raising money inside the ten-year budget window and paying it out in forms of lower tax revenues in a more distant future.

**Audience Member:** The question is really, do you have any thoughts about how to fix the ten-year? If we looking at it the wrong way, how can that be fixed? I think you mentioned a Senate point of order.

**Kleinbard:** That is a really good question. I think that the right answer is that legislation needs to be scored on a present value basis, as well as the ten-year window basis. If we did a present value calculation, making some straightforward

assumptions, legislation like your example of the IRA switching game would be seen as radically not revenue-neutral. You would do that as an additional check on the process. In the Senate, my recollection, I'm not a parliamentarian, but my recollection of the new point of order is that the JCT has to certify to the Senate whether the legislation is predicted to lose more than \$100 million, I think, in any decade in the second, third, or fourth decade, and this legislation clearly would. So I think that there might be a point of order issue in the Senate. No one has said otherwise because nobody thinks that this legislation will ever get that far, but I can send to anyone that is interested a reference to the Senate point of order I have in mind.

**Audience Member:** Thanks so much. Just a hypothetical: General Motors has a subsidiary that makes a car in Germany, it competes with the Volkswagen model made by Volkswagen in Germany. Under your proposal of the tax going with the United States jurisdiction, assume for a moment, again, all of these are hypotheticals, that the U.S. tax rate is higher than the German tax rate, why is that not a competitive issue?

**Kleinbard:** There are a lot of levels to that answer. What you implicitly point out is that one of the consequences of relying on a residence-type approach to international taxation is that you lose some control over your tax rate. You cannot be that out of line with Germany's rate and France's rate because if you are, then you have this issue. That is sort of answer 1. Answer 2 is that worldwide tax systems, as we currently understand them, allow you to blend. So if in Fredonia your rate is lower than the German rate, you would blend—effectively for U.S. purposes—the two, which would get you down to the U.S. rate. Now, an economist would say, "That just means you are compelling someone to invest in Freedonia as well as in Germany." But multinationals tend to be everywhere, so the blending kind of works naturally for the large multinationals. Third, even if a U.S. individual invested directly in Volkswagen, we would expect her to pay tax on her worldwide income to bear whatever the U.S. tax cost is on top, so that if you think of a U.S. firm, again, recognizing it is not perfect; it is a rough-and-ready proxy for U.S. ultimate individual owners. The extra tax is in effect as one that should be imposed in that case.

**Audience Member:** On the third point, the taxation on the corporate entity, it is undoubtedly higher if you follow your rule for the American entity. Your first point of course, is because we have chosen that, and obviously that is a policy call. It is kind of a libertarian answer which happens to warm my heart because you are saying, you choose America under this rule, this is the

consequence of your having a higher corporate high tax rate than your competitor. I did not hear you say that my point was wrong as much as that it is a consequence of what policy a government might choose.

**Kleinbard:** I think that that is fair. Remember, however, my second point about blending. My basic response remains what I meant about losing control of our tax rate. When you go down this road, there has to be a concomitant commitment to a tax rate that is in the middle of the pack, so we do lose control of our tax rate to that extent. I acknowledge that.

**Audience Member:** I am thinking about the last point. If there is a materially lower rate in Germany than in the U.S., and the tax system is working right, then that raises the question: Why is that the case? Why would it be that, in Germany, the rate on German enterprises is 20% and in the U.S., it is 30%? There ought to be pressure to bring the U.S. tax rate down in that case. Maybe that sort of goes back to your first point, but probably the answer is, it is not going to be lower as a real matter. In fact, if you look at OECD countries, real effective tax rates do not actually vary all that much, which is one reason why territorial worldwide would not be that big of a problem if you did not have the stateless income problem.

**Kleinbard:** Exactly.

**Audience Member:** But then you also have these other problems you pointed to, which is: Where does the income arise in all of that?

**Kleinbard:** Which is why I get to residence, but it absolutely means you lose control, and you had to have a rate in the middle of the pack. Okay, with that, thank you very much.