

Ed Kleinbard's BEIT

Presentation to Conference in Honor of Ed Kleinbard

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Introductory Remarks



- Great honor to be asked to discuss Ed's work
- World is divided into big thinkers and detail people
 - Ed was both
- Varied experiences gave Ed unique insights
 - Practitioner, public official, academic
- Intellectual rigor combined with passion for social justice

Plan of Presentation



- Preliminary Reflections on Capital Income and Criteria for Fairness and Efficiency
- Comparison of BEIT with Current Law and Other Reforms
 - Perfect competition, uniform tax rates
 - Preferential treatment of some saving
 - Preferential treatment of some investment
 - Economic rent or windfalls
- Other issues
 - owner-managed firms, financial institutions, international capital flows, constructive realization at death
- Broader Issue: How to Address Income Inequality

What is Capital Income?



	Labor Income and "Windfalls"	Capital Income
Contractual Income	Employee compensation	Interest income
"Residual" Income or Profits	Economic rent (return to entrepreneur)	Normal return to equity ("risk-adjusted")

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Major question is the bottom left quadrant of the chart. Ed would include economic rent as capital income.

But if you define capital income as the reward for deferring consumption (plus a risk premium), then economic rent may alternatively viewed as either a reward to the labor of the entrepreneur or a windfall (such as from the discovery of valuable mineral deposits or oil in one's backyard).

Note that the normal return is amount that is necessary to induce people to invest in equity shares in a business and includes a risk premium that reflects the predicted variability of investment returns.

Ed in his papers distinguishes between "risk" and "uncertainty". Risk in his view (and mine) is akin to variance – like a coin toss, where you know the distribution of outcomes but not the outcome of a single or small number of events. Uncertainty is when you have no idea of the underlying distribution.

Alternative Measures of Economic Well-Being



- Consumption
 - Equals initial wealth + windfalls + PV(lifetime earnings) – bequests/gifts (?)
- Haig Simons Income
 - Equals annual consumption plus change in net worth (from net saving or asset value change)
- Permanent income
 - Potential permanent consumption from all wealth (assets and human capital)

To give a brief preview, Ed's vision in his BEIT proposal is much more akin to a tax on permanent income than to a tax on Haig Simons income because of the way (with exceptions) that he treats capital gains.

Haig Simons (HS) vs. Permanent Income (PI): Are Capital Gains Income?



- Example of British consol that pays \$200,000 per year in perpetuity at 10% interest rate (i)
 - Current value (V) is \$2 million
 - If i falls to 5%, V goes up to \$4 million
- What happens to well-being of investor?
 - No change if living off annual coupons (PI)
 - \$2 million gain if wanting to consume immediately (HS)
 - Worse off if wanting to save more

More generally, changes in the relative price of present and future consumption affect people differently depending on their planned pattern of future consumption, so one can use different measures of well-being,

Capital Income is Very Hard to Measure



- Do Firms' Outlays Contribute to Current or Future Revenues?
 - Perhaps can measure for purchases of physical capital (machines, buildings)
 - Much harder for "self-constructed assets"
- How to Measure Changes in Firm Valuation From Changes in (Unobserved) Expected Future Earnings?
- Possible Responses
 - Measure at individual investor level
 - Mark to market
 - Imputed return to basis (BEIT)
 - Don't tax at all (consumption tax)

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Biggest point here is that changes in net worth arise at the business activity level and are hard to measure because the time pattern of future net revenues resulting from most current expenditures is very hard to discern.

There are different responses to this difficulty in measuring the change in firm valuation produced by different outlays; i.e., the amount of capital income. One response is to try to measure capital income at the individual investor level. Ed's solution is to impute a normal return to the investor's basis in financial assets (and allow a corresponding deduction at the firm level).

Another approach would measure capital income of individuals by looking at financial payouts (dividends and interest) plus net changes in the market value of the financial asset. But this is difficult in the case of ownership of non-publicly traded companies.

Example of Entrepreneurial Income



Year	Disc Rate	Net Rev.	Labinc	Value at 6%	Capital Income
0	.06	0	\$13.30m	\$13.30m	0
1	.06	0	0	\$14.10m	0.80m
2	.06	0	0	\$14.95m	0.85m
3	.06	0	0	\$15.84m	0.90m
4	.06	0	0	\$16.79m	0.95m
5	.06	0	0	\$17.80m	1.01m
6	.06	0	0	\$18.87m	1.07m
7	.06	0	0	\$20.00m	1.13m
8	.06	\$1.20 m	0	\$20.00m	\$1.20m
SUM	.06		\$13.30m		\$6.70m
% of value			66.5%		33.5%

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For simplicity of exposition in this presentation, I divide firms into two polar categories – 1) new firms with no current revenue, but which are building towards revenues that will begin in the future, and 2) established firms with a steady stream of revenues. In fact, all firms are a combination of both, generating both current revenue and new sources of either growth or decay.

Ed’s BEIT proposal works differently in the case of stable firms and growing or declining firms.

This slide illustrates an example of a new firm started by an entrepreneur in year 1, which starts to generate a steady stream of revenues (net or current operating costs and depreciation) in year 8.

The entrepreneur’s “labor income” in year 1 is the discounted present value of the future stream of revenues that begins in year 8. Her capital income is the return for waiting until year 8 to earn profits - that is, the appreciation in value when the profits become closer to beginning. In the example, the labor component is 2/3 of the entrepreneur’s income from starting the firm.

The capital share would vary positively with the discount rate and the length of time before profits begin.

Do We Want to Tax Capital Income?



- Atkinson-Stiglitz Result (1976)
 - Zero tax on capital income optimal under certain assumptions
- Kleinbard View:
 - In world with inheritances, need to tax capital income
 - But capital income should be taxed at lower rate than earnings
- Rest of my talk will concern how to achieve this rather than whether to

Kleinbard's papers on BEIT include an extensive discussion of the Atkinson-Stiglitz theorem and how it has affected both economists' and lawyers' approaches to tax policy analysis.

Goal of Achieving Neutrality



- Debt vs. equity
- Taxable corporations vs. flow-throughs
- Labor income vs. capital income
- Changes in ownership
 - Corporate re-organizations
 - Financial assets sales by investors
- Real investments in assets and industries
- International margins
 - Location of physical investments
 - Place of corporate residence

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In general, it is impossible to achieve neutrality across all margins because some activities are administratively or politically very difficult to tax – such as labor used in home production, returns to household capital (imputed rent), unrealized appreciation of assets in privately-owned businesses, and foreign-source profits of foreign-resident companies.

Given these non-neutralities, however, efficiency considerations dictate similar treatment of activities that are very close substitutes. Kleinbard's proposal focuses in particular on neutrality across methods of finance (due to the ambiguous definitions of debt and equity), among types of firms (corporations vs. pass-throughs), among capital investments in different assets, industries or countries, and among different locations for reporting profits of multinational corporations.

He favors a lower top rate on capital than on labor income and addresses the problem of how to distinguish between labor and capital income within owner-managed firms.

And he is willing to accept differences in tax rates based on the tax residence of multinational corporations and would address this concern by keeping the corporate tax rate low (25%) and modifying the definition of corporate residence so it is more based on real activities than simply on place of incorporation.

Business Enterprise Income Tax (BEIT)



- 25% tax on “normal” returns to capital at individual level; no tax at firm level
 - Imputed returns to savers and COCA deduction for firms
 - COCA deduction equivalent to expensing
- 25% tax on economic rent at firm level
- Graduated tax with 40% top rate on earnings
- All firms taxed as corporations
 - Special rules for capital income of owner-managed firms
- No tax on capital gains realizations (exceptions)
 - But higher basis raises future tax liability of investors

The COCA deduction and the tax on imputed returns make the taxation of debt and equity equivalent in risk-adjusted terms.

All firms pay the business enterprise tax (other than sole props) so there is no tax reasons to choose whether a firm is a C corporation or a pass-through.

Capital income (including economic rent) is taxed at flat rate of 25%; labor income (which excludes economic rent) is taxes at graduated rates up to a maximum of 40%.

Comparison of BEIT to Other Options



- Alternative tax rules
 - Current law (CL)
 - Partial integration of corporate tax (INT)
 - Mark to market (MTM)
- Alternative Situations
 - Flat rates, perfect competition, no preferences
 - Treatment of preferences
 - For favored assets and industries
 - For favored individual investors
 - Entrepreneurial Income (economic rent)

Assumptions in Examples of \$1,000 Investment



- Graduated tax on ordinary income, top rate of 40%
- Flat tax on personal investment income of 25%
- Flat tax on corporate profits of 25%
- Discount rate = 6%
- Firms financed 40% with debt
 - Interest rate = 3%
 - Equity yield = 8%
- Equity yield dividend into three parts
 - 50% dividends, 25% realized gains, 25% unrealized gains

In the slides that follow, I seek to compare structural alternatives with a common set of tax rates and focus on differences in tax bases and what incomes qualify for a preferential rate.

Example: Perfect Competition, No Preferences



	BEIT	CL	INT	MTM
Net revenue	60	60	60	60
COCA deduction	60	0	0	0
Int deduction	0	12	12	12
Taxable profits	0	48	48	48
Corporate tax	0	12	12	0
Imp inc (tax)	60 (15)	0	0	0
Interest (tax)	0 (0)	12 (4.8)	12 (4.8)	12 (4.8)
Dividends (tax)	24 (0)	18 (4.5)	18 (3.6)	24 (9.6)
Real. gains (tax)	12 (0)	9 (2.25)	9 (2.25)	12 (4.8)
Accr. gains (tax)	12 (0)	9 (0)	9 (0)	12 (4.8)
Net income	45	36.45	37.35	36
Tax rate	25%	39.3%	37.8%	40%

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This is an asset worth \$1,000 with a 6 percent yield (\$60 per year) at the business level.

The interest rate is 3 percent, which at a 40 percent debt-capital ratio makes interest payments equal to 1.2 percent of asset value. The equity yield is 8 percent (\$48 on \$600 of equity).

BEIT allows a COCA deduction equal to 6 percent of the asset value. The present value of the deduction is invariant to the rate of depreciation. (With expensing, a \$1,000 immediate deduction is equivalent to a permanent deduction of \$60 per year.)

Both shareholders and lenders impute a 6 percent return to their asset value. So imputed income of asset holders is \$60, which pays the capital income tax rate of 25 percent. So the combined firm /investor tax rate under BEIT is 25%.

Under CL, assuming economic depreciation, interest but not equity returns are deductible. The corporate tax rate is 25%, Dividends are taxes at the capital income rate. Retained earnings result in realized capital gains, taxed at 25% and unrealized capital gains, tax-deferred. Interest income is taxes at the ordinary income rate of 40%. The result is a combined rate of 39.1 percent.

Example: Perfect Competition, No Preferences, 100% Equity-Financed



	BEIT	CL	INT	MTM
Net revenue	60	60	60	60
COCA deduction	60	0	0	0
Int deduction	0	0	0	0
Taxable profits	0	60	60	60
Corporate tax	0	15	15	0
Imp Inc (tax)	60 (15)	0 (0)	0 (0)	0 (0)
Interest (tax)	0	0 (0)	0 (0)	0 (0)
Dividends (tax)	30 (0)	22.5 (5.63)	22.5 (4.5)	24 (9.6)
Real. gains (tax)	15 (0)	11.25 (2.81)	11.25 (2.81)	12 (4.8)
Accr. gains (tax)	15 (0)	11.25 (0)	11.25 (0)	12 (4.8)
Net income	45	36.56	37.69	36
Tax rate	25%	39.1%	37.2%	40%

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Example: Perfect Competition, No Preferences, 100% Debt-Financed



	BEIT	CL	INT	MTM
Net revenue	60	60	60	60
COCA deduction	60	0	0	0
Int deduction	0	30	30	30
Taxable profits	0	30	30	30
Corporate tax	0	7.5	7.5	0
Imp Inc (tax)	60 (15)	0 (0)	0 (0)	0 (0)
Interest (tax)	30 (0)	30 (12)	0 (0)	30 (12)
Dividends (tax)	15 (0)	11.25 (2.81)	11.25 (2.25)	15 (6)
Real. gains (tax)	7.5 (0)	5.625 (1.41)	5.625 (1.41)	7.5 (3)
Accr. gains (tax)	7.5 (0)	11.25 (0)	5.625 (0)	7.5 (3)
Net income	45	36.28	36.84	36
Tax rate	25%	39.5%	38.6%	40%

Effective Tax Rates – Perfect Competition



	BEIT	CL	INT	MTM
Corporate: Debt Finance	25%	39.5%	38.6%	40%
Corporate: Equity Finance	25%	39.1%	37.2%	40%
Pass- through: Equity	25%	32/40%	40%	40%

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This slide compares taxation of corporate debt, corporate equity, and taxation of equity in a partnership.

BEIT is fully neutral, a 25% tax rate in all cases. MTM is also neutral, but at a 40% rate.

CL is close to neutral between debt and equity. Debt benefits from the corporate interest deduction, but there is still a corporate tax on the leveraged return. And interest pay the 40 percent rate. Equity faces the full corporate tax, but benefits from deferral of unrealized capital gains and the lower rate on realized capital gains and dividends. Pass-throughs pay a lower rate if eligible for the QBI deduction.

MTM is also fully neutral among the three alternatives, but at a 40% rate.

As Kleinbard notes, CL could favor debt if the investor is in a lower tax bracket. So CL results in portfolio specialization and arbitrage across assets among households and between households and non-profits.

Example: Perfect Competition, Tax-Exempt Saver



	BEIT	CL	INT	MTM
Net revenue	60	60	60	60
COCA deduction	60	0	0	0
Int deduction	0	12	12	12
Taxable profits	0	48	48	48
Corporate tax	0	12	12	0
Imp inc (tax)	60 (0)	0	0	0
Interest (tax)	0 (0)	12 (0)	12 (0)	12 (0)
Dividends (tax)	24 (0)	18 (0)	18 (0)	24 (0)
Real. gains (tax)	12 (0)	9 (0)	9 (0)	12 (0)
Accr. gains (tax)	12 (0)	9 (0)	9 (0)	12 (0)
Net income	60	48	48	60
Tax rate	0%	20%	20%	0%

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The tax-exempt saver example is important because US taxable shareholders hold only about 25% of US corporate stock (Rosenthal and Austin, 2106); the remainder is owned by qualified retirement plans, tax-exempt institutions, and foreign investors.

Under BEIT and MTM, there is no tax at either the corporate or investor level, absent special rules to impose tax on retirement plans, tax-exempt institutions or foreigners.

Under current law and most integration proposal, the tax rate on corporate capital income is 20 percent, under this example with a corporate rate is 25 percent and interest deductions accounting for 20 percent of pretax corporate profits.

Both BEIT and MTM would result in a large tax cut on corporate source income relative to current law. Proponents could argue, however, that full exemption is what the law intends.

Example: Perfect Competition, Expensed Investment

	BEIT	CL	INT	MTM
Net revenue	60	60	60	60
COCA deduction				
Int deduction	0	12	12	12
Taxable profits	0	-12	-12	-12
Corporate tax	0	-3	-3	0
Imp inc (tax)	60 (15)	0	0	0
Interest (tax)	12 (0)	12 (4.8)	12 (4.8)	12 (4.8)
Dividends (tax)	24 (0)	25.5 (6.38)	25.5 (12)	24 (9.6)
Real. gains (tax)	12 (0)	12.75 (3.19)	12.75 (3.19)	12 (4.8)
Accr. gains (tax)	12 (0)	12.75 (0)	12.75 (0)	12 (4.8)
Net income	60	48.64	43.01	36
Tax rate	25%	18.9%	28.3%	40%

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With full expensing BEIT still taxes at 25% because expensing is equivalent to the COCA deduction. So BEIT (and MTM) effectively eliminates all business investment preferences (except for refundable or tradable credits), whether intentional or accidental.

CL claws back some of the preferences through taxes on individual investment income, but preferences in this example cut the tax rate under CL almost in half and make CL for generous than BEIT.

Integration claws back more of the firm level preference than CL because credit is given only for corporate taxes paid and dividends are assumed to face the ordinary income tax rate of 40%.

Effects of Preferences on Effective Tax Rates with 40% Debt Finance



	BEIT	CL	INT	MTM
No preferences	25%	39.25%	37.75%	40%
Tax-free saver	0%	20%	20%	0%
Expensed Investment	25%	18.94%	28.31%	40%

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This slide summarizes the effects of tax preferences for the marginal investment under the different systems.

BEIT and MTM both allow full exemption for the tax-favored saver, but provide no benefit to otherwise tax-favored investment.

CL provides a different, but almost equal benefit to both the tax-favored saver and the tax preferred investment.

Integration provides larger benefits to the tax-favored saver than to the tax-preferred investment.

Effects of Preferences on Effective Tax Rates for Profits of Equity-Financed Pass-Throughs



	BEIT	CL	INT	MTM
No preferences	25%	32/40%	32/40%	40%
Tax-free saver	0%	0%	0%	0%
Expensed Investment	25%	0%	0%	0%

This slide shows the effects of preferences on pass-throughs. Bottom line is expensing reduces ETR to zero under all the options except BEIT and MTM (the latter because MTM does not apply to non-publicly traded assets). And since there is no corporate level tax under any option, the ETR is always zero for tax-exempt savers.

Example: Economic Rent – Equity Return from Asset Worth \$1,000 Created from Tax-Free Income



	BEIT	CL	INT	MTM
Net revenue	60	60	60	60
COCA deduction	0	0	0	0
Taxable profits	60	60	60	60
Corporate tax	15	15	15	0
Imp inc (tax)	60 (0)	0	0	0
Interest (tax)	0 (0)	0 (0)	0 (0)	0 (0)
Dividends (tax)	22.5 (0)	22.5 (5.63)	22.5 (4.5)	30 (12)
Real. gains (tax)	11.25 (0)	11.25 (2.81)	11.25 (2.81)	15 (6)
Accr. gains (tax)	11.25 (0)	11.25 (0)	11.25 (0)	15 (6)
Net income	45	36.56	37.69	36
Tax rate	25%	39.06%	37.19%	40%

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This slide presents the taxation of economic rent as Ed would view it. There is a 25 percent tax at the firm level, but not tax at the individual level... Let's unpack this.

Economic rent occurs because value has been created in excess of the investor's basis in the asset. But once new value has been created, new investors will pay the market price for the share. So the prior examples might accurately describe a current investor in Apple getting a normal return, for example, but not the earlier owners.

But the firm pays tax on its profits in excess of deductions for existing real assets, reflecting its return from intangible assets. So the tax has been shifting from the original investor (with a zero basis) to the firm, but nothing else changes.

But is this the right way to look at it?

Is there really a 25% tax on rent in BEIT?



- International Income Shifting
 - Shifting of intangible profits to low-tax countries
 - Kleinbard's solution: Global residence tax. Does it work?
- Interpretation of tax on zero basis investments?
 - Is reinvestment of untaxed gains the same as expensing of investment from after-tax dollars?
 - Is this just a deferred tax on labor or windfall gains?
 - Why tax at 25% instead of 40%?

International income shifting may be on reason ED wants to tax economic rent at 25 percent instead of 40 percent.

Note that for normal returns, BEIT works perfectly for internationally mobile capital. The tax is paid by the shareholder, who is much less mobile internationally, than the capital owned by the firm. But there is a problem with intangible profits, which BEIT would tax at the firm level.

The other issues is how the accrued gains associated with the firm's current excess return on its invested capital (them difference between firm value and the basis of real assets) was previously taxed. If those gains were exempt, then that exemption is the equivalent of expensing of this excess value and the relevant example is the competitive firm with expensed capital.

It all depends on how capital gains associated with either entrepreneurial "sweat equity" or windfall changes in asset value were taxed.

Taxation of Capital Gains			
BEIT	Current Law	Haig-Simons	Consumption Tax
Deferred corporate tax on gain; if realized and reinvested, additional shareholder tax on return to new basis; no tax if realized for consumption; selective realization tax on gains of entrepreneurs	Deferred partial corporate and investor taxes on gain; additional shareholder tax when realized.	Taxable as accrued.	Deferred if unrealized or realized and reinvested; taxable when consumed.

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Three sources of capital gains: 1) retained earnings of corporate normal returns, 2) windfalls, and 3) entrepreneurial income. Kleinbard would tax 1) as accrued, would exempt 2) even when realized, and 3) would impose a special reduce rate tax on 3) when new firms go public, but no tax on 3) if the entrepreneurial returns were earned within an existing firm.

MTM would tax all gains accrued within publicly-traded companies, but would tax gains on privately-held firms only when realized (possibly with a deferral charge).

All systems could be made more comprehensive by taxing unrealized gains on assets transferred at death, with the exception of the consumption tax which does not need to tax any reinvested gains.

Other Issues: Owner-Managed Firms



- Need way to separate labor from capital income because of split-rate tax
 - Also issue for HI tax, QBI deduction
- One Simple method: Capital income is normal return on basis; labor everything else
 - Exempt time value, but taxed rent as capital income
- Ed's approach is somewhat *ad hoc*
 - 3 times normal return is capital income
 - Current income above that is labor income
 - Realized gains on sale above that are taxed as capital income
- An Alternative: VAT plus reduced income tax rate.

Other Issues: Financial Institutions



- Problem with all systems that do not tax financial income directly
 - Examples: VAT, X tax, DBCFT
- For these firms, the return is the interest spread (reflecting risk differentials) on a small base of real assets
 - Imputed return method would not work
 - Ed would tax these firms on their net interest income

- Would tax worldwide normal returns at individual investor level
 - Exploits fact that capital assets are much more mobile than individual residents.

- Would tax rents at firm level:
 - Intangible profits easy to shift, so rightly rejects a source-based approach
 - But alternative of worldwide residence tax creates problems of inversions and other residence shifts
 - Low rate and change in residence definition
 - Maybe more feasible now because of Pillar 2

Other Issues: Constructive Realization at Death



- Needed to prevent lifetime capital gains from escaping tax.
- Problem in many systems
 - BEIT: most capital gains exempt
 - Current law: Biden proposal to tax unrealized gains at death
 - Mark to market systems: Inability to measure gains of non-publicly traded assets
- Included in proposal, but would be an equally valuable reform without the BEIT

Broader Issue: How to Use the Tax Code to Reduce Income Inequality



- **Concerns about income inequality**
 - Rise in share of top 1% or top 0.01%
 - Lagging incomes of poor and middle class
 - Kleinbard much more concerned about the latter
- **All approaches fail to tax all the rich uniformly**
 - Measuring capital income at firm level
 - Measuring non-traded wealth of individuals
 - Limiting international income shifting
- **BEIT fits with Kleinbard's broader worldview**
 - Moderate low-rate taxation of most capital income
 - Combine moderately progressive taxation with more spending on public goods

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A very important point made in other presentations: Kleinbard's emphasis that we should be looking at the progressivity of fiscal systems as a whole, not just tax. A moderately progressive tax with a large role for government social programs can generate more progressive outcomes than a steeply progressive tax with a smaller public sector.

Final comment: BEIT is a major contribution to the work on capital income taxation, which has received less attention than it deserves (including from me, until now).

It does not, however, solve the problem of preventing the wealthiest among us from paying very low rates on their accrued capital gains. I am not aware, however, of any robust solution to that problem.

THANK YOU

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