Replacing the Corporate Income Tax with a Cash-Flow Tax

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Americans have been inundated with financial scandals at large corporations during the past two years. In many cases, unethical behavior and poor oversight of corporate management are to blame. But the corporate income tax has also been a key source of corporate inefficiency and scandal. The tax code distorts financial and investment decisions, and spurs executives to hunt for tax shelters.

These tax problems are highlighted in the 2,700-page report on Enron Corporation by the congressional Joint Committee on Taxation (JCT 2003a). Enron is just one company, but it took a team of JCT investigators a year to figure out how all its tax shelters worked. The JCT's efforts were a mirror image of the efforts of Enron, the accounting firms, and investment banks that put Enron's tax shelters into place originally. The JCT (2003a:16) concluded that Enron "excelled at making complexity an ally." While an ally to Enron, tax complexity is an enemy to productive corporate management and efficient investment decisionmaking.

Enron-style tax sheltering has not been the only type of corporate tax scandal in the news. Attention has also focused on the growing number of U.S. companies reincorporating in low-tax jurisdictions, such as Bermuda. U.S. firms can save taxes on their foreign operations by creating a foreign parent company for their worldwide operations. At the same time, there are growing concerns about the uncompetitiveness of the U.S. corporate tax because of the high statutory rate of 35 percent and the complex rules on foreign investment (Edwards and de Rugy 2002).

The corporate income tax is also feeling pressure from financial innovation on Wall Street. A recently decided case in the U.S. Tax Court, which involved Bank One's use of derivatives, was an 8-year battle with a trial that produced a 3,500-page transcript and

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10,000 exhibits (Simpson 2003: C1). The corporate tax system is having trouble keeping up with today's complex and globalized economy.

The corporate income tax has three fundamental flaws. The first flaw is that the U.S. statutory tax rate is the second highest among the 30 major industrial countries (KPMG 2003). That high rate reduces investment, encourages firms to move profits abroad, and provides incentives to push the legal margins with complex tax shelters.

The second flaw is that the corporate tax base of net income or profits is inherently complex because it relies on concepts, such as capital gains and capitalization of long-lived assets, that are difficult to consistently account for in a tax system. Costs of capitalized assets are deducted through depreciation, amortization, and other rules. The income tax rules for capitalized assets and capital gains are repeatedly exploited in tax shelters, and they distort capital investment, business reorganizations, and other decisions.

The third fundamental flaw is the gratuitous inconsistency that Congress has injected into the tax code. One example is the different treatment given to corporate debt and equity. Another example is the different tax rules imposed on corporations and the half dozen other types of businesses. Such inconsistencies have played a key role in the tax shelters exploited by Enron and other firms. Worse, they distort capital markets and channel investment into less productive uses.

This article discusses the most serious corporate tax distortions and examines fundamental reforms to fix them. One option examined is full repeal of the corporate tax. Alternately, the replacement of the corporate income tax with a cash-flow tax is discussed. A cash-flow tax would eliminate most of the serious distortions in the corporate tax system by eliminating capital gains taxation, replacing capitalization with expensing, and creating financial neutrality between debt and equity. By cutting individual dividend and capital gains tax rates and providing partial expensing treatment for business investment, the 2003 tax law was a good first step toward corporate tax reform (see JCT 2003b).

Tax Shelters: Finding Fundamental Economic Solutions

Corporate tax avoidance has been on the upswing by most accounts, though there are no firm estimates of the magnitude of these activities. The upswing has been spurred by sophisticated tax planning made possible by advanced computers and software, Wall Street financial innovation, global competitive pressures, and the high U.S.

corporate tax rate. The increase in tax avoidance has been costly in time and money for both companies and the government. Accounting and Wall Street firms have developed high levels of expertise at combining disparate parts of the tax code to engineer tax savings. But that expertise costs money: tax shelter promoters have been paid as much as $25 million for a single deal (U.S. Treasury 1999: vi, 23). Enron paid $88 million for advice on 12 tax shelter deals between 1995 and 2001 (JCT 2003a:107). For the government, it can cost $2 million just to litigate a single tax shelter case (U. S. Treasury 1999: v).

The Internal Revenue Service, U. S. Treasury, and courts are kept busy as each new tax shelter is discovered and then squelched through statutes, regulations, enforcement, and litigation. In 1999, a major Treasury Department study on tax shelters noted that at least 30 new narrow provisions had been added to the tax code in the prior few years in response to particular abuses (U. S. Treasury 1999: iv). These new rules in turn force taxpayers and their advisers to abide by growing lists of anti-abuse statutes, penalties, reporting requirements, and disclosure rules.

One might think that these wasteful efforts could be reduced if corporations simply stopped acting improperly. But there is usually no clear-cut right or wrong in the income tax avoidance cat-and-mouse game. Most corporate tax disputes involve different interpretations of the rules, not straightforward cheating. Many issues are so gray that tax disputes between companies and the IRS can remain unsettled for 10 years or more.

Given this level of legal uncertainty, companies have strong incentives to push the tax code's limits. After all, no taxpayer has an obligation to pay more than what is owed, and the government cannot tell them for sure what an illegal tax shelter is. One expert noted that "virtually all tax shelters comply with the literal language of a relevant (and perhaps the most relevant) statute, administrative ruling, or case" (Bankman 1999: 1775). With regard to Enron tax shelter activities, then JCT chief of staff, Lindy Paull, testified, "I don't know if you could call it illegal" (Behr 2003: E1).

There is debate regarding the best way to crack down on tax shelters from a legal point of view. Some experts support more detailed rules, while others support stronger general standards. Ultimately, a large and sustained reduction in tax sheltering can be achieved by changing fundamental economic incentives, not by adding endless layers of new rules. The U.S. Treasury (1999: 6, 9) noted that tax "shelters typically rely on some type of discontinuity in the tax law that treats certain types or amounts of economic activity more favorably than comparable types or amounts of activity." For example, the tax

code favors debt over equity financing by allowing corporations a deduction for interest payments but not for dividend payments. That discontinuity has spurred companies to design complex financial structures that have many features of equity but are treated as debt for tax purposes.

Another problem are the narrow benefits carved into the tax code by Congress. A classic example was recently reported by the *New York Times* (Johnston 2003: C1). Decades ago, Congress carved out a tax exemption for small insurance companies—those with less than $350,000 in premiums—to help farmers and others get coverage. The *Times* reports that a host of millionaires and noninsurance companies have seized the opportunity to set up insurance company shells that do little actual insurance business. Instead, these tax avoiders transfer billions of dollars of assets to these shells to generate tax-free earnings—all legally.

If the tax code were instead built on a neutral and transparent base, it would make administration and compliance easier for taxpayers and the government. It would also reduce tax inequalities between companies, which is one cause of corporate tax sheltering. As the Treasury Department noted, effective tax rates are "viewed as a performance measure, separate from after-tax profits. That has put pressure on corporate financial officers to generate tax savings through shelters" (U. S. Treasury 1999: 28). That problem would be reduced if effective tax rates were similar across companies and industries.

High Rate Exacerbates All Corporate Tax Problems

Corporate income tax rates are tumbling across nations in the Organization for Economic Cooperation and Development. The average top rate in the OECD fell from 37.6 percent in 1996 to just 30.8 percent by 2003 (KPMG 2003). That compares with a 40 percent rate in the United States, including the 35 percent federal rate and an average 5 percent state rate. The United States now has the second highest statutory corporate tax rate in the OECD next to Japan.

Countries are realizing that high corporate tax rates discourage inflows of foreign investment and encourage domestic companies to invest abroad. As world direct investment flows soared from about $200 billion to $1.3 trillion annually during the 1990s, countries have sought to attract their share of investments in automobile factories, computer chip plants, and other facilities (Edwards and de Rugy 2002). Extensive empirical research has concluded that tax rates are important in channeling these cross-border investments (Hines 2001). As just one current example, the world's third largest memory

chip maker, Infineon Technologies, recently announced that it may move its headquarters out of Germany partly because of that country's high tax burden (Nagl 2003).

Corporate tax rates also influence the financial structures of multinational corporations. For example, there is concern regarding "earnings stripping" today, which occurs when parent firms and their affiliates use intercompany borrowing to shift profits from high-tax to low-tax countries. The benefits of such transactions depend on the tax rates in the two countries. As our trading partners have cut tax rates, it is not surprising that the U.S. corporate tax is feeling pressure from such tax avoidance techniques.

An important conclusion of public finance research is that in an open-world economy countries should greatly reduce tax rates on capital income (Engen and Hassett 2002). Higher tax rates raise the required pretax return on investments, which reduces a country's capital stock and wages. In that situation, it would be more efficient for a country, and better for workers, to tax wages directly. Corporate profits are mobile in today's economy, and thus should be taxed very lightly, if at all, to maximize U.S. investment and gross domestic product.

Flaws Intrinsic to the Corporate Income Tax

The corporate income tax was enacted in 1909 as an "excise" tax (Blakey 1934: Section I). Since the Supreme Court had struck down the income tax in 1895, attempts were made to work around the Court's decision and apply taxes to an income base.[1] The Corporation Tax Act of 1909 applied a 1 percent tax on corporate net income, based on the theory that it was an excise on the "privilege" of organizing in the corporate form.[2] Support for the tax came from the anti-big business movement that had grown in prior decades and from tariff opponents who wanted to find a substitute revenue source (Webber and Wildavsky 1986: 420).

Congress imposed the corporate tax on the very troublesome base of net income or profits, which created substantial complexity from the beginning. Indeed, the JCT was created in 1926 to study simplification of the already complicated income tax. By the 1930s, experts were lamenting all the basic income tax problems that cause distor-

[1]The income tax law of 1894 was struck down in *Pollock v. Farmers' Loan and Trust Company*, 157 U.S. 429 (1895).

[2]It is often stated that the corporate business form only exists because of government "privileges," but that view has been challenged (e.g., see Barry 2003).

tions today. A report by the Treasury at that time (Blakey 1934: Section VIII) noted with regard to the corporate income tax:

> The irregularity of income, the taxation of capital gains, the definition of the time of "realization," the handling of depreciation and appreciation, the cash versus accrual method of accounting, the holding and distributing of corporation earnings in the form of dividends, all raise serious difficulties in the definition of income and administration of a net income tax.

Income Taxation is Sensitive to Timing

Timing is everything under the income tax, which relies on capitalization and accrual accounting. The basic idea is to match expenses against corresponding income when earned. For example, if cash is spent this year on an asset that creates benefits in future years, the cost should not be currently deducted. Instead, the cost must be capitalized and deducted later. The corporate income tax generally requires that long-lived assets be capitalized. The cost of structures, machines, and other assets are deducted over time under rules for depreciation and amortization, and inventory has its own set of complex rules. Goodwill, an asset created under some corporate acquisition transactions, is amortized over 15 years. In sum, in any given year there are numerous income and deduction items on corporate income tax returns that do not coincide with flows of cash but are based on tax law definitions determining the proper timing of recognition.

The corporate income tax generally uses accrual accounting, meaning that income is included in the tax base when earned, not when cash is received, and expenses are deducted when incurred, not when cash is paid. But capital gains is an exception. In theory, broad-based, or Haig-Simons, income taxation would tax capital gains on an accrual basis. But since that is not feasible, the income tax falls back on taxing most, but not all, gains when realized. Recent tax shelters have exploited the fact that some gains are taxed on a realization basis and other gains are taxed on a mark-to-market or accrual basis, such as foreign currency contracts (U.S. Treasury 1999: 16).

A number of Enron tax shelters exploited the income tax's sensitivity to timing. For example, "commodity prepay" deals were set up to allow Enron to generate up-front income to utilize special energy tax credits before they expired (JCT 2003a: 346). Enron received up-front payments to utilize the tax credits, but then the deals were reversed-out with further transactions after the tax benefits had been received.

Net Cash Flow is an Alternative Tax Base

An alternative to income taxation based on accrual accounting is consumption taxation based on cash-flow accounting. A cash-flow tax would be imposed on net cash-flow of businesses, not net income or profits. The most commonly proposed type of cash-flow tax, an "R-based" tax, would have a tax base of receipts from the sale of goods and services less current and capital expenses. Under an R (real) base, financial items such as interest, dividends, and capital gains would be disregarded—they would not be included in income nor allowed as deductions. (Alternately, an R+F base, real plus financial, would include financial flows). Under cash-flow accounting, businesses would include receipts when cash is received, and deduct the full costs of materials, inventories, equipment, and structures when they are purchased.

Most such manipulations with regard to the timing of income and expenses would be eliminated under a cash-flow tax. Income would be included in the tax base when received. Deductions would be taken when cash went out the door. That treatment would not only be more economically efficient, it would remove a great many tax avoidance opportunities that exist under the current tax regime. Most corporate income tax distortions would be eliminated under a cash-flow tax. These include the different treatment of debt and equity, the different treatment of corporate and noncorporate businesses, the bias against saving, and distortions caused by depreciation and inflation.

Business cash-flow taxes have formed the basis of numerous legislative proposals. The most well known is the flat tax designed by the Hoover Institution's Robert Hall and Alvin Rabushka (1995). The flat tax is based around an R-based business cash-flow tax, and versions were championed by Dick Armey and others in the 1990s.

Capitalization

Under the income tax, business purchases of assets that generate revenues in future years are typically not deducted when purchased. Instead, such items as buildings, machines, and intangible assets are capitalized and deducted over future years. Under income tax theory, the purchase price of buildings and machines should be deducted, or depreciated, over time to match the loss in economic value of the asset. When intangible assets are purchased, they are amortized over a specified period. Materials purchased for inventory and related expenses face special deduction rules.

There are two key problems with capitalization. The first problem

is any asset that produces benefits in future years should be capitalized in income tax theory. But that principle becomes extremely ambiguous in practice. For example, the IRS has battled companies over whether or not fees to management consultants should be immediately deducted since they may create long-term benefits. Also, the tax code is not consistent. On the one hand, advertising and research and development expenses are immediately deducted under current rules, yet they produce benefits in future years. On the other hand, the tax law requires capitalization of numerous expenses that taxpayers think of as current expenses.

The second key problem with capitalization is determining the time period and method for which each asset should be deducted. In income tax theory, depreciation deductions should match an asset's obsolescence over time. But every asset is different, and new types of assets are being invented all the time, so rough approximations must be used. For newer technologies, the asset classification system is long out-of-date. But even up-to-date depreciation schedules would be inaccurate because of the distortionary effect of inflation.

Depreciation plays an important role in corporate tax sheltering. A basic strategy is to artificially raise the basis of an asset to increase future depreciation deductions. ("Basis" is generally the original cost less accumulated depreciation). This strategy was used in Enron's Teresa tax deal in 1997 (JCT 2003a: 165, 173–74). Enron and an investment bank set up a partnership to which Enron contributed its Houston North office building. Through complex transactions, Enron was able to shift $1 billion in basis from a nondepreciable asset to the office building and other depreciable assets. Similarly, Enron deals Tammy 1 and Tammy 2 involved shifting about $2 billion in basis from nondepreciable to depreciable assets to gain increased depreciation deductions (JCT 2003a: 221, 234).

A business cash-flow tax would eliminate capitalization and related concepts such as depreciation. Basis could not be shifted from some assets to others as under the Enron deals because asset basis is always zero under a cash-flow tax. Businesses would include the full price of asset sales in taxable receipts, and would deduct the full cost when purchased. All business purchases would be treated the same way and immediately deducted. Partnerships would be taxed the same as other business entities so there would be no advantages in shifting assets to them. Expensing would create tax neutrality across all types of assets.

Capital Gains

Capital gains taxation has caused complexities and distortions throughout the history of the income tax. As early as 1944, a Treasury

Department report noted that, "the treatment of capital gains has long been a source of controversy in federal taxation" (Blough 1944). Congress has not found a stable and efficient treatment for capital gains: it repeatedly changes the rates, exclusion amounts, holding periods, and treatment of losses. And more rules are added whenever new financial products are developed. For example, complex "constructive sale" rules were added in 1997 to prevent investors from using short-selling to lock-in gains without paying tax. But the new rules have since prompted the development of other techniques to allow investors to accomplish essentially the same thing.

Although Congress has made capital gains taxation more complex than it needs to be, most of the complexity is intrinsic. For example, practicality dictates than most gains be taxed on a realization basis, yet that treatment spurs a great deal of tax planning since gains and losses need to be optimally matched. For corporations, net capital gains are taxed at the regular corporate rate, generally 35 percent. Capital losses may only be deducted against capital gains, not ordinary income. Net capital losses may be carried back three years or forward five years. These basic rules necessitate complex tax planning. Companies try to avoid realizing gains unless they have losses available. Also, they generally prefer income to be characterized as capital gains not ordinary income, and losses to be characterized as ordinary losses not capital losses, because of the limitations on capital losses.

Corporations pay capital gains on sales of capital assets, such as shares of other corporations. But gains on the sale of depreciable assets involve other rules. For example, sales of personal property, such as machinery, are taxed partly as capital gains and partly as ordinary income. The overall taxable amount is the difference between the sales price and basis, which is generally the original cost less accumulated depreciation. That amount is taxed as ordinary income to the extent of previous depreciation allowances (depreciation is "recaptured").

Aside from being complex, corporate capital gains taxes create distortions, such as "locking-in" investments. That occurs because built-in gains face corporate taxation when shares are sold. Consider SunTrust and Coca-Cola. SunTrust owns roughly $2 billion in Coca-Cola company shares, which it has held since 1919. If SunTrust wanted to unload those shares, it would face corporate capital gains taxes of roughly $700 million at the 35 percent corporate tax rate (Lang, Maydew, and Shackelford 2001: 10).[3] In such situations, companies may avoid selling shares and refocusing their investments.

[3]The authors' example was recalculated at today's share price.

The high corporate capital gains tax has caused corporations to devise elaborate strategies to avoid it. Corporations have developed techniques to effectively divest holdings in other firms while retaining legal ownership and deferring capital gains tax until later years (Lang, Maydew, and Shackelford 2001: 6). For example, Times Mirror wanted to unload its holding of Netscape Communications without paying the corporate capital gains tax in 1996 (Browning 1996: 223). With help from Wall Street, Times Mirror designed and issued a financial instrument called "PEPS," allowing it to put off taxes until later and receive interest deductions on its PEPS payments. "PHONEs" are another financial instrument giving companies the benefit of unloading their holdings without actually selling stock and incurring capital gains tax. PHONES were used a few years ago by Comcast when it unloaded its AT&T holdings, and by Tribune company to unload its AOL holdings.

Enron built a number of tax shelters around the capital gain and loss rules, such as the Tanya and Valor deals initiated in the mid-1990s. These deals involved transactions designed to create capital losses to offset gains that Enron had generated from the sale of Enron Oil and Gas (JCT 2003a: 118, 124, 128). Under the Steele and Cochise deals, Enron acquired built-in losses from another company to offset some of its income.

Another tax avoidance strategy prompted by taxation of capital gains is to increase asset basis before a sale to reduce taxable gain. Enron used this strategy with the Tomas deal, which involved entering transactions to increase the basis of a portfolio of assets it wanted to dispose of, including leased airplanes and rail cars (JCT 2003a: 189, 201).

Under the income tax, capital gains taxation creates endless incentives for corporate tax planning and avoidance. Under a business cash-flow tax, capital gains taxation would be eliminated. Asset basis would not be a variable to manipulate up or down to create gain or loss. Businesses would simply include the market price of asset sales in taxable revenue, and symmetrically expense assets when purchased. That would create an enormous simplification of business tax planning, close many tax shelters, and reduce the need for government rules and enforcement efforts.

Mergers and Acquisitions

The tax law controlling the world of corporate reorganizations—mergers, acquisitions, and other transactions—is a messy interaction of the rules for capital gains, depreciation, interest deductions, net

operating losses, goodwill, and other items. Many tax experts echo Cleveland State University professor Deborah Geier's views on this area of tax law:

> The current state of the law regarding corporate reorganizations is incomprehensible. The law in this area is not the result of a grand, coherent scheme but rather is the end result of a long accumulation of cases, statutory amendments, and IRS ruling positions, the sum total of which is a system that is staggering in its complexity and unpredictability. Moreover, the system exacts extremely high and inefficient transactions costs, as deals must be structured in ways that make sense only to the tax lawyers [Geier 1997: 801].

Optimally, tax rules should neither stand in the way of efficient business restructuring nor encourage transactions that make no economic sense. Yet, the income tax does both. For example, there was much concern in the 1980s that the preferential tax treatment of debt helped fuel the leveraged buyout spree, which was financed by high-yield bonds. Part of the game plan of the famous 1989 RJR-Nabisco buyout was to wipe out the company's taxable income for years with interest deductions from a large high-yield bond issue (Bulow, Summers, and Summers 1990: 135). Tax law changes over the decades have variously encouraged or discouraged mergers and acquisitions (M&As).

The complexity of the tax rules on corporate reorganizations spurs companies to create elaborate strategies for tax avoidance. The *Washington Post*'s Allan Sloan chronicles business reorganizations in his column, and he seems to find a tax scandal in every deal. Some of his column's headlines have been, "Northrop Grumman Deal Scores a Direct Hit on Taxes," and "GM Finds a Hole in the Tax Code Big Enough to Drive Billions Through" (Sloan 1996, 1997). Surely, something is wrong with a tax system that turns every M&A into a supposed scandal.

M&A problems are rooted in the basic structure of the income tax, such as the rules for capital gains taxation and capitalization (see Gaughan 2002). Shareholders of companies being bought (target firms) may be paid either in cash or in shares of the acquiring firm. A tax-free transaction generally occurs when the target's shareholders receive shares. In these deals, target shareholders do not pay capital gains taxes in the transaction. (They will pay taxes later when they sell their shares). By contrast, under taxable transactions the target firm shareholders receive cash and may face current capital gains taxes. Deals are sometimes partly stock and partly cash, in which case target shareholders may pay some taxes.

Different transaction structures (called "A," "B," "C," etc.) provide

rules for different amounts of stock and cash, different classes of shares, and other specifics. For example, Sloan (2001) criticized General Motors for a deal that used multiple share classes to get around capital gains taxes on the sale of GM's Hughes Electronics to Echostar. GM was apparently able to avoid restrictive rules put in place in 1997. In turn, the 1997 rules had been put in place to prevent transactions of a type for which GM had been able to avoid taxes on in a prior deal.

Another key tax issue for M&As is how much depreciation companies will be able to deduct on target assets after a reorganization. Under some types of transactions, particularly taxable ones, the basis of the target's assets is stepped-up to market value. If a target firm's assets have a market value higher than their current tax basis, the assets will be worth more to another company, which will be able to take larger depreciation deductions than the current owner. That creates incentives for acquisitions.

Most of the tax rules for business reorganization would be swept away under a business cash-flow tax. Generally, business reorganizations that involve an exchange of shares—the purchase of stock of one firm by another—would not be taxable events. However, sales of assets for cash between businesses would be taxable events. The market value of assets would be included in the seller's tax base, which provides symmetrical treatment to the expensing of asset purchases. The concept of "basis" that is behind capital gains and depreciation under the income tax would disappear under a cash-flow tax. There would be no step-up in asset basis during restructuring, no future streams of depreciation or goodwill deductions to consider, and no distinctions between debt and equity for financing. Businesses could merge, split-up, spin-off, and reorganize any way that is efficient without the tax distortions that plague business restructuring today.

Gratuitous Flaws in the Corporate Income Tax

On top of the intrinsic problems of income taxation, such as capitalization and capital gains taxation, Congress has gratuitously or needlessly added to the tax system's distortions. For example, corporate and noncorporate businesses are taxed differently and earnings paid out as dividends face double taxation. Such distortions result in investment being misallocated—too little investment flows into corporations, too much debt is used in financial structures, and corporate profits are retained rather than paid out. The following sections summarize some of the major distortions of the income tax that should be eliminated under any type of business tax system.

Multiple Business Structures

The largest business enterprises in the United States are organized as "subchapter C" corporations and are subject to the corporate income tax. The corporate income tax forms a second layer of tax on investment returns in addition to individual income taxes. By contrast, noncorporate businesses face a single layer of income taxation. As a result, the overall marginal effective tax rate on corporate income is about twice that of the noncorporate sector (Gravelle 1994: 52). That tax distortion means that fewer businesses take advantage of the benefits of the corporate structure, such as limited liability, ease of ownership transfer, access to public capital markets, and rapid growth potential.

The list of competitors to subchapter C corporations includes sole proprietorships, partnerships, subchapter S corporations, limited liability corporations (LLCs), limited liability partnerships (LLPs), real estate investment trusts (REITS), regulated investment companies (RICs), real estate mortgage investment conduits (REMICs), and financial asset securitization investment trusts (FASITs). Each of these structures is subject to an array of special tax rules. As a result, entrepreneurs and investors must consider the unique limitations of each structure when starting, expanding, or investing in a business. For example, subchapter S corporations can only issue a single class of stock and can have no more than 75 shareholders.

The existence of different business structures creates tax planning opportunities because the same activity can be undertaken in different ways with different tax results. Business structures, such as partnerships, can be used by corporations to conceal debt, change the form of financial flows, and confuse tax authorities and investors. The idea behind partnerships is that income, gains, and losses are not taxed at the partnership level, but passed through to individual partners based on the parameters in the partnership agreement.

One basic tax-sheltering idea is for a corporation to set up a partnership with a tax-exempt entity, and then to allocate the tax-exempt partner most of the income with the corporation allocated the losses to offset other income it has. Enron used the partnership rules in a number of its tax shelters, sometimes using them to move assets between entities to engineer increases in asset basis. Increases in asset basis can reduce capital gains taxes or generate higher depreciation deductions (JCT 2003a: 181).

Enron used other business structures in its tax shelters, such as REMICs, FASITs, and REITs. FASITs (created in 1996) and REMICs (created in 1986) are used in the securitization of debt.

REMICs are mainly used to securitize mortgage debt, while FASITS hold a broader array of debt. One indication of income tax complexity is that a tax guide on REMICs, FASITs, and similar investments spans 1,309 pages (Peaslee and Nirenberg 2001). The authors of this guide say that it is written in "plain English" and not just for specialists, which makes one wonder how long the specialist version would be.

Enron used a REMIC in the Steele shelter and a REIT in the Cochise shelter. In the Apache deal, Enron used a FASIT to get around some punitive parts of the tax code, including the subpart F rules on inclusion of foreign income (JCT 2003a: 115, 244, 255). Congress did not create these special interest business structures for companies such as Enron to exploit. But since Congress created them, corporate financial engineers have swooped in to extract what tax benefits they can out of the special rules.

The alternative is to establish a single form of business organization across every type of business, big or small. That is a key idea behind business cash-flow taxes, such as the Hall-Rabushka flat tax. It would treat all business activity equally under the same rules. Hall-Rabushka would also integrate individual and business taxes so that all business income would only be taxed just once. There would be no need for special entities such as REITs. Marginal investments would produce the same after-tax return no matter which type of business undertook it. Corporate governance would be improved as investors would not have to hunt for suspicious "special purpose entities" on financial statements, which typically use the rules for partnerships and LLCs.

Double Taxation of Corporate Equity

A Treasury Department report said, "Double taxation of corporate profits is the principal problem raised in connection with the corporation income tax. At the present time corporate profits are taxed first to the corporations, then again to the stockholders when they are distributed as dividends" (Blough 1944). That assessment was not from the Bush Treasury, but from Roy Blough, director of tax research at the Treasury Department in 1944. The double taxation of dividends was a long-festering problem that Congress has just taken the first step in fixing under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

Corporate earnings distributed as dividends face both the 35 percent corporate income tax and the individual income tax, which had a top rate of 38.6 percent before this year's tax law. JGTRRA reduced the maximum individual rate on dividends to 15 percent through 2008. Earnings retained in the corporation also face double taxation

because retentions generally increase share price, thus imposing a capital gains tax when the stock is sold. By contrast to dividends and retained earnings, interest is only taxable at the individual level. JGTRRA reduced the maximum individual tax rate on capital gains to 15 percent through 2008. With the new tax law, the United States joins nearly all major countries in partly or fully alleviating the double taxation of dividends. Currently, 28 of 30 countries in the OECD have adopted one or more methods of dividend tax relief (Edwards 2003).

The economic distortions created by the tax bias against corporate equity are briefly reviewed here. These distortions were reduced, but not eliminated, by JGTRRA. As discussed below, a cash-flow business tax would fully eliminate all these distortions by equalizing the treatment of debt and equity, removing the bias against dividend payouts, and creating neutrality in corporate financial and investment decisions.

Increased Cost of Capital. High dividend taxes add to the income tax code's general bias against savings and investment. Dividend taxes raise the cost of capital, which is the minimum pretax rate of return that firms must earn to proceed with a new project. Income taxes on individuals and corporations place a wedge between the after-tax return enjoyed by individual savers and the gross return on corporate investment that their money finances. The tax wedge pushes up the cost of capital and reduces the number of profitable business investments. Reduced business investment means reduced output in the long run.

Nonetheless, there are differences of opinion among economists as to exactly how dividend taxes affect the cost of capital and marginal investment decisions (Sinn 1991 and Zodrow 1991). The "traditional view" contends that the dividend tax burden falls heavily on marginal investment, and thus creates large economic distortions. The "new view" contends that most firms finance marginal investments through retained earnings or debt, and thus dividend taxation does not have a large marginal investment effect. Differences in these two positions affect policy views regarding the effects of dividend taxes on stock market valuation, dividend payout, and other items. Empirical studies lean toward favoring the traditional view. However, there is general agreement that the cost of capital for investment financed by new share issues is increased by dividend taxation. As a result, heavy dividend taxation certainly hurts new, growing companies that may not have substantial retained earnings and thus need to tap equity markets.

Excessive Debt. When corporations borrow money to finance investment they are able to deduct interest payments and reduce their

tax liability. By contrast, when new investment is financed by equity, dividend payments cannot be deducted. As a result, the tax system favors debt, and U.S. corporate structures have become overleveraged. There are varying empirical estimates about the extent of this distortion. Roger Gordon and Young Lee (1999) found that a 10 percentage point reduction in the corporate tax rate would reduce the share of assets financed with debt by about 4 percentage points. The authors conclude that this is a large distortion, given that the share of assets financed by debt has been about 19 percent historically.

Corporate debt levels are not any higher than they are currently because there are nontax costs to overleveraging. The marginal cost of debt rises with increases in debt load, which curtails debt issuance. That occurs because added debt increases the risk of financial difficulty and thus affects credit ratings. Also, there are nontax advantages to equity financing that offset equity's tax disadvantage.

To the extent that taxes distort corporate decisions, the costs can be large given that corporations are the nation's dominant form of business organization. If tax rules favor excessive debt, the entire economy may be destabilized as more corporations are pushed into bankruptcy during recessions. As profits turn to losses during recessions, dividends can be suspended, but interest payments must be paid. Since equity provides a cushion against the ups and downs of the business cycle, penalizing it is a poor policy choice.

Excessive Retained Earnings. When a corporation earns a profit, it has the choice of retaining earnings or paying them out as dividends. The 2003 tax law cut the top dividend rate to 15 percent. When earnings are retained, they generate individual taxes if they push up the share price and create a capital gain. The 2003 law created a maximum capital gains tax rate of 15 percent. But gains are only taxed when realized, thus reducing the effective tax rate below the statutory rate. The lower rate on retained earnings than dividends creates a bias toward earnings retention.

The precise effects of dividend taxation on earnings payout has been studied many times but with few concrete results. The traditional and new views of dividend taxation provide differing perspectives. But it is clear that there has been a downward trend in dividend payments by U.S. corporations (Allen and Michaely 2002: 8, 134). Newer firms, in particular, avoid paying dividends. One reason is that corporations are paying out earnings in the form of share repurchases, which avoid the individual dividend tax (but do generate capital gains tax). Repurchases have accelerated since the mid-1980s (Allen and Michaely 2002: 116).

Why do corporations pay dividends at all given the heavy tax pen-

alty? The answer seems to be that there are important nontax benefits to dividends. Dividends help reduce the principal-agent problem caused by the separation of ownership and control in large corporations. Retained earnings allow corporate executives to more easily make imprudent investment decisions and fund wasteful projects. Dividends signal to shareholders that a corporation is earning solid profits because they are paid in hard cash and cannot be manipulated. The 2003 dividend tax cut may spur a return to this old-fashioned but effective check on corporate management and performance.

Wasteful Financial Engineering. The tax advantage of debt has caused corporations to design complex structures that are treated as debt for tax purposes, but as equity for financial statements (Gentry and Hubbard 1998). In response, Congress and the Treasury have added more and more tax rules to police the debt-equity distinction. Disputes between taxpayers and the government on securities that have both debt and equity characteristics have gone on for years (JCT 2003a: 327).

In the 1980s, the tax advantage of debt apparently helped fuel a binge in leveraged buyouts (LBOs) financed by high-yield bonds. LBOs relying on these securities, such as the RJR-Nabisco deal, allowed companies to substantially cut their taxable income with interest deductions (Bulow, Summers, and Summers 1990: 135). In the 1990s, Enron and other companies created hybrid securities called monthly income preferred securities, "MIPS," part of a broader category of "tiered preferred securities."[4]

In one deal, Enron set up a special purpose entity (SPE), Enron Capital LLC, in the Turks and Caicos in 1993 (McKinnon and Hitt 2002). This SPE issued $214 million of preferred shares, then lent the money to Enron to be paid back over 50 years. Enron began deducting interest payments to the SPE on its tax return. But on its financial statements, Enron counted the transaction as equity called "preferred stock in subsidiary companies." As a result, Enron reduced its taxes but avoided increasing its financial statement debt, which might have hurt its credit rating.

During the 1990s, the use of tiered preferred securities exploded with $180 billion outstanding by 2002 (McKinnon and Hitt 2002). A legal battle over these hybrids between taxpayers and the Treasury Department raged throughout the 1990s, likely costing hundreds of millions of dollars in lawyer and accountant fees. This is pure waste

[4]MIPS were the Goldman Sachs version of this financial structure, while TOPRS were the Merrill Lynch version.

from the perspective of the broader economy, and would be eliminated under a neutral cash-flow tax.

Tax Rules on International Investment

The tax rules on international investment are perhaps the most complex part of the corporate income tax (see Dubert and Merrill 2001). Most large U.S. corporations have dozens, sometimes hundreds, of foreign branches and subsidiaries, and they must do a great deal of planning to minimize their global tax burden. A key source of complexity is the application of the corporate tax to the worldwide income of U.S. companies. For example, a U.S. company owning a winery in France or an oil rig in Iraq must report that foreign income on its U.S. tax return.

An alternative method, used by about half of the major industrial nations, is the "territorial" approach, under which active foreign business income is not taxed (Dubert and Merrill 2001: Table 10–2). Business cash-flow tax proposals, such as the Hall-Rabushka flat tax, generally adopt the territorial approach, which would allow for a much simplified set of international tax rules.

Simplification is badly needed. For example, profits earned abroad by majority-owned subsidiaries are generally not taxed until repatriated—taxation is deferred. But there are overlapping sets of antideferral rules that do tax certain types of foreign income as soon as it is earned. On top of those rules, a complex system of foreign tax credits provides relief from taxation when income is taxed in both the United States and abroad. But foreign tax credits are subject to complicated limitations. For example, firms may average out income earned in high-tax and low-tax countries to maximize their tax credits. But the tax code limits such cross-crediting by dividing up foreign income in nine different categories, or "baskets," that cannot be blended.

The U.S. international tax rules have been widely criticized for complexity and uncompetitiveness, and Enron's tax situation illustrates the problems. Enron was particularly concerned with the allocation of interest deductions between domestic and foreign income, the tax disincentive to repatriating its foreign earnings, and utilization of its foreign tax credits. The JCT's Enron report found that "the company faced the possibility of significant double taxation of its foreign source income. This potential for unmitigated double taxation was of paramount concern in Enron's international tax planning and significantly influenced the structures of Enron's international operations and transactions" (JCT 2003a: 370).

Some pundits zeroed in on Enron's use of hundreds of foreign affiliates as proof of tax evasion activity. But the JCT found instead that "prudent tax planning typically requires a U.S.-based multinational enterprise to use a combination of many different entities in many different jurisdictions, even if the enterprise's tax planning goals are limited to ... generally unobjectionable ones" (JCT 2003a: 373). Enron had 1,300 foreign entities in its structure, although only about 250 were used for ongoing business. A key reason for the existence of so many affiliates was the inability of Enron to utilize foreign tax credits, which gave the company strong incentives to defer tax on foreign earnings through use of complicated affiliate structures (JCT 2003a: 377). Tax planning for a foreign investment often requires creating a complex tier of entities to minimize the risk of excess U.S. taxation.

The JCT also found that companies such as Enron that have affiliates in low-tax jurisdictions, such as the Cayman Islands, are not necessarily illegally or unethically avoiding taxes (JCT 2003a: 375). Overall, Enron's international tax planning was representative of the normal grossly complex planning that large U.S. corporations must perform under the corporate income tax. For investors, the fact that tax rules encourage companies to create complex business structures is an impediment to transparency and accurate assessments of firms' financial health.

Replacement of the current system with a territorial cash-flow tax would greatly simplify business planning by eliminating most international tax rules. There would be no need for foreign tax credits and numerous other parts of the international tax apparatus. A territorial tax would allow U.S. businesses to compete in foreign markets without the burdens imposed by the U.S. tax code. The United States would become an excellent location for multinational corporate headquarters because foreign affiliates could repatriate their profits free of U.S. tax. The current disincentive for repatriation—a key tax planning factor for Enron—would be eliminated.

Employee Compensation: $1 Million Wage Limit

Recent corporate scandals have highlighted distortions in the income tax relating to employee compensation and pensions. Some distortions are deeply rooted, such as the general practice of taxing saving more heavily than consumption and then selectively relieving taxes on favored forms of savings, such as pensions. Other distortions stem from narrow special interest provisions in the tax code.

One narrow and problematic provision is the arbitrary $1 million

limit on tax deductions for nonperformance-based compensation. The tax law denies businesses a deduction for executive wages of more than $1 million, but allows tax deductions for stock option compensation above that limit. This provision was added in 1993 in an attempt to micromanage corporate compensation policy. But the micromanaging has backfired because the limit seems to have caused a rapid growth of stock option compensation, which observers now argue causes corporate governance problems.

A traditional argument in favor of stock options was that they helped align the interests of shareholders with corporate executives by encouraging executives to earn higher profits. As such, stock options appeared to be a solution to the principal-agent problem in large corporations. But more recently, analysts have criticized stock options for promoting irresponsible efforts by executives to pump up share prices for personal gain without creating solid long-term growth. Stock options may also discourage executives from paying out dividends because retained earnings help push up stock prices. It appears that the combination of excessive stock option compensation caused by the $1 million cap, and the double taxation of dividends, has caused executives to excessively retain earnings and overemphasize short-term financial results.

Employee Compensation: ESOPs

Micromanaging employee compensation through the tax laws has also backfired in other areas. In the wake of the Enron scandal, it is clear that the tax rules that encourage workers to invest in their own company are misguided. Such rules encourage a nondiversified savings strategy, which was evident when many Enron workers lost their savings that had been invested in Enron stock. Enron workers held an average of 62 percent of their 401(k) portfolios in company stock (Gravelle 2003). Similar employee losses occurred when Global Crossing and WorldCom collapsed.

Jane Gravelle (2003) examined compensation issues raised by the Enron scandal. She finds particular fault with the "juicy" tax benefits given to Employee Stock Ownership Plans—defined contribution plans in which employee accounts are invested primarily in a company's own stock. Enron's ESOP was used to provide matches of its stock in workers' 401(k) plans in a structure called a KSOP. The income tax encourages worker ownership of company stock through ESOPs and KSOPs, and yet discourages it under other rules.

ESOPs represent classic congressional micromanaging gone bad. ESOPs received special tax breaks in 1974, and further benefits have

been added since including new breaks in 2001 (Gravelle 2003: 21). ESOPs have created an entrenched interest that pushes for expanded benefits. They have gained supporters by promising to create a kind of worker capitalism with employee-owned companies. Yet worker ownership does not seem to work very well: bankrupt United Airlines is a prominent employer-owed firm, and its "ESOP was a disaster," according to one industry expert (Alexander 2003: E4).

Another distortion is the widespread use of the ESOP as a financial tool to ward off hostile takeovers and protect incumbent corporate managers, as occurred with Polaroid (Gravelle 2003: 9). ESOPs interfere with the "market for corporate control," which is crucial to any economy dominated by large corporations. Corporate executives, of course, do not always act in the best interests of shareholders. As such, it is important that shareholders have tools to oust bad executives. ESOPs stand in the way of such shareholder empowerment by making it more difficult to launch an outside takeover.

Policy Options

Repeal the Corporate Income Tax

The corporate income tax has survived for more than 90 years despite having little support in economic theory. Indeed, the corporate income tax is very costly in terms of economic distortions created. Conservative economists have tended to favor a consumption-based tax system, which has no place for a corporate tax on net income. Liberal economists have tended to favor the Haig-Simons ideal of broad-based income taxation, but that ideal does not require a corporate income tax either. The Haig-Simons approach could be implemented by imposing a broad tax on capital income at the individual level. In his classic *Blueprints for Basic Tax Reform*, David Bradford ([1977] 1984) sketched out both a consumption tax and a broad-based income tax model for fundamental reform, and neither included a tax on corporations.

With no compelling economic rationale, then Treasury Secretary Paul O'Neill and others have suggested repealing the corporate income tax. But there are some administrative and political hurdles to corporate tax repeal. The political hurdles are easy to understand. Corporations provide a concentrated pool of cash that government can tap to fill its coffers—governments tax corporations "because that is where the money is." Corporations are an easy target because corporations do not vote. Corporate taxes get passed along to consumers, workers, and investors, but those individuals do not observe

the burden that falls on them. Tax invisibility is beneficial to politicians, but it creates a basic dishonesty in democratic government. It denies individuals the ability to make informed and efficient choices because government spending appears to be partly "free."

Aside from politics, there are administrative issues to consider in repealing the corporate tax. The tax is supported as a backstop to individual taxation of capital income because corporations act as withholding agents for capital income that flows to individuals. Under the Haig-Simons income tax ideal, businesses would not need to be taxed if all capital income were taxed on an accrual basis at the individual level. But that is very impractical, in addition to being bad economic policy. Instead, the current income tax system settled on using corporations as precollectors of income taxes. That structure prevents individuals from accumulating income within corporations tax-free, which would violate accrual income tax theory.

However, there would be no need for a corporate-level tax under some proposals for consumption-based tax reform. "Savings-exempt" or "consumed-income" tax proposals would apply a comprehensive tax at the individual level without need for a business-level tax. One example is the model cash-flow consumption tax included in Bradford's *Blueprints* study.[5] It would eliminate the corporate-level tax and allow individuals a choice of two treatments for saving (Bradford 1984: 13). Saving in qualified accounts would be deducted up front with withdrawals taxed later. Alternately, saving could be made from after-tax earnings with the returns received tax free.

Corporate tax repeal would involve some tricky issues with regard to international investment. Cross-border investments by multinational corporations have caused country tax systems to become entangled with one another. For example, corporate tax repeal could result in the federal government ceding tax revenue to foreign governments that have worldwide tax systems. If the United States did not tax the U.S. profits of foreign companies, other countries would have an incentive to do so. However, a number of factors would mitigate this possible problem.

The inefficiencies of the corporate income tax are being magnified as globalization and international tax competition continues to increase. At the same time, revenues from the corporate income tax have fallen from more than 30 percent of federal revenues in the early 1950s to just 8 percent today. Thus, as a highly inefficient tax that

[5]Another example is the proposal by the Institute for Research on the Economics of Taxation, "The Inflow-Outflow Tax—A Savings-Deferred Neutral Tax System," undated, see *www.iret.org*.

collects a shrinking fraction of federal revenue, full corporate tax repeal is a policy option that is becoming more attractive all the time.

Replace the Corporate Income Tax with a Business Cash-Flow Tax

If a corporate-level tax is retained, reforms should focus on reducing the rate and creating a transparent and uniform base to maximize efficiency and minimize tax sheltering. One idea is to retain an income tax, but eliminate some of the inconsistencies. For example, the corporate tax could be "integrated" with the individual tax to reduce the disparities between corporate and noncorporate businesses.

In 1992, the U.S. Treasury issued a major study on corporate tax reform that included various integration proposals. One option was a comprehensive business income tax (CBIT). The CBIT would tax capital income only once—at the business level. Neither dividends nor interest would be deductible by businesses. However, individual taxes on interest, dividends, and capital gains would be repealed. The CBIT would equalize taxes on corporate and noncorporate businesses, equalize taxes on interest and dividends, and remove the bias against dividend payouts.

Nonetheless, the CBIT would retain core problems of income-based taxation, particularly capitalization and a bias against savings and investment. Those remaining distortions could be eliminated by replacing the corporate tax with a cash-flow tax—essentially taking the CBIT and adding capital expensing (rather than depreciation) and cash accounting (rather than accrual accounting).

A cash-flow tax would be imposed on net business cash flow, which is receipts from the sale of goods and services less current and capital expenses. Financial flows such as interest income and interest expense would be disregarded. Accrual accounting under the income tax would be replaced with simpler cash accounting. Businesses would include receipts when cash is received, and deduct materials, inventories, equipment, and structures when purchased.

Various proposals for business cash-flow taxes have differed with regard to whether compensation is deductible. If compensation deductions were disallowed, the tax would be a value-added tax (VAT). Alternately, a cash-flow tax of the Hall-Rabushka flat tax structure allows deductions for wages. Under Hall-Rabushka, individuals would be taxed on wages at a flat 19 percent, with large basic exemptions provided. Individuals would not be taxed on interest, dividends, or capital gains. Businesses would pay a 19 percent tax on receipts from sales of goods and services less wages and purchases of materials,

equipment, buildings, and other expenses.[6] Businesses would disregard interest, dividends, and capital gains under the real, or "R base."

The flat tax business structure would be similar to the CBIT except businesses would expense capital purchases rather than depreciate them. That difference makes the CBIT an "income tax," and the flat tax a "consumption-based tax." Since income = consumption + investment, a tax on income with a deduction for investment is said to be a consumption-based tax. However, the Hall-Rabushka flat tax does not exempt business profits or capital income from taxation. Capital expensing only exempts the normal risk-free rate of return, but fully taxes above-normal returns or economic rents.[7] The normal risk-free rate of return is usually measured by the Treasury bill interest rate. Above-normal returns are made through monopoly profits, unexpected windfalls, and other unique factors. Because it is thought that above-normal returns account for most of business profits, a cash-flow tax with expensing would continue to tax most business profits (Bradford 2000: 91–93).

While a cash-flow tax would continue to tax most business profits, it would do so much more efficiently. That is because marginal investments yielding the normal return would not be taxed. In present value terms, the up-front tax benefit of expensing offsets future tax payments on normal returns. As a result, the tax would not distort marginal investment choices. Investment would not be distorted by inflation, depreciation, or other factors that affect marginal effective tax rates under the income tax.

While a business cash-flow tax would be simpler and more efficient than the corporate income tax, it would create some problems that would need to be ironed out if enacted:

- While a cash-flow tax would close many tax shelters, it may open some new ones. One point of trouble for a cash-flow tax with an R-base is the separation of financial from nonfinancial flows, which would create tax avoidance opportunities. For example, businesses would try to characterize normal sales receipts as interest to exclude them from taxation.

[6]Business expenses that would not be deductible under the Hall-Rabushka plan include interest, dividends, nonpension fringe benefits, employer's share of payroll taxes, and bad debts.

[7]Gentry and Hubbard (1996) define this issue by breaking down capital income into four parts: (1) the opportunity cost of capital or the return to waiting, (2) the return to risk taking, (3) inframarginal returns or economic profit, and (4) realizations differing from expectation or unexpected windfalls. The income tax taxes all four components. A consumption-based tax taxes only the last three components.

- A number of tax avoidance problems under the current tax system would continue to be problems under some cash-flow taxes, such as transfer pricing by multinational corporations. That refers to the shifting of profits from high-tax to low-tax countries using the prices of goods, services, and intangibles traded between corporations and their subsidiaries. Transfer pricing would continue to be a problem under a Hall-Rabushka cash-flow tax, although it would be eliminated under cash-flow taxes that are "border adjustable."[8] However, tax reform is designed to cut marginal tax rates, which would reduce all types of tax avoidance.
- Financial businesses, such as banks and insurance companies, would require special rules under any tax reform plan, just as they do under the income tax. Special rules would be needed under an R-based cash-flow tax because it does not include financial flows in the tax base. One solution would be to simply exclude financial businesses from tax, as is the case under most state retail sales taxes and foreign value-added taxes (Grubert and Mackie 1996). Another option would be to tax financial businesses under an R+F cash-flow tax basis (Merrill and Edwards 1996).
- A challenge will be to transition from the old tax system to the new one (Schwarz, Merrill, and Edwards 1998). A key issue is treatment of the existing basis in assets, which is that portion of the asset's cost not yet recovered by depreciation deductions. Not allowing the remaining deductions on old capital would impose large losses on owners. Thus, creating rules for basis and other transition items would be essential to generating support for reform.

Conclusion

The flawed structure of the corporate income tax is a key driver of inefficient and wasteful business activities. The income tax distorts corporate investment and financial choices, and its complexity and inconsistency stimulate an aggressive pursuit of tax shelters.

Three fundamental flaws of the corporate income tax would be addressed by the adoption of a cash-flow tax with a low rate. First, a low tax rate would reduce wasteful tax-sheltering activities, mitigate

[8]A border-adjustable tax would exempt exports from U.S. taxation and symmetrically deny a deduction for imported inputs.

the economic distortions caused by the income tax, and respond to rising global competition faced by U.S. businesses.

Second, a business cash-flow tax would eliminate key flaws intrinsic to the income tax, particularly capitalization and capital gains taxation. Enron and other companies zeroed in on these weaknesses and exploited them with elaborate tax shelters.

Third, most of the gratuitous inconsistencies in the corporate income tax would be reduced or eliminated under a cash-flow tax. All types of businesses would face equal tax treatment, corporate financing would be neutral between debt and equity, and there would be little ability or incentive for companies to pursue complex transactions to avoid tax.

Today's combination of corporate management problems and rising global competitive pressures make this an excellent time to fundamentally rethink U.S. business taxation. A cash-flow tax holds out hope of dramatically reducing the complexity, distortions, and scandals that mark the current corporate tax system.

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